

11.1 Introduction

A well-organised and efficient banking system is a pre-requisite for economic growth. Banks play an important role in the functioning of organised money markets. Presently, there are four types of banking institutions in India. These are:

- ◆ Commercial banks
- ◆ Regional rural banks
- ◆ Co-operative banks
- ◆ Development banks (more commonly known as 'term-lending institutions')

Besides, the Reserve Bank of India (hereinafter referred to as RBI) acts as the central bank of the country.

Commercial banks are by far the most widespread banking institutions in India. Typically, commercial banks provide the following major products and services:

(a) Acceptance of Deposits; (b) Granting of Advances; (c) Remittances; (d) Collections; (e) Cash Management Product; (f) Issuance of Letters of Credit and Guarantees; (g) Merchant Banking Business; (h) Credit Cards; (i) Technology-based Services; (j) Dividend / Interest / Refund Warrants; (k) Safe-keeping Services; (l) Lockers; (m) Handling Government Business; (n) Depository Participant (DP) Services; (o) Automated Teller Machines (ATMs); (p) Exchange of Notes, (q) Debit Cards, (r) Cross –selling, (s) Auto Sweep facility in saving account, (t) Third party advertisement on ATM network, (u) Securitization of future lease rentals, (v) Derivative business.

Commercial banks operating in India can be divided into two categories based on their ownership – public sector banks and private sector banks. However, irrespective of the pattern of ownership, all commercial banks in India function under the overall supervision and control of the RBI.

Public sector banks comprise the State Bank of India, its seven subsidiaries (also called 'associate banks' of State Bank of India; these are State Bank of Bikaner and Jaipur, State Bank of Hyderabad, State Bank of Indore, State Bank of Mysore, State Bank of Patiala, State Bank of Saurashtra, and State Bank of Travancore) and other nationalised banks.

The ownership of private sector banks is in private hands. They are of three types:

- (a) Indian scheduled commercial banks other than public sector banks. (The term 'scheduled commercial banks' refers to commercial banks which are included in the Second

Schedule to the Reserve Bank of India Act, 1934.) It may be noted that not all scheduled banks are commercial banks; some co-operative banks are also scheduled banks. Commonly known as 'banking companies', these banks are 'companies' registered under the Companies Act, 1956 or an earlier Indian Companies Act.

- (b) Non-scheduled banks.
- (c) Indian branches of banks incorporated outside India, commonly referred to as 'foreign banks'.

Regional Rural Banks have been established "with a view to developing the rural economy by providing, for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas, credit and other facilities, particularly to the small and marginal farmers, agricultural labourers and artisans and small entrepreneurs" (Preamble to the Regional Rural Banks Act, 1976).

Co-operative Banks are banks in the co-operative sector which cater primarily to the credit needs of the farming and allied sectors. Co-operative banks include central co-operative banks, state co-operative banks, primary co-operative banks and land development banks.

Development Banks were started with the objective of providing only long-term finance for development purposes; they are referred to as 'development banks' or 'term-lending institutions'. There are a number of all-India level term-lending institutions.

11.2 Special Features

Banks have the following characteristics which distinguish them from most other commercial enterprises:

- ◆ They have custody of large volumes of monetary items, including cash and negotiable instruments, whose physical security has to be ensured. This applies to both the storage and the transfer of monetary items and makes banks vulnerable to misappropriation and fraud. They, therefore, need to establish formal operating procedures, well-defined limits for individual discretion and rigorous systems of internal control.
- ◆ They engage in a large volume and variety of transactions in terms of both number and value. This necessarily requires complex accounting and internal control systems.
- ◆ They normally operate through a wide network of branches and departments which are geographically dispersed. This necessarily involves a greater decentralisation of authority and dispersal of accounting and control functions, with consequent difficulties in maintaining uniform operating practices and accounting systems, particularly when the branch network transcends national boundaries.
- ◆ They often assume significant commitments without any transfer of funds. These items, commonly called 'off-balance-sheet' items, may not involve accounting entries and, consequently, the failure to record such items may be difficult to detect.
- ◆ They are regulated by governmental authorities and the resultant regulatory requirements often influence accounting and auditing practices in the banking sector.

11.3 Legal Framework

There is an elaborate legal framework governing the functioning of banks in India. The principal enactments which govern the functioning of various types of banks are: Banking Regulation Act, 1949

- ◆ State Bank of India Act, 1955
- ◆ Companies Act, 1956
- ◆ State Bank of India (Subsidiary Banks) Act, 1959
- ◆ Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970
- ◆ Regional Rural Banks Act, 1976
- ◆ Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980
- ◆ Information Technology Act, 2000
- ◆ Prevention of Money Laundering Act, 2002
- ◆ Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
- ◆ Credit Information Companies Regulation Act, 2005
- ◆ Payment and Settlement Systems Act, 2007

Besides, the above enactments, the provisions of the Reserve Bank of India Act, 1934, also affect the functioning of banks. The Act gives wide powers to the RBI to give directions to banks which also have considerable effect on the functioning of banks.

11.4 Form and Content of Financial Statements

Sub-sections (1) and (2) of section 29 of the Banking Regulation Act, 1949, deal with form and content of financial statements of a banking company and their authentication. These sub-sections are also applicable to nationalised banks, State Bank of India, subsidiaries of the State Bank of India, and Regional Rural Banks.

Salient Features of the Third Schedule - Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of balance sheet and Form B contains the form of profit and loss account.

The balance sheet as well as the profit and loss account are required to be presented in vertical form. **Capital and liabilities** are to be presented under the following five broad heads:

- ◆ Capital
- ◆ Reserves and Surplus
- ◆ Deposits
- ◆ Borrowings
- ◆ Other liabilities and provisions

Assets are required to be presented under the following six broad heads:

- ◆ Cash and Balances with Reserve Bank of India
- ◆ Balances with Banks and Money at call and short notice
- ◆ Investments
- ◆ Advances
- ◆ Fixed assets
- ◆ Other assets

Details of items of capital, liabilities and assets are required to be presented in the prescribed form in various schedules.

The aggregate amounts of contingent liabilities and bills for collection are to be presented on the face of the balance sheet. While details of contingent liabilities are to be presented by way of a schedule.

The following items are required to be presented on the face of the profit and loss account.

I. Income

- Interest earned
- Other income

II. Expenditure

- Interest expended
- Operating expenses
- Provisions and contingencies

III. Profit (Loss)

- Net profit (loss) for the year
- Profit/loss brought forward

IV. Appropriations

- Transfer to statutory reserves
- Transfer to other reserves
- Transfer to Government/Proposed Dividend
- Balance carried over to balance sheet

Prescribed details of interest earned, other income, interest expended and operating expenses are required to be given by way of schedules to the profit and loss account.

Other Disclosures - In addition to the disclosures to be made in the balance sheet and profit and loss account in pursuance of the requirements of the Third Schedule to the Act, the RBI has directed to disclose some other information specified by RBI by way of notes on accounts.

Note : For details about the Format and Contents of the Schedules of Balance sheet and Profit

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and Loss account prescribed under The Banking Act, 1949 and other information specified by RBI by way of notes on accounts, Student may refer Chapter 6 Financial Statements of Banking Companies of IPCC Level Paper 5 Advanced Accounting Study Material.

Signatures - Sub-section (2) of section 29 of the Act requires that the financial statements of banking companies incorporated in India should be signed by the manager or principal officer of the banking company and by at least three directors (or all the directors in case the number is less than three). The financial statements of a foreign banking company are to be signed by the manager or agent of the principal office in India. It may be noted that the accounts of a branch are usually signed by the manager of the branch and/or the accountant.

The provision of sub-section (2) of section 29 are also applicable to nationalised banks, State Bank of India, its subsidiaries, and regional rural banks.

Requirements of Banking Regulation Act, 1949, vis a vis Companies Act, 1956 - The requirements of the Companies Act, 1956, relating to the balance sheet and profit and loss account of a company, in so far as they are not inconsistent with the Banking Regulation Act, 1949, also apply to the balance sheet or profit and loss account, as the case may be, of a banking company [sub-section (3) of section 29 of the Act]. It may be noted that this provision does not apply to nationalised banks, State Bank of India, its subsidiaries and regional rural banks. Banks listed on a stock exchange have to comply with the requirements of the Listing Agreement as amended from time to time.

11.5 Audit of Accounts

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

Qualifications of Auditor –Students may refer section 226 of the Companies Act, 1956.

Further, it may be noted that in case of indebtedness in excess of the specified limit as mentioned in above section, the chartered accountant concerned (or the firm of chartered accountants) becomes disqualified to audit any branch of the bank; the disqualification is not confined to appointment as auditor of the particular branch to which the debt is owed.

In the context of banks, the expression indebtedness would cover, *inter alia*, the amounts outstanding in respect of credit cards issued by a bank. Thus, where the credit card outstandings exceed the prescribed limit of ₹ 1,000, the chartered accountant in whose name the card is issued as well as the firm of which he is a partner would be disqualified for appointment as auditor of the issuing bank.

Appointment of Auditor - As per the provisions of the relevant enactments, the auditor of a banking company is to be appointed at the annual general meeting of the shareholders, whereas the auditor of a nationalised bank is to be appointed by the bank concerned acting through its Board of Directors. In either case, approval of the Reserve Bank is required before the appointment is made. The auditors of the State Bank of India are to be appointed by the Comptroller and Auditor General of India in consultation with the Central Government. The auditors of the subsidiaries of the State Bank of India are to be appointed by the State Bank of

India. The auditors of regional rural banks are to be appointed by the bank concerned with the approval of the Central Government.

As mentioned earlier, the State Bank of India Act, 1955, specifically provides for appointment of two or more auditors. Besides, nationalised banks and subsidiaries of State Bank of India also generally appoint two or more firms as joint auditors.

Remuneration of Auditor - The remuneration of auditor of a banking company is to be fixed in accordance with the provisions of section 224 of the Companies Act, 1956 (i.e., by the company in general meeting or in such manner as the company in general meeting may determine). The remuneration of auditors of nationalised banks and State Bank of India is to be fixed by the Reserve Bank of India in consultation with the Central Government. The remuneration of auditors of subsidiaries of State Bank of India is to be fixed by the latter. In the case of regional rural banks, the auditors' remuneration is to be determined by the bank concerned with the approval of the Central Government.

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

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

- (a) whether, in his opinion, the balance sheet is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the bank, and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory;
- (b) whether or not the transactions of the bank, which have come to his notice, have been within the powers of that bank;
- (c) whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit;
- (d) whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and
- (e) any other matter which he considers should be brought to the notice of the Central Government.

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

The auditor's report in the case of subsidiaries of State Bank of India is identical to the auditor's report in the case of a nationalised bank, except that all references to Central Government have to be construed instead as references to the State Bank of India. Similar is the position in the case of regional rural banks, except that the references are instead to the bank concerned.

Format of Audit Report: *The auditors, central as well as branch, should also ensure that the audit report issued by them complies with the requirements of Revised SA 700*, "Forming an Opinion and Reporting on Financial Statements", SA 705, "Modifications to the Opinion in the Independent Auditor's Report" and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report". 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. Such disclosure in the audit report is not only in accordance with the best international trends but also provides useful information to users of financial statements, for example, though the absolute number of unaudited branches might be quite large but in relation to overall operations of the bank such unaudited branches are quite miniscule and thus, not material. Therefore, the auditor should ensure that the complete information in respect of unaudited branches is collected and disclosed in the audit report.*

In addition to matters on which he is required to report to the shareholders under the Companies Act, 1956, the auditor of a banking company is required to state in his report:

- (a) Whether or not the information and explanations required by him have been found to be satisfactory;
- (b) whether or not the transactions of the company which have come to his notice have been within the powers of the company;
- (c) whether or not the returns received from the branch offices of the company have been found adequate for the purpose of his audit;
- (d) whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and
- (e) any other matter which he considers should be brought to the notice of the shareholders of the company.

It may be noted that in the case of a banking company, by virtue of the provisions of clause (d) of sub-section (3) of section 227 of the Companies Act, 1956, the auditor has to specifically report whether, in his opinion, the profit and loss account and balance sheet of the banking company comply with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956.

Long Form Audit Report - Besides the audit report as per the statutory requirements discussed above, the terms of appointment of auditors of public sector banks, private sector banks and foreign banks [as well as their branches, require the auditors to also furnish a long form audit report (LFAR)]. The matters which the banks require their auditors to deal with in the long form audit report have been specified by the Reserve Bank of India.

11.5.1 Books and Accounts - A banking company is required to maintain the books of account in accordance with Section 209 of the Companies Act. There are, however, certain imperatives in banking business they are the requirements to maintain accurate and always

* Effective for all audits relating to accounting periods beginning on or after April 1, 2012.

up-to-date accounts. Banks, therefore, device their accounting systems to suit these requirements. The main characteristics of a bank's system of book keeping are as follows:

- (a) Entries in the personal ledgers are made directly from vouchers instead of being posted from the books of prime entry.
- (b) The vouchers entered into different personal ledgers each day are summarised on summary sheet, the totals of which are posted to the control accounts in the general ledger.
- (c) The general ledger trial balance is extracted and agreed every day.
- (d) All entries in the detailed personal ledgers and the summary sheets are checked by persons other than those who have made the entries, with the general result that most clerical mistakes are detected before another day begins.
- (e) A trial balance of the detailed personal ledgers is prepared periodically, usually every two weeks, and agreed with the general ledger control accounts.
- (f) Excepting for cash transactions, always two vouchers are prepared for each transaction, one for debit and the other for credit. This system ensures double entry at the basic level and obviates the possibility of errors in posting.

Principal books of account

- (i) General Ledger - (ii) Profit and Loss Ledger -

Subsidiary Books of Accounts

(i) Personal Ledgers (ii) Bill Registers (iii) Other Subsidiary registers (iv) Departmental Journals (v) Other Memoranda Books besides the books mentioned above, various departments of a bank have to maintain a number of memoranda books to facilitate their work.

Statistical Books

Note : For details about abovementioned books and accounts student may refer Chapter 6 Financial Statements of Banking Companies of IPCC Paper 5: Advanced Accounting.

11.5.2 Conducting an Audit -The audit of banks or of their branches involves the following stages -

- 1. Initial consideration by the Statutory auditor
- 2. Identifying and Assessing the Risks of Material Misstatements
- 3. Understanding the Bank and Its Environment including Internal Control
- 4. Understand the Bank's Accounting Process
- 5. Understanding the Risk Management Process
- 6. Engagement Team Discussions
- 7. Establish the Overall Audit Strategy
- 8. Develop the Audit Plan
- 9. Audit Planning Memorandum

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10. Determine Audit Materiality
11. Consider Going Concern
12. Assess the Risk of Fraud including Money Laundering
13. Assess Specific Risks
14. Risk Associated with Outsourcing of Activities
15. Response to the Assessed Risks
16. Stress Testing
17. BASEL II framework .

1. Initial consideration by the statutory auditor

(i) Declaration of Indebtedness : The RBI has advised that the banks, before appointing their statutory central/circle/ branch auditors, should obtain a declaration of indebtedness

(ii) Internal Assignments in Banks by Statutory Auditors : The RBI, vide its circular no. Ref. DBS. ARS. No. BC. 02/ 08.91.001/ 2008-09 dated December 31, 2008 on "Internal assignments in banks by statutory auditors", decides that the audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the bank during the same year. In case the firms are associated with internal assignment it should be ensured that they relinquish the internal assignment before accepting the statutory audit assignment during the year.

(iii) Planning: Standard on Auditing (SA) 300 (Revised), "Planning an Audit of Financial Statements" requires that the auditor shall undertake the following activities prior to starting an initial audit:

- (a) Performing procedures required by SA 220, "Quality Control for Audit Work" regarding the acceptance of the client relationship and the specific audit engagement; and
- (b) Communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements

(iv) 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.

(v) Terms of Audit Engagements: Standard on Auditing (SA) 210, "Terms of Audit Engagements" requires that for each period to be audited, the auditor should agree on the terms of the audit engagement with the bank before beginning significant portions of fieldwork. It is imperative that the terms of the engagement are documented, in order to prevent any confusion as to the terms that have been agreed in relation to the audit and the respective responsibilities of the management and the auditor, at the beginning of an audit relationship.

(vi) Initial Engagements: Standard on Auditing (SA) 510, "Initial Engagements-Opening Balances", paragraph 3 states that when the financial statements are audited for the first time or when the financial statements for the preceding period were audited by another auditor, the auditor should obtain sufficient appropriate audit evidence that:

- ◆ the closing balances of the preceding period have been correctly brought forward to the current period;
- ◆ the opening balances do not contain misstatements that materially affect the financial statements for the current period; and
- ◆ appropriate accounting policies are consistently applied.

(vii) Assessment of Engagement Risk: The assessment of engagement risk is a critical part of the audit process and should be done prior to the acceptance of an audit engagement since it affects the decision of accepting the engagement and also in planning decisions if the audit is accepted.

(viii) Establish the Engagement Team: The selection of the engagement team is a key activity in the development and execution of an effective and efficient audit plan. The assignment of qualified and experienced professionals is an important component of managing engagement risk. The size and composition of the engagement team would depend on the size, nature, and complexity of the bank's operations.

(ix) Understanding the Bank and its Environment: Standard on Auditing (SA) 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" (applicable for audits of financial statements beginning on or after April 1, 2008) lays down that the auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.

2. Identifying and Assessing the Risks of Material Misstatements: Standard on Auditing (SA) 315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and Its Environment" requires the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures.

3. Understanding the Bank and Its Environment including Internal Control: An understanding of the bank and its environment, including its internal control, enables the auditor:

- ◆ to identify and assess risk;
- ◆ to develop an audit plan so as to determine the operating effectiveness of the controls, and to address the specific risks. Further, documentation of the auditor's understanding of the bank and its environment provides an effective mechanism for accumulating and sharing knowledge and experience and briefing the same to all the members of the engagement team, particularly in case of multi-location audit engagements.

4. Understand the Bank's Accounting Process : [@] The accounting process produces financial and operational information for management's use and it also contributes to the

[@] Revised in 2009 edition.

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bank's internal control. Thus, understanding of the accounting process is necessary to identify and assess the risks of material misstatement whether due to fraud or not, and to design and perform further audit procedures.

5. **Understanding the Risk Management Process:** Management develops controls and uses performance indicators to aid in managing key business and financial risks. An effective risk management system in a bank generally requires the following:

- ◆ *Oversight and involvement in the control process by those charged with governance:* 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, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable. *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. *Control activities:* A bank should have appropriate controls to manage its risks, including effective segregation of duties (particularly, between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliation of positions and results, setting of limits, reporting and approval of exceptions, physical security and contingency planning.
- ◆ *Monitoring activities:* Risk management models, methodologies and assumptions used to measure and manage risk should be regularly assessed and updated. This function may be conducted by the independent risk management unit. Internal auditing should test the risk management process periodically to check whether management policies and procedures are complied with and whether the operational controls are effective. Both the risk management unit and internal auditing should have a reporting line to those charged with governance (i.e., the BOD or the Executive Committee) and management that is independent of those on whom they are reporting.

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

6. **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.

7. **Establish the Overall Audit Strategy:** Standard on Auditing (SA) 300, "Planning an Audit of financial Statements" states that the objective of the auditor is to plan the audit so that it will be performed in an effective manner. For this purpose, the audit engagement partner should:

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

8. Develop the Audit Plan: Standard on Auditing (SA) 300, "Planning an Audit of Financial Statements" 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. Before starting the planning of an audit, the auditor must perform the procedures as defined under SA 220, "Quality Control for Audit Work" for reviewing the ethical and independence requirements. In addition to this, the auditor is also required to comply with the requirements of SA 210, "Terms of Audit Engagement".

9. Audit Planning Memorandum: The auditor should summarise their audit plan by preparing an audit planning memorandum in order to:

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

10. 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 and depends upon the knowledge of the bank, assessment of engagement risk, and the reporting requirements for the financial statements.

11. 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. The auditor needs to consider events and conditions relating to the going concern assumption when performing risk assessment procedures so as to make timely discussions with the management, review the management's plans, and resolution of any identified going concern issues. Audit procedures, which may indicate that there could be a question about a bank's ability to continue as a going concern for the foreseeable future including the following:

- ◆ Reading of minutes of meetings of shareholders, board of directors, and other important meetings;
- ◆ Analytical Procedures;
- ◆ Review of compliance with the terms of debt and loan agreements;
- ◆ Confirmation with related and third parties of the details of arrangements to provide or maintain financial support;
- ◆ Inquiry of the bank's legal counsel about litigation, claims, and assessments; and
- ◆ Review of subsequent events.

There are certain specific events or conditions, which could specifically cast a significant doubt on the ability of the bank to continue as a going concern:

- ◆ Rapid increase in the volume of derivative business without necessary controls being in place.

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- ◆ Decline in the projected profitability, if the bank is at or near its minimum level of regulatory capital.
- ◆ Higher interest rates being paid on deposits and borrowing than the market rates.
- ◆ Actions taken or threatened by regulators that may have an adverse effect on the ability of the bank to continue as a going concern.
- ◆ High concentration of exposure to certain borrowers or industries.

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

	<i>Deposit Taking</i>	<i>Dealing</i>	<i>Lending</i>
<i>Management and employee frauds</i>	<ul style="list-style-type: none"> • <i>Camouflage of depositors by hiding their identity in connection with funds transfer or money laundering.</i> • <i>Unrecorded deposits.</i> • <i>Theft of customer deposits particularly, from dormant accounts.</i> 	<ul style="list-style-type: none"> • <i>Off market / related party deals whereby no checks are carried out on the prices at which deals are transacted or there are unusual activity levels with certain counterparties.</i> • <i>High level of business with particular brokers, including payment of abnormal commission.</i> • <i>False deals represented by unusual number of cancelled deals or unusually high number of unsettled transactions.</i> • <i>Delayed deal allocations represented by no time stamping of deals or alterations or overwriting on deals sheets.</i> • <i>Exploiting</i> 	<ul style="list-style-type: none"> • <i>Loans to fictitious borrowers.</i> • <i>Transactions with connected companies.</i> • <i>Kick backs and inducements.</i> • <i>Selling recovered collateral at below market prices.</i> • <i>Bribes to obtain release of security or to reduce the amount claimed.</i> • <i>Theft or misuse of collateral held as security.</i>

	<i>Deposit Taking</i>	<i>Dealing</i>	<i>Lending</i>
		<i>weaknesses in matching procedures due to absence of proper guidelines.</i>	
<i>External Frauds</i>	<ul style="list-style-type: none"> • <i>Money Laundering.</i> • <i>Fraudulent instructions.</i> • <i>Counterfeit currency.</i> 	<ul style="list-style-type: none"> • <i>Fraudulent custodial sales.</i> • <i>False information or documents regarding counterparties.</i> 	<ul style="list-style-type: none"> • <i>Impersonation and false information on loan applications.</i> • <i>Fraudulent valuations.</i> • <i>Misappropriation of loan funds by agents / customers</i>

Due to the nature of their business, banks are ready for targeting those who are engaged in the money laundering activities by which the proceeds of illegal acts are converted into proceeds from the legal acts. The RBI has framed specific guidelines that deal with prevention of money laundering and “Know Your Customer (KYC)” norms. The RBI has from time to time issued guidelines (“Know Your Customer Guidelines – Anti Money Laundering Standards”), requiring banks to establish policies, procedures and controls to deter and to recognise and report money laundering activities.

13. Assess Specific Risks: The auditors should identify and assess the risks of material misstatement at the financial statement level which refers to risks that relate pervasively to the financial statements as a whole, and potentially affect many assertions. Risk of material misstatement at the assertion level for specific class of transactions, account balances and disclosures need to be considered because such consideration directly assists in determining the nature, timing and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence.

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

15. Response to the Assessed Risks: SA 330, “The Auditor’s Responses to Assessed Risks” deals with the auditor’s responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with SA 315. Further, it requires the auditor to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. The auditor should design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.

The auditor shall design and perform tests of controls and substantive procedures to obtain sufficient appropriate audit evidence, as to the operating effectiveness of relevant controls, and to detect material misstatements at the assertion level.

16. Stress Testing: RBI, vide its circular no. DBOD. No. BP. BC.101 / 21.04.103/ 2006-07 dated June 26, 2007 has required that all commercial banks (excluding RRBs and LABs) shall put in place a Board approved 'Stress Testing framework' to suit their individual requirements which would integrate into their risk management systems. The circular further requires that the framework should satisfy certain essential requirements as listed therein.

17. BASEL II framework

Structure of Basel II : Basel II consists of 3 'pillars' which enshrine the key principles of the new regime. Collectively, they go well beyond the mechanistic calculation of minimum capital levels set by Basel I, allowing lenders to use their own models to calculate regulatory capital while seeking to ensure that lenders establish a culture with risk management at the heart of the organisation up to the highest managerial level.

Pillar 1 sets out the mechanism for calculating minimum regulatory capital. Under Basel I this calculation related only to credit risk, with a calculation for market risk added in 1996. Basel II adds a further charge to allow for operational risk.

Credit risk : While Basel I offered a single approach to calculating regulatory capital for credit risk, one of the greatest innovations of Basel II is that it offers lenders a choice between:

- 1. The standardised approach.** This follows Basel I by grouping exposures into a series of risk categories. However, while previously each risk category carried a fixed risk weighting, under Basel II three of the categories (loans to sovereigns, corporates and banks) have risk weights determined by the external credit ratings assigned to the borrower. Amongst the other categories that continue to have fixed risk weights applied by Basel II, loans secured on residential property will carry a risk weight of 35% against 50% previously, as long as the loan-to-value (LTV) is up to 80%. This lower weighting is a recognition of the historically low rate of losses typically incurred on residential mortgage loan portfolios across different countries and over a range of economic environments.

- 2. Foundation internal ratings based (IRB) approach.** Lenders will be able to develop their own models to determine their regulatory capital requirement using the IRB approach. Under the foundation IRB approach, lenders will estimate a probability of default (PD) while the supervisor provides set values for loss given default (LGD), exposure at default (EAD) and maturity of exposure (M). These values are plugged into the lender's appropriate risk weight function to provide a risk weighting for each exposure or type of exposure.

- 3. Advanced IRB approach.** Lenders with the most advanced risk management and risk modelling skills will be able to move to the advanced IRB approach, under which the lender will estimate PD, LGD, EAD and M. In the case of retail portfolios only estimates of PD, LGD and EAD are required and the approach is known as retail IRB.

Given that a key objective of Basel II is to improve risk management culture, it is unsurprising that the regime encourages lenders to move towards the IRB approach and ultimately, the advanced or retail IRB approach. To this end, it is expected that banks will see a modest release of regulatory capital in moving from the standardised to foundation IRB approach and on to the advanced or retail IRB approach.

Operational risk: The Accord defines operational risk as 'the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events'. In keeping with the approach to credit risk, it provides three mechanisms for computing operational risk of rising complexity to suit lenders' varying characteristics.

Pillar 2 is meant to identify risk factors not captured in Pillar 1, giving regulators discretion to adjust the regulatory capital requirement against that calculated under Pillar 1. For most lenders, the Pillar 2 process is expected to result in a higher regulatory capital requirement than calculated under Pillar 1. Pillar 2 requires banks to think about the whole spectrum of risks they might face including those not captured at all in Pillar 1 such as interest rate risk.

Pillar 3 is designed to increase the transparency of lenders' risk profile by requiring them to give details of their risk management and risk distributions. Information is likely to be released through the normal mandatory financial statements lenders are required to publish or through lenders' websites.

Timetable: All lenders covered by the CRD will be required to have fully implemented Basel II from the beginning of 2008.

Implications of Basel II: There has been a considerable amount of debate concerning the potential impact of Basel II. Perhaps the most obvious effect will be to alter the percentage return on regulatory capital by altering the denominator (the amount of regulatory capital required). For residential mortgages, the release of regulatory capital under both the standardised and retail IRB approaches should be considerable. Many commentators see this as the basis for significant changes in industry pricing, which they believe could alter the competitive landscape and drive consolidation.

Preparation and submission of audit report - The branch auditor forwards his report to the statutory auditors who have to deal with the same in such manner as they consider necessary. It is desirable that the branch auditors' reports are adequately detailed in unambiguous terms. As far as possible, the financial impact of all qualifications or adverse comments on the branch accounts should be clearly brought out in the branch audit report. It would assist the statutory auditors if a standard pattern of reporting, say, head-wise, commencing with assets, then liabilities and thereafter items related to income and expenditure, is followed. Similarly, for statutory auditors of a bank, the form and content of the audit report should be determined by the auditor taking into account his terms of engagement and applicably statutory, regulatory and professional requirements.

In all cases, matters covering the statutory responsibilities of the auditors should be dealt with in the main report. The LFAR should be used to further elaborate matters contained in the main report and not as a substitute thereof. Similarly, while framing his main report, the auditor should consider, wherever practicable, the significance of various comments in his LFAR, where any of the comments made by the auditor therein is adverse, he should consider whether a qualification in his main report is necessary by using his discretion on the facts and circumstances qualification in his main report is necessary by using his discretion on the facts and circumstances of each case. It may be emphasized that the main report should be self-contained document.

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11.5.3 *Special Considerations in a CIS Environment* - As in today's environment all banks have embarked upon a large scale computerization, this has resulted in changes in the processing and storage of information and affects the organisation and procedures employed by the entity to achieve adequate internal control. Thus, while the overall objective and scope of audit do not change simply because data is maintained on computers, the procedures followed by the auditor in his study and evaluation of the accounting system and related internal controls and the nature, timing and extent of his other audit procedures are affected in a CIS environment.

11.5.4 *Internal Audit and Inspection* - Banks generally have a well organised system of internal audit. Their internal auditors pay frequent visit to the branches. They are an important link in the internal control of the bank. The systems of internal audit in different banks also have a system of regular inspection of branches and head office. The internal audit and inspection function is carried out by a separate department within the bank by firms of chartered accountants.

The statutory auditors should evaluate internal audit, concurrent audit and inspection functions to the extent they consider that these will be relevant in designing their audit procedures. They should also review the internal/concurrent/inspection/audit programmes. Such a review helps the statutory auditors in determining the nature, timing and extent of their audit tests. They can assist the bank management in improving the effectiveness of internal audit/concurrent audit/inspection functions.

11.6 Internal Control in Certain Selected Areas

11.6.1 General

- (a) The staff and officers of a bank should be shifted from one position to another frequently and without prior notice.
- (b) The work of one person should always be checked by another person (usually by an officer) in the normal course of business.
- (c) The arithmetical accuracy of the books should be proved independently every day.
- (d) All bank forms (e.g. Cheque books, demand draft books, travellers' cheques etc.) should be kept in the possession of an officer, and another responsible officer should occasionally verify the stock of such stationery.
- (e) The mail should be opened by a responsible officer. Signatures on all the letters and advices received from other branches of the bank or its correspondence should be checked by an officer with the signature book.
- (f) The signature book and the telegraphic code book should be kept with responsible officers and used and seen by authorised officers only.
- (g) The bank should take out insurance policies against loss and employees' infidelity.
- (h) The powers of officers of different grades should be clearly defined.

- (i) There should be surprise inspection of head office and branches at periodic interval by the internal audit department. The irregularities pointed out in the inspection reports should be promptly rectified.

11.6.2 Cash

- (a) Cash should be kept in the joint custody of two responsible officers.
- (b) In addition to normal checking by the chief cashier, cash should be test-checked daily and counted in full occasionally by a responsible officer unconnected with the cash department. Actual cash in hand should agree with the balance shown by the Day Book every day.
- (c) The cashier should have no access to the customer's ledger accounts and the Day Book. This is an important safeguard. Bank managements are often tempted to use cashiers because of their shorter working hours as ledger clerks in the absence of regular staff on leave, etc. This can be a very expensive price of economy.
- (d) The counterfoil cash receipt vouchers (e.g. counterfeits of pay-in-slips lodged by the depositors) should be signed by an officer in Cash Department, in addition to the receiving cashier.
- (e) Payments should be made only after the vouchers (e.g. cheques, demand drafts etc.) have been passed for payment by the proper officer and have been entered in the customer's account.
- (f) Receipt and payment scrolls or their totals should be compared with the cash column of the Day-Book by independent persons.
- (g) Where the teller system is prevalent.
 - (i) A limit should be placed on the powers of tellers to make payment.
 - (ii) All vouchers relating to the accounts of customers which the tellers handle should first be sent to them and entered by them in the ledger cards.
 - (iii) Total payment made by a teller should be reconciled with the cash columns of the Voucher Summary Sheet of the ledger concerned every day.
 - (iv) There should be frequent rotation of tellers.

11.6.3 Clearings

- (a) Cheques received by the bank in clearing should be checked with the list accompanying them. Independent list should be prepared for cheques debited to different customers accounts and those returned unpaid and these should be checked by officers. The total number and amount of cheques included in these lists should be agreed with the list first mentioned by a person unconnected with both the customers, ledgers and the clearing department.
- (b) The total number and amount of cheques sent out by the bank for clearing should be agreed with the total of the clearing pay- in-slips, by an independent person.
- (c) The unpaid cheques received back in return clearing should be checked in the same manner as the cheques received.

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11.6.4 Constituents' Ledgers

- (a) Before making payment, cheques should be properly checked in respect of signature, date, balance in hand etc. and should be passed by an officer and entered into constituents' accounts.
- (b) No withdrawals should normally be allowed against clearing cheques deposited on the same day.
- (c) An officer should check all the entries made in the ledger with the original documents particularly noting that the correct accounts have been debited or credited.
- (d) Ledger keepers should not have access to Voucher Summary Sheet after they have been checked by an officer and to the Day Book.
- (e) Interest debited or credited to constituents' accounts should be independently checked.

11.6.5 Bills for Collection

- (a) All the documents accompanying the bills should be received and entered in the Register by a responsible officer. At the time of despatch, the officer should also see that all the documents are sent along with the bills.
- (b) 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 branch or agent to which they were sent for collection.
- (c) 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.

11.6.6 Bills Purchased

- (a) At the time of purchase of the bills, an officer should verify that all the documents of title are properly assigned to the bank.
- (b) Sufficient margin should be kept while purchasing or discounting a bill so as to cover any decline in the value of the security etc.
- (c) If the bank is unable to collect a bill on the due date, immediate steps should be taken to recover the amount from the drawer against the security provided.
- (d) All irregular outstanding accounts should be reported to the Head Office.
- (e) 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.

11.6.7 Loans and Advances

- (a) The 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.

- (b) All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- (c) Sufficient margin should be kept against securities taken so as to cover any decline in the value thereof and also to comply with Reserve Bank directives. Such margins should be determined by the proper authorities of the bank as a general policy or for particular accounts.
- (d) All the securities should be received and returned by responsible officer. They should be kept in the Joint custody of two such officers.
- (e) All securities requiring registration should be registered in the name of the bank or otherwise accompanied by the documents sufficient to give title of the bank.
- (f) In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipts. The godowns should be regularly and frequently inspected by a responsible officer of the branch concerned, in addition by the inspectors of the bank.
- (g) Surprise checks should be made in respect of hypothecated goods not in the possession of the bank.
- (h) Market value of goods should be checked by officers of the bank by personal enquiry in addition to the invoice value given by the borrowers.
- (i) As soon as any increase or decrease takes place in the value of securities proper entries should be made in the Drawing Power Book and Daily Balance Book. These entries should be checked by an officer.
- (j) All accounts should be kept within both the drawing power and the sanctioned limit at all times.
- (k) 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/Head Office regularly.
- (l) The operation (in each advance should be reviewed at least once every year.)

11.6.8 Telegraphic Transfers and Demand Drafts

- (a) The bank should have a reliable private code known only to responsible officers of its branches, coding and decoding of telegrams should be done only by such officers.
- (b) The signatures on a demand draft should be checked by an officer with the Signature Book.
- (c) All the T.Ts and D.Ds. sold by a branch should be immediately confirmed by the advices to the branches concerned.
- (d) If the paying branch does not receive proper confirmation of any T.T. or 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.

11.6.9 Inter Branch Accounts

- (a) The accounts should be adjusted only on the basis of advices (and not on the strength of entries found in the statement of account) received from other branches,
- (b) Prompt action should be taken preferably by central authority, if any entries (particularly debit entries) are not responded to by any branch within a reasonable time.

11.6.10 Credit Card Operations

- (a) There should be effective screening of applications with reasonably good credit assessments.
- (b) There should be strict control over storage and issue of cards.
- (c) 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.
- (d) There should be a system of prompt reporting by the merchants of all settlements accepted by them through credit cards.
- (e) Reimbursement to merchants should be made only after verification of the validity of merchant's acceptance of cards.
- (f) All the reimbursement (gross of commission) should be immediately charged to the customer's account.
- (g) There should be a system to ensure that statements are sent regularly and promptly to the customer.
- (h) There should be a system to monitor and follow-up customers' payments.
- (i) Items overdue beyond a reasonable period should be identified and attended to carefully. Credit should be stopped by informing the merchants through periodic bulletins, as early as possible, to avoid increased losses.
- (j) There should be a system of periodic review of credit card holders' accounts. On this basis, the limits of customers may be revised, if necessary, The review should also include determination of doubtful amounts and the provisioning in respect thereof.

Insurance cover to cardholders (RBI vide its Master Circular DBOD.No.FSD.BC.14/24.01.011/2011-12 dated July 1st, 2011):

In cases where the banks are offering any insurance cover to their credit card holders, in tie-up with insurance companies, the banks may consider obtaining in writing from the credit card holders the details of nominee/s for the insurance cover in respect of accidental death and disablement benefits. Banks may ensure that the relevant nomination details are recorded by the Insurance Company. Banks may also consider issuing a letter to the credit card holder indicating the details regarding the name, address and telephone number of the Insurance Company which will handle the claims relating to the insurance cover.

11.7 Verification of Assets and Balances

The following are the steps involved in verification of assets and balances.

I. Cash, Bank Balances and Money at Call and Short Notice - The Third Schedule to the Banking Regulation Act, 1949, requires the following disclosures to be made in the balance sheet regarding cash, balances with RBI, balances with other banks, and money at call and short notice.

Cash and Balances with Reserve Bank of India

- I. Cash in hand (including foreign currency notes)
- II. Balances with Reserve Bank of India
 - (i) in Current Account
 - (ii) in Other Accounts

Balances with Banks and Money at Call and Short Notice

I. In India

- (i) Balances with other banks
 - (a) in Current Accounts
 - (b) in Other Deposit Accounts
- (ii) Money at call and short notice
 - (a) with banks
 - (b) with other institutions

II. Outside India

- (i) in Current Accounts
- (ii) in Other Deposit Accounts
- (iii) Money at call and short notice

1. Cash Reserve - One of the important determinants of cash balances to be maintained by banking companies and other scheduled banks is the requirement for maintenance of a certain minimum cash reserve. While the requirement for maintenance of cash reserve by banking companies is contained in the Banking Regulation Act, 1949, corresponding requirement for scheduled banks is contained in the Reserve Bank of India Act, 1934.

2. Statutory Liquidity Ratio - Section 24 of the Banking Regulation Act, 1949 requires that every banking company shall maintain in India in cash, gold or unencumbered approved securities an amount of which shall not, at the close of business on any day, be less than such percentage not exceeding forty, as the RBI may from time to time specify, of the total of its demand and time liabilities in India as on the last Friday of the second preceding fortnight. This is referred to as 'statutory liquidity ratio'. In this regard, RBI has also issued circular on

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“Maintenance of Statutory Liquidity Ratio (SLR)” (Ref. DBOD No. Ret. BC.62/12.02.001/2007-08) dated February 13, 2008

The RBI's Master Circular no. DBOD. No.Ret. BC.13/12.01.001/2011-12 Dated July 1st, 2011 on Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) also contains procedure of computation of demand and time liabilities for SLR. The said Master Circular also requires the statutory auditors to verify and certify that all items of outside liabilities, as per the bank's books had been duly compiled by the bank and correctly reflected under DTL/NDTL in the fortnightly/monthly statutory returns submitted to RBI for the financial year.

3. Balances with Reserve Bank of India, Balances with Other Banks: Banks maintain accounts with RBI and other Banks. Generally only select branches maintain account with RBI. The branches also maintain accounts with other banks.

4. Money at Call and Short Notice: Money at call and short notice represents short-term investment of surplus funds in the money market. Money lent for one day is money at 'call' while money lent for a period of more than one day and up to fourteen days is money at 'short notice'.

Audit Procedures

(a) Cash - The auditor should count the balance of cash on hand. As far as possible, the auditor should visit the branch at the close of business on the last working day of the year or before the commencement of business on the next day for carrying out the physical verification of cash. If, for any reason, the auditor is unable to do so, he should carry out the physical verification of cash as close to the balance sheet date as possible. It is sometimes arranged by the branch to deposit a large portion of its cash balance with the Reserve Bank of India or the State Bank of India or any other bank on the closing day, in which case, the work of the auditor is reduced substantially.

The cash balance as physically verified should be agreed with the balance shown in the cash book and the cash balance book. When the physical verification of cash is carried out by the auditor before or after the date of the balance sheet, the auditor should work forward/backward (as the case may be) to reconcile the results of his verification with the cash balance at the balance sheet date as shown by the books.

(b) Balance with Reserve Bank of India - In a bank, only a few select branches are designated to have account with the Reserve Bank. Thus, this item would not appear in the balance sheet of every branch. The following procedures are therefore applicable only to branches having account with the Reserve Bank of India.

Verify the ledger balances in each account with reference to the bank confirmation certificates and reconciliation statements as at the year-end.

Review the reconciliation statements. He should pay special attention to the following items appearing in the reconciliation statements:

- (i) Cash transactions remaining unresponded;
- (ii) Revenue items requiring adjustments/write-offs; and

(iii) Old outstanding balances remaining unexplained / unadjusted for over one year.

Obtain a written explanation from the management as to the reasons for old outstanding transactions in bank reconciliation statements remaining unexplained / unadjusted for over one year.

(c) Balance with Banks (Other than Reserve Bank of India) - Apart from the procedures described above in examining the balances with banks other than Reserve Bank, while reviewing the reconciliation statements, the auditor should pay particular attention to the following.

- (i) Examine that no debit for charges or credit for interest is outstanding and all the items which ought to have been taken to revenue for the year have been so taken.
- (ii) Examine that no cheque sent or received in clearing is outstanding.
- (iii) Examine that all bills or outstanding cheques sent for collection and outstanding as on the closing date have been credited subsequently.

The balances with banks outside India should also be verified in the manner described above. These balances should be converted into the Indian currency at the exchange rates prevailing on the balance sheet date.

(d) Money at Call and Short Notice - The auditor should examine whether there is a proper authorisation, general or specific, for lending of the money at call or short notice. Compliance with the instructions or guidelines laid down in this behalf by the head office or controlling office of the branch, including the limits on lendings in inter-bank call money market, should also be examined.

Call loans should be verified with the certificates of the borrowers and the call loan receipts held by the bank. The auditor should examine whether the aggregate balances comprising this item as shown in the relevant register tally with the control accounts as per the general ledger. He should also 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.

II. Investments The Third Schedule to the Banking Regulation Act, 1949, requires the disclosure of investments in the balance sheet as follows:

I. *Investments in India in*

- (i) Government securities
- (ii) Other approved securities
- (iii) Shares
- (iv) Debentures and Bonds
- (v) Subsidiaries and/or joint ventures
- (vi) Others (to be specified)

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II. *Investments outside India in*

- (i) Government securities (including local authorities)
- (ii) Subsidiaries and/or joint ventures abroad
- (iii) Other investments (to be specified)

In addition to other disclosures regarding investments, the Notes and Instructions for Compilation of Balance Sheet, also require the following information to be disclosed in the balance sheet:

- (1) gross value of investments in India and outside India;
- (2) aggregate of provisions for depreciation, separately on investments in India and outside India; and
- (3) net value of investments in India and outside India.

The gross value of investments and provisions need not, however, be shown against each of the categories specified in the Schedule. The break-up of net value of investments in India and outside India (gross value of investments less provision) under each of the specified category need only be shown.

The following are some of the terms which are commonly used in relation to investments of banks:

(a) Approved Securities: Section 5(a) of the Banking Regulation Act, 1949 defines 'approved securities' to mean securities in which a trustee may invest money under clauses (a) to (d) and (f) of section 20 of the Indian Trusts Act, 1882. Approved securities comprise primarily the securities issued or guaranteed by the Central or State Government, or any other security expressly authorised by the Central Government by notification in the official gazette.

(b) Bank Receipt (BR): Bank receipt is acknowledgement from the selling bank to the buying bank that the former has received payment for certain securities, which it will deliver within a certain time. BR is non-transferable and can be issued by banks and certain specified institutions only.

(c) Collateralised Borrowing and Lending Obligation: CBLO is a discounted instrument available in electronic book entry form for the maturity period ranging from one day to ninety days (can be made available up to one year as per RBI guidelines). The CBLO transactions can be undertaken on NDS only. CBLO is –

- ◆ an obligation by the borrower to return the money borrowed, at a specified future date;
- ◆ an authority to the lender to receive money lent, at a specified future date with an option/privilege to transfer the authority to another person for value received; and
- ◆ an underlying charge on securities held in custody (with CCIL) for the amount borrowed/lent.

(d) Government Security: A government security is an instrument issued by the Central or a State Government, which is redeemable after a fixed period and may either be coupon bearing or issued at discount to face value.

(e) **Liquidity Adjustment Facility (LAF):** A monetary tool used by the RBI for injecting liquidity or absorption of the liquidity from the banking system. The LAF is operationalised through Repo and Reverse Repo.

(f) **Negotiated Dealing System (NDS):** It is an electronic platform for facilitating dealing in Government Securities and Money Market Instruments. It is closed user group network open only for its members. The members of this network could be only those participants who are maintaining either a current account or SGL account with the RBI. NDS acts like a stock exchanges in respect of Government Securities and money market instruments.

(g) **NDS OM:** The Reserve Bank introduced the Negotiated Dealing System-Order Matching system or NDS-OM as it is called, in August 2005. The NDS-OM is an electronic, screen based, anonymous, order driven trading system for dealing in Government securities. The Reserve Bank owns NDS-OM and CCIL maintains it. The platform is in addition to the existing facility of over-the-counter (OTC) or phone market in Government securities.

(h) **Portfolio Management Scheme (PMS):** In a portfolio management scheme, the bank administering the scheme makes investments on behalf of clients for a 'management fee'. This is a fiduciary activity in which the profit or loss from the transactions belongs to the client. A bank can perform the services of PMS only after obtaining prior approval of RBI and only after getting itself registered with Securities and Exchange Board of India (SEBI).

(i) **Prudential Exposure Limits:** The RBI from time to time prescribes the limits up to which investments in any one type of security or in any industry group or in any one company/group of companies, etc., can be made by a bank. These limits are known as "Prudential Exposure Limits". Reference to Master Circular on Exposure Norms (RBI/2011-12/58 DBOD. No.Dir.BC. 7 /13.03.00/ 2011-12 dated July 1, 2011) can be made for the Prudential Exposure Limits prescribed by the RBI.

(j) **Ready-forward Transactions or Repo:** Ready-forward or Repo transactions are arrangements for current sale of securities and their simultaneous re-purchase at a future date at a price fixed at the time of sale. From the viewpoint of the other party, the transaction involves current purchase and subsequent resale of the securities concerned. In substance, a ready forward transaction involves financing of the bank that sells and agrees to repurchase the securities subsequently from the other party to the transaction. From the viewpoint of such other party, the difference between its current purchase price and subsequent resale price represents the yield on the transaction.

(k) **Repo Constituents' SGL Account (RC SGL Account):** A SGL account of a bank maintained with RBI with authorisation to RBI to act as custodian on its behalf, where the securities delivered by RBI under Repo is held.

(l) **Reverse Ready-forward Transactions or Reverse Repo:** Reverse Ready-forward or Reverse Repo transactions are arrangements for current purchase of securities and their simultaneous re-sale at a future date at a price fixed at the time of purchase. In substance, a reverse ready forward transaction involves temporary deployment of the funds by the bank that purchases the securities and agrees to sell the securities subsequently to the other party to the transaction. The difference between its current purchase price and subsequent resale

price represents the yield on the transaction.

(m) Reverse Repo Constituents' SGL Account (RRC SGL Account): A SGL account of a bank maintained with RBI with authorisation to RBI to act as custodian on its behalf, where the securities to be delivered to RBI under Reverse Repo is held.

(n) Subsidiary General Ledger (SGL): This is a ledger maintained by the Public Debt Office (PDO) of RBI in which accounts of different banks are maintained regarding their holding of select government securities. On a purchase or a sale of the securities, the transaction is recorded when the purchasing bank sends to PDO the Subsidiary General Ledger Form (SGL Form), signed on behalf of both the transferor and the transferee banks. In case the transaction is transacted at NDS, the CCIL, as central counter party, issues instructions to debiting/crediting of the SGL accounts with PDO. PDO acts like a depository in respect of government securities.

(o) Treasury Bills: Treasury bills are government securities representing obligations, which mature in one year or less and are issued at a discount to the face value.

(p) Yield-to-Maturity (YTM): This is the average annual compound rate of return on a security (taking into account both the interest and the redemption value), which the investor will earn if he holds it till maturity. YTM rates are put out by the PDAI/FIMMDA at periodical intervals.

Audit Procedures: The auditor's primary objective in audit of investments is to satisfy himself as to their existence and valuation. Examination of compliance with statutory and regulatory requirements is also an important objective in audit of investments in as much as non-compliance may have a direct and material affect on the financial statements. The latter aspect assumes special significance in the case of banks where investment transactions have to be carried out within the numerous parameters laid down by the relevant legislation and directions of the RBI. The auditor should keep this in view while designing his audit procedures relating to investments.

(a) Internal Control Evaluation and Review of Investment Policy: The auditors should familiarise themselves with the instructions issued by the RBI regarding transactions in securities. They should review the investment policy of the bank to ascertain that the policy conforms, in all material respects, to the RBI's guidelines as well as to any statutory provisions applicable to the bank. While examining the internal controls over investments (including those on SGL forms and BRs), the auditor should particularly examine whether the same are in consonance with the guidelines of the RBI. He should also judge their efficacy.

(b) Separation of Investment Functions: The auditor should also examine whether the bank, as required by the RBI, is maintaining separate accounts for the investments made by it on their own Investment Account, on PMS clients' account, and on behalf of other constituents (including brokers). As per the RBI guidelines, banks are required to get their investments under PMS separately audited by external auditors.

(c) Examination of Reconciliation: The auditor should examine the reconciliation of the investment account, physically verify the securities on hand, obtain confirmations from counter-party banks for BRs issued by such banks and on hand, obtain confirmation of SGL

balances with the PDO, and examine the control and reconciliation of BRs issued by the bank.

(d) Examination of Documents: The auditor should ascertain whether the investments made by the bank are within its authority. In this regard, the auditor should examine whether the legal requirements governing the bank, in so far as they relate to investments, have been complied with and the investments made by the bank are not *ultra virus* the bank. Apart from the above, the auditor should also ensure that any other covenants or conditions which restrict qualify or abridge the right of ownership and/or disposal of investments, have been complied with by the bank.

The auditor should satisfy himself that the transactions for the purchase/sale of investments are supported by due authority and documentation. The acquisition/disposal of investments should be verified with reference to the broker's contract note, bill of costs, receipts and other similar evidence. The auditor should pay special attention to ascertaining whether the investments have been purchased or sold cum-dividend/ex-dividend, cum-interest/ex-interest, cum-right/ex-right, or cum-bonus/ex-bonus. He should check whether appropriate adjustments in this regard have been made in the cost/sales value of securities purchased or sold.

In the case of a right issue, the offer to the bank contained in the letter of rights should be examined. Where the rights have been renounced or otherwise disposed off or not exercised, the auditor should examine the relevant decision of the appropriate authority in this behalf, as also that the sale proceeds, if any, have been duly accounted for. Similarly, the auditor should examine the relevant documents in the case of detachable warrants. He should also examine that these have been properly accounted for.

As regards bonus shares, the intimation to the bank regarding such issue should be examined with a view to ascertaining the receipt and recording of the requisite number of shares in the records maintained by the bank in this regard.

(e) Physical Verification: The auditor should verify the investment scrips physically at the close of business on the date of the balance sheet. In exceptional cases where it is not possible, the auditor should carry out the physical verification on a date as near to the balance sheet date as possible. In such a case, he should take into consideration any adjustments for subsequent transactions of purchase, sale, etc. Normally, the investments of a bank are held by the bank itself or the Public Debt Office (PDO) of the RBI or a depository (in the case of dematerialised securities other than government securities).

Investments should not normally be held by any other person (as laid down in the City Equitable Fire Insurance Co. case). If any investments are so held, proper enquiry should be made to ensure that there is some justification for it, e.g., shares may be held by brokers for the purpose of transfer or splitting-up etc. In respect of dealings in government securities through SGL account, confirmation of balances should be obtained from the Public Debt Office of the RBI. In respect of scripless dealings in investments through the OTC Exchange of India, the auditor should verify the interim and other acknowledgements issued by dealers as well as the year-end confirmation certificates of the depository organisation.

In respect of BRs issued by other banks and on hand with the bank at the year-end, the auditor should examine confirmations of counterparty banks about such B Where any BRs

have been outstanding for an unduly long period, the auditor should obtain written explanation from the management for the reasons thereof. The auditor should examine the reconciliation of BRs issued by the bank. He should also examine whether the securities represented by BRs issued by the bank and outstanding at the year-end have been excluded from investments disclosed in the balance sheet.

If certain securities are held in the names of nominees, the auditor should examine whether there are proper transfer deeds signed by the holders and also an undertaking from them that they hold the securities on behalf of the bank.

While examining the investment portfolio, the auditor should pay special attention to securities whose maturity dates have already expired. It is possible that income on such investments may also not have been received.

(f) Examination of Valuation: Method of valuation of investments followed by a bank may, therefore, have a significant effect on its balance sheet and profit and loss account. The auditor should examine whether the method of accounting followed by the bank in respect of investments, including their year-end valuation, is appropriate.

The auditor should examine the manner of accounting for investments in the context of the guidelines of the RBI and the accounting policy followed by the bank in respect of investments. The auditor should examine the appropriateness of accounting policies followed by the bank. In case any of the accounting policies is not appropriate, the auditor should consider the effect of adoption of such policy on the financial statements and, consequently, on his audit report. In this regard, it may be noted that Accounting Standard (AS) 13, "Accounting for Investments", does not apply to banks. However, notwithstanding this position, the following aspects of guidelines issued by the RBI are not in consonance with the generally accepted accounting principles relating to investments:

- (i) Non-inclusion of incidental charges such as brokerage in the cost of available-for-sale and held-to-maturity securities.
- (ii) Non-recognition of a decline, other than temporary, in the value of securities under held-to-maturity category except those representing investments in subsidiaries and joint ventures.
- (iii) Charging of broken period interest (interest accrued up to the time of acquisition on the securities purchased) to the Profit and Loss Account.

According to RBI guidelines, in respect of shares which are unquoted or for which current quotations are not available, the market value has to be determined on the basis of the latest balance sheet of the company. This might create a problem in the case of new companies whose first annual reports are not yet available. It appears that in such a situation, it would be appropriate to value the shares at cost except where the evidence available indicates the probability of the cost being not fully recoverable. In the latter case, the relevant investment should be written down to recoverable amount; in the case of a held-to-maturity investment, this should be done only if the fall in value is other than temporary.

RBI guidelines require that individual scrips in the available-for-sale category should be marked to market at quarterly or more frequent intervals. It is further required that net depreciation in respect of each of the categories in which investments are presented in the balance sheet should be provided for while any similar net appreciation should be ignored. Where scrips in the available-for-sale category are marked to market during the course of the year, there may be net depreciation in respect of some of the aforesaid categories. A question arises about the treatment of such depreciation where the market valuation of the relevant scrips at the balance sheet date shows that such depreciation has been fully or partly offset due to increase in market values of the scrips. In other words, whether such increase should be considered as a net appreciation or ignored.

As far as annual accounts are concerned, the figure of net depreciation or net appreciation in respect of each balance sheet category needs to be worked out on the basis of the total value of investments in that category at the end of the current year and as at the end of the previous year. Accordingly, the net appreciation in the value of investments in a category subsequent to its interim valuation during the year would need to be recognised. If this position is not adopted, the profit or loss for the year as well as balance sheet valuation of investments may change depending upon the frequency of valuations of investments. Interest on investments classified under held-for-trading category assumes importance. In determining the market value of debt securities under held-to-maturity and available-for-sale categories, interest accrued up to the balance sheet date should be reduced from the market price, if the market price includes the accrued interest, to avoid its double counting - first as accrued interest and secondly as a part of market value.

The auditor should examine whether the profit or loss on sale of investments has been computed properly. Accounting Standard (AS) 13, "Accounting for Investments", requires that the carrying amount of investments disposed of should be determined on the basis of the average carrying amount of the total holding of the particular investment scrip. The carrying amount of investments disposed off should be determined consistently on similar basis.

The classification of investments into held-to-maturity, held-for-trading and available-for-sale categories is based on the intention with which the respective investments have been acquired by the bank. The auditor should examine whether the investments have been properly classified into the three categories at the time of acquisition based on such intention as evidenced by the decision of the competent authority such as Board of directors, ALCO or Investment Committee.

As per RBI guidelines, investments classified under held-for-trading category should be sold within 90 days of their acquisition, failing which they should be shifted to the available-for-sale-category. The auditor should accordingly ensure that no investments purchased more than 89 days before the balance sheet date have been classified under this category.

Subject to what is stated above, the auditor should examine compliance by the bank with the guidelines of the RBI relating to valuation of investments.

In respect of debt securities, interest accrued upto the balance sheet date is usually recognised as income in the profit and loss account. One of the essential conditions for accrual of income is that it should not be unreasonable to expect ultimate collection thereof.

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A change in the method of valuation of investments constitutes a change in accounting policy and adequate disclosure regarding the fact of the change along with its financial effect should be made in the balance sheet.

- (i) The auditor should examine whether income from investments is properly accounted for. This aspect assumes special importance in cases where the bank has opted for receipt of income through the electronic/on line medium.
- (ii) There may be cases where the certificates of tax deduction at source (TDS) received along with the dividend/interest on investments are found missing. This increases the incidence of tax on the bank. The auditor should see that there is a proper system for recording and maintenance of TDS certificates received by the bank.

Special-purpose Certificates Relating to Investments: It may be noted that pursuant to RBI's circulars, issued from time to time, banks require their central auditors to issue the following certificates regarding investments of the bank (in addition to their main audit report and the long form audit report)

- (iii) Certificate on reconciliation of securities by the bank (both on its own Investment Account as well as PMS clients' account). The reconciliation is to be presented in a given format.
- (iv) Certificate on compliance by the bank in key areas of prudential and other guidelines relating to such transactions issued by the Reserve Bank of India.

(g) Dealings in Securities on Behalf of Others: Apart from making investments on its account, a bank may also deal in securities on behalf of its customers only with the prior approval from RBI. These activities of banks are in the nature of trust or fiduciary activities. The accounting implications of the trust activities of banks may be noted:

"Banks commonly act as trustees and in other fiduciary capacities that result in holding or placing of assets on behalf of individuals, trusts, retirement benefit plans and other institutions. Provided the trustee or similar relationship is legally supported, these assets are not assets of the bank and, therefore, are not included in its balance sheet. If the bank is engaged in significant trust activities, disclosure of that fact and indication of the extent of those activities is made in its financial statements because of the potential liability if it fails in its fiduciary duties. For this purpose, trust activities do not encompass safe custody functions".

The auditor should examine whether bank's income from such activities has been recorded and is fairly stated in the bank's financial statements. The auditor also needs to consider whether the bank has any material undisclosed liability from a breach of its fiduciary duties, including the safekeeping of assets.

(h) Examination of classification and shifting: The auditor should examine whether the shifting of the investments from available for sale to held to maturity is duly approved by the Board of Directors of the bank. The auditor should also ensure the compliance of the RBI guidelines, issued from time to time, in this regard.

Extract from Master Circular-Prudential norms for classification, valuation and operation of investment portfolio by banks issued on July 1, 2011.

The Reserve Bank of India has issued the Master Circular No. RBI/2011-12/65 DBOD No. BP. BC. 19/21.04.141/2011-12 dated 1st July, 2011 on "Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks". (This circular is given in the CD along with the Guidance Note), consolidating instructions/guidelines issued to banks on matters regarding prudential norms for classification, valuation and operation of Investment portfolio of banks. The salient points arising from the circular are discussed below.

Investment policy: Banks are required to frame their investments policy and obtain the Board's approval. Such policies should be implemented to ensure that the operations in securities are conducted in accordance with sound and acceptable business practices. Within the policy framework, banks may undertake primary dealers' activities in Government Securities.

Investments in Shares/debenture: Banks opting to invest in shares/debentures to observe the following guidelines:

- (i) Build up adequate expertise in equity research and establish equity research facility.
- (ii) Formulate transparent policy and procedure for investment in shares as approved by its board.
- (iii) Investment committee is to be set up by the bank's board for direct investments and such committee should be held accountable for the investments made by the bank.

Ready Forward (buy back) Deals: No bank shall undertake inter-bank ready forward transactions other than in treasury bills (of all maturities) and dated securities of the Government of India and State Governments. Double ready-forward deals in any securities are prohibited. Only banks having SGL account or Gilt account with an entity having CGSL account with RBI can enter into ready forward transactions.

Transactions through SGL: All transactions in government securities for which SGL facility is available are to be put through SGL accounts only.

Use of Bank Receipts: Banks should not issue BRs under any circumstance in respect of transactions in government securities for which SGL facility is available. No BR should be issued covering transactions relating to PMS client or other constituents' accounts including brokers. In the case of other securities, BRs may be issued for bank's own ready transactions under the following circumstances:

- (i) The issuer is yet to issue the scrips and the bank holds the allotment advice; or
- (ii) The underlying security is physically held at different centre and the bank is in a position to physically transfer the security and effect delivery within a short period; or
- (iii) The underlying security has been lodged for transfer/interest payment and the bank holds necessary records of such lodgements, and it would be in a position to effect physical delivery of the security within a short period.

No BR should be issued on the basis of a BR of another bank held by the bank, and no transaction should be made on the basis of a mere exchange of BRs held by the bank.

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BRs should not remain outstanding for more than fifteen days and should be redeemed only by actual delivery. All BRs should be in a standard format, on semi-security paper, and serially numbered. Separate registers for BRs issued and BRs received should be maintained and the same should be systematically used for follow-up purpose.

There should be a proper system for custody of unused BRs and their utilisation. The central auditors should review the existence and operations of the control over unused BRs. Central auditors are required to furnish annual certificate to Regional Office of Department of Banking Supervision of RBI to this effect.

Any violation of the guidelines would attract penal consequences.

Retailing of Government securities: It is permitted with non-banking clients provided the retailing is on an outright basis and on the basis of ongoing market rates/yield curves of secondary market operations. Further, there should be no restrictions on the period between sale and purchase.

Internal Control System: Banks should establish an internal control system, which should, in particular, cover the following areas:

- (i) There should be a clear functional separation of the (a) trading, (b) settlement, monitoring and control, and (c) accounting activities. Similarly, there should be a functional separation of trading and back-office functions relating to bank's own investments, PMS Clients and other constituents (including brokers') accounts. External auditors should separately audit PMS clients' accounts.
- (ii) A deal slip should be prepared by the trading desk for every transaction entered into containing prescribed details. The deal slips should be serially numbered and controlled separately to ensure that each deal slip is properly accounted for. On completion of deal, the dealer should immediately pass the slip to back office for recording and processing. There should be a system of issuing confirmation to counterparty and receiving written confirmation from the counterparty on a timely basis. In respect of transactions on NDS-OM, counterparty confirmation is not required as CCIL is the central counterparty to all deals. However, all government securities transactions, other than those matched on NDS-OM, will continue to be physically confirmed by the back offices of the counterparties, as hitherto.
- (iii) Once a deal has been concluded, there should not be any substitution of the counterparty. Likewise, the security sold/purchased in the deal should also not be substituted by another security.
- (iv) On the basis of the voucher passed by the back-office (which should be made after verification of actual contract notes received from the brokers/counterparty, and confirmation by the counterparty), the accounts section should independently record the transactions.
- (v) In the case of transactions relating to PMS and other constituents, the relative records should give a clear indication that they do not belong to the bank's own Investment Account.

- (vi) Proper records of SGL transfer forms issued/received should be maintained. The balances as per the bank's books should be reconciled at quarterly intervals with the balances in the books of PDO. The reconciliation may be made more frequently if the number of transactions so warrants. The reconciliation should be periodically checked by internal audit department.
- (vii) Any bouncing of the SGL transfer forms needs to be reported immediately to the Department of Banking Supervision of the RBI by the buying bank.
- (viii) A record of BRs issued/received should be maintained.
- (ix) A system for verification of the authenticity of the BRs and SGL transfer forms received from the other banks and confirmation of authorised signatories should be put in place.
- (x) Banks should not draw cheques on their account with the RBI for third party transactions, including inter-bank transactions. For such transactions, bankers' cheques/ pay orders should be issued.
- (xi) A system of reporting to the top management on weekly basis, giving details of transactions in securities, bouncing of SGL forms, BRs outstanding for more than one month etc., should be instituted.
- (xii) In case of investment in shares, the surveillance and monitoring of investment should be done by the Audit Committee of the Board, which shall review in each of its meetings, the total exposure of the bank to capital market both fund based and non-fund based, in different forms as stated above and ensure that the guidelines issued by RBI are complied with and adequate risk management and internal control systems are in place.
- (xiii) The Audit Committee should keep the Board informed about the overall exposure to capital market, the compliance with the RBI and Board guidelines, adequacy of risk management and internal control systems.
- (xiv) In order to avoid any possible conflict of interest, it should be ensured that the stockbrokers as directors on the Boards of banks or in any other capacity, do not involve themselves in any manner with the Investment Committee or in the decision with regard to making investments in shares, etc., or advances against shares.
- (xv) The internal audit department should audit the transactions in securities on an ongoing basis, monitor the compliance with the laid down management policies and prescribed procedures and report the deficiencies directly to the management of the bank.
- (xvi) The banks' managements should ensure that there are adequate internal control and audit procedures for ensuring proper compliance of the instructions in regard to the conduct of the investment portfolio. The banks should institute a regular system of monitoring compliance with the prudential and other guidelines issued by the RBI. The banks should get compliance in key areas certified by their statutory auditors and furnish such audit certificate to the Regional Office of Department of Banking Supervision of RBI under whose jurisdiction the HO of the bank falls.

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Dealings through Brokers: Banks should follow the guidelines prescribed in the above-mentioned Master Circular:

- (i) Transactions between banks should not be put through the broker's account.
- (ii) The brokerage on the deal payable to brokers should be clearly indicated on the notes/memorandum put up to the top management.
- (iii) A separate account of brokerage paid, broker-wise, should be maintained. Further, a record of broker-wise details deals should also be maintained.
- (iv) The role of the broker should be restricted to that of bringing the two parties to the deal together.
- (v) While negotiating the deal, the broker is not obliged to disclose the identity of the counterparty to the deal. On conclusion of the deal, he should disclose the counterparty and his contract note should clearly indicate the name of the counterparty. It should also be ensured by the bank that the broker note contains the exact time of the deal. Their back offices may ensure that the deal time on the broker note and the deal ticket is the same. The bank should also ensure that their concurrent auditors audit this aspect.
- (vi) Panel of brokers as approved by top management to be constituted and should be reviewed annually based on criteria laid down by the Board for their empanelment including creditworthiness, market reputation, etc., of the brokers.
- (vii) The business through brokers should be distributed among the panel and a limit of 5% of the total transactions entered by the bank through brokers during a year has been specified in respect of an individual approved broker. However, the norm of 5% is not applicable to banks' dealings through primary dealers.
- (viii) Inter bank securities transactions should not be entered through a broker unless such transactions are undertaken on NSE, BSE or OTCEI.
- (ix) Concurrent auditors who audit the treasury operations should scrutinise the business done through brokers and report to the appropriate authority in accordance with the Master Circular.

Audit, Review and Reporting: Banks should undertake half-yearly reviews (as of 30th September and 31st March) of their investment portfolio. These half yearly reviews should not only cover the operational aspects of the investment portfolio but also clearly indicate amendments made to the investment policy and certify the adherence to laid down internal investment policy and procedures and RBI guidelines. The copy of the review reports should be put up to banks' boards within a month, and should be forwarded to RBI by 15 November and 15 May respectively.

The internal auditors are required to separately conduct the concurrent audit of treasury transactions and the results of their report should be placed before the CMD once every month. Banks need not forward copies of the audit report of internal auditor to RBI. However, major irregularities observed in these reports and position of compliance thereto may be incorporated in the half yearly review of the investment portfolio.

Prudential Guidelines on investment in Non-SLR Securities: The above-mentioned Master Circular lays down the guidelines in respect of investment in non-SLR securities. (For Guidelines student may refer Guidance note on Audit of Banks.)

Trading and Settlement in debt securities: All trades with the exception of the spot transactions, in a listed debt security, shall be executed only on the trading platform of a stock exchange. The banks should ensure compliance with RBI and SEBI guidelines. In addition to complying with the SEBI guidelines, banks should ensure that all spot transactions in listed and unlisted debt securities are reported on the NDS and settled through the CCIL from a date to be notified by RBI.

General Aspects: Banks should also observe the following:

- (i) Banks should at the end of every accounting year furnish 'Statement of the Reconciliation of Bank's Investments (held in own Investment account, as also under PMS)', duly certified by its auditors, to RBI. (Annexure VI to the Master Circular contains the format and instructions).
- (ii) Custodial functions on behalf of merchant bank subsidiaries should also be subjected to same safeguards as would be applicable to other constituents.
- (iii) The general powers vested in banks to operate PMS and similar schemes have been withdrawn. No bank can, therefore, restart or introduce any new PMS or similar scheme in future without obtaining specific prior approval of the RBI. (iv) To minimise chances of fraudulent transactions in the guise of Government Securities transactions, the RBI has prescribed the following:
 - ◆ For banks which do not have SGL account with RBI, only one gilt account can be opened.
 - ◆ In case the gilt accounts are opened with a scheduled commercial bank, the account holder has to open a designated funds account (for all gilt account related transactions) with the same bank.
 - ◆ The entities maintaining the gilt/designated funds accounts will be required to ensure availability of clear funds in the designated funds accounts for purchases and of sufficient securities in the gilt account for sales before putting through the transactions.
 - ◆ No transactions by the bank should be undertaken in physical form with any broker.
 - ◆ Banks should ensure that brokers approved for transacting in Government securities are registered with the debt market segment of NSE/BSE/OTCEI.

Classification of Investments

Banks are required to classify their entire investments portfolio into three categories: held-to-maturity, available-for-sale and held-for-trading.

(i) *Held-to-maturity (HTM):* This category would comprise securities acquired by the bank with the intention to hold them up to maturity.

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(ii) *Held-for-trading (HFT)*: This category would comprise securities acquired by the bank with the intention of trading, i.e., to benefit from short-term price/interest rate movements.

(iii) *Available-for-sale (AFS)*: This category will comprise securities, which do not qualify for being categorised in either of the above categories, i.e., those that are acquired neither for trading purpose nor for being held till maturity.

Banks should decide the category of the investment at the time of acquisition and the decision should be recorded on the investment proposal/deal slip.

(i) **HTM Category-Broad Guidelines**: The RBI has prescribed the following guidelines with regard to HTM category:

- (1) Investments under this category should not normally exceed 25 per cent of the total investments of the bank, however, this limit can be exceeded, provided-
 - (a) the excess comprises only SLR securities, and
 - (b) the total SLR securities held in the HTM category is not more than 25 per cent of their DTL as on the last Friday of the second preceding fortnight.
- (2) the following securities are to be classified under HTM but are not to be reckoned while applying the ceiling of 25 per cent:
 - ◆ Re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in their investment portfolio. This will not include re-capitalisation bonds of other banks acquired for investment purposes.
 - ◆ Investment in subsidiaries and joint ventures (A Joint Venture would be one in which the bank, along with its subsidiaries, holds more than 25 percent of the equity).
 - ◆ The investments in debentures/bonds, which are deemed to be in the nature of advance (as per definition provided in the Master Circular).
- (3) Banks may hold the following securities under HTM category:
 - (a) SLR securities upto 25 per cent of DTL as on the last Friday of the second preceding fortnight.
 - (b) Non-SLR securities included under HTM as on September 2, 2004. No fresh non-SLR securities are permitted to be included under HTM except:
 - ◆ Fresh re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in investment portfolio.
 - ◆ Fresh investment in the equity of subsidiaries and joint ventures (A joint venture would be one in which bank, along with its subsidiaries, holds more than 25 per cent of the equity).
 - ◆ RIDF/ SIDBI deposits.
- (4) Profit on sale of HTM category investments should first be credited to Profit & Loss account and thereafter appropriated to 'Capital Reserve Account' and loss is to be charged to Profit & Loss Account.

(ii) **Held for Trading:** The broad RBI guidelines are as follows:

- (1) These securities are to be sold within 90 days.
- (2) Profit/loss is recognised in the Profit & Loss Account.

(iii) **Available for Sale:** Profit/loss on sale of investments under this category is recognised in the Profit & Loss Account.

Shifting Among Categories: Banks may shift investments to/from held-to-maturity category with the approval of the board of directors once a year. Such shifting would normally be allowed at the beginning of the accounting year. No further shifting to/from this category would be allowed during the remaining part of the accounting year.

Banks may shift investments from available-for-sale category to held-for-trading category with the approval of their board of directors/ALCO /Investment Committee. In case of exigencies, such shifting may be done with the approval of the Chief Executive of the bank/head of the ALCO, but should be ratified by the board of directors/ALCO.

Shifting of investments from Held for Trading category to Available for Sale category is not permitted except under exceptional circumstances only with the approval of board/ ALCO/ Investment Committee.

Shifting of investments from one category to another should, under all circumstances, be done at the lowest of-

- (i) acquisition cost;
- (ii) book value; and
- (iii) market value on the date of transfer.

Any resultant depreciation should be fully provided for at the time of the transfer and should be disclosed in the Profit and Loss account of the bank in "Schedule 14 – Other Income: Item III – Profit on revaluation of investment" as a deduction. The book value of the security should be reduced to the extent of the revaluation loss booked. Banks may apply the values as on the date of transfer and in case, there are some practical difficulties in applying the values as on the date of transfer, banks have the option of applying the values as on the previous working day, for arriving at the depreciation requirement on shifting of securities.

Valuation

(i) **Held-to-Maturity Securities:** Investments classified under held-to-maturity category need not be marked to market. They should be carried at acquisition cost unless it is more than the face value, in which case the premium should be amortised over the period remaining to maturity.

(ii) **Available-for-Sale Securities:** The individual scrips in the Available for Sale category will be marked to market at quarterly or at more frequent intervals. Domestic Securities under this category shall be valued scrip-wise and depreciation/ appreciation shall be aggregated for each classification referred to in item 2(i) above and foreign investments under this category shall be valued scrip-wise and depreciation/ appreciation shall be aggregated for five

classifications (viz. Government securities (including local authorities), Shares, Debentures & Bonds, Subsidiaries and/or joint ventures abroad and Other investments (to be specified)). Further, the investment in a particular classification, both in domestic and foreign securities, may be aggregated for the purpose of arriving at net depreciation/appreciation of investments under that category. Net depreciation, if any, shall be provided for. Net appreciation, if any, should be ignored. Net depreciation required to be provided for in any one classification should not be reduced on account of net appreciation in any other classification. The banks may continue to report the foreign securities under three categories (Government securities (including local authorities), Subsidiaries and/or joint ventures abroad and other investments (to be specified)) in the balance sheet. The book value of the individual securities would not undergo any change after the marking of market.

(iii) Held-for-Trading Securities: The individual scrips in the held-for-trading category should be marked to market at monthly or at more frequent intervals and provided for as in the case of those in the available-for-sale category. The book value of the individual securities in this category would also not undergo any change after marking to market.

(iv) Market Value: The '*market value*' for the purpose of periodical valuation of investments included in the Available for Sale and Held for Trading categories would be the market price of the scrip as available from the trades/ quotes on the stock exchanges, SGL account transactions, price list of RBI, prices declared by Primary Dealers Association of India (PDAI) jointly with the Fixed Income Money Market and Derivatives Association of India (FIMMDA) periodically.

(v) Valuation of Unquoted SLR Securities: The RBI has prescribed the following in respect of valuation of unquoted SLR Securities:

- (1) *Central Government Securities* are to be valued at prices/YTM rates put out by PDAI/FIMMDA at periodicals intervals.
- (2) *6% Capital Indexed Bonds and Treasury Bills* are to be valued at cost as defined in the relevant circulars of RBI.
- (3) *Treasury Bills* should be valued at carrying cost.
- (4) *State Government Securities* are to be valued by applying YTM method by marking it up by 25 basis points above the yields of Central Government securities of equivalent maturity put out by PDAI/FIMMDA periodically.
- (5) *Other "Approved" Securities* are to be valued by applying YTM method by marking it up by 25 basis points above the yields of Central Government securities of equivalent maturity put out by PDAI/FIMMDA periodically.

(vi) Valuation of Unquoted Non-SLR Securities: RBI has prescribed the following procedure for valuation of unquoted non-SLR Securities

- (1) Special non-SLR securities issued by Government of India to the beneficiary entities may be valued at a spread of 25 basis points above the corresponding yield on Government of India securities,. Currently, such special securities comprise Oil Bonds, Fertiliser Bonds, bonds issued to the State Bank of India during their rights issue, Unit Trust of

India, Industrial Finance Corporation of India Ltd., Food Corporation of India, Industrial Investment Bank of India Ltd., the erstwhile Industrial Development Bank of India and the erstwhile Shipping Development Finance Corporation.

- (2) The market value of all *debentures/bonds except those in the nature of advances* should be determined on YTM basis. Debentures/bonds of different companies having different ratings should be valued with appropriate mark-up over the YTM rates for Central Government securities put out by PDAI/ FIMMDA periodically. The mark-up should be graded by the bank concerned according to the ratings assigned to the debentures/bonds by the rating agencies subject to the following:
- ◆ The rate used for the YTM for rated debentures/bonds should be at least 50 basis points above the rate applicable to a Government of India securities of equivalent maturity
 - ◆ The rate used for the YTM for unrated debentures/ bonds should not be less than the rate applicable to rated debentures/bonds of equivalent maturity. The mark-up for the unrated debentures/ bonds should appropriately reflect the credit risk borne by the bank.
 - ◆ Where the debenture/bond is quoted and there have been transactions within 15 days prior to the valuation date, the value adopted should not be higher than the rate at which the transaction is recorded on the stock exchange.
- (3) *Zero coupon bonds* should be shown at carrying cost, i.e., acquisition cost plus discount accrued at the rate prevailing at the time of acquisition, which may be marked to market with reference to the market value. In the absence of market value, the zero coupon bonds may be marked to market with reference to the present value of the zero coupon bond. The present value may be calculated by discounting the face value using the Zero Coupon Yield Curve with appropriate mark up as per the zero coupon spreads put out by FIMMDA periodically. In case the bank is still carrying the zero coupon bonds at acquisition cost, the discount accrued on the instrument should be notionally added to the book value of the scrip, before marking it to market.
- (4) The market value of *preference shares* should be determined on YTM basis, subjected, however, to the condition that the market value so determined should not be above the redemption value of the preference shares. In other words, the market value of a preference share should be taken as its value calculated on YTM basis or its redemption value, whichever is lower. Preference shares issued by different companies having different ratings should be valued with appropriate mark-up over the YTM rates for Central Government securities put out by PDAI/FIMMDA periodically. The mark-up should be graded by the bank concerned according to the ratings assigned to the preference shares by the rating agencies subject to the following:
- (a) The YTM rate should not be lower than the coupon rate/YTM for a Government of India loan of equivalent maturity.
 - (b) The rate used for the YTM for unrated preference shares should not be less than the rate applicable to rated preference shares of equivalent maturity. The mark-up

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for unrated preference shares should appropriately reflect the credit risk borne by the bank.

- (c) Preference shares acquired as part of the project finance may be valued at their par value for a period of two years after commencement of production or five years after subscription, whichever is earlier.
 - (d) Where investment in preference shares is as part of rehabilitation, the YTM rate should not be lower than 1.5% above the coupon rate/YTM for Government of India loan of equivalent maturity.
 - (e) Where preference dividends are in arrears, no credit should be taken for accrued dividends. Further, the value determined on YTM basis should be discounted by at least 15% if arrears are for one year, and more if arrears are for more than one year. The depreciation/provision required in respect of such preference shares should not be set-off against appreciation in respect of other performing preference shares. This requirement implies that for the purposes of valuation, preference shares would need to be classified into (i) those where dividends are in arrears, and (ii) others.
 - (f) The preference shares should not be valued above its redemption value.
 - (g) When a preference share has been traded on stock exchange within 15 days prior to the valuation date, the value should not be higher than the price at which the share was traded.
- (5) The *equity shares* in the bank's portfolio should be marked to market preferably on a daily basis, but at least on a weekly basis. The market value of equity shares for which current quotations are not available or where the shares are not quoted on stock exchanges should be taken at their break-up value (without considering 'revaluation reserves', if any). The break-up value should be ascertained from the company's latest balance sheet, but the date of the balance sheet should not be more than one year prior to the date of valuation. In case the latest balance sheet of a company is not available, its shares should be valued at Re. 1 per company.
- (6) Investment in quoted mutual fund units should be valued as per Stock Exchange quotations. The market value of *unquoted mutual fund units* should be determined on the basis of the latest repurchase price declared by the mutual fund in respect of the particular scheme. In the case of funds with a lock-in period, where repurchase price/market quote is not available, net asset value (NAV) can be taken as the market value. If NAV is not available, the units could be valued at cost till the end of the lock-in period. Wherever the repurchase price is not available, the NAV of the respective scheme can be considered to be the market value.
- (7) Commercial paper and Certificate of Deposits should be valued at carrying cost.
- (8) Investment in RRB's is to be valued at carrying cost on consistent basis.

The PDAI/FIMMDA puts out the mark up at periodical intervals for different rated corporate bonds of different maturities, which may be used for the purpose of arriving at the appropriate

YTM at which different non SLR investments are to be valued.

Where the maturity date of securities are different than maturity dates for which PDAI/ FIMMDA has put out the YTM/mark up, the YTM/mark up may be interpolated for the desired maturity.

(vii) Valuation of Securities Issued by SC/RC: Securities (Security Receipts and Pass Through Certificates (PTCs)) issued by Securitisation and Reconstruction Companies in consideration of purchase of financial assets are to be initially recognised at lower of redemption value or net book value of the financial assets (book value of the financial asset sold less provisions held). These securities should be valued at initially recognised amount until its sale/realisation, and on such sale or realisation, the loss or gain must be dealt with as under:

- (1) if the sale to SC/RC is at a price below the NBV, the shortfall should be debited to the profit and loss account of that year.
- (2) If the sale is for a value higher than the net book value, the excess provision will not be reversed but will be utilised to meet the shortfall/loss on account of sale of other financial assets to SC/RC. All instruments received by banks from SC/RC as sale consideration for financial assets sold to them and also other instruments issued by SC/RC in which banks invest will be in the nature of non-SLR securities. Accordingly, the valuation, classification and other norms applicable to investment in non-SLR instruments prescribed by RBI from time to time would be applicable to bank's/Financial Institution's investment in debentures/bonds/ security receipts/PTCs issued by SC/RC. However, if any of the above instruments issued by SC/RC is limited to the actual realisation of the financial assets assigned to the instruments in the concerned scheme the bank/Financial Institution shall reckon the Net Asset Value (NAV), obtained from SC/RC from time to time, for valuation of such investments.

(viii) Valuation of Investment in VCFs: Quoted Investments in VCF are to be held under AFS category and marked to market preferably on daily basis but at least on weekly basis in line with valuation norms for equity shares.

Unquoted Investments in VCF made after August 23, 2006 are to be held under HTM category for the initial period of three years and valued at cost during this period. The period of three years is to be reckoned for each disbursement separately. The transfer of those investments in VCF which have completed three years under HTM to AFS category would be carried out at the beginning of the year. Investments in VCF made upto August 23, 2006 would be done at existing norms.

After the three year period, the unquoted investments in VCF which has been transferred to AFS category are to be valued as follows:

- (1) Units: In the case of investments in the form of units, the valuation will be done at the Net Asset Value (NAV) shown by the VCF in its financial statements. Depreciation, if any, on the units based on NAV has to be provided at the time of shifting the investments to AFS category from HTM category and also on subsequent valuations which should be done at quarterly or more frequent intervals based on the financial statements received from the

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VCF. At least once in a year, the units should be valued based on the audited results. However, if the audited balance sheet/ financial statements showing NAV figures are not available continuously for more than 18 months as on the date of valuation, the investments are to be valued at Rupee 1.00 per VCF.

- (2) Equity: In the case of investments in the form of shares, the valuation can be done at the required frequency based on the break-up value (without considering 'revaluation reserves', if any) which is to be ascertained from the company's (VCF's) latest balance sheet (which should not be more than 18 months prior to the date of valuation). Depreciation, if any on the shares has to be provided at the time of shifting the investments to AFS category and also on subsequent valuations which should be done at quarterly or more frequent intervals. If the latest balance sheet available is more than 18 months old, the shares are to be valued at Rupee. 1.00 per company.
- (3) Bonds: The investment in the bonds of VCFs, if any, should be valued as per valuation norms applicable to unquoted non-SLR bonds/debentures.

(ix) Valuation of Investment acquired on conversion of loans: Investments acquired on conversion of loans should be classified under Available for Sale category. The investments should be valued following the valuation criteria applicable to the type of instrument except that:

- (1) Quoted equity shares should be valued at market value
- (2) Unquoted equity shares, acquired on conversion of standard assets, should be valued at break-up value and in case such shares are acquired on conversion of non-performing assets, it should be valued at ₹ 1 per company till the time the asset is restored/ upgraded to standard asset, in which case it is to be valued at break-up value.

Non-Performing Investments: A non performing investment (NPI), similar to a non-performing advance (NPA), is one where

- (i) Interest/ instalment (including maturity proceeds) is due and remains unpaid for more than 90 days.
- (ii) The above would apply mutatis-mutandis to preference shares where the fixed dividend is not paid.
- (iii) In the case of equity shares, in the event the investment in the shares of any company is valued at ₹ 1 per company on account of the non-availability of the latest balance sheet.
- (iv) If any credit facility availed by the issuer is NPA in the books of the bank, investment in any of the securities, including preference shares issued by the same issuer would also be treated as NPI and vice versa. However, if only the preference shares are classified as NPI, the investment in any of the other performing securities issued by the same issuer may not be classified as NPI and any performing credit facilities granted to that borrower need not be treated as NPA.
- (v) The investments in debentures/bonds, which are deemed to be in the nature of advance would also be subjected to NPI norms as applicable to investments.

- (vi) In case of conversion of non-performing loans into equity, debentures, bonds, etc., such instruments should be treated as NPI ab-initio in the same asset classification in which the relevant non-performing loans were classified and provision should be made as per the norms.

The guidelines specified above for identification of NPI will apply to state government guaranteed securities also.

Bank should make appropriate provisions for such NPIs by way of depreciation in the value of the investment. The banks should not set-off the depreciation requirement in respect of these non-performing securities against the appreciation in respect of other performing securities.

Investment Fluctuation Reserve (IFR), Market Risk & Investment Reserve Account (IRA)

The Master Circular specifies the following guidelines with respect to IFR and IRA:

- (i) Banks have been advised to build reserves towards investment fluctuation, of a minimum 5% of the investment portfolio within 5 years period.
- (ii) To ensure smooth transition to Basel II norms, banks have been advised to build adequate reserve towards capital charge for market risks in a phased manner as follows:
 - (a) In respect of securities included in the HFT category, open gold position limit, open foreign exchange position limit, trading positions in derivatives and derivatives entered into for hedging trading book exposures by March 31, 2005; and
 - (b) In respect of securities included in the AFS category by March 31, 2006.
- (iii) Banks are allowed to consider balance in excess of 5% held in IFR as Tier I capital subject to the conditions specified in the Master Circular.
- (iv) Banks are allowed to consider balance held in IFR as Tier I capital subject to the conditions specified in the Master Circular. For the purpose of treatment of IFR as Tier I capital, banks may transfer the balance in the IFR 'below the line' in the P&L appropriation account to statutory reserve, general reserve or balance of Profit and Loss Account.
- (v) Provisions created for depreciation on investments in the AFS and HFT categories if found excessive should be credited to the Profit & Loss Account and equivalent amount (net of taxes, if any and net of transfer to Statutory Reserve as applicable to such excess provision) should be appropriated to an Investment Reserve Account in Schedule 2 – "Reserves and Surplus" under the head "Revenue and Other Reserves" and would be eligible for inclusion under Tier II within the overall ceiling of 1.25% of total risk weighted assets prescribed for general provisions/ Loss Reserves.
- (vi) The Investment Reserve Account can be utilised in the manner prescribed in the Master Circular.
- (vii) The amounts debited to the P&L Account for provision should be debited under the head "Expenditure -Provisions & Contingencies". The amount transferred from the Investment Reserve Account to the P&L Account should be shown as "below the line" item in the Profit and Loss Appropriation Account after determining the profit for the year. Provision

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towards any erosion in the value of an asset is an item of charge on the profit and loss account and hence should appear in that account before arriving at the profit for the accounting period. Adoption of the following would not only be adoption of a wrong accounting principle but would, also result in a wrong statement of the profit for the accounting period:

- (a) the provision is allowed to be adjusted directly against an item of reserve without being shown in the profit and loss account, or
- (b) a bank is allowed to draw down from the Investment Reserve Account before arriving at the profit for the accounting period (i.e., above the line), or
- (c) a bank is allowed to make provisions for depreciation on investment as a below the line item, after arriving at the profit for the period,

Hence none of the above options are permissible.

- (vii) The withdrawal from the Investment Reserve Account cannot be used for dividend declaration. However, the balance in the Investment Reserve Account transferred 'below the line' in the Profit and Loss Appropriation Account to Statutory Reserve, General Reserve or balance of Profit & Loss Account would be eligible to be reckoned as Tier I capital.

Income Recognition:The banks may book income in the following manner:

- (i) Banks may book income on accrual basis on securities of corporate bodies/ public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the Central Government or a State Government, provided interest is serviced regularly and as such is not in arrears.
- (ii) Banks may book interest income from all other performing investments on accrual basis provided interest rates on these instruments are pre-determined.
- (iii) Discount earned on discounted instruments like commercial papers, zero coupon bonds should be booked on accrual basis. The discount may either be accrued equally over the remaining period to maturity or by following the constant yield method.
- (iv) Interest income from non-performing investments should be booked on realisation.
- (v) Dividend on shares may be booked on accrual basis provided it is approved by the corporate body in its Annual General Meeting and the owner's right to receive dividend is established.
- (vi) Income from units of mutual funds should be booked on cash basis.
- (vii) Discount on interest bearing government securities classified under HTM should be recognised on redemption of the investments and should not be amortised over the remaining period to maturity.
- (viii) Profit and loss on sale of investments including on HTM category, should be shown under Profit/Loss on sale of investments in Schedule 14.
- (ix) In case of sale of investments acquired on conversion of loan, if the sale proceeds are

higher than the net book value, the excess to the extent of provision will not be reversed but will be utilised to meet the shortfall / loss on account of sale of other financial assets to SC /RC.

- (x) Except for profit/loss on sale/revaluation of investment, provision for investments and dividend from subsidiaries and joint ventures, all other income from investments should be shown under the head income from investment in Schedule 13.

Acquisition Charges: Costs such as brokerage, fees, commission or taxes incurred at the time of acquisition of securities in the available-for-sale and held-to-maturity categories should be recognised immediately as expenses.

Broken-period Interest: Banks should not capitalise the Broken Period Interest paid to seller as part of cost, but treat it as an item of expenditure under Profit and Loss Account in respect of investments in Government and other approved securities. It is to be noted that the above accounting treatment does not take into account taxation implications and hence the banks should comply with the requirements of Income Tax Authorities in the manner prescribed by them.

Dematerialised Holding: With effect from October 31, 2001, banks, FIs, PDs and SDs are permitted to make fresh investments and hold bonds and debentures, privately placed or otherwise, only in dematerialised form. Outstanding investments in scrip forms have to be converted into dematerialised form by June 30, 2002. As regards equity instruments, banks were required to convert all their equity holding in scrip form into dematerialised form by December 31, 2004.

III. Advances: The Third Schedule to the Act requires classification of advances made by a bank from three different angles, *viz.*, nature of advance, nature and extent of security, and place of making advance (i.e. whether in India or outside India). Accordingly, the advances are to be classified in Schedule 9 to the balance sheet as follows.

- A. (i) Bills purchased and discounted
- (ii) Cash Credits, Overdrafts and Loans repayable on demand
- (iii) Term loans
- B. (i) Secured by tangible assets
- (ii) Covered by bank/government guarantees
- (iii) Unsecured
- C. I. Advances in India
 - (i) Priority sectors
 - (ii) Public sector
 - (iii) Banks
 - (iv) Others
- II. Advances outside India
 - (i) Due from banks

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- (ii) Due from others
- (iii) Bills purchased and discounted
- (iv) Syndicated loans
- (v) Others

The amount receivable from Government of India under Agricultural Debt Waiver Scheme, 2008 should be shown as mentioned in the RBI's Circular no. DBOD. No. BP. BC. 26/21.04.048/2008-09 dated July 30, 2008 on "Agricultural Debt Waiver and Debt Relief Scheme, 2008-Prudential Norms on Income Recognition, Asset Classifications and Provisioning, and Capital Adequacy".

Extracts from Prudential Norms on Income Recognition, Asset Classification, Provisioning and Other Related Matters

The salient points of the RBI circular No. RBI/2011-12/66 DBOD.No.BP.BC.12/21.04.048/2011-12 dated July 1, 2011 as presently in force are discussed below.

Non-Performing Assets: An asset, including a leased asset, becomes non performing when it ceases to generate income for the bank.

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

- i. interest and/ or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan,
- ii. the account remains 'out of order' in respect of an Overdraft/Cash Credit (OD/CC),
- iii. the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,
- iv. the instalment of principal or interest thereon remains overdue for two crop seasons for short duration crops,
- v. the instalment of principal or interest thereon remains overdue for one crop season for long duration crops,
- vi. the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated February 1, 2006.
- vii. in respect of derivative transactions, the overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

Criteria for Classification of Various Types of Credit Facilities: In line with the international best practices and to ensure greater transparency, the RBI has directed the banks to adopt the '90 days' overdue' norm for identification of NPAs from the year ending March 31, 2004.

Banks have been charging interest at monthly rests, from April 1, 2002. However, the banks were advised that the date of classification of an advance as NPA would not be changed on account of charging of interest at monthly rests. Banks should, therefore, continue to classify

an account as NPA only if the interest charged during any quarter is not serviced fully within 90 days from the end of the quarter.

An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'. Further, any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.

The following criteria are to be applied for determining the status of various types of credit facilities:

- (a) *Term Loans:* A term loan is treated as a non-performing asset (NPA) if interest and/or instalment of principal remain overdue for a period of more than 90 days.
- (b) *Cash Credits and Overdrafts:* A cash credit or overdraft account is treated as NPA if it remains out of order as indicated above.
- (c) *Bills Purchased and Discounted:* Bills purchased and discounted are treated as NPA if they remain overdue and unpaid for a period of more than 90 days.
- (d) *Securitisation:* The asset is to be treated as NPA if the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated February 1, 2006.
- (e) *Agricultural Advances:* A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons and, a loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

As per the guidelines, "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. Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made applicable to agricultural term loans availed of by him.

The above norms should be made applicable to all direct agricultural advances as listed in the Master Circular on Lending to Priority Sectors. In respect of all other agricultural loans, identification of NPAs would be done on the same basis as non-agricultural advances, which, at present, is the 90 days delinquency norm.

Classification Norms relating to NPAs

Temporary Deficiencies: In the matter of classification of accounts with temporary deficiencies, banks have to follow the following guidelines:

- (a) Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets. Drawing power is required to be arrived at based on current stock statement. However, considering the difficulties of large borrowers, stock

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statements relied upon by the banks for determining drawing power should not be older than three months.

- (b) The outstanding in the account based on drawing power calculated from stock statements older than three months is deemed as irregular.
- (c) A working capital borrowing account will become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days even though the unit may be working or the borrower's financial position is satisfactory.
- (d) The accounts where regular/*ad hoc* credit limits have not been reviewed/renewed within 180 days from the due date/date of *ad hoc* sanction, the account should be treated as NPA.

Regularisation Near About Balance Sheet: The asset classification of borrower accounts where a solitary or a few credits are recorded before the balance sheet should be handled with care and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA.

Asset Classification to be Borrower-wise not Facility-wise: All facilities granted to a borrower and investment made in securities issued by the borrower will have to be treated as NPA/NPI and not the particular investment/facility once any or a part of the facility/investment has become irregular.

Erosion in Value of Securities/ Frauds Committed by Borrowers: In respect of accounts where there are potential threats for recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers, such accounts need not go through the stages of asset classification. In such cases, the asset should be straightaway classified as doubtful or loss asset, as appropriate. Further,

- (i) Erosion in the value of securities by more than 50% of the value assessed by the bank or accepted by RBI inspection team at the time of last inspection, as the case may be, would be considered as "significant", requiring the asset to be classified as doubtful straightaway and provided for adequately.
- (ii) The realisable value of security as assessed by bank/approved valuers/RBI is less than 10% of the outstanding in the borrowal accounts, the existence of the security should be ignored and the asset should be classified as loss asset. In such cases the asset should either be written off or fully provided for.

Government Guaranteed Advances: The credit facilities backed by guarantees of central government though overdue may be treated as NPA only when the government repudiates its guarantee when invoked. This exemption from classification of Central Government guaranteed advances as NPA is not for the purpose of recognition of income. In case of State Government guaranteed loans, this exemption will not be available and such account will be NPA if interest / principal / other dues remain overdue for more than 90 days.

Advances Under Consortium: Consortium advances should be based on the record of recovery of the respective individual member banks and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances

is not parting with the share of other member banks, the account should be treated as not serviced in the books of the other member banks and therefore, an NPA.

The banks participating in the consortium, therefore, need to arrange to get their share of recovery transferred from the lead bank or to get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

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

Agricultural Advances Affected by Natural Calamities: Relevant provisions are discussed below:

- i. Banks may decide on their own relief measures, *viz.*, conversion of the short term production loan into a term loan or rescheduling of the repayment period etc., subject to the guidelines contained in RBI's circular No. RPCD. No.PLFS.BC.1/ 05.04.02/ 201011 dated July 1, 2010.. In such cases the NPA classification would be governed by such rescheduled terms.
- ii. *Successive Calamities:* In case of farmers owing debts to the banks as on March 31st, 2004, and who have suffered production and income losses on account of successive natural calamities which might have occurred in the districts for two or more successive years during the past five years may be rescheduled/ restructured by the bank. The classification of such facilities would be governed by the terms of rescheduling.

Further, the interest outstanding/accrued in the accounts of such borrowers (crop loans and agriculture term loans) up to March 31, 2004 may be clubbed with the principal outstanding therein as on March 31, 2004, and the amount thus arrived at shall be repayable over a period of five years, at current interest rates, including an initial moratorium of two years.

As regards the crop loans and agricultural term loans which have already been restructured on account of natural calamities as per the standing guidelines, only the overdue instalments including interest thereon as on March 31, 2004 may be taken into account for the proposed restructuring. On restructuring as above, the farmers concerned will become eligible for fresh loans. The rescheduled/restructured loans as also the fresh loans to be issued to the farmers may be treated as current dues and need not be classified as NPA.

- iii. The RBI has covered tidal waves in the definition of natural calamities. iv. While fixing the repayment schedule in case of rural housing advances granted to agriculturist under Indira Awas Yojana and Golden Jubilee Rural Housing Finance Scheme, banks should ensure that the interest/ instalment payable on such advances are linked to crop cycles.

Advances Granted Under Rehabilitation Packages Approved by BIFR/Term Lending Institutions: In respect of advances under rehabilitation package approved by BIFR/term lending institutions, the provision should continue to be made in respect of dues to the bank on the existing credit facilities as per their classification as sub-standard or doubtful asset. As

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regards the additional facilities sanctioned as per package finalised by BIFR and/or term lending institutions, the income recognition, asset classification norms would apply after a period of one year from the date of disbursement.

Post Shipment Supplier's Credit: Where the credit extended by banks are guaranteed by EXIM Bank, the extent to which payment has been received from EXIM bank on guarantee the advance may not be treated as NPA.

Takeout Finance: Under such an arrangement, the bank or financial institution financing the project transfers to another bank or financial institution, the outstanding of a project finance. During the time-lag involved in the taking-over, the account may slip into NPA. In respect of such takeout finances, the taking over bank/institution should classify the account as NPA on the basis of the actual date of NPA with the previous institution/bank irrespective of the fact that the account was not in its books as on that date. Similarly, the lending institution should also make provision against any asset turning into NPA pending its take over by the take over institution. As and when the asset is taken over by the taking over institution, the lending institution can reverse such provision.

Export Project Finance: Where the actual importer has paid the dues to the bank abroad and the proceeds have not been made good to the bank granting finance due to any political reasons, such account need not be classified as NPA if the bank is able to establish through documentary evidence that the importer has cleared the dues in full. The account will, however, have to be considered as NPA if at the end of one year from the date the amount was deposited by the importer in the bank abroad, the amount has not still been remitted to the bank.

Net Worth of Borrower/Guarantor or Availability of Security: Since income recognition is based on recoveries, net worth of borrower/guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise. Likewise, the availability of security guarantee is not relevant for determining whether or not an account is NPA.

Project Finance Under Moratorium Period: In the case of bank finance given for industrial projects or for agricultural plantations etc., where moratorium is available for payment of interest, payment of interest becomes due after the moratorium or gestation period is over, and not on the date of debit of interest. Therefore, such amounts of interest do not become overdue and hence the accounts do not become NPA, with reference to the date of debit of interest. They become overdue after due date for payment of interest as per the terms of sanction and consequently NPA norms would apply to those advances from that due date.

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

Income Recognition

On Advances Granted: Banks recognise income (such as interest, fees and commission) on accrual basis, i.e., as it is earned. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection. In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognise income on non-performing assets until it is actually realised. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realised should be reversed or provided for. Further,

- i. Interest income on advances against term deposits, NSCs, IVPs, KVPs and life policies may be taken to income account on the due date, provided adequate margin is available in the accounts.
- ii. 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.
- iii. If Government guaranteed advances become NPA, the interest on such advances should not be taken to income account unless the interest has been realised.

Reversal of Income: If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognised as income in the previous year(s).

On Leased Assets: The finance charge component of finance income [as defined in 'AS 19 – Leases] on the leased asset which has accrued and was credited to income account before the asset became non-performing, and remaining unrealised, should be reversed or provided for in the current accounting period.

On Take-out Finance: In the case of take-out finance, if based on record of recovery, the account is classified by the lending bank as NPA, it should not recognise income unless realised from the borrower/taking-over institution (if the arrangement so provides).

On Partial Recoveries in NPAs: In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner. The appropriate policy to be followed is to recognise income as per AS 9 when certainty attaches to realisation and accordingly amount reversed/derecognised or not recognised in the past should be accounted.

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Interest partly 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.

Classification of Advances: The guidelines require banks to classify their advances into four broad categories for the purpose of provisioning as follows.

(a) **Standard assets:** A standard asset is one which does not disclose any problems and which does not carry more than normal risk attached to the business. Such an asset is not a non-performing asset.

(b) **Sub-standard assets:** With effect from March 31, 2005, a sub-standard asset is one which has remained NPA for a period less than or equal to 12 months. In such cases, the current net worth of the borrower/ guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the bank in full.

(c) **Doubtful assets:** With effect from March 31, 2005, an asset is classified as doubtful if it has remained in the sub-standard category for a period of 12 months. Such an asset has all the inherent weaknesses as in a sub-standard asset and an added characteristic that the weaknesses make the collection or liquidation in full highly improbable or questionable.

(d) **Loss assets:** A loss asset is one where loss has been identified by:

- (a) the bank; or
- (b) the internal or external auditors; or
- (c) the RBI inspection

but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

It may be noted that the above classification is meant for the purpose of computing the amount of provision to be made in respect of advances. The balance sheet presentation of advances is governed by the Third Schedule to the Banking Regulation Act, 1949, which requires classification of advances altogether differently.

Upgradation of Loan Accounts Classified as NPAs: If arrears of interest and/instalment are paid by the borrower in the case of loan accounts classified as NPAs, the account should no longer be treated as non-performing and may be classified as 'standard' accounts.

Provisioning for Loans and Advances: The RBI's master circular of July 1, 2011 on Income Recognition, Asset Classification and Provisioning Pertaining to Advances contains the principles to be followed by the bank in calculating the provisions required for the NPAs in conformity with the prudential norms. The circular also requires the bank to take into consideration aspects such as time lag between an account becoming an NPA, its recognition as such, realisation of security and the erosion over time in the value of security charged to the bank, while calculating the required amount of provision. The specific requirements of the Master Circular in respect of provisioning are as follows:

(a) **Loss assets:** The entire amount should be written off. If the assets are permitted to remain in the books for any reason, 100 percent of the outstanding should be provided for.

(b) *Doubtful assets*: The provisioning for doubtful assets under loans and advances is as under:

- (i) Full provision to the extent of the unsecured portion should be made. In doing so, the realisable value of the security available, to which the bank has a valid recourse, should be determined on a realistic basis. DICGC/ECGC cover is also taken into account).
- (ii) In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 25% to 100% of secured portion depending upon the period for which the asset has remained doubtful. In case the advance covered by CGTSI guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per the extant guidelines on provisioning for non-performing advances.

Period for which the advance has been considered as doubtful	% of provision on secured portion
Upto 1 year	25
More than 1 year and upto 3 years	40
More than three years	100

Valuation of Security: With a view to bringing down divergence arising out of difference in assessment of the value of security, in cases of NPAs with balance of ₹ 5 crore and above, stock audit at annual intervals by external agencies appointed as per the guidelines approved by the Board is mandatory in order to enhance the reliability on stock valuation. Collaterals, such as immovable properties charged in favour of the bank are required to be got valued once in three years by valuers appointed as per the guidelines approved by the Board of Directors.

(c) **Sub-standard assets**

- (i) A general provision of 15 percent on total outstanding should be made without making any allowance for ECGC guarantee cover and **securities available**.
- (ii) The 'unsecured exposures' which are identified as 'substandard' would attract additional provision of 10 per cent, i.e., a total of 25 per cent on the outstanding balance. However, in view of certain safeguards such as escrow accounts available in respect of infrastructure lending, infrastructure loan accounts which are classified as sub-standard will attract a provisioning of 20 per cent instead of the aforesaid prescription of 25 per cent. To avail of this benefit of lower provisioning, the banks should have in place an appropriate mechanism to escrow the cash flows and also have a clear and legal first claim on these cash flows. The provisioning requirement for unsecured 'doubtful' assets is 100 per cent. Unsecured exposure is defined as an exposure where the realisable value of the security, as assessed by the bank/approved valuers/Reserve Bank's inspecting officers, is not more than 10 percent, *ab-initio*, of the outstanding exposure. 'Exposure' shall include all funded and non-funded exposures (including underwriting and similar commitments). 'Security' will mean tangible security properly discharged to the bank and will not include intangible securities like guarantees (including State government guarantees), comfort letters etc.
- (iii) In order to enhance transparency and ensure correct reflection of the unsecured

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advances in Schedule 9 of the banks' balance sheet, it is advised that the following would be applicable from the financial year 2009-10 onwards :

- a) For determining the amount of unsecured advances for reflecting in schedule 9 of the published balance sheet, the rights, licenses, authorisations, etc., charged to the banks as collateral in respect of projects (including infrastructure projects) financed by them, should not be reckoned as tangible security. Hence such advances shall be reckoned as unsecured.
- b) However, banks may treat annuities under build-operate-transfer (BOT) model in respect of road / highway projects and toll collection rights, where there are provisions to compensate the project sponsor if a certain level of traffic is not achieved, as tangible securities subject to the condition that banks' right to receive annuities and toll collection rights is legally enforceable and irrevocable.
- c) Banks should also disclose the total amount of advances for which intangible securities such as charge over the rights, licenses, authority, etc. has been taken as also the estimated value of such intangible collateral. The disclosure may be made under a separate head in "Notes to Accounts". This would differentiate such loans from other entirely unsecured loans.

(d) Standard Assets

- (i) The provisioning requirements for all types of standard assets stands as below. Banks should make general provision for standard assets at the following rates for the funded outstanding on global loan portfolio basis:
 - (a) direct advances to agricultural and Small and Micro Enterprises (SMEs) sectors at 0.25 per cent;
 - (b) advances to Commercial Real Estate (CRE) Sector at 1.00 per cent;
 - (c) housing loans extended at teaser rates.
 - (d) all other loans and advances not included in (a) (b) and (c) above at 0.40 per cent
- (ii) The provisions on standard assets should not be reckoned for arriving at net NPAs.
- (iii) The provisions towards Standard Assets need not be netted from gross advances but shown separately as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions Others' in Schedule 5 of the balance sheet.
- (iv) It is clarified that the Medium Enterprises will attract 0.40% standard asset provisioning. The definition of the terms Micro Enterprises, Small Enterprises, and Medium Enterprises shall be in terms of Master Circular RPCD.SME&NFS.BC.No. 9/06.02.31/2010-11 dated July 1, 2010 on Lending to Micro, Small & Medium Enterprises (MSME) Sector.

Accounting and Provisioning Norms for Equipment Leasing Activity: While the accounting and provisioning norms discussed above shall also apply in respect of equipment leasing activities. The bank should follow the Accounting Standard 19 on "Leases" in accounting for lease transactions.

Provisioning for Certain Specific Types of Advances: The guidelines also deal with provisioning for certain specific types of advances as follows.

Advances Granted Under Rehabilitation Packages Approved by BIFR/ Term Lending Institutions

(i) In respect of advances under rehabilitation package approved by BIFR/term lending institutions, the provision should continue to be made in respect of dues to the bank on the existing credit facilities as per their classification as substandard or doubtful asset.

(ii) As regards the additional facilities sanctioned as per package finalised by BIFR and/or term lending institutions, provision on additional facilities sanctioned need not be made for a period of one year from the date of disbursement.

(iii) In respect of additional credit facilities granted to SSI units which are identified as sick [as defined in Section IV (Para 2.8) of RPCD circular RPCD.PLNFS.BC. No 83 /06.02.31/20042005 dated 1 March 2005] and where rehabilitation packages/nursing programmes have been drawn by the banks themselves or under consortium arrangements, no provision need be made for a period of one year.

Advances against term deposits, NSCs eligible for surrender, IVPs, KVPs, gold ornaments, government & other securities and life insurance policies.

The above type of advances would attract provisioning requirements as applicable to their asset classification status.

Advances Guaranteed by ECGC: In the case of advances guaranteed by ECGC, provision should be made only for the balance in excess of the amount of such guarantee. Further, while arriving at the provision required to be made for doubtful assets, realisable value of the securities should first be deducted from the outstanding balance in respect of the amount guaranteed by these Corporations and then provision should be made.

Advance covered by CGTSI (Credit Guarantee Fund Trust for Small Industries): In case the advance covered by CGTSI guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per the extant guidelines on provisioning for non-performing advances.

Restructuring/Reschedulement of Loans (Including Under Corporate Debt Structuring (CDR) Scheme): The RBI, vide its circular no. RBI/2011-12/66 DBOD.No.BP.BC.12/21.04.048/2011-12 of July 1, 2011 issued prudential guidelines on restructuring of advances by banks. The Guidelines also contain the organisational framework for restructuring of advances under consortium/ multiple banking/ syndication arrangements, i.e., the CDR mechanism. The provisions relating to restructuring/ reschedulement of loans and CDR system were hitherto contained in the Master Circular on Income Recognition, Asset Classification and Provisioning Pertaining to Advances.

Eligibility criteria for restructuring of advances: Banks may restructure the accounts classified under 'standard', 'sub-standard' and 'doubtful' categories.

Banks can not reschedule / restructure / renegotiate borrowal accounts with retrospective effect. While a restructuring proposal is under consideration, the usual asset classification norms would continue to apply. The asset classification status as on the date of approval of

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the restructured package by the competent authority would be relevant to decide the asset classification status of the account after restructuring / rescheduling / renegotiation. In case there is undue delay in sanctioning a restructuring package and in the meantime the asset classification status of the account undergoes deterioration, it would be a matter of supervisory concern.

No account can be taken up for restructuring by the banks unless the financial viability is established and there is a reasonable certainty of repayment from the borrower, as per the terms of restructuring package. The viability should be determined by the banks based on the acceptable viability benchmarks determined by them, which may be applied on a case-by-case basis, depending on merits of each case. The parameters may, for example, include:

- ◆ Return on Capital Employed
- ◆ Debt Service Coverage Ratio
- ◆ Gap between the Internal Rate of Return and Cost of Funds and the amount of provision required in lieu of the diminution in the fair value of the restructured advance.

BIFR cases are not eligible for restructuring without the express approval of the BIFR. CDR Core Group in the case of advances restructured under CDR Mechanism, the lead bank in the case of SME Debt Restructuring Mechanism and the individual banks in other cases, may consider the proposals for restructuring in such cases, after ensuring that all the formalities in seeking the approval from BIFR are completed before implementing the package.

Asset Classification Norms: The stages at which the restructuring/rescheduling/renegotiation of the terms of loan agreement could take place are as under:

- (a) before commencement of commercial production/operation;
- (b) after commencement of commercial production/operation but before the asset has been classified as sub standard; and
- (c) after commencement of commercial production/operation and after the asset has been classified as sub standard or doubtful.

The accounts classified as 'standard assets' should be immediately re-classified as 'sub-standard assets' upon restructuring (except for in certain cases mentioned in Para 11.1 and 11.2 of the said circular).

The non-performing assets, upon restructuring, would continue to have the same asset classification as prior to restructuring and slip into further lower asset classification categories as per extant asset classification norms with reference to the pre-restructuring repayment schedule (except for in certain cases mentioned in Para 11.1 and 11.2 of the said circular).

Any additional finance may be treated as 'standard asset', up to a period of one year after the first interest/principal payment, whichever is earlier, falls due under the approved restructuring package. However, in case of accounts where the pre-restructuring facility was classified as "sub-standard" and "doubtful", interest income on the additional finance should be recognized on cash basis only. If the restructured asset does not qualify for upgradation at the end of the

above specified one year period, the additional finance shall be placed in the same asset classification category as the restructured debt.

Upgradation of Accounts: All restructured accounts which have been classified as non-performing assets upon restructuring, would be eligible for up-gradation to the 'standard' category after observation of 'satisfactory performance' during the 'specified period'. Specified Period means a period of one year from the date when the first payment of interest or installment of principal falls due under the terms of restructuring package.

Subsequent Restructuring: In case a restructured asset, which is a standard asset on restructuring, is subjected to restructuring on a subsequent occasion, it should be classified as sub-standard. If the restructured asset is a sub-standard or a doubtful asset and is subjected to restructuring, on a subsequent occasion, its asset classification will be reckoned from the date when it became NPA on the first occasion. However, such advances restructured on second or more occasion may be allowed to be upgraded to standard category after one year from the date of first payment of interest or repayment of principal whichever falls due earlier in terms of the current restructuring package subject to satisfactory performance.

Income Recognition Norms: Interest income in respect of restructured accounts classified as 'standard assets' is to be recognised on accrual basis and that in respect of the accounts classified as 'non-performing assets' is to be recognised on cash basis. However, in the case of accounts where the pre-restructuring facilities were classified as 'sub-standard' and 'doubtful', interest income on the additional finance classified as Standard Asset should be recognised only on cash basis.

Provisioning Norms

Normal provisions: Banks are required to hold provision against the restructured advances as per the existing provisioning norms.

Provision for diminution in the fair value of restructured advances: Reduction in the rate of interest and /or reschedulement of the repayment of principal amount, as part of the restructuring, will result in diminution in the fair value of the advance. Such diminution in value is an economic loss for the bank and will have impact on the bank's market value of equity. It is, therefore, necessary for banks to measure such diminution in the fair value of the advance and make provisions for it by debit to Profit & Loss Account. Such provision should be held in addition to the provisions as per existing provisioning norms as indicated above, and in an account distinct from that for normal provisions.

The erosion in the fair value of the advance should be computed as the difference between the "*the present value of future cash flows (principal and interest) reckoned based on the current BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring*", and "*the present value of future cash flows' (principal and interest) based on rate charged as per the restructuring package*". For computing the present value, the discount rate to be applied should be equivalent to the (current BPLR as on the date of restructuring + appropriate term premium + credit risk premium applicable to the borrower as on the date of restructuring).

In the case of working capital facilities, the diminution in the fair value of the cash credit /overdraft component may be computed as indicated in para above, reckoning the higher of the outstanding amount or the limit sanctioned as the principal amount and taking the tenor of the advance as one year. The term premium in the discount factor would be as applicable for one year. The fair value of the term loan components(Working Capital Term Loan and Funded Interest Term Loan) would be computed as per actual cash flows and taking the term premium in the discount factor as applicable for the maturity of the respective term loan components.

In the event any security is taken in lieu of the diminution in the fair value of the advance, it should be valued at Re.1/- till maturity of the security. This will ensure that the effect of charging off the economic sacrifice to the Profit & Loss account is not negated.

Prudential Norms for Conversion of Principal into Debt/Equity

Asset Classification Norms: A part of the outstanding principal amount can be converted into debt or equity instruments as part of restructuring. The debt/equity instruments so created will be classified in the same asset classification category in which the restructured advance has been classified. Further, movement in the asset classification of these instruments would also be determined based on the subsequent asset classification of the restructured advance.

Income Recognition Norms

Standard Accounts: In the case of restructured accounts classified as 'standard', the income, if any, generated by these instruments may be recognised on accrual basis.

Non- Performing Accounts: In the case of restructured accounts classified as non-performing assets, the income, if any, generated by these instruments may be recognised only on cash basis.

Valuation and Provisioning Norms: These instruments should be held under AFS and valued as per usual valuation norms. Equity classified as standard asset should be valued either at market value, if quoted, or at break-up value, if not quoted (without considering the revaluation reserve, if any,)which is to be ascertained from the company's latest balance sheet. In case the latest balance sheet is not available the shares are to be valued at Rs 1. Equity instrument classified as NPA should be valued at market value, if quoted, and in case where equity is not quoted, it should be valued at Re. 1. Depreciation on these instruments should not be offset against the appreciation in any other securities held under the AFS category.

Organisational Framework for Restructuring of Advances under Consortium/Multiple Banking/ Syndication Arrangements

A. Corporate Debt Restructuring (CDR) Mechanism: A Corporate Debt Restructuring system has been evolved for restructuring of the corporate debts of viable entities facing problems, which are out side the purview of BIFR, DRT and other legal proceedings. All the banks have been advised by RBI to follow the Corporate Debt Restructuring mechanism, which would be a non-statutory voluntary system based on debtor creditor agreement and inter creditor agreement. The RBI has issued separate guidelines in respect of debt restructuring for small and medium enterprises (SMEs).

The RBI has also suggested that in order to improve effectiveness of the CDR mechanism a

clause may be incorporated in the loan agreements involving consortium/syndicate accounts whereby all creditors, including those which are not members of the CDR mechanism, agree to be bound by the terms of the restructuring package that may be approved under the CDR mechanism, as and when restructuring may become necessary.

Corporate Debt Restructuring (CDR) would generally affect the operations both at Branch level as well as the Head office level, although, in most of the cases the effects of provisioning due to sacrifice in the interest would be made at the Head Office level.

One of the main features of the restructuring under CDR system is the provision of two categories of debt restructuring under the CDR system. Accounts, which are classified as 'standard' and 'substandard' in the books of the creditors, will be restructured under the first category (Category 1). Accounts which are classified as 'doubtful' in the books of the creditors would be restructured under the second category (Category 2).

Category 1 CDR system: It is applicable only to accounts classified as 'standard' and 'sub-standard'. There may be a situation where a small portion of debt by a bank might be classified as doubtful. In that situation, if the account has been classified as 'standard'/'substandard' in the books of at least 90% of creditors (by value), the same would be treated as standard / substandard, only for the purpose of judging the account as eligible for CDR, in the books of the remaining 10% of creditors. There is no requirement of the account / company being sick, NPA or being in default for a specified period before reference to the CDR system. However, potentially viable cases of NPAs will get priority.

Category 2 CDR System: Second category of CDR applies to such cases where the accounts have been classified as 'doubtful' in the books of creditors, and if a minimum of 75% (by value) and 60% (by number) of the lenders satisfy themselves of the viability of the account and consent for such restructuring, subject to the following conditions:

- (i) It will not be binding on the creditors to take up additional financing worked out under the debt restructuring package and the decision to lend or not to lend will depend on each creditor bank/FI separately. (ii) All other norms under the CDR mechanism such as the standstill clause, asset classification status during the pendency of restructuring under CDR, etc. will continue to apply.

All CDR approved packages must incorporate creditors' right to accelerate repayment and borrowers' right to prepay. The right of recompense should be based on certain performance criteria to be decided by the Standing Forum.

Following are the general provisions relating to operation of the CDR system, as prescribed by the RBI:

(a) Eligibility criteria

- (i) The scheme does not apply to accounts involving only one financial institution or one bank. The CDR mechanism covers only multiple banking accounts/syndication/consortium accounts of corporate borrowers with outstanding fund-based and non-fund based exposure of ₹ 10 crore and above by banks and institutions.

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- (ii) Corporates indulging in frauds and malfeasance even in a single bank are ineligible for restructuring under CDR mechanism. The CDR Core group, however, may review the reasons for classification of the borrower as wilful defaulter specially in old cases where the manner of classification of a borrower as a wilful defaulter was not transparent and satisfy itself that the borrower is in a position to rectify the wilful default provided he is granted an opportunity under the CDR mechanism. Such exceptional cases may be admitted for restructuring with the approval of the Core Group only. The Core Group may ensure that cases involving frauds or diversion of funds with *malafide* intent are not covered.
- (iii) The accounts where recovery suits have been filed by the creditors against the company, may be eligible for consideration under the CDR system provided, the initiative to resolve the case under the CDR system is taken by at least 75% of the creditors (by value) and 60% of creditors (by number).

(b) Reference to CDR System

- (i) Reference to Corporate Debt Restructuring System could be triggered by (i) any or more of the creditor who have minimum 20% share in either working capital or term finance, or (ii) by the concerned corporate, if supported by a bank or financial institution having stake as in (i) above.
- (ii) Though flexibility is available whereby the lenders could either consider restructuring outside the purview of the CDR system or even initiate legal proceedings where warranted, banks/FIs should review all eligible cases where the exposure of the financial system is more than Rs 100 crore and decide about referring the case to CDR system or to proceed under the new SRFAESI Act, 2002 or to file a suite in DRT etc.

(c) Stand-Still Clause

- (i) One of the most important elements of Debtor-Creditor Agreement is the 'stand still' agreement binding for 90 days, or 180 days by both sides. Under this clause, both the debtor and creditor(s) should agree to a legally binding 'stand-still' whereby both the parties commit themselves not to take recourse to any other legal action during the 'stand-still' period. The significant provisions relating to the Stand-Still clause are as under:
 - (a) Stand-still clause is applicable only to any civil action either by the borrower or any lender against the other party and will not cover any criminal action.
 - (b) During the stand-still period, outstanding foreign exchange forward contracts, derivative products, etc., can be crystallised, provided the borrower is agreeable to such crystallisation.
 - (c) The borrower would additionally need to undertake that:
 - ◆ during the stand-still period the documents would stand extended for the purpose of limitation and also that he would not approach any other authority for any relief; and

- ◆ the directors of the borrowing company will not resign from the Board of Directors during the stand-still period.
- (ii) During pendency of the case with the CDR system, the usual asset classification norms would continue to apply. If the Empowered Group approves a restructuring package under the CDR system and the approved package is implemented within 120 days from the date of approval, the asset classification status may be restored to the position, which existed when the reference to the CDR Cell was made. Consequently, any additional provisions made by banks towards deterioration in the asset classification status during the pendency of the case with the CDR system may be reversed.

Failure to implement an approved package within 120 days after the date of approval indicates that the success of the package is uncertain and hence, the asset classification status of the account should not be restored to the position as on the date of reference to the CDR Cell.

(d) Additional finance

- (i) Additional finance, if any, is to be provided by all creditors of a 'standard' or 'substandard account' irrespective of whether they are working capital or term creditors, on a pro-rata basis. In case for any internal reason, any creditor (outside the minimum 75 per cent and 60 per cent) does not wish to commit additional financing, that creditor will have an option in accordance with the provisions of (e) below.
- (ii) The providers of additional finance, whether existing creditors or new creditors, shall have a preferential claim, to be worked out under the restructuring package, over the providers of existing finance with respect to the cash flows out of recoveries, in respect of the additional exposure.

(e) Exit option

- (i) A creditor (outside the minimum 75 per cent and 60 per cent) who for any internal reason does not wish to commit additional finance have an exit option. At the same time, in order to avoid the "free rider" problem, it is necessary to provide some disincentive to the creditor who wishes to exercise this option. Such creditors can either (a) arrange for its share of additional finance to be provided by a new or existing creditor, or (b) agree to the deferment of the first year's interest due to it after the CDR package becomes effective. The first year's deferred interest as mentioned above, without compounding, will be payable along with the last installment of the principal due to the creditor.
- (ii) In addition, the exit option would also be available to all lenders within the minimum 75 percent and 60 percent provided the purchaser agrees to abide by restructuring package approved by the Empowered Group. The exiting lenders may be allowed to continue with their existing level of exposure to the borrower provided they tie up with either the existing lenders or fresh lenders taking up their share of additional finance.

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- (iii) The lenders who wish to exit from the package would have the option to sell their existing share to either the existing lenders or fresh lenders, at an appropriate price, which would be decided mutually between the exiting lender and the taking over lender. The new lenders shall rank on par with the existing lenders for repayment and servicing of the dues since they have taken over the existing dues to the exiting lender.
- (iv) In order to bring more flexibility in the exit option, One Time Settlement can also be considered, wherever necessary, as a part of the restructuring package. If an account with any creditor is subjected to One Time Settlement (OTS) by a borrower before its reference to the CDR mechanism, any fulfilled commitments under such OTS may not be reversed under the restructured package. Further payment commitments of the borrower arising out of such OTS may be factored into the restructuring package.

(f) Conversion option

- (i) The CDR Empowered Group, while deciding the restructuring package, should decide on the issue regarding convertibility (into equity) option as a part of restructuring exercise, whereby, the banks/financial institutions shall have the right to convert a portion of the restructured amount into equity, keeping in view the statutory requirement under Section 19 of the Banking Regulation Act, 1949, (in the case of banks) and relevant SEBI regulations.
- (ii) Equity acquired by way of conversion of debt / overdue interest under the CDR mechanism is allowed to be taken up without seeking prior approval from RBI, even if by such acquisition the prudential capital market exposure limit prescribed by the RBI is breached, subject to reporting such holdings to RBI, Department of Banking Supervision (DBS), every month along with the regular DSB Return on Asset Quality. However, banks will have to comply with the provisions of Section 19(2) of the Banking Regulation Act, 1949.
- (iii) Acquisition of non-SLR securities by way of conversion of debt is exempted from the mandatory rating requirement and the prudential limit on investment in unlisted non-SLR securities prescribed by the RBI, subject to periodical reporting to RBI in the aforesaid DSB return. The above relaxations allowed would be reviewed after a year.

B. Debt Restructuring Mechanism for Small and Medium Enterprises (SMEs): Apart from CDR Mechanism, RBI has also prescribed a separate scheme for restructuring of loans availed by Small and Medium Enterprises (SMEs). Unlike in the case of CDR Mechanism, the operational rules of the mechanism have been left to be formulated by the banks concerned. This mechanism will be applicable to all the borrowers which have funded and non-funded outstanding up to ₹ 10 crore under multiple/consortium banking arrangement. Major elements of this arrangements are as under:

- (i) Under this mechanism, banks may formulate, with the approval of their Board of Directors, a debt restructuring scheme for SMEs within the prudential norms laid down by

RBI. Banks may frame different sets of policies for borrowers belonging to different sectors within the SME if they so desire.

- (ii) While framing the scheme, banks may ensure that the scheme is simple to comprehend and will, at the minimum, include parameters indicated in these guidelines.
- (iii) The main plank of the scheme is that the bank with the maximum outstanding may work out the restructuring package, along with the bank having the second largest share.
- (iv) Banks should work out the restructuring package and implement the same within a maximum period of 90 days from date of receipt of requests.
- (v) The SME Debt Restructuring Mechanism will be available to all borrowers engaged in any type of activity.
- (vi) Banks may review the progress in rehabilitation and restructuring of SMEs accounts on a quarterly basis and keep the Board informed.

Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SRFAESI), 2002

Securitisation of Standard Assets: After the enactment of the Securitization and Reconstruction of Financial Asset and Enforcement of Security Interest Act, 2002, banks have got significant power to possess the securities of defaulting borrower. Banks can now take possession of the assets from borrower and convert the same in Security Receipts. In the process of securitisation, assets are sold to a bankruptcy remote special purpose vehicle (SPV) in return for an immediate cash payment. The cash flow from the underlying pool of assets is used to service the securities issued by the SPV. Securitisation thus follows a two-stage process. In the first stage, there is sale of single asset or pooling and sale of pool of assets to a 'bankruptcy remote' special purpose vehicle (SPV) in return for an immediate cash payment and in the second stage repackaging and selling the security interests representing claims on incoming cash flows from the asset or pool of assets to third party investors by issuance of tradable debt securities. Thus, the non-performing asset of the banker is taken out of the balance sheet of the bank and converted into Security Receipts.

Securitized asset should be derecognised in the books of the bank, if and only if, either by a single transaction or by a series of transactions taken as a whole, the bank loses control of the contractual rights that comprise the securitized asset. The bank loses such control if it surrenders the rights to benefits specified in the contract. Determining whether the bank has lost control of the securitized asset depends both on the bank's position and that of the SPV. Consequently, if the position of either the bank or the SPV indicates that the bank has retained control, the bank should not remove the securitized asset from its balance sheet.

For enabling the transferred assets to be removed from the balance sheet of the originator in a securitisation structure, the isolation of assets or 'true sale' from the originator to the SPV is an essential prerequisite. In case the assets are transferred to the SPV by the originator in full compliance with all the conditions of true sale, the transfer would be treated as a 'true sale' and originator will not be required to maintain any capital against the value of assets so transferred from the date of such transfer. The effective date of such transfer should be expressly indicated in the subsisting agreement. In the event of the transferred assets not meeting the "true-sale" criteria the assets would be deemed to be on the balance sheet of the

originator and accordingly the originator would be required to maintain capital for those assets.

These Security Receipts are treated as non-SLR security (Investment) in the books of subscribing bank as per RBI guidelines. In the absence of ready market for the Security Receipts, the subscribing bank needs to value Security Receipts on the basis of Net Asset Value to be declared by Securitising Company on a quarterly basis.

Further, when a bank sells the non-performing assets to securitising company, if the sale value of assets is less than the Net book Value, i.e., books value of advances less provisions, the shortfall needs to be debited to Profit & Loss Account. However, in case the sale value being higher, excess provision can not be reversed and is kept to meet the shortfall/ loss on account of other non-performing assets.

Projects Under Implementation: The projects under implementation are grouped into three categories for the purpose of determining the date when the project ought to be completed:

- ◆ *Category I:* Projects where financial closure had been achieved and formally documented.
- ◆ *Category II:* Projects sanctioned before 1997 with original project cost of ₹ 100 crore or more where financial closure was not formally documented.
- ◆ *Category III:* Projects sanctioned before 1997 with original project cost of less than ₹ 100 crore where financial closure was not formally documented.

Asset classification: In case of each of the three categories, the date when the project ought to be completed and the classification of the underlying loan asset should be determined in the following manner:

- ◆ *Category I* (Projects where financial closure had been achieved and formally documented): In such cases the date of completion of the project should be as envisaged at the time of original financial closure. In all such cases, the asset may be treated as standard asset for a period not exceeding two years beyond the date of completion of the project, as originally envisaged at the time of initial financial closure of the project.

In case, however, in respect of a project financed after 1997, the financial closure had not been formally documented, the norms enumerated for category III below, would apply.

- ◆ *Category II* (Projects sanctioned before 1997 with original project cost of ₹ 100 crore or more where financial closure was not formally documented): For such projects sanctioned prior to 1997, where the date of financial closure had not been formally documented, an independent Group was constituted with experts from the term lending institutions as well as outside experts in the field to decide on the deemed date of completion of projects. The Group, based on all material and relevant facts and circumstances, has decided the deemed date of completion of the project, on a project-by-project basis. In such cases, the asset may be treated as standard asset for a period not exceeding two years beyond the deemed date of completion of the project, as decided by the Group. Banks, which have extended finance towards such projects, may approach the lead financial institutions to which a copy of the independent

Group's report has been furnished for obtaining the particulars relating to the deemed date of completion of project concerned.

- ◆ *Category III* (Projects sanctioned before 1997 with original project cost of less than ₹ 100 crore where financial closure was not formally documented): In these cases, sanctioned prior to 1997, where the financial closure was not formally documented, the date of completion of the project would be as originally envisaged at the time of sanction. In such cases, the asset may be treated as standard asset only for a period not exceeding two years beyond the date of completion of the project as originally envisaged at the time of sanction.

In all the three foregoing categories, in case of time overruns beyond the aforesaid period of two years, the asset should be classified as substandard regardless of the record of recovery and provided for accordingly.

As regards the project to be financed by the FIs/banks after May 28th, 2002, the date of completion of the project should be clearly spelt out of financial closure of the project. In such cases, if the date of commencement of commercial production extends beyond a period of six months after the date of completion of the project, as originally envisaged at the time of initial financial closure of the project the account should be treated as a sub-standard asset. However, for infrastructure projects alone, w.e.f. March 31, 2008, if the date of commencement of commercial production extends beyond a period of two year after the date of completion of the project, as originally envisaged, the account should be treated as substandard.

Provisioning Norms

Normal provisions: Banks will hold provision against these advances as per the existing provisioning norms.

Income Recognition: The banks may recognise income on accrual basis in respect of the three categories of projects under implementation which are classified as 'standard'. RBI, however, prohibits banks from recognising income on accrual basis in respect of the above three categories of projects under implementation which are classified as a 'substandard' asset. Banks may recognise income in such accounts only on realisation on cash basis. However, in case of uncertainties related to such income, members should consider the compliance with revenue recognition norms explained in AS 9, Revenue Recognition

Reserve for Exchange Rate Fluctuations Account (RERFA): When exchange rate movements of Indian rupee turn adverse, the outstanding amount of foreign currency denominated loans (where actual disbursement was made in Indian Rupee) which become overdue goes up correspondingly, with its attendant implications of provisioning requirements. Such assets should not normally be revalued. In case such assets need to be revalued as per requirement of accounting practices or for any other requirement, the following procedure may be adopted:

- ◆ The loss on revaluation of assets has to be booked in the bank's Profit & Loss Account.
- ◆ Besides the provisioning requirement as per Asset Classification, banks should treat the

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full amount of the Revaluation Gain relating to the corresponding assets, if any, on account of Foreign Exchange Fluctuation as provision against the particular assets.

Provisioning For Country Risk: Banks are required to make provisions, with effect from the year ending 31 March 2003, on the net funded country exposures on a graded scale ranging from 0.25 to 100 percent according to the risk categories mentioned below. To begin with, banks are required to make provisions as per the following schedule:

<i>Risk Category</i>	<i>ECGC Classification</i>	<i>Provisioning requirement (per cent)</i>
Insignificant	A1	0.25
Low	A2	0.25
Moderate	B1	5
High	B2	20
Very high	C1	25
Restricted	C2	100
Off-credit	D	100

Banks are required to make provision for country risk in respect of a country where its net funded exposure is one per cent or more of its total assets. The provision for country risk shall be in addition to the provisions required to be held according to the asset classification status of the asset. In the case of 'loss assets' and 'doubtful assets', provision held, including provision held for country risk, may not exceed 100% of the outstanding. Banks may not make any provision for 'home country' exposures i.e. exposure to India. The exposures of foreign branches of Indian banks to the host country should be included. Foreign banks shall compute the country exposures of their Indian branches and shall hold appropriate provisions in their Indian books. However, their exposures to India will be excluded. Banks may make a lower level of provisioning (say 25% of the requirement) in respect of short-term exposures (i.e. exposures with contractual maturity of less than 180 days).

Provisioning norms for sale of financial assets to Securitisation Company (SC) / Reconstruction company (RC) –

- (i) If the sale of financial assets to SC/RC, is at a price below the net book value (NBV) (i.e. book value less provisions held), the shortfall should be debited to the profit and loss account of that year.
- (ii) If the sale is for a value higher than the NBV, the excess provision will not be reversed but will be utilised to meet the shortfall/loss on account of sale of other financial assets to SC/RC.
- (iii) With a view to enabling banks to meet the shortfall, if any, banks are advised to build up provisions significantly above the minimum regulatory requirements for their NPAs, particularly for those assets, which they propose to sell to securitisation/reconstruction companies.

Other Aspects: Certain other important aspects of the guidelines relating to provisioning are discussed below.

Floating Provisions: *Principle for Utilisation of Floating Provisions by Banks (Para 5 of RBI Master Circular RBI/2011-12/66 DBOD.No.BP.BC.12/21.04.048/2011-1 dated July 1, 2011):*

Principle for creation of floating provisions by banks: The bank's board of directors should lay down approved policy regarding the level to which the floating provisions can be created. The bank should hold floating provisions for 'advances' and 'investments' separately and the guidelines prescribed will be applicable to floating provisions held for both 'advances' & 'investment' portfolios.

Principle for utilisation of floating provisions by banks

- i The floating provisions should not be used for making specific provisions as per the extant prudential guidelines in respect of nonperforming assets or for making regulatory provisions for standard assets. The floating provisions can be used only for contingencies under extraordinary circumstances for making specific provisions in impaired accounts after obtaining board's approval and with prior permission of RBI. The boards of the banks should lay down an approved policy as to what circumstances would be considered extraordinary.
- ii To facilitate banks' boards to evolve suitable policies in this regard, it is clarified that the extra-ordinary circumstances refer to losses which do not arise in the normal course of business and are exceptional and non-recurring in nature. These extra-ordinary circumstances could broadly fall under three categories viz. General, Market and Credit. Under general category, there can be situations where bank is put unexpectedly to loss due to events such as civil unrest or collapse of currency in a country. Natural calamities and pandemics may also be included in the general category. Market category would include events such as a general melt down in the markets, which affects the entire financial system. Among the credit category, only exceptional credit losses would be considered as an extra-ordinary circumstance.
- iii In terms of the Agricultural Debt Waiver and Debt Relief Scheme, 2008, lending institutions shall neither claim from the Central Government, nor recover from the farmer, interest in excess of the principal amount, unapplied interest, penal interest, legal charges, inspection charges and miscellaneous charges, etc. All such interest / charges will be borne by the lending institutions. In view of the extraordinary circumstances in which the banks are required to bear such interest / charges, banks are allowed, as a one time measure, to utilise, at their discretion, the Floating Provisions held for 'advances' portfolio, only to the extent of meeting the interest / charges referred to above.

Accounting: Floating provisions cannot be reversed by credit to the profit and loss account. They can only be utilised for making specific provisions in extraordinary circumstances as mentioned above. Until such utilisation, these provisions can be netted off from gross NPAs to arrive at disclosure of net NPAs. Alternatively, they can be treated as part of Tier II capital within the overall ceiling of 1.25 % of total risk weighted assets.

Disclosures: Banks should make comprehensive disclosures on floating provisions in the "notes on accounts" to the balance sheet on (a) opening balance in the floating provisions account, (b) the quantum of floating provisions made in the accounting year, (c) purpose and

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amount of draw down made during the accounting year, and (d) closing balance in the floating provisions account.

Write-off of NPAs: Banks may write-off advances at Head Office level, even though the advances are still outstanding in the branch books. At the branch level, provision requirement as per classification norms shall be made and in respect of loss assets 100% provision shall be made. There can be partial write off relating to the borrower's account in head office.

Interest Suspense Account: As mentioned earlier, the guidelines prohibit recognition of income on non-performing assets until it is actually realised. In order to comply with guidelines while ensuring at the same time that legal remedies against defaulting borrowers are not adversely affected and that proper control is exercised over non-performing advances, many banks adopted the practice of recording interest on non-performing advances to a separate account which is usually styled as 'Interest Suspense Account'. The balance in this account represents interest on non-performing advances debited to the respective borrowers' accounts in accordance with the terms of the agreement but not recognised as income. For purposes of balance sheet presentation, the gross advances portfolio is arrived at after deducting the credit balance in Interest Suspense Account from the total advances as per the ledgers. When the advances are identified as NPAs and banks chooses not to further debit the borrower in the manner aforesaid, the interest on contractual basis is to be computed and recorded as unapplied interest in the memoranda records.

The amounts held in Interest Suspense Account should not be reckoned as part of provisions for the purpose of computing the provision for NPAs. Amounts lying in the Interest Suspense Account should be deducted from the advances concerned and provisions should be made on the balances remaining after such deduction.

Guidelines on Sale/Purchase of NPAs: The Reserve Bank of India, in May 2007, issued guidelines in respect of sale/ purchase of NPAs. These Guidelines are aimed at increasing the options available to banks for resolving their non-performing assets and to develop a healthy secondary market for non-performing assets, where securitisation companies and reconstruction companies are not involved, guidelines have been issued to banks on purchase / sale of Non-Performing Assets.

The guidelines require the Board of Directors of the banks to lay down policy in respect of the aspects relating to sale/ purchase of NPAs, including:

- (a) Non-performing financial assets that may be purchased/ sold;
- (b) Norms and procedure for purchase/ sale of such financial assets;
- (c) Valuation procedure to be followed to ensure that the economic value of financial assets is reasonably estimated based on the estimated cash flows arising out of repayments and recovery prospects;
- (d) Delegation of powers of various functionaries for taking decision on the purchase/ sale of the financial assets etc.; and
- (e) Accounting policy.

RBI also casts a responsibility on the Board to satisfy itself that the bank has adequate skills

to purchase non-performing financial assets and deal with them in an efficient manner which will result in value addition to the bank. The Board also needs to ensure that appropriate systems and procedures are in place to effectively address the risks that a purchasing bank would assume while engaging in this activity.

Any purchase/sale of non-performing financial assets should be conducted in accordance with the policy approved by the Board. It should also be ensured that once a case is filed before a Court/DRT/BIFR, any settlement arrived at with the borrower is subject to obtaining a consent decree from the Court/DRT/BIFR concerned.

Banks should, while selling NPAs, work out the net present value of the estimated cash flows associated with the realisable value of the available securities net of the cost of realisation. The sale price should generally not be lower than the net present value so arrived.

The estimated cash flows are normally expected to be realised within a period of three years and at least 10% of the estimated cash flows should be realised in the first year and at least 5% in each half year thereafter, subject to full recovery within three years.

A bank may purchase/sell non-performing financial assets from/to other banks only on 'without recourse' basis, i.e., the entire credit risk associated with the non-performing financial assets should be transferred to the purchasing bank. The selling bank should ensure that the effect of the sale of the financial assets should be that the asset is taken off its books and after the sale there should not be any known liability devolving on the selling bank.

Banks should ensure that subsequent to sale of the non-performing financial assets to other banks, they do not have any involvement with reference to assets sold and do not assume operational, legal or any other type of risks relating to the financial assets sold. Consequently, the specific financial asset should not enjoy the support of credit enhancements / liquidity facilities in any form or manner.

Each bank should make its own assessment of the value offered by the purchasing bank for the financial asset and decide whether to accept or reject the offer.

Under no circumstances can a sale to other banks be made at a contingent price whereby in the event of shortfall in the realisation by the purchasing banks, the selling banks would have to bear a part of the shortfall.

A non-performing asset in the books of a bank is eligible for sale to other banks only if it has remained a nonperforming asset for at least two years in the books of the selling bank.

Further, NPAs can be sold to other banks only on cash basis. The entire sale consideration should be received upfront and the asset can be taken out of the books of the selling bank only on receipt of the entire sale consideration.

A non-performing financial asset should be held by the purchasing bank in its books at least for a period of 15 months before it is sold to other banks. Banks should not sell such assets back to the bank, which had sold the NPFA.

Banks are also permitted to sell/buy homogeneous pool within retail non-performing financial assets, on a portfolio basis provided each of the non-performing financial assets of the pool has remained as non-performing financial asset for at least 2 years in the books of the selling bank.

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The pool of assets would be treated as a single asset in the books of the purchasing bank.

The selling bank should pursue the staff accountability aspects as per the existing instructions in respect of the non-performing assets sold to other banks.

Prudential norms for banks for the purchase/sale transactions issued by RBI, from time to time, should be adhered to.

Asset Classification Norms: The asset classification norms for sale/purchase of NPAs are as follows:

- (i) The non-performing financial asset purchased, may be classified as 'standard' in the books of the purchasing bank for a period of 90 days from the date of purchase. Thereafter, the asset classification status of the financial asset purchased, shall be determined by the record of recovery in the books of the purchasing bank with reference to cash flows estimated while purchasing the asset which should be in compliance with requirements as discussed in preceding paragraphs.
- (ii) The asset classification status of an existing exposure (other than purchased financial asset) to the same obligor in the books of the purchasing bank will continue to be governed by the record of recovery of that exposure and hence may be different.
- (iii) Where the purchase/sale does not satisfy any of the prudential requirements prescribed in these guidelines the asset classification status of the financial asset in the books of the purchasing bank at the time of purchase shall be the same as in the books of the selling bank. Thereafter, the asset classification status will continue to be determined with reference to the date of NPA in the selling bank.
- (iv) Any restructure/reschedule/rephrase of the repayment schedule or the estimated cash flow of the non-performing financial asset by the purchasing bank shall render the account as a non-performing asset.

Provisioning Norms

Books of Selling Bank: The provisioning norms for books of selling bank are as under:

- (i) When a bank sells its nonperforming financial assets to other banks, the same will be removed from its books on transfer.
- (ii) If the sale is at a price below the net book value (NBV) (i.e., book value less provisions held), the shortfall should be debited to the profit and loss account of that year.
- (iii) If the sale is for a value higher than the 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.

Books of Purchasing Bank: The provisioning norms for books of purchasing bank are as under:

The asset shall attract provisioning requirement appropriate to its asset classification status in the books of the purchasing bank.

Accounting of Recoveries: Any recovery in respect of a non-performing asset purchased from

other banks should first be adjusted against its acquisition cost. Recoveries in excess of the acquisition cost can be recognised as profit.

Capital Adequacy: For the purpose of capital adequacy, banks should assign 100% risk weights to the non-performing financial assets purchased from other banks. In case the nonperforming asset purchased is an investment, then it would attract capital charge for market risks also.

Exposure Norms: The purchasing bank will reckon exposure on the obligor of the specific financial asset. Hence these banks should ensure compliance with the prudential credit exposure ceilings (both single and group) after reckoning the exposures to the obligors arising on account of the purchase. For NBFCs the relevant instructions on exposure norms would be applicable.

Auditor's Report in Case of Bank Borrowers: The RBI vide its circular number DBOD.No. CAS(COD)BC.146/27-77 dated December 22, 1977 had prescribed that all borrowers having credit limit of ₹ 10 lakh and above from the banking system should get their annual accounts audited by chartered accountants. The RBI vide its circular DBOD.No.BP.BC. 33/21.04.018/2002-03 dated October 21, 2002 has authorised the Board of Directors of banks to fix a suitable cut off limit with reference to the borrowing entity's overall exposure on the banking system, over which audit of accounts of borrower by chartered accountants would be mandatory.

Audit Procedures - Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.

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

- a. Amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.
- b. Advances represent amount due to the bank.
- c. Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.
- d. There are no unrecorded advances.
- e. The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.
- f. The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
- g. Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

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

- ◆ examining the validity of the recorded amounts;

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- ◆ examining loan documentation;
- ◆ reviewing the operation of the accounts;
- ◆ examining the existence, enforceability and valuation of the security;
- ◆ checking compliance with RBI norms including appropriate classification and provisioning; and
- ◆ carrying out appropriate analytical procedures.

In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis. The accounts identified to be problem accounts however need to be examined in detail unless the amount involved is insignificant. The extent of sample checking would also depend on the auditor's assessment of efficacy of internal controls. What constitutes a 'large advance' would need to be determined in the context of volume of operations of the branch. As a general rule, however, an advance may be considered to be a large advance if the year-end balance is in excess of ₹ 2 crore or 5% of the aggregate year-end advances of the branch, whichever is less.

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

Evaluation of Internal Controls over Advances: The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, *inter alia*, the following:

- ◆ The bank should make an advance only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank. The sanction for an advance should specify, among other things, the limit of borrowing, nature of security, margin to be kept, interest, terms of repayment etc. It also needs to be ensured that the loans sanctioned are as per the Loan Policy of the bank and adhere to the regulatory (RBI) norms unless a specific exemption is taken in this regard.
- ◆ All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- ◆ The compliance with the terms of sanction and end use of funds should be ensured.
- ◆ Sufficient margin as specified in the sanction letter should be kept against securities taken so as to cover for any decline in the value thereof. The availability of sufficient margin needs to be ensured at regular intervals.
- ◆ If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and the effective control of such securities be retained as a part of documentation.
- ◆ All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.

- ◆ In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipt. The godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.
- ◆ Surprise checks should be made in respect of hypothecated goods not in the physical possession of the bank.
- ◆ As soon as any increase or decrease takes place in the securities or their value, proper entries should be made in the Drawing Power Book and Daily Balance Book. These entries should be checked by an officer.
- ◆ The accounts should be kept within both the drawing power and the sanctioned limit.
- ◆ All the accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the controlling authority regularly.
- ◆ The operation of each advance account should be reviewed at least once a year, and at more frequent intervals in the case of large advances.

Long Form Audit Report: The auditor has to comment on various specific issues as mentioned in the Long Form Audit Report of the bank. While evaluating the efficacy of internal controls over advances, the auditor should particularly examine those aspects on which he is required to comment in his long form audit report. Thus, he should examine, *inter alia*, whether the loan applications are complete and in prescribed form; procedural instructions regarding grant/ renewal/ enhancement of facilities have been complied with; sanctions are within delegated authority and disbursements are as per terms of the sanction; documentation is complete; and supervision is timely, effective and as per prescribed guidelines. The auditor can gather the requisite evidence by examining relevant documents (such as loan application forms, supporting documentation, sanctions, security documents, etc.) and by obtaining information and explanations from the branch management in appropriate cases. The auditors must familiarise themselves with those issues and guidance relating to the same and should cover the same during the regular course of audit of advances.

Examining the Validity of Recorded Amounts: The auditor should ascertain the status of balancing of subsidiary ledgers relating to advances. The total of balances in the subsidiary ledgers should agree with the control accounts in the General Ledger. The auditor should also tally the total of the statement of advances with the balances as per general ledger/ subsidiary ledgers. He should also cross-check the balances of the advances selected for examination as listed in the statement of advances with the balances in the relevant advance accounts in the subsidiary ledgers. Banks often obtain balance confirmation statements from borrowers periodically. Such statements have a dual advantage in preventing disputes by the customer and extending the period of limitation by reference to the date of confirmation. Wherever available, such confirmations may be seen.

These days most of the banks have their 'advances' statements generated through the system. The auditor should ensure that the fields which system copies from last year are the same and he should take extra care in relation with the date of NPA and date of becoming doubtful asset as these facts have great bearing on the provisioning. The auditor should obtain audit trail from the bank to verify whether there are any changes or not.

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Examination of Loan Documents: As indicated earlier, the documents relating to advances would be affected by the legal status of the borrower and the nature of security. Thus, where the borrower is a company, loan documents would include certificate of incorporation, memorandum and articles of association, certificate of commencement of business (in the case of public limited companies), resolution of board of directors, and resolution of shareholders [in cases covered by section 293(1)(d) of the Companies Act, 1956], etc. Where the borrower is a partnership firm, loan documents would include copy of partnership deed. Where the security is in the form of mortgage, apart from mortgage deed (in the case of English Mortgage) or letter of intent to create mortgage (in the case of Equitable Mortgage), the evidence of registration of the charge with the Registrar of Companies would also form part of loan documentation if the borrower is a company. Each bank has its own set of rules regarding the documents to be obtained from various types of borrowers and in respect of different kinds of securities. The formats of many of the documents are also prescribed. The auditor should evaluate the adequacy of the loan documents in the context of the rules framed by the bank in this regard.

Review of Operation of Account: The auditor should review the operation of the advance accounts. In doing so, an intelligent scrutiny of the operation of the account should be carried out to see that the limit is not generally exceeded; that the account is not becoming stagnant; that the customer is not drawing against deposits which are not free from lien; that the account is not window-dressed by running down overdrafts at the year end and again drawing further advances in the new year, etc.

The auditor should also examine whether there is a healthy turnover in the account. It should be seen that the frequency and the amounts of credits in the account are commensurate with the sanctioned limit and the nature and volume of business of the borrower. Any unusual items in the account should be carefully examined by the auditor. If the auditor's review indicates any unhealthy trends, the account should be further examined. The auditor's examination should also cover transactions in the post-balance sheet date period. Large transactions in major accounts particularly as at the year-end may be looked into, to identify any irregularities in these accounts. A written note/explanation may be obtained from the management as regards any major irregularities which may have a bearing on his report.

The auditor may also review the following to assess the recoverability of advances:

- (a) Periodic statements submitted by the borrowers indicating the extent of compliance with terms and conditions.
- (b) Latest financial statements of borrowers.
- (c) Reports on inspection of security.
- (d) Auditors' reports in the case of borrowers enjoying aggregate credit limits of ₹ 10 lakh or above for working capital from the banking system.

The auditor should satisfy himself that interest is being charged on all performing accounts regularly. He should compare the rate of interest with the agreement and the sanction and with the credit rating reports where the rate of interest is linked to credit rating. In case the interest rate is to be revised based on the changes in PLR / BPLR of the bank, it needs to be ensured

that the rate of interest to be charged from the borrower is suitably revised as and when there are changes in PLR/BPLR. Calculation of interest should be test-checked. The auditor should examine that interest not received on any account, which is a non-performing asset as per the guidelines of the RBI, has not been recognised as income. It may be noted that interest accrued but not due on advances does not form part of advances.

The penal interest in case of delayed submission of stock statements, non-creation of security overdrawn accounts etc., needs to be charged as per sanctioned terms and norms of the bank. The compliance of the same should be checked in detail by the auditors.

In the case of advances covered by guarantees of DICGC/ECGC/CGTS, in case of default the auditor should examine whether appropriate steps have been taken for lodging of claims for guarantees in accordance with the applicable procedure. The claims declined by DICGC/ECGC/CGTS should not be considered as recoverable while calculating the provisions against the respective advances.

In respect of consortium advances, the auditor should particularly examine–

- (a) compliance with the limits stipulated by the consortium in lending moneys to the borrower;
- (b) the bank's monitoring of securities like stocks, etc., which are in its custody/charge; and
- (c) follow-up with lead bank on pending issues.

Apart from the usual audit procedures applicable in respect of advances, the auditor should examine whether the bank has correctly classified the inter-bank participation certificates. In the case of participations on risk-sharing basis, the auditor should examine whether any loss has devolved on the bank as on the balance sheet date and, if so, whether adequate provision in respect of such loss has been made.

Verification of Security against Advances: From the view point of security, advances are to be classified in the balance sheet in the following manner:

- (a) Secured by tangible assets
- (b) Covered by bank/government guarantees
- (c) Unsecured

An advance should be treated as secured to the extent of the value of the security on the balance sheet date. If only a part of the advance is covered by the value of the security as at the date of the balance sheet, that part only should be classified as secured; the remaining amount should be classified as unsecured.

As mentioned earlier, the Reserve Bank has specified that advances against book debts may be included under the head 'secured by tangible assets'.

The following points are relevant for classifying the advances based on security.

- (a) Government guarantees include guarantees of Central/State Governments and also advances guaranteed by Central/State Government owned corporations and financial institutions like IDBI, IFCI, ICICI, State Financial Corporations, State Industrial

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Development Corporations, ECGC, DICGC, etc.

- (b) Advances covered by bank guarantees also include advances guaranteed against any negotiable instrument, the payment of which is guaranteed by a bank.
- (c) Advances covered by bank/government guarantees should be included in unsecured advances to the extent the outstanding in these advances exceed the amount of related guarantees.
- (d) While classifying the advances as secured, the primary security should be applied first and for the residual balance, if any, the value of collateral security should be taken into account. If the advance is still not fully covered, then, to the extent of bank/government guarantees available, the advance should be classified as 'covered by bank/government guarantee'. The balance, if any, remaining after the above classification, should be classified as 'unsecured'.
- (e) There may be situations where more than one facility is granted to a single borrower and a facility is secured, apart from primary and collateral securities relating specifically to that facility, by the residual value of primary security relating to any other credit facility (or facilities) granted to the borrower. In such a case, in the event of shortfall in the value of primary security in such a credit facility, the residual value of primary security of the other facility (or facilities, as the case may be) may be applied first to the shortfall and the value of collateral securities should be applied next.
- (f) In the case of common collateral security for advances granted to more than one borrower, if there is a shortfall in value of primary security in any one or more of the borrowal accounts, the value of collateral security may be applied proportionately to the shortfall in each borrowal account.
- (g) Loans/overdrafts against drafts/pay orders/bankers' cheques may be classified as covered by bank guarantees, as payments are guaranteed by banks.
- (h) Advances covered by ECGC/DICGC guarantees should be treated as covered by guarantees to the extent of guarantee cover available. The amount already received from DICGC/ECGC and kept in sundry creditors account pending adjustment should be deducted from advances.
- (i) An account which is fully secured but the margin in which is lower than that stipulated by the bank should nevertheless be treated as fully secured for the purposes of balance sheet presentation.
- (j) All documentary bills under delivery-against-payment terms (i.e., covered by RR/Airway Bill/Bill of lading) for which the documents are with the bank as on the balance sheet date should be classified as 'secured'.
- (k) Documentary bills under delivery-against-acceptance terms which remain unaccepted as at the close of 31st March (i.e., for which the documents of title are with the bank on this date) should be classified as secured. All accepted bills should be classified as 'unsecured' unless collaterally secured.
- (l) Cheques purchased including self-cheques (i.e., where the drawer and payee are one

and the same) should be treated as unsecured.

- (m) Advances against supply bills, unless collaterally secured, should be classified as unsecured even if they have been accepted by the drawees.

In examining whether an advance is secured and, if so, to what extent, the auditor is concerned with determining –

- (a) whether the security is legally enforceable, i.e., whether the necessary legal formalities regarding documentation, registration, etc., have been complied with;
- (b) whether the security is in the effective control of the bank; and
- (c) to what extent the value of the security, assessed realistically, covers the amount outstanding in the advance.

The auditor should examine the following aspects in respect of advances classified as 'secured':

- (a) Documents executed are complete and in force.
- (b) Where documents have not been renewed, the limitation period has not expired.
- (c) Evidence is available as to the market value of the security.
- (d) Evidence is available that –
 - (i) hypothecated/pledged goods are the property of the borrowers and are not old/obsolete or otherwise unsaleable;
 - ◆ advances against book debts of borrowers are related to their current debts and not old/doubtful debts; and
 - ◆ Stocks hypothecated/pledged are paid stocks owned by the borrower.
- (e) In the case of companies, the charge is appropriately registered with the Registrar of Companies and a certificate of registration of charge or other evidence of registration is held.
- (f) Borrowers are regular in furnishing the requisite information regarding the value of security lodged with the bank.
- (g) In respect of the second charge being available in respect of certain assets, the amount of the lender(s) enjoying the first charge on such asset be worked out and only the residuary value, if any, available for second charge holders, be considered.

The following paragraphs deal with the different types of securities against advances generally accepted by banks and the manner in which the auditor should verify them.

Stock Exchange Securities and Other Securities: The auditor should verify stock exchange securities and their market value in the same manner as in the case of investments. The auditor should examine whether the securities have been registered or assigned in favour of the bank, wherever required. If the securities have been lodged for registration/assignment and the amounts involved are material, the auditor should insist on production of evidence of lodgement, e.g., certificates/ acknowledgements from the companies concerned.

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As already discussed, advances by a banking company against its own shares are prohibited under section 20 of the Banking Regulation Act, 1949. A contravention of this provision may warrant a qualification in the auditor's report.

In addition to any directions of the RBI under section 21 of the Banking Regulation Act, 1949 banks generally have their own lists of approved and unapproved securities.³ Advances are generally made against approved securities only. Unapproved securities should be accepted only with a special sanction of the appropriate authority. Advances made against unapproved securities are, nevertheless, to be classified as secured advances in the same manner as those against approved securities.

It sometimes happens that a quoted security may not have frequent transactions on the stock exchange and the quotation included in the official quotations may be that of a very old transaction. In such a case, the auditor should satisfy himself as to the market value by scrutiny of balance sheet, etc., of the company concerned, particularly if the amount of advance made against such security is large.

Banks do not generally make advances against partly paid securities. If, however, any such shares are accepted by the bank as security and these are registered in the name of the bank, the auditor should examine whether the issuing company has called up any amount on such securities and, if so, whether the amount has been paid in time by the borrower/bank.

Goods: In respect of hypothecated goods, the auditor should check the quantity and value of goods hypothecated with reference to the statement received from the borrower. He should also examine the reasonableness of valuation. Letter of hypothecation should also be examined by the auditor. If the value of the goods is higher than the amount mentioned in the letter of hypothecation, the bank's security is only to the extent of the latter.

In respect of goods pledged with the bank, the auditor should check the statement received from the borrower regarding the quantity and value of goods pledged by him. He should test check the godown registers and the valuation of the goods. If there is any outstanding delivery order against the goods as on the balance sheet date, the same should be deducted from the total quantity in hand in ascertaining the value of the goods constituting the security. The auditor may also examine the key movement register to verify the movement of goods inwards and/or outwards.

Sometimes, goods are in the possession of third parties, such as clearing and forwarding agents, transporters, brokers, warehouse-keepers, etc. If these parties have given an undertaking to the bank that they will hand over the goods or sale proceeds thereof to the bank only, i.e., they have 'attorned' to the bank the advances made against such goods should be considered as secured. In such cases, certificates should be obtained by the bank from such third parties regarding quantities on hand on balance sheet date. The valuation of such goods should be checked by the auditor.

In case the borrower is a company, the auditor should examine the certificate of registration of

³ It may be mentioned that the expression 'approved securities' here refer to those securities which can be accepted as security for an advance generally, i.e. having to undergo special sanction procedures. The use of this term in the present context should be distinguished from its definition in section 5(a) of the Banking Regulation Act.

charge on the goods hypothecated with the Registrar of Companies. It may be mentioned that in case of pledge of goods, registration of charge is not necessary.

Gold Ornaments and Bullion: The auditor should inspect and weigh (on a test basis) the ornaments on the closing date. He should also see the assayer's certificate regarding the net gold content of the ornaments and their valuation. Valuation should also be checked with reference to the current market price of gold.

In respect of gold and silver bars, the auditor should inspect the bars on a test basis and see that the mint seals are intact. The weights mentioned on the bars may generally be accepted as correct.

Life Insurance Policies: The auditor should inspect the policies and see whether they are assigned to the bank and whether such assignment has been registered with the insurer. The auditor should also examine whether premium has been paid on the policies and whether they are in force. Certificate regarding surrender value obtained from the insurer should be examined. The auditor should particularly see that if such surrender value is subject to payment of certain *premia*, the amount of such *premia* has been deducted from the surrender value.

Bank's Own Deposit Certificates: The auditor should inspect such certificates and examine whether they have been properly discharged and whether the lien of the bank is noted on the face of the certificates as well as in the relevant register of the bank.

Hire-purchase Documents: These advances may be classified as secured against the hypothecation of goods. Where there is no hypothecation, the advance will be classified as unsecured.

Plantations: These advances are classified as secured against the crop and/or the fixed assets of the plantation. The auditor should examine the agreement and the title deeds. Regarding the estimate of the crop, he may examine the record of the garden for the last few years. He should also ascertain whether the crop is properly insured against natural calamities and other disasters such as hail, etc.

Auditor should keep in mind that where moratorium is available for payment of interest in such plantation projects, the payment of interests becomes due only after the moratorium or gestation period is over and in such a case the account will become NPA in case interest is not recovered after the due date of such interest.

Immovable Property: The auditor should inspect the title deed, the solicitor's opinion taken by the bank in respect thereof, and the mortgage deed. For valuation, he may rely upon the architect's or valuer's report (which should be taken at least once in three years) after carrying out appropriate audit procedures to satisfy himself about the adequacy of the work of the architect/valuer for his purpose.⁴ He should also examine the insurance policies.

In some cases, banks make advances against immovable properties where the title deeds are not in the name of the borrower. For example, an advance may be given against the security of a flat in a co-operative group housing society, the title deeds of which may not be in the name of the borrower. In such cases, the auditor should examine the evidence regarding the

⁴ Reference may be made in this regard to Standards on Auditing (SA) 620, "Using the Work of an Expert".

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right or interest of the borrower in the property mortgaged, e.g., power of attorney, share certificate of co-operative group housing society, 'no objection certificate' from the society/lessor (in the case of leasehold properties) for offering the property as security, etc.

Reliance on / review of other reports: The auditor should take into account the adverse comments, if any, on advances appearing in the following:

- ◆ Previous audit reports.
- ◆ Latest internal inspection reports of bank officials.
- ◆ Reserve Bank's latest inspection report.
- ◆ Concurrent / Internal audit report.
- ◆ Report on verification of security.
- ◆ Any other internal reports specially related to particular accounts.
- ◆ Manager's charge-handing-over report when incumbent is changed.

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

Third Party Guarantees: The auditor should examine the guarantee bonds and the demand promissory notes in order to verify the third party liability. He should satisfy himself that the guarantee is in force as at the date of the balance sheet. In the absence of a provision to the contrary, a guarantee terminates by revocation or upon death of the surety. The surety is also discharged (unless there is a specific covenant to the contrary) if the creditor arranges with the principal debtor for composition, or agrees to give time or agrees not to sue him, without consulting the surety. If any variation is made in the terms of the contract between the principal debtor and the creditor without the surety's consent, it discharges the surety as to transactions subsequent to the variation. The guarantee forms used by banks normally seek to ensure the continuing obligation of the guarantor in spite of these contingencies.

Verification of Bills Purchased and Discounted: The auditor should familiarise himself with the guidelines issued by the RBI and the policies framed by the bank itself regarding the discounting and rediscounting of bills. The auditor should ascertain that the policy framed by the bank conforms to the requirements laid down by the RBI.

Bills purchased and discounted have to be shown separately in the balance sheet as a part of 'advances'. Further, under the head 'advances outside India' in the balance sheet, bills purchased and discounted outside India have to be shown separately. This category will include bills covering export of goods, bills discounted by foreign branches of the bank and payable in their respective countries, etc.

Banks purchase or discount bills of exchange drawn or endorsed by their customers. The bank credits the amount of the bill to its customer after deducting the discount. The total amount of such bills is shown as an asset in the balance sheet.

In certain eligible cases, the bills purchased or discounted by the bank may be rediscounted by it with the RBI IDBI/SIDBI. Such bills would not be included under advance but would constitute a contingent liability.

Bills purchased and discounted by the bank are generally drawn on outstation parties and are, therefore, sent by the bank to its branches or agents for collection immediately after their receipt. They are generally not in the possession of the bank on the closing date. The auditor therefore has to rely upon the Register of Bills Purchased and Discounted and the party-wise Register of Bills maintained by the bank. The auditor should examine these registers and satisfy himself that:

- (a) all the outstanding bills have been taken in the balance sheet;
- (b) all the details, including the nature of the bills and documents, are mentioned in the register and that the bills have been correctly classified;
- (c) the bills purchased or discounted from different parties are in accordance with the agreements with them and the total of outstanding bills of each party is not in excess of the sanctioned limit; and
- (d) the bills are not overdue. If there are any overdue bills, the auditors should ascertain the reasons for the delay and the action taken by the bank.

The auditor should examine whether registers of bills purchased and discounted are properly maintained and the transactions are recorded therein correctly. He should examine whether the bills and the documents accompanying the bills are properly endorsed and assigned in favour of the bank. In checking the bills, it should be ensured that the bills are held along with the documents of title. In the case of documentary bills, it should be ensured that the related RRs/TRs are held along with the invoices/ hundies / bills and that these have not been parted with. Wherever such RRs/TRs are not held on record, the fact should be duly considered by the auditor. The auditor should also examine bills collected subsequent to the year-end to obtain assurance regarding completeness and validity of the recorded bill amounts.

Other Aspects: Sometimes, a customer is sanctioned a cash credit limit at one branch but is authorised to utilise such overall limit at a number of other branches also, for each of which a sub-limit is fixed. In such a case, the determination of status of the account as NPA or otherwise should be determined at the limit-sanctioning branch with reference to the overall sanctioned limit/drawing power, and not by each of the other branches where a sub-limit has been fixed. The auditor should examine that any advances made by a banking company otherwise than in the course of banking business, such as, prepaid expenses, advance for purchase of assets, etc., is not included under the head 'advances' but is included under 'other assets'.

The amounts of advances in India and those outside India are to be shown separately in the balance sheet. The auditor should examine whether any loan has been granted in violation of the statutory limitations contained in section 20 of the Banking Regulations Act, 1949. If any such loan has been granted the report will have to be drafted with suitable qualifications, as the transaction would be *ultra vires*.

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It may also be examined whether the bank has a system of ensuring the end use of the funds granted as compared with the purpose of sanction. The reports submitted by the inspectors/officers in this regard should be reviewed to form opinion on the quality of the asset and also to consider reporting any matter in the LFAR.

Adverse features in a borrower's account are required to be reported in LFAR and hence during the course of verification all material information should be noted and documented in appropriate format. Following is an illustrative but not an exhaustive format:

1. Name of the Borrower.
2. Constitution.
3. Sanctioned limits as on Balance Sheet date.
4. Any change in limit during the year.
5. Terms of sanction.
6. Details of fulfilment of terms of sanction.
7. Details of Loan documents and observations on the same.
8. Balance outstanding as at balance sheet date.
9. Classification as per bank.
10. Whether classification requires a change.
11. If so the reasons for the differing view and the impact of the same.
12. Whether necessary changes made in Memorandum of Changes.
13. Observations on the conduct of the account.
14. Deficiencies noted in the account.
15. Availability of security.
16. Timely submission of stock statement and other statements.

Verification of Provision for Non-performing assets: An important aspect of audit of advances relates to their classification and provisioning. This implies that a proper provision should be made in respect of advances where the recovery is doubtful. As mentioned earlier, the Reserve Bank has prescribed objective norms for determining the quantum of provisions required in respect of advances. The auditors must take / download the latest Master Circular of RBI to familiarise himself fully with the norms prescribed by RBI in this regard. The circulars issued by RBI after the date of issue of Master Circular and till the date of audit should also be taken / downloaded and reviewed by the auditors for its adherence. However, these norms should be construed as laying down the minimum provisioning requirements and wherever a higher provision is warranted in the context of the threats to recovery, such higher provision should be made. In this regard, the provisions of section 15 of the Banking Regulation Act, 1949 may be noted. This section, which applies to banking companies, nationalised banks, State Bank of India, its subsidiaries, and regional rural banks, requires the bank concerned to make adequate provision for bad debts to the satisfaction of its auditor before paying any dividends on its shares.

The accounting entry for provision in respect of debts that are doubtful of recovery is usually made at the head office level and is not recorded in the books at the branch level. The amount

of provision to be made at the head office level is based largely on the classification of various advances into standard, sub-standard, doubtful and loss categories. The auditor should carefully examine whether the classification made by the branch is appropriate. In doing so, he should particularly examine the classification of advances where there are threats to recovery. The auditor should also examine whether the secured and the unsecured portions of advances have been segregated correctly and provisions have been calculated properly.

As per the Reserve Bank guidelines, if an 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. Where, subsequent to repayment by the borrower (which makes the account regular), the branch has provided further funds to the borrower (including by way of subscription to its debentures or in other accounts of the borrower), the auditor should carefully assess whether the repayment was out of genuine sources or not. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA. In other genuine cases, the banks must furnish satisfactory evidence to the Statutory Auditors about the manner of regularisation of the account to eliminate doubts on their performing status.

It is to be ensured that the classification is made as per the position as on date and hence classification of all standard accounts be reviewed as on balance sheet date. The date of NPA is of significant importance to determine the classification and hence specific care be taken in this regard.

Drawing Power Calculation: Working capital borrowal account, drawing power calculated from stock statement older than 3 months has to be considered as "irregular" (overdue). If such "irregular" account continues for 90 days, account has to be classified as NPA, even though the account is otherwise operated regularly.

The stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinised in detail.

The audited Annual Report submitted by the borrower should be scrutinised properly. The monthly stock statement of the month for which the audited accounts are prepared and submitted should be compared and the reasons for deviations, if any, should be ascertained.

It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

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

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The drawing power needs to be calculated carefully in case of working capital advances to companies engaged in construction business. The valuation of work in progress should be ensured in consistent and proper manner. It also needs to be ensured that mobilization advance being received by the contractors is reduced while calculating drawing power.

Limits not reviewed: Accounts where regular/*ad hoc* limits are not reviewed within 180 days from the due date/date of adhoc sanction, have to be considered as NPA. Auditors should also ensure that the *ad hoc* short reviews are not done on repetitive basis. In such cases, auditor can consider the classification of account based on other parameters and functioning of the account.

Erosion of Security: In case of accounts where erosion of security has taken place or fraud has been committed by borrower, the same should be straightaway classified as doubtful or loss without waiting for the period as per IRAC norms; specifically –

- (a) where value of security has eroded by more than 50%, account should be classified as 'doubtful'; and
- (b) where realisable value of security is less than 10% of the outstanding amount, account should be classified as 'loss'.

In these cases, the unsecured portion of loan should be provided fully and on the secured portion, the same should be provided as per the classification given to the account.

For this purpose, even the standard accounts should be reviewed to check if there is any major erosion in the value of security provided by the borrower. The reports submitted by the branches to their controlling authorities and RBI should be checked to verify if any account has been reported as fraud case.

Government Guaranteed Advances: If government guaranteed advance becomes NPA, then for the purpose of income recognition, interest on such advance should not to be taken to income unless interest is realised. However, for purpose of asset classification, credit facility backed by Central Government Guarantee, though overdue, can be treated as NPA only when the Central Government 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 w.e.f. year ended 31st March, 2006.

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: A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons. A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season. For the purpose of these guidelines, "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. Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made

applicable to agricultural term loans availed of by him. The above norms should be made applicable to all direct agricultural advances listed in Master Circular on lending to priority sector, RPCD. No.Plan.BC.9 /04.09.01/ 2008-2009 dated July 1, 2008. In respect of agricultural loans, other than those specified in the circular, identification of NPAs would be done on the same basis as non-agricultural advances, which, at present, is the 90 days delinquency norm.

Special concessions have been given to -

- (i) Relief measures in drought affected areas for kharif crops during the financial year 2002-03
- (ii) Agricultural loans granted upto 31st March, 2004 in districts declared as 'calamity affected'.
- (iii) Where natural calamities impair the repaying capacity of agricultural borrowers, banks may decide on their own as a relief measure conversion of the short-term production loan into a term loan or re-schedulement of the repayment period; and the sanctioning of fresh short-term loan, subject to guidelines contained in RBI circular RPCD. No.PLFS.BC.6/ 05.04.02/ 2004- 05 dated July 1, 2005. In such cases of conversion or re-schedulement, the term loan as well as fresh short-term loan may be treated as current dues and need not be classified as NPA. The asset classification of these loans would thereafter be governed by the revised terms & conditions and would be treated as NPA if interest and/or instalment of principal remains overdue for two crop seasons for short duration crops and for one crop season for long duration crops.

Agricultural Debt Waiver and Debt Relief Scheme, 2008: The guidelines pertaining to Income Recognition, Asset Classification and Provisioning, and Capital Adequacy as applicable to the loans covered by the captioned scheme, are furnished below.

Prudential Norms for the Borrowal Accounts Covered under the Agricultural Debt Waiver and Debt Relief Scheme, 2008 (ADWDRS): As advised vide the circular RPCD.No.PLFS.BC.72/05.04.02/2007-08 dated May 23, 2008, while the entire 'eligible amount' shall be waived in the case of a small or marginal farmer, in the case of 'other farmers', there will be a one time settlement scheme (OTS) under which the farmer will be given a rebate of 25 per cent of the 'eligible amount' subject to the condition that the farmer repays the balance of 75 per cent of the 'eligible amount'.

Norms for the Accounts subjected to Debt Waiver: As regards the small and marginal farmers eligible for debt waiver, the amount eligible for waiver, as defined in the Para 4 of the enclosure to the aforesaid circular, pending receipt from the Government of India, may be transferred by the banks to a separate account named "Amount receivable from Government of India under Agricultural Debt Waiver Scheme 2008". The balance in this account should be reflected in Schedule 9 (Advances) of the Balance sheet.

The balance in this account may be treated by the banks as a "performing" asset, provided adequate provision is made for the loss in Present Value (PV) terms, computed under the assumption that such payments would be received from Government of India in the following installments :

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- a) 32% of the total amount due by September 30, 2008,
- b) 19% by July 31, 2009,
- c) 39% by July 2010, and
- d) the remaining 10% by July 2011.

However, the provision required under the current norms for standard assets, need not be provided for in respect of the balance in this account.

The discount rate for arriving at the loss in PV terms should be taken as 9.56 per cent, being the yield to maturity on 364-day Government of India Treasury Bill, prevailing as on July 30, 2008.

The prudential provisions held in respect of the NPA accounts for which the debt waiver has been granted may be reckoned for meeting the provisions required on PV basis.

In case, however, the amount of prudential provision held is more than the amount of provision required on PV basis, such excess provision may be reversed in a phased manner. This phased reversal may be effected in the proportion of 32%, 19%, 39%, and 10% during the years ended March 2009, 2010, 2011 and 2012, respectively, only after the installments due from the Government, for the relative years, have been received.

On receipt of the final instalment from the Government, the provision made for loss in PV terms may be transferred to the General Reserves, below the line.

In case the claim of a farmer is specifically rejected at any stage, the asset classification of the account should be determined with reference to the original date of NPA (as if the account had not been treated as performing in the interregnum based on the transfer of the loan balance to the aforesaid account) and suitable provision should be made. The provision made on PV basis may also be reckoned against the NPA-provisions required, consequent upon the account being treated as NPA due to the rejection of the claim.

Norms for the Accounts subjected to the Debt Relief: Under the scheme, in the case of 'other' farmers, the farmer will be given a rebate of 25% of the "eligible amount", by the Government by credit to his account, provided the farmer pays the balance of 75% of the 'eligible amount'. The Scheme provides for payment of share of 75% by such farmers in three instalments and the first two instalments shall be for an amount not less than one-third of the farmer's share. The last dates of payment of the three instalments will be September 30, 2008; March 31, 2009 and June 30, 2009, respectively.

Asset Classification: Where the farmers covered under the Debt Relief Scheme have given the undertaking, agreeing to pay their share under the OTS, their relevant accounts may be treated by banks as "standard" / "performing" provided :

- (a) adequate provision is made by the banks for the loss in PV terms for all the receivables due from the borrowers as well as the Government; and
- (b) such farmers pay their share of the settlement within one month of the due dates

However, no grace period is allowed for the last instalment and the entire share of the farmer is payable by June 30, 2009 (cf Para 21.2)

Provisioning

Provisioning for Standard Assets: The accounts subject to debt relief would stand classified as standard assets after receipt of the aforesaid undertaking from the borrowers. Accordingly, such accounts would also attract the prudential provisioning as applicable to standard assets.

Provisioning on PV Basis: For computing the amount of loss in PV terms under the Scheme, the cash flows receivable from the farmers, as per the repayment schedule as well as from the government should be discounted to the present value. It may be assumed in this context that the Government's contribution would be received by June 30, 2010. The discount rate to be applied for the purpose should be the interest rate at which the loan was granted including the element of interest subsidy, if any, available from the Government.

The prudential provisions held in respect of the NPA accounts, for which the debt relief has been granted, may be reckoned for meeting the provisions required on PV basis as well as for the standard assets (pursuant to classification of these loans as standard) and shortfall, if any, may be provided for. Thus, the total provisions held would comprise the provisions required on PV basis, provision for standard assets and excess prudential provisions, if any, towards NPA.

Provisioning in case of down-gradation of accounts: As mentioned above, the accounts subject to Debt Relief Scheme would be classified as standard / performing assets only if the farmers pay their share of the settlement within one month of the pre-specified due dates. In case, however, the payments are delayed by the farmers beyond one month of the respective due dates, the outstanding amount in the relevant accounts of such farmers shall be treated as NPA. The asset classification of such accounts shall be determined with reference to the original date of NPA, (as if the account had not been treated as performing in the interregnum based on the aforesaid undertaking). On such down-gradation of the accounts, additional provisions as per the extant prudential norms should also be made.

For meeting this additional provisioning requirement, the excess prudential provisions, if any, held; the amount of provisions held for standard assets together with the provision made on PV basis, all in respect of such downgraded account, could be reckoned. Such additional prudential provisions too should be continued to be held and reversed only as per the stipulation at para mentioned below.

Reversal of Excess Prudential Provisions: In case the amount of the prudential NPA provisions held are larger than the aggregate of the provision required on PV basis and for the standard assets (pursuant to classification of these loans as standard), such excess prudential provision should not be reversed but be continued to be held till the earlier of the two events, viz., :

- (a) till the entire outstanding of the borrower stands repaid - at which point, the entire amount could be reversed to the P/L account; or
- (b) when the amount of such excess provision exceeds the amount outstanding on account of the repayments by the borrower - at which point, the amount of provision in excess of the outstanding amount could be reversed to the P/L account.

Reversal of the Provisions made on PV Basis: The provision made on PV basis represents a permanent loss to the bank on account of delayed receipt of cash flows and hence, should not be reversed to the P/L Account. The amount of such provision should, therefore, be carried till the account is finally settled and after receipt of the Government's contribution under the Scheme, the amount should be reversed to the General Reserves, below the line.

Grant of Fresh Loans to the Borrowers covered under the ADWDRS: A small or marginal farmer will become eligible for fresh agricultural loans upon the eligible amount being waived, in terms of para 7.2 of the enclosure to the circular RPCD.No.PLFS.BC.72/05.04.02/2007-08 dated May 23, 2008. The fresh loan may be treated as "performing asset", regardless of the asset classification of the loan subjected to the Debt Waiver, and its subsequent asset classification should be governed by the extant IRAC norms.

In case of "other farmers" eligible for fresh short-term production loans and investment loans, as provided for in Para 7.6 and 7.7, respectively, of the enclosure to the circular RPCD.No.PLFS.BC.72/05.04.02/2007-08 dated May 23, 2008, these fresh loans may be treated as "performing assets", regardless of the asset classification of the loan subjected to the Debt Relief, and its subsequent asset classification should be governed by the extant IRAC norms.

Capital Adequacy: The amount outstanding in the account styled as "Amount receivable from Government of India under Agricultural Debt Waiver Scheme 2008" shall be treated as a claim on the Government of India and would attract zero risk weight for the purpose of capital adequacy norms. However, the amount outstanding in the accounts covered by the Debt Relief Scheme shall be treated as a claim on the borrowers and risk weighted as per the extant norms. This treatment would apply under the Basel I as well as Basel II Frameworks.

Subsequent Modifications to the Prudential Norms

Interest payment by the GOI: The Government of India has subsequently decided to pay interest on the 2nd, 3rd, and 4th instalments, payable by July 2009, July 2010, and July 2011 respectively, at the prevailing Yield to Maturity Rate on 364-day Government of India Treasury Bills. The interest will be paid on these instalments from the date of the reimbursement of the first instalment (i.e. November 2008) till the date of the actual reimbursement of each instalment.

In view of the above, in supersession of the instructions contained in paragraphs mentioned above, it has been decided that the banks need not make any provisions for the loss in Present Value (PV) terms for moneys receivable only from the Government of India, for the accounts covered under the Debt Waiver Scheme and the Debt Relief Scheme.

Change in instalment schedule of "other farmers" under the Debt Relief Scheme: In view of the recent drought in some States and the severe floods in some other parts of the country, the Government of India, as announced in the Union Budget 2010-11, has now decided to extend the last date of payment of 75% of overdue portion by the 'other farmer' under Debt Relief Scheme (under ADWDR) up to June 30, 2010. The eligible "other farmers" may be allowed to repay this amount in one or more instalments up to June 30, 2010. The banks will not charge any interest on the eligible amount for the period from February 29, 2008 to June 30, 2009. However, they may charge normal rate of interest on the eligible amount from July

01, 2009 up to the date of settlement. Further, no interest shall be paid by the Government of India to the lending institutions for this extension under the Scheme while reimbursing the 25% amount to the lending institutions as per the delayed reimbursement schedule

The Government of India has also advised that the banks / lending institutions are allowed to receive even less than 75% of the eligible amount under OTS provided the banks / lending institutions bear the difference themselves and do not claim the same either from the Government or from the farmer. The Government will pay only 25% of the actual eligible amount under debt relief.

In case, however, the payments are delayed by the farmers beyond June 30, 2010, the outstanding amount in the relevant accounts of such farmers shall be treated as NPA. The asset classification of such accounts shall be determined with reference to the original date of NPA, (as if the account had not been treated as performing in the interregnum based on the aforesaid undertaking). On such down-gradation of the accounts, additional provisions as per the extant prudential norms should also be made.

It is provided that in case of small and marginal farmers eligible for debt waiver, the amount eligible for waiver, pending receipt from the Government of India may be transferred by the banks to a separate account named "Amount receivable from Government of India under Agricultural Debt Waiver Scheme 2008", and the balance in this account should be reflected in Schedule 9 (Advances) of the Balance Sheet. It is now clarified that in case of 'other farmers' eligible for debt relief, after the 'other farmer' has paid his entire share of 75%, banks may open an account for Debt Relief Scheme, similar to the one opened for the receivables from GOI under the Debt Waiver Scheme, and bearing the nomenclature "Amount receivable from Government of India under Agricultural Debt Relief Scheme 2008". This amount may also be reflected in Schedule 9 (Advances) of the Balance Sheet.

Provisioning Towards Standard Assets: The auditor should check the latest RBI Circulars in this regard. The provisions need to be checked in detail with the statement of advances. The provisions bifurcation of standard advances under relevant category for proper calculation of provision should be checked and certified at branches level. The definition of respective items specified should be adhered as defined by RBI.

Retail Assets: There may be a large number of accounts under retail assets, which have been restructured/rescheduled during respective years including repetitive rephasements. The process of the bank to report / record all such reschedulement/ restructuring needs to be reviewed and adequacy of the same should be checked. In case of restructuring of consumer and personal advances, the same should immediately be treated as sub standard. The accounts are treated as restructured when the bank, for economic or legal reasons relating to borrower's financial difficulty, grants to the borrower concessions that the bank would otherwise not consider. The HO of the bank should instruct properly to branches in this regard.

In case of housing loans, if the restructuring of the account is approved, then the classification of the account can be restored to the position which existed when the restructuring application was received by the bank provided:

- ◆ the cases are restructured within 90 days of the receipt of application,

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- ◆ the dues to the bank are fully secured from tangible assets,
- ◆ the repayment period is within the limits fixed by the Board of Directors of the bank in this regard, and
- ◆ the restructuring is for the first time only.

Restructuring of cases: RBI has given revised guidelines for treatment of restructured accounts by its circular dated August 27, 2008. The provisions of this Circular has been discussed earlier in the Chapter. The auditor should verify compliance with the requirements of the said circular.

Funding of Interest: In addition, the auditor should also consider the fact that during the course of restructuring/rescheduling in any manner, the interest element, in addition to the principal may also be rescheduled by the bank. This rescheduling of interest may be with or without sacrifice. In some cases future interest may also be funded apart from the principal. In such cases, the auditor should examine whether the RBI's requirements with regard to provisioning for sacrifice have been complied with by the bank. In case of interest sacrifice, the model prescribed by RBI includes calculation and provisioning for sacrifice on future interest as well. The auditor should examine the terms of funding of interest and if the same is in the nature of moratorium for payment of interest, then the interest would become due only after the moratorium period is over. The funded interest cannot be recognised as income if the account is treated as NPA.

Sacrifice of interest: In respect of sacrifice of interest, the auditor should examine whether:

- (a) Interest sacrifice involved in the amount of interest has been written off or provided for by debit to Profit & Loss account and held in a distinct account.
- (b) Sacrifice is recomputed on each balance sheet date till satisfactory completion of all repayment obligations and full repayment of the outstanding in the account, so as to capture the changes in the fair value on account of changes in BPLR, term premium and the credit category of the borrower and the consequent shortfall in provision or reversal of the amount of excess provision has been held in the distinct account.
- (c) In the event any security is taken against interest sacrifice, the same has been valued at ₹ 1/- till maturity of the security.
 - As per RBI norms, the interest sacrifice in all the restructured cases needs to be worked out including for Working Capital Loans. In the case of working capital facilities, the diminution in the fair value of the cash credit /overdraft component may be computed reckoning the higher of the outstanding amount or the limit sanctioned as the principal amount and taking the tenor of the advance as one year. The term premium in the discount factor would be as applicable for one year. The fair value of the term loan components (Working Capital Term Loan and Funded Interest Term Loan) would be computed as per actual cash flows and taking the term premium in the discount factor as applicable for the maturity of the respective term loan components. The process of identifying such interest sacrifice in case of working capital loans needs to be looked upon in detail.

Upgradation of Account: The auditor should examine all the accounts upgraded during the year to ensure that the upgrading of each account is strictly in terms of RBI guidelines.

Auditor has to ensure that any upgrading of accounts classified as 'Sub-Standard' or 'Doubtful' category wherein restructuring / rephasing of principal or interest has taken place should be upgraded to the 'Standard Asset' category only after a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms, subject to satisfactory performance during the period. The total amount becoming due during this period of one year should be recovered and there should be no overdues to make it eligible for upgradation. If the amount which has become due during this one year period is on a lower side vis a vis total amount outstanding, the other aspects of the account, viz financial performance, availability of security, operations in account, etc., should be reviewed in detail and only if found satisfactory, the account should be upgraded.

Rescheduling of recovery cannot give the advance a better classification than the previous one. NPA accounts can be upgraded to Performing Accounts, provided all overdue are adjusted or atleast reduced to a period of less than 90 days.

Upgradation within the NPA category is not permitted i.e. a Doubtful account cannot be made Sub-standard even if the overdue are reduced to less than 12 months.

Other Aspects: Separate norms for classification have been prescribed for accounts covered under schemes for 'Restructuring / Rescheduling of Loans', 'Corporate Debt Restructuring (CDR)' or 'Small & Medium Enterprises (SME)'. The auditors should go through the same to see whether these have been properly applied by the bank.

Projects under implementation have also been brought under the NPA norms, with a separate set of guidelines for classification. In cases of substantial time overrun in the projects under implementation, the asset classification, income recognition and provisioning should be done as per RBI master circular in this regard.

For all accounts classified as 'Doubtful', it is essential to determine a)- the existence of primary and collateral securities properly charged to the Bank, b) – its present value through approved valuer (once in 3 years) and c) - inspection (periodical). In case of NPAs with balance of ₹ 5 crores and above, stock audit at annual interval by external agency is mandatory.

Suit filed accounts should generally be classified as doubtful, unless there is a strong justification to show it is Sub-standard.

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

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Till the time the account is identified as NPA, income is recognised irrespective of whether realised or not. Where an account is identified as NPA during the year, unrealised income should not be recognised for the year. Also, interest accrued and credited to income account in the previous year should be reversed or provided for if the same is not realised.

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

The list of borrowers' accounts, where classification made as at the end of the previous year has been changed to a better classification or where there is reversal of provisions, should be taken from the branch officials alongwith the reasons for the same. These cases would need to be reviewed in detail to ensure correctness.

The bank is supposed to take details of net worth of Borrowers/ Guarantors at the time of original loan proposal and review / renewal of the same. For example, in case of Flat/ building, the detailed address, area of building / Flat should be noted, and in case of LIC policies, the number of LIC Policy could be taken. Similarly, in case of NSCs / KVPs / other investments, the distinctive nos. of such instruments, maturity date and details of issuing authority should be taken. The auditors should review the same.

The valuation of assets is important from the aspect of finding out the realisable value of assets and especially in case of NPA cases. Auditors should review the method used by the bank/valuers while valuing the assets. The valuation method used should reflect the realisable value of the assets rather than replacement cost. Further, the resolution cost / time cost for realising such assets should also be deducted while working out the net realizable value of the assets. In case of depreciable assets whose valuation was not carried out in the current financial year, adequate provision for depreciation needs to be made for the period from the date of valuation to the reporting date. The old stock and debtors should also not be considered for valuation purposes. Generally, the debtors outstanding beyond six months are not considered for valuation purposes.

The bank needs to closely monitor borrowal accounts, both as regards the funded and non-funded facilities. This is imperative in borderline cases where slippages due to persistent irregularities and deficiencies are observed, and in any case where the borrower is required to be classified as NPA. The off-balance sheet items / non-funded facilities are also to be recognised as credit facilities and involve risk of loss, which, on fructification, is recorded / provided in the same manner as the loss arising out of funded exposures. The same needs to be scrutinized in detail to verify if any amount is expected to be crystallised against the same. In case of expected liabilities, provisions against the same should be made as per AS-29 on Contingent Liabilities.

Any receivable representing positive mark-to-market value of a derivative contract, if overdue for a period of 90 days or more, is required to be treated as non-performing asset.

The bank is not supposed to account unrealised interest in NPA Accounts in the books of accounts. The unrealised interest in NPA accounts is generally termed as unapplied interest.

The detail of unapplied interest is supposed to be maintained in Memorandum record. Though it is not to be recognised as income, it is of paramount importance that complete details with regard to the unapplied interest for each individual account is maintained in all NPA cases. Proper emphasis needs to be given to this aspect for adequate control on the receivables and recovery. Auditors should review the system to ensure that there are no mistakes in the same.

Audit Procedure for Accounts falling under CDR Programme: Following audit procedures are to be carried out to assess / gain an understanding about the borrower account.

- (a) Review the present classification of the account under IRAC norms adopted by the bank and corresponding provision made in the books of accounts, if any. If the account is already treated as NPA in the books of the bank, the same cannot be upgraded only because of the CDR package.
- (b) Review the Debtor- Creditor Agreement (DCA) and Inter Creditor Agreement (ICA) with respect to availability of such agreements and necessary provisions in the agreement for reference to CDR cell in case of necessity, penal clauses, stand-still clause, to abide by the various elements of CDR system etc., (DCA may be entered into at the time of original sanction of loan or at the time of reference to CDR) .
- (c) Auditor has to ascertain the terms of rehabilitation along with the sacrifices, if any, assumed in the rehabilitation program to verify whether such sacrifices have been accounted in the books of accounts of the lender. Ascertain whether any additional financing / conversion of loan into equity have been envisaged in the rehabilitation / restructuring program.

There are two Categories of CDR system namely Category 1 CDR system and Category 2 CDR system. Category 1 CDR system covers borrower accounts classified as 'Standard' and 'Sub-Standard' assets whereas Category 2 CDR system covers advances classified as 'Doubtful' asset. Corporates classified as willful defaulter, indulging in fraud or misfeasance even in a single bank will not be considered for CDR scheme. Auditor needs to ascertain whether the borrower account falls under Category 1 CDR system or Category 2 CDR system or classified as willful defaulter, fraud etc.,

Auditor should also ascertain whether account has been referred to BIFR, as such cases are not eligible for restructuring under CDR system. Large value BIFR cases may be eligible for restructuring under CDR if specifically recommended by CDR core group. Auditor has to verify the necessary approvals / recommendations by CDR core group if auditor comes across any BIFR cases.

Auditor has to ensure that accounts wherein recovery suits have been filed, the initiative to resolve under CDR system is taken by at least by 75% of the creditors by value and 60% in number provided the account meets the basic criteria for becoming eligible under CDR mechanism.

Treatment of accounts restructured under CDR program: Classification and Provisioning: The criteria for classification of accounts will be on the basis of record of recovery as per the existing prudential norms. The asset classification will be as per the lender bank's record of recovery and will be bank specific.

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The auditor should ensure that the lender has applied the usual asset classification norms pending outcome of the account with the CDR Cell. The asset classification status should be restored to the position, which existed at the time of reference to the cell if the restructuring under the CDR system takes place.

The auditor should also ensure that in case a standard asset has been restructured second or more time, it has been downgraded to "substandard" asset.

The auditor should also ensure that proper disclosure in the Notes to Accounts in respect of CDR of SME undertaken by the bank during the year, as prescribed in the RBI's circular, has been made.

Sale/ Purchase of NPAs: In case of a sale/ purchase of NPAs by the bank, the auditor should examine the policy laid down by the Board of Directors in this regard relating to procedures, valuation and delegation of powers.

The auditor should also examine that:

- (i) only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years.
- (ii) the assets have been sold/ purchased "without recourse' only.
- (iii) 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.
- (iv) the NPA has been sold at cash basis only.
- (v) 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:

- (i) on the sale of the NPA, the same has been removed from the books of the account.
- (ii) the short fall in the net book value has been charged to the profit and loss account.
- (iii) where the sale is for a value higher than the NBV, no profit is recognised and the excess provision has not been reversed but retained 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:

- (i) the NPA purchased has been subjected to the provisioning requirements appropriate to the classification status in the books of the purchasing bank.
- (ii) any recovery in respect of an NPA purchased from other banks is first adjusted against its acquisition cost and only the recovered amount in excess of the acquisition cost has been recognised as profit.
- (iii) for the purpose of capital adequacy, banks has assigned 100% risk weights to the NPAs purchased from other banks.

IV. Fixed Assets: The Third Schedule to the Banking Regulation Act, 1949 requires fixed assets to be classified into two categories in the balance sheet, *viz.*, Premises and Other Fixed Assets. Though not specifically mentioned under the Banking Regulation Act, 1949, the

assets taken on lease and intangible assets should be shown separately for proper classification and disclosure and also to comply with the requirements of the Accounting Standards (ASs).

Audit Procedures: In carrying out the audit of fixed assets, the auditor is concerned, primarily, with obtaining evidence about their existence and valuation. For this purpose, the auditor should review the system of internal controls relating to fixed assets, particularly the following:

- ◆ Control over expenditures incurred on fixed assets acquired or self constructed;
- ◆ Accountability and utilisation controls; and
- ◆ Information controls for ensuring availability of reliable information about fixed assets.

The branch auditor should ascertain whether the accounts in respect of fixed assets are maintained at the branch or centrally. Similarly, he should ascertain the location of documents of title or other documents evidencing ownership of various items of fixed assets. The procedures described in the following paragraphs would be relevant only to the extent the accounts and documents of title, etc., relating to fixed assets are maintained at the branch. Where the acquisition, disposal, etc., of fixed assets take place at branches / other offices, but accounting of fixed assets is done at the head office, the branch auditor should examine whether acquisitions, disposals, etc. effected at the branch during the year have been properly communicated to the head office.

Premises: The auditor should verify the opening balance of premises with reference to schedule of fixed assets, ledger or fixed assets register. Acquisition of new premises should be verified with reference to authorisation, title deeds, record of payment, etc. Self-constructed fixed assets should be verified with reference to authorisation and documents such as, contractors' bills, work order records and record of payments. The auditor should also examine whether the balances as per the fixed assets register reconcile with those as per the ledger and the final statements.

In the case of leasehold premises, capitalisation and amortisation of lease premium, if any, should be examined. Any improvements to leasehold premises should be amortised over their balance residual life.

In case the title deeds are held at the head office or some other location, the branch auditor should obtain a written representation to this effect from the branch management and should bring this fact to the notice of the central statutory auditor through a suitable mention in his report. This fact should also be brought in the Long Form Audit Report (LFAR).

Where premises are under construction, it should be seen that they are shown under a separate heading, e.g., 'premises under construction'. Advances to contractors may be shown as a separate item under the head 'fixed assets' or under the head 'other assets'. It should be ensured that where the branch has obtained the licence to commence business and is ready for use then the same is not shown as "premises under construction". In such cases even if all the bills/ documents from the contractors/suppliers are not received, at the year end, an estimate of the expenditure thereon should be made and capitalised on a provisional basis.

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Where the premises (or any other fixed assets) are re-valued, the auditor should examine the appropriateness of the basis of revaluation. The auditor should also examine whether the treatment of resultant revaluation surplus or deficit is in accordance with Accounting Standard (AS) 10, "Accounting for Fixed Assets"⁵. The auditor should also check the impairment, if any, by applying the principles laid down in Accounting Standard (AS) 28, "Impairment of Assets".

The auditor should specifically keep in mind the provisions of section 9 of the Banking Regulation Act, 1949, which prohibit a banking company from holding any immovable property, howsoever acquired (i.e., whether acquired by way of satisfaction of claims or otherwise), for a period exceeding seven years from the date of acquisition, except such as is required for its own use. The auditor should specifically examine that no immovable properties other than those required for the own use of the bank have been included in fixed assets (own use would cover use by employees of the bank, e.g., residential premises provided to employees). The branch auditor should also obtain a written representation to the above effect from the branch management.

Other Fixed Assets: The procedures discussed above regarding premises also apply, to the extent relevant, to verification of other fixed assets. In respect of moveable fixed assets, the auditor should pay particular attention to the system of recording the movements as well as other controls over such fixed assets, e.g., their physical verification at periodic intervals by the branch management and/or by inspection/internal/concurrent audit team. He should also examine whether discrepancies have been properly dealt with in the books of account and adequate provision in respect of any damaged assets has been made.

In recent years, banks have incurred substantial expenditure on computer hardware and software. Computer hardware qualifies the definition of a 'fixed asset' as given in AS 10, "Accounting for Fixed Assets". Computer software that is essential for the functioning of the hardware (e.g., operating system) can be considered an integral part of the related hardware. The expenditure incurred on acquisition and installation of the hardware (as also on any systems software considered to be an integral part of the related hardware) should be capitalised in accordance with the principles laid down in AS 10, "Accounting for Fixed Assets", and depreciated over the remaining useful life of the hardware. Hardware and software are susceptible to faster rate of technical obsolescence, hence the auditor must take into consideration this fact while verifying the provision for depreciation on these assets. The same, however, should not be depreciated for a period of more than three years.

Application software is not an integral part of the related hardware and is treated as an intangible asset. Accordingly, the same should be accounted for as per Accounting Standard (AS 26), "Intangible Assets". The treatment of expenditure on applications software, whether acquired from outside or developed in-house, would also be similar. However, in estimating the useful life of applications software, the rapid pace of changes in software as also the need for periodic modification/ upgradation of software to cater to changes in nature of transactions, information needs etc. need special consideration. As far as expenditure during the stage of in-house development of software is concerned, the same needs to be accounted for in

⁵ AS 10 is being revised to bring it in line with the current International Accounting Standard (IAS) 16, "Property, Plant and Equipment".

accordance with AS 26, "Intangible Assets", according to which expenditure incurred during the research phase should not be capitalised as part of cost of intangibles. While capitalising the development phase expenditure, due consideration should be given to Paragraph 44 of the said Standard. While conducting the audit of intangible assets, the auditor should also consider the guidelines given by RBI by way of Circular No.DBOD.No.BP.BC.82/21.04.018/2003-04, dated April 30, 2004, which broadly states as follows:

- ◆ It may be difficult to estimate the useful life of computer software which has been customised for the bank's use and is expected to be in use for some time. It is observed that the detailed recognition and amortisation principle in respect of computer software prescribed in **Appendix A** to the Standard adequately addresses these issues and may be followed by banks.
- ◆ Intangible assets recognised and carried in the balance sheet of banks in compliance with AS 26 will attract provisions of Section 15(1) of the Banking Regulation Act, 1949 in terms of which banks are prohibited from declaring any dividend until all its capital expenditures (including preliminary expenses, organisation expenses, share-selling commission, brokerage, amount of loss incurred and any other item of expenditure not represented by tangible assets) have been completely written-off. The intangible assets which would be created in the books of banks consequent upon the adoption of AS 26 would generally represent payments made by enterprises towards acquisition of assets which may not be tangible like, corporate computer software, brand equity etc. and would not be in the nature of deferred revenue expenditure like expenses incurred to raise capital, expenses incurred for launching any new products etc. All these items are intangible assets. Therefore, any expenditure incurred towards these intangible items would attract the provisions of Banking Regulation Act, 1949 and for carrying any such item in the books; banks would have to seek exemption from Section 15(1) of the Banking Regulation Act, 1949, from the Government.

Many a time, fixed assets like furniture, office equipments, etc. are transferred from one branch to another. The auditor should examine whether accumulated depreciation in respect of such assets is also transferred. It may be noted that the consolidated accounts of the bank would not be affected by such transfers.

It should be examined whether fixed assets have been properly classified. Fixed assets of similar nature only should be grouped together. For example, items like safe deposit vaults should not be clubbed together with the office equipments or the theft alarm system of the bank.

Common Procedures: In respect of fixed assets sold during the year, a copy of the sale deed, if any, and receipt of the sale value should be examined by the auditor. In such a case, it should also be seen that the original cost and accumulated depreciation on the assets sold have been correctly adjusted. Profit earned or loss incurred on such sales should also be checked.

The auditor should examine whether any expenditure incurred on a fixed asset after it has been brought to its working condition for its intended use, has been dealt with properly.

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According to AS 10, "Accounting for Fixed Assets", such expenditure should be added to the book value of the fixed asset concerned only if it increases the future benefits from the asset beyond its previously assessed standard of performance.

The auditor at head office level should examine if the consolidated fixed assets schedule matches in all respect and all the transfers ins/outs, are tallied. A broad check on the depreciation amount *vis-a-vis* the gross block of assets be reviewed with special emphasis on the computer hardware/software.

Leased Assets: RBI's Circular No. DBOD No.FSC.BC.70/24.01.001/99 dated July 17, 1999 deals with accounting and provisioning norms to be followed by banks undertaking leasing activity. The auditor, in respect of leased assets, should also have regard to the requirements of AS 19, "Leases".

Impairment of Assets: AS 28 prescribe the procedures that an enterprise should apply to ensure that its assets are carried at not more than their recoverable amount. An asset is treated as carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and this Standard requires the enterprise to recognise an impairment loss. This Standard also prescribes when an enterprise should reverse an impairment loss and it prescribes certain disclosures for impaired assets. This Standard requires that an enterprise should assess at each balance sheet date whether there is any indication that an asset may be impaired. The impairment loss if recognised shall be debited in the profit and loss account provided no revaluation reserve exists at that date in relation to the asset, and if it exists, the loss should first be debited to revaluation reserve. After debiting the revaluation reserve, if still there is impairment loss then the same should be debited to profit and loss account. RBI's circular on compliance with Accounting Standards, issued in April 2004 states as follows in respect of AS 28:

- ◆ The Standard would not apply to investments, inventories and financial assets such as loans and advances and may generally be applicable to banks in so far as it relates to fixed assets.
- ◆ Banks may also take into account the following specific factors while complying with the Standard:
 - Paragraphs 7 and 8 of the Standard have clearly listed the triggers which may indicate impairment of the value assets. Hence, banks may be guided by these in determining the circumstances when the Standard is applicable to banks and how frequently the assets covered by the Standard need to be reviewed to measure impairment.
 - In addition to the assets of banks which are specifically identified above, *viz.*, financial assets, inventories, investment, loans and advances etc to which the Standard does not apply, the Standard would apply to financial lease assets and non banking assets acquired in settlement of claims only when the indications of impairment of the entity are evident.

V. Other Assets: The branch auditor may carry out the audit of various items appearing under the head 'other assets' in the following manner.

Inter-Office Adjustments: The balance in the inter-branch accounts, if in debit, is to be shown under this head. The inter-branch accounts are generally sub-divided into segment or specific areas, e.g., 'Demand Drafts Paid', 'Inter-branch Remittances', 'Head Office Account', etc. The net aggregate of all such accounts should be shown under this head.

Interest Accrued: The main components of this item are interest accrued but not due on investments and advances and interest due but not collected on investments. As banks normally debit the borrower's account with interest due on the balance sheet date, there would not usually be any amount of interest accrued but not due on advances as banks normally debit the borrowers account with interest due on the balance sheet date, there would not usually be any amount of interest accrued but not due on advances. On the other hand interest on government securities, debentures, bonds, etc. which accrues from day to day should be calculated and brought into account, in so far as it has accrued on the date of the balance sheet. The auditor should examine this item in the usual manner, i.e., by reference to terms of payment of interest, rate of interest, period elapsed till the date of balance sheet, etc.

The auditor should ensure that only such interest as can be realised in the ordinary course of business should be shown under this head. This is based on the principle, recognised in AS 9, that revenue cannot be recognised if there is a significant uncertainty about its collectability. Dividends recognised as income but not received may be included in the residuary sub-head of 'others'. Dividends and interest on investments would be recognised in the books of the branch only if it is handling the work relating to investments or receipt of income on investments.

Tax Paid in Advance/Tax Deducted at Source: Generally, this item is dealt with at the head office level only and would, therefore, not appear in the balance sheet of a branch, except that tax deducted at source on fixed deposits and other products/services is handled at the branch level. The procedures to be followed by the branch auditor for verification of tax deducted at source by the branch would be similar to those in an audit of other types of entities. The branch auditor needs to ensure that the certificates for such tax deducted at source is collected by the branch and the original copy is sent to the Head Office along with the transfer of such Tax Deducted at Source (TDS) amount to Head Office on periodic basis as defined.

At Head Office level, the availability of all the TDS Certificates, submission of the same with Income Tax Department/claim of the same in Income Tax returns filed should be checked to ensure the justification of the claim towards such certificates.

Stationery and Stamps: Internal controls over stationery of security items (like term deposit receipts, drafts, pay orders, cheque books, traveller's cheques, gift cheques, etc.) assume special significance in the case of banks as their loss or misuse could eventually lead to a misappropriation of the most valuable physical asset of a bank, viz., cash. The branch auditor should study and evaluate the existence, effectiveness and continuity of internal controls over these items in the normal course of his audit. It may be noted that the branch auditor is required to specifically comment on the adequacy of the relevant internal controls in his LFAR.

The item "Stationery and Stamps" should include only exceptional items of expenditure on

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stationery like, bulk purchase of security paper, loose leaf or other ledgers, etc., which are shown as quasi-asset to be written off over a period of time. In other words, the normal expenditure on stationery may be treated as an expense in the profit and loss account, while unusually heavy expenditure may be treated as an asset to be written off based on issue/consumption. At the branch level, the expenditure on latter category may not appear since a considerable part of the stationery is supplied to branches by the head office.

The auditor should physically verify the stationery and stamps on hand as at the year-end, especially stationery of security items. Any shortage should be inquired into as it could expose the bank to a potential loss from misuse. The auditor should 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 in the context of the accounting policy/instructions from the head office regarding treatment of cost of stationery and stamps.

Non-Banking Assets Acquired in Satisfaction of Claims: Under this heading, will be included, those immovable properties/tangible assets, which the bank has acquired in satisfaction of debts due or its other claims and are being held with the intention of being disposed of.

While examining this item, the auditor should specifically keep in mind the provisions of section 9 of the Banking Regulation Act, 1949, which prohibit a banking company from holding any immovable property, however, acquired (i.e. whether acquired by way of satisfaction of claims or otherwise), except such as is required for its own use, for any period exceeding seven years from the date of acquisition thereof. During this period, the bank may deal or trade in any such property for the purpose of facilitating the disposal thereof. The RBI has the power to extend the aforesaid period in a particular case up to another five years. (It may be noted that the aforesaid section is applicable to banking companies only and not to other types of banks like nationalised banks.)

Except when held for its own use, AS 10, "Accounting for Fixed Assets", would not be applicable on those fixed assets which are held with the bank in satisfaction of claim. At the date of acquisition, the assets should be recorded at amount lower of the net book value of the advance or net realisable value of asset acquired. At each balance sheet date, net realisable value of such assets may be re-assessed and necessary adjustments may be made.

The auditor should verify such assets with reference to the relevant documentary evidence, e.g., terms of settlement with the party, order of the Court or the award of arbitration, etc. He should satisfy himself that the ownership of the property has legally vested in the bank. If there is any dispute or other claim about the property, the auditor should examine whether the recording of the asset is appropriate or not. In case the dispute arises subsequently, the auditor should examine whether a provision for liability or disclosure of a contingent liability is appropriate, keeping in view the requirements of AS 29 "Provisions, Contingent Liabilities and Contingent Assets".

Others: This is the residual heading, which will include items not specifically covered under other sub-heads, e.g., claims which have not been received, debit items representing additions to assets or reductions in liabilities which have not been adjusted for technical reasons or want of particulars, etc., receivables on account of government business, prepaid

expenses, Accrued income other than interest (e.g., dividend declared but not received) may also be included under this head. The audit procedures relating to some of the major items included under this head are discussed below.

Non-Interest Bearing Staff Advances: The auditor should examine non-interest bearing staff advances with reference to the relevant documentation and the policy in this regard which is framed by the bank. The availability, enforceability and valuation of security, if any, should also be examined. It needs to be ensured that the same relates to employees on the roll of the bank on the date of the preparation of financial statements.

Security Deposits: Security deposits with various authorities (e.g., on account of telephone, electricity, etc.) and with others (e.g., deposits in respect of premises taken on rent) should be examined with reference to documents containing relevant terms and conditions, and receipts obtained from the parties concerned. It needs to be ensured that the deposit amount has not become due as per the terms and conditions. If it is so, then the recoverability of the same needs to be looked into in detail and appropriate provision be made against the amount which is doubtful to recover.

Suspense Account: 'Suspense' account is another item included under 'other assets'. Ideally, where accounts are maintained properly and on a timely basis, the suspense account may not arise. However, in a practical situation, suspense account is often used to temporarily record certain items such as the following:

- (i) amounts temporarily recorded under this head till determination of the precise nature thereof or pending transfer thereof to the appropriate head of account;
- (ii) debit balances arising from payment of interest warrants/ dividend warrants pending reconciliation of amounts deposited by the company concerned with the bank and the payment made by various branches on this account;
- (iii) amounts of losses on account of frauds awaiting adjustment.

The auditor should pay special attention to any unusual items in suspense account. He should obtain from the management details of old outstanding entries in suspense account along with reasons for delay in adjusting the entries. Where the outstanding balances comprised in suspense account require a provision/write-off, the auditor should examine whether the necessary provision has been made/write-off effected.

Prepaid Expenses: The auditor should verify prepaid expenses in the same manner as in the case of other entities. Thus, the auditor should examine whether the basis of allocation of expenditure to different periods is reasonable. He should particularly examine whether the allocation of discounting and rediscounting charges paid by the bank to different accounting periods is in consonance with the accounting policy followed for the bank as a whole.

Miscellaneous Debit Balances on Government Account: Miscellaneous debit balances on government account in respect of pension, public provident funds, compulsory deposit scheme payments, etc., for which the branch obtains reimbursement from the government through a designated branch, are also included under the head 'others'. The auditor should review the ageing statements pertaining to these items. He should particularly examine the recoverability

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of old outstanding items. The auditor should also examine whether claims for reimbursement have been lodged by the branch in accordance with the relevant terms and conditions. The net balances of the amount recoverable at the Head Office level should also be taken along with the age-wise analysis of the same. In case of old outstanding balances without any confirmation or proper justification of the same, should be provided for in the accounts.

The residual item of "Others" in Other Assets generally constitutes a significant amount in the Balance Sheet of the bank. The Head Office auditors should obtain the head wise details of the same along with the previous year figures. The age-wise details of the major outstanding should also be obtained, wherever, feasible. Further, the major variance as compared to the previous year figures should also be enquired into and reasons for the same should be recorded and reviewed. In case any amount seems doubtful of recovery, appropriate provisions against the same should be made.

VI. Capital: The following particulars have to be given in respect of share capital in the balance sheet.

(a) For Banks Incorporated in India

Authorised Capital	(shares of ₹ each)
Issued Capital	(-do-)
Subscribed Capital	(-do-)
Called-up Capital	(-do-)

Less: Calls unpaid

Add: Forfeited shares

(In case of Nationalised Banks capital owned by Central Government as on the date of balance sheet including contribution from Government, if any, for participating in World Bank Projects should be shown separately.)

(b) For Banks Incorporated Outside India

- (i) Capital (the amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head).
- (ii) Amount of deposit kept with the RBI under section 11(2) of the Banking Regulation Act, 1949.

The auditor should verify the opening balance of capital with reference to the audited balance sheet of the previous year. In case there has been an increase in capital during the year, the auditor should examine the relevant documents supporting the increase. For example, in case of an increase in the authorised capital of a banking company, the auditor should examine the special resolution of shareholders and the memorandum of association. An increase in subscribed and paid-up capital of a banking company, on the other hand, should be verified with reference to prospectus/other offer document, reports received from registrars to the issue, bank statement, etc.

11.8 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.

Adequacy of capital of banks has been the subject matter of consideration by banking authorities around the world for several decades. For example, in 1975, the Bank of England published the conclusions of a Joint Working Party which had been formed by the Bank along with several clearing banks to examine the nature of capital and of liquidity of banks and to develop principles for examining their adequacy. The paper outlined two ratios for assessing the adequacy of capital: 'free resources ratio' and 'risk asset ratio'. The *free resources ratio* related current liabilities to capital resources excluding the part of capital devoted to financing infrastructure and other non-banking assets. The *risk asset* ratio related the risk of losses inherent in the assets of the business of banks to the capital available to absorb such losses. The paper argued that the risk asset ratio was more useful.

The risk asset measure has since received wide international acceptance as the basis for measuring the capital adequacy of banks. An international agreement on a common risk-based capital framework and definition of bank capital was framed by the Committee on Banking Regulations and Supervisory Practices of the G-10 Nations (popularly known as the Basel Committee) and was formally adopted in 1988. It was also adopted by all the twenty-five countries that were either full members of the Organisation for Economic Co-operation and Development or had special lending arrangements under the International Monetary Fund's general borrowing procedures.

The framework attempted to relate a bank's capital needs to its risk profile. Besides serving to strengthen the soundness and stability of the banking system, it also sought to give banks an incentive to hold lower-risk assets, incorporate off-balance sheet exposures explicitly into capital assessments, and achieve greater uniformity in application of capital standards to banks across different countries. The prescribed minimum capital standards for risk-based capital were to apply to banks on a transitional basis beginning at the year end 1990 and were to be fully in place by end 1992.

Capital Adequacy Measures in India: In India, the statutes governing various types of banks lay down the minimum capital requirements for them. Besides, there are also requirements for maintenance of statutory reserves. Considering the variations in minimum capital requirements applicable to different types of banks and taking into account the approach adopted by Basel Committee, the Reserve Bank prescribed, in year 1992, a uniform methodology for determining the capital adequacy of scheduled commercial banks (other than regional rural banks). The Master Circular No. RBI/2011-12/62 DBOD.No.BP.BC. 17/21.01.002/2011-12 of July 1, 2011 on "Prudential Norms on Capital Adequacy-Basel-I Framework" (The Circular is given in the CD along with the Guidance Note) provides the guidelines to be followed by banks for capital adequacy. Some of the important aspects of the circular are covered below.

The basic approach of capital adequacy framework is that a bank should have sufficient capital to provide a stable resource to absorb any losses arising from the risks in its business.

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Capital is divided into tiers according to the characteristics/qualities of each qualifying instrument. For supervisory purposes capital is split into two categories: Tier I and Tier II, representing different instruments' quality as capital.

- ◆ **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.

Components of Capital: The Master Circular on Capital Adequacy discusses the Capital Funds in two categories – capital funds for Indian banks and capital funds of foreign banks operating in India. The following table shows the components of the Capital Funds for Indian *vis a vis* foreign banks operating in India.

	Indian Banks	Foreign Banks operating in India
Tier I Capital	Paid up capital (ordinary shares)	Interest free funds from Head Office ⁶
	Statutory reserves	Statutory reserves kept in Indian books
	Other disclosed free reserves, if any	Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India
	Innovative perpetual debt instruments eligible for inclusion as Tier I capital	Innovative Instruments eligible for inclusion as Tier I capital
	Perpetual non-cumulative preference shares eligible for inclusion as Tier I capital subject to laws in force from time to time*	
	Capital reserves representing surplus arising out of sale proceeds of assets	

Tier II Capital	Undisclosed reserves	Undisclosed reserves
	Revaluation reserves	Revaluation reserves
	General provisions and loss reserves	General provisions and loss reserves
	Hybrid debt capital instruments, which	Hybrid debt capital instruments

⁶ Kept in a separate account in Indian books specifically for the purpose of meeting the capital adequacy norms.

* The annexure to the Master Circular on "Prudential Norms on Capital Adequacy-Basel I Framework" dated July 1, 2008 provides the guidelines for Perpetual non-cumulative preference shares eligible for inclusion as Tier I capital.

	includes Perpetual Cumulative Preference Shares (PCPS) / Redeemable Non-Cumulative Preference Shares (RNCPS) / Redeemable cumulative preference shares(RCPS) and Debt capital instruments	which includes Perpetual Cumulative Preference Shares (PCPS)/Redeemable Non-Cumulative Preference Shares(RNCPS) /Redeemable cumulative preference shares(RCPS) and Debt capital instruments
	Subordinate debts	Subordinate debts
	Bonds issued to Employees under VRS	Bonds issued to employees under VRS
	Investment reserve account	Investment reserve account
		Head office borrowings raised in foreign currency <i>Subject to the provisions laid down in the Master Circular on Capital Adequacy</i>

In case of foreign banks operating in India, RBI's Master Circular on Capital Adequacy also lays down certain additional provisions in respect of capital to be followed by such banks.

Undisclosed Reserves: They can be included in capital, if they represent accumulations of post-tax profits and are not encumbered by any known liability and should not be routinely used for absorbing normal loss or operating losses.

Re-valuation Reserves: It would be prudent to consider re-valuation reserves at a discount of 55 percent while determining their value for inclusion in Tier II capital. Such reserves will have to be reflected on the face of the Balance Sheet as re-valuation reserves.

General Provisions and Loss Reserves: Such reserves can be included in Tier II capital if they are not attributable to the actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses. Adequate care must be taken to see that sufficient provisions have been made to meet all known losses and foreseeable potential losses before considering general provisions and loss reserves to be part of Tier II capital. General provisions/loss reserves will be admitted up to a maximum of 1.25 percent of total risk weighted assets. 'Floating Provisions' held by the banks, which is general in nature and not made against any identified assets, may be treated as a part of Tier II capital within the overall ceiling of 1.25 percent of total risk weighted assets, if such provisions are not netted off from gross NPAs to arrive at disclosure of net NPAs

Hybrid Debt Capital Instruments: Those instruments which have close similarities to equity, in particular when they are able to support losses on an ongoing basis without triggering liquidation, they may be included in Tier II capital. At present following instruments have been recognised and placed under this category.

- i. Perpetual Cumulative Preference Shares (PCPS)/ Redeemable Non-Cumulative

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Preference Shares (RNCPS)/Redeemable Cumulative Preference shares (RCPS) as part of upper 2 capital.

- ii. Debt capital instruments eligible for inclusion as Upper Tier II capital.

The guidelines governing the instruments at (i) and (ii) above, indicating the minimum regulatory requirements are furnished in Annex 4 and Annexure 3 respectively of the Master Circular on Capital Adequacy.

Subordinated Debt: To be eligible for inclusion in Tier II capital, the instrument should be fully paid-up, unsecured, subordinated to the claims of other creditors, free of restrictive clauses, and should not be redeemable at the initiative of the holder or without the consent of the RBI. They often carry a fixed maturity, and as they approach maturity, they should be subjected to progressive discount, for inclusion in Tier II capital. Instruments with an initial maturity of less than 5 years or with a remaining maturity of one year should not be included as part of Tier II capital. The quantum of subordinated debt instruments eligible to be reckoned as Tier II capital will be limited to 50 percent of Tier I capital. Banks can raise, with the approval of their Boards, rupee-subordinated debt as Tier II capital, subject to the terms and conditions given in the Annexure-5 to the Master Circular on Capital Adequacy. Banks should indicate the amount of subordinated debt raised as Tier II capital by way of explanatory notes/ remarks in the Balance Sheet as well as in Schedule 5 to the Balance Sheet under 'Other Liabilities & Provisions'.

Bond Issued to Employees Under VRS: In the case of public sector banks, the bonds issued to the VRS employees as a part of the compensation package, net of the unamortised VRS Deferred Revenue Expenditure, could be treated as Tier II capital, subject to compliance with the terms and conditions stipulated by the RBI in this regard.

Investment Reserve Account: In the event of provisions created on account of depreciation in the 'Available for Sale' or 'Held for Trading' categories being found to be in excess of the required amount in any year, the excess should be credited to the Profit & Loss account and an equivalent amount (net of taxes, if any and net of transfer to Statutory Reserves as applicable to such excess provision) should be appropriated to an Investment Reserve Account in Schedule 2 –“Reserves & Surplus” under the head 5 “Revenue and other Reserves” and would be eligible for inclusion under Tier II within the overall ceiling of 1.25 per cent of total Risk Weighted Assets prescribed for General Provisions/ Loss Reserves.

Banks are allowed to include the 'General Provisions on Standard Assets' and 'Provisions held for Country Exposures' in Tier II capital. However, the provisions on 'standard assets' together with other 'general provisions/ loss reserves' and 'provisions held for country exposures' will be admitted as Tier II capital up to a maximum of 1.25 per cent of the total risk-weighted assets.

Deductions from Computation of Capital Funds: The Master Circular on Capital Adequacy prescribes the following deductions to be made from the Tier I and Tier II Capital.

Item	Extent of Deduction (in %)	
	Tier I	Tier II
Equity and non-equity capital	50	50

instruments issued by a subsidiary		
Intangible assets	100	----
Losses in current period	100	----
Losses brought forward from previous periods	100	----
Deferred Tax Asset resulting in increase of Tier I capital	100	---
First loss facility	50	50
Second loss facility	50	50
Credit enhancements provided by third party	50	50
Underwriting by an originator	50	50
Underwriting by third party service provider	50	50

Further, in the case of public sector banks which have introduced Voluntary Retirement Scheme (VRS), in view of the extra-ordinary nature of the event, the VRS related Deferred Revenue Expenditure would not be reduced from Tier I capital. However, it will attract 100% risk weight for capital adequacy purpose. Tier II elements should be limited to a maximum of 100 percent of total Tier I elements for the purpose of compliance with the norms.

Capital Risk Adequacy Ratio (CRAR)

The CRAR is computed as follows:

$$\frac{\text{Capital funds}}{\text{Risk weighted assets and – off balance sheet items}} \times 100$$

The RBI requires banks to maintain a minimum CRAR of 9 per cent on an ongoing basis. The Master Circular on Capital Adequacy contains detailed guidelines on calculation of risk weighted assets and off-balance sheet items and CRAR.

Reporting Requirements: The banks, both Indian banks as well as foreign banks, are required to submit a report to RBI giving details of the subordinated debt issued for raising Tier II capital, such as, amount raised, maturity of the instrument, rate of interest together with a copy of the offer document, soon after the issue is completed.

The New Capital Adequacy Framework–Basel II: The Reserve Bank of India, vide its circular no. RBI/2011-12/62 DBOD.No.BP.BC. 17/21.01.002/2011-12 , dated July 1, 2011 on Prudential Guidelines on Capital Adequacy and Market Discipline – Implementation of the New Capital Adequacy Framework (The circular is given in the CD along with this book) has taken a step forward in the direction of the implementation of the New Capital Accord, i.e., Basel II. In terms of the said circular all foreign banks operating in India and Indian banks having operational presence abroad need to adopt the new capital adequacy framework with effect from March 31, 2009. All other commercial banks (excluding Local Area Banks and Regional Rural Banks) are encouraged to migrate to these approaches under the Revised Framework in

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alignment with them but in any case not later than March 31, 2009. These banks shall continue to apply the Standardised Duration Approach (SDA) for computing capital requirement for market risks under the Revised Framework.

Parallel run: With a view to ensuring smooth transition to the Revised Framework and with a view to providing opportunity to banks to streamline their systems and strategies, banks were advised to have a parallel run of the Revised Framework. The Boards of the banks should review the results of the parallel run on a quarterly basis. The broad elements which need to be covered during the parallel run are as under:

- (i) Banks should apply the prudential guidelines on capital adequacy – both current guidelines and these guidelines on the Revised Framework – on an on-going basis and compute their Capital to Risk Weighted Assets Ratio (CRAR) under both the guidelines.
- (ii) An analysis of the bank's CRAR under both the guidelines should be reported to the board at quarterly intervals.
- (iii) A copy of the quarterly reports to the Board should be submitted to the RBI, one each to Department of Banking Supervision, Central Office and Department of Banking Operations and Development, Central Office. While reporting the above analysis to the board, banks should also furnish a comprehensive assessment of their compliance with the other requirements relevant under the Revised Framework, which will include the following, at the minimum:
 - (a) Board approved policy on utilization of the credit risk mitigation techniques, and collateral management,
 - (b) Board approved policy on disclosures,
 - (c) Board approved policy on Internal Capital Adequacy Assessment Process (ICAAP) along with the capital requirement as per ICAAP,
 - (d) Adequacy of bank's MIS to meet the requirements under the New Capital Adequacy Framework, the initiatives taken for bridging gaps, if any, and the progress made in this regard,
 - (e) Impact of the various elements / portfolios on the bank's CRAR under the revised framework,
 - (f) Mechanism in place for validating the CRAR position computed as per the New Capital Adequacy Framework and the assessments / findings/ recommendations of these validation exercises,
 - (g) Action taken with respect to any advice / guidance / direction given by the Board in the past on the above aspects.

All the banks in India would continue to have the parallel run till March 31, 2013, subject to review, and ensure that their Basel II minimum capital requirement continues to be higher than the prudential floor of 80% of the minimum capital requirement computed as per Basel I framework for credit and market risks. Attention of the reader is drawn to the RBI circular No. DBOD.NO.BP.BC.92/21.06.001/2008-09 dated December 4, 2008 on

“Implementation of the New Capital Adequacy Framework (NCAF) –Parallel run reporting format – Monitoring of Prudential Floor” (The Circular is given in the CD along with the Guidance Note). The Circular advises the banks to adopt the formats prescribed in the Circular for reporting to their Board of Directors with effect from the quarter ending December 31, 2008. The format represents the minimum reporting requirements to the Board and banks could provide such additional information to their Boards as may be considered necessary. A copy of the quarterly report, duly approved by the Boards in the format prescribed, may also be sent to the RBI not later than a month from the end of the quarter to which it relates. In cases, where there the Board’s approval of the report is likely to take longer time, the banks may furnish an advance copy of the report to the RBI, to be followed by the comments/remarks/ guidance of the Board, if any, on the report

VII. Reserves and Surplus: The following are required to be disclosed in the balance sheet under the head ‘Reserves and Surplus’.

I. Statutory Reserves

II. Capital Reserves

III. Share Premium

IV. Revenue and Other Reserves including investment Fluctuation Reserve

(In respect of items I – IV above, opening balance, additions during the year and deductions during the year are to be shown separately in respect of each item)

V. Balance in Profit and Loss Account

Statutory Reserves: Under sub-section (1) of section 17 of the Banking Regulation Act, 1949 every banking company incorporated in India has to transfer 20% of its profits to its reserve fund each year before declaring dividends. The transfer to reserve as above and any other reserve created in pursuance of any section of the Act has also to be disclosed under the aforesaid head. Sec 17(2) of Act provides that where a banking company appropriates any sum or sums from the reserve fund or the share premium account, it shall, within twenty-one days from the date of such appropriation, report the fact to the RBI, explaining the circumstances relating to such appropriation.

All scheduled commercial banks, including foreign banks operating in India, (except RRBs/LABs) have been instructed to transfer not less than 25% of the ‘net profit’ (before appropriations) to the Reserve Fund with effect from the year ending 31st March, 2001. Such transfer to reserves may be made “after adjustment / provision towards bonus to staff”.

Capital Reserves: The expression ‘capital reserves’ does not include any amount regarded as free for distribution through the profit and loss account. According to the Notes and Instructions for Compilation of Balance Sheet, issued by the RBI, surplus on re-valuation or sale of fixed assets is to be treated as capital reserve. The Notes and Instructions further specify that any exchange gain on translation of the financial statements of foreign branches is not a revaluation reserve and that such exchange gain should be shown under the head ‘other liabilities, and provisions’.

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Securities Premium Account: According to section 78 of the Companies Act, 1956, where a company issues shares at a premium, the amount of premium should be transferred to a separate account to be called 'the securities premium account'. The provisions of the Companies Act, 1956 regarding reduction of capital also apply to securities premium account. However, as per section 78, the securities premium may be applied for the following purposes:

- (a) issuing fully paid bonus securities;
- (b) writing off the preliminary expenses;
- (c) writing off the expenses of, or the commission paid or discount allowed on, any issue of securities or debentures; or
- (d) providing for the premium payable on the redemption of any redeemable preference securities or debentures.

A banking company has to report to the RBI any appropriations made from the securities premium account. Such an appropriation can be only for the purposes described above or in accordance with the provisions governing reduction of share capital by a company.

Revenue and Other Reserves: According to the Notes and Instructions for Compilation of Balance Sheet and Profit and Loss Account, issued by the RBI, the expression 'Revenue Reserve' shall mean any reserve other than capital reserve.

All reserves, other than those separately classified (viz., statutory reserves, capital reserves and share premium) will be shown under this head. The expression 'reserve' shall not include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability. In terms of RBI guidelines, the 'Investment Fluctuation Reserve' representing write back of excess provision on investments has to be treated as revenue reserve.

Balance of Profit: This item includes balance of profit after appropriations. According to the Notes and Instructions for compilation of balance sheet and profit and loss account, issued by the RBI, in case of loss, the balance may be shown as a deduction. Though it is not mentioned whether the loss is to be deducted from the aggregate of 'reserves' or from 'revenue and other reserves' only, it is obvious on a consideration of legal requirements and sound accounting principles that the loss should be deducted only from revenue reserves.

Further, as prescribed by RBI's circular no. DBOD.BP.BC.31/21.04.018/2006-07 dated September 20, 2006, the banks need to obtain prior approval of the Reserve Bank of India before any appropriation is made from the statutory reserve or any other reserve (The Circular is given in CD along with the Guidance Note).

The said circular also requires that:

- (i) all expenses including provisions and write offs recognised in a period, whether mandatory or prudential, should be reflected in the Profit and Loss Account for the period as an 'above the line' item (i.e., before arriving at the net profit);
- (ii) wherever draw down from reserves takes place with the prior approval of Reserve Bank,

it should be effected only "below the line", (i.e., after arriving at the profit/loss for the period); and

- (iii) suitable disclosures should be made of such draw down of reserves in the 'Notes on Accounts' to the Balance Sheet.

Audit Procedures: The auditor should verify the opening balances of various reserves with reference to the audited balance sheet of the previous year. Additions to or deductions from reserves should also be verified in the usual manner, e.g., with reference to board resolution. In the case of statutory reserves and share premium, compliance with legal requirements should also be examined. Thus, the auditor should specifically examine whether the requirements of the governing legislation regarding transfer of the prescribed percentage of profits to reserve fund have been complied with. In case the bank has been granted exemption from such transfer, the auditor should examine the relevant documents granting such exemption. Similarly, it should be examined whether the appropriations from share premium account conform to the relevant legal requirements.

VIII. Deposits: Deposits are required to be classified in the balance sheet under the following heads.

- A. I. *Demand Deposits*
 - (i) From Banks
 - (ii) From Others
- II. *Savings Bank Deposits*
- III. *Term Deposits*
 - (i) From Banks
 - (ii) From Others
- B. I. *Deposits of branches in India*
- II. *Deposits of branches outside India*

Audit Procedures: In carrying out audit of deposits and liabilities, the auditor is primarily concerned with obtaining reasonable assurance that all known liabilities are recorded and stated at appropriate amounts.

The auditor may verify various types of deposits in the following manner:

Current Accounts: The auditor should verify the balances in individual accounts on a sampling basis. He should also examine whether the balances as per subsidiary ledgers tally with the related control accounts in the General Ledger. In case of any differences, the auditor should examine the reconciliation prepared by the branch in this regard.

Some banks have a procedure for obtaining confirmation of balances periodically. The auditor should examine whether the procedure laid down in this behalf has been followed consistently throughout the year. He should also examine, on a sampling basis, the confirmations received.

The auditor should ensure that debit balances in current accounts are not netted out on the liabilities side but are appropriately included under the head 'advances'.

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Inoperative accounts are a common area of frauds in banks. While examining current accounts, the auditor should specifically cover in his sample some of the inoperative accounts revived during the year. The auditor should also ascertain whether inoperative accounts are 'revived' only with proper authority. For this purpose, the auditor should identify cases where there has been a significant reduction in balances compared to the previous year and examine the authorisation for withdrawals.

Savings Bank Deposits: The auditor should verify the balances in individual accounts on a sampling basis. He should also examine whether the balances as per subsidiary ledgers tally with the related control accounts in the General Ledger. In case of any differences, the auditor should examine the reconciliation prepared by the branch in this regard.

The auditor should also check the calculations of interest on a sampling basis. It is not unusual for branches to compute interest savings bank upto a date close to the end of the accounting period e.g. 25th March based on the actual balances with interest for the remaining period on an estimated basis at the head office level.

As in the case of current accounts, the auditor should pay special attention to inoperative savings bank accounts.

Term Deposits: While evaluating the internal controls over term deposits, the auditor should specifically examine whether the deposit receipts and cash certificates are issued serially and all of them are accounted for in the registers. The auditor should also satisfy himself that there is a proper control over the unused forms of deposit receipts and cash certificates to prevent their misuse.

As stated earlier, the rate of interest on Certificates of Deposits (CDs) is negotiable with the depositor. This area is quite sensitive. The auditor should bear this fact in mind while examining the efficacy of prescribed internal controls with regard to rates of interest on CDs.

The auditor should verify the deposits with reference to the relevant registers. The auditor should also examine, on a sampling basis, the registers with the counter-foils of the receipts issued and with the discharged receipts returned to the bank. The reconciliation of subsidiary records for various types of term deposits with the related control accounts in the General Ledger should be examined. The auditor should also examine whether provision has been made for interest accrued on the deposits up to the date of the balance sheet. Auditor should ensure that proper provision for interest payable on deposits is made.

In some cases, banks employ some persons as 'collectors' to collect the deposits from depositors, e.g., in case of recurring deposits. In such cases, the auditor should specifically examine the efficacy of the internal control procedures for reconciling the records of the bank with those of the collectors.

Term deposits from banks are usually (though not necessarily) in round figures. Any odd balances should, therefore, put the auditor to enquiry.

Deposits Designated in Foreign Currencies: In the case of deposits designated in a foreign currency, e.g., foreign currency non-resident deposits, the auditor should examine whether they have been converted into Indian rupees at the rate notified in this behalf by the head office. The auditor should also examine whether any resultant increase or decrease has been

taken to the profit and loss account. It may also be seen that interest on deposits has been paid on the basis of 360 days in a year. Further, in case of conversion of FCNR (B) deposits into NRE deposits or *vice versa* before maturity has been subjected to the provisions relating to premature withdrawal.

Interest Accrued But Not Due: The auditor should examine that interest accrued but not due on deposits is not included under the relevant deposits but is shown under the head 'other liabilities and provisions'.

Overall Reconciliation: The procedures of banks usually provide for periodic correlation of outstanding deposits with the cost of deposits. The auditor should ascertain from the management whether such an exercise has been carried out and if so, he should review the same. The auditor should examine that interest accrued but not due has also been considered for this purpose.

Window-dressing: There are several ways in which the deposits of a bank may be inflated for purposes of balance sheet presentation. For example, some of the constituents may be allowed overdraft on or around the date of the balance sheet, the overdrawn amounts may be placed as deposits with the bank, and further advances may be given on the security of the deposit receipts, thus inflating deposits as well as advances. The transactions may be reversed immediately after the close of the year. Where the auditor comes across transactions, which indicate the possibility of window-dressing, he may report the same in his long form audit report. In appropriate cases, the auditor should consider making a suitable qualification in his main audit report also.

Know Your Customers Norms: RBI has issued instructions to all banks to implement without fail certain procedural norms on KYC. Failure would attract levy of penalty and if penalty has been levied the same is to be disclosed in the notes to accounts. In view of the nature of the directive the audit procedure may be suitably adopted to enquire the system of implementation and review of other reports in respect of this area. The auditor should examine that an adequate there exists proper procedure in place to ensure that framework relating to 'Know Your Customer' and Anti-Money Laundering measures is formulated and put in place by the bank.

IX. Borrowing: Borrowings of a bank are required to be shown in balance sheet as follows.

I. Borrowings in India

- (i) Reserve Bank of India
- (ii) Other Banks
- (iii) Other Institutions and Agencies

II. Borrowings outside India

The total amount of secured borrowings included under the above heads is to be shown by way of a note to the relevant schedule (Schedule 4). Secured borrowings for this purpose include borrowings/refinance in India as well as outside India. It may be noted that the inter-office transactions are not borrowings and therefore, should not be presented as such. **Audit Procedures**

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Borrowings from RBI, other banks/financial institutions, etc. should be verified by the auditor with reference to confirmation certificates and other supporting documents such as, agreements, correspondence, etc. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence that the auditor requires to respond to significant risks of material misstatement. The auditor is required to comply with the requirements of Standard on Auditing (SA) 505, "External Confirmations" which contains guidance on designing and performing external confirmation procedures to obtain relevant and reliable audit evidence.

The auditor should also examine whether a clear distinction has been made between 'rediscount' and 'refinance' for disclosure of the amount under the above head since rediscount does not figure under this head.

The auditor should examine whether borrowings of money at call and short notice are properly authorised. The rate of interest paid/payable on, as well as duration of such borrowings should also be examined by the auditor.

The auditor should similarly examine the relevant correspondence or other documents to ensure that the branch has been authorised by the head office to borrow/retain other borrowings and that the terms on which borrowings have been made are in accordance with the authorisation.

The auditor should examine whether the amount shown in the branch accounts is properly classified based on security or otherwise.

X. Other Liabilities and Provisions: The Third Schedule to the Banking Regulation Act, 1949, requires disclosure of the following items under the head 'Other Liabilities and Provisions'.

- (a) Bills payable
- (b) Inter-office adjustments (net)
- (c) Interest accrued
- (d) Others (including provisions)

Audit Procedures: The auditor may verify the various items under the head 'other liabilities and provisions' in the following manner.

Bills Payable: The auditor should evaluate the existence, effectiveness and continuity of internal controls over bills payable. Such controls should usually include the following:

- (a) Drafts, mail transfers, traveller's cheques, etc. should be made out in standard printed forms.
- (b) Unused forms relating to drafts, traveller's cheques, etc. should be kept under the custody of a responsible officer.
- (c) The bank should have a reliable private code known only to the responsible officers of its branches coding and decoding of the telegrams should be done only by such officers.
- (d) The signatures on a demand draft should be checked by an officer with the specimen signature book.

- (e) All the telegraphic transfers and demand drafts issued by a branch should be immediately confirmed by advices to the branches concerned. On payment of these instruments, the paying branch should send a debit advice to the originating branch.
- (f) If the paying branch does not receive proper confirmation of any telegraphic transfers or demand draft from the issuing branch, it should take immediate steps to ascertain the reasons.
- (g) In case an instrument prepared on a security paper, e.g., draft, has to be cancelled (say, due to error in preparation), it should be ensured that the manner of cancellation is such that the instrument cannot be misused. (For example, in the case of drafts, banks generally cut the distinctive serial number printed on the form and paste it in the book in which drafts issued are entered.) Cases of frequent cancellation and re-issuance of drafts, pay orders, etc. should be carefully looked into by a responsible official.

Based on his evaluation of the efficacy of the relevant internal controls, the auditor should examine an appropriate sample of outstanding items comprised in bills payable accounts with the relevant registers. Reasons for old outstanding debits in respect of drafts or other similar instruments paid without advice should be ascertained. Correspondence with other branches after the year-end (e.g., responding advices received from other branches, advices received from other branches in respect of drafts issued by the branch and paid by the other branches without advice) should also be examined specially in so far as large value items outstanding on the balance sheet date are concerned.

Others (Including Provisions): It may be noted that the figure of advances and investments in the balance sheet of a bank excludes provisions in respect thereof made to the satisfaction of auditors. The auditor should examine other provisions and other items of liabilities in the same manner as in the case of other entities.

Inter-office Adjustments - The balance in inter-office adjustments account, if in credit, is to be shown under this head.

Interest Accrued - Interest accrued but not due on deposits and borrowings is to be shown under this head. The auditor should examine this item with reference to terms of the various types of deposits and borrowings. It should be specifically examined that such interest has not been clubbed with the figures of deposits and borrowings shown under the head 'Deposits and Borrowings'.

Others (including provisions) - According to the Notes and Instructions for compilation of balance sheet and profit and loss account, issued by the RBI, the following items are to be included under this head:

- (a) Net provision for income tax and other taxes like interest tax, less advance payment and tax deducted at source.
- (b) Surplus/provisions in bad and doubtful debts provision account (such surplus is in the nature of a reserve).
- (c) Surplus/provisions for depreciation in securities (such surplus is in the nature of a reserve).

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- (d) Contingency funds, which are actually in the nature of reserves but are not disclosed as such.
- (e) Proposed dividend/transfer to Government.
- (f) Other liabilities, which are not disclosed under any of the major heads such as unclaimed dividend, provisions and funds kept for specific purposes, unexpired discount, outstanding charges like rent, conveyance, etc.
- (g) Certain types of deposits like staff security deposits, margin deposits, etc., which are repayable only subject to compliance with certain conditions. (The interest on such deposits would also be included under this head).
- (h) Exchange gain on translation of financial statements of foreign branches. (i) Amount of subordinated debt raised as Tier II capital. (It may be mentioned that the nature of subordinated debt is similar to that of borrowings. However, the instructions of the RBI require their classification under the head 'Other Liabilities and Provisions').
- (j) Blocked Account arising from transfer of credit entries in inter-branch accounts outstanding for more than five years.

Besides the above items, the following are other important items usually included under this head:

- (a) Collections in respect of suit-filed accounts. These are not adjusted against advances till final settlement. (However, for the purpose of provisioning against non-performing advances, such credit balances are taken into account for ascertaining net outstandings).
- (b) Collection of income-tax on behalf of the Government.
- (c) Collection from DICGC. These are carried till final realisation/write-off of the concerned advance account.
- (d) Provisions for frauds. These are ultimately adjusted by way of a write-off.
- (e) Insurance claims received in respect of frauds. These are retained separately till final write-off in respect of fraud.
- (f) Provision for gratuity, pension and other staff benefits.
- (g) Provision for bank's share in the expenses of the Banking Services Recruitment Board.
- (h) Provision for audit fees.

It may be noted that many of the items to be disclosed under this head are accounted for at the head office level and would not therefore form part of balance sheet of a branch.

XI. Contingent Liabilities: The Third Schedule to the Banking Regulation Act, 1949, requires the disclosure of the following as a footnote to the balance sheet.

- (a) Contingent Liabilities
 - I. Claims against the bank not acknowledged as debts
 - II. Liability for partly paid investments

- III. Liability on account of outstanding forward exchange contracts.
- IV. Guarantees given on behalf of constituents
 - (a) In India
 - (b) Outside India
- V. Acceptances, endorsements and other obligations
- VI. Other items for which the bank is contingently liable

(b) *Bills for Collection*

Audit Procedures

Contingent Liabilities: In respect of contingent liabilities, the auditor is primarily concerned with seeking reasonable assurance that all contingent liabilities are identified and properly valued. To this end, the auditor should, generally follow the audit procedures given below:

- (a) the auditor should ensure that there exists a system whereby the non fund based facilities or additional/*ad hoc* credit facilities to parties are extended only to their regular constituents, etc.
- (b) Ascertain whether there are adequate internal controls to ensure that transactions giving rise to contingent liabilities are executed only by persons authorised to do so and in accordance with the laid down procedures.
- (c) The auditor should also ensure that in case of LCs for import of goods, as required by the abovementioned Master Circular on guarantees and co-acceptances, the payment to the overseas suppliers is made on the basis of shipping documents and after ensuring that the said documents are in strict conformity with the terms of LCs.
- (d) Ascertain whether the accounting system of the bank provides for maintenance of adequate records in respect of such obligations and whether the internal controls ensure that contingent liabilities are properly identified and recorded.
- (e) Performs substantive audit tests to establish the completeness of the recorded obligations. Such tests include confirmation procedures as well as examination of relevant records in appropriate cases.
- (f) Review the reasonableness of the year-end amount of contingent liabilities in the light of previous experience and knowledge of the current year's activities.
- (g) Review whether comfort letters issued by the bank has been considered for disclosure of contingent liabilities.
- (h) Obtain representation from the management that
 - (i) all contingent liabilities have been disclosed;
 - (ii) the disclosed contingent liabilities do not include any contingencies which are likely to result in a loss/ expense and which, therefore, require creation of a provision in the financial statements;
 - (iii) the estimated amounts of financial effect of the contingent liabilities are based on

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the best estimates in terms of Accounting Standard 29, including any possibility of any reimbursement;

- (iv) in case of guarantees issued on behalf of the bank's directors, the bank has taken appropriate steps to ensure that adequate and effective arrangements have been made so that the commitments would be met out of the party's own resources and that the bank will not be called upon to grant any loan or advances to meet the liability consequent upon the invocation of the said guarantee(s) and that no violation of section 20 of the Banking Regulations Act, 1949 has arisen on account of such guarantee; and
 - (v) such contingent liabilities which have not been disclosed on account of the fact that the possibility of their outcome is remote, include the management's justification for reaching such a decision in respect of those contingent liabilities.
- (i) The auditor should also examine whether the bank has given any guarantees in respect of any trade credit (buyer's credit or seller's credit)*. The period of guarantees is co-terminus with the period of credit reckoned from the date of shipment.
 - (j) Verify whether bank has extended any non-fund facility or additional/*ad hoc* credit facilities to other than its regular customers. In such cases, auditor should ensure concurrence of existing bankers of such borrowers and enquire regarding financial position of those customers.

The specific procedures to be employed by the auditor to verify various items of contingent liabilities are discussed in the following paragraphs. It may be noted that many of the items discussed in the following paragraphs, may be designated in foreign currencies.

Claims Against the Bank Not Acknowledged as Debts: The auditor should examine the relevant evidence, e.g., correspondence with lawyers/others, claimants, workers/officers, and workmen's/officers' unions. The auditor should also review the minutes of meetings of board of directors/committees of board of directors, contracts, agreements and arrangements, list of pending legal cases, and correspondence relating to taxes, and duties, etc. to identify claims against the bank. The auditor should ascertain from the management the status of claims outstanding as at the end of the year. A review of subsequent events would also provide evidence about completeness and valuation of claims.

Liability on Account of Outstanding Forward Exchange Contracts: The auditor may verify the outstanding forward exchange contracts with the register maintained by the branch and with the broker's advice notes. In particular, the net "position" of the branch in relation to each foreign currency should be examined to see that the position is generally squared and not uncovered by a substantial amount. The net "position" as reported in the financial statements may be verified with reference to the foreign exchange position report prepared by the back office.

Guarantees Given on Behalf of Constituents: The auditor should ascertain whether there are

* In terms of the Circular No. A.P. (Dir. Series) 60 dated January 31, 2004, any trade credit extended for a period of three years and above comes under the category of external commercial borrowings.

adequate internal controls over issuance of guarantees, e.g., whether guarantees are issued under proper sanctions, whether adherence to limits sanctioned for guarantees is ensured, whether margins are taken from customers before issuance of guarantees as per the prescribed procedures, etc.

The auditor should ascertain whether there are adequate controls over unused guarantee forms, e.g., whether these are kept under the custody of a responsible official, whether a proper record is kept of forms issued, whether stock of forms are periodically verified and reconciled with the book records, etc.

The auditor should examine the guarantee register to seek evidence whether the prescribed procedure of marking off the expired guarantees is being followed or not.

The auditor should check the relevant guarantee registers with the list of outstanding guarantees to obtain assurance that all outstanding guarantees are included in the amount disclosed in this behalf. The auditor should also examine that expired guarantees are not included in this head. He should verify guarantees with the copies of the letters of guarantee issued by the bank and with the counter-guarantees received from the customers. He should also verify the securities held as margin. If a claim has arisen, the auditor should consider whether a provision is required in terms of the requirements of AS 29, "Provisions, Contingent Liabilities and Contingent Assets".

The auditor should obtain a written confirmation from the management that all obligations in respect of guarantees have been duly recorded and that there are no guarantees issued upto the year-end which are yet to be recorded.

Acceptances, Endorsements and Other Obligations: The auditor should 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.

The auditor should verify the balance of letters of credit from the register maintained by the bank. The register indicates the amount of the letters of credits and payments made under them. The auditor may examine the guarantees of the customers and copies of the letters of credit issued. The security obtained for issuing letters of credit should also be verified.

Other Acceptances and Endorsements: The auditor should study the arrangements made by the bank with its customers. He should test check the amounts of the bills with the register maintained by the bank for such bills. The auditor should also examine whether such bills are marked off in the register on payment at the time of maturity.

In respect of letters of comfort, the auditor should examine whether the bank has incurred a potential financial obligation under such a letter. If a comfort letter does not cast any such obligation on the bank, no contingent liability need to be disclosed on this account.

Common Procedures: The auditor should obtain a written confirmation from the management that all obligations assumed by way of acceptances, endorsements and letters of credit have been duly recorded and there are no such obligations assumed upto the year-end, which are yet to be recorded.

The auditor should ascertain whether a contingent obligation assumed by a bank either by way of acceptance, endorsement etc. has resulted in an actual obligation owing to any act or

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default on the part of its constituent. In such a case, a provision would have to be made in the accounts for the bank's obligation. The amount of the provision should be determined taking into account the probable recovery from the customer.

Other Items for Which the Bank is Contingently Liable: The auditor should examine whether commitments under all outstanding underwriting contracts have been disclosed as contingent liabilities. For this purpose, the auditor should examine the terms and conditions of the relevant contracts.

Rediscounting is generally done with the RBI, Industrial Development Bank of India or other financial institutions or, in the case of foreign bills, with foreign banks. If the drawer dishonours the bill, the rediscounting bank has a right to proceed against the bank as an endorser of the bill. The auditor may check this item from the register of bills rediscounted maintained by the branch. He should satisfy himself that all the bills are properly marked off on payment at the time of maturity.

In respect of disputed tax demands, the auditor should examine whether there is a positive evidence or action on the part of the bank to show that it has not accepted the demand for payment of tax or duty. Where an application for rectification of mistake has been made by the entity, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of tax is for a certain amount and the dispute relates to only a part and not the whole of the amount, only such amount should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure as per provisions of AS 29, "Provisions, Contingent Liabilities and Contingent Assets". In determining whether a provision is required, the auditor should, among other procedures, make appropriate inquiries of management, review minutes of the meetings of the board of directors and correspondence with the entity's lawyers, and obtain appropriate management representations.

Disputed tax liabilities in respect of income-tax and similar central taxes would not form part of balance sheet of a branch as these items are dealt with at the head office level. However, the principles enunciated above should be followed in dealing with taxes and duties (such as, local taxes) dealt with at the branch level.

The auditor should also look into the manner of disclosure of interest rate swaps in the financial statements of the bank. The interest rate swaps would be treated as real or contingent liability depending upon the facts and circumstances of each case in accordance with the provisions of the Accounting Standard (AS) 29.

The auditor as in the case of other entities may verify other items under this head.

Bills for Collection: The auditor should ensure that the bills drawn on other branches of the bank are not included in bills for collection.

Inward bills are generally available with the bank on the closing day and the auditor may inspect them at that time. The bank dispatches outward bills for collection soon after they are received. They are, therefore, not likely to be in hand at the date of the balance sheet. The auditor may verify them with reference to the register maintained for outward bills for collection.

The auditor should also examine collections made subsequent to the date of the balance

sheet to obtain further evidence about the existence and completeness of bills for collection.

In regard to bills for collection, the auditor should also examine the procedure for crediting the party on whose behalf the bill has been collected. The procedure is usually such that the customer's account is credited only after the bill has actually been collected from the drawee either by the bank itself or through its agents, etc. This procedure is in consonance with the nature of obligations of the bank in respect of bills for collection.

The commission of the branch becomes due only when the bill has been collected. The auditor should, accordingly, examine that there exists adequate internal control system that debits the customer's account with the amount of bank's commission as soon as a bill collected is credited to the customer's account. The auditor should also examine that no income has been accrued in the accounts in respect of bills outstanding on the balance sheet date.

Co-acceptance of Bills: The auditor should ensure that the bank has instituted an adequate internal control system to comply with the safeguards as set out by the RBI's Master Circular on Guarantees and Co-acceptances.

Liability on Partly Paid Investments - If the bank holds any partly paid shares, debentures, etc., the auditor should examine whether the uncalled amounts thereof are shown as contingent liability in the balance sheet.

Liability on Account of Outstanding Forward Exchange Contracts - All branches which undertake foreign exchange business (i.e., those which are authorised foreign exchange dealers) usually enter into forward exchange contracts. The amount of forward exchange contracts, which are outstanding on the balance sheet date, is to be shown under this head.

XII. Accounting Policies: The term 'accounting policies' refers to the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

The specimen form given by the Reserve Bank recommends the disclosure of the fact that the financial statements are prepared on the historical cost basis and conform to the statutory provisions and practices prevailing in the country. Besides, disclosure of accounting policies relating to the following areas is recommended in the specimen form.

- (a) Transactions involving foreign exchange, viz., monetary assets and liabilities, non-monetary assets, income and expenditure of Indian branches in foreign currency and of overseas branches, and profit/loss on pending forward contracts.
- (b) Investments
- (c) Provisions in respect of doubtful advances
- (d) Fixed assets and depreciation
- (e) Staff benefits
- (f) Significant provisions deducted in computing net profit, e.g., provision for income, provision for doubtful advances, etc.
- (g) Grouping of contingency funds in presenting balance sheet.

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The specimen form of accounting policies was issued by the Reserve Bank in 1991. Since then, the Reserve Bank has issued a number of guidelines relating to income recognition, asset classification, provisioning and investments. These guidelines have had a profound impact on the accounting policies of banks in the relevant areas. Disclosure of accounting policies formulated by banks to comply with these guidelines is essential to enable the users to properly understand the financial statements. Besides, in the case of banks having overseas branches, the methodology adopted for translating the financial statements of such branches may also constitute a significant accounting policy.

Segment Reporting by Banks: While complying with the above Accounting Standard, banks are required to adopt the following:

- The business segment should ordinarily be considered as the primary reporting format and geographical segment would be the secondary reporting format.
- The business segments will be 'Treasury', 'Corporate/Wholesale Banking', 'Retail Banking' and 'Other banking operations'.
- ' Domestic' and 'International' segments will be the geographic segments for disclosure.
- Banks may adopt their own methods, on a reasonable and consistent basis, for allocation of expenditure among the segments.

Accounting Standard 17 - Format for disclosure under segment reporting

Part A: Business segments

(Amounts in ₹ crore)

Business Segments	Treasury		Corporate / Wholesale Banking		Retail Banking		Other Banking Operations		Total	
	Current Year	Previous Year	Current Year	Previous Year	Current Year	Previous Year	Current Year	Previous Year	Current Year	Previous Year
Result										
Unallocated expenses										
Operating profit										
Income taxes										
Extraordinary profit/ loss										
Net profit										
Other information:										

Segment assets										
Unallocated assets										
Total assets										
Segment liabilities										
Unallocated liabilities										
Total liabilities										
Part B: Geographic segments										

(Amount in Rs. crore)						
	<i>Domestic</i>		<i>International</i>		<i>Total</i>	
	<i>Current Year</i>	<i>Previous Year</i>	<i>Current Year</i>	<i>Previous Year</i>	<i>Current Year</i>	<i>Previous Year</i>
Revenue						
Assets						

Donations by banks: In terms of RBI Circular DBOD.No.Dir.BC. 50/13.01.01/2005-06 dated December 21, 2005, the policy relating to donations given by banks to various entities may be formulated by the banks' Boards of Directors, keeping in view the following general principles:

- i. The profit making banks may make donations during a financial year aggregating upto **one per cent** of the published profit of the banks for the previous year. In some cases, banks create funds for specific purposes to encourage research and development in fields related to banking. The Board of the banks may determine the amount of contribution to be made to such funds. The contribution made to such funds in a year will be reckoned for computation of the one percent ceiling.
- ii. The donations out of the research and development funds should normally be made for setting up professional chairs, granting fellowships/ scholarships for studies and research at universities and approved institutions and for commissioning special projects for investigation, analysis and research for areas pertaining to banking, finance, statistics, management and economics, etc.
- iii. The donations to Prime Minister's National Relief Fund (Procedure to be followed for remitting the contributions / donations to the fund is indicated in the Annexure) and

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subscriptions / contributions to professional bodies / institutions related to banking industry like Indian Banks' Association, National Institute of Bank Management, Indian Institute of Banking and Finance, Institute of Banking Personnel Selection and Foreign Exchange Dealers' Association of India may be excluded from the limit indicated in para (i) above.

iv. Loss-making banks can make donations totalling Rs.5 lakh only in a financial year including donations to exempted entities / funds indicated in para (iii) above.

v. Unutilised portion of the limit of one percent should not be carried forward to the next year.

Internal assignments in banks by statutory auditors: Audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the bank during the same year. In case the firms are associated with internal assignment it should be ensured that they relinquish the internal assignment before accepting the statutory audit assignment during the year vide RBI Circular RBI/2008-09/ 335 Ref.DBS.ARS.No.BC. 02/ 08.91.001/ 2008-09 dated December 31, 2008

11.9 Concurrent Audit

Concurrent audit, as the name suggests, is an audit or verification of transactions or activities of an organisation concurrently as the transaction/activity takes place. It is not a pre-audit. The concept in this audit is to verify the authenticity of the transaction/activity within the shortest possible time after the same takes place. It is akin to internal audit which is a concept recognised under the Companies Act. In view of the complexities of economic activities it is now well recognised that there must be a system of someone, other than the person involved in the operations, verifying the authenticity of the transaction/activity on a regular basis so that any deviation from the laid down procedures can be noticed in the shortest possible time and remedial action can be taken.

The concept of concurrent audit in the public as well as the private sector banks has gained acceptance in recent years. In some banks this task has been entrusted to the internal inspection staff who are not engaged in operational activities. In other banks, this work is allotted to outside professional firms of chartered accountants. The Reserve Bank of India (RBI) has issued certain guidelines for the conduct of this audit.

These guidelines are mandatory and all banks are required to cover 50 percent of total deposits and 50 per cent of total advances under this audit. This will mean that all banks will have to put their large branches under this audit.

11.9.1 Scope of Concurrent Audit - The guidelines issued by the RBI cover all the important areas of activities of the branch which is under concurrent audit. Most banks have prepared an Audit Manual for this purpose. Broadly stated, the following areas are covered by these guidelines:

- (i) Daily cash transactions with particular reference to any abnormal receipts and payments. This will include currency chest transactions, major expenses incurred by cash payments and high value cash receipts and disbursements.

- (ii) Purchase and sale of shares, securities, etc. physical verification of investments and verification of rates at which transactions are entered into. Similarly, examination of capital expenditure on purchase of capital assets as well as sales of such assets. This will include verification of relevant documents and authorisation.
- (iii) Verification of procedure and documentation for opening new current, savings, term deposit accounts, etc. If there are any unusual operations in these new accounts the same should be examined thoroughly and unusual-features should be reported.
- (iv) Verification of Advances-Overdrafts, TOD, CC Accounts, Term Loans, Bills Purchase, L.C., Guarantees, Overdues, devolvement, and L.C./Guarantee, etc. For this verification special attention is required to be given to (a) procedure for sanction and renewal of limits and proper authorisation (b) disbursement of funds within limits and according to terms of sanction (c) recovery of funds (d) verification of godown, stock, securities, etc. (e) documentation including renewal of documents, registration of charges, mortgages, etc. (f) classification of advances (g) study of financial health of customers by observation about conduct of accounts, regular compliance by submission of financial information, stock statements, etc. and study of audited annual accounts of corporate as well as non-corporate customers, (h) timely signals for accounts likely to become doubtful (i) timely legal action for recovery (j) verification of interest and other service charges levied as per terms of sanction (k) credit rating of borrower and (l) compliance with special conditions contained in the terms of sanction.
- (v) Foreign Exchange transactions – if the branch is authorised to handle foreign exchange transactions these transactions have to be verified in detail in accordance with RBI guidelines. All aspects of Import/Export transactions, Foreign Bills transactions, Foreign L.C./Guarantees, FCNR/NRI deposits, Nostro/Vostro accounts, compliance with RBI guidelines and reporting will have to be examined.
- (vi) House keeping – This is another sensitive area. This will include verification of balancing of all ledgers and registers, inter-branch reconciliation, bank reconciliation, bank reconciliation, test calculations and verification of interest, discount, commission and exchange income, vouchers for expenses, transactions with staff members, reconciliation of clearing differences, reconciliation of suspense and other sensitive accounts, debit balances in savings accounts and Temporary Overdrafts.
- (vii) Special effort to detect revenue leakage should be made.
- (viii) Special attention to be paid to all fraud prone areas. The attempt should be to ensure that effective measures are taken to prevent frauds. In spite of these measures, if some manipulation is done by any staff or outside party, the auditor should be able to detect the same as early as possible so that further damage is prevented and timely action is taken.
- (ix) Verification of high value transactions.
- (x) Procedure for safe custody of security forms with the branch.

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- (xi) Whether all procedures for tax deduction at source from salaries, rent, interest, professional fees, etc. are followed and tax deducted is deposited with Government in time.
- (xii) Verification of statements, H.O. Returns, statutory returns, calculation of capital adequacy ratio, and compliance with requirements of government business (collection of tax and disbursements).
- (xiii) Study of RBI and internal inspection reports, statutory auditor's report, LFAR relating to branch, etc. and compliance thereto.
- (xiv) Whether customers' complaints are dealt with promptly.

11.9.2 Concurrent audit system in commercial banks -

1. It hardly needs to be stressed that the concurrent audit system is to be regarded as part of a bank's early-warning system to ensure timely detection of irregularities and lapses which helps in preventing fraudulent transactions at branches. It is, therefore, necessary for the bank's management to bestow serious attention to the implementation of various aspects of the system such as selection of branches/coverage of business operations, appointment of auditors, appropriate reporting procedures, follow-up/rectification processes and utilisation of the feedback from the system for appropriate and quick management decisions.
2. The bank should once in a year review the effectiveness of the system and take necessary measures to correct the lacunae in the implementation of the programme.

(A) Scope of concurrent audit: Concurrent audit is an examination which is contemporaneous with the occurrence of transactions or is carried out as near thereto as possible. It attempts to shorten the interval between a transaction and its examination by an independent person not involved in its documentation. There is an emphasis in favour of substantive checking in key areas rather than test checking. This audit is essentially a management process integral to the establishment of sound internal accounting functions and effective controls and setting the tone for a vigilance internal audit to preclude the incidence of serious errors and fraudulent manipulations.

A concurrent auditor may not sit in judgement of the decisions taken by a branch manager or an authorised official. This is beyond the scope of concurrent audit. However, the audit will necessarily have to see whether the transactions or decisions are within the policy parameters laid down by the Head Office, they do not violate the instructions or policy prescriptions of the RBI, and that they are within the delegated authority.

In very large branches, which have different divisions dealing with specific activities, concurrent audit is a means to the incharge of the branch to ensure on an on going basis that the different divisions function within laid-down parameters and procedures.

(B) Coverage of business/branches

- (i) The Departments/Divisions at the Head Office dealing with Treasury functions viz investments, funds management including inter-bank borrowings bill rediscount and foreign exchange business are to be subjected to concurrent audit. In addition, all branch

offices, undertaking such business and dealing rooms have to be subjected to continuous audit.

- (ii) The coverage of branches should ensure that concurrent audit covers:
 - (a) Branches whose total credit and other risk exposures aggregate to not less than 50% of the total credit and other risk exposures of the bank; and
 - (b) Branches whose aggregate deposits cover not less than 50% of the aggregate deposits of the Bank.
- (iii) To achieve these twin criteria it is suggested that branches may be listed according to credit and other risk exposures and selected in the descending order of exposures to achieve a 50% coverage. If the deposits of these branches do not aggregate to 50% of the Bank's deposits, additional branches in descending order of deposits may be added to achieve a 50% coverage of the branches.
- (iv) While complying with the above parameters, it is necessary to ensure that the coverage encompasses:
 - ◆ exceptionally large branches
 - ◆ very large and large branches
 - ◆ special branches handling foreign exchange business, merchant banking business, large corporate wholesale banking business and forex dealing room operations
 - ◆ large problem branches rated as poor/very poor
 - ◆ Head Office department dealing with treasury/funds management and handling investment portfolio
 - ◆ any other branches or departments where in the opinion of the Bank concurrent audit is desirable.
- (v) Branches subjected to concurrent audit should not normally be included for revenue/income audit.

(C) Types of activities to be covered

- (1) The main role of concurrent audit is to supplement the efforts of the bank in carrying out simultaneous internal check of the transactions and other verifications and compliance with the procedures laid down.
- (2) The scope of concurrent audit should be wide enough to cover certain fraud-prone areas like handling of cash, deposits, safe custody of securities, investments, overdue bills, exercise of discretionary powers, sundry and suspense accounts, inter-branch reconciliation, clearing differences, foreign exchange business including Nostro accounts, off-balance sheet items like letters of credit and guarantee, treasury functions and credit-card business.

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- (3) The detailed scope of the concurrent audit should be clearly and uniformly determined for the Bank as a whole by the Bank's Inspector and Audit Department in consultation with the Bank's Audit Committee of the Board of Directors (ACB).
- (4) In determining the scope, importance should be given to checking high-risk transactions having large financial implications as opposed to transactions involving small amounts.
- (5) While the detailed scope of the concurrent audit may be determined and approved by the ACB.

(D) Appointment of Auditors and accountability

- (i) The option to consider whether concurrent audit should be done by bank's own staff or external auditors is left to the discretion of individual banks.
- (ii) In case the bank has engaged its own officials, they should be experienced, well trained and sufficiently senior. The staff engaged on concurrent audit must be independent of the branch where concurrent audit is conducted.
- (iii) Appointment of an external audit firm may be initially for one year and extended up to three years - after which an auditor could be shifted to another branch subject to satisfactory performance.
- (iv) If external firms are appointed and any serious acts of omissions or commissions are noticed in their working their appointments may be cancelled and the fact may be reported to RBI & ICAI.

(E) Facilities for effective Concurrent Audit: It has been represented that Concurrent Audit is not often effective because adequate facilities in terms of space, availability of records, etc are not available. To improve the effectiveness of concurrent audit it is suggested that -

- (i) banks arrange for an initial and periodical familiarisation process both for the bank's own staff when entrusted with the concurrent audit and for the external auditors appointed for the purpose;
- (ii) all relevant internal guidelines/circulars/important references as well as relevant circulars issued by RBI/SEBI and other regulating bodies should be made available to the concurrent auditors on an on - going basis;
- (iii) where adequate space is not available, concurrent auditors can commence work immediately after the close of banking hours.

(F) Remuneration - Terms of appointment of the external firms of Chartered Accountants for the concurrent audit and their remuneration may be fixed by banks at their discretion. Broad guidelines should be framed by ACB for these purposes. Suitable packages should be fixed by each bank's management in consultation with its ACB, keeping in view various factors such as coverage of areas, quality of work expected, number of people required for the job, number of hours to be spent on the job, etc.

(G) Reporting Systems

- (i) Concurrent auditors should be attached to the branches and not the zonal offices.
- (ii) Minor irregularities pointed out by the concurrent auditors are to be rectified on the spot. Serious irregularities should be straightaway reported to the controlling offices/ Head Offices for immediate action.
- (iii) There should be zone-wise reporting of the findings of the concurrent audit to ACB and an annual appraisal/report of the audit system should be placed before the ACB.
- (iv) Whenever fraudulent transactions are detected, they should immediately be reported to Inspection & Audit Department (Head Office) as also the Chief Vigilance Officer as well as Branch Managers concerned (unless the branch manager is involved).
- (v) There should be proper reporting of the findings of the concurrent auditors. For this purpose, each bank should prepare a structured format. The major deficiencies/ aberrations noticed during audit should be highlighted in a special note and given immediately to the bank's branch/controlling offices. A quarterly review containing important features brought out during the concurrent audits should be placed before the ACB.
- (vi) Follow-up action on the concurrent audit reports should be given high priority by the controlling office/Inspection and Audit Department and rectification of the features done without any loss of time.
- (vii) A Special Cell in the Inspection and Audit Department may be created in each bank to:
 - (1) review the selection of auditors;
 - (2) initiate and operate a system for the appraisal of the performance on concurrent auditors;
 - (3) ensure that the work of concurrent auditors is properly documented;
 - (4) be responsible for the follow-up on audit reports and the presentation of the quarterly review to the ACB.

Suggested items of coverage are given below:

(A) Cash

- (i) Daily cash transactions with particular reference to any abnormal receipts and payments.
- (ii) Proper accounting of inward and outward cash remittances.
- (iii) Proper accounting of currency chest transactions, its prompt reporting to the RBI.
- (iv) Expenses incurred by cash payment involving sizeable amount.

(B) Investments

- (i) Ensure that in respect of purchase and sale of securities the branch has acted within its delegated power having regard to its Head Office instructions.
- (ii) Ensure that the securities held in the books of the branch are physically held by it.

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(iii) Ensure that the branch is complying with the RBI/head Office guidelines regarding BRs, SGL forms, delivery of scrips, documentation and accounting.

(iv) Ensure that the sale or purchase transactions are done at rates beneficial to the bank.

(C) Deposits

(i) Check the transactions about deposits received and repaid.

(ii) Percentage check of interest paid on deposits may be made including calculation of interest on large deposits.

(iii) Check new accounts opened particularly current accounts. Operations in new current/SB accounts may be verified in the initial periods to see whether there are any unusual operations.

(D) Advances

(i) Ensure that loans and advances have been sanctioned properly (i.e. after due scrutiny and at the appropriate level).

(ii) Verify whether the sanctions are in accordance with delegated authority.

(iii) Ensure that securities and documents have been received and properly charged/registered.

(iv) Ensure that post disbursement supervision and follow-up is proper, such as receipt of stock statements, instalments, renewal of limits, etc.

(v) Verify whether there is any mis utilisation of the loans and whether there are instances indicative of diversion of funds.

(vi) Check whether the letters of credit issued by the branch are within the delegated power and ensure that they are for genuine trade transactions.

(vii) Check the bank guarantees issued, whether they have been properly worded and recorded in the register of the bank. Whether they have been promptly renewed on the due dates.

(viii) Ensure proper follow-up of overdue bills of exchange.

(ix) Verify whether the classification of advances has been done as per RBI guidelines.

(x) Verify whether the submission of claims to DICGC and ECGC is in time.

(xi) Verify that instances of exceeding delegated powers have been promptly reported to controlling/Head Office by the branch and have been got confirmed or ratified at the required level.

(xii) Verify the frequency and genuineness of such exercise of authority beyond the delegated powers by the concerned officials.

(E) Foreign Exchange transactions

(i) Check foreign bills negotiated under letters of credit.

- (ii) Check FCNR and other non-resident accounts whether the debits and credits are permissible under rules.
- (iii) Check whether inward/outward remittance have been properly accounted for.
- (iv) Examine extension and cancellation of forward contracts for purchase and sale of foreign currency. Ensure that they are duly authorised and necessary charges have been recovered.
- (v) Ensure that balances in Nostro accounts in different foreign currencies are within the limit as prescribed by the bank.
- (vi) Ensure that the over bought/oversold position maintained in different currencies is reasonable taking into account the foreign exchange operations.
- (vii) Ensure adherence to the guidelines issued by RBI/HQ of the bank about dealing room operations.
- (viii) Ensure verification/reconciliation of Nostro and Vostro account transactions/balances.

(F) Housekeeping

- (i) Ensure that the maintenance and balancing of accounts, ledgers and registers including clean cash is proper.
- (ii) Early reconciliation of entries outstanding in the inter-branch and inter-bank accounts, Suspense Account, Sundry Deposits Account, DDDR Account, Drafts Account, etc.
Ensure early adjustment of large value entries.
- (iii) Carry out a percentage check of calculations of interest, discount, commission and exchange.
- (iv) Check whether debits in income account have been permitted by the competent authorities.
- (v) Check the transactions of staff accounts,
- (vi) In case of difference in clearing there is a tendency to book it in an intermediary suspense account instead of locating the difference. Examine the day book to verify as to how the differences in clearing have been adjusted. Such instances should be reported to Head Office in case the difference persists.
- (vii) Detection & prevention of revenue leakages through close examination of income and expenditure persists.
- (viii) Check cheques returned/bills returned register and look into reasons for return of those instruments.
- (ix) Checking of inward and outward remittances (DDs, MTs & TTs).

(G) Other items

- (i) In case the branch has been entrusted with government business, ensure that the transactions are done in accordance with the instructions issued by Government, RBI & HQ.
- (ii) Ensure that the branch gives proper compliance to the internal inspection/audit reports.

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- (iii) Ensure that customers' complaints are dealt with promptly.
- (iv) Verification of statements, returns, statutory returns. The aforesaid list is illustrative and not Exhaustive.

11.9.3 Reporting by Concurrent Auditors - Timely reporting is the essence of the concurrent audit. Therefore, depending on the size of the operations in a branch the bank decides to get the audit conducted on a daily basis, monthly basis or quarterly basis. In any of these assignments, the auditor has to cover the entire area of operations. In the case of daily or monthly, audit, the audit report of the work done for a particular work is required to be submitted by the auditor by the 10th of the next month. In the case of quarterly audit the report is to be given by the 10th of the month after the end of the quarter. In the case of any serious irregularity noticed by the auditor while conducting the audit he has to give a flash report immediately so that the bank can take remedial action without any delay. Where monthly reports are given, the auditor is required to give an executive summary of audit report at the end of the each quarter. The auditor has to adhere to this discipline of timely reporting.

A member of the accounting profession has to use his specialised knowledge, skill and experience while drafting his audit report. Normally, the audit report should be divided in three parts. The first part should deal with major irregularities. The second part should deal with minor irregularities which have not been attended during the course of audit. The last part should deal with compliance with earlier reports. All issues pointed out in earlier reports which have not been complied with should be briefly stated in this last part. Items where no irregularities are found need not be stated in the report. Areas covered by the audit for the period covered by the report may be stated in the preamble. The rest of the reporting should be by exception so that only those items which require attention by the bank management are stated in the report.

Before submission of the report the auditor should discuss the important issues on which he wishes to report with the branch manager and concerned officers. This will enable him to take into consideration the opposite view point and clarify his doubts. In the case of a bank where there is four-tier system, that is, Branch, Regional Office, Zonal Office and Central Office, the detailed monthly/quarterly report is to be given to branch manager and regional manager. Quarterly executive summary is to be given to all the four authorities.

It is also essential for the bank management to take effective steps to study these reports and take remedial action so as to improve the working of the branches. Since this type of audit is conducted at the large branches only, the bank management should view the common irregularities pointed out by the auditors as illustrative and ensure that such irregularities do not take place in other branches which are not under concurrent audit. It is also essential that periodical meetings are held by the regional managers with the concurrent auditors. This will enable them to know the views of the auditors on certain important issues covering their audit assignments.

11.9.4 Audit Committee - In pursuance of RBI circular September 26, 1995, a bank is required to constitute an Audit Committee of its Board. The membership of the audit committee is restricted to the Executive Director, nominees of the Central Government and the RBI, Chartered Accountant director and one of the non-official directors.

One of the functions of this committee is to provide direction and also oversee the operations of the total audit function in the bank. The committee also has to review the internal inspection/audit function in the bank, with special emphasis on the system, its quality and effectiveness in terms of follow up. The committee has to review the system of appointment and remuneration of concurrent auditors.

The Audit Committee is, therefore, connected with the functioning of the system of concurrent audit. The method of appointment of auditors, their remuneration and the quality of their work is to be reviewed by the Audit Committee. It is in this context that periodical meetings by the members of the audit committee with the concurrent auditors and statutory auditors help the audit committee to oversee the operations of the total audit function in the bank.

Considering the coverage of this audit assignment and the specialised nature of work there is also a need for training to be imparted to the staff of the auditors. This training has to be given in specialised fields such as foreign exchange, computerisation, areas of income leakage, fraud prone areas, determination of credit rating and other similar specialised areas. The bank can organise such training programmes at various places so that it can ensure the quality of audit.

Annexure I

A. Salient Provisions of Banking Regulation Act, 1949: Of the above, the Banking Regulation Act, 1949 (hereinafter referred to as the Act), is the most important as it affects the functioning of all institutions carrying on banking business whereas the other enactments relate only to certain specific type(s) of banks. Some of the important provisions of the Act are briefly described below since familiarity with them is essential for the performance of the duties of an auditor. It may, however, be emphasised that the ensuing discussion is not an exhaustive discussion on all the relevant provisions of the Act. It may also be noted that some of the provisions discussed hereunder are not applicable to certain types of banks in view of there being specific provisions with regard to the relevant matters in the respective principal statutes governing their functioning.

Banking Companies: A banking company means “any company which transacts the business of banking in India” [section 5(c) of the Banking Regulation Act]. The term ‘company’ for this purpose covers companies registered in India as well as foreign companies, i.e., companies incorporated outside India and having a place of business within India [section 5(d)].

Forms of Business of Banking Companies: ‘Banking’ is defined as “the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise” [section 5(b)]. It has been clarified that any company which is engaged in the manufacture of goods or carries on any trade and which accepts deposits of money from the public merely for the purpose of financing its business as such manufacturer or trader shall not be deemed to transact the business of banking [Explanation to section 5(c)].

Section 6 of the Act permits a banking company to engage in certain forms of business in addition to the business of banking. Besides the forms of business specifically listed in clauses (a) – (m) of sub-section (1) of section 6, a banking company may do “all such other things as are incidental or conducive to the promotion or advancement of the business of the company” [clause (n) of sub-section

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(1) of section 6]. Under clause (o), a banking company may engage in any other form of business (besides those covered by other clauses) which the Central Government may, by notification in the Official Gazette, specify as a form of business in which it is lawful for a banking company to engage.

Under sub-section (2) of section 6, a banking company is prohibited from entering into any form of business other than those covered by sub-section (1) of the said section. Section 8 specifically prohibits a banking company from buying, selling or bartering of goods except in connection with the realisation of a security held by it. It also prohibits a banking company from engaging in any trade or buying, selling or bartering of goods for others except in connection with collecting or negotiating bills of exchange or in connection with undertaking the administration of estates as executor, trustee or otherwise. However, the above prohibitions are not applicable to any business specified by the Central Government in pursuance of clause (o) of sub-section (1) of section 6.

Licensing of Banking Companies: Section 22 of the Act prohibits a company from carrying on banking business in India unless it holds a license issued by the Reserve Bank of India. The licence may be a conditional licence. The licence may be cancelled if the company ceases to carry on banking business in India or fails to comply with the conditions of the licence or fails to fulfil any other condition laid down in the section.

Power to Suspend Operation of the Act: On a representation made by the RBI in this behalf, the Central Government may suspend the operation of the Act or of any provision thereof for a period up to 60 days either generally or in relation to any specified banking company. In case of a special emergency, the Governor of the Reserve Bank or, in his absence, any authorised Deputy Governor may also similarly suspend such operation for a period up to 30 days. In either case, the Central Government may extend the period of suspension from time to time for periods not exceeding 60 days at any one time. The total period of suspension cannot, however, exceed one year [section 4].

Requirements as to Minimum Paid-up Capital and Reserves and Regulation of Capital: Section 11 of the Act lays down the requirements as to minimum paid-up capital and reserves. Different limits have been laid down for banking companies incorporated outside India and other banking companies. Under section 12, the capital of a banking company can consist of ordinary (i.e., equity) shares only, except where preference shares have been issued prior to July 1, 1944 or where the banking company has been incorporated before January 15, 1937.

Restrictions on Opening and Transfer of Places of Business: Under section 23, prior permission of the RBI is required for opening of new, or transfer of existing, places of business in India. Similar permission is required by a banking company incorporated in India for opening a new, or transferring an existing, place of business outside India. The above restrictions, however, do not cover the change of location of an existing place of business within the same city, town or village. Opening of a temporary place of business for a period not exceeding one month is also exempted provided the conditions laid down in this behalf are satisfied. The term 'place of business' includes any sub-office, pay office, sub-pay office and any place of business at which deposits are received, cheques encashed or moneys lent.

It may be noted that recently, the RBI has permitted banks to open new places of business or transfer existing ones without obtaining specific permission from it provided certain conditions specified by the Reserve Bank in this behalf are satisfied.

Monthly Return to be Submitted to Reserve Bank: Every banking company is required to submit a monthly return to the Reserve Bank in the prescribed form and manner showing its assets and liabilities in India as at the close of business on the last Friday of the month (or if that Friday is a public holiday, at the close of business on the preceding working day). The return has to be submitted before the close of the succeeding month. The RBI also has the power to call for other returns and information [section 27].

Inspection by the Reserve Bank: Wide powers have been given to the RBI under section 35 for inspection of any banking company and its books and accounts. The Central Government can also direct the Reserve Bank to cause such an inspection.

Power of the Reserve Bank to Give Directions: The RBI is empowered to issue such directions to banking companies generally or to any banking company in particular as it deems fit in public interest, or in the interest of banking policy, or to prevent the affairs of any banking company from being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company, or to secure the proper management of any banking company generally (section 35A). The RBI is also empowered to caution or prohibit banking companies generally or any particular banking company against entering into any particular transaction or class of transactions, and generally give advice to any banking company [Clause (a) of sub-section (1) of section 36].

Provisions Relating to Accounts and Audit: Section 29 of the Act lays down requirements as to profit and loss account and balance sheet. Section 30 deals with audit of profit and loss account and balance sheet prepared in accordance with section 29. Section 31 deals with publication of profit and loss account and balance sheet and their submission to RBI whereas section 32 deals with submission of profit and loss account and balance sheet to Registrar of Companies. Section 33 deals with display of audited balance sheet, and profit and loss account by companies incorporated outside India and carrying on banking business in India. It may be noted that some of the above provisions are not applicable to nationalised banks, State Bank of India, subsidiaries of State Bank of India, regional rural banks, and co-operative banks (this aspect is discussed later in this chapter).

Other Important Provisions of the Banking Regulation Act, 1949: Besides the above provisions, a number of other provisions of the Act are relevant to the work of the auditor. The more important of these provisions are as follows.

Section 9	Disposal of non-banking assets
Section 13	Restriction on commission, brokerage, discount, etc., on sale of shares
Section 14	Prohibition of charge on unpaid capital
Section 15	Restrictions as to payment of dividend
Section 17	Reserve fund
Section 18	Cash reserve
Section 19	Restriction on nature of subsidiary companies
Section 20	Restrictions on loans and advances
Section 20A	Restrictions on power to remit debts
Section 21	Power of Reserve Bank to control advances by banking companies

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Section 24	Maintenance of a percentage of (<i>liquid</i>) assets
Section 25	Assets in India
Section 26	Return of unclaimed deposits
Section 45Y	Power of Central Government to make rules for the preservation of records

B. Applicability of Various Enactments to Different Types of Banks: As mentioned in paragraph 2.01, a number of enactments govern the functioning of banks in India. While the Banking Regulation Act, 1949 is applicable to all types of banks (though some of its provisions may not be applicable to certain types of banks or may be applicable with certain modifications), the other enactments are relevant only to particular type(s) of banks. The enactments applicable to different types of banks are discussed below.

Nationalised Banks: Nationalised banks are governed by –

- (a) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980; and
- (b) specified provisions of the Banking Regulation Act, 1949.

Fourteen banks were nationalised under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 while another six were nationalised under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980. The provisions of these two enactments are identical and deal, *inter alia*, with such matters as the following:

- ◆ Authorised and paid-up capital
- ◆ Annual accounts
- ◆ Qualifications, appointment, powers and duties of auditor (including contents of audit report)
- ◆ Disposal of profits
- ◆ Special audit at the instance of the Central Government
- ◆ Time and place of annual general meeting and business to be transacted thereat
- ◆ Restrictions on payment of bonus to officers and other employees
- ◆ Powers of the Board of Directors to make regulations in consultation with the Reserve Bank and with the previous sanction of the Central Government

Apart from all the provisions of the aforesaid Act of 1970/1980, the following provisions of the Banking Regulation Act, 1949, also apply to nationalised banks by virtue of section 51 of the latter Act.

Section 10	Prohibition of employment of managing agents and restrictions on certain forms of employment
Section 13	Restriction on commission, brokerage, discount, etc., on sale of shares
Section 14	Prohibition of charge on unpaid capital
Section 14A	Prohibition of floating charge on assets
Section 15	Restrictions as to payment of dividend
Section 17	Reserve Fund
Section 19	Restriction on nature of subsidiary companies

Section 20	Restrictions on loans and advances
Section 20A	Restriction on power to remit debts
Section 21	Power of Reserve Bank to control advances by banking companies
Section 21A	Rate of interest charged by banking companies not to be subject to scrutiny by Courts
Section 23	Restrictions on opening of new, and transfer of existing, places of business
Section 24	Maintenance of a percentage of assets
Section 25	Assets in India
Section 26	Return of unclaimed deposits
Section 27	Monthly returns and power to call for other returns and information
Section 28	Power to publish information
Section 29	Accounts and balance sheet
[excluding sub-section (3)]	
Section 30	Audit
[excluding sub-sections (1), (1A) and (3)]	
Section 31	Submission of returns
Section 34	Accounting provisions of the Act not retrospective
Section 35	Inspection
Section 35A	Power of the Reserve Bank to give directions
Section 36	Further powers and functions of Reserve Bank
[excluding clause (d) of sub-section (1)]	
Section 45Y	Power of Central Government to make rules for the preservation of records
Section 45Z	Return of paid instruments to customers
Section 45ZA	Nomination for payment of depositors' money
Section 45ZB	Notice of claims of other persons regarding deposits not receivable
Section 45ZC	Nomination for return of articles kept in safe custody with banking company
Section 45ZD	Notice of claims of other persons regarding articles not receivable
Section 45ZE	Release of contents of safety lockers
Section 45ZF	Notice of claims of other persons regarding safety lockers not receivable
Section 46	Penalties
Section 46A	Chairman, director, etc., to be public servants for the purposes of Chapter IX of the Indian Penal Code
Section 47	Cognizance of offences
Section 47A	Power of Reserve Bank to impose penalty

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Section 48	Application of fines
Section 50	Certain claims for compensation barred
Section 52	Power of Central Government to make rules
Section 53	Power to exempt in certain cases

State Bank of India and its Subsidiaries: State Bank of India and its subsidiaries are governed by –

- (a) State Bank of India Act, 1955/State Bank of India (Subsidiary Banks) Act, 1959, as the case may be; and
- (b) specified provisions of the Banking Regulation Act, 1949.

The provisions of the Banking Regulation Act, 1949, applicable to State Bank of India and its subsidiaries are specified in section 51 of the said Act and are the same as those applicable to nationalised banks (described in paragraph 2.21).

Banking Companies: Section 2 of the Banking Regulation Act, 1949, provides that the provisions of the Act shall be in addition to, and not, save as expressly provided thereunder, in derogation of the Companies Act, 1956, and any other law for the time being in force. Thus, banking companies attract the provisions of both the Banking Regulation Act, 1949, as well as the Companies Act, 1956. In case the provisions of these enactments are at variance, the provisions of the Banking Regulation Act, 1949, shall prevail.

Regional Rural Banks: Regional rural banks are governed by –

- (a) Regional Rural Banks Act, 1976; and
- (b) specified provisions of the Banking Regulation Act, 1949.

The provisions of the Banking Regulation Act, 1949, applicable to regional rural banks are specified in section 51 of the said Act and are the same as those applicable to nationalised banks (described in paragraph 2.21).

Co-operative Banks: Co-operative banks are governed by –

- (a) the Co-operative Societies Act, 1912, or the Co-operative Societies Act of the state concerned, as the case may be; and
- (b) Part V of the Banking Regulation Act, 1949.

Part V of the Banking Regulation Act, 1949, modifies certain provisions of the Act in their application to co-operative banks and omits certain others. The sections which have been significantly modified in their application to co-operative banks are sections 2, 5-A, 8, 9, 11, 18, 19, 20, 22, 23, 24, 27, 29, 31, 35, 35A, 36, 36A, 49A, 54 and 55. Besides, the First Schedule to the Act is not applicable to co-operative banks while the Third and the Fourth Schedules to the Act have been replaced by a schedule applicable only to co-operative banks.

C. Scheduled Banks: These are the banks included in the Second Schedule to the Reserve Bank of India Act, 1934. The Reserve Bank includes a bank in this Schedule if it fulfils certain conditions.

The Reserve Bank gives certain facilities to scheduled banks including the following:

- (a) Purchase, sale and rediscounting of certain bills of exchange (including foreign bills of exchange) or promissory notes.

- (b) Purchase and sale of foreign exchange.
- (c) Making of loans and advances to scheduled banks.
- (d) Maintenance of the accounts of scheduled banks in its banking department and issue department.
- (e) Remittance of money between different branches of scheduled banks through the offices, branches or agencies of the Reserve Bank free of charge or at nominal charges.

D. Returns to be Submitted to the Reserve Bank of India: The Banking Regulation Act, 1949, requires banking companies, nationalised banks, State Bank of India, its subsidiaries, and regional rural banks to furnish the following returns to the Reserve Bank of India:

- (a) Monthly return of assets maintained in India in accordance with section 24 and demand and time liabilities in India at the close of business on each alternate Friday during the month. [Section 24]
- (b) Quarterly return of assets and liabilities in India at the close of business on the last Friday of every quarter. [Section 25]
- (c) Annual return of unclaimed accounts which have not been operated for 10 years. [Section 26]
- (d) Monthly return of assets and liabilities in India at the close of business on the last Friday of every month. [Section 27]

The above types of banks have also to furnish such other statements or information as may be required by the RBI under section 27 of the Act. In exercise of its powers under the aforesaid section, the RBI requires a large number of returns to be furnished to it. Some of the important returns required to be furnished to the RBI are as enumerated below, with their periodicity indicated in parentheses.

- (a) Report on Non-performing Advances (annual)
- (b) Statement showing the position of reconciliation of investment account (annual)
- (c) Statement on compromises and settlements involving write off (half-yearly)
- (d) Statement on bad debts written off (annual)
- (e) Details of Doubtful or Loss Assets and also Suit Filed accounts with outstandings aggregating ₹ 1.00 crore and above (half-yearly)
- (f) Details of remittance of profits / surplus retained in India (annual)
- (g) Particulars of provisions held on problem credits of overseas branches (half-yearly)
- (h) Inter-branch reconciliation (quarterly)
- (i) Reconciliation of outstanding inter-branch accounts (annual)
- (j) Reconciliation of clearing differences (annual).
- (k) Position of balancing of books (quarterly)
- (l) Returns relating to frauds, robbery, etc. including fraud involving ₹ 1.00 crore and above (quarterly).
- (m) Return of Capital Adequacy (quarterly)
- (n) Return on Asset Quality (quarterly)