

## Verification of Advances



*As we know, there are severe time constraints in the matter of completion of the audit and this could have a serious impact on the quality of work and we need to gear up for ensuring that quality is not sacrificed by mere mechanical attempt to complete the Audit. The preparatory work involves an extensive exercise, requiring detailed programme and check lists to ensure compliances with the latest regulatory guidelines in letter and spirit and by drawing up elaborate check lists for all the areas of banking transactions and Verification of advances is the major and most critical area in any bank audit. We need to consider these critical aspects, to avoid any omissions, when the financial statements are subsequently reviewed, including by the Regulators. This article gives a brief guidance for verification of advances while conducting Statutory Bank Branch Audit.*

In the said topic we are not touching upon the Agricultural and Foreign Advances, NPA and prudential norms and basic questions to be answered in the LFAR, nevertheless this will assist in answering many of the questions of LFAR related to advances.



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Auditor should also review the Internal Controls on the advances portfolio which mainly includes: Defined policy of sanctioning the Loan, Eligibility and Authorisation Criteria, proper KYC Compliance, Documentation and Disbursement Policy, Pre and post disbursement procedures to be followed and its reporting to various levels as per the findings, Review and required modifications in the banking software, review of various MIS and exception reports generated through the system at regular intervals etc.

### **How to Begin:**

Due to time constraints and voluminous number of accounts, it is not possible to verify each and every

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account at the Branch level. For identification of accounts for verification, Auditor should review Advances mix of various types of advances at the Branch, apart from the mandatory Regulatory requirements.

Branch Auditor should verify in detail the Advances which are in excess of 5% of total advances of the Branch and advances above ₹ 2.00 crores (also required to be reported as Annexures to the LFAR), fresh additions and upgradations of NPA's during the year (can be identified through Movement of NPA statement) and the advances which were frequently overdrawn or irregular during the Audit period (can be identified from exceptional reports or various returns and reports required to be submitted to the Controlling Authorities).

Auditors should give special attention to Special Mention Accounts (SMA). All the Banks have some set of system for reporting of irregular accounts at various stages to its higher authorities. As per the RBI Circular RBI/2017-18/131 DBR.No.BP.BC.101/21.04.048/2017-18 on Resolution of Stressed Assets – Revised Framework:- Lenders shall identify incipient stress in loan accounts, immediately on default, by classifying stressed assets as SMA as per the following categories:

SMA Sub-categories	Basis for classification – Principal or interest payment or any other amount wholly or partly overdue between
SMA-0	1-30 Days
SMA-1	31-60 Days
SMA-2	61-90 days

Lenders have to report to the credit information, including classification of an account as SMA to Central Repository of Information on Large Credits (CRILC) on all borrower entities having aggregate exposure of ₹ 50 million and above with them.

Branch auditors should review the list of New sanctions and enhancement during the year (including Ad hoc limit / TOD sanctioned in case of working capital limits) and more emphasis should be given on the enhancement of limits and ad hoc sanctions to frequently irregular accounts. Ad hoc Limits are generally sanctioned for three months and the separate documents are required to be obtained for the same. Auditors also need to verify, whether such accounts have been properly reported in the periodical control returns submitted by the branch.

Special care should also be taken in verification of Taken Over accounts from other banks. In case of Taken Over accounts, Branch should have obtained Credit report of the previous banker and reason of shifting of the account with justification. The format of credit information to be sought by the Banks is prescribed in Annex II of RBI circular DBOD.No.BP.BC.94/08.12.001/2008-09 dated December 8, 2008.

The accounts for verification can also be identified from the review of other Reports (along with its respective Compliance report) such as RBI Inspection, Concurrent/Internal Audit, Risk Based Audit, previous Year's Statutory and LFAR audit Report, Credit and Stock Audit Reports etc. These reports shall alert the Branch auditors to identify the accounts which require more attention and verification during the course of audit.

After identification of accounts for scrutiny and verification, Branch Auditor Should:

## 1. Review of Other Records:

### a. Latest Sanction/Review Letter:

Generally in most of the Banks, all major information and issues are noted and addressed in the Sanction/ review letters (if not, the Auditor should also refer appraisal note), such as facilities sanctioned past and Current, major points of appraisal notes, name of the Directors and Guarantors with their CIBIL score and Net worth, Details of Prime and Collateral securities offered with latest valuation details, Credit ratings, required government approvals and NOCs, projections with justification, brief information about the previous year financials with Ratio Analysis, etc.

Auditor should also verify that the Proposal has been routed through appropriate authorisation levels and also that the recommendations are properly documented and noted along with a specific mention of deviation from standard credit policy of the bank and sanction for such deviations are separately approved. Sanction should be within the discretionary powers and if not, it is timely ratified by the appropriate authority.

### b. Review of Documents and Creation of Charges on Security:

After verification of Sanction/review letter, Auditor should check whether all the documents obtained are as per the sanctioned terms and are valid. If loan

documents are not executed properly, the same may lead to a difficult situation for the bank in case of litigations. Whether there is proper creation of charge (with concerned authorities) on the assets of the borrower which are taken as securities by the bank and are adequately insured with bank clause. Whether the documents are properly stamped (according to respective Stamp Act and Rules applicable to States/Areas) and are in force. Acknowledgment of debt from borrower and guarantors have been obtained wherever required. Auditor should also ensure that the documents are vetted by the legal department or by the empaneled lawyer of the bank and the report is on record.

### c. Latest Financials

Auditor should not only review the latest audited financial statements submitted by the borrower but also review the Quarterly Information Statement submitted by the Borrower. Auditor should also see that the financials are complete and are obtained with Accounting Polices / Notes / Audit Report. While reviewing the financials focus should also be on the diversion and siphoning of funds, if any. The terms “diversion of funds” and “siphoning of funds” should construe to mean the following :

- (a) Utilisation of short-term working capital funds for long-term purposes not in conformity with the terms of sanction;
- (b) deploying borrowed funds for purposes / activities or creation of assets other than those for which the loan was sanctioned;
- (c) transferring funds to the subsidiaries / Group companies or other corporates by whatever modalities;
- (d) routing of funds through any bank other than the lender bank or members of consortium without prior permission of the lender;
- (e) investment in other companies by way of acquiring equities / debt instruments without approval of lenders;
- (f) shortfall in deployment of funds vis-à-vis the amounts disbursed / drawn and the difference not being accounted for.

### d. Stock Statements :

In case of working capital limits and/or limit sanctioned against current

assets, auditor should check whether the stock statements are submitted in the prescribed format regularly and is properly reviewed by the Bank. In most of the formats prescribed by the Bank, Stock statement also contains the details regarding periodical movement of the Stock and Book debts for the month. Auditor should review those statements meticulously. Auditor should also check the computation of drawing power as per the terms of sanction with requisite margins.

### e. Adequacy of Insurance with Bank Clause.

Auditor should also verify whether all the Primary as well as Collateral securities are adequately insured and are having Bank Hypothecation Clause and the location of the assets is properly mentioned on the policies. It should also further verify whether the insurance policies are valid and in force as on the date. In case of Working Capital limits against stock all the locations (including third party locations if stock is stored at that place) are covered including coverage for stock in transit.

### f. Latest Internal Inspection, Credit Audit and Stock/Security Verification Audit Report.

Auditor should also go through the Credit Audit, Stock and Asset inspections/Audit reports, wherever mandatory and as per the laid down system and policy of the Bank. These Audits are generally carried out in respect of borrowers where credit facilities are against their inventories/assets to determine the existence and valuation thereof and to gauge the adequacy of the Primary/Collateral securities. Auditor should review these reports with its compliance report submitted by the borrower and the concerned staff.

### g. Checking of Non-Fund based Advances:

Common Non-Fund Based facilities provided by the bank are BG- Bank Guarantees (Financial or performance), LC- Letter of Credit and Letter of Comfort (mostly in favour of Overseas Banks or Financial Institutions). Outstanding balance in these accounts are reflected as contra items on both assets and liabilities sides of balance sheet of banks. These facilities may

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get converted into funded facility in case of defaults and may have more risk due to inadequate coverage of security. Mostly the process of sanction is same as that of fund based facility and most of the large borrowers have both types of facilities and may have inter-changeability.

Here, first the auditor must ascertain the level of interface between CBS and books of accounts if the BG and LC is having different modules in CBS. Get total List of Outstanding BGs and LCs and check whether there are any expired BGs and LCs. Auditor should also verify whether the Bank guarantees which are expired are reversed after due process after getting original guarantee document back and in case of LC's auditor need to verify that letter of credit is reversed after its validity period or after its partial utilisation. Auditor should also verify that proper documentation is done and Appropriate margin is obtained as per the sanction terms.

Branch auditors should also verify whether Devolved Letters of Credit as well as Invoked Bank Guarantees during the audit period which have not been recovered from the Borrower as at the year end. Further it would also be confirmed whether the funded portion of these facilities are not parked separately and are debited to the operating current/working capital account of the Borrower immediately on devolvement/invocation.

## 2. Review of Bank Operations:

In case of Cash Credit and Overdraft accounts, Auditors should critically review the operations in the account specially at month end, quarter end. While verifying the auditor should check are there any Large Cash Transactions in the account, whether turnover in account is healthy and is in sync (credit and debit summation) of account with the stock and book debt statements submitted by the borrower. If the borrower is having allocated limits with other branches, information of the same should also be reviewed. Auditor should also go through the Exceptional Reports generated through the system to identify any unusual operations in the account. Special attention should be given for TOD/frequent bouncing of cheques.

If credit limits are further divided in to sub-limits/within limits in CC, like B/D, B/P/ Capex/ Opex LC's etc.), care should be taken to review the operations in these limits also.

If the operations are neck to neck to sanctioned limits (almost 100% utilisation), special care should be given to transactions after the year end to avoid the possibility of window dressing. Auditor should also get the Snap/short report/Turnover Report of account where summary of Transactions (for specific period) is given such as, Turnover in account, Average Balance, Minimum and maximum Debit/Credit balances, Number of occasions overdrawn etc. is conveyed.

## 3. Advances under Consortiums:

If Auditee Branch is one of the members of Consortium advance, in addition to regular verification of other areas, auditor should also go through the minutes of Consortium meetings held and other correspondence with the Lead Banker and other member banks. Auditor should ensure whether effective reporting and communication has been there with the Lead Bank and the details of operations and information about the account from other consortium member(s) is also available on record.

If the Auditee Branch/Bank is the leader of consortium then more responsibility is assumed on the branch to review and monitor the account not only with the Branch but also to act as a conduit within the consortium member banks and sharing of important information and operation of such accounts amongst the consortium members. Also, as an Auditor we must carefully and diligently take due care in verification of such advances by verifying the periodic review of operation and conduct of the account. Generally, common set of loan documents are obtained by the lead bank on behalf of other participating banks.

Even though the Advance is in consortium, in most of the cases, borrower has direct business relationship with all member banks of the consortium. Because of the same, it become crucial to have updated information about the status and operations of all the member banks at regular intervals.

## 4. Advances under Multiple Banking:

Here also, auditor has to take due care as there is no formal arrangement amongst the lending banks and each of them has its own set of loan documents, securities and mode of lending and most critical is lending banks do not necessarily have exchange of information



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amongst themselves. It has been observed in the past that the accounts have become irregular or frauds have taken place mainly due to lack of effective sharing of information about the credit history and the conduct of the account of the borrowers among various banks.

RBI for improving effective sharing/dissemination of Information among the Banks have given some guidelines and have suggested some formats of reporting (Circular Ref No. RBI/2008-2009/183 DBOD No. BP. BC.46/08.12.001/2008-09).

## 5. Advances under Disbursement or disbursed during the year:

While verifying the Advances which are under disbursement or disbursed during the year, Auditor should go through the following documents in detail: Credit appraisal note, fulfilment of all terms of sanction, pre disbursement visit/inspection report, Techno-economic feasibility report, disbursement with proper supporting, utilisation certificate from management supported by the certification by professionals, Stage of completion on the basis of inspection and technical report etc. Auditor should also review that proper Margin is infused by the Promoters as per the sanction terms and the progress of project is in line with the projected DCCO, Cost overrun etc. Auditor should also ensure that the disbursement (in the form of new loan or an enhancement in limit) is not done to accommodate the overdrawing of an existing advance account or for the purpose of diversion of funds to group/ associate concerns.

## 6. Re-structured Advances:

It is a very vast topic and here I am touching only about the verification of such advances.

In most of the cases, account is restructured or rescheduled due to some inherent weakness. Auditor should review the sanction of restructure and check whether same is in compliance with RBI guidelines/directives and credit policy of the Bank. Check all the documents and verify fulfillment of all the sanctioned terms. Verify the calculation of DFA (diminution in the fair value of the advance). If auditor feels that financial viability is not established and there is no reasonable certainty of repayment from the borrower, as per the terms of restructuring package same should be brought on record and be dealt with accordingly.

Recently by circular No. RBI/2018-19/100 DBR. No.BP.BC.18/21.04.048/2018-19 dated 1<sup>st</sup> January 2019 with reference to its circular circulars DBR.No.BP.BC.100/21.04.048/2017-18 dated February 07, 2018 and DBR.No.BP. BC.108/21.04.048/2017-18 dated June 6, 2018 decided to permit a one-time restructuring of existing loans to MSMEs classified as 'standard' without a downgrade in the asset classification, subject to certain conditions in case of accounts were aggregate exposure, including non-fund based facilities of banks and NBFCS to the borrower does not exceed ₹ 250 million as on January 1, 2019.

## 7. Documents held Centrally:

Now most of the banks are having system of centralised sanctioning and documentation while the account is operated in other Branches. There are chances of error, omissions and irregularities if there is lack of co-ordination procedures between administrative centralised offices having custody/control over documentation and sanction and the branch where the borrower's account (dealing Branch) is maintained and serviced. If possible, auditor should do the verification of these documents and sanctions, if not, obtain confirmation from branch and report the same, (to the extent examination of the borrowal accounts could not be made due to non-access to the records sought and not produced at the branch). Branch auditor should also go through the (for accounts related to branch) adverse features pointed out by the Internal/Concurrent/Inspection audit of the centralised office as regards the appraisal, disbursement, sanction, documentation under their control.

Most importantly as per SA 580, auditor should also obtain the Written Representation Letter from the branch management before the commencement of audit covering all areas of the Branch. "Guidance note on Audit of Banks" issued by the ICAI have given Illustrative format of Management Representation to be obtained.

- 8. Note:** Only few important points are considered in this article. Reader should also refer "Guidance Note on Audit of Banks" issued by the Institute of Chartered Accountants of India and various Master Circulars in respect of advances/non-funded facilities and other circulars issued by Reserve Bank of India. ■