11
Audit of Banks

Question 1

Shy & Co. had been allotted the branch audit of a nationalized bank for the year ended 31st March, 2014. In the audit planning, the partner of Shy & Co. observed that the allotted branches are predominantly based in rural areas and major portion of the advances were for agricultural purpose. He needs your assistance in incorporating the criteria prescribed for determination of NPA norms in respect of agricultural advance, in audit plan.

(5 Marks, May, 2014)

Answer

NPA Norms in Respect of Agricultural Advance: A loan granted for short duration crops will be treated as Non Performing Asset, 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.

If 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 issued by RBI.

Question 2

While doing the audit of a nationalized bank, your Audit Assistant informed you that there are a lot of irregularities in Telegraphic Transfers and Demand Drafts. What guidance would be give to the Audit Assistant? *(4 Marks, November, 2013)*

Answer

In respect of Telegraphic Transfers and Demand Drafts, the audit assistant would be given the following guidance-

(i) 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.

(ii) The signatures on a demand draft should be checked by an officer with the Signature Book.

(iii) All the T.Ts and D.Ds. sold by a branch should be immediately confirmed by the advices to the branches concerned.

(iv) 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.

Question 3

In course of audit of Good Samaritan Bank as at 31st March 13 you observed the following:

(a) In a particular account there was no recovery in the past 18 months. The bank has not applied the NPA norms as well as income recognition norms to this particular account. When queried the bank management replied that this account was guaranteed by the central government and hence these norms were not applicable. The bank has not invoked the guarantee. Please respond. Would your answer be different if the advance is guaranteed by a State Government? (5 Marks, May, 2013)

(b) The bank's advance portfolio comprised of significant loans against Life Insurance Policies. Write suitable audit program to verify these advances. (3 Marks, May, 2013)

Answer

(a) Government Guaranteed Advance: If a 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 realized. 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.

Since the bank has not revoked the guarantee, the question of repudiation does not arise. Hence the bank is correct to the extent of not applying the NPA norms for provisioning purpose. But this exemption is not available in respect of income recognition norms. Hence the income to the extent not recovered should be reversed.

The situation would be different if the advance is guaranteed by State Government because this exception is not applicable for State Government Guaranteed advances, where advance is to be considered NPA if it remains overdue for more than 90 days.

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

(b) The audit programme to verify bank's advances against Life Insurance Policies is as under -

(i) 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.

(ii) The auditor should also examine whether premium has been paid on the policies and whether they are in force.

(iii) Certificate regarding surrender value obtained from the insurer should be examined.

(iv) The auditor should particularly see that if such surrender value is subject to payment of certain premium, the amount of such premium has been deducted from the surrender value.

Question 4

As the concurrent auditor of Z Bank Ltd you are requested by its management to draft an internal control policy in respect of loans and advances. What factors do you consider as important while drafting such a policy? (10 Marks, May, 2012)

Answer

Drafting of Internal Control Policy for Loans and Advances: The following are the important factors to be considered while drafting internal control policy in respect of loans and advances of Z Bank Ltd.-

(i) The bank should make advances only after satisfying itself as to the credit worthiness of the borrowers and after obtaining sanction from the proper authorities of the bank.

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

(iii) 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.

(iv) All the securities should be received and returned by responsible officer. They should be kept in the Joint custody of two such officers.

(v) 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.

(vi) 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.

(vii) Surprise checks should be made in respect of hypothecated goods not in the possession of the bank.

(viii) 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.

(ix) 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.

(x) All accounts should be kept within both the drawing power and the sanctioned limit at all times.

(xi) 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.

(xii) The operation in each advance should be reviewed at least once every year.

(xiii) Post disbursement supervision and follow-up should be proper, such as receipt of stock statements, instalments, renewal of limits, etc.

(xiv) There should not be any misutilisation of the loans and instances indicative of diversion of funds should be checked.

(xv) Letters of credit issued by the branch should be within the delegated power and should be for genuine trade transactions.

(xvi) Bank guarantees issued, should be properly worded and recorded in the register of the bank. They should be promptly renewed on the due dates.

(xvii) Proper follow-up should be made for overdue bills of exchange.

(xviii) The classification of advances should be done as per RBI guidelines.

(xix) The submission of claims to DICGC and ECGC should be on time.

(xx) Instances of exceeding delegated powers should be promptly reported to controlling/Head Office by the branch and should be got confirmed or ratified at the required level.

Question 5

As a bank branch auditor, what aspects will be considered while reporting on credit appraisal, sanctioning /disbursement and documentation in respect of advances in the LFAR?

(5 Marks, November, 2011)

Answer

Verification of Advances in the Long Form Audit Report (LFAR): 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-

(i) Whether the loan applications are complete and in prescribed form;

(ii) Procedural instructions regarding grant/ renewal/ enhancement of facilities have been complied with;

(iii) Sanctions are within delegated authority and disbursements are as per terms of the sanction;

(iv) 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 auditor 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.

Question 6

"An asset, including a leased asset, becomes non-performing when it ceases to generate income for the Bank." Define the criteria for classification of non-performing assets.

(8 Marks, May, 2011)

Answer

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

Criteria for the classification of 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 instalments of principal or interest thereon remain 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 securitization dated 1st February, 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.

Question 7

Write a short note on Reversal of Income under Bank Audit. *(5 Marks, November, 2010)*

Answer

Reversal of Income: If any advance, including bills purchased and discounted, becomes Non-Performing Assets 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).

Question 8

(a) While auditing the Branch of a Bank you are required to examine Inter Branch adjustments. Which points require your special attention? (6 Marks, May, 2010)

(b) How do you examine claims against the Bank not acknowledged as debts?

(4 Marks, May, 2010)

Answer

(a) Special Points to Examine Inter Branch Adjustments: The following points require special attention in the examination of Inter Branch transactions-

(i) While verifying the closing balance, special attention should be paid to the origin and validity of old outstanding unmatched entries, particularly debit entries. The auditor may also seek confirmation of transactions relating to outstanding in appropriate cases.

(ii) Whether there are any reversal entries indicating the possibility of irregular payments or frauds.

(iii) Whether the balances include any items in the nature of cash in transit included in this head which remain pending for more than a reasonable period. This is because such items are not expected to remain outstanding beyond a very small period during which they are in transit.

(iv) Whether transactions other than those relating to inter branch transactions have been included in inter branch accounts. Any unusual items put through inter branch accounts as well as old or large entries outstanding in Inter branch accounts should be carefully looked into. The auditor should also seek explanations from the Management in this regard in appropriate cases.

(b) Examination of Claims Against the Bank Not Acknowledged as Debts: The auditor should examine the relevant evidence, for example correspondence with lawyers, claimants, workers/officers and workmen's/officer's unions. The auditor should also review the minutes of the meeting of the Board of directors/committees of the Board,

contracts, agreements and arrangements, list of pending legal cases and correspondence relating to taxes, 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 previous year. A review of subsequent events would also provide evidence about completeness and valuation of claims.

Question 9

How will you evaluate the Internal Control system in the area of Credit Card operations of a Bank? *(5 Marks, November, 2009)*

Or

How will you evaluate the internal control system in the area of credit card operations in a bank? *(8 Marks, May, 2004)*

Answer

Evaluation of Internal Control System in the area of Credit Card Operations in a Bank:

(i) There should be effective screening of applications with reasonably good credit assessments.

(ii) There should be strict control over storage and issue of cards.

(iii) 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.

(iv) There should be system of prompt reporting by the merchants of all settlements accepted by them through credit cards.

(v) Reimbursement to merchants should be made only after verification of the validity of merchant's acceptance of cards.

(vi) All the reimbursements (gross of commission) should be immediately charged to the customer's account.

(vii) There should be a system to ensure that statements are sent regularly and promptly to the customer.

(viii) There should be a system of monitor and follow-up of customers' payments.

(ix) 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.

(x) 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.

Question 10

(a) What do you understand by Long-form Audit Report? *(2 Marks, November 2008)*

(b) As the concurrent auditor of Nagpur Main Branch of XYZ Bank Ltd. state the issues which have to be considered in the audit of advances. (6 Marks, November, 2008)

Answer

(a) Long Form Audit Report: The long form Audit Report has to be furnished by the auditor of a bank in addition to the audit report as per the statutory requirement. The matters which the banks require their auditor to deal with in the form of Long Form Audit Report have been specified by to Reserve Bank of India.

(b) Audit of Advances of a Bank: The items to be covered in the concurrent audit of advances of a bank are as follows-

(i) Ensure that loans and advances are sanctioned properly.

(ii) Verify whether the sanctions are in accordance with the 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.

(v) Verify whether there is any misuse of loans and advances and whether there are instances indicative of diversion of funds.

(vi) Check whether letters of credit issued by the branch are within the delegated power and ensure that they are genuine trade transactions.

(vii) Check bank guarantees issued are properly worked and recorded.

(viii) Ensure proper follow up of overdue bills of exchange.

(ix) Verify the classifications of advances are as per RBI directions.

(x) Verify whether the submission of claims to DICGC and ECGC is in time.

(xi) Verify the instances of exceeding delegated powers have been promptly reported.

(xii) Verify the frequency and genuineness of such exercise of authority beyond to delegated powers of the concerned officials.

Question 11

As a Statutory Auditor, how would you verify advances against Goods? (6 Marks, May, 2008)

Answer

Verification of Advances against Goods (Banking Companies):

(i) *Sanction:* Examine the sanction letter, letter of hypothecation and note the important terms and conditions of the advances.

(ii) *Stock statements:* Verify the quantity and value of goods hypothecated based on the stock statements received from the borrower. Test check the Godown Register and examine the valuation of goods to ascertain the reasonableness of the same.

(iii) *Inspection:* Ascertain as to whether the premises of the borrowers are periodically visited by the bank officials to verify the quantity as per the periodic stock statements.

(iv) *Stock Audit:* See whether the bank has got a system of obtaining stock and receivables audit report in respect of such advances. If so, review the stock audit report and identify adverse comments, if any.

(v) *Hypothecation/Pledge:* Examine the letter of hypothecation and certificate of registration of charge, in respect of goods pledged with the bank.

(vi) *Insurance:* Examine the insurance policies for their validity, adequacy etc. and see that policies are in favour of the bank.

(vii) *Documents of title:* Inspect the documents of title to goods like bill of lading, dock warrant, railway receipts etc to ensure that they are endorsed registered in favour of the bank.

(viii) *Third party certificate:* Where the hypothecated goods are in possession of third parties, such as clearing and forwarding agents, transporters, bankers, etc. undertaking has been obtained by the bank that they will handover the goods or sale proceeds thereof to the bank only. In such cases, certificate 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.

Question 12

How would you verify "Acceptances, Endorsements and other obligations" appearing in the Balance Sheet of a bank? *(6 Marks, May, 2007)*

Answer

Acceptances, Endorsements and Other Obligations: This item includes the following balances-

(a) letters of credit opened by the bank on behalf of its customers and

(b) bills drawn by the bank's customers and accepted/endorsed by the bank.

Letters of credit: Evaluate the adequacy of the internal controls over LC Forms e.g. custody, maintenance of records, periodical verification, reconciliation etc.

Verify the balance of LC from the Register maintained by the bank to ascertain the amount of LC and payments made under them.

Examine the guarantees of the customers, copies of the LC issued & security obtained for issuing LC.

In respect of other acceptances and endorsements, the following procedure may be adopted-

(i) Examine the arrangements made by the bank with its customers.

(ii) Test check the amounts of bills with the register maintained by the bank.

(iii) Verify whether such bills are marked off in the register on payment at maturity.

Letters of comfort: Where letters of comfort has been issued, verify whether the bank has incurred a potential financial obligation under such a letter. If an obligation has been cast under letters of comfort, ensure that the amount has also been shown as contingent liability in the Balance Sheet.

Question 13

Explain the scope of concurrent audit of a bank with reference to Reserve Bank of India guidelines. *(16 Marks, November, 2006)*

Answer

Scope of Concurrent Audit of Banks with Reference to RBI Guidelines: The following are the areas to be covered-

(i) Daily cash transactions with reference to abnormal receipts and payments. This will include currency chest transactions, major expenses met by cash, high value receipts and disbursements.

(ii) Purchase and sale of shares securities etc. Physical verification of investments and rates at which they are entered into.

(iii) Verification of procedure and documentation to open new current, savings, term deposit accounts, etc. Unusual operations noticed have to be thoroughly examined.

(iv) Verification of advances, overdrafts, temporary OD, Cash credit accounts, term loans, bills purchase, letters of credit etc. Procedure for sanction and documentation to be verified. Any deviation noticed to be examined in great detail.

(v) Foreign exchange transactions to be verified with reference to RBI guidelines.

(vi) Verification of balancing of all ledgers and registers, inter branch reconciliation calculation and verification of interest, discount, commission etc.

(vii) Revenue leakage to be detected.

(viii) Special efforts to be made in all fraud prone areas. The attempt should be to ensure that all effective measures are taken to prevent frauds.

(ix) Verification of high value transactions.

(x) Procedure for safe custody of security forms with the branch.

(xi) Whether all procedures for tax deduction at source are followed and the tax so deducted are deposited into Government Account within the time fixed.

(xii) Verification of returns, statements, calculation of capital adequacy ratio and compliance with requirements of government business.

(xiii) Study of RBI and Internal Inspection reports, statutory auditor's report and compliance thereto.

(xiv) Whether the customers' complaints are dealt with promptly.

Question 14

As a Statutory Auditor, of a bank, how would you verify the "Sacrifice" on Non-Performing Assets for which Corporate Debt Restructuring has been undertaken? (6 Marks, May, 2006)

Answer

Corporate Debt Restructuring and Sacrifice Element: The Revised Guidelines on Corporate Debt Restructuring (CDR) Mechanism specified that in case of rescheduling of accounts, the element of interest to be computed in present value terms. The guidelines state that the sacrifice should be computed as the difference between the present value of future interest income 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 interest charged as per the restructuring package discounted by the current BPLR as on the date of restructuring plus appropriate term premium and credit risk premium as on the date of restructuring. Accordingly, the following steps may be taken in this regard-

(i) Check the appropriate credit risk premium for the specific borrower category for all restructured accounts.

(ii) Ascertain appropriate rate of discount.

(iii) Check the computation of present value interest and the sacrifice amount.

(iv) See that the entire amount should be written off or provided for in case sacrifice is positive.

(v) Verify provision of adequate security coverage of the loan in case restructuring of principal amounts.

Question 15

Write a short note on Valuation of Investments "held to maturity" by banks.

(4 Marks, November, 2005)

Answer

Valuation of Investments "Held to Maturity": The banks are required to classify their entire investment portfolio into three categories: held to maturity (HTM), available for sale (AFS), and held for trading (HFT). Securities acquired with the intention to hold them up to maturity should be classified under HTM category. Thus, this category will comprise only debt securities (e.g., debentures, redeemable bonds, government securities), preference shares and similar securities having a defined period of maturity, except that equity shares of subsidiaries/joint ventures have also to be included in HTM category.

These investments need not be Marked to Market and will be carried at acquisition cost unless it is more than the face value, in which case the premium should be amortized over the period remaining to maturity. For instance if a bond is acquired at say ₹ 90 and it is redeemable at ₹100 after three years, the discount, i.e., ₹10 should also be amortised as income over the next three years unless there is significant uncertainty of receipt of full face value on maturity.

Any diminution, other than temporary should be recognised in the value of their investments in subsidiaries/JVs and provided for. Such diminution should be determined and provided for each investment individually.

Question 16

What are the exceptions to the general rule of treating advances as Non-performing Assets (NPAs)? (4 Marks, May, 2005)

Answer

Non-performing Assets: RBI has laid down norms for classification of assets and provisioning norms for NPAs. However, certain exceptions to these norms are discussed below-

(i) *Temporary deficiencies,* e.g., non availability of current drawing power due to non-receipt of latest stock statement, temporary delay in renewals of limits on due date, etc.

(ii) *Natural Calamities:* Where, in the wake of natural calamities, short-term agricultural loans are converted into term loans or there is rescheduling of repayment period or fresh short-term loans are sanctioned, the term loan as well as fresh short term loan may be treated as current dues and need not be classified as NPA.

(iiii) *Facilities Backed by Central Government Guarantees*: Credit facilities backed by guarantee of the Central Government though overdue should be treated as NPA only when the government repudiates its guarantee when invoked (this exemption is only for the purpose of asset classification and provisioning and not for the purpose of recognition of income).

(iv) *Advances to "On Lending" arrangements* are also exempted under this category.

Question 17

Write a short note on Principal Enactments Governing Bank Audit. (4 Marks, November, 2004)

Answer

Principal Enactments Governing Bank Audit: 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-

(i) Banking Regulation Act, 1949.

(ii) State Bank of India Act, 1955.

(iii) Companies Act, 2013.

(iv) State Bank of India (Subsidiary Banks) Act, 1959.

(v) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970.

(vi) Regional Rural Banks Act, 1976.

(vii) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.

(viii) Information Technology Act, 2000.

(ix) Prevention of Money Laundering Act, 2002.

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

(xi) Credit Information Companies Regulation Act, 2005.

(xii) 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.