

**GUIDANCE NOTE
ON
AUDIT OF BANKS
(2014 EDITION)**



The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

Guidance Note on Audit of Banks

Attention

Members' attention is invited to relevant circulars issued by the Reserve Bank of India up to February 23, 2014, included in a CD accompanying this Guidance Note for ease of use and reference. Members are advised to keep track of legislative/regulatory developments, for example, circulars of the Reserve Bank of India, issued subsequent to the aforementioned date and having a bearing on the statutory audit of banks/bank branches for the year ended March 31, 2014.



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Foreword

The banking industry in India has a huge canvas of history, which covers the traditional banking practices from the time of Britishers to the reforms period, nationalization to privatization of banks and now increasing numbers of foreign banks in India. Therefore, the banking industry in India has been through a long journey and has also achieved new heights with the changing times. The use of technology brought a major revolution in the working system of the banks. Nevertheless, the fundamental aspects of banking i.e. trust and confidence of the people on the institution remains the same, which comes on the back of strong quality of audit system and practices in place.

Since the issuance of the last edition of the Guidance Note on Audit of Banks, a number of important developments have taken place in the banking sector, warranting attention of the auditors. It is, therefore, essential that the members undertaking statutory audit of banks, both at the branch as well as the central level, keep themselves abreast with the latest developments in the banking sector.

I am pleased that in order to help the members maintain the quality in bank audits, the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India under the able and dynamic Chairmanship of CA. Abhijit Bandyopadhyay, has come out with a completely revised and edited 2014 edition of the Guidance Note on Audit of Banks. The revised edition incorporates the guidance for the statutory auditors at branch as well as central level w.r.t. the various circulars of the Reserve Bank of India as well as important pronouncements of the Institute. I am also happy that the 2014 Guidance Note has been totally revamped to make it more reader-friendly.

I hope that the members would find the 2014 edition of the Guidance Note immensely helpful.

New Delhi
February 24, 2014

CA. K. Raghu
President, ICAI

Preface

Independent audit of financial statements of banks is one of the important tools for throwing light on their financial health, the state of their affairs, the results of their operations and the position of their cash flows. Financial statement audit therefore is important for a strong and resilient banking industry. Audit of banks, however, involves certain typicalities which make the task of the auditors quite onerous. Most significant of these being volume and complexity of transactions, geographical spread, client portfolio, wide variety of products and services offered, extensive use of technology and above all, high sensitivity to the slightest of changes in the social, economic or political environment. As a result, the risks faced by banks vary in nature and quantum with the all these aspects.

Obtaining an appropriate and adequate understanding of these aspects and the resultant risks, particularly, their impact on the truth and fairness of a bank or its component's financial statements becomes a humungous but nonetheless essential task for the auditors. Every year, the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India brings out the Guidance Note on Audit of Banks to help the common members understand the important aspects of the banking industry so that they can understand these risks and plan and perform their audits effectively and efficiently against the strict time deadlines.

It is, therefore, my great pleasure to place in your hands, the 2014 Guidance Note on Audit of Banks. The 2014 edition of the Guidance Note has been written to not only reflect the important regulatory changes that have been brought about by the Reserve Bank of India since 2013 through its Master and other general circulars issued till 23rd February 2014 as usual but also implementation of Core Banking Solutions at almost all levels in the banks. The guidance to the auditors has been suitably revised to reflect the impact of CBS on financial reporting system. Besides, in sync with the requirements of the current suite of Standards on Auditing, the Guidance Note has also been given the flavour of risk-based audit approach. Further, guidance has also been included on aspects on which members have frequently posed queries. We have also identified and removed repetitive guidance and shifted certain conceptual and basic level aspects to the accompanying CD to reduce the volume of the publication and make the Guidance Note more user-friendly. In addition to the text of the Guidance Note, this CD also contains important data such as text of RBI's Master Circulars as well as other important circulars issued till 23rd February 2014, appendices, illustrative checklists, etc.

At this juncture, I wish to place on record my gratitude to each and every member of the Mumbai study group viz., CA. Shrinivas Y Joshi, CA. Abhay Kamat, CA. Ashutosh Pednekar, CA. Ganesh Sampath, CA. Gautam Shah, CA. Manish Sampat, CA. Neville Daruwalla, CA. Niranjan Joshi, CA. Sandeep Kumar Sarawgi, CA. Sandeep Welling, CA. Sanjay Khemani, CA. Shivratn Agarwal, CA. Shrawan Kumar B Jalan, CA. Ulhas Chitale, CA. Vikas Kumar, CA. Vipul Choksi, CA. Zubin Billimoria for taking time out of their pressing professional and personal preoccupations to work on this herculean project .

I also place on record my sincere thanks to CA K Raghu, President, ICAI and CA. Manoj Fadnis, Vice President, ICAI for their constant support to the activities of the Board.

I am also thankful to all my Council colleagues, for their unstinted support and helpful guidance that I have always been fortunate to receive in the activities of the Board. I also wish to express my gratitude to all the members and special invitees on the Auditing and Assurance Standards Board for 2013-14, viz., CA. Naveen N.D. Gupta, the then Vice Chairman, CA. Rajkumar S. Adukia, CA. Subodh K Agrawal, CA. Jay Ajit Chhaira, CA. Sanjeev K. Maheshwari, CA. Shiwaji Bhikaji Zaware, CA. M. Devaraja Reddy, CA. Dhinal Ashvinbhai Shah, CA. S. Santhanakrishnan, CA. J. Venkateswarlu, CA. Vijay Kumar Gupta, CA. Sanjiv K Chaudhary, Shri Gautam Guha, Shri Bhaskar Chatterjee, CA. Sanjay Vasudeva, CA. Niraj Kumar Jhunjhunwala, CA. Ganesh Balakrishnan, CA. Charanjeet Surendra Attra, CA. Harinderjit Singh, CA. Saunak Ray, Shri Anindya Kumar Das, CA. Nilesh S. Vikamsey, CA. Jitendra K Agarwal, CA. Amit Roy, CA. Vijay Sachdeva and CA. Aniruddh Sankaran without whose support this publication would not have been possible. I also wish to thank the Secretariat of the Auditing and Assurance Standards Board for their efforts in giving the Guidance Note its final shape.

I am sure that the 2014 edition of the Guidance Note on Audit of Banks would also be as warmly received by the members as its earlier editions. I look forward to the readers' feedback on the publication.

Kolkata
February 24, 2014

CA. Abhijit Bandyopadhyay,
Chairman,
Auditing & Assurance Standards Board

Foreword to Eighth Edition

The Banking Sector is the most dominant segment of the financial sector in the Indian economy. It is fairly mature in terms of product range and reach. The banking sector, like all economic activities, is also exposed to the risk in the conduct of their business. However, Indian banks continue to build on their strengths with good quality audits serving as the backbone of the strong banking system in place today.

In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets relative to other banks in comparable economies. The statutory auditors have had a critical role to play in this.

I am happy that the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India has come out with the Revised 2013 Edition of the Guidance Note on Audit of Banks. The Revised edition incorporates the impact of the various circulars of the Reserve Bank of India as well as certain important pronouncements of the Institute which would be relevant to bank audits for the financial year ending March 31, 2013.

At this juncture, I wish to place my appreciation to CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board for his zeal and commitment in bringing out such literature and make it available to the members at large thereby enabling them in maintaining quality in the audit services rendered.

I am confident that the members would find the revised edition of the Guidance Note immensely helpful.

New Delhi
March 14, 2013

CA. Subodh Kumar Agrawal
President, ICAI

Preface to Eighth Edition

Audit of banks has been much in the limelight in the professional and regulatory circles for a variety of reasons. As the financial year 2012-13 draws to an end, the members who have been allotted bank statutory central audits and bank branch audits would be busy preparing for these audits. The Profession must utilize this opportunity to demonstrate how an audit of financial statements is not just a regulatory requirement to be complied with but it indeed has an immense value to not only the auditee banks but also to the banking regulator, i.e., the Reserve Bank of India.

At this juncture, it gives me immense pleasure to place in your hands the 2013 edition of the Guidance Note on Audit of Banks, which would help the auditors in efficient and effective conduct of the audit. This edition of the Guidance Note has been updated since the last edition which came out in 2011. During these two years a number of important directives have been issued by the banking regulator i.e., the Reserve Bank of India which the statutory auditors are required to be aware of, particularly, those brought about by the RBI through its various Master Circulars and a number of other relevant circulars. I also take this opportunity to reiterate that the auditor's report for the financial year 2012 – 13 onwards would have to be issued in the revised format as prescribed under the Revised SA 700 issued by the Institute of Chartered Accountants of India.

I take this opportunity to place on record my sincere gratitude and appreciation for the members of the Mumbai study group, viz., CA Shrinivas Y. Joshi, coordinator of the study group, CA Vipul Choksi, CA Ashutosh Pednekar, CA Akeel Master, CA Sanjay Khemani, CA Vikas Kumar, CA Zubin Billimoria, CA Manish Sampat, CA Niranjana Joshi, CA Sandeep Welling, CA Shivratana Agarwal, CA Ulhas Chitale, CA Gautam Shah, CA Neville M. Daruwalla and CA Ashwin Suvarna for squeezing time out of their pressing professional and personal commitments to work on the 2013 edition of the Guidance Note on Audit of Banks and finalise it in a short time.

I also wish to place on record my gratitude to CA. Subodh K Agrawal, President, ICAI and CA. K Raghu, Vice President, ICAI for their unstinted support to the activities of the Board.

I am also grateful to my colleagues at the Auditing and Assurance Standards Board, CA. Naveen ND Gupta, Vice Chairman, AASB, CA. Rajkumar S Adukia, CA. Jay Ajit Chhaira, CA. Shrinivas Y Joshi, CA. Sanjeev Maheshwari, CA. Dhinal A Shah, CA. Shiwaji B Zaware, CA. M. Devaraja Reddy, CA. S. Santhanakrishnan, CA. J. Venkateswarlu, CA. Manoj Fadnis, CA. Sanjiv K Chaudhary and CA. Vijay K Gupta for their support to the various projects of the Board. I also wish to thank the Secretariat of the Auditing and Assurance Standards Board for their efforts in giving the Guidance Note its final shape.

I am sure that like its predecessors, the readers would find this updated edition of the Guidance Note also extremely useful.

March 14, 2013
Kolkata

CA. Abhijit Bandyopadhyay,
Chairman,
Auditing & Assurance Standards Board

Foreword to Seventh Edition

The Banking system remains, as always, the most dominant segment of the financial sector in the Indian economy. Today, the banking sector in India is fairly mature in terms of supply, product range and reach. The banking sector, like all economic activity is also exposed to risk in the exercise of their business. Indian banks continue to build on their strengths with good quality audits serving as the backbone of the strong banking system in place today.

In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets relative to other banks in comparable economies in its region. The responsibility for this lies on the shoulders of the auditors.

I am pleased to note that the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India has, in order to help the members maintain the good quality of bank audits, come out with the 2011 Edition of the Guidance Note on Audit of Banks. The Revised edition incorporates the impact of the various circulars of the Reserve Bank of India as well as certain important pronouncements of the Institute which would be relevant to bank audits for the financial year ending March 31, 2011.

At this juncture, I wish to place my appreciation to CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board for his zeal and commitment to reach out to the members in the profession in maintaining quality in the audit services rendered by them. More so, as the Guidance Note on Audit of Banks is a publication which is eagerly awaited by one and all.

I am extremely confident that the members would find the revised edition of the Guidance note immensely helpful in efficiently conducting audit of banks.

New Delhi
March 11, 2011

CA. G RAMASWAMY
President, ICAI

Preface to Seventh Edition

The banking industry is a systemically important industry for the Indian economy in general and financial sector in particular as it comprises nearly 90% of the total financial services sector of the country. The banking industry in India has undergone significant transformation since the initiation of the financial sector reforms that were part of the structural reforms of early 1990s. The banking sector has steadily evolved from a state-directed banking system into a fairly open competitive banking system.

Banking in India has become service oriented, maturing from the days of 'walking in business' to the present situation of 24 hour banking solutions to attract customers. With such widespread and rapid growth of the banking industry and their entry into a wide variety of services like insurance, mutual funds, etc., the onus of the healthy sustenance and growth of the banking industry lies on the back of reliable financial statements which can only be assured by good quality audits. The bank audit is thus an important step for all banks who seek a better optimization of its overall management.

To help the members provide value add audit of the financial statements of a bank, the Institute has brought out the 2011 edition of the *Guidance Note on Audit of Banks*, thoroughly revised in the light of the relevant circulars issued by the Reserve Bank of India between 2009 till date. Since adequate and appropriate understanding of an auditee is a prerequisite for any effective audit, the Guidance Note contains comprehensive information on the working of a modern bank, its control systems, books of account, legal and regulatory requirements, including introduction of new banking concepts, in addition to comprehensive information and audit guidance on important items on the financial statements of banks.

The 2011 Guidance Note covers critical aspects such as Knowledge of the Banking Industry, Risk Assessment and Internal Control, Items of Bank's Financial Statements and Auditing Aspects, Long Form Audit Reports, Special Aspects. The text of the relevant circulars of the Reserve Bank of India is given in the CD with the Guidance Note.

At this juncture, I would wish to place my gratitude to CA. G Ramaswamy, President and CA. Jaydeep N Shah, Vice President, ICAI for their support and valuable guidance to the initiatives of the Auditing and Assurance Standards Board. My sincere thanks is also due to CA. M M Khanna, CA. Sanjay Vasudeva and CA. Ajay K Jain from New Delhi and CA. Vipul Chokshi from Mumbai for their valuable inputs in making the 2011 edition of the Guidance Note more useful and comprehensive.

I also wish to place on record my sincere thanks to my colleagues at the Board, viz., CA. Rajkumar S Adukia, Vice-Chairman, AASB, CA. Amarjit Chopra, CA. Naveen N.D. Gupta, CA. Sanjeev K. Maheshwari, CA. M. Devaraja Reddy, CA. Rajendra Kumar P., CA. J. Venkateswarlu, CA. Sumantra Guha, CA. Anuj Goyal, CA. Pankaj Tyagee, CA. Jayant P. Gokhale, CA. S. Santhanakrishnan, CA. Mahesh P. Sarda, CA. Vijay Kumar Garg, CA. V. Murali, CA. Nilesh S. Vikamsey, Ms. Usha Sankar, Shri Prithvi Haldea, CA. David Jones, CA. Sanjay Vasudeva, CA. Raviprasad, CA. P.R. Vittel, CA. C.N. Srinivasan and CA. Ramana Kumar B for their views for further improvements to the Guidance Note. My sincere gratitude is also due to all my other Central Council colleagues without whose support this edition of the Guidance Note would not seen the light of the day.

I am extremely confident that the Guidance Note would prove to be highly useful and relevant for authoritative reference for the auditors and also for all those who are connected with the banking industry in one way or other.

Kolkata
March 11, 2011

CA. Abhijit Bandyopadhyay
Chairman
Auditing and Assurance Standards Board

Foreword to Sixth Edition

India's banking industry must strengthen itself significantly in order to support the modern and vibrant economy which India aspires to be. The last decade has seen many positive developments in the Indian banking sector. Policy makers have made some notable changes in policy and regulation to help strengthen the sector. These changes include strengthening prudential norms, enhancing the payments system and integrating regulations between commercial and co-operative banks.

For safe and sound banking system, one of the most important ingredient is reliable, clear financial information supported by quality audits. At the same time, audit also complements supervisory efforts of the regulators in risk management and efficient functioning of banking system.

In order to equip our members with requisite updated knowledge on functional areas of the banking operation, I am pleased to note that the Auditing and Assurance Standards Board of the Institute has brought out the revised edition of the Guidance Note on Audit of Banks. The revised edition has been updated by incorporating insightful guidance into the impact of various new/ revised circulars issued by the Reserve Bank of India.

I am sure that the members will find the revised Guidance Note, like its earlier editions, useful in providing a comprehensive overview of the functioning of a bank and guidance on critical aspects of a bank audit. I am confident that this publication would surely help the members in discharging their responsibility in an effective manner.

New Delhi
February 04, 2009

Ved Jain
President, ICAI

Preface to Sixth Edition

Liberalization and de-regulation process that started in 1991-92 made a sea change in the working and reach of the banking system. From a totally regulated environment, it has moved gradually into a market driven competitive system though the move towards global benchmarks has been, by and large, calibrated and regulator driven.

In this dynamic environment, the auditors of banks, in their own way, play a crucial role in upholding and enhancing the credibility of the banking system. In order to equip the members with updated knowledge on banking industry, the Auditing and Assurance Standards Board has been from several past years coming out with Guidance Note on Audit of Banks. The 2009 edition of the Guidance Note has thoroughly been revised by taking the impact of the relevant circulars issued by the RBI from time to time. The audit procedures have been thoroughly revised in view of the issuance of risk-based Standards on Auditing which have come into force with effect from 1st April, 2008. Further, three new chapters have been added in the 2009 edition, i.e., “Special features of bank treasury operations, foreign exchange and derivative transactions”, “Basel II” and “Disclosure requirements in financial statements”.

I wish to place on record my sincere gratitude to CA. Vipul K. Choksi, FCA, convenor of the Study Group constituted at Mumbai and all the other members of the Study Group, viz., CA Abhijit Sanzgiri, CA Ashutosh Pednekar, CA Akeel Master, CA Ketan Vikamsey, CA Sanjay Khemani, CA Vikas Kumar, CA Zubin Billimoria, CA. Kamlesh Vikamsey, CA. Uday Chitale, CA. Asit Pal, CA. Jatin Lodaya, CA. Shiv Ratan Agarwal CA. Manoj Daga and CA Dharini Shah who have squeezed time from their professional and personal commitments to complete this mammoth task of revising the Guidance Note. I would also take the opportunity of placing on record my gratitude to all the members of the Expert Group viz., CA. Amarjit Chopra, CA. K. P. Khandelwal CA. S. Santhanakrishnan, CA.

Manoj Fadnis and CA. Shanti Lal Daga for their invaluable comments and suggestions. I am also thankful to all my colleagues on the Auditing and Assurance Standards Board and Council for their continuous support and guidance.

I am sure that the members will find the guidance contained in this revised edition effective in conducting audit of banks and their branches.

New Delhi
February 04, 2009

Harinderjit Singh
Chairman
Auditing and Assurance Standards Board

Foreword to Fifth Edition

Sounding clichéd as I may do, yet I would begin with stating what has been said at a number of for a number of times that the economic growth and development of the society hinges to a large extent on the soundness of the accountancy profession. It is one profession which has had a reach and has enjoyed unwavering trust of one and all, not withstanding the political, cultural or economic barriers that might have separated them.

Whereas this unwavering trust has placed the accountancy profession in a unique position to command authority and respect, it has also been something which has given sleepless nights to not only the regulators but also the professional accountancy bodies across the world. These professional bodies have been working relentlessly towards equipping their members with the latest knowledge and skill sets to help them perform efficiently and uphold that trust.

The Institute too has been committed to that cause and has a clear approach to keeping its members technically sound. Issuing authoritative technical literature has been an integral part of this approach. The challenge however is to keep that literature current and relevant. I am happy to note that the Auditing and Assurance Standards Board of the Institute has brought out the revised version of the Guidance Note on Audit of Banks incorporating the latest regulatory and other professional requirements having an impact on audit of banks.

I am sure that the readers will find the revised Guidance as useful as its earlier version, not only as a one stop reference for audit procedures in case of banks but also as a concise compendium of significant banking activities.

New Delhi
February 4, 2008

Sunil H. Talati,
President, ICAI

Preface to Fifth Edition

Banking is a unique industry in itself. In a world divided by political, economic and social boundaries and barriers, it acts as a glue to keep it integrated in one way or the other. This fact has been underlined time and again; the tremors of the recent crises in the US banking industry have been felt in almost all parts of the world. Extensive geographical spread, wide array of products and services offered, high volumes of transactions many of which are quite complex, advanced level of automation, large customer base are some of the other elements of uniqueness of the banking industry.

This uniqueness of banking industry, however, poses a major challenge in the audit of banks. The answer to this challenge for the auditors lies, to a considerable extent, I personally believe, in two things, one, having a firm grip on the knowledge of the banking industry and second, in keeping update with the professional (in particular the latest auditing standard & pronouncements), regulatory and other industry related developments. The Guidance Note on Audit of Banks (2008 edition) has been designed keeping in view the aforesaid requirements. The Guidance Note has been divided into four parts, first, the knowledge of the banking industry and its operational aspects; second, related audit procedures; third, LFAR both at the branch as well as head office level; and fourth, special purpose reports and certificate and other special aspects, etc. Also the relevant circulars are contained in the accompanying CD. At this juncture, I also wish to underline the fact that it is necessary to read the Guidance Note in its entirety to properly appreciate the guidance given therein.

I would like to place on record my sincere gratitude to CA S Swaminathan, from Chennai who volunteered to undertake this mammoth task of revising and restructuring the 2006 edition of the Guidance Note. I am also thankful to all my colleagues in the Auditing and Assurance Standards Board and Council for their continuous support and guidance. I would also like to place on record my thanks to CA. Ashok Batra from Delhi and CA. Mitil Chokshi from Mumbai for providing his invaluable inputs on the Guidance Note. I also wish to appreciate the contribution of CA. Priya Subramaniam, Senior Assistant Director, Board of Studies in respect of taxation of banks. Finally, I

also wish to record my thanks to Shri Vijay Kapur, Director, Auditing and Assurance Standards Board and his team at the AASB Secretariat for giving final shape to the revised Guidance Note.

I am sure that the readers would find the guidance note useful.

New Delhi
February 4, 2008

Harinderjit Singh
Chairman
Auditing and Assurance Standards Board

Foreword to Fourth Edition

Since the issuance of the last edition of the Guidance Note on Audit of Banks in March 2005, a number of important developments have taken place in the banking sector, warranting attention of the auditors. Some of these developments are usual and happen every year such as the issuance of the revised income recognition and asset classification norms, investment exposure norms, etc. Some of these changes, however, highlight some major policy shifts by the Reserve Bank of India and would have a lasting impact on the future of the banking industry in India, such as move towards risk-based supervision of banks, para banking activities, new capital adequacy norms, etc.

In addition, the banking industry in India in the recent past has been a witness to the flurry of merger and acquisition activities. Further, the recent years have also seen a growing interest of the banking industry in the capital markets. It is, therefore, essential that members undertaking statutory audit of banks keep themselves abreast with the latest developments in the banking including the actions of the banking regulator, the Reserve Bank of India. I am happy to note that the Auditing and Assurance Standards Board has brought out the 2006 edition of the Guidance Note on Audit of Banks well in-time to keep the members abreast with the vital changes in the banking to help them appropriately understand the impact of these changes on their audit.

I sincerely hope that the members would find this edition of the Guidance Note also useful and informative.

New Delhi
March 14, 2006

T N Manoharan
President

Preface to Fourth Edition

The economic development of any country depends significantly on the support that it gets from the banking sector of the economy. In order to build up a resilient banking industry, it is essential that the industry is founded on sound banking principles and practices, complemented by effective regulation and supervision. The recent past has witnessed the banking industry becoming the focus of investment opportunities be it by way of IPOs or mergers and acquisitions or FDI. Another significant development over the past few years has been the growing activism of the banking industry in the capital markets.

The mammoth amounts of public monies being handled by the banks as well as the inherent vulnerable nature of the banking industry, however, make it imperative that the activities of the industry are closely monitored and regulated without strangulating the spirit of entrepreneurship. Audit forms an integral and important part of such monitoring and regulation. For past number of years the members of the Institute have been taking on this responsibility with that extra fervour and commitment. The Institute too has been actively supporting the members in their role as statutory auditors of banks by bringing out a number of technical publications dealing with the various aspects of bank audit, especially the Guidance Note on Audit of Banks. The Guidance Note deals with several important aspects of bank audit both at branch as well as head office level. Keeping abreast with the latest developments in the banking industry and understanding their impact on audit of banks is quintessential for the auditors if they want to make any value addition.

The 2006 edition of the Guidance Note contains guidance on important aspects such as risks associated with the banking industry, assessment of the risk based internal audit system in banks, audit of ATMs, audit under CDR, and more importantly the revised formats of the audit reports of nationalized banks as well as banking companies, to name a few. This edition of the Guidance Note is targeted at helping the members understand the various developments in the banking industry since the issuance of the 2005 edition of the Guidance Note and their impact on their audits. Some of the important aspects of the banking industry that have undergone a change as a result of regulatory intervention include the changes in the prudential norms on income recognition and asset classification, exposure norms for credit and investment portfolio, loans and advances, capital adequacy requirements, changes in the CRR, SLR, new guidelines on corporate debt restructuring as well as small and medium enterprises, introduction of risk based supervision in banks, guidelines on

securitization of standard assets, KYC norms, etc. Some other important developments that have impacted the banking industry are the banking cash transaction tax, the fringe benefit tax, service tax etc. Further, for ease of reference of the readers, the important changes in the 2006 edition from the 2005 edition are also indicated by way of footnote references.

The 2006 edition of the Guidance Note is divided into two Sections, Section I contains the Text of the guidance whereas Section II contains the Appendices. Section I is divided into four parts – initial considerations, audit of branches, audit of head office and special purpose reports and certificates. Part II contains the text of the relevant circulars of the Reserve Bank of India as well as the formats of the audit reports. For the benefit of the readers, the appendices have also been given in a CD along with the Guidance Note.

At this juncture, I wish to place on record my immense gratitude to S/Shri Dinesh Mehta, FCA, Rajiv Sogani, FCA, Anil Goyal, FCA, Atul Atolia, FCA, Ashok Batri, FCA and Nitant Trilokekar, FCA who squeezed time out of their busy professional and personal lives to revise certain important aspects of the Guidance Note. My thanks are also due to Shri Nagesh D Pinge, Sr. General Manager, ICICI Bank for his contribution in respect of the guidance on risk based internal audit in banks. I also express my gratitude to Shri Amarjit Chopra, FCA, my colleague in the Council as well as my immediate predecessor as Chairman, Auditing and Assurance Standards Board under whose able guidance and vision the revision of the 2005 Guidance Note was initiated. I also wish to place my sincere thanks to my colleagues at the Auditing and Assurance Standards Board for their valuable inputs on the draft Guidance Note. My thanks are also due to my colleagues at the Council, in specific to Shri Harinderjit Singh, also Vice Chairman of AASB as well as Shri S C Vasudeva, for their incisive comments on improving upon the draft Guidance Note and giving it a final shape. I also wish to place on record the efforts put in by Shri Vijay Kapur, Secretary, Auditing and Assurance Standards Board and his team of officers, viz., Smt. Puja Wadhwa, Senior Technical Officer, Shri Nitin Singhal and Shri Amit Sinha, Executive Officers in finalizing the Guidance Note.

I am confident that the bank audit being just round the corner, this edition of the Guidance Note too, as its predecessors, prove to be of immense use to the members as also other interested readers.

New Delhi
March 16, 2006

Sunil Goyal
Chairman
Auditing and Assurance Standards Board

Foreword to Third Edition

An audit based on the sound knowledge of the audit client is quintessential if the Profession has to maintain its competitive edge as well as the confidence reposed in it by all. Audit of the banking sector is no exception to that. In fact, audit of a bank requires quite good knowledge of almost all the functional areas of the banking operations.

As all are aware, the Institute has taken a number of initiatives to keep the members abreast with the latest developments in the areas of professional relevance, be it in the form of technical literature or seminars, etc. The 2005 edition of the Guidance Note on Audit of Banks, developed by the Auditing and Assurance Standards Board is one such initiative. This edition is thorough update of the Guidance Note issued in 2001 and the subsequent 2003 Supplement.

I am happy to note that the 2005 edition also contains an insightful guidance into the impact of various new/revised circulars of the Reserve Bank of India with respect to prudential norms, exposure norms on investments, etc. In tune with times, the Guidance Note also contains specific guidance on service tax matters.

With bank audits just around the corner, I am sure that this edition of the Guidance Note on Audit of Banks too will prove to be immensely useful to our members in discharge of their attest functions in the most appropriate manner.

New Delhi
March 31, 2005

(Kamlesh S. Vikamsey)
President

Preface to Third Edition

The banking industry is no doubt the backbone of any economy. It is, therefore, very essential to ensure that the banking industry remains healthy and robust. The accountancy profession, within its given means and scope of work contributes actively by ensuring proper financial reporting and disclosure aspects of the banking industry. Statutory audit of banks is one such area by which the accountancy profession makes such a contribution.

To be able to contribute to the health of the banking industry, it is essential that the statutory auditors are well equipped in terms of the knowledge of the banking industry. Guidance Note on Audit of Banks is an important tool in the kitty of the members of the Institute to gain an insight into the systems and processes in the significant functional areas of the banking industry, such as the acceptance of deposits, credit, investments, fixed assets, branch functions, etc. These all are obviously aimed at helping the members understand and effectively evaluate the internal controls and accounting systems in a bank.

A number of changes have taken place in the banking sector, having a bearing on the functioning of the banks as also, consequently, statutory audit of banks. The 2005 edition of the Guidance Note, therefore, is an extensively revised and updated version of the 2001 Guidance Note and the 2003 Supplement, all with the basic aim of keeping our members abreast with the latest developments in the area of bank audits. Like the 2001 Guidance Note and the Supplement, the 2005 edition too delves into the impact of several new circulars in the field of prudential and income recognition norms, investment norms, exposure of investments, investment portfolio etc., on the functioning of as well as financial reporting by the banks. In addition, the Guidance Note also touches upon the aspect of application of various Accounting Standards, issued after the 2003 Supplement as well as the Report of the N D Gupta Committee on Compliance with Accounting Standards by Banks. Another critical area in the banking industry, which is being stressed upon by the Reserve Bank of India is prevention of money laundering. The regulator has issued a number of circulars relating to "Know Your Customer" guidelines. These circulars too have been dealt with by the revised Guidance Note.

The revised Guidance Note also provides an insight into the technological advancements impacting the banking sector, such as the internet banking feature, etc. In addition to the above, as is the norm, the Appendices to the revised Guidance Note contain the text of various relevant circulars issued by the Reserve Bank of India as a source of ready reference for readers as also the illustrative format of the auditor's report. In nut shell, the Guidance Note aims to provide a comprehensive overview of the functioning of a bank and critical aspects of a bank audit.

At this juncture, I wish to place my gratitude to the Study Group constituted at Indore under the Convenorship of Shri Manoj Fadnis, FCA, which prepared the basic draft of the revised Guidance Note at such a short notice. In particular my special thanks are due to S/Shri Aseem Trivedi and Santosh Deshmukh of Indore for the hard work put in by them. S/Shri Ashok Batra and Nishith Seth of Delhi also deserve special mention for their valuable contribution. I am also grateful to all my colleagues at the Auditing and Assurance Standards Board for providing insights from their rich knowledge and experience for improving upon the draft Guidance Note. A word of thanks is also due to all my colleagues at the Council for providing their invaluable guidance and support in giving the final shape to the revised Guidance Note.

I am extremely grateful to Shri Vijay Kapur, Secretary, Auditing and Assurance Standards Board, for his efforts and valuable inputs which were so essential in bringing out this Guidance Note. Also my thanks are due to technical staff of Auditing and Assurance Standards Board for their valuable contribution.

I am sure that the members and other interested users will find this edition of the Guidance Note useful in discharge of their professional obligations.

New Delhi
March 30, 2005

Amarjit Chopra
Chairman
Auditing and Assurance Standards Board

Foreword to the Second Edition

The banking system in India, perhaps, is one of the largest in the world as far as its extensive branch network is concerned. The role of the banking sector in the overall growth and development of the Indian economy is also quite significant and laudable. Today, disclosure practices followed by Indian commercial banks are almost at par with those of international banks. The introduction of prudential norms, capital adequacy norms, requirement to attach the financial statements of the subsidiaries beginning from year 2000-01 are definite measures to bring more transparency in the banking industry. In this context, the Reserve Bank of India has been performing a stellar role by issuance of detailed guidelines in close consultation with the ICAI.

In view of stringent disclosure practices and far-reaching technological developments, the role of accounting profession with respect to the banking industry has assumed considerable significance. The original Guidance Note on Audit of Banks was issued in 1994. In view of far reaching changes, it was imperative to revise the Guidance Note, to bring it in line with these developments. I am pleased to note that the Auditing Practices Committee of the Institute has brought out the revised Guidance Note on Audit of Banks. A salient feature of the revised Guidance Note is that a considerable emphasis has been laid on explaining the distinguishing characteristics of the banking industry – how it operates, what transactions take place, the sequence of these transactions, the accounting system for recording the transactions and the legal and regulatory framework within which it operates. Another important feature of the revised Guidance Note worth mentioning is that it deals separately with the audit of banks at the head office and that at the branch level.

The draft of the Guidance Note was considered by the Council of the Institute at its meeting held on 6th, 7th and 8th March 2001. I wish to specially commend the efforts and contribution made by Mr. S. Gopalakrishnan, Chairman, Mr. K.S. Vikamsey, Vice-Chairman and all the members of the Auditing Practices Committee who undertook the mammoth task of bringing out the revised Guidance Note in such short span of time. I also wish to

thank the members of the Central Council of the Institute for their valuable suggestions in enriching the contents of the revised Guidance Note.

I appreciate the efforts of Mr Vijay Kapur, Secretary, Auditing Practices Committee of the Institute and his team of Officers, without whose untiring efforts, this Guidance Note would not have been published in time.

I am sure that the revised Guidance Note would prove immensely useful not only to the members who have an experience in audit of banks but also those members who are uninitiated to the area of bank audit.

New Delhi
March 20, 2001

(N.D. Gupta)
President

Preface to the Second Edition

While the auditing principles remain the same regardless of the nature of the entity under audit, the manner of their application has to be determined in the context of the specific features of the industry to which the entity belongs and also the specifics of the entity itself. This revised Guidance Note seeks to provide guidance on application of generally accepted auditing principles in the specific context of Banks.

A number of developments have taken place in the Banking industry. Some of the prominent changes include, from time to time, in prudential guidelines relating to income recognition, asset classification, provisioning and investment valuation, capital adequacy and extensive computerization of Banking operations. These developments have necessitated a thorough revision of the Guidance Note to maintain its relevance in the changed scenario.

This Guidance Note makes a clear distinction between audit at Branch level and Head office level and elaborates on general considerations in audit of Banks at Head Office/Branch level and special consideration in the case of audit of Branches.

The Guidance Note consists of 29 chapters (besides a number of appendices), divided into four parts:

- Part I deals with general considerations in audit of banks and applies to audit at both head office level and branch level.
- Part II deals with special considerations in the case of audit of branches.
- Part III deals with audit at head office and zonal/regional office level.
- Part IV deal with special-purpose reports and certificates to be issued by auditors of head office or branches of banks.

While every attempt has been made to cover the latest circular issued by Reserve Bank of India on the subject, it is advisable for the members in the

ever changing scenario to keep a constant watch on the latest developments in the Banking sector and familiarize themselves on the update.

I am confident that the members will find this Guidance Note user friendly and a good companion on the subject.

I take this opportunity to express my sincere thanks to Shri M.M. Khanna, Past Council Member and past/present members of the Auditing Practices Committee for their valuable contribution in the preparation of the Guidance Note.

I would like to record my sincere appreciation to the faculty who assisted the Committee in preparation of this Guidance Note. I also wish to thank Shri Vijay Kapur, Secretary, Auditing Practices Committee and his team whose untiring efforts made it possible for the Committee to bring out this Guidance Note in good time.

Hyderabad
March 20, 2001

(S. Gopalakrishnan)
Chairman
Auditing Practices Committee

Foreword to the First Edition

I am glad to note that the Auditing Practices Committee of the Council of the Institute is bringing out this Guidance Note on Audit of Banks.

Banking is a dynamic activity which has constantly been undergoing a change. In recent years, there has been a remarkable change in the nature, volume and spread of transactions of banks. Apart from this, the non-traditional functions of banks, e.g., foreign exchange activities, merchant banking, portfolio management, investment, etc., have acquired considerable importance during this period. Another significant development from the auditors' view point is the issuance, by the Reserve Bank of India, of detailed guidelines regarding income recognition, asset classification, provisioning and other related matters. Yet another development which affects the work of bank auditors is the revision of formats of financial statements of banks as also of the formats of long form audit reports. These developments made it imperative for the Institute to revise its existing publications dealing with audit of banks. I am glad that the Auditing Practices Committee took up the work of revision on a priority basis and completed this task in a short period. The draft prepared by the Committee was considered by the Council at its meeting held in September, 1994 and approved for publication.

The members would recall that during the first half of 1994, a series of seminars on the subject of 'Bank of Audit' was organised at all major places throughout the country. For this purpose, the Institute had brought out a uniform background material. The present Guidance Note draws heavily on the background material, supplemented by the large number of suggestions made during the course of the seminars. The Guidance Note, thus, reflects the collective thinking of the profession on the subject.

It is noteworthy that the earlier edition of this publication on 'Audit on Banks' was in the form of a 'Study'. However, considering the importance of the banking sector in the economy, it has been decided to bring out the present edition in the form of a Guidance Note. As the members are

aware, Guidance Notes are recommendatory in nature. Accordingly, while carrying out the statutory audit of a bank or a branch of a bank, a member should ordinarily follow the recommendations made in this Guidance Note except where he is satisfied that in the circumstances of the case, it may not be necessary to do so.

In the fast changing economic scenario of the country, the banking sector is likely to witness many more changes in the years to come. I am sure, the Auditing Practices Committee will strive to keep this publication up-to-date by revising it periodically. However, the process of revision, by its very nature, takes time. Therefore, I would strongly urge upon the members to keep a constant watch on the developments in the banking sector specially insofar as they affect their work and adapt their audit procedures and techniques in response to the changes in the environment.

I have great pleasure in acknowledging the efforts and the contribution made by the Chairman of the Auditing Practices Committee, Mr. Dipankar Chatterji. I profoundly thank members of the Auditing Practices Committee and of the Council for their valuable suggestions. On behalf of the Council, I would like to record the sincere appreciation to the faculty of the Technical Directorate especially to Dr. Kamal Gupta, Technical Director and Mr. Ashok Arora, Deputy Director, for their utmost dedication and technical input in bringing out this publication.

I am sure, the members would find the guidance contained in this publication useful in conducting the audit of banks and their branches.

New Delhi
November 22, 1994

B.P. Rao
President

Preface to the First Edition

The Auditing Practices Committee has pleasure in placing before the members this Guidance Note on Audit of Banks. The Guidance Note is a thoroughly revised, updated and enlarged edition of the two existing publications titled 'Study on Audit of Banks' and 'Guidance Note on Long Form Audit Reports in case of Public Sector Banks'.

The need for bringing out this revised edition arose because of a number of significant developments in the banking sector which have affected the work of the auditors in recent years. One of the most significant developments is the issuance of guidelines for income recognition, asset classification, provisioning and other related matters by the Reserve Bank of India. The guidelines lay down objective parameters for determining the quantum of provision required in respect of advances. Similarly, with the issuance of guidelines for valuation of investments, a considerable degree of uniformity has been brought about in the manner in which investments are accounted for and valued by banks.

The formats of financial statements of banks have been recently modified, thereby bringing about a greater degree of transparency therein. The Reserve Bank of India has similarly revised the formats of long form audit reports and also extended the requirement for obtaining such reports to private banks and foreign banks.

The changes in the nature and volume of activities of banks also affect the work of the auditors. In particular, the treasury functions of banks such as investments, foreign exchange, etc., have assumed considerable significance in the last few years. The portfolio management services rendered by banks have also been a subject matter of considerable interest during the last couple of years.

This revised edition seeks to respond to the above, as well as several other, developments that have taken place since the publication of the last editions of the aforesaid two publications. I would like to particularly draw the attention of the members to the chapter on Audit Objectives and Approach to audit of banks in the present-day context. I would also like to make a special mention of chapters dealing with investments and advances which have been thoroughly revised in the context of the relevant guidelines issued by the Reserve Bank of India.

Apart from a thorough revision of the existing chapters, several new chapters have also been added to provide guidance on areas which have gained considerably in significance during the last few years. These chapters deal with the problem of arrears in inter-branch accounts, examination of foreign exchange transactions, application of analytical procedures by the auditors, and consolidation of accounts of

branches. A separate chapter deals with the role of the statutory auditors of banks in relation to portfolio management services. Similarly, a chapter has been added to provide guidance on the requirement of the Reserve Bank of India that the statutory auditors of a bank give a separate report on compliance with the SLR requirements.

The ten appendices to the Guidance Note contain useful reference material for the auditors. These include the formats of financial statements of banks, revised formats of audit reports in case of nationalised banks and banking companies, formats of long form audit reports and the various guidelines issued by the Reserve Bank of India regarding securities transactions of banks, valuation of investments, income recognition, asset classification, provisioning and other related matters.

An important aspect to which I would like to invite the attention of the members in the new nomenclature of this publication. As would be observed, this publication is in the form of a Guidance Note while the earlier publication on Audit of Banks was in the form of a 'Study'. The decision to bring out this edition in the form of a Guidance Note has been taken by the Council in the context of the increasing importance of the banking sector in the economy.

I must acknowledge the very hard work put in by the members of the Auditing Practices Committee, members of the Study Group formed in Calcutta for preparing the background material for Seminars on Bank Audit and also Mr. T. Neogi, F.C.A., Mr S.V. Zaregaonkar, F.C.A., and Mr K.Kannan, F.C.A. who gave their unstinted time and guidance. The Technical Directorate made an extraordinary effort to bring out this publication. Special mention must be made of Mr. Ashok Arora, Deputy Director. Only shortage of space prevents me from special mention of many others who have given their invaluable help.

The changes in the banking sector are taking place at a rapid pace. In this edition of the Guidance Note, an attempt has been made to capture the relevant developments till September 15, 1994. It is, however, appreciated that as the future unfolds itself, many of the aspects dealt with in the Guidance Note may need revision. It will be the endeavour of the Auditing Practices Committee to update this publication on a regular basis. In this task, I invite suggestions from members as to how the utility of this publication can be enhanced.

I hope the members will find the guidance provided in this publication useful while conducting statutory audit of banks and their branches.

Calcutta
November 21, 1994

Dipankar Chatterji
Chairman
Auditing Practices Committee

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PART – I

I-1

Banking in India

An Overview of Banking Institutions in India

1.01 Banks are one of the foremost agents of financial intermediation in an economy like India and, therefore, development of a strong and resilient banking system is of utmost importance. The banking institutions in the country are performing in a competitive environment and their regulatory framework is aligned with the international best practices. Thus, financial deepening has taken place in India and continues to be in progress with a focus on orderly conditions in financial markets while sustaining the growth momentum.

1.02 The Reserve Bank of India (hereinafter referred to as RBI) acts as the monetary authority and the central bank of the country.

1.03 Presently, there are following four types of banking institutions in India:

- (a) Commercial banks;
- (b) Regional rural banks;
- (c) Co-operative banks; and
- (d) Development banks (more commonly known as 'term-lending institutions').

1.04 The following paragraphs describe the salient features of different types of banking institutions enumerated above.

Commercial Banks

1.05 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*: Acceptance of deposits from the public is one of the most important functions of a commercial bank. Commercial banks accept deposits in various forms: term deposits, savings bank deposits, current account deposits, etc.
- (b) *Granting of Advances*: This again is an important function of commercial banks. Advances granted by commercial banks take various forms such as

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cash credit, overdrafts, purchase or discounting of bills, term loans, etc. Apart from granting traditional facilities, banks are also providing facilities like issuance of commercial papers, ECB on behalf of bank/borrower, securitisation of credit sales, cash overdraft, etc.

- (c) *Remittances*: Remittances involve transfer of funds from one place to another. Two of the most common modes of remittance of funds are drafts and telegraphic/mail transfers (TT/MT). Drafts are issued by one branch of the bank and are payable by another branch of the bank (or, in case there being no branch of the bank at the place of destination, branch of another bank with which the issuing bank has entered into necessary arrangement). The drafts are handed over to the applicant. In the case of telegraphic/mail transfer, no instrument is handed over to the applicant; the transmission of the instrument is the responsibility of the branch. Generally, the payee of both the TT and the MT is an account holder of the paying branch. Electronic funds transfer (EFT) is another mode of remittance which facilitates almost instantaneous transfer of funds between two centres electronically.
- (d) *Collections*: The customers can lodge various instruments such as cheques, drafts, pay orders, travellers cheques, dividend and interest warrants, tax refund orders, etc., drawn in their favour and the trade bills drawn by them on their buyers with their bank for collection of the amount from the drawee (the bank or the drawee of the bill). They can also lodge their term deposit receipts and other similar instruments with the bank for collection of the proceeds from the bank with which the term deposit, etc., is maintained. Banks also collect instruments issued by post offices, like national savings certificates, postal orders, etc.

The instruments mentioned above may be payable locally or at outside centres. The instruments payable locally are collected through the clearing house mechanism, while the instruments payable outside are sent by the bank, with which instrument has been lodged, for collection to the branches of the issuing bank at those centres or, if there is no such branch, to other banks.

Clearing house settles the inter-bank transactions among the local participating member banks. Generally, post offices are also members of the house. There may be separate clearing houses for MICR (Magnetic Ink Character Recognition) and non-MICR instruments. The clearing house is managed by the RBI, State Bank of India or any other bank nominated by RBI. In case a bank has many branches within the area of a clearing house,

it nominates one branch to act as the 'nodal' branch of that bank for all the branches within that area. This nodal branch collects instruments to be presented by other branches also. The accounts of all member banks are maintained by the clearing house. All member banks have to pay an agreed sum to the bank managing the clearing house for meeting the cost of infrastructure and services it provides to them.

In addition to the regular clearing houses as discussed above, Electronic Clearing Service (ECS) is also in vogue. ECS takes two forms: ECS credit or ECS debit.

- In the case of ECS credit, there is a single receiver of funds from a large number of customers, e.g., public utilities, mutual funds, etc. The beneficiary (i.e., the receiver of funds) obtains mandate from its customers to withdraw funds from their specified bank accounts on a particular date. These customers may have accounts with different banks in the same clearing house area. Before the specified date, the beneficiary compiles bank-branch-wise particulars of the accounts to be debited and furnishes the details in the electronic media like a floppy disk to its own bank which, in turn, arranges to provide them to the banks concerned, through the clearing house, for verification of particulars of accounts. Any discrepancies are rectified and, on the specified date, the accounts are debited by the respective banks and the beneficiary gets the credit.
- In the case of ECS debit, there is a single account to be debited against which a number of accounts with a number of banks in the same clearing house area are credited. This system is useful for distribution of dividend/interest, payment of salaries by large units, etc.

Roll-out of Speed Clearing is one of the many initiatives taken by RBI for improving efficiency in the time frame for and process of collection of outstation cheques – the time frame has reduced from 7-45 days to 2-3 days, Speed Clearing leverages on the Core Banking Solutions (CBS) implemented in banks across the country and facilitates realization of outstation cheques drawn on CBS-enabled branches at the local centre itself, thus obviating the need of such cheques to physically move to the outstation centre. Keeping in view the benefits to customers as also the

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infrastructural and processing preparedness of banks, RBI, vide its circular no. DPSS.CO.CHD. No. 1514 / 03.01.03 / 2010-2011 dated January 4, 2011 on "Enhancing the scope of Speed Clearing" decided to extend the scope of Speed Clearing to cover all transaction codes, other than those relating to government cheques. Banks, however, need to exercise usual care and caution while handling such instruments. These revised instructions are effective from February 1, 2011.

- (e) *Receipt of Foreign Contribution on behalf of the registered persons/ organization:-* Scheduled Banks also handle the foreign contribution receipt on behalf of the registered persons/ organization as per the Foreign Contribution (Regulation) Act, 2010. Banks need to ensure that the concerned persons/organization are registered with the Central Government or has obtained the prior permission to receive such foreign contribution if required by law, and that no branch other than the specified branch accepts 'foreign contribution'.
- (f) *Cash Management Product:* A derivative of the collection business, this facility is provided for expeditious transfer of funds collected by a customer at the specified centres in the country to his central account with the use of computers/satellites. It is particularly useful for large units which have their sales/collection network in a very wide geographical area. Only selected branches of a bank may handle the business due to the infrastructural requirements.
- (g) *Issuance of Letters of Credit and Guarantees:* These are two important services rendered by banks to customers engaged in business, industrial and commercial activities. A letter of credit (LC) is an undertaking by a bank to the payee (the supplier of goods and/or services) to pay to him, on behalf of the applicant (the buyer) any amount up to the limit specified in the LC, provided the terms and conditions mentioned in the LC are complied with. The guarantees are required by the customers of banks for submission to the buyers of their goods/services to guarantee the performance of contractual obligations undertaken by them or satisfactory performance of goods supplied by them, or for submission to certain departments like excise and customs, electricity boards, or to suppliers of goods, etc., *in lieu* of the stipulated security deposits.
- (h) *Merchant Banking Business:* Many bank branches act as collection agents

to issue business for merchant bankers. The customer and the bank have to agree to the modalities of the scheme, like names of branches authorised as collecting branches, the procedure for retaining the subscription and its remittance periodically, the documents required by the customer from the collecting branches, etc.

- (i) *Credit Cards*: The processing of applications for issuance of credit cards is usually entrusted to a separate division at the central office of a bank. The dues against credit cards are collected by specified branches. Many of them also act as 'cash points' to provide cash to the cardholder on demand up to the specified limits. Most credit cards issued by banks are linked to one of the international credit card networks like VISA, Master or Amex.
- (j) *Technology-based Services*: Many banks have started providing internet banking services and phone banking services. Some banks, acting as stock brokers, also provide facility to their customers to buy or sell securities on stock exchanges through the internet. The fast changing technology has synchronised the banking facility in such a way that the customer need not come physically to the bank for any transactions. The banks are now providing the facility of payment of utility bills, railway reservation, tax deposition through ATM/internet and also provide recharge facility to mobile phone users.
- (k) *Dividend/Interest/Refund Warrants*: Many entities require facilities for distribution of funds to their shareholders and others. For this purpose, they issue warrants in favour of shareholders/others payable at designated branches of specified banks, with a prior arrangement with the banks concerned. The aggregate amount of the warrants or other instruments issued is deposited by the entity with a nodal branch. The designated branches pay the warrants when presented to them.
- (l) *Safe-keeping Services*: Banks provide services for safe keeping of the scrips and valuables of customers in their vaults. A receipt is issued to the customer by the branch at the time of deposit of the items and an acknowledgement is obtained from him at the time of delivery. Each transaction – a receipt or delivery – is duly recorded in appropriate register(s) and periodically, the items physically available are cross-checked with the balances as per registers.
- (m) *Lockers*: This facility is provided to customers for safe-keeping of their valuables, etc., in lockers. The branch has no knowledge of the contents of the locker. Only the account holder (the hirer) or his *bonafide*

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representative, duly authorised by the account holder, can operate on the locker. Each access to the locker is properly recorded in the appropriate registers.

- (n) *Handling Government Business*: Banks act as agents for receipts and payments on behalf of various government departments. There are authorised branches to handle the specified type of work. Normally, a specified branch acts as a nodal branch for a particular segment of the government business within a given geographical area. The responsibility of the nodal branch includes obtaining details of transactions from the linked branches and to reconcile their accounts *inter se* and with the department concerned. Banks are remunerated for handling this business by way of service charges which are usually as agreed or a stated percentage of the collections or payments, as the case may be.
- (o) *Depository Participant (DP) Services*: The depository system is meant to facilitate quick transfer of stock market securities in a dematerialised form from the seller to the buyer by using satellite connectivity. The depository scheme is operated presently by two depositories – Central Depository Services Limited (CDSL) and National Securities Depository Limited (NSDL). Depository participants, i.e., bank branches providing depository services are in effect agents of the depository concerned. Each participating branch has to get itself registered with a depository. The customer has to open an account with the branch which provides the DP services. This account is debited by the branch with the securities sold by the account holder and credited with the purchases.
- (p) *Automated Teller Machines (ATMs)*: Operations on ATMs are through a card which contains information about the cardholder in a magnetic form. The cardholder has to also use the password (also known as Personal Identification Number, i.e., PIN) to carry out any transaction through ATM. Earlier, ATMs were used merely as cash dispensing machines but now-a-days, other services like issue of drafts, deposit of cash and instruments, balance enquiry, etc., are also being provided by many banks. ATMs may be on-site (i.e., housed in the branch premises) or off-site. The transactions routed by the customers through the ATMs may be entered into the books of account of the branch either on-line (i.e., simultaneously with the transactions) or off-line. However, on an off-line mode, the proper recording of transactions needs to be ensured.
- (q) *Exchange of Notes*: Banks exchange mutilated notes from the public for good quality notes. These mutilated notes are periodically sent to the RBI which gives equivalent credit to the branch concerned.

- (r) *Debit Cards*: Debit cards are issued by the bank where customer is having his account. The debit cards are generally issued from central office of the bank. The debit card facilitates the customer to pay at any authorised outlet as well as to withdraw money from ATM from his account. The debit cards are sometimes networked with inter-bank network.
- (s) *Auto Sweep facility in saving account*: The banks are offering auto sweep facility in saving accounts of their customers where balance exceeding a certain limit automatically get transferred to term deposit account having higher rate of interest and in case of need, the funds in term deposit automatically gets transferred to saving account.
- (t) *Third Party Advertisement on ATM Network*: The banks are providing advertisement facility to the vendors on ATM Network. The advertisement on ATM Network provides the opportunity of earning revenue to the bank.
- (u) *Securitisation of future lease rentals*: The banks are advancing loans to lessor on securitisation of future lease rentals receivable based on the mortgage of leased assets at net present value (NPV). The banks are advancing the loans to lessor (owners) of the assets under a tri-partite agreement and collect the future rentals to appropriate the advance made.
- (v) *Derivatives*: Financial derivatives are gaining importance in India. Banks are offering derivative options against exchange fluctuation losses.
- (w) *Prepaid Payment Instruments in India*¹:—Pre-paid payment instruments are payment instruments that facilitate purchase of goods and services against the value stored on such instruments. The value stored on such instruments represents the value paid for by the holders by cash, by debit to a bank account, or by credit card. The pre-paid instruments can be issued as smart cards, magnetic stripe cards, internet accounts, internet wallets, mobile accounts, mobile wallets, paper vouchers and any such instrument which can be used to access the pre-paid amount (collectively called Payment Instruments hereafter). The pre-paid payment instruments that can be issued in the country are classified under three categories viz. (i) Closed system payment instruments (ii) Semi-closed system payment instruments and (iii) Open system payment instruments. Issuer may be the persons operating the payment systems issuing pre-paid payment instruments to individuals/organizations. The money collected is retained by these persons

¹ RBI vide its circular no. DPSS.CO.PD.No. 1873 /02.14.06/ 2008-09 dated April 27, 2009 on "Policy Guidelines for issuance and operation of Prepaid Payment Instruments in India" provides the broad guidelines on this subject.

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and they make payment to the merchants who are part of the acceptance arrangement directly, or through a settlement arrangement. Further it requires that other non-bank persons issuing payment instruments are required to maintain their outstanding balance in an escrow account with any scheduled commercial bank subject to the following conditions:

- The amount so maintained shall be used only for making payments to the participating merchant establishments.
- No interest is payable by the bank on such balances.
- A quarterly certificate from the auditors shall be submitted certifying that the entity has been maintaining adequate balance in the account to cover the outstanding volume of payment instruments issued.
- The entity shall also submit an annual certificate, as above, coinciding with the accounting year of the entity to the Reserve Bank of India.
- Adequate records indicating the daily position of the value of instruments outstanding vis-à-vis balances maintained with the banks in the escrow accounts shall be made available for scrutiny to the Reserve Bank or the bank where the account is maintained on demand.

Further, RBI vide its circular no. DPSS.CO.OSD. No. 1445 /06.12.001/ 2010-2011 dated December 27, 2010 on "Issuance and operation of Prepaid Payment Instruments in India – Auditor Certificate on the balances in Escrow account" advised to furnish a quarterly certificate on the balances held in the Escrow account in accordance with the above Guidelines, from an auditor within a fortnight from the end of the quarter to which it pertains.

Para-banking Activities

1.06 Banks also undertake certain eligible financial services or para banking activities either departmentally or by setting up subsidiaries. However, banks can set up subsidiary for undertaking such activities only with prior approval of RBI. Some of those activities are listed below:

- (i) *Equipment Leasing, Hire Purchase and Factoring Services*: Banks also undertake equipment leasing, hire purchase and factoring services as departmental activities.
- (ii) *Investment in Venture Capital Funds (VCFs)*: Bank should obtain prior approval of RBI for making strategic investment in venture capital funds i.e. investment equivalent to more than 10% of the equity/unit.-
- (iii) *Mutual fund business*: Banks are not permitted to directly undertake mutual fund business but sponsor mutual funds, subject to the RBI guidelines in

this regard. Banks normally refer clients to these mutual funds and earn a commission* in return.

Banks may enter into agreements with mutual funds for marketing the mutual fund units subject to the terms and conditions specified in the RBI Master Circular on "Para Banking Activities".

- (iv) *Money Market Mutual Funds (MMMFs)*: Banks can also sponsor MMMFs business subject to the prior approval of the RBI. The MMMFs are, however, subject to regulation by the Securities and Exchange Board of India (SEBI). Banks also, at time, provide cheque-writing facilities for MMMFs subject to the RBI guidelines in this regard.
- (v) *Entry of banks into insurance business*: Banks intending to set up insurance joint ventures with equity contribution on risk participation basis or making investments in the insurance companies for providing infrastructure and services support should obtain prior approval of Reserve Bank of India before engaging in such business. However, insurance business will not be permitted to be undertaken departmentally by the banks..
- (vi) *Primary Dealership Business* – Banks can undertake primary dealership business subject to the approval of the RBI and after satisfying certain eligibility criteria prescribed by the RBI:
 - a) Banks, which do not at present, have a partly or wholly owned subsidiary and fulfill the following criteria:
 - a. Minimum Net Owned Funds of Rs. 1,000 crore.
 - b. Minimum CRAR of 9 percent.
 - c. Net NPAs of less than 3% and a profit making record for the last three years.
 - b) Indian banks which are undertaking PD business through a partly or wholly owned subsidiary and wish to undertake PD business departmentally by merging/taking over PD business from their partly/wholly owned subsidiary subject to fulfilling the criteria mentioned in A (a) to (c) above.

* Keeping in view the need for transparency in the interest of the customers to whom the products are being marketed / referred, the banks are advised to disclose to the customers, details of all the commissions / other fees (in any form) received, if any, from the various mutual fund / insurance / other financial services companies for marketing / referring their products. This disclosure would be required even in cases where the bank is marketing/ distributing/ referring products of only one mutual fund/ insurance companies etc.

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- c) Foreign banks operating in India who wish to undertake PD business departmentally by merging the PD business being undertaken by group companies subject to fulfilment of criteria at A (a) to (c).
- (vii) *Pension Funds Management*: Banks have been permitted to undertake Pension Funds Management (PFM) through their subsidiaries set up for the purpose subject to their satisfying the eligibility criteria prescribed by Pension Fund Regulatory Development Authority (PFRDA) for Pension Fund Managers. PFM can not be undertaken departmentally. Banks intending to undertake pension funds management as per the guidelines set out in the RBI Master Circular on “Para Banking Activities”.
- (viii) *Portfolio Management Services*: The general powers vested in banks to operate Portfolio Management Services and similar schemes have been withdrawn vide RBI circular DBOD.No.BC.73/27.07.001/94-95 dated June 7, 1994 on Acceptance of Deposits/Funds under Portfolio Management Scheme. No bank therefore is permitted to, restart or introduce any new PMS or similar scheme in future without obtaining specific prior approval of the RBI. However, bank-sponsored NBFCs are allowed to offer discretionary PMS to their clients, on a case-to-case basis.
- (ix) *Referral Services*: Banks can offer referral services to their customers for financial products subject to the following conditions:
 - a) The bank/third party issuers of the financial products should strictly adhere to the KYC/AML guidelines in respect of the customers who are being referred to the third party issuers of the products.
 - b) The bank should ensure that the selection of third party issuers of the financial products is done in such a manner so as to take care of the reputational risks to which the bank may be exposed in dealing with the third party issuers of the products.
 - c) The bank should make it explicitly clear upfront to the customer that it is purely a referral service and strictly on a non-risk participation basis.
 - d) The third party issuers should adhere to the relevant regulatory guidelines applicable to them.
 - e) While offering referral services, the bank should strictly adhere to the relevant RBI guidelines.
- (x) *Underwriting of Corporate Shares and Debentures*: Banks can undertake underwriting of corporate shares and debentures within the ceiling

prescribed for the bank's exposure to capital markets and subject to the provisions contained in the Section 19(2) and 19(3) of the Banking Regulation Act, 1949. The guidelines contained in the SEBI (Underwriters) Rules and Regulations, 1993 and those issued from time to time are also to be complied with. Moreover, banks should not underwrite issue of Commercial Paper by any Company or Primary Dealer and not extend Revolving Underwriting Facility to short term Floating Rate Notes/Bonds or debentures issued by corporate entities. However, with effect from April 16, 2008, banks may exclude their own underwriting commitments, as also the underwriting commitments of their subsidiaries, through the book running process for the purpose of arriving at the capital market exposure both on a solo and consolidated basis.

- (xi) *Underwriting of bonds of Public Sector Undertakings:* Banks can play a useful role in relation to issue of bonds by Public Sector Undertakings (PSUs) by underwriting a part of these issues. They may also subscribe outright initially but sell them later to the public with the aid of their wide branch network. It should, however, be ensured that the increase in the holdings of public sector bonds by banks arising out of their underwriting or subscription is kept within reasonable limits. While undertaking the underwriting of bonds of PSUs, banks should formulate their own internal guidelines as approved by their Boards of Directors on investments in and underwriting of PSU bonds, including norms to ensure that excessive investment in any single PSU is avoided and that due attention is given to the maturity structure of such investments.
- (xii) *Retailing of Government Securities:* Banks are permitted to undertake the business of retailing of Government securities with non-bank clients subject to the following conditions:
 - a) Banks are free to buy and sell Government Securities on an outright basis at prevailing market prices without any restriction on the period between sale and purchase.
 - b) Banks shall not undertake ready forward transactions in Government Securities with non-bank clients.
 - c) The retailing of Government Securities should be on the basis of ongoing market rates / yields emerging out of secondary market transactions.
 - d) No sale of Government Securities should be effected by banks unless they hold the securities in their portfolio either in the form of physical scrips or in the SGL Account maintained with the Reserve Bank of India.

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- e) Immediately on sale, the corresponding amount should be deducted by the bank from its investment account and also from its SLR assets.
- f) Banks should put in place adequate internal control checks/mechanism in this regard.
- g) These transactions should be subjected to concurrent audit as per our extant instructions and should also be looked into by the auditors at the time of bank's statutory audit.

(xiii) *Sponsors to Infrastructure Debt Funds (IDFs)* - In order to accelerate and enhance the flow of long term funds to infrastructure projects for undertaking the Government's ambitious programme of infrastructure development, scheduled commercial banks have been allowed to act as sponsors to Infrastructure Debt Funds (IDFs). IDFs can be set up either as Mutual Funds (MFs) or as Non-Banking Finance Companies (NBFCs). While IDF-MFs are regulated by SEBI (SEBI has amended the Mutual Funds Regulations to provide regulatory framework for IDF-MFs by inserting Chapter VI-B to the MF Regulations), IDF-NBFCs are regulated by Reserve Bank of India (RBI). Banks can sponsor IDF-MFs and IDF-NBFCs with prior approval from RBI subject to the conditions given in the 2013 RBI Master Circular on Para Banking Activities.

(xiv) *Membership of currency futures exchanges* - Scheduled commercial banks (AD Category I) have been permitted to become trading / clearing members of the currency derivatives segment to be set up by the Stock Exchanges recognized by SEBI, subject to their fulfilling the following prudential requirements:-

- a) Minimum networth of Rs. 500 crores,
- b) Minimum CRAR of 10%
- c) Net NPA not exceeding 3%
- d) Net Profit for last 3 years

Banks which fulfill the conditions mentioned above should lay down detailed guidelines with Board's approval for conduct of this activity and management of risks. It should be ensured that the bank's position is kept distinct from the clients' position. In case of supervisory discomfort with the functioning of a bank, the Reserve Bank may impose restrictions on the bank regarding the conduct of this business as it deems fit.

The banks which do not meet the above minimum prudential requirements are permitted to participate in the currency futures market only as clients.

1.07 The RBI has issued a Master Circular No. on “Para Banking Activities” dated July 1, 2013 containing instructions/guidelines issued by it to banks in respect of their para banking activities.

1.08 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.

1.09 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 nationalised banks.

1.10 While the majority stake in State Bank of India is of the Government of India, there are private individual/institutional shareholders also. The share capital of associate banks of State Bank has been subscribed to by the parent bank and private shareholders.

1.11 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, 2013 or an earlier Indian Companies Act.
- (b) Non-scheduled banks.
- (c) Indian branches of banks incorporated outside India, commonly referred to as ‘foreign banks’.

1.12 Some of the banks have set up subsidiaries – wholly-owned or partly-owned – to operate in some specialised spheres of activity such as merchant banking, funds management, housing finance, dealing in government securities, etc. These subsidiaries do not carry on all the principal functions of a commercial bank.

Regional Rural Banks

1.13 These 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). While regional rural banks can carry on any business in which a bank is legally permitted to engage. Section 18 of the Regional Rural Banks Act, 1976, specifically lists the following businesses which such a bank may undertake:

- (a) the granting of loans and advances, particularly to small and marginal farmers and agricultural labourers, whether individually or in groups, and to co-operative societies, including agricultural marketing societies, agricultural processing societies, co-operative farming societies, primary agricultural credit societies or farmers’ service societies, for agricultural purposes or agricultural operations or for other purposes connected therewith;
- (b) the granting of loans and advances, particularly to artisans, small entrepreneurs and persons of small means engaged in trade, commerce or industry or other productive activities, within the notified area in relation to the RRB.

1.14 In order to strengthen and consolidate RRBs, the government in 2005 initiated the process of amalgamation of RRBs in a phased manner. Consequently, the total number of RRBs has reduced from 196 to 64 as on March 31, 2013*.” Further, the Government of India has issued a notification dated May 17, 2007 specifying ‘Regional Rural Bank’ as ‘bank’ for the purpose of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002.

1.15 In recent years, in an attempt to strengthen the regional rural banks, several measures have been taken by the Central Government and the RBI. These banks are no longer required to confine their lending to the weaker sections and are permitted to lend to non-target groups also up to specified limits. They can also undertake various types of business such as issuance of guarantees, demand drafts, travellers’ cheques, etc. Moreover, RRBs are no longer required to confine their operations only within local limits notified by the Central Government; they are now permitted, subject to fulfilling service area obligations, to lend monies outside their service area. In the wake of these

* As appearing on www.nabard.org/English/rrbs.aspx on 22.01.2014.

developments, the distinction between commercial banks and RRBs has become somewhat blurred.

1.16 Each RRB has a public sector bank as its 'sponsor bank'. Capital in each such bank is contributed by the Central Government, the sponsor bank and the State Government concerned in proportion of 50, 35 and 15 per cent, respectively.

1.17 Apart from subscribing to the share capital of a RRB sponsored by it, the sponsor bank is also required to train personnel of the RRB as also to provide managerial and financial assistance to such bank during the first five years of the latter's functioning (this period can, however, be extended by the Central Government).

1.18 Like commercial banks, regional rural banks also function under the overall supervision and control of the RBI. Some of the regulatory functions of the RBI in relation to RRBs have been delegated to the National Bank for Agriculture and Rural Development (NABARD).

Co-operative Banks

1.19 These 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. Of these, primary co-operative banks operate in metropolitan cities, urban and semi-urban centres to cater principally to the credit needs of small industrial units, retail traders, etc. Due to their existence primarily in urban areas, primary co-operative banks are more commonly known as 'Urban Co-operative Banks' (UCB). The UCB sector, has witnessed significant improvement in recent years. Constitution of Task Forces for Urban Co-operative Banks (TAFUCBs) has instilled public confidence in the UCB sector which is evident from the increase in deposits for three successive years, i.e., from 2005-06 to 2007-08. Land development banks provide long-term finance for agriculture and have a two-tier structure – State Land Development Banks and the Primary Land Development Banks, the latter being at District or Block level. In a few states, however, the structure is unitary where the State Land Development Bank directly carries out activities through its own branches at district level.

1.20 Each co-operative bank operates within a specific geographic jurisdiction as determined by its bye-laws. Unlike commercial banks which raise funds primarily in the form of deposits from public, co-operative banks rely to a considerable extent on the RBI for providing funds at concessional rates. Co-operative banks can lend monies only to their members or to registered societies. RBI is the regulatory authority for co-operative banks also, though some of its

regulatory functions in relation to co-operative banks are now vested in NABARD.

Development Banks

1.21 As these 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'. These institutions provide facilities for the units set up in any part of the country. Of late, some of these institutions have sponsored commercial banks also. Besides these all-India level institutions, virtually every State has a State Financial Corporation and a State Industrial Development Corporation (though they may be known by different names) to cater to the needs of the units set up in that particular state. Normally, state-level institutions have a monetary ceiling on the quantum of finance they can grant to a single unit.

Foreign Banks

1.22 Foreign banks operate in India through a network of branches and do not have a separate legal entity existence in India. However, for all practical purposes, the RBI regulates the functioning of these banks in India, with regards to scale and nature of business they undertake in India. Foreign banks normally have a CEO or a Country Head as the highest decision making authority based out of the country. This position generally reports to the regional management board or the global board as the case may be. In comparison to a locally incorporated bank, the management structure of foreign banks is not very 'top' concentrated, i.e., it will be minus the various boards and committees.

1.23 Foreign banks operate with limited branch network in the country and operate in a structure wherein most of their operations are centralised. Bank branches operate as customer relationship windows and do not record substantial financial statements impacting transactions. Almost all foreign banks are technologically advanced and use a high level of IT integration into their operations. These systems, in most instances, are similar to those being used by their branches globally. Due to cost-benefit and other considerations, in some instances, foreign banks, get certain financial or other information processed at one of their global centres. This processing of data out of the country is generally with specific consent from the RBI. Due to their existence in global financial centres and their expertise, banks undertake complex treasury transactions (to the extent allowed by RBI regulations). In most cases these transactions are undertaken back to back with their foreign branches and would be hedged from a local risk perspective. Additionally, banks also undertake and participate in

international advisory and syndication transactions, in partnership with their international branches, which in effect generates fee revenue for the bank.

Branch Network of Commercial Banks

1.24 Apart from term-lending institutions, commercial banks are arguably the most important constituent of the banking system in India. To carry out their functions effectively, these banks have established a large network of branches in India. Based on their location, these 'domestic' branches are commonly classified into rural branches, semi-urban branches, urban branches and metro branches. Apart from these domestic branches, some banks have also established offices abroad. The foreign offices of banks are generally of the following types:

- *Full-fledged branches* – Such branches transact all kinds of banking business.
- *Off-shore banking units* – Such branches transact foreign exchange business of any kind except domestic banking business with the residents/corporations, etc., domiciled in the country concerned.
- *Subsidiaries* – The laws in some countries do not permit foreign banks to open their branches in those countries. Therefore, Indian banks have to set up wholly or partly-owned subsidiaries in such countries.
- *Representative offices* – Such branches do not transact any banking business. The objective behind setting up such offices is to maintain close liaison with the important bodies there to promote mutual business interests.

1.25 Generally, branches of banks conduct a variety of banking business under one roof. Recently, however, the trend of creating 'thrust-based' or 'focus-based' branches has caught up. This has led to setting up of branches by banks exclusively for a specified segment of their clients. Presently, such specialised branches are generally of the following types (nomenclature may, however, vary from bank to bank):

- Personal Banking branches, catering to the needs of individual customers only.
- Commercial or Industrial Finance branches, catering to the needs of industries in the small, medium and/or large sectors.
- Recovery branches, which deal only with the recovery aspects of non-performing advances which were originally granted at other branches of the bank.

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- Housing Finance branches which deal only with housing loan proposals – from individuals, and in some cases, also from the developers of housing units.
- Agricultural Finance branches, catering to the needs of the agriculture sector only.
- Service branches, handling only the local clearing instruments received from outstation branches or from other local branches of the bank for collection.
- Commodity specific branches, which handle the accounts, predominantly borrowal accounts, of the units belonging to a particular industry, e.g., leather, diamonds.
- Overseas or International Banking or Foreign Exchange branches catering to the banking needs of those enterprises which are engaged in imports into/exports from India.
- Corporate or Industrial Finance/SME/SSI branches, catering exclusively to the requirements of the large, medium and small scale industrial units respectively.
- NRI (Non-Resident Indian) branches, catering exclusively to the banking needs of NRIs.
- Securities branches, dealing only with the securities portfolio of the bank.

1.26 The trend towards specialisation may, in future, cause the opening of dedicated branches of various other segments of clients such as, government business, remittance business, trade sector business, locker business, rehabilitation, educational loans, etc.

Organisational Structure of Banks

1.27 While the exact organisational structure may differ from one bank to another, most large-sized public sector banks have a four-tier structure – head office, zonal offices, regional offices and branches (the nomenclature may, however, vary among banks) – each tier of the structure being responsible for performing the functions specified by the Head Office.

1.28 At the apex level is the head office of the bank whose main functions are:

- Laying down policies and procedures for smooth and efficient functioning of the bank and to review them periodically.
- Deciding on the extent of powers – financial and administrative – which may be vested in various functionaries of the bank.

- Planning and performance budgeting.
- Asset-liability management.
- Laying down lending policy of the bank, the risk management guidelines, and the rehabilitation and recovery guidelines including policies for compromise, settlement and write-off.
- Deciding about the interest rates on both the deposits and the loans as well as about charges for various services and review interest rates and charges periodically.
- Treasury and investment management (usually handled by the head office, though in some cases, select large branches may also be involved in this function).
- Monitoring and controlling the functioning of various offices of the bank. Periodic inspections and internal audit are important constituents of such monitoring and control mechanism.
- Reconciling the transactions among various offices of the bank.
- Introducing new products and services and reviewing the existing ones.
- Issuing instructions to branches and other offices from time to time on matters deserving their attention or requiring compliance by them.

1.29 At the second level are the zonal offices which are responsible for overall working of the branches in their areas of operation. Zonal offices act as a link between the branches and the head office, either directly or through regional offices.

1.30 Below the zonal offices are the regional offices which are the immediate controllers of the branches under their jurisdiction. They are responsible for business development, compliance with the laid down systems and procedures, satisfactory customer service, quick redressal of complaints and submissions of the required statements/reports/returns by branches under their jurisdiction. They are also responsible for smooth functioning of the branches under them.

1.31 Branches are lowest in the hierarchy of the banking organisation structure. In fact, the banking operations (i.e., accepting deposits and making loans) actually take place at the branch level. Their jobs are numerous, practically everything in relation to banking, except the pricing of products/services and the policy formulation.

1.32 Some branches have extension counters and sub-offices functioning under them. The extension counters/sub-offices are meant for specific locations like airports, large institutions, large project sites, etc., and cater exclusively to the banking needs (either all or limited) of the concerned locale.

Role of the Reserve Bank of India as the Central Bank

1.33 The RBI is the central bank of our country. As such, RBI is responsible for development and supervision of the constituents of the Indian financial system (which comprises banks and non-banking financial institutions) as well as for determining, in conjunction with the Central Government, the monetary and credit policies keeping in with the need of the hour. Among its important functions are issuance of currency; regulation of currency issue; acting as banker to the central and state governments; and acting as banker to commercial and other types of banks including term-lending institutions. Besides, RBI has also been entrusted with the responsibility of regulating the activities of commercial and other banks. No bank can commence the business of banking or open new branches without obtaining licence from RBI. The RBI also has the power to inspect any bank.

1.34 RBI is empowered under section 21 of the Banking Regulation Act, 1949, to control advances by banks in general or by any bank in particular. Among the measures that the RBI can adopt for this purpose are to prescribe purposes and extent of advances, margin requirements, maximum exposure to a single borrower, rate of interest and other terms and conditions, etc. Besides these measures (which are usually called 'selective credit control' measures), RBI also controls the total volume of bank credit by varying bank rate through open market operations or by varying cash reserve and similar requirements.

1.35 Bank rate refers to the rate of interest at which the RBI re-discounts the first class bills of exchange or other eligible instruments from banks. Variations in bank rate affect the interest rates charged by banks – generally, interest rates of banks move up or down *in tandem* with movements in bank rate.

1.36 Open market operations involve sale or purchase of government securities in the open market. When RBI buys government securities from banks in the open market, the funds in the hands of selling banks increase, enabling them to expand credit, and *vice versa*.

1.37 Banks are required to maintain at least a prescribed minimum

percentage of their demand and time liabilities in India in the form of cash and/or current account balances with the RBI (called 'cash reserve ratio'). Additionally, they are required to maintain a further percentage in the form of cash and/or other liquid assets (called 'statutory liquidity ratio'). Varying the cash reserve ratio and/or statutory liquidity ratio enables the RBI to increase or decrease (as the case may be) the funds available to banks for lending and other similar purposes.

1.38 Apart from directions relating to operational matters, RBI also issues, from time to time, guidelines on accounting matters to be followed by banks. These guidelines have a profound effect on annual accounts of banks. The text of the notifications/circulars/guidelines, etc., issued by RBI are normally also available on its website **www.rbi.org.in**.

Accounting and Auditing Framework

2.01 This Chapter discusses the statutory provisions and regulatory requirements affecting the accounts and audit of banks. As provisions relating to accounts and audit of co-operative banks may differ from one State to another, they are not discussed in this Guidance Note.

Form and Content of Financial Statements

2.02 Sub-sections (1) and (2) of section 29 of the Banking Regulation Act, 1949, deals with the 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.

2.03 Sub-section (1) of section 29 requires every banking company to prepare a balance sheet and a profit and loss account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit. These financial statements have to be prepared as on the last working day of each financial year (i.e., 31st March) in respect of all business transacted during the year. A foreign banking company (i.e., a banking company incorporated outside India and having a place of business in India) has to similarly prepare a balance sheet and a profit and loss account every year in respect of all business transacted through its branches in India.

Salient Features of the Third Schedule

2.04 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.

2.05 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

2.06 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

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

2.08 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.

2.09 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

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2.10 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.

Disclosures Prescribed by RBI

2.11 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, vide its Master Circular no. DBOD.BP.BC No.7 /21.04.018/2013-14 of July 1, 2013 on "Disclosure in Financial Statements – Notes to Accounts", prescribes disclosures to be made in the Notes to Accounts in respect of certain significant aspects of the items of financial statements of banks.

Disclosures Required Under Accounting Standards

2.12 The disclosure requirements under the various Accounting Standards, issued by the Central Government under the Companies Accounting Standard Rules, 2006 as well as any other Accounting Standards issued by the ICAI are also to be complied with.

Requirements of the Banking Regulation Act, 1949, vis-a-vis Companies Act, 1956

2.13 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

2.14 Banks listed on a stock exchange have to also comply with the requirements of the Listing Agreement as amended from time to time. In respect of securities issued and traded on foreign bourses, if any, the issuer bank has to comply with the applicable regulations of that jurisdiction.

Financial Statements, Auditor's Report and Directors' Report of Subsidiary

2.15 Public sector banks are also required to annex the balance sheet, profit and loss account, report of the board of directors and auditor's report in respect of each of their subsidiaries, to their own financial statements. The banking

* Now Companies Act, 2013.

companies are required to attach the financial statements, directors' report and auditor's report to their own annual reports by virtue of section 212 of the Companies Act, 1956.

Notes and Instructions Issued by RBI

2.16 The RBI has issued notes and instructions for compilation of balance sheet and profit and loss account. These notes and instructions provide an authoritative interpretation of the requirements of the Third Schedule to the Act and are thus useful in preparation of financial statements of banks.

Signatures

2.17 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.

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

Auditor's Report

2.19 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.

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2.20 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.

2.21 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

2.22 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.

2.23 Further, in accordance with the recent Announcement issued by the Institute of Chartered Accountants of India, the bank branch auditors need to mention the total number of debits/ credits and amounts in the Memorandum of Changes submitted by them, under the Other Matters Paragraph in the their audit report. This would help in ensuring that all issues raised by the bank branch auditors in the Memorandum of Changes, including those which have not per se been accepted by the bank branch managements, have been duly brought to the knowledge of the statutory central auditors. It may be noted that the information in respect of Memorandum of Changes under the "Other Matters Paragraph" would include both such MoCs which have been accepted as well as those not accepted by the bank branch management, though this distinction need not per se be brought out in the audit report.

2.24 An illustrative format of the auditor's report in the case of Nationalised Banks is reproduced in Appendix 4 to this Guidance Note.

2.25 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 also 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.

2.26 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.

2.27 The Companies (Amendment) Act, 2000 inserted two new clauses (e) and (f) in section 227(3) of the Companies Act, 1956. Clause (e) requires that the auditor's report shall state "in thick type or in italics the observations or comments of the auditors which have any adverse effect on the functioning of the company". Clause (f) requires the auditor to report "whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274". Member's attention is invited to the Revised Guidance Note on section 227(3) (e) and (f) of the Companies Act, 1956.

2.28 It may also be noted that the Companies (Auditor's Report) Order, 2003 (Revised in 2005), is not applicable to banking companies.

2.29 An illustrative format of the audit report in the case of a banking company is given in Appendix 3 to the Guidance Note.

Long Form Audit Report

2.30 Besides the audit report as per the statutory requirements discussed above, the terms of appointment of auditors of public sector banks, private sector

* Now Companies Act, 2013.

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 RBI.

Reporting to RBI

2.31 The RBI issued a Circular No. DBS.FGV.(F).No. BC/ 23.08.001/2001-02 dated May 3, 2002 relating to implementation of recommendations of the Committee on Legal Aspects of Bank Frauds (Mitra Committee) and the recommendations of the High Level Group set-up by the Central Vigilance Commission applicable to all scheduled commercial banks (excluding RRBs). Regarding liability of accounting and auditing profession, the said circular provided as under:

“If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action”.

2.32 As per the above requirement, the member shall be required to report the kind of matters stated in the circular to regulator, i.e., RBI. In this regard, attention of the members is also invited to Clause 1 of Part I of the Second Schedule to the Chartered Accountants Act, 1949, which states that:

“A chartered accountant in practice shall be deemed guilty of professional misconduct, if he discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise than as required by any law for the time being in force.”

2.33 Under the said provision, if a member of the Institute *suo motu* discloses any information regarding any actual or possible fraud or foul play to the RBI, the member would be liable for disciplinary action by the Institute. However, a member is not held guilty under the said clause if the client explicitly permits the auditor to disclose the information to a third party. If the above-mentioned requirement of the Circular is included in the letter of appointment (which constitutes the terms of audit engagement) then it would amount to the explicit permission by the concerned bank (client) to disclose information to the third party, i.e., the RBI.

2.34 Thus, auditors while reporting such a matter to C&MD of the bank should also report the matter simultaneously to the Department of Banking Supervision, RBI provided the terms of audit engagement require him to do so.

2.35 Auditor should also consider the provisions of SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements". Para A19 of the said Standard explains that the duty of confidentiality is over-ridden by statute, law or by courts (For example, the auditor is required to report certain matters of non-compliance to RBI as per the requirements of the Non-Banking Financial Companies Auditor's report (Reserve Bank) Directions, 1988, issued by the RBI).

2.36 RBI has issued a Master Circular no. DBS.FrMC.BC.No.1/23.04.001/2013-14 dated July 1, 2013 on "Frauds – Classification and Reporting" on the matters relating to classification and reporting of frauds and laying down a suitable reporting system. As per the said circular, the primary responsibility for preventing frauds is that of bank management. Banks are required to report frauds to the board of directors and also to the RBI.

2.37 In the aforesaid context, it may be emphasised that such a requirement does not extend the responsibilities of an auditor in any manner whatsoever as far as conducting the audit is concerned. The requirement has only extended the reporting responsibilities of the auditor. As far as conduct of audit is concerned, the auditor is expected to follow the Standards on Auditing issued by the ICAI and perform his functions within that framework. SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements " states that an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Members' attention is invited to audit procedures as dealt in Chapter 2, "Risk Assessment and Internal Control" of Part II of the Guidance Note.

2.38 There are several reporting requirements relating to frauds, if detected, in LFAR and Ghosh Committee recommendations. The auditor should also refer to reports of internal auditors, concurrent auditors, inspectors, etc., which may point out significant weaknesses in the internal control system. Such an evaluation would also provide the auditor about the likelihood of occurrence of transaction involving exercise of powers much beyond entrusted to an official. It must be noted that auditor is not expected to look into each and every transaction but to evaluate the system as a whole. Therefore, if the auditor while performing his normal duties comes across any instance, he should report the matter to the RBI in addition to Chairman/Managing Director/Chief Executive of the concerned bank.

Audit of Branches

2.39 Audit of branches of banking companies is required under section 228

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of the Companies Act, 1956*. It is thus obligatory for a banking company to get the financial statements of each of its branch offices audited except where exemption from audit is obtained in respect of certain branches under the Companies (Branch Audit Exemption) Rules, 1961 and as per the guidelines of the RBI issued from time to time.

2.40 The branch auditor has the same powers and duties in respect of audit of financial statements of the branch as those of the central auditors in relation to audit of head office. The branch auditor's report on the financial statements examined by him is forwarded to the central auditors with a copy to the management of the bank. The branch auditor of a public sector bank, private sector bank or foreign bank is also required to furnish a long form audit report to the bank management and to send a copy thereof to the central auditors. The central auditors, in preparing their report on the financial statements of the bank, deal with the branch audit reports in such manner as they consider necessary.

2.41 Some Indian banks also have overseas branches. The audit of financial statements of these branches is usually carried out by an accountant duly qualified to act as an auditor of the branch in accordance with the laws of the country concerned. The form of audit report is usually governed by the laws of the country in which the branch is situated.

Branch Audit *vis-à-vis* Audit at Head Office Level

2.42 There is a significant difference in the scope of audit at a branch of a bank (conducted by branch auditors) and at head office (conducted by central auditors) as well as other controlling offices such as zonal offices and regional offices (usually conducted by central auditors). This difference stems from the fact that the banking business – receiving deposits and making loans and advances – as well as most other banking services take place at the branch level; in the normal course, the head office and the regional/zonal offices do not conduct any banking business. They are generally responsible for administrative and policy decisions which are executed at the branch level. However, accounting for certain transactions, for example, those relating to treasury functions (viz., investments, funds management, bill re-discounting) is usually centralised, i.e., carried out at the head office. Specialised activities like merchant banking are carried on by separate divisions which operate at the head office and/or at the large designated branches.

2.43 The branch auditors furnish their audit reports on the branch financial statements to central auditors. Branch returns (comprising balance sheet, profit

* Corresponding to Section 143 of the Company Act, 2013 yet to be notified by the Central Government.

and loss account and other information relevant for preparation of financial statements of the bank such as particulars of advances) are also received at the head office from un-audited branches. Audited as well as un-audited branch returns are consolidated at the head office. (In some banks, returns pertaining to a region/zone are sent by the branches to the region/zone concerned and are consolidated there. The returns received from various regions/ zones are then consolidated at the head office.)

2.44 The central auditors, apart from examining consolidation of branch returns, look into specific matters which are normally not dealt with at the branch level. These generally include the following:

- Depreciation on assets like premises, etc., where the recording of the relevant fixed assets is centralised at the head office.
- Valuation of investments, and provisions for depreciation in value thereof.
- Provisions in respect of non-performing advances and doubtful elements of other current assets.
- Provisions for gratuity, pension and other retirement benefits.
- Provision for payment of bonus or ex-gratia in lieu of bonus.
- Provision for interest on overdue term deposits.
- Provision for interest on saving bank deposits beyond the date upto which interest has been provided at the branch level. [For expeditious finalisation of financial statements of branches, some banks follow the practice of requiring the branches to provide for interest on savings bank deposits based on balances therein as at a cut-off (say, 25th March). The interest for the remaining period is provided at the head office level on an estimated basis.]
- Provision in respect of losses arising from frauds discovered.
- Provision for taxation.
- Provision for audit fee.
- Provisions to meet any other specific liabilities or contingencies, the amount of which is material, for example, provision for revision in pay-scales of employees, provision for foreign exchange fluctuations, etc.
- Transfers to reserves.
- Dividends.
- Any other matter dealt with at the head office.

2.45 Another area which is of utmost importance for the central auditors in the present-day context is that related to inter-office reconciliation. Such

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reconciliation is mostly centralised at the head office. Each bank has laid down methods and procedures for reconciling the transactions among the various offices of the bank.

2.46 SA 600, 'Using the Work of Another Auditor', states that the principal auditor should consider the significant findings of the other auditor. The central auditors have to judge whether the observations appearing in the branch auditor's reports, though considered material at the branch level are material in the context of the financial statements of the bank as a whole.

Other Important Provisions Relating to Accounts and Audit

2.47 Section 31 of the Banking Regulation Act, 1949 requires publication of annual accounts (balance sheet and profit and loss account) and auditor's report thereon to be published in the prescribed manner. It is further required that three copies of the above-referred documents should be furnished as returns to the RBI within three months from the end of the period to which they relate. The RBI can extend the aforesaid period by a further period not exceeding three months. These requirements are applicable to banking companies, nationalised banks, State Bank of India, its subsidiaries, and regional rural banks. The regional rural banks are, however, required to furnish the aforesaid returns to NABARD also.

2.48 Section 32 of the Act requires a banking company (but not other types of banks) to furnish three copies of its annual accounts and auditor's report thereon to the Registrar of Companies at the same time when it furnishes these documents to the RBI. This is considered compliance with section 220 of the Companies Act, 1956* also.

2.49 Every banking company incorporated outside India is required by section 33 of the Act, to display, not later than the first Monday in August every year, in a conspicuous place in its principal office and every branch office in India a copy of its last audited annual accounts. It has to also similarly display its complete audited balance sheet and profit and loss account relating to its banking business as soon as they are available. The aforesaid documents have to be kept displayed until replaced by subsequent corresponding documents.

* Corresponding to Section 137 of the Company Act, 2013 yet to be notified by the Central Government.

Accounting Systems

3.01 The accounting systems of different banks vary in terms of hardware configuration, software capabilities, levels of hardware and software security, and nature of transactions processed. It is, therefore, not possible to identify a single accounting system that would describe all the features of such systems in operation in different banks.

3.02 SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" lays down that the use of Information Technology (IT) affects the way control activities are implemented. From the auditor's perspective, controls over IT system are effective when they maintain the integrity of the information and the security of the data such systems process, and includes effective IT controls and application controls. In recent years, many banks have moved towards computerisation of their operations. The degree of computerisation, however, varies among different banks and also among various branches of the same bank. While some branches have been fully computerised, some others have been partly computerised while many others are non-computerised.

3.03 The auditor of a bank needs to obtain an adequate understanding of the accounting system of the bank to assess the relevance and reliability of the accounting records and other source data underlying the financial statements. He should gain an understanding of the books of account and other related records maintained by the auditee including an understanding of the flow of various kinds of transactions. He can gain such understanding through enquiries of appropriate personnel, corroborated by making reference to documents such as accounting and procedures manual, flow charts, underlying documentary evidence and by observing the actual conduct of operations.

Salient Features of Accounting Systems of Banks

3.04 Banks, like most other large-sized institutions, follows the mercantile system of accounting. Thus, the system of recording, classifying and summarising the transactions in a bank is in substance no different from that followed in other entities having similar volume of operations. However, in the case of banks, the need for the ledger accounts, especially those of customers, being accurate and up-to-date on a real time basis is much stronger than in most

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other types of enterprises. A bank cannot afford to ignore its ledgers particularly those containing the accounts of its customers and has to enter each and every transaction in its ledgers as soon as it takes place.

3.05 Banks follow the accounting procedure of 'voucher posting' under which the vouchers are straightaway posted to the individual accounts in the subsidiary ledgers. Simultaneously, the debit and credit vouchers relating to particular type of transactions (e.g., savings bank accounts, current accounts, demand loans, cash credit accounts, etc.) get posted to the respective control account in the General Ledger. The trial balance of the general ledger is prepared every day.

3.06 It is imperative to note that most of the banks in the private and public sector have now networked all or most of their branches in the country which has over a period of time led to operational and financial efficiencies. Accordingly the traditional practice of preparing vouchers and maintaining manual records has largely been discontinued by online processing of transactions.

3.07 The accounting system in an enterprise is designed keeping in view the nature and volume of operations and information needs of management, regulators and third parties with whom the enterprise has dealings. With the advent of technology every big bank has customized banking software as per its own requirement and as such, the accounting systems differ amongst different enterprises. The following discussion should, therefore, be construed, as generic in nature and the auditor should ascertain the exact design of the accounting system in each auditing situation.

Accounting and Financial Control Manual ('AFCM')

3.08 The General Ledger ('GL') is the comprehensive repository of the Bank's financial information and prime source of data for internal and external reporting. It is imperative that the GL be complete, accurate and all its data valid. Banks should be encouraged to frame and adopt an AFCM, the primary objective of which should be to set out comprehensive, unified and standardised GL controls, standard accounting and financial operating procedures, accounting policies with the ultimate objective of strengthening the financial reporting and monitoring processes.

3.09 The manual should be reviewed centrally at the Head office level on an on-going basis and minimum, annually.

3.10 The salient features of the AFCM should include:

- Defining roles and responsibilities for the accounting and finance reporting team across key departments/ branches;

- Laying out the process controls to be applied to processes, procedures and practices followed by accounting and finance teams; and
- Outlining escalation requirements for reconciliations and process exceptions.

Reconciliation of sub-systems and suspense accounts

3.11 A Bank uses multiple sub-systems managing certain instruments, products and offerings for recording business transactions. These subsystems are electronically interfaced and need to be reconciled with the GL on a daily basis. There has to be adequate process to review the reconciliation between GL and the sub-systems highlighting significant unreconciled items, if any, to the Head office.

3.12 All Sundry Suspense accounts should also be tracked by the Bank on a regular basis. The Bank should have defined procedures for reconciling and monitoring sundry/suspense accounts at periodical intervals and escalating issues, if any, to the concerned departments/ branches for speedy resolution of open items.

Regulatory reporting to the Reserve Bank of India ('RBI')

3.13 Large banks generally have a dedicated regulatory reporting team for the purpose of ensuring appropriate reporting to the RBI. The information for the purpose of regulatory reporting is sourced from the GL and other subsystems of the Bank. In case of specific disclosure requirement, information is sourced from the respective business divisions. The reporting team should maintain an RBI reporting schedule based on which various reports are compiled and submitted to the RBI after being subject to a maker-checker process.

Audit Considerations

Information Produced by the Entity ('IPE') and used as Audit Evidence

3.14 Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based and includes the information contained in the accounting records underlying the financial statements and other information. Accounting records generally include the records of initial entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries, and other adjustments to the financial statements that are not reflected in formal journal entries; and records such as worksheets and spreadsheets supporting cost allocations, computations, reconciliations, and disclosures. The entries in the accounting records are often initiated, authorized, recorded, processed, and

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reported in electronic form. In addition, the accounting records may be part of integrated systems that share data and support all aspects of the entity's financial reporting, operations, and compliance objectives.

3.15 Management is responsible for the preparation of the financial statements based on the accounting records of the entity. The auditor should obtain audit evidence by testing the accounting records, for example, through analysis and review, reperforming procedures followed in the financial reporting process, and reconciling related types and applications of the same information. Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements. However, because accounting records alone do not provide sufficient appropriate audit evidence on which to base an audit opinion on the financial statements, the auditor should obtain other audit evidence. Other information that the auditor may use as audit evidence includes minutes of meetings; confirmations from third parties; industry analysts' reports; information obtained by the auditor from such audit procedures as inquiry, observation, and inspection; and other information developed by or available to the auditor that permits the auditor to reach conclusions through valid reasoning.

3.16 IPE is not only used for testing controls relating to assertions on material classes of transactions, account balances and disclosures but is also used when performing procedures to evaluate the operating effectiveness of general IT controls. When evaluating the IPE, it is important to first obtain an appropriate understanding of the IPE. The auditor should begin with understanding what the IPE is, how the IPE is generated, and how it is intended to use as audit evidence. This allows the auditor to design the most appropriate testing approach to determine whether the IPE is sufficient and appropriate for purposes of the audit. The auditor should also consider the matters referred in SA 500 – Audit Evidence whilst testing IPE.

Elements of IPE

3.17 Information Produced by the Entity (IPE) typically consists of three elements:

- (1) *Source data*: The information from which the IPE is created. This may include data maintained in the IT system (e.g., within an application system or database) or external to the system (e.g., data maintained in an Excel spreadsheet or manually maintained), which may or may not be subject to general IT controls.
- (2) *Report logic*: The computer code, algorithms, or formulas for transforming, extracting or loading the relevant source data and creating the report.

Report logic may include standardized report programs, user-operated tools (e.g., query tools and report writers) or Excel spreadsheets, which may or may not be subject to the general IT controls.

For example, for the advances Aging report, the report logic is typically a program in the advances application that contains the code and algorithms for creating the advances Aging (report) from the advances sub-ledger detail (source data).

- (3) *Report parameters:* Report parameters allow the user to look at only the information that is of interest to them. Common uses of report parameters including defining the report structure, specifying or filtering data used in a report or connecting related reports (data or output) together. Depending on the report structure, report parameters may be created manually by the user (user-entered parameters) or they may be pre-set (there is significant flexibility in the configuration of parameters, depending on the application system), and they may or may not be subject to the general IT controls.

Understanding the IPE

3.18 The following questions may assist the auditor in understanding the IPE:

- What is the purpose of the IPE?
 - If in connection with the operation of a control, does the user depend on the accuracy and completeness of the information? If not, how is the user able to validate that the information is accurate and complete?
- What is the nature of the IPE?
 - Is it a standard or custom report?
 - Is the IPE system-generated or manually created? If manually created, what is the process for creating it?
- How is it created?
 - What is the relevant source data and where does the source data reside? Is the source data subject to the general IT controls (e.g., access controls)?
 - Where does the report logic reside? If system-generated, is the report logic subject to the general IT controls (e.g. access and program change controls)?
 - Is the report generated through a report writer tool? Is the report writer tool subject to the general IT controls (e.g. access and program change controls)?
 - What functions are being performed by the report logic, including:
 - How is the data extracted, transformed or loaded

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- Are algorithms or calculations performed on the source data
- Is the information further manipulated after the IPE is generated by the system
- Is there additional information that is manually added to the report?
- Does the user enter parameters when the IPE is generated? If so what are the user-entered parameters?
- Have any errors been identified in the IPE? If so, what type of errors?

3.19 When using information produced by the entity the auditor has to evaluate whether the information is sufficiently reliable for audit purposes, including as necessary in the circumstances. Obtaining audit evidence about the accuracy and completeness of such information may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the preparation and maintenance of the information. In some situations, however, the auditor may determine that additional audit procedures are needed.

Segregation of Duties

3.20 A standard approach for preventing fraud and effective control governance mechanism is to separate employee responsibilities in such a way that the opportunity to commit fraudulent activities is not available. For particularly vulnerable functions, it is common to require at least two employees participate in the functions of initiating, authorizing, recording, processing, and reporting of transactions. Application owners are responsible for determining who should have access, and what access privileges are granted. When determining a user's access privileges, the application owner should validate that segregation of duties is maintained and that job requirements are fulfilled.

3.21 The bank may use procedures such as a manual review of access listings and spreadsheets to compare the access rights granted to users, or alternatively, may use complex application systems and databases built to extract, analyse, and identify potential segregation of duties conflicts within the organization. When new users are added or when current users' change responsibilities within the organization, these procedures and/or application systems should be used to evaluate that the user's new access capabilities do not include the combination of two or more job functions that should be segregated (representing a segregation of duties conflict). The configuration of the access privileges within segregation of duties applications and spreadsheets, and any changes to these privileges, should be approved by management.

Management should periodically review access to these applications. Any issues noted during the review should be remediated on a timely basis.

3.22 The auditor can obtain the System Access Report, for each of the responsibilities defined in for the General Ledger module to identify the functions, menus, and sub-functions by responsibility. The segregation of duties for a specific client should be determined by obtaining an understanding of the entity's business processes, including related manual processes and controls.

Journal Entry Testing

3.23 The term 'journal entry' usually refers to "journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements". Journal entry testing is frequently associated with tests for management override. SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" requires testing for management override, which includes:

- Testing appropriateness of journal entries.
- Reviewing accounting estimates for biases.
- Understanding the business rationale for significant transactions that are outside the normal course of business for the entity.

3.24 Journal entries may be tested as part of tests of controls or substantive procedures at assertion level or as part of audit procedures relating to financial closing process.

3.25 The auditor should use professional judgment to determine the nature, timing, and extent of testing of journal entries and other adjustments.

3.26 For the purposes of identifying and selecting journal entries and other adjustments for testing and determining the appropriate method of examining the underlying support for the items selected, the following matters are relevant:

- The assessment of the risks of material misstatement due to fraud
- Controls that have been implemented over journal entries and other adjustments
- The entity's financial reporting process and the nature of evidence that can be obtained
- The characteristics of fraudulent journal entries or other adjustments
- The nature and complexity of the accounts
- Journal entries or other adjustments processed outside the normal course of business.

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3.27 SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" lays down that the use of Information Technology (IT) affects the way control activities are implemented. From the auditor's perspective, controls over IT system are effective when they maintain the integrity of the information and the security of the data such systems process, and includes effective IT controls and application controls. Chapter 3, "Special Consideration in a CIS Environment" of Part II contains further guidance on this.

PART - II

Initial Considerations

1.01 This Chapter discusses the matters to be considered by a proposed central auditor/branch auditor upon receiving intimation of appointment. It also deals with aspects of planning and preliminary work to be undertaken by the central/branch auditor before actually commencing the audit work.

Statutory Central Auditors

1.02 Most banks, especially those in public sector, appoint three or more (depending upon their size and Board decision, as per RBI guidelines) firms of chartered accountants to act jointly as statutory central auditors (SCAs).

1.03 The appointment letter sent by banks in connection with the appointment of SCAs typically contains the following:

- Period of appointment.
- Particulars of other central auditors.
- Particulars of previous auditors.
- Procedural requirements to be complied with in accepting the assignment, e.g., letter of acceptance (the letter usually contains, *inter alia*, averment as to absence of disqualification for appointment, way in which the audit has to be conducted and confirmation of present name, constitution and address of the auditor), declaration of fidelity and secrecy, restriction on accepting other assignments from the bank, etc.
- Scope of assignment which includes any special reports or certificates to be given by the central auditors in addition to the main report. Presently, the central auditors have to furnish the following reports/certificates in addition to their main report:
 - a) Long form audit report.
 - b) Report on compliance with SLR requirements.
 - c) Report on whether the treasury operations of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.

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- d) Certificate on reconciliation of securities by the bank (both on its own investment account as well as PMS Banks' account).
 - e) Certificate on compliance by the bank in key areas of prudential and other guidelines relating to such transactions issued by the RBI.
 - f) Report on whether the income recognition, asset classification and provisioning have been made as per the guidelines issued by the RBI from time to time.
 - g) Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention.
 - h) Certificate in respect of custody of unused Bank Receipt forms and their utilisation.
 - i) Authentication of capital adequacy ratio, including disclosure requirements and other ratios reported in the notes on accounts.
 - j) Certificate in respect of DICGC claims.
 - k) Report on status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to frauds and malpractices and of the recommendations of Jilani Committee on internal control and inspection/credit system.
 - l) Report on instances of adverse credit-deposit ratio in the rural areas.
 - m) Asset liability management.
 - n) Certificate on Corporate Governance in case of banks listed on Stock Exchange. In some banks this certification may not be got done from the central auditors
 - o) Certification on claim of various interest subsidies and interest subvention
- Basis of computation of audit fee and scale of travel and related allowances and conveyance charges and other expense reimbursement entitlements, if any.

Declaration of Indebtedness

1.04 The RBI has advised that the banks, before appointing their statutory central/circle/ branch auditors, should obtain a declaration of indebtedness in proforma 'A' given in Annexure to the Notification No. RBI/2004/161 Ref DBS.ARS No B.C. 09 /08.91.001/2003-04 dated April 20, 2004. In addition to this, the RBI has further advised the banks that no credit facility (including guaranteeing any facilities availed of by third party) should be availed of by the

proprietor/any of the partners of the audit firm/members of his/their families or by firm/ company in which he/they are partners/directors.

Internal Assignments in Banks by Statutory Auditors

1.05 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”, decided that the audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the bank during the same year. 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.

1.06 As the central auditors for private banks are appointed every year by their shareholders in the Annual General Meetings (AGM), each bank is required to obtain prior approval of the RBI in terms of the provisions of Section 30 (1A) of the Banking Regulation Act, 1949 before making appointment/re-appointment of the auditors.

Some Important Standards on Auditing (SA) for the Initial Consideration

Planning

1.07 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 Revised SA 220, “Quality Control for an Audit of Financial Statements” regarding the acceptance of the client relationship and the specific audit engagement; and
- (b) Establish understanding of terms of engagement as per SA 210 (R), “Agreeing the Terms of Audit Engagement”

1.08 Planning would involve establishing overall strategy to set the scope, nature, timing, extent of resources required & direction of audit. The audit plan needs to be properly documented with respect to timing, extent of checking, audit procedures to be followed at assertion level and should be flexible and updated or changed as and when necessary. Further the audit plan should be communicated to the audit team. Standard on Auditing (SA) 220 (Revised), “Quality Control for an Audit of Financial Statements” establishes standards on the quality control, generally, and with regard to the work delegated to assistants on an individual audit. Before starting initial

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audit engagement perform procedures required under SA 220 (R) regarding client acceptance etc. Also ensure that a proper communication has been sent to the predecessor auditor.

1.09 The below-mentioned procedures, as applicable to Head Office, may also be applicable in case of audit of a Branch Office, modified to the extent relevant for the particular branch audit assignment.

Communication with Previous Auditor

1.10 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.

1.11 The objective of communicating with the previous auditor is that the proposed auditor may have an opportunity to know the reasons for the change in order to be able to safeguard his interest, the legitimate interest of the public, and the independence of the existing chartered accountant. When communicating with the previous auditor, the incoming auditor should primarily find out whether there is any professional or other reason why he should not accept the appointment.

1.12 A mere posting of letter under certificate of posting is not sufficient to establish communication with the previous auditor unless there is some evidence to show that the letter has in fact reached the previous auditor. The incoming auditor should, therefore, communicate with the previous auditor in such a manner as to retain in his hands positive evidence of the delivery of the communication to the addressee. In the opinion of the Council of the Institute, communication by a letter sent 'Registered Acknowledgement Due' or by hand against a written acknowledgement would in the normal course provide such evidence. Further it is seen, nowadays, that auditors communicate with each other electronically by email and often soft copies are used, however it is always advisable to subsequently procure the hard copies of the letters and proof of delivery and file the same in the audit files.

1.13 It is desirable that a member, on receiving communication from the auditor who has been appointed in his place, should send a reply to him as soon as possible.

1.14 The RBI has advised the banks that in order to enable the proposed auditors to comply with the requirement of communication with the previous auditor, they should mention the name and address of the previous auditor in the appointment letter. Communication with the previous auditor becomes more

relevant in case of Bank branch audits, since there is rotation of auditors every year instead of once in three years as is the case with SCAs.

1.15 In case of joint auditors, each of the incoming auditors needs to communicate with each of the outgoing auditors.

Terms of Audit Engagements

1.16 Standard on Auditing (SA) 210 (Revised), "Agreeing the 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.

1.17 When establishing the terms of engagement, the auditor must agree on its understanding with the management as to the objectives and scope of the audit engagement, the extent of management's responsibilities and its own responsibilities. This minimises the risk misunderstandings in future and there is no expectation gap from both the parties.

1.18 The form and content of audit engagement letter may vary for each bank to another, but it would generally include reference to following:

- The objective of the audit of financial statements.
- Management's responsibility for the financial statements.
- Management's responsibility for selection and consistent application of appropriate accounting policies, including implementation of the applicable accounting standards along with proper explanation relating to material departures from those accounting standards.
- Management's responsibility for assessment of the entity's ability to continue as a going concern.
- Management's responsibility for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the bank at the end of the financial year and of the profit or loss of the bank for that period.
- Management's responsibility for the maintenance of adequate accounting records and internal controls for safeguarding the assets of the company and for preventing and detecting fraud or other irregularities.
- The scope of the audit, including reference to the applicable legislation, regulations, and the pronouncements of the RBI and the ICAI.

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- The fact that having regard to the test nature of an audit, persuasive rather than conclusive nature of audit evidence together with inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements, resulting from fraud, and to a lesser extent error, if either exists, may remain undetected.
- Unrestricted access to whatever records, documentation and other information requested in connection with the audit.
- The fact that the audit process may be subjected to a peer review under the Chartered Accountants Act, 1949.

1.19 The auditor may also include the following matters in the engagement letter:

- Arrangements regarding the planning and performing the audit, including the fact that the audit will be carried out in accordance with the auditing standards generally accepted in India. Further that the audit would be performed to obtain reasonable assurance about whether the financial statements are free of material misstatements. It should clearly be spelt out that the audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements including assessment of the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. However, having regard to the nature of the audit and volume and complexity of transactions, persuasive rather than conclusive nature of audit evidence, together with inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements of financial statements, resulting from fraud, and to a lesser extent error, if either exists, may remain undetected.
- Expectation of receiving from management written confirmation concerning representations made in connection with the audit.
- Request for the bank to confirm the terms of the engagement by acknowledging receipt of the engagement letter.
- Description of any other letters or reports the auditor expects to issue to the bank.
- Basis on which fees are computed and any billing arrangements.
- A reference to any further agreements between the auditor and the client.

1.20 The following are certain specific aspects which need to be kept in mind while issuing an engagement letter in case of banks:

- The use and source of specialised accounting principles, with particular reference to any requirements under the law or regulations applicable to banks, e.g., the Banking Regulation Act, 1949, various RBI master circulars on matters, such as, provision for NPAs, classification and valuation of investments, etc.
- The contents and form of the financial statements (including disclosures) and auditors' report as laid down in the Banking Regulation Act, 1949 and various RBI circulars as well as the various special purpose reports required from the auditor in addition to the report on the financial statements.
- The nature of any special communication requirements or protocols that may exist between the auditor and the regulators, e.g., communication directly by the auditor to the RBI in case of serious irregularities or material frauds observed during the course of the audit.

Initial Engagements

1.21 Standard on Auditing (SA) 510 (Revised), "Initial Audit Engagements-Opening Balances", deals with the auditor's responsibility relating to opening balances when conducting initial consideration and opening balances include financial statement amounts as well as matters requiring disclosures. The sheer volume makes verification of opening balances a challenge by itself where normal traditional techniques of verification are not practice.

1.22 The auditor needs to perform the audit procedures as mentioned in Revised SA 510 and if after performing that procedures, the auditor concludes that the opening balances contain misstatements which materially affect the financial statements for the current period and the effect of the same is not properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate.

Assessment of Engagement Risk

1.23 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.

1.24 The process of assessing engagement risk consists of identifying risk factors and exercising professional judgment to determine whether such factors, separately or in combination, are significant enough to require a special response. Prior to accepting an engagement, the auditor should obtain a preliminary knowledge of the banking industry and of the nature of ownership, management and operations of the bank to be audited.

1.25 For a prospective audit engagement, the auditor must assess engagement risk based on past experience in the industry, the information obtained from predecessor auditors, inquiries of senior management, those charged with governance, and other appropriate sources. For a continuing audit engagement, the auditor must assess engagement risk based on his experience with the bank and additional audit procedures performed in the previous audits.

1.26 For an audit engagement for which a higher engagement risk is assessed, the auditor should respond appropriately in planning and performing the audit. The auditor then needs to determine whether the increased engagement risk is pervasive to the audit engagement as a whole, as a result of one or more pervasive risks, or as a result of one or more specific risks.

1.27 The auditor would ordinarily need to document the assessment of engagement risk, factors identified as increasing engagement risk, and, if the additional information obtained during the engagement indicates a change in engagement risk, the auditor would need to document its considerations as to whether the planning decisions remain appropriate and the effect, if any, on the audit plan. A yearly assessment of engagement risk will ensure the firm's continuing independence and ability to act and that the engagement risk is still within the firm's pre-determined appetite for risk.

Establish the Engagement Team

1.28 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, time available to complete the assignment, nature, and complexity of the bank's operations.

1.29 The audit engagement partner should be satisfied that the engagement team collectively has the appropriate capabilities, competence, and time to perform the audit engagement. The audit engagement partner should determine that the engagement team selected is appropriate for the audit engagement.

1.30 The audit engagement partner is also responsible for ensuring where additional technical assistance or specialised knowledge is required as a result of the nature and characteristics of the audit engagement. This may require the inclusion of one or more specialists, like, IT specialists, fair value specialists, etc. Other specialists with appropriate competencies can also be used, including but not limited to those related to fraud, exploratory data analysis, tax, industry, financial instruments and derivatives, legal, actuarial, post-employment benefits, etc.

Understanding the Bank and its Environment

1.31 It is the Auditor's responsibility to identify and assess risk of material misstatement in financial statements and assertion levels, through understanding, the entity, its environment and its internal control system. This would help him in designing and implementing various audit procedures as response to such assessed risk areas and reduce the risk to acceptable low levels.

1.32 Standard on Auditing (SA) 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" 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 in the financial statements whether due to fraud or error, and sufficient to design and perform audit procedures.

1.33 In performing audit of a bank, the auditor should have or obtain knowledge of the business sufficient to enable him to identify and understand the events, transactions and practices that, in the auditor's judgment, may have a significant effect on the financial statements or on the examination or comments in the audit report. Such knowledge is used by the auditor in assessing inherent and control risks and in determining the nature, timing and extent of audit procedures. Understanding the bank and its environment is a continuous and cumulative process of gathering and assessing the information and relating the resulting knowledge to audit evidence and information at all stages of the audit. The auditor can obtain knowledge of the bank from a number of sources namely:

- Discussion with management of the bank.
- Discussion with internal/concurrent/other audit personnel and review of their audit reports.
- Discussion with peers (other auditors) and with legal and other advisors who have provided services to the bank or within the industry.
- Discussion with knowledgeable people outside the bank (for example, industry economists, industry regulators, customers and suppliers).
- RBI guidelines and other regulatory pronouncements.
- Documents produced by the bank (for example, minutes of meetings, annual reports, etc.).
- RBI inspection reports.
- General reading and keeping of breast with the latest developments in the Industry and general economic scenario.

- In case of audit of foreign branches, knowledge of the local laws and trade practices of the geographical location of bank would also be used.

1.34 Understanding the business and using this information appropriately assists the auditor in assessing risks and identifying problems, planning and performing the audit effectively and efficiently, evaluating audit evidence, and providing better services to the bank.

Review of Closing Instructions and communication with Branch Auditors

1.35 It is a common practice that all public sector banks issue closing instructions to branches, based on which branches prepare their balance sheet, profit and loss account and other returns necessary for preparation of the financial statements of the bank as a whole. These instructions issued by the HO are called 'accounts closing instructions' and include the format of the financial statements and other relevant returns, significant accounting policies to be followed, other instructions necessary for the conduct and completion of the audit, time lines of audit completions and consolidations etc. Many a times, besides general instructions this may also include specific directions on review and verification of certain information required by the SCA for their audit. Considering the significance of these instructions, it is advisable that before these instructions are sent to branches, the central auditors review them to assess whether the instructions are sufficiently comprehensive, clear and adequate to facilitate the compilation of branch financial statements and other relevant data accurately and expeditiously. The central auditors should particularly examine whether the instructions are in consonance with the accounting policies of the bank and are in such compliant that stand the test of SA 600 – Using work of Another Auditor, so that the SCA has the comfort and confidence in the procedures adopted by the branch auditors by relying on the information and assurance provided by them.

1.36 Further, in many cases, immediately after the appointment of branch auditors but before the commencement of audit, the bank's management organizes a face to face meeting between the SCA and the branch auditors, wherein the SCA issues specific instructions for the conduct of audit detailing the areas of concern that require extra care and special notice by branch auditors.

Co-ordination with Bank Management

1.37 A proper and smooth co-ordination between the auditor and the bank management is essential for an effective audit and time completion of the assignment. In the past, many a times, the audit work has got delayed due to

non-availability of books, information, records, etc. To minimise the possibility of such an occurrence, it is advisable that after accepting the appointment, the central auditor should send a formal communication to the bank management specifying the books, records, analyses and other information that the auditor would require in the course of his audit. Such a communication would enable the bank management to keep the requisite documents, information, etc., ready well in advance. Further it is also advisable to complete verification of certain non-financial areas (like documentation, verification of sanction and post sanction terms, review, monitoring and supervision etc.) before the year end so that the pressure of completion of audit post year end is minimal.

1.38 In fact now with the introduction of CBS, the auditor can also request for the data dump in a soft copy (depending upon the confidentiality compliances) well in advance and can complete his analysis, testing, verification and sampling sitting in the comfort of his own office without personal visits to the concerned department of the bank.

Relationship among Joint Auditors

1.39 Public sector banks in India as well as some private sector banks appoint more than one firm as statutory auditors. There is also a rotation policy in place. The joint auditors should mutually decide and divide the audit work amongst themselves so as to ensure equitable distribution of work. This is usually done so in consultation with the management. The division of work as well as the areas of work to be covered by all of them should be approved by all, adequately documented and communicated to the management and in case of public sector banks, communicated to RBI also. With all banks on CBS platform and with the level of automation, the division of work is usually done based on various departments at the HO, like Treasury, central accounts, etc. or geographical areas. However certain areas of work, owing to their nature or importance would often not be divided and would be covered by all the joint auditors.

1.40 As per Standard on Auditing (SA) 299, "Responsibility of Joint Auditors", in respect of audit work divided, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible -

- in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

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- in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors. It may, however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;
- in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;
- for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and
- for ensuring that the audit report complies with the requirements of the relevant statute.

1.41 It is the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the area of work allocated to him. The issues such as appropriateness of using test checks or sampling should be decided by each joint auditor in relation to his own area of work. This responsibility is not shared by the other joint auditors. Thus, it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him. Similarly, the nature, timing and extent of the enquiries to be made in the course of audit as well as the other audit procedures to be applied are solely the responsibility of each joint auditor.

1.42 In the case of audit of large banks with several branches, including those required to be audited by branch auditors, the branch audit reports/returns may be required to be scrutinised by different joint auditors in accordance with the allocation of work. In such cases, it is the specific and separate responsibility of each joint auditor to review the audit reports/returns of the branches allocated to him and to ensure that they are properly incorporated into the accounts of the entity.

1.43 Generally, the joint auditors may arrive at an agreed report. However, where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express their own opinion through a separate report. A joint auditor is not bound by the views of the majority of the joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

Statutory Branch Auditors

1.44 This section discusses the matters to be considered by a proposed statutory branch auditor (SBA) upon receiving intimation of appointment and before commencing the actual audit engagement. It deals with aspects of preliminary work to be undertaken by the branch auditor before actually commencing the audit work. The letter of appointment sent by banks to branch auditors typically contains the following:

- Appointment under the Banking Regulation Act, 1949, and the underlying duties and responsibilities of the SBA.
- Particulars of branch(s) to be audited and of the region/zone to which the branch reports.
- Particulars of central auditors.
- Particulars of previous auditors.
- Guidelines for conducting audit of Branches, completion of audit, eligible audit fees and reimbursement of expenses etc.
- Procedural requirements to be complied with in accepting the assignment, e.g., letter of acceptance, Declaration of indebtedness, declaration of fidelity and secrecy, other undertaking by the firm/SBA, specimen signatures, etc.
- *Scope of work*- Besides the statutory audit under the provisions of the Banking Regulation Act, 1949, SBA is also required to verify certain other areas and issue various report and certificates like LFAR, Tax Audit, certificates for cash verification on odd dates, Ghosh & Jilani reports etc.

Co-ordination with Branch Management

1.45 Nowadays typically, SBA, are given limited time within which they have to undertake the audit of branches allotted to them. Co-ordination between the auditor and the branch management is essential for an effective audit, timely completion with the highest audit quality. NOC from the previous auditor should be on record before SBA accepts the appointment. It is advisable that immediately after accepting the appointment, the SBA should send a formal communication to the branch management/HO accepting his appointment and other declarations and undertakings so required. Further he should also specify the books, records, and other information that the auditor would require in the course of his audit. Such a communication would enable the branch management to keep the requisite documents, information, etc., ready.

After the completion of the appointment formalities, it is advisable for the SBA to visit the concerned branches allotted, so as to get the feel of the business, nature

and competences of the staff and understanding of the flow of information and authority. Thereafter the SBA should draw up a detailed plan for the audit and it is advisable to complete the entire non financial verification (like documentation, sanctioning terms, review of the supervision and monitoring terms, review of the concurrent/internal audit and inspection reports before the yearend.

Standard on Auditing (SA) 600, "Using the Work of Another Auditor"

1.46 The SBA's report on the financial statements examined by him is forwarded to the SCA with a copy to the management of the bank. The SCA, in preparing his report on the financial statements of the bank as a whole, deals with the branch audit reports in such manner as he considers necessary. In such a reporting arrangement Standard on Auditing (SA) 600, "Using the Work of Another Auditor" needs to be emphasised.

1.47 Now a days with all banks operating on CBS platform and moving towards more centralization of functions at HO adds to the dynamics of reporting. Considering the volume of transactions to be verified and the organizational structure of bank, particularly in the case of public sector banks, SCA's reliance on work done by the SBA is of utmost importance.

1.48 The SCA would be the Principal Auditor (PA), who is responsible for the reporting on the financial information for the bank as a whole and the SBA would be the other auditor (OA) other than the PA, who is responsible for reporting on financial information of the branch as a component. As per Standard on Auditing (SA) 600, the degree of reliance, SCA would have on the SBA would depend upon many considerations, as few of which are discusses as follows:

- (a) the materiality of the portion of the financial information which the SBA audits and its effect on the overall financial position;
- (b) the technical competence and knowledge of the SBA and the degree of confidence he provides to the SCA;
- (c) the SCA's assessment of risk of material misstatements in the financial information of the components audited by the other auditor; and
- (d) the performance of additional procedures as set out in SA 600 regarding the components audited by other auditor resulting in the principal auditor having significant participation in such audit.

1.49 The SCA should perform procedures to obtain sufficient appropriate audit evidence, that the work of the SBA is adequate for the SCA's purposes in the context of the specific assignment. The SCA might discuss with the SBA the audit procedures applied or review a written summary of the SBA's procedures

and findings which may be in the form of a completed questionnaire or check-list. This is usually done via the personal meeting between the SCA and all the SBA or via the bank's closing instruction (as discussed before). The nature, timing and extent of procedures will depend on the circumstances of the engagement and the SCA's knowledge of the professional competence of the SBA. The SCA may conclude that it is not necessary to apply procedures such as those described in above paragraph because sufficient appropriate audit evidence has been previously obtained that acceptable quality control policies and procedures are complied with in the conduct of SBA's practice.

1.50 The SCA should consider the significant findings of the SBA. The SCA may consider it appropriate to discuss with the SBA and the management of the component, the audit findings or other matters affecting the financial information of the components. He may also decide that supplemental tests of the records or the financial statements of the component are necessary. Such tests may, depending upon the circumstances, be performed by the SCA or the SBA.

1.51 In certain circumstances, the SBA may happen to be a person other than a professionally qualified auditor. This may happen, for instance, where a component is situated in a foreign country and the applicable laws permit a person other than a professionally qualified auditor to audit the financial statements of such component. In such circumstances, the procedures outlined above assume added importance.

1.52 The SCA should document in his working papers the extent of reliance he has relied upon the work done by other auditors with reasons therefor. The SCA should also document the procedures performed as prescribed by SA 600 and his conclusions reached. For example, the auditor would document the reasons why he has decided to drop an item of qualification mentioned by a SBA, from his own report or how he has dealt with an adverse opinion or adverse remarks contained in the SBA's report in framing his own report.

1.53 Further, it is also the responsibility of the SBA to inform or bring to the notice of the SCA any areas of concern that have come to his knowledge in the context in which his work is to be used by the SCA. For example, by bringing to the SCA's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc. He should ensure compliance with the relevant statutory requirements. Similarly, the SCA should advise the SBA of any matters that come to his attention that he thinks may have an important bearing on the SBA's work.

1.54 When the SCA has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the SBAs, his

report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the SBAs have been included in the financial information of the entity, e.g., the number of divisions/branches/ subsidiaries or other components audited by SBAs. The SCA would not be responsible in respect of the work entrusted to the SBAs, except in circumstances which should have aroused his suspicion about the reliability of the work performed by the SBAs.

Engagement and Quality Control Standards

1.55 The auditor or the auditing firm should establish a system of quality control designed to provide reasonable assurance that the auditor/firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm or engagement partner(s) are appropriate in the circumstances and will survive the test of any regulatory, legal or other action that may arise in future. This system of quality control should consist of policies designed to achieve its objectives and the procedures necessary to implement and monitor compliance with those policies. The nature of the policies and procedures developed by individual or firms to comply with SQC will greatly depend on various factors such as the size, maturity, geographical location, type of work handled and other operating characteristics.

1.56 The ICAI, has issued various Engagement and Quality Control Standards applicable to an audit of financial statements which are mandatorily to be followed by all practitioners. Understanding of the concepts in these Engagement Standards would help the auditor in discharging his duties in a diligent way.

Special Audit Considerations in Foreign Banks

1.57 Audit of foreign banks operating in India, poses unique challenges compared to local banks in India. Foreign banks have different operating models compared to local banks, and, to a limited extent, they also operate in a different regulatory environment.

1.58 Foreign banks operate in India through branches and do not have a separate legal entity existence in India. However, for all practical purposes, the RBI regulates their functioning in India, with regards to scale and nature of business they undertake in India.

1.59 Foreign bank auditor will have to modify their audit procedures so as to take care of the operational structure and operations of these banks.

1.60 Some of the important elements related to foreign banks which may have a bearing on the audit plan and procedure are listed below :-

- Management structure
- More Centralised operational functions–
- High level of automation and IT functions
- Requirement for Compliance with foreign legal and regulatory requirements
- Cross border flow and processing of data
- Complex treasury operations and cross border forex deals.

Risk Assessment and Internal Control

Characteristics of a bank

2.01 Banks have the following characteristics, which distinguish them from most other commercial enterprises.

- Custody of large volumes of monetary items, including cash and negotiable instruments, whose physical security has to be ensured. 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.
- Engagement in a large volume and variety of transactions in terms of both number and value. This necessarily requires complex accounting and internal control systems and widespread use of Information Technology (IT).
- 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.
- Assumption of 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.
- Engagement in transactions that are initiated at one location, recorded at a different location and managed at yet another location.
- Direct Initiation and completion of transactions by the customer without any intervention by the bank's employees. For example, over the Internet or through automatic teller machines (ATMs).
- Constitute integral part of, or are linked to, national and international settlement systems and consequently could pose a systemic risk to the countries in which they operate.

Risk Assessment and Internal Control

- Regulated by governmental authorities and the resultant regulatory requirements often influence accounting and auditing practices in the banking sector.

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

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

The auditor should consider the effect of the above factors in designing his audit approach.

Identifying and Assessing the Risks of Material Misstatements

2.03 Standard on Auditing (SA) 315, "Identifying and Assessing the Risks 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 and paragraph 26 of SA 315 provides a basis for designing and performing further audit procedures.

SA 315 requires the auditor to put specific emphasis on the risks arising out of the fraud, changes in regulatory environment, complex transactions, related party transactions, and abnormal business transactions.

Understanding the Bank and Its Environment including Internal Control

2.04 As per SA 315, the auditor's objective is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level and enable him to issue his audit report based on his audit findings.

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2.05 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.

2.06 The audit engagement partner should appropriately be involved so as to achieve its basic objective of identifying and assessing the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels. The use of professional skepticism, and experience acquired during the course of other audits play a vital role in this process.

2.07 In addition to the considerations mentioned in paragraph 11 of SA 315, when obtaining an understanding of the bank and its environment, including its internal control, the auditor is required to:

- Obtain an understanding of the bank's accounting process relevant to financial reporting.
- Obtain an understanding of the bank's internal control relevant to the audit.

2.08 Management may prepare a variety of information so as to operate the business more effectively and efficiently. The auditor may consider to use those information in identifying risks of material misstatements. Such information may be internally generated (e.g., budgets and strategic plans, monthly financial and operating reports) or externally generated (e.g., trade periodicals, analysts' reports on the banking industry or the bank).

2.09 While obtaining an understanding of the bank and its environment, including its internal control, the auditor should consider whether the information obtained during the course of audit indicates risks of material misstatement due to fraud. For this purpose, the following factors assume importance:

- Understanding the bank's corporate governance structure. RBI has laid down specific guidelines, which need to be complied with by the banks, with regard to the formation of various committees and determination of their specific functions, extent of audit coverage, etc. Apart from this, provisions of clause 49 of the Listing Agreement need to be complied with by the listed banks.

- Obtaining and maintaining a record of the understanding of the products and services offered by the bank. The auditor should be aware of the variations in the basic deposit, loan and treasury services that are offered and continue to be developed and modified by the bank in response to market conditions and guidelines which are issued by the RBI from time to time. Similarly, the auditor should obtain an understanding of the nature of services rendered through off balance sheet instruments and other similar instruments; the inherent risks arising as a result thereof; and also the auditing, accounting and disclosure implications thereof.
- The extent of use of service organisations needs to be evaluated, since it is the responsibility of the bank to ensure compliance with the rules and regulations, as well as to ensure that the service organisations have adequate internal controls.

2.10 The auditor may decide to visit the significant operating units of the bank, especially, in case of multi-location bank. This would enhance the auditor's understanding, and would also assist in the assessment of engagement risk, and identification of pervasive risks and specific risks. Such visits enable the auditor to interact with the local management so as to acquire understanding of their significant policies, and other relevant factors affecting the working of that particular operating unit.

2.11 In obtaining an understanding of the bank and its environment, the auditor, ordinarily, documents the following:

- pervasive risks and specific risks that have been identified;
- needs, expectations, and concerns of senior management and those charged with governance; and Other relevant administrative matters.

Structure of overall internal control environment of a bank

2.12 The auditor should obtain an understanding of the control environment sufficient to assess management's attitudes, awareness and actions regarding internal control and their importance in the entity. Such an understanding would help to make a preliminary assessment of the adequacy of the accounting and internal control system as a basis for the preparation of the financial statements, and of the likely nature, timing and extent of audit procedures.

2.13 The overall control environment of a bank generally includes a mix of the following:

I. Board of Directors or senior management and its Committees

2.14 The organisational structure of a bank assists it in managing its

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responsibility of oversight and control. All banks usually have the following committees:

- *Executive Committee* – monitors the overall functioning of the bank and ensures compliance with laid down policies and procedures. This committee usually consists of the Chief Executive Officer, Chief Operating Officer and all business line heads.
- *Operations Committee* – reviews potential operational risks.
- *Asset Liability Committee* -monitors the capital and liquidity profile, maturity mismatches, core gap analysis, etc. of the bank.
- *Risk Committee* – entity-wide risk assessment and risk management by formulating appropriate strategies to mitigate the identified risks.

2.15 Banks also have an Audit Committee, Corporate Governance Committee and, Shareholder Grievance Committee. Further, function specific committees such as, the Investment Committee, Credit Committee, Information Technology Committee, etc. also exist which report to the Board of Directors or the Executive Committee.

2.16 The Board of Directors or the Executive Committee of a bank is responsible for the strategic planning process of the bank such as identifying goals and objectives, formulating the strategies to attain the objectives, assessing performance of the bank against approved budgets. Thus, it sets the tone and operating style at the top and weaves the entire control environment in the bank.

II. Internal Audit

2.17 The internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operating. Banks generally have a well-organised system of internal audit. The internal audit is carried out either by a separate department within the bank or by independent firms of chartered accountants. Apart from these, the inspectors of RBI also review the system and transactions of important branches.

2.18 RBI has advised banks to adopt a framework for Risk-Based Internal Audit to ensure that the internal audit is undertaken in the bank in a risk focused manner. This would also facilitate in adoption of the Risk-based Supervision framework. Attention is invited to RBI circular DBS.CO.PP.BC. 14 /11.01.005/2003-04, dated June 26, 2004.

III. Revenue Audit

2.19 Revenue audit is usually conducted at large and medium-sized branches and is aimed at identifying cases of leakage of revenue due to wrong computation of interest, non-application of interest on time, application of incorrect rates of interest/exchange/commission, non-application of penal interest, non-recovery or short-recovery of service charges on guarantees and letters of credit, etc. This type of audit is also known as 'income and expenditure audit' or 'income leakage audit'.

IV. Branch Inspection

2.20 Such inspection is much broader in scope than revenue audit, and covers all important areas of functioning of the branch, including efficacy of systems and procedures, compliance with head office directions, customer service, maintenance of books and records, etc. Most banks have a fixed schedule of branch inspection.

V. Head Office Inspection

2.21 The inspection at head office level is aimed at evaluating the functions being carried out at the head office and covers, *inter alia*, investment and other treasury functions, functioning of the central stationery department, fixed assets (if centralised), inter-branch reconciliation, etc.

VI. Concurrent Audit

2.22 A system of concurrent audit at large and other selected branches has been in vogue in most of the banks for quite long. Recognising the importance of concurrent audit in the banking sector, the RBI, *vide* its circular no.BC.182/16.13.100/93-94 dated October 11, 1993, addressed to all scheduled commercial banks (except regional rural banks) formally advised such banks to institute an appropriate system of concurrent audit. The RBI also specified the minimum extent of banking operations to be covered under concurrent audit within a defined time-frame, and also suggested the areas to be covered by concurrent audit. Subsequently, *vide* its circular DOS No. B.C. 16/08-91-021/96 dated August 14, 1996 the RBI has made certain refinements in the scope of concurrent audit.

VII. Systems Audit

2.23 The bank carries out a systems audit periodically to assess the effectiveness of the hardware, software and operations to identify any changes required therein based on the guidelines mentioned in the RBI, *vide* its circular

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no. DBS.CO.OSMOS.BC/ 11 /33.01.029/2003-04 dated April 30, 2004 on "Information System Audit - A review of Policies and Practices". Also refer to the guidelines relevant to Information System Audit in the circular no. DBS.CO.ITC.BC.No.6/31.02.008/2010-11 dated April 29, 2011.

2.24 Such audits should be preferably undertaken prior to the statutory audit so that the IS audit reports are available to the statutory auditors well in time, for examination and incorporating comments, if any, in the audit reports.

2.25 The report of RBI's Working Group on Information Security, Electronic Banking, Technology Risk Management and Cyber Frauds has recommended implementation of good level of controls in areas of IT Governance, Information Security, IT Operations, IT Outsourcing, IS Audit, Cyber Fraud, Business Continuity Planning, Customer Education and Legal Issues

VIII. Vigilance Function in banks

2.26 All banks have a vigilance department, though it may be assigned different names in different banks. Its functions include- to keep surveillance over the suspect staff/transactions, to look into cases of frauds/misappropriation/connivance, etc. leading to loss to the bank. In the case of large non-performing assets, the department may be required to investigate and find out the reasons for the account becoming non-performing. The nature of findings of the vigilance department is of relevance to the auditor, particularly in evaluating the efficacy of internal controls.

IX. RBI Inspection

2.27 The RBI carries out inspection of Head Office functions and departments as well as branches under section 35 of the Banking Regulation Act, 1949, to examine compliance by the bank of various policies and norms about credit and other functions laid down by the RBI from time to time. Besides, it also carries out inspection of currency chest branches to review chest balances and other functions being performed by the branch as an agent of the RBI. RBI inspections, however, are not in the nature of internal audit.

Understand the Bank's Accounting Process

2.28 The accounting process produces financial and operational information for management's use and it also contributes to the 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. In obtaining an understanding the accounting

process, the auditor may seek to identify the significant flow of the transactions and significant application systems that are relevant to the accounting process.

2.29 When obtaining an understanding of the accounting process, the auditors, ordinarily, focus only on such processes that relate to the effectiveness and efficiency of operations and compliance with laws and regulations and impact the financial statements or their audit procedures. While obtaining the understanding of the significant flow of the transactions, the auditor should also obtain an understanding of the process of recording and processing of journal entries, and should also make inquiries about inappropriate or unusual activity relating to the processing of journal entries and other adjustments.

2.30 The auditors should also document their understanding of the accounting process, including the significant flow of transactions, the relevant computer processing environments or any other relevant information. Such documentation would ordinarily be either a narrative description, graphical representation (e.g., a flow chart), or a combination of the two. The following factors should be kept in mind while obtaining the understanding of the accounting process in case of banks:

- The need to process high volumes of transactions accurately within a short time which is met through large scale use of IT.
- The need to use electronic funds transfer or other telecommunication systems to transfer large sums of money.
- The conduct of operations in many locations with a resultant geographic dispersion of transaction processing and internal controls.

Structure of Internal Control Procedures in a bank

2.31 The specific internal control procedures to be followed in an enterprise depend on the nature, volume and complexities of its operations and the management's attitude towards control. However, as in the case of other enterprises, the internal control procedures relevant to assertions made in the financial statements of bank generally fall under the following categories:

I. Segregation and Rotation of Duties

2.32 One of the fundamental features of an effective internal control system is the segregation and rotation of duties in a manner conducive to prevention and timely detection of occurrence of frauds and errors. The functions typically segregated are authorisation of transactions; execution of transactions; physical custody of related assets; and maintenance of records and documents.

2.33 In the case of banks, the following measures are usually adopted:

- Work of one staff member is invariably supervised / checked by another staff member, irrespective of the nature of work.
- Banks have a system of rotation of job amongst staff members, which reduces the possibility of frauds and is also useful in detection of frauds and errors. Also, most banks usually have a process of giving “block” leave to its staff members wherein the employee stays away from work for at least a continuous period of 2 weeks.

2.34 RBI has also *vide* its circulars and notifications suggested banks to establish effective segregation in its functions, for example, the master circulars on prudential norms for classification, valuation and operation of investment portfolio by banks, clearly advises banks to have functional separation of trading, settlement, monitoring and accounting activities.

II. Authorisation of Transactions

2.35 Authorisation may be general (i.e., it may relate to all transactions that conform to prescribed conditions referred to as routine transactions) or it may be specific with reference to a single transaction (non-routine transactions and accounting estimates). It is necessary to establish procedures which provide assurance that authorisations are issued by persons acting within the scope of their authority, and that the transactions conform fully to the terms of the authorisations. The following procedures are usually established in banks for this purpose:

- The financial and administrative powers of each official/each position are fixed and communicated to all persons concerned, For example, in a bank, procedures in relation to the settlement of transactions, reconciliation of nostro accounts and the payment system are clearly defined and documented in a manual. This reduces the risk that segregation of duties may be compromised or that transactions may not be settled in a systematic manner.
- All financial decisions at any level are required to be reported to the next higher level for confirmation/information. For example, in case of a money market transaction, if the dealer exceeds the pre-defined limits such as a position limit or counterparty limit, then the transaction has to be vetted and confirmed by the head dealer.
- Any deviation from the laid down procedures requires confirmation from/intimation to higher authorities.

- Branch managers have to send periodic confirmation to their controlling authority on compliance of the laid down systems and procedures.

III. Maintenance of Adequate Records and Documents

2.36 Accounting controls should ensure that the transactions are recorded at correct amount and in the accounting periods in which they are executed, and that they are classified in appropriate accounts. Moreover, recording of transactions should be such as would facilitate maintaining the accountability for assets. The procedures established in banks to achieve these objectives usually include the following:

- All records are maintained in the prescribed books and registers only. This ensures that all requisite particulars of a transaction are adequately recorded and also that the work of finalisation of accounts is facilitated. For example, deal slips pertaining to purchase and sale of securities along with the respective counterparty confirmations for the deals are filed together in the deal register.
- All branches of a bank have a unique code number which is circulated amongst all offices of the bank. This code number is required to be put on all important instruments.
- All books are to be balanced periodically and it is to be confirmed by an official. For example, in case of purchase and sale of security transactions, the banks periodically reconcile the security balance in the banks book vis-à-vis the balance in the custodian account (i.e., Subsidiary General Ledger or Demat account). It may be noted that the RBI vide its master circular DBOD No. BP. BC.8/21.04.141/2013-14 dated July 1, 2013 has also mandated that investment balances as per bank's book should be reconciled at quarterly intervals with the balances in the Public Debt Office's books. If the number of transactions warrant, such reconciliation should be undertaken more frequently, say on a monthly basis. This reconciliation should be periodically checked by the internal audit department.
- All inter-office transactions are to be reconciled within a specified time frame.

IV. Accountability for and Safeguarding of Assets

2.37 The accountability for assets starts at the time of their acquisition and continues till their disposal. The accountability for assets is achieved by maintenance of records of assets and their periodic physical verification. To safeguard the assets, it is also necessary that access to assets is limited to authorised personnel. This covers not only direct physical access, but also indirect access through the preparation or processing of documents that

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authorise the use or disposal of assets. The following are some of the important controls implemented by banks in this regard:

- Particulars of lost security forms are immediately advised to branches so that they can exercise caution.
- The specimen signatures of all officers are maintained in a book which is available in all branches. The officials approving the payment of the instruments drawn on their branches by other branches are required to confirm the signatures on the instruments with reference to the specimen signatures. Likewise, the branches have on record the specimen signatures of the authorised officials of approved correspondent banks also.
- The instruments which are evidence of remittances of funds above a cut-off level are to be signed by more than one official.
- Important financial messages, when transmitted electronically, are generally encrypted.
- Negative lists like stop-payment cheques are kept which may deal with the particular kind of transaction. There may be a caution list for advances also.
- Sensitive items like currency, valuables, draft forms, term deposit receipts, traveller's cheques and other such security forms are in the custody of at least two officials of the branch. (However, in the case of very small branches having only one official, single custody is also permitted.)
- All assets of the bank/charged to the bank are physically verified at specified intervals.

V. System Configuration and Account Mapping

2.38 Information technology (IT) has played a major role in providing a competitive edge to banks in differentiating themselves in the market place and to deliver their services more effectively at a lower cost.

VI. Independent Checks

2.39 Independent checks involve a periodic or regular review of functioning of the system by independent persons to ascertain whether the control procedures are being performed properly. Banks have an elaborate system of various forms of internal audit covering virtually every aspect of their functioning.

Understanding the Risk Management Process

2.40 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:

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- *Oversight and involvement in the control process by those charged with governance:* Those charged with governance should approve the documented 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. Those charged with governance are also responsible for establishing a culture within the bank that emphasises commitment to internal controls and high ethical standards. Management is responsible for implementing the strategies and policies set by those charged with governance thereby ensuring that an adequate and effective system of internal control is established and maintained.
- *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. This function is usually performed by the bank's Risk Committee or an independent risk management unit, which is also responsible for validating and stress testing the pricing and valuation models used by the front and back offices. Further, it also monitors risk management activities and evaluates the effectiveness of risk management models, methodologies and assumptions used. The mid office, which is responsible for identifying, measuring and reporting the risk associated with the transaction, within each function usually reports to the Risk Committee or the independent risk management unit. Thus, in this manner the bank's management monitors the overall risks faced by the bank.
- *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.

2.41 RBI has informed banks *vide* its master circular Master Circular No. 5/2013-14 on 'Risk Management and Inter-bank Dealings' dated July 1, 2013, the risk management framework and reporting requirements with respect to certain categories of transactions such as, forward contracts and hedging transactions entered into by the bank with residents, managing of assets and liabilities of the bank and hedging the same, hedging of Tier I capital in case of foreign banks, etc.

2.42 For every bank in India, certain risk management limits such as, the net open position ('NOP') limit and aggregate gap limit ('AGL') are approved by the RBI after making an assessment of each bank overall risk appetite. Banks install checks in their daily processes to ensure that these limits are being adhered to at all times.

2.43 As part of regulatory reporting, banks are also required to report to the RBI a host of other risk management limits such as, single and group borrower limits (these limits give an indication of concentration risk), credit exposure for derivatives (this indicates the potential replacement cost of the derivative portfolio), capital market exposure of the bank, country risk exposure and exposure to sensitive sectors such as, real estate, etc.

- *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 auditors should have a reporting line to those charged with governance 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.

Engagement Team Discussions

2.44 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. The discussion provides:

- An opportunity for more experienced engagement team members, including the audit engagement partner, to share their insights based on their knowledge of the bank and its environment.
- An opportunity for engagement team members to exchange information about the bank's business risks.

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- An understanding amongst the engagement team members about affect of the results of the risk assessment procedures on other aspects of the audit, including decisions about the nature, timing, and extent of further audit procedures.

2.45 The discussion between the members of the engagement team and the audit engagement partner should be done on the susceptibility of the bank's financial statements to material misstatements. These discussions are ordinarily done at the planning stage of an audit. Specific emphasis should be provided to the susceptibility of the bank's financial statements to material misstatement due to fraud, that enables the engagement team to consider an appropriate response to fraud risks, including those related to engagement risk, pervasive risks, and specific risks. It further enables the audit engagement partner to delegate the work to the experienced engagement team members, and to determine the procedures to be followed when fraud is identified. Further, audit engagement partner may review the need to involve specialists to address the issues relating to fraud.

2.46 The engagement team discussion includes a discussion of the following matters:

- Errors that may be more likely to occur;
- Errors which have been identified in prior years;
- The method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;
- Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;
- The need to maintain professional skepticism throughout the audit engagement; and
- The need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances).

2.47 On the matters relating to fraud, the engagement team discussion ordinarily includes the following:

- An exchange of ideas among engagement team members about how and where they believe the bank's financial statements may be susceptible to material misstatement due to fraud. Further, manner of involvement of the management, those charged with governance and others within the entity should also be discussed.

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- Consideration of circumstances that might be indicative of fraud in the earnings of the bank; and the practices that might be followed by the bank's management to manage earnings that could lead to fraudulent financial reporting.
- Consideration of the external/internal factors affecting the bank that may create an incentive or pressure on management or others to commit fraud.
- Consideration of management's involvement in overseeing the employees having access to cash or other assets susceptible to misappropriation.
- Consideration of any unusual or unexplained changes in behaviour or lifestyle of management or employees that may have come to the attention of the engagement team.
- Consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.
- Selection of audit procedures to respond to the susceptibility of the fraud.
- Consideration of any allegations of fraud or suspected fraud that may have come to the auditor's attention.
- Consideration of the risk of management override of controls.

2.48 Further, the audit engagement partner should also consider matters to be communicated to the members of the Engagement Team not involved in the discussion. For multi-location audit engagements for which separate engagement teams are performing work under the supervision of audit engagement partners in separate locations, the auditor may hold multiple discussion that involve the members of the engagement team in each significant location.

2.49 With respect to the engagement team discussions, the auditor may document the following matters:

- discussion amongst the engagement team regarding the susceptibility of the material misstatement whether due to fraud or not; and
- significant decisions reached during the discussion amongst the engagement team regarding the susceptibility of the material misstatement whether due to fraud or not.

Establish the Overall Audit Strategy

2.50 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.

2.51 The overall audit strategy sets the scope, timing and direction of the audit as it guides the development of detailed audit plan. The establishment of the overall audit strategy involves:

- Identifying the characteristics of the audit engagement that define its scope, such as the financial reporting framework used (Third Schedule to the Banking Regulation Act, 1949), additional reporting requirements at various locations of the components of the bank prescribed by the RBI, etc.
- Consider the requirements of various Accounting Standards and Standards on Auditing, to the extent applicable, to assess the nature and extent of audit procedures to be performed.
- Ascertaining the reporting objectives of the audit engagement to plan the timing of the audit and the nature of the communications required, such as deadlines for interim and final reporting, key dates for expected communications with the management and with those charged with governance.
- Considering the important factors that will determine the focus of the engagement team's efforts, such as determination of appropriate audit materiality, preliminary identification of significant risks, preliminary identification of material components and significant account balances and disclosures.
- Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts.
- Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the bank is relevant.
- Ascertain the nature, timing and extent of resources necessary to perform the engagement.

2.52 The auditors should document the overall audit strategy, including any significant changes thereto. The documentation of the overall audit strategy records the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team. For example, the auditor may summarise the overall audit strategy in the form of a memorandum

that contains key decisions regarding the overall scope, timing and conduct of the audit. Ordinarily, following are documented as part of establishing the overall audit strategy:

- Summarisation of significant matters relating to overall audit strategy.
- Significant risks identified.
- Other decisions considered necessary to properly plan the audit.

Develop the Audit Plan

2.53 Revised 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 Revised SA 220, "Quality Control for an Audit of Financial Statements" for reviewing the ethical and independence requirements. In addition to this, the auditor is also required to comply with the requirements of Revised SA 210, "Agreeing the Terms of Audit Engagement".

2.54 The auditor must establish overall audit strategy for developing an audit plan for the bank's financial statements as a whole, and at the assertion level for classes of transactions, account balances, and disclosures. To be efficient, the auditor must plan their audit by considering the inter-relationships amongst the various risk assessment procedures, planned control-reliance strategy, planned substantive procedures, and at the assertion level for classes of transactions, account balances, and disclosures so as to avoid unnecessary duplication of effort. This can further be summarised by preparing an audit planning memorandum detailing the various activities to be performed by an auditor while conducting an audit of a bank. The audit plan documents the nature, timing and extent of the planned audit procedures.

2.55 Ordinarily, to develop the audit plan the auditor would need to gather more detailed information about the bank and its environment, which will enable them to plan their audit procedures for each significant account balances and disclosure. The requisite detailed information may be obtained from the following:

- Obtaining an understanding of the bank and its environment, including the bank's internal control;
- Understanding the bank's accounting process;
- Reading the minutes of various committees of the bank;

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- Reading the Annual Financial Inspection for the prior year(s);
- Performing a preliminary analytical review;
- Assessment of risk at the assertion level;
- Planning a Control-Reliance Strategy;
- Planning substantive procedures;
- In case of identified misstatements, obtaining reasonable assurance from the substantive procedures;
- Consider the expectations and concerns of management, which could impact the timing of the audit procedures. Further, in some cases, management may request the auditor to perform audit procedures on specific areas (e.g., controls) so as to provide assurance on the design, implementation, and operating effectiveness of those specific areas;
- Work performed by internal auditors;
- Statutory or other legal and regulatory requirements;
- Using the work of an Expert;
- Determine specific risks at the assertion level for classes of transactions, account balances, and disclosures and audit procedures based on the overall engagement risk;
- Consider the impact of multiple locations and subsidiaries and associates on the audit procedures
- Consider the nature, timing, and extent of audit procedures required under Standard on Auditing (SA) 540 (Revised), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures" for fair value measurements and disclosures; and
- Consider the appropriateness of going concern assumptions.

2.56 The auditor could use the information gathered above to develop an effective audit plan that will appropriately respond to identified risks, and would also help in providing the necessary level of assurance.

2.57 When developing audit plan for an initial audit engagement, the auditor should consider the nature, timing, and extent of audit procedures that will need to be performed on the opening balances, as well as their effect on the current year's audit procedures if the auditor is unable to obtain sufficient appropriate audit evidence supporting the opening balances. In this regard, the auditor is also required to perform the procedures as given in SA 510 (Revised), "Initial Audit Engagements-Opening Balances".

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2.58 In developing the audit plan, the auditor should ordinarily document the following:

- The overall audit strategy;
- Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes;
- Decisions impacting the nature, timing, and extent of audit procedures; and
- Audit plan, including any significant changes made during the audit engagement.

Audit Planning Memorandum

2.59 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.

2.60 The audit planning memorandum should be approved by the audit engagement partner. It ordinarily addresses the following matters:

- Assessment of and planned responses to the engagement risk, pervasive risks or specific risk at the assertion level for classes of transactions, account balances, and disclosures.
- Assessment of the initial conclusions in respect to the independence and potential conflict of interest.
- Other significant issues arising out of the planning activities, which may include the following:
 - Identified fraud risk factors;
 - Preliminary conclusions regarding the components of internal control;
 - Audit materiality;
 - IT environment of the bank and need to use the work of an expert; and
 - Changes in the bank's environment such as, changes in accounting policies or accounting process of the bank.

Determine Audit Materiality

2.61 SA 320 (Revised), "Materiality in Planning and Performing an Audit" defines the materiality in the context of an audit. It describes that financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.
- The determination of audit materiality is a matter of professional judgment and is affected by the auditor's perception of the financial information needs of users of the financial statements.

2.62 SA 320 (Revised) also defines performance materiality as the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

2.63 When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. The auditor shall determine performance

materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures.

2.64 As per SA 450, "Evaluation of Misstatements Identified during the Audit", the auditor is required to accumulate material misstatements identified during the audit. Further, it also requires an auditor to communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation and also request management to correct those misstatements. If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor should obtain an understanding of management's reasons for not making the corrections and should take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement. The auditor is also required to reassess materiality determined in accordance with SA 320 (Revised) to confirm whether it remains appropriate in the context of the entity's actual financial results. Further, he should also determine whether uncorrected misstatements are material, individually or in aggregate. The auditor should unless prohibited by law or regulation communicate with those charged with governance, uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report.. The auditor's communication should identify material uncorrected misstatements individually. The auditor should request that uncorrected misstatements be corrected. The auditor should request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation.

Consider Going Concern

2.65 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 as mentioned in paragraph A15 of SA 570.

SA 570 (Revised), “Going Concern”

2.66 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.
- 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.

Operating Framework for Identifying and Dealing with Frauds

2.67 All banks have policy and operating framework in place for detection, reporting and monitoring of frauds as also the surveillance/ oversight process in operation so as to prevent the perpetration of frauds. The Reserve Bank of India, based on the findings from certain forensic scrutinies conducted by it, vide its Circular No. DBS. CO.FrMC.BC.No.10/23.04.001/2010-11 date 31st May 2011, had identified certain areas wherein frauds had shown occurrence or increasing trend in banks. These areas include:-

- loans/ advances against hypothecation of stocks
- housing loans cases
- submission of forged documents including letters of credit
- escalation of overall cost of the property to obtain higher loan amount
- over valuation of mortgaged properties at the time of sanction
- grant of loans against forged FDRs
- over-invoicing of export bills resulting in concessional bank finance, exemptions from various duties, etc.
- frauds stemming from housekeeping deficiencies.

2.68 RBI has accordingly prescribed certain guidelines to be incorporated by the banks in their operating framework for identifying and dealing with frauds. These guidelines have been detailed in the following paragraphs.

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2.69 The operating framework for tracking frauds and dealing with them should be structured along the following three tracks:

- (i) Detection and reporting of frauds
- (ii) Corrective action and
- (iii) Preventive and punitive action

Detection and Reporting of Frauds

- (a) The banks are required to have a set of prescribed procedures and criteria with which the events or transactions having serious irregularities are analysed and assessed to establish occurrence of fraud.
- (b) The banks may define a 'fraud' based on the guidelines issued by RBI. While doing so, they may clearly demarcate/ distinguish the occurrence of an event on account of negligence '*in conduct of duty*' from '*collusion*' by the bank staff (with the borrowers and with an intention to cheat the bank).
- (c) Care needs to be exercised while dealing with instances of 'willful default'. In this connection, a willful default would be deemed to have occurred if any of the following events is noted:
 - The unit has defaulted in meeting its payment / repayment obligations to the lender even when it has the capacity to honour the said obligations.
 - The unit has defaulted in meeting its payment / repayment obligations to the lender and has not utilised the finance from the lender for the specific purposes for which finance was availed of but has diverted the funds for other purposes.
 - The unit has defaulted in meeting its payment / repayment obligations to the lender and has siphoned off the funds so that the funds have not been utilised for the specific purpose for which finance was availed of, nor are the funds available with the unit in the form of other assets.
 - The unit has defaulted in meeting its payment / repayment obligations to the lender and has also disposed off or removed the movable fixed assets or immovable property given by him or it for the purpose of securing a term loan without the knowledge of the bank / lender.
 - Further, the banks may also examine the 'intent' to defraud, irrespective of whether or not actual loss takes place. Keeping these key factors in mind, any action taken in collusion to derive undue/ unjust benefit or advantage should be termed as fraud.

- Accordingly, once a fraud is detected, a report must be prepared and submitted to the “Competent Authority”.
- As a part of their overall policy and operating framework, the banks need to identify and designate the Competent Authority to whom such reports should be submitted.
- The fraud report should be a diagnostic assessment, clearly bringing out the causes of the fraud and identify whether the fraud occurred due to ‘system failure’ or ‘human failure’.

Corrective Action

2.70 An important corrective step in a fraud is recovery of the amount siphoned off through the fraud. A structured scrutiny/ examination of events or transactions would lead to quick conclusion whether a fraud has occurred and the bank’s funds have been siphoned off. Therefore, this exercise is the first critical step towards corrective action in the sense that it would lead to expeditious filing of police complaints, blocking/ freezing of accounts and salvaging funds from the blocked/ frozen accounts in due course.

2.71 Once a set of transactions is explicitly identified as fraudulent, the mandate for seizing and taking possession of related documents, issuance of suspension order/ order to proceed on leave to identified/ suspected employees would be easier thereby preventing them from destroying/ manipulating evidences or obstruction of investigations.

Preventive and Punitive Action

2.72 The preventive action as deemed necessary to address the ‘system failure’ and/ or punitive action as prescribed internally for ‘human failure’ should be initiated immediately and completed expeditiously by the banks.

2.73 Generally, in the current system driven environment in banks, wherever transactions occur in breach of/ overriding “Controls”, they get reflected in the “end of day exception report”. Accordingly, all such exception reports should be perused by the designated officials and a *post facto* authorization for the transactions accorded.

2.74 In certain cases the process may not have got duly implemented reflecting the poor internal control mechanisms. Therefore, banks should ensure that they bring in the needed refinement in this process and also specify the levels/ authority to whom the exception reports will be invariably submitted and the manner in which the authority will deal with the exception reports.

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2.75 The entire gamut of the manner in which the exception reports are generated, transactions contained in the reports are examined/ scrutinised, and the reports submitted to higher authorities for necessary authorizations for breaches should be periodically subjected to review and oversight by the bank's management/ Board of Directors.

2.76 In addition to the above, banks have also been advised by RBI to take steps to put in place certain controls and disincentives in their HR processes and internal inspection/ audit processes as part of their fraud risk management framework. These include:

- (a) For key and sensitive posts such as those in dealing rooms, treasury, relationship managers for high value customers, heads of specialized branches, etc., selecting only such officers who satisfy the "Fit and Proper" criteria. The appropriateness of such postings should be subjected to periodical review.
- (b) Putting in place the "staff rotation" policy and policy for "mandatory leave" for staff. The internal auditors as also the concurrent auditors must be specifically required to examine the implementation of these policies and point out instances of breaches irrespective of apparent justifications for non-compliance, if any. The decisions taken / transactions effected by officers and staff not rotated/ availing leave as per policy should be subjected to comprehensive examination by the internal auditors/ inspectors including concurrent auditors. The findings thereon should be documented in a separate section of the audit/ inspection reports.
- (c) Building up a database of officers/ staff identified as those having aptitude for investigation, data analysis, forensic analysis, etc. and expose them to appropriate training in investigations and forensic audit. For investigation of frauds, only such officers/ staff should be deployed through the "fraud investigation unit/ outfit".

Assess the Risk of Fraud

2.77 As per SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor's objectives 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

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skepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud. When obtaining an understanding of the bank and its environment, the auditor should make inquiries of management, internal auditors and others regarding the following:

- Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments as well as the controls in place to prevent and detect fraud.
- Management's process for identifying and responding to the risk of fraud in the bank, including any specific risks of fraud that management has identified or that have been brought to its attention; or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; and the internal control that management has established to address these risks.
- Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the bank.
- Management's communication, if any, to regulatory authorities.
- Management's communication, if any, to employees regarding its views on business practices and ethical behaviour.
- Actual, suspected, or alleged fraud that the bank is investigating.
- Process the bank undertakes to respond to internal or external allegations of fraud affecting the bank.
- Understanding how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the bank, and the internal control that management has established to address these risks. This also helps to corroborate management's responses to the inquiries mentioned above.

2.78 The auditor could use the information gathered above to develop an effective audit plan that will appropriately respond to identified risks, and would also help in providing the necessary level of assurance.

2.79 Some of the common fraud risk factors in deposit taking, dealing and lending activities areas are summarised hereunder:

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	Deposit Taking	Dealing	Lending
Management and employee frauds	<ul style="list-style-type: none"> • Camouflage of depositors by hiding their identity in connection with funds transfer or money laundering. • Unrecorded deposits. • Theft of customer deposits particularly, from dormant accounts. 	<ul style="list-style-type: none"> • 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 counter-parties. • High level of business with particular brokers, including payment of abnormal commission. • False deals represented by unusual number of cancelled deals or unusually high number of unsettled transactions. • Delayed 	<ul style="list-style-type: none"> • Loans to fictitious borrowers. • Transactions with connected companies. • Kick backs and inducements. • Selling recovered collateral at below market prices. • Bribes to obtain release of security or to reduce the amount claimed. • Theft or misuse of collateral held as security.

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		<p>deal allocations represented by no time stamping of deals or alterations or overwriting on deals sheets.</p> <ul style="list-style-type: none"> Exploiting weaknesses in matching procedures due to absence of proper guidelines. 	
External Frauds	<ul style="list-style-type: none"> Money Laundering. Fraudulent instructions. Counterfeit currency. 	<ul style="list-style-type: none"> Fraudulent custodial sales. False information or documents regarding counter-parties. 	<ul style="list-style-type: none"> Impersonation and false information on loan applications. Fraudulent valuations. Misappropriation of loan funds by agents / customers

Assess the Risk of Money Laundering

2.80 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

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recognise and report money laundering activities. The RBI, vide its master circular no. DBOD. AML. BC. No. 24 /14.01.001/2013-14 dated July 1, 2013 on “Know Your Customer (KYC) norms/Anti-Money Laundering (AML) standards/Combating of Financing of Terrorism (CFT)/Obligation of banks under PMLA, 2002”, have advised the banks to follow certain customer identification procedure for opening of accounts and monitoring transactions of a suspicious nature for the purpose of reporting it to appropriate authority. These policies, procedures and controls commonly extend to the following:

- *Customer acceptance policy*, i.e., criteria for accepting the customers.
- *Customer identification procedure*, i.e., procedures to be carried out while establishing a banking relationship; carrying out a financial transaction or when the bank has a doubt about the authenticity/veracity or the adequacy of the previously obtained customer identification data. A requirement to obtain customer identification (know your client).
- *Monitoring of transactions* – Banks are advised to set key indicators for risk sensitive (e.g., high turnover accounts or complex or unusual transactions accounts) accounts, taking note of the background of the customer, such as the country of origin, sources of funds, the type of transactions involved and other risk factors. Banks should also put in place a system of periodical review of risk categorisation of accounts and the need for applying enhanced due diligence measures. Such review of risk categorisation of customers should be carried out at a periodicity of not less than once in six months. In view of the risks involved in cash intensive businesses, accounts of bullion dealers (including sub-dealers) & jewellers, the banks are also advised to categorise these accounts as ‘high risk’ requiring enhanced due diligence. Further, the banks are also required to subject these ‘high risk accounts’ to intensified transaction monitoring. High risk associated with such accounts should be taken into account by banks to identify suspicious transactions for filing Suspicious Transaction Reports (STRs) to FIU-IND.

2.81 Further, banks should closely monitor the transactions in accounts of marketing firms (MLM Companies). In cases where a large number of cheque books are sought by the company, there are multiple small deposits (generally in cash) across the country in one bank account and where a large number of cheques are issued bearing similar amounts/dates, the bank should carefully analyse such data and in case they find such unusual operations in accounts, the matter should be immediately reported to Reserve Bank and other appropriate authorities such as Financial Intelligence Unit India (FIU-Ind) under Department of Revenue, Ministry of Finance.

2.82 Banks were advised to complete the process of risk categorization and compiling/updating profiles of all of their existing customers in a time-bound manner, and in any case not later than end-March 2013.

2.83 Such review of risk categorisation of customers has to be carried out at a periodicity of not less than once in six months.

- *Closure of accounts*-In case of non-application of proper KYC measures, banks may decide to close the account of the particular customer after giving due notice to the customer.
- *Risk Management*- The Board of Directors of the bank should ensure that an effective KYC programme is put in place by establishing appropriate procedures and ensuring their effective implementation. It should cover proper management oversight, systems and controls, segregation of duties, training and other related matters. Responsibility should be explicitly allocated within the bank for ensuring that the bank's policies and procedures are implemented effectively. Concurrent/ Internal Auditors should specifically check and verify the application of KYC procedures at the branches and comment on the lapses observed in this regard. The compliance in this regard should be put up before the Audit Committee of the Board on quarterly intervals.
- Reporting to the authorities of suspicious transactions or of all transactions of a particular type, for example, cash transactions over a certain amount.

2.84 The RBI master circular also advised the banks to pay special attention to any money laundering threats that may arise from new or developing technologies including, internet banking that might favour anonymity, and take measures, if needed, to prevent their use in money laundering schemes. Further, banks are required to report all frauds to the RBI on a periodical basis. The auditors should review the same to get an idea of the nature and extent of frauds. "Money mules"^{*} can be used to launder the proceeds of fraud schemes (e.g., phishing and identity theft) by criminals who gain illegal access to deposit accounts by recruiting third parties to act as "money mules." In some cases these third parties may be innocent while in others they may be having complicity with the criminals. In a money mule transaction, an individual with a bank account is recruited to receive cheque deposits or wire transfers and then transfer these

^{*} The RBI, vide its circular no. DBOD. AML. BC. No. 65/14 .01.001/2010-11 dated December 7, 2010 provides guidance on Operation of bank accounts & money mules.

funds to accounts held on behalf of another person or to other individuals, minus a certain commission payment. Money mules may be recruited by a variety of methods, including spam e-mails, advertisements on genuine recruitment web sites, social networking sites, instant messaging and advertisements in newspapers. When caught, these money mules often have their bank accounts suspended, causing inconvenience and potential financial loss, apart from facing likely legal action for being part of a fraud. Many a times the address and contact details of such mules are found to be fake or not up to date, making it difficult for enforcement agencies to locate the account holder. The operations of such mule accounts can be minimised if banks follow the guidelines contained in the Master Circular on Know Your Customer (KYC) norms /Anti-Money Laundering (AML) standards/ Combating of Financing of Terrorism (CFT)/Obligation of banks under PMLA, 2002. Banks are, therefore, required to strictly adhere to the guidelines on KYC/AML/CFT issued from time to time and to those relating to periodical updation of customer identification data after the account is opened and also to monitoring of transactions in order to protect themselves and their customers from misuse by such fraudsters.

Assess Specific Risks

2.85 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.

2.86 For this purpose, the auditor should perform the following:

- Identify risks throughout the process of obtaining an understanding of the bank and its environment, including applicable controls that relate to the risks, and by considering the account balances or disclosures in the financial statements.
- Ascertain account balances or disclosures wherein control lapses or errors have been identified in the past.
- Pinpoint each risk to one or more assertions relating to the account balances or disclosures.

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- Consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements.
- Document the identified and assessed risks of material misstatement at the assertion level.

2.87 Although there is always a risk of misstatement for each significant account balance and disclosure, a specific risk exists when the auditor recognises one or more factors that significantly increases the risk of material misstatement. This assessment is based on the nature of the risk, the likelihood of the occurrence of the risk, and the likely magnitude of any resulting misstatements.

2.88 The identification of specific risks, which arise on most audits, is a matter of professional judgment. The factors influencing the identification of specific risks may include the following:

- past misstatements strongly indicate about the likely occurrence of future misstatements;
- the application systems are unreliable;
- non-systematically processed transactions have a disproportionately higher likelihood of misstatement than those routine transactions that are processed by reliable application systems;
- absence of secondary review;
- the incidence of misstatements is greater in transactions relating to accounting estimates and adjustments at or near to the end of an accounting period (i.e., cut-offs and accruals); and
- the incidence of misstatements associated with unusual or complex transactions.

The greater the likelihood that the risk could result in a material misstatement of the financial statements, the greater the potential for that risk of material misstatement to be assessed as a specific risk.

2.89 The auditor's assessment of the risks of material misstatement at the assertion level is based on available audit evidence which may change during the course of the audit as and when further audit evidence is obtained indicating the change in the previously obtained audit evidence (e.g., when performing substantive procedures, the auditor may detect misstatements in amounts or frequency greater than that of consistent with their risk assessment). In these

circumstances, the auditor needs to consider whether it is appropriate to revise the risk assessment procedures and modify the further planned audit procedures accordingly. The auditor is required to document the identified and assessed risks of material misstatement at the assertion level.

2.90 Most transactions involve more than one type of the risk identified, as mentioned in the Annexure-1 to this chapter. Furthermore, the individual risks set out above may be correlated with one another. For example, a bank's credit exposure in a securities transaction may increase as a result of an increase in the market price of the securities concerned. Similarly, nonpayment or settlement failure can have consequences for a bank's liquidity position. The auditor therefore considers these and other risk correlations when analysing the risks to which a bank is exposed.

Risk Associated with Outsourcing of Activities

2.91 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. RBI's circular no. DBOD.BP.40/21.04.158/2006-07 dated November 3, 2006 contains extensive guidelines on managing the risks associated with the outsourcing of financial services by banks. The circular, however, also mandates that banks which choose to outsource financial services should not outsource core management functions including internal audit, compliance function and decision-making functions like, determining compliance with Know Your Customer ('KYC') norms for opening deposit accounts, according sanction for loans (including retail loans) and management of investment portfolio.

2.92 In addition to understanding the external factors that could indicate increased risk, the natures of risks arising from the bank's operations are also of significant importance. Factors that contribute significantly to operational risk include the following:

- (a) The need to process high volumes of transactions accurately within a short time through the large-scale use of IT.
- (b) The need to use electronic funds transfer (EFT) or other telecommunication system to transfer ownership of large sums of money, with the resultant risk of exposure to loss arising from payments to incorrect parties through fraud or error.

- (c) The conduct of operations in many locations with a resultant geographic dispersion of transaction processing and internal controls. As a result:
 - (i) there is a risk that the bank's worldwide exposure, customer-wise and product-wise may not be adequately aggregated and monitored; and
 - (ii) control breakdowns may occur and remain undetected or uncorrected because of the physical separation between management and those who handle the transactions.
- (d) The need to monitor and manage significant exposures that can arise over short timeframes. The process of clearing transactions may cause a significant build-up of receivables and payables during a day, most of which are settled by the end of the day. This is ordinarily referred to as intra-day payment risk. These exposures arise from transactions with customers and counterparties and may include interest rate, currency and market risks.
- (e) The handling of large volumes of monetary items, including cash, negotiable instruments and transferable customer balances, with the resultant risk of loss arising from theft and fraud by employees or other parties.
- (f) The inherent complexity and volatility of the environment in which banks operate, resulting in the risk of inappropriate risk management strategies or accounting treatment, in relation to such matters as the development of new products and services.
- (g) Overseas operations are subject to the laws and regulations of the countries in which they are based as well as those of the country in which the parent entity has its headquarters. This may result in the need to adhere to differing requirements, thereby, leading to risk that operating procedures that comply with regulations in some jurisdictions do not meet the requirements of others.

Response to the Assessed Risks

2.93 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. In designing the further audit

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procedures to be performed, the auditor should:

- (a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:
 - (i) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risk); and
 - (ii) Whether the risk assessment takes into account the relevant controls (i.e., the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and
- (b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk.

2.94 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.

2.95 Banks usually use a wide range of quantitative tools and matrices to measure and monitor risks. Some of the commonly used tools to measure and monitor market risk are Value at Risk (VAR) and Stress Testing.

Value-at-risk ('VAR')

2.96 For a given portfolio, value-at-risk measures the potential future loss (in terms of market value) that, under normal market conditions, will not be exceeded, with a defined confidence level in a defined period. The value-at-risk for a total portfolio represents a measure of diversified market risk (aggregated using pre-determined correlations) in that portfolio. Banks calculate value-at-risk for both internal and regulatory reporting using a 99% confidence level.

Stress Testing

2.97 Globally, banks are increasingly relying on statistical models to measure and manage the financial risks to which they are exposed. These models are gaining credibility because they provide a framework for identifying, analysing, measuring, communicating and managing these risks. Since models cannot

incorporate all possible risk outcomes and are generally not capable of capturing sudden and dramatic changes, banks supplement models with 'stress tests'. Internationally, stress testing has become an integral part of banks' risk management systems and is used to evaluate the potential vulnerability to some unlikely but plausible events or movements in financial variables. There are broadly two categories of stress tests used in banks, viz., sensitivity tests and scenario tests. These may be used either separately or in conjunction with each other.

2.98 RBI, vide its circular no. DBOD. No. BP. BC.101 / 21.04.103/ 200607 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.

2.99 The circular also states that while traditionally stress tests are used in the context of managing market risks, these may also be employed in the management of credit risks, operational risks and liquidity funding risk. Banks should identify their major risks that should be subjected to stress tests.

2.100 Banks should stress the relevant parameters at least at three levels of increasing adversity – minor, medium, and major – with reference to the normal situation and estimate the financial resources needed by it under each of the circumstances to:

- a) meet the risk as it arises and for mitigating the impact of manifestation of that risk;
- b) meet the liabilities as they fall due; and
- c) meet the minimum CRAR requirements. Banks may apply stress tests at varying frequencies dictated by their respective business requirements, relevance and cost.

2.101 The results of the various stress tests should be reviewed by the senior management and reported to the Board. The circular emphasises that these results should be an essential ingredient of bank's risk management systems.

2.102 The remedial actions that banks may consider necessary to activate when the various stress tolerance levels are breached may include:

- a) Reduction of risk limits;
- b) Reduction of risks by enhancing collateral requirements, seeking higher level of risk mitigants, undertaking securitisation, and hedging;

- c) Amend pricing policies to reflect enhanced risks or previously unidentified risks;
- d) Augmenting the capital levels to enhance the buffer to absorb shocks;
- e) Enhancing sources of funds through credit lines, managing the liability structure, altering the liquid asset profile, etc.

2.103 Stress tests should, as far as possible, be conducted on a bank-wide basis and should be adequately tailored to capture country or market or portfolio specific factors. Stress tests undertaken on a bank-wide basis enable the Board and senior management to assess the potential impact of the stress situations on the bank's earnings and capital position, and enable them to develop or choose appropriate strategies for mitigating and managing the impact of those situations. The framework also helps bank managements in understanding the bank's risk profile and adjusting it in accordance with their risk appetite. The stress test results should be considered while establishing and reviewing various policies and limits.

2.104 RBI requires the banks to put in place appropriate stress test policies and the relevant stress test framework for the various risk factors by September 30, 2007 as also to ensure that their formal stress testing frameworks, which are in accordance with these guidelines, are operational from March 31, 2008.

BASEL III framework

2.105 The Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB) has undertaken an extensive review of the regulatory framework in the wake of the sub-prime crisis. In the document titled 'Basel III: A global regulatory framework for more resilient banks and banking systems', released by the BCBS in December 2010, it has inter alia proposed certain minimum set of criteria for inclusion of instruments in the new definition of regulatory capital. The reader may refer to the chapter 1, Basel II of Part V of the Guidance Note for the detailed guidance on the New Capital Adequacy Framework, i.e., Basel III.

Annexure 1

Risks Associated with the Banking Activities

The risks associated with the banking activities can be broadly categorised as follows:

- (a) *Concentration risk*: Banking risks increase with the degree of concentration of a bank's exposure to any one customer, industry, geographic area or country. For example, a bank's loan portfolio may have large concentrations of loans or commitments to particular industries, and some, such as real estate, shipping and natural resources, may have highly specialized practices. Assessing the relevant risks relating to loans to entities in those industries may require knowledge of these industries, including their business, operational and reporting practices.
- (b) *Country risk*: The risk of foreign customers and counterparties failing to settle their obligations because of economic, political and social factors of the counterparty's home country and external to the customer or counterparty.
- (c) *Credit risk*: The risk that a customer or counterparty will not settle an obligation for full value, either when due or at any time thereafter. Credit risk, particularly from commercial lending, may be considered the most important risk in banking operations. Credit risk arises from lending to individuals, companies, banks and governments. It also exists in assets other than loans, such as investments, balances due from other banks and in off-balance sheet commitments. Credit risk also includes country risk, transfer risk, replacement risk and settlement risk.
- (d) *Currency risk*: The risk of loss arising from future movements in the exchange rates applicable to foreign currency assets, liabilities, rights and obligations.
- (e) *Fiduciary risk*: The risk of loss arising from factors such as failure to maintain safe custody or negligence in the management of assets on behalf of other parties.
- (f) *Interest rate risk*: The risk that a movement in interest rates would have an adverse effect on the value of assets and liabilities or would affect interest cash flows.

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- (g) *Legal and documentary risk*: The risk that contracts are documented incorrectly or are not legally enforceable in the relevant jurisdiction in which the contracts are to be enforced or where the counterparties operate. This can include the risk that assets will turn out to be worthless or liabilities will turn out to be greater than expected because of inadequate or incorrect legal advice or documentation. In addition, existing laws may fail to resolve legal issues involving a bank; a court case involving a particular bank may have wider implications for the banking business and involve costs to it and many or all other banks; and laws affecting banks or other commercial enterprises may change. Banks are particularly susceptible to legal risks when entering into new types of transactions and when the legal right of the counterparty to enter into a transaction is not established.
- (h) *Liquidity risk*: The risk of loss arising from the changes in the bank's ability to sell or dispose of an asset.
- (i) *Modelling risk*: The risk associated with the imperfections and subjectivity of valuation models used to determine the values of assets or liabilities.
- (j) *Operational risk*: The risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.
- (k) *Price risk*: The risk of loss arising from adverse changes in market prices, including interest rates, foreign exchange rates, equity and commodity prices and from movements in the market prices of investments.
- (l) *Regulatory risk*: The risk of loss arising from failure to comply with regulatory or legal requirements in the relevant jurisdiction in which the bank operates. It also includes any loss that could arise from changes in regulatory requirements. (In this context, the circular no. DBS.CO.PP.BC.6/11.01.005/2006-07 dated April 20, 2007 is also relevant. The circular lays down detailed requirements in respect of compliance related aspects such as compliance risk, responsibility of the Board of Directors, responsibility of the senior management, compliance policy, compliance structure, compliance principles, process and procedures, compliance programme, etc.)
- (m) *Replacement/Performance risk*: The risk of failure of a customer or counterparty to perform the terms of a contract. This failure creates the need to replace the failed transaction with another counterparty at the current market price. This may result in a loss to the bank equivalent to the difference between the contract price and the current market price.

Risk Assessment and Internal Control

- (n) *Reputational risk*: The risk of losing business because of negative public opinion and consequential damage to the bank's reputation arising from failure to properly manage some of the above risks, or from involvement in improper or illegal activities by the bank or its senior management, such as money laundering or attempts to cover up losses.
- (o) *Settlement risk*: The risk that one side of a transaction will be settled without value being received from the customer or counterparty. This will generally result in the loss to the bank of the full principal amount.
- (p) *Solvency risk*: The risk of loss arising from the possibility of the bank not having sufficient funds to meet its obligations, or from the bank's inability to access capital markets to raise required funds.
- (q) *Transfer risk*: The risk of loss arising when a counterparty's obligation is not denominated in the counterparty's home currency. The counterparty may be unable to obtain the currency of the obligation irrespective of the counterparty's particular financial condition.
- (r) *Volatility risk*: This is a type of market risk which specifically pertains to option positions. An increase in the volatility of the price of the instrument underlying the option will generally result in an increase in the value of any bought (long) option position. The opposite will apply for a decrease in volatility

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3.01 As per SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", the overall objective and scope of an audit does not change in a Computer Information Systems ('CIS') environment. However, the use of a computer changes the processing, storage, retrieval and communication of financial information and may affect the accounting and internal control systems employed by the bank. Accordingly, CIS environment may affect:

- the procedures followed by the auditor in obtaining sufficient understanding of the accounting and internal control system;
- the auditor's evaluation of inherent risk and control risk through which the auditor assesses the audit risk; and
- the auditor's design and performance of tests of control and substantive procedures appropriate to meet the audit objective.

3.02 The auditor should evaluate, *inter alia*, the following factors to determine the effect of CIS environment on the audit:

- the extent to which the CIS environment is used to record, compile and analyse accounting information;
- the system of internal control in existence in the bank with regard to:
 - (i) flow of authorised, correct and complete data to the processing centre;
 - (ii) processing, analysis and reporting tasks undertaken; and
- the impact of computer-based accounting system on the audit trail that could otherwise be expected to exist in an entirely manual system.

3.03 As in today's environment all banks have set up and implemented large scale computerisation projects, which has resulted in changes in the processing and storage of information. Information generated by computers are also used for decision making. The importance, extent of use and complexity of a bank's information systems affect 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,

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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. The nature of audit evidence and the techniques used to evaluate them have also undergone a significant change. Audit procedures are now transformed from “Auditing around the computer” to “Auditing through the computer”.

3.04 The control concerns arising from the use of IT by a bank are similar to those arising when IT is used by other organisations. However, the matters that are of particular concern to the auditor of a bank include the following:

- The use of IT to calculate and record, substantially, all of the interest income and interest expense, which are ordinarily two of the most important elements in the determination of a bank’s earnings.
- The use of IT and telecommunications systems to determine the foreign exchange security and derivative trading positions, and to calculate and record the gains and losses arising from them.
- The extensive, and in some cases almost total, dependence on the records produced by IT because they represent only readily accessible source of detailed up-to-date information on the bank’s assets and liability positions, such as, customer loan and deposit balances.
- The use of complex valuation models incorporated in the IT systems.
- The models used to value assets and the data used by those models are often kept in spreadsheets prepared by individuals on personal computers not linked to the bank’s main IT systems and not subject to the same controls as applications on those systems.
- The use of different IT systems resulting in the risk of loss of audit trail and incompatibility of different systems.
- The use of multiple channels of delivery of services to a bank’s customers such as ATM, EFT, internet banking, card-based payment systems, etc.
- The integrity of financial data moving through data interfaces between several systems.
- Potential risk of management override of controls through privileged access to information systems.
- Potential segregation of duty issues arising from access to multiple systems granted to users.
- The extensive use of third party vendors (service organizations) to whom financial data processing activities or management of IT infrastructure is outsourced.

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3.05 Electronic Funds Transfer ('EFT') systems are used by banks both internally (for example, for transfers between branches and between automated banking machines and the computerised files that record account activity) and externally between the bank and other financial institutions (for example, through the SWIFT network) and also between the bank and its customers through the internet or other electronic commerce media.

3.06 The auditor obtains an understanding of the core IT, EFT and telecommunication applications and the links between those applications. The auditor relates this understanding to the major business processes or balance sheet positions in order to identify the risk factors for the organisation and therefore, for the audit. In addition, it is important to identify the extent of the use of self-developed applications or integrated systems, which will have a direct effect on the audit approach. (Self-developed systems require the auditor to focus more extensively on the program change controls.)

3.07 When auditing in a distributed IT environment, the auditor obtains an understanding of where the core IT applications are located. If the bank's Wide Area Network (WAN) is dispersed over several countries, specific legislative rules might apply to cross-border data processing. In such an environment, audit work on the access control system, especially on access violations, is an important part of the audit.

3.08 RBI has issued guidelines to scheduled commercial banks on information security, electronic banking, technology risk management and cyber frauds vide its circular ref.: BI/2010-11/494 DBS.CO.ITC.BC.No. 6 /31.02.008/2010-11 dated April 29, 2011.

Categorisation of Banks based on level of Computerisation

3.09 Banks may be divided into three board categorises based on the level of computerisation:

- Non-computerised banks
- Partially Computerised banks
- Fully computerised banks

The importance, extent of use and complexity of information systems of each bank may be different than the others. For effectively using a risk-based audit approach, an auditor needs to evaluate the IT risks for a bank before determining the nature, timing and extent of audit procedures.

3.10 Special care has to be taken while doing an audit in a fully computerised environment (where the Bank uses Core Banking Solution-CBS).

Responsibility of Central Auditor vis-à-vis Branch Auditor in fully computerised bank

3.11 Banks, which have high level of computerisation and centralisation, equally have a high level of decentralisation of processes and underlying activities, e.g., in case of advances, the credit processing and accounting are centralised but at the same time there could be separate teams carrying out various parts of credit processing and day-to-day monitoring at the central level; and each team is aware of the specific part of activity only. The central auditor's biggest challenge is to first get acquainted with all the decentralised processes and activities and then to co-ordinate with the relevant persons for the required information. Normally, the central auditor uses the work of an expert for reviewing the computerisation processes and systems, especially in case of core banking system. The findings and reservations, if any, of an expert should be communicated to the other joint auditors. Similarly, the central auditor may, considers necessary, communicate the findings and reservations, if any, of an expert to branch auditors to review certain specific aspects at the branch level. This will not only aid in enhancing the control review process of an audit but also enable the central auditor as well as the branch auditors to formulate their audit methodology and sampling techniques.

3.12 It may also be noted that foreign banks in India are largely guided by global policies, processes and systems (including IT systems) with some level of customisations to meet the local requirements. In some foreign banks, even the IT systems (hubs, servers, etc.) and monitoring thereof (periodic system audit, etc.) are centralised in other countries and no country-specific-process documentation and periodic validations are prescribed by that foreign bank. Therefore, the local IT teams may at the time of an audit, be not in a position to explain the basic configuration of accounting systems and how the local requirements are in-built in the global systems. In some other banks, the primary accounting records are maintained as per global reporting standards and the local financial statements are extracted from those records. Further, the scope of internal auditors and system auditors, etc., is decided on the global basis rather than on country basis. Such high level of globalisation poses big challenge for the local auditors and they have to largely rely on the past consistent globally accepted practices and then to base their audit opinion on explanations and representations coupled with test of controls and substantive checking to the extent possible. Of course these banks are also

required to adhere to the guidelines of the RBI with regard to computerisation and the checks and controls around it.

3.13 Generally, the branch auditors do not have access to the overall IT policy, processes, controls and accounting procedures implemented by the bank. Moreover, the branch auditors confront following practical issues at fully computerised branches:

- Accounting manual, entries, calculations and framework is built in computerised accounting systems
- Critical IT and manual controls
- Periodical MIS and exception reports generated by the system
- Documentation of critical processes performed for accounting and book keeping (IT and Manual)
- Access to primary records and entry level transactions
- Audit sampling
- Hard copies of transactions
- Independent IT Audit at branches, etc.

3.14 The overall review of IT environment and of the computerised accounting system has to be taken up at central level. The management plays a more proactive role to ensure that the computerised accounting systems are working properly and effectively. It is for the central auditor to review whether the management is performing this role effectively. The roles and responsibilities of bank, the central auditor and the branch auditors can be enumerated as under.

Role and responsibilities of the Bank

3.15 Considering the importance of IT systems in the preparation and presentation of financial statement, it is imperative that the bank should share the detailed information about the following key aspects relating to IT environment of the bank with the central auditor at regular intervals:

- Overall IT Policy, structure and environment of the bank's IT system and changes/developments, if any, thereto.
- Data processing and data interface under various systems.
- Data integrity and data security.
- Business Continuity Plans and Disaster Recovery Plans.
- Accounting manual and critical accounting entries (including month-end and year-end) and the processes and involvement of IT systems.

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- Controls over key aspects, such as, account codes and mapping thereof, use of various account heads including other assets and other liabilities, income recognition, expense booking, overdue identification, month-end and year-end procedures, valuation and re-valuation of various items of the financial statements, KYC, ALM, etc.
- Controls and recording of various e-banking and internet banking products.
- Manual processing of key transactions.
- MIS reports being generated and the periodicity thereof.
- Hard copies being generated and the periodicity thereof.
- Process of generating information related to various disclosures in the financial statements and the involvement of the IT systems.
- Major exception reports and the process of generation thereof.
- Major IT related issues (including frauds and failures) faced and resolved/unresolved during the year, such as, data/system corruption, system break-down, etc., having bearing on the preparation and presentation of financial statements.
- Significant observations of internal auditors, concurrent auditors, system auditors, RBI inspection and internal inspection, etc., related to computerised accounting and overall IT systems.
- Customer complaints related to mistakes in transactions (interest application, balances, etc.).
- In order to ensure that the technology deployed to operate the payment system/s authorised is/are being operated in a safe, secure, sound and efficient manner and as per the process flow submitted by the bank for which authorisation has been issued, banks are required to get a System audit done by a firm of Chartered Accountants. The scope of the System audit would include evaluation of the hardware structure, operating systems and critical applications, security and controls in place, including access controls on key applications, disaster recovery plans, training of personnel managing systems and applications, documentation, etc. The system auditor also required to comment on the deviations, if any, in the processes followed from the process flow submitted to RBI while seeking authorisation.¹

¹ Refer RBI circular No. DPSS.AD.No./ 1206/02.27.005/2009-2010 dated 7th December, 2009 on "System Audit of the Payment Systems operated under the PSS Act, 2007".

Role and responsibilities of the central auditor

3.16 Based on the information received from the bank, the statutory central auditor would:

- Need to review whether there is clear segregation of work to be undertaken at central level and branch level under the bank's IT system for accounting of transactions.
- Consider the need for sending a detailed note to the branch auditors explaining their roles and responsibilities in the light of what is stated above.
- Review whether access to primary and subsidiary records is provided and use of data analysis tools is allowed at central and branch level.
- Perform test of controls and substantive checking of sample transactions at the central level and if required, share the results with the branch auditors.
- Based on the work undertaken, identify key issues to be taken up with the Audit Committee and the Board of the bank.
- Consider whether the significant adverse observations in the periodic system audit reports need to be shared with the branch auditors, and also be considered while framing the opinion of true and fair view of the financial statements of the bank.

Role and responsibilities of branch auditors

3.17 Based on the guidance and information received from the central auditor, the branch auditors need to ensure that:

- Their roles and responsibilities are clearly understood and implemented.
- To the extent possible, data analysis tools are used for better and effective audit.
- Test of controls and substantive checking of sample transactions is carried out at the branch level and, where considered necessary, the results are shared with the statutory central auditors.
- Significant observations having bearing on the true and fair view are reported to the statutory central auditors.
- Any other limitations on audit which are required to be reported to the central auditors are reported in a timely manner.

Audit in a CIS environment

Assessment of Inherent and Control Risks

3.18 The nature of banking operations is such that the auditors may not be able to reduce audit risk to an acceptably low level by the performance of

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substantive procedures alone. This is because of factors such as the following:

- The extensive use of IT and EFT systems, which means that much of the audit evidence is available only in electronic form and is produced by the bank's own IT systems.
- The high volume of transactions processed by banks, which makes reliance on substantive procedures alone impracticable.
- The geographic spread of banks' operations.
- Complex trading transactions.

3.19 In most situations, the auditors' ability to reduce audit risk to an acceptably low level would be affected by the internal control systems established by the management that allow the auditors to be able to assess the level of inherent and control risks as less than high. The auditors obtains sufficient appropriate audit evidence to assess the level of inherent and control risks.

3.20 The Auditor's procedures would need to be adapted as the circumstances warrant and in respect of each account, different procedures may be necessary. An illustrative checklist on audit considerations in a CIS environment is given as **Annexure A** to this Chapter. Further, an illustrative checklist on Bank Audit in computerised environment, which is divided in two parts, viz., Part I, bank audit in computerised environment and Part II, automatic teller machines is given as **Annexure B** to this Chapter.

3.21 The principal objective of the auditor in undertaking an audit in a CIS environment is to evaluate the effectiveness of controls. In simple words, controls are those policies and procedures which the organisation implements to minimise the events and circumstances whose occurrence could result in a loss. There are mainly four types of controls.

- A. *Deterrent controls* - Deterrent Controls are designed to deter people, internal as well as external, from doing undesirable activities. For example, written policies including the punitive measures may deter people from doing undesired activities.
- B. *Preventive Controls* - Preventive Controls prevent the cause of exposure from occurring or at least minimise the probability of unlawful event taking place. For example, security controls at various levels like hardware, software, application software, database, network, etc.
- C. *Detective Controls* - When a cause of exposure has occurred, detective controls report its existence in an effort to arrest the damage further or

minimise the extent of the damage. Thus, detective controls limit the losses if an unlawful event has occurred.

- D. *Corrective Controls* - Corrective Controls are designed to recover from a loss situation. For example, Business Continuity Planning is a corrective control. Without corrective controls in place, the bank has risk of loss of business and other losses due to its inability to recover essential IT based services, information and other resources after the disaster has taken place.

3.22 The auditor should obtain a preliminary understanding of the IT environment and various controls put in place by the management, including entity-level controls and then test and evaluate whether the controls are operating effectively. The auditor should discuss the methodology adopted by the bank in implementing controls and their monitoring with the Head of the IT department and the Head of the audit department. These discussions will enable the auditor to get a view on the manner in which the bank has implemented controls. Based on these discussions, the auditor could interact with the various officials of the bank to determine whether they are sensitised to the control expectations of the management considering the technology deployed. If this sensitisation level is low, the auditor may need to perform more extensive audit procedures.

Security Control Aspects

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

- Ensure that authorised, accurate and complete data is made available for processing.
- Ensure that in case of interruption due to power, mechanical or processing failures, the system restarts without distorting the completion of the entries and records.
- Ensure that the system prevents unauthorised amendments to the programmes.
- Verify whether “access controls” assigned to the staff-working match with the responsibilities, as per manual. It is important for the auditor to ensure that access and authorisation rights given to employees are appropriate.
- Verify that segregation of duties is ensured while granting system access to users and that user activities are monitored by performing an activities log review.

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- Verify that changes made in the parameters or user levels are authenticated.
- Verify that charges calculated manually for accounts when function is not regulated through parameters are properly accounted for and authorised.
- Verify that all modules in the software are implemented.
- Exception reports are a major audit tool. The auditor should verify that exceptional transaction reports are being authorised and verified on a daily basis by the concerned officials.
- Verify that the account master and balance cannot be modified/amended/alterd except by the authorised personnel.
- Verify that all the general ledger accounts codes authorised by Head Office are in existence in the system.
- Verify that balance in general ledger tallies with the balance in subsidiary book.
- Verify that important passwords, like database administrator and branch manager's password, are kept in sealed cover with branch manager, so that in case of emergency and the absence of any of them the passwords could be used to run the system properly.
- Verify that the bank takes daily and monthly backups. The backup media should be duly labelled and indexed properly and should be maintained under joint custody.
- Ideally, daily backup should be taken in 6 sets, one for each weekday and 12 sets for each month end. Verify that backup register is maintained and updated.
- Verify that the backup media is stored in fireproof cabinet secured with lock and key and also that the off-site backups are preserved for the emergency.
- Verify that the anti-virus software of latest version is installed in servers/PCs of branches to prevent data corruption, and is being regularly updated for new viruses.
- Verify that security patches are applied to systems as and when they are released by the vendors / developers.
- Verify that access to the computer room is restricted to authorised persons only.

Outsourcing of Financial Services by Banks

3.24 Outsourcing is a worldwide phenomenon, finding presence in every industry, including the banking industry. With a view to ensure that the banks

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adequately address the risks associated with outsourcing of some of their activities (especially financial services) by banks as also to bring such outsourced activities under the regulatory purview and protect the interests of the customers, the RBI, issued circulars no. DBOD.BP.40/21.04.158/2006-07 dated November 3, 2006 on "Managing the Risks and Code of Conduct in Outsourcing of Financial Services by Banks." read with DBOD.No.BP.97/21.04.158/2008-09 dated December 11, 2008 and DBS.CO.PPD.BC.5/ 11.01.005/2008-09 dated April 22, 2009.

3.25 The circular defines "outsourcing" as "a bank's use of a third party (either an affiliated bank within a corporate group or an bank that is external to the corporate group) to perform activities on a continuing basis that would normally be undertaken by the bank itself, now or in the future". 'Continuing basis' would include agreements for a limited period.

3.26 The said circular contains detailed requirements in respect of the various aspects related to outsourcing, including:

- Activities that should not be outsourced
- Material outsourcing
- Bank's role and regulatory and supervisory requirements
- Risk management practices for outsourced financial services
- Role of Board of Directors and senior management
- Evaluation of risks
- Evaluating the capability of the service provider
- Outsourcing agreement
- Confidentiality and security
- Responsibility of DSA/ DMA/ Recovery Agents
- Business continuity and management of disaster recovery plan
- Monitoring of outsourced activities
- Redressal of grievances related to outsourced services
- Reporting of transactions to Financial Intelligence Unit
- Off-shore outsourcing of financial services
- Self assessment/ proposed outsourcing arrangements

3.27 Further, paragraph 5.9.3 of the circular envisages that regular audits either by the internal auditors or external auditors of the bank should assess the adequacy of the risk management practices adopted in overseeing and managing the outsourcing arrangement, the bank's compliance with its risk

management framework and the requirements of these guidelines. The auditor should accordingly undertake procedures necessary to meet these requirements. The scope of the auditor's procedures would, however, be within the requirements of the SA 402, "Audit Considerations relating to an Entity Using a Service Organisation".

Security and Risk Mitigation Measures for Electronic Payment Transactions

3.28 Electronic Payments effected through alternate products/channels are becoming popular among the customers, with more and more banks providing such facilities to their customers. One such initiative by RBI, is mandating additional factor of authentication for all Card Not Present (CNP) transactions. Banks have also to put in place mechanisms and validation checks for facilitating on-line funds transfer, such as: (i) enrolling customer for internet/mobile banking; (ii) addition of beneficiary by the customer; (iii) velocity checks on transactions, etc.

3.29 With cyber-attacks becoming more unpredictable and electronic payment systems becoming vulnerable to new types of misuse, it is imperative that banks introduce certain minimum checks and balances to minimise the impact of such attacks and to arrest/minimise the damage. Accordingly, banks are required by RBI to put in place security and risk control measures *vide* its circular RBI/2012-13/424 DPSS (CO) PD No.1462/02.14.003 / 2012-13 dated February 28, 2013.

Opening and Operation of Accounts and Settlement of Payments for Electronic Payment Transactions Involving Intermediaries

3.30 The use of Electronic/Online Payment modes for payments to merchants for goods and services like bill payments, online shopping etc., has been gaining popularity in the country. The increased facilitation by banks and prepaid payment instrument issuers of the use of electronic modes by customers for payments to merchants generally involves the use of intermediaries like aggregators and payment gateway service providers. Further, Electronic Commerce and Mobile Commerce (e-commerce and m-commerce) service providers have also been acting as intermediaries by providing platforms for facilitating such payments. In most existing arrangements involving such intermediaries, the payments made by customers (for settlement of e-commerce/m-commerce/bill payment transactions), are credited to the accounts of these intermediaries, before the funds are transferred to the accounts of the merchants in final settlement of the obligations of the paying customers. Any delay in the transfer of the funds by the

intermediaries to the merchants account will not only entail risks to the customers and the merchants but also impact the payment system. With a view to safeguard the interests of the customers and to ensure that the payments made by them are duly accounted for by the intermediaries receiving such payments and remitted to the accounts of the merchants who have supplied the goods and services without undue delay, RBI vide its circular no. DPSS.CO.PD.No.1102 /02.14.08/ 2009-10 dated November 24, 2009 issued guidelines for opening and operation of accounts and settlement of payments for electronic payment transactions involving intermediaries to ensure safe and orderly conduct of such transactions.

E –Banking

3.31 E-banking may be defined as the automated delivery of new and traditional banking products and services directly to customers through electronic, interactive communication channels. E-banking includes the systems that enable financial institution customers, individuals or businesses, to access accounts, transact business, or obtain information on financial products and services through a public or private network, including the internet. Customers access e-banking services using an intelligent electronic device, such as, a personal computer (PC), personal digital assistant (PDA), smart phones, automated teller machine (ATM), kiosk, etc.

Risks associated with E-banking

Transaction/ Operations Risk

3.32 Transaction/Operations risk arising from fraud, processing errors, system disruptions, or other unanticipated events shows the bank's inability to deliver products or services. This risk exists in each product and service offered. The level of transaction risk is affected by the structure of the bank's processing environment, including the types of services offered and the complexity of the processes and supporting technology.

3.33 In most instances, e-banking activities will increase the complexity of the bank's activities and the quantity of its transaction/operations risk, especially if the bank is offering innovative services that have not been standardised. Since customers expect e-banking services to be available 24x7, banks should ensure their e-banking infrastructures contain sufficient capacity and redundancy to ensure reliable service availability.

3.34 The auditor should examine whether in order to mitigate transaction/operations risk, the bank has put in place effective policies,

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procedures, and controls to meet the new risk exposures introduced by e-banking. The basic internal controls would include segregation of duties, dual controls, and reconciliations. Information security controls, in particular, become more significant requiring additional processes, tools, expertise and testing.

Credit Risk

3.35 Generally, the bank's credit risk is not increased by the mere fact that a loan is originated through an e-banking channel. However, the bank should ensure that additional precautions are in place when originating and approving loans electronically, including assuring management information systems effectiveness by preparing a track of the performance of portfolios originated through e-banking channels. The following aspects of on-line loan origination and approval tend to make risk management of the lending process more challenging.

- Verifying the customer's ID for on-line credit applications and executing an enforceable contract.
- Monitoring and controlling the growth, pricing, and on-going credit quality of loans originated through e-banking channels.
- Monitoring and oversight of third-parties operations doing business as agents or on behalf of the banks.
- Valuing collateral and perfecting liens over a potentially wider geographic area; and
- Collecting loans from individuals over a potentially wider geographic area.

If not properly managed, these aspects can significantly increase credit risk.

Compliance/ Legal Risk

3.36 Compliance and legal issues arise out of the rapid growth in usage of e-banking services and the differences between the electronic and paper-based processes. E-banking is a new delivery channel where the laws and rules governing the electronic delivery of certain financial products or services may be ambiguous or still evolving. Specific regulatory and legal challenges include:

- Uncertainty over the legal jurisdictions applicable to the transaction taking place through e-banking;
- Delivery of credit and deposit related disclosures/notices as required by law or regulation;

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- Retention of required compliance documentation for on-line advertising, applications, statements, disclosures, notices; and
- Establishment of legally binding electronic agreements.

3.37 Banks offering e-banking services, both informational and transactional, assume a higher level of compliance risk because of the changing nature of the technology, the speed at which errors can be replicated, and the frequency of regulatory changes to address e-banking issues. The potential for violations is further heightened by the need to ensure consistency between paper and electronic advertisements, disclosures and notices.

Reputational Risk

3.38 The rise of the sophisticated cyber crime has become one of the fastest growing security and reputational risks to banks. The cyber crime landscape features malware exploits that can routinely evade traditional security controls. The reactive attack and penetration approaches of the past may no longer be sufficient to deal effectively with that level of ingenuity of cyber attacks and are being replaced with new forms of cyber intelligence capable of enhancing traditional security programs. Adding a layer of complexity to the issue is the rise of social networking, online communications, and online financial transactions. The bank has a significant role to play in identifying and addressing this risk thereby safeguarding its reputation and instilling the confidence in its customers.

Mobile Banking

3.39 Mobile banking involves undertaking banking transactions using mobile phones by bank customers that involve credit/debit to their accounts. It also covers accessing the bank accounts by customers for non-monetary transactions like, balance enquiry, 'stop payment' instruction of cheques, transactions enquiry, location of the nearest ATM/branch, etc.

3.40 With a view to ensure that the banks adequately address the risks associated with mobile banking, the RBI, has issued Master Circular on Mobile Banking Transactions in India – Operative Guidelines for Banks dated July 1, 2013. The guidelines are applicable to all commercial banks (including Regional Rural Banks), Urban Cooperative Banks, State Cooperative Banks and District Central Cooperative Banks. A bank needs to obtain prior approvals of the RBI before commencement of mobile banking services in India.

3.41 In carrying out an audit of mobile banking transactions, the auditor is

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primarily concerned about aspects such as authentication procedures, understanding the information security framework, compliances with regulatory requirements, etc.

Authentication procedures for mobile banking transactions - All transactions affecting an account including those which lead to an account being debited or credited should be allowed only after authentication of the mobile number and the MPIN associated with it. Further, the accounts allowed to be transacted through mobile banking should be correctly linked with the mobile phones so as to safeguard against spoofing of the phone numbers. The auditor needs to ensure that the bank has put in place a system of document based registration with relevant details and with mandatory physical presence of the customers, before commencing mobile banking services.

Information Security framework- The auditor needs to ensure that the bank has proper infrastructure and information security policy put in place since information security is of paramount importance and critical to the business of mobile banking services and its underlying operations. Therefore, technology used for mobile banking should be secure and should be able to ensure confidentiality, integrity, availability and authenticity. Proper level of encryption should be implemented for communicating between the customer, mobile service provider and the bank. The bank needs to ensure that proper security checks have been made to ascertain the security levels of the service providers. The payment authorisation message from the user's mobile phone should be securely encrypted and checked for tampering by the service provider or the bank. It should not be possible for any interceptor to change the contents of the message. The statutory auditor should, accordingly, undertake procedures necessary to evaluate the bank's compliance with these requirements.

Compliance with Regulatory Guidelines- Banks need to ensure that the guidelines on KYC norms, anti money laundering, risks and controls in computers and telecommunications, etc., issued by the RBI which apply to mobile banking are also adhered to. The auditor also needs to examine whether the transaction limit, as stipulated by the RBI, is adhered to and imposed on mobile banking transactions.

3.42 The dependence of banks on mobile banking service providers may place knowledge of bank systems and customers in a public domain. Mobile banking system may also make the banks dependent on small firms (i.e., mobile banking service providers) with high employee turnover. It is therefore imperative that sensitive customer data, and security and integrity of

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transactions are protected. It is necessary that the mobile banking servers at the bank's end or at the mobile banking service provider's end, if any, should be certified by an accredited external agency. In addition, banks should conduct regular information security audits on the mobile banking systems to ensure complete security.

Annexure A

An Illustrative Checklist on Audit Considerations in CIS environment

While carrying out the audit in fully computerised environment, it is important to note that the primary audit objective does not undergo change, it is only the approach and methodology that undergoes a change. For achieving the primary objective in each of the aspects of the financial statements – balance sheet, profit and loss account, financial disclosures, notes to accounts, and special purpose certificates, the auditors must consider the following broad suggestions-

- Clearly identify and document the underlying audit objective and also the significant inherent risks (accounting, compliance, etc.) involved in each of the area.
- Gain an understanding of the IT system in use, flow of activities/processes, data interface, flow of accounting entries, regular and exception reports generated on daily basis, critical manual processes and controls.
- Understand and document the processes involved and IT systems used for month end and year end financial closures and data extractions.
- Identify sample size and carry out test of controls and substantive checking.
- Document process and results.
- Form an opinion.

The following indicative checklist can be used (centralised and decentralised) while undertaking the audit in fully computerised environment:

Sr. No.	Particulars	Yes/No/NA	Comments
A	Basic Approach and Methodology – Centralised		
i.	Have you understood the overall IT Policy, IT organization structure, IT Governance framework and control environment of the bank and the relation thereof to the preparation and presentation of financial statements?		
ii.	Have you obtained sufficient appropriate information about the total IT systems in use		

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Sr. No.	Particulars	Yes/No/NA	Comments
	and the area covered therein?		
iii.	Have you obtained flow charts of activities in relation to data entry, recording, processing, storage and interface in each of the systems? Obtain a list of unprocessed transactions as at the year end.		
iv.	Have you gathered information about the critical IT and manual controls in relation to data processing and data interface, in general, and accounting and preparation and presentation of financial statements in particular?		
v.	Have you reviewed the process documents for all the critical processes having bearing on recording of transactions and preparation and presentation of financial statements? In case the processes are not documented, have you ensured that written representation explaining the whole process has been taken on record?		
vi.	Have you reviewed the work done by other agencies, such as, internal auditors, concurrent auditors, internal inspectors and system auditors in relation to IT processes and systems? Have you documented significant observations, if any, made by any of the above agencies?		
vii.	Have you enquired about the major breakdowns/corruption in system/data during the year having bearing on the preparation and presentation of financial statements and how the same were resolved? Obtain details of unresolved issues, if any, as at the year end.		
viii.	Have you identified the samples for test of controls and substantive checking? Have you documented the process of sampling and the details of sample selected? Have you taken screen shots of the relevant accounts/data used in sampling?		
ix.	Have you compared the outcome of testing with the financial records? Are you satisfied		

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Sr. No.	Particulars	Yes/No/NA	Comments
	with the results of test of controls and substantive checking? If not, have you taken some more samples for further testing?		
x.	If you are not satisfied with the results, has this been escalated to concerned officials and those issues have been resolved.		
xi.	Are there any unresolved issues and have you noted the same for final reporting?		
xii.	Have you documented the entire audit process and significant observation at all stages?		
xiii.	Have you obtained written representations from the management on all the required matters?		
B	System of accounting and record keeping – Centralised		
i.	Have you understood the process of creating head of accounts? Are there adequate controls on creating new heads of accounts and closing unused heads of account? Obtain a list of accounts heads created and closed during the year?		
ii.	Have you understood the nature and title of all the account heads used in preparation and presentation of financial statements? Obtain written note on basic purpose and usage of all head of accounts and their mapping/linkage with main heads of financial statements.		
iii.	Have you understood process of recording transactions in all the heads of accounts including routing/intermediary accounts? Obtain a list of all the routing accounts and purpose and usage thereof? Review the balances held and the ageing of these accounts as at the year end.		
iv.	Have you understood the concept of out of the book entries passed at the year end for the purpose of financial closure and subsequent accounting/reversal thereof? Obtain a list of common OBE passed the year end. Have you reviewed the OBE		

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Sr. No.	Particulars	Yes/No/NA	Comments
	passed at year end and also subsequent accounting and reversal thereof till the date of signing?		
v.	Have you ensured that the balances as the general ledger are tallied with the balances as per the sub-systems used for recording primary transactions? In case of significant differences, ensure that the same are reported in the audit report as qualification?		
vi.	In respect of financial information required for disclosures in the notes to accounts and also for special purpose certificate, have you understood the process of compiling information and the underlying systems used? Obtain all the back up papers used for generating such financial information.		
C	Certain specific aspects – Decentralised		
i.	In case of deposits have you understood the process for compliance with KYC? Please carry out test check of certain cases and document the test results.		
ii.	In case of deposits have you understood various types of deposits and carried out test check to ensure interest accrual, application, year end provisions, TDS calculations, etc., are correct? (In view of voluminous records/accounts, many a times, it is not possible to compare the results of test of controls and substantive checking for year end interest accrual with the books of account as individual customer level data is not generated.) Please document the process and test results.		
iii.	In case of advances have you understood various types of facilities being offered, the process of monitoring the limits and interest accrual and application (including year end provisions) in accounts under various types of facilities? Special care needs to be taken while monitoring the excesses/over-limits in case of fungible/interchangeable limits. Special care also needs to be taken for new		

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Sr. No.	Particulars	Yes/No/NA	Comments
	<p>age products being offered by various banks, such as, Channel Financing, Business Banking, Small and Medium Enterprises Financing, Gold Loans, etc. (In view of voluminous records/accounts, many a times, it is not possible to compare the results of test of controls and substantive checking for year end interest accrual with the books of account as individual customer level data is not generated.) Please document the process and test results.</p>		
iv.	<p>In case of advances have you understood the process of identifying non-performing assets (NPA) under various types of facilities (cash credit, overdraft, term loan, packing credit, bill purchase and discounting) and segments (wholesale and retail)? Special care need to be taken while reviewing the overdue or DPD (days past due) reports provided by the banks, as many banks have filtration process before final reports are generated. (In case private sector and foreign banks, the retail assets are categorised under various products and monitored accordingly for asset classification and security-wise classification. Even the NPA norms (which are generally more stringent than RBI norms) and security-wise classification is decided on product level basis and applied accordingly.</p>		
v.	<p>Have you understood the process of identifying NPA borrower-wise and not facility-wise? (In case of private sector banks and foreign banks, due to voluminous data, such identification is either not done or is done at a time lag and in some case, the customer data in retail portfolio is not matched with wholesale portfolio for this purpose. Further, special care need to be taken in case of new age products as, in some banks, these facilities may not fall within wholesale and retail portfolio for the purpose of monitoring.) Please document the</p>		

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Sr. No.	Particulars	Yes/No/NA	Comments
	process and test results.		
vi.	In case of foreign currency assets and liabilities, have you understood the process of revaluation (as per Accounting Standard (AS) 11 /FEDAI guidelines) periodically and at the year end, as the case may be? Please document the process and results.		
vii.	In case of sundry assets and liabilities, have you understood the usage, process of clearance of outstanding items, periodic ageing and reporting and provisioning of old items? (In case of fully computerised banks, some of these heads of account are used as routing accounts and have specified frequency for periodic clearance.) Please document the process and test results.		
viii.	In case of day to day operating expenses, have you understood the process of accounting, payments, TDS calculation and year end provisioning? (In case of private sector banks, the accounting and payment of expenses is centralised and generally there is substantial time gap between receipt of goods/services, receipt of bill and accounting thereof. Special care need to be taken for provision for expenses as at the year end. Further in case of payments to staff, many banks do not provide access to staff records due to confidentiality. In such cases, please ensure that alternate audit approach is used to verify aggregate payments instead of merely relying on representation by the management or outsourced service provider.) Please document the process and test results.		
ix.	In case of fixed assets have you understood the process of the entire process of purchasing fixed assets and the capitalisation and amortisation thereof? (Due to voluminous transactions and internal processes involved in purchase of fixed assets, many banks follow the practice of		

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Sr. No.	Particulars	Yes/No/NA	Comments
	capitalising the assets (largely in case of it assets) on the date of payment rather than date on which asset is ready for use or date on which asset is put to use. Such practices must be corrected.) Please document the process and test results.		
x.	Have you understood the process of maturity-wise classification of assets and liabilities of the bank? (In many banks it is not possible to compare the results of test check carried out in this regard with the actual classification, as it is in-built in the basic system and moreover, the account level information is not readily available.) Please document the process and test results.		
xi.	In case of data migration from one platform to another platform have you verified that the same was error free and there are no pending issues having bearing on the preparation and presentation of financial statements?		
xii.	In case of errors spotted during the audit, have you enquired about the primary reason/s and specific pattern/s, if any for the errors? (In computerised accounting, due to automated data processing, it is quite likely that there are some primary reasons and some patterns behind the errors which, if not detected, could lead to serial misstatement in the financial statements.) Please document the process and test results.		

I. Bank Audit in Computerised Environment

An Illustrative Checklist

This Annexure is divided in two parts, viz., Part I deals with Bank Audit in Computerised Environment while Part II deals with Automatic Teller Machines. The checklists given therein does not form part of the Guidance Note and is only illustrative in nature. Members are expected to exercise their professional judgement while making its use depending upon facts and circumstances of each case.

Existing Installation

Auditors need to verify the system software and version being operated at the Branch. It is advised to obtain the licensed copy of the software along with the documentation provided by the vendor and compare the same with the software running in the live environment. To carry out verification, auditor may look into the following:

- a) The software register to check whether all the softwares in use is entered and maintained desktop-wise.
- b) Note the Name and Version of software currently in use.
- c) It is the latest version of the software authorised by the Central Office of the Bank to be used.
- d) Installation of the Software is in accordance with the directions issued by the Central Office.
- e) All the modules of the software are properly installed and are working. If any module is not in use presently, reason has to be ascertained and documented.
- f) Physical verification of the copies of the softwares, documentation and manuals was carried out by Internal / Concurrent / Statutory Auditors.
- g) The existence of Annual Maintenance Contract is in operation and was duly renewed on the expiry date.

Purchases

Computerisation is a constant process of development and improvement over the previous technology. In this process Banks also upgrade their hardware's and softwares installed to improve efficiency and provide better service to the customers. There has being a phase of such improvements, where branches

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operating on Automatic Ledger Posting Machines (ALPM) where upgraded to semi-computerised branches and then to fully computerised branches. The fully computerised branches are now in the process of being upgraded to fully networked branches. The phase is not over and there are still ALPM branches, which are in the process of upgradation. Auditors, in many branches might come across the purchases made for new softwares during the concerned Financial Year. To achieve the desired level of satisfaction that the purchase process was in accordance with the guidelines of the Central Office and installation was carried out under the supervision of the appropriate person. auditor may verify the following:

- a) Software register is duly updated with new purchases.
- b) Purchase Order was duly filed and purchase was properly authorised and software was obtained from authorised vendor only.
- c) The license of the software, warranty obtained and registration with the manufacturer is completed.
- d) Installation was inspected and completed in the prescribed order.
- e) Purchase was at reasonable value.

Logical Access Controls

To ascertain that assets are safeguarded and data integrity is maintained by the computer system, auditors may verify the following:

- a) Does security policy address specific capabilities of operating systems and require that the available security features be implemented?
- b) Is there a security officer appointed in writing?
- c) Does the security officer ensure that available features have been implemented?
- d) Is there a process in place for granting access levels?
- e) Do users have only the minimum access level needed to do their job?
- f) Are Users' access restricted to specific applications, menus within applications, files, and servers?
- g) Is file maintenance a separate access privilege?
- h) Is maintenance restricted to a minimum number of persons and is it properly approved and reviewed?

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- i) Is the password file encrypted?
- j) Are methods in place to detect security violations?
- k) Can security restrictions be overridden?
- l) Are access levels periodically reviewed by the internal auditor?
- m) Are procedures implemented to limit access to workstations after normal working hours?
- n) Is modem access protected by a secure system, such as call back?
- o) Are modem numbers changed periodically?

Password Controls

There are few fundamental problems in maintaining the integrity of the Password, they are:

- i. Users for their convenience write down the password, as they are hard to remember.
- ii. Users to reduce the burden of remembering cumbersome passwords, opt for easy to use passwords, which are also easy to guess.
- iii. Users in routine do not change their passwords at regular intervals.
- iv. Users fail to appreciate the importance of having password and consequences of its being compromised.
- v. Passwords in Banks change hands very fast for the convenience of work.
- vi. Certain Access Control Mechanism requires users to enter multiple passwords.
- vii. Certain System Software does not store password in the encrypted form.
- viii. Passwords are not changed / deleted on the transfer / retirement of the operator / officer in the Master Record of the System Software.
- ix. Passwords are transmitted in clear text form, especially in Wide Area Network (WAN).

Auditors are required to take extra caution in verifying the integrity of passwords in the Branches. Following issues should be looked into to establish the integrity:

- a) Password Register for the updating with the changes.
- b) Passwords secrecy is maintained by the following officers of the Bank:
 - i. Branch Manager

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- ii. System Administrator
 - iii. Users
 - iv. Authorised Persons
- c) The critical passwords, for accepting sensitive jobs are known only to Branch Manager or System Administrator. Sensitive jobs include:
- i. To enter operating systems.
 - ii. To take back-ups.
 - iii. To monitor disk space.
 - iv. To create/edit Master Records.
- d) The Operating System Password is kept under Dual Control of Branch Manager and System Administrator. The password should be protected in a sealed cover and opened in the presence of at least two persons. It should be changed at once on being opened.

Day Start-up Activities

Following areas require the attention of the auditor:

- (a) Verify that day start-up Activities of a computer system is carried out either by the Branch Manager or System Administrator. It should be properly documented and signed in the register maintained.
- (b) Verify the time of commencement of day-start-up activities. It should not be carried out prior to the banking hours.
- (c) Verify that all the security checks are performed as per the prescribed guidelines from the Central Office of the Bank.
- (d) Verify that Banking date is verified daily and check sum facility is used regularly.

Transaction Controls

Following are the areas the auditor may verify along with going through the manuals in relation to data base management:

- a. Date is authorised either by Branch Manager or System Administrator.
- b. The control exists in the software to check that the entries pertaining to current date would be only accepted. There should not be any provision to

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feed back dated or future dated entries.

- c. In the case of non-usage of terminals, terminals are logged-off.
- d. Register for recording of problems in the software and the suitable action taken.
- e. For only physically present users of the computer system, the requisite terminal/user account is enabled, else the account remains disabled.
- f. Special batch reports are printed, checked, authenticated and duly filed.

Personnel Controls

To discourage misuse of funds and such practices, it is important to implement Personnel Controls. Auditor may verify the following to establish that efficient and effective personnel management practices are followed:

- a. The technical competence of the employees of the bank, operating the computer system.
- b. Whether adequate training was imparted to the employees in connection with the operations of the software, presently being used in the bank.
- c. The segregation of duties among the bank employees and the process of monitoring the performance of each employee.
- d. Authorization for amounts entered by the operators are clearly defined and documented.
- e. Job rotation is carried out at regular intervals.

Day End Activities

Keeping in view, the serious effects on the system software, auditor may scrutinize the entries on and around the various closing dates of the Bank. This verification can be conducted by going through the exceptional report or Supplementary generated by the system software. Besides this, auditor should also verify that following activities are carried out regularly and documented:

- a. Day end activities are carried out by either the Branch Manager or System Administrator and are properly documented.
- b. Supplementary are checked and special users are deleted.
- c. The following functions are completed at the day end:
 - i. Minimum balances calculated.
 - ii. Products calculated for Current Account (Debit balances)

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- iii. Mandatory reports generated.
 - iv. Fall back procedures activated.
 - v. Day end back up taken.
 - vi. Recording of entries in back-up register.
 - vii. Recording in Log Books.
 - viii. Filing of reports.
 - ix. Shutting down of complete computer system.
- d. The data back-ups taken are in safe custody and properly documented.
- e. Server Room is properly locked and the keys are kept only with authorised person.
- f. The generation of following documents:
- i. Access log
 - ii. Supplementary
 - iii. Audit Trail
 - iv. Transaction number is given for each transaction entered.
- g. After the business hours of the bank computer operators perform the following functions:
- i. Supplementary Report is printed either by Branch Manager or System Administrators and filed.
 - ii. Cash Denomination Report is printed and filed.
 - iii. Vouchers are tallied and signed either by Branch Manager or System Administrator.

Parameter/ Master File

Parameters/ Master is quantity constant but could vary for different cases. In banks, we come across various types of accounts with different guidelines to operate them. In a Parameter/ Master File, all the relevant information related to that particular account is feeded and stored. The information would relate to Rate of Interest to be applied, Penal Interest to be charged, Commission Rates, Operation Limits in case of loans, Nature of operation of account, single / jointly etc. This exercise is carried out at the first stage of implementation of computerisation of the Branch. Thereafter, the system software behaves according to the Parameters enforced currently are as per latest circulars. It

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important to check that Parameter/ Master File if accessible to the operators should only be in read-only format, else it would invite undesirable modifications, which would lead to revenue leakage and misuse of funds. Whenever any alterations are to be made in the Parameter/ Master File, printouts of the file prior to the changes and after the changes should be taken and documented in safe custody of Branch Manager. Auditor should verify the following:

- a. Authorised personnel mark all the Bank Holidays into the software in the beginning of the Financial Year.
- b. Operation limits and authorisation levels are defined clearly for the operators and supervisors.
- c. The parameters for Interest and Bank Charges are defined in accordance with the relevant rates and guidelines. The file is updated as and when changes are announced.
- d. Printouts of parameter file are taken out before and after changes are given effect and documented.
- e. The safe custody of the printouts with Branch Manager and alterations are entered into "Parameter Register".

e-Banking/Internet Banking Procedures

1. Identify the bank's current and planned e-Banking activities and review the bank's public Internet Websites. Consider whether the bank provides the following types of services:
 - a. Telephone banking
 - b. Retail Internet banking services
 - c. Corporate/ wholesale Internet banking services
 - d. Internet services provider (ISP)
 - e. Brokerage services over the Internet
 - f. Insurance service over the Internet
 - g. Trust services over the Internet
 - h. Account aggregation
 - i. Electronic bill payment
 - j. Other activities (e.g. Web portals, financial calculators, cross-marketing arrangements and alliances, unique services, etc.)
2. Review prior audit reports related to e-Banking, including compliance, information technology, and other examination areas that may be relevant.

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3. Determine if material changes have been made to e-Banking products, services, or operations since the last examination and if any significant changes are planned in the near future.
4. Determine if the bank operates the Web site(s), e-Banking system(s) or core data processing system(s) internally and whether any activities are outsourced to a vendor. Identify the location of the following operations:
 - a. Design and maintenance of the bank's public Web site or home page.
 - b. Computer/ server for the bank's public Web site.
 - c. Development and maintenance of the bank's electronic banking system(s).
 - d. Computer/ server for the bank's e-Banking system(s).
 - e. Customer service (e.g., call center) for electronic banking services.
 - f. Electronic bill payment processing or other ancillary services.
5. If the bank operates the e-Banking system or core data processing system in-house, review the topology (schematic diagram) of the systems and networks, and determine whether there is a direct, on-line connection between the bank's core processing systems and the electronic banking system.
6. If the bank operates the e-Banking system or core data processing system in-house, review the transaction processing flows between the e-Banking system and the bank's core processing systems and identify key control points. Determine whether information is exchanged in a real-time, batch (overnight), or hybrid processing mode. In case the bank uses the services of any professional agency for any part of the work, the auditor should apply the standards laid down in Revised SA 402, "Audit Considerations Relating to an Entity Using a Service Organisation".
7. Determine the adequacy of risk management for e-Banking activities given the level of risk to the institution; following procedures are to be valuated:
 - a. Adequacy of policies and procedures governing e-Banking activities.
 - b. Adequacy of internal controls and security for e-Banking activities.
 - c. Adequacy of audit coverage for e-Banking activities.

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- d. Adequacy of monitoring and compliance efforts.
 - e. Adequacy of vendor and outsourcing management.
 - f. Adequacy of Board and management oversight.
8. Determine the impact of any deficiencies on the financial condition of the organization.
9. Determine the extent of supervisory attention needed to ensure that any weaknesses are addressed and that associated risk is adequately managed.

Adequacy of Internal Controls:

- 1. Are updates and changes to the bank's public website(s) are made only by authorised staff and subject to dual verification?
- 2. Are website information and links to other websites regularly verified and reviewed by the bank for:
 - a. Accuracy and functionality?
 - b. Potential reputational, compliance, and legal risk?
 - c. Appropriate disclaimers?
- 3. Do operating policies and procedures include:
 - a. Procedures for, and controls, over opening new customer accounts submitted via electronic channels to verify potential customer identity and financial condition?
 - b. Procedures for administering access to the electronic banking system (e.g., customer passwords, PINs, account numbers)?
 - c. Requirements for review of or controls over wire transfers or other large transfers initiated through the electronic banking system for potentially suspicious activity?
 - d. Appropriate authorizations for electronic debits initiated against accounts at other institutions, if such transfers are allowed?
 - e. Depending on the type of account, dollar limits on transactions over a given time period initiated through the electronic banking service?
 - f. Reconciliation and accounting controls over transactions initiated

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through the electronic banking system, including electronic bill payment processing?

4. Do written information security policies and procedures address electronic banking products and services?
5. Are business recovery procedures adequate? Consider whether the procedures address:
 - a. Events that could affect the availability of the electronic banking system, such as system outages, natural disasters, or other disruptions?
 - b. Planned recovery times that are consistent with the degree of importance of the electronic banking activities to the institution?
 - c. Has management established an incident response plan to handle potential system security breaches, website disruptions, malicious tampering with the Web site, or other problem situations?
6. Has the bank or service provider implemented a firewall to protect the bank's Web site?
7. Are ongoing monitoring and maintenance arrangements for the firewall in place to ensure the firewall is properly maintained and configured?
8. If the bank uses a turnkey e-Banking software package or outsources to a service provider:
 - a. Are bank staff are familiar with key controls detailed by the vendor's security and operating manuals and training materials?
 - b. Are workstations that interface with the service provider's system for administrative procedures or transfer of files and data are kept in a secure location with appropriate password or other access control, dual verification procedures, and other controls?
9. Does the bank's administration of access to the e-Banking system by bank staff and customers include:
 - a. Procedures to ensure that only appropriate staff is authorised to access e-Banking systems and data, including access to any workstations connected to a remote system located at a service provider?
 - b. The length and composition of passwords and PINs?

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- c. Encryption of passwords and PINs in transit and storage?
 - d. The number of unsuccessful logon attempts before the password is suspended?
 - e. Procedures for resetting customer passwords and PINs?
 - f. Automatic logoff controls for user inactivity?
10. Have security vulnerability assessments and penetration tests of e-Banking systems been conducted and results reviewed by the bank?
11. Has the bank or its service provider established:
- a. An intrusion detection system for e-Banking applications?
 - b. Procedures to detect changes in e-Banking files and software?
 - c. Measures to protect the e-Banking system from computer viruses?
 - d. Procedures for ensuring on an ongoing basis that e-Banking applications, operating systems, and related security infrastructure incorporate “patches” and upgrades that are issued to address known security vulnerabilities in these systems?
12. If e-mail is used to communicate with customers, are communications encrypted or does the bank advise customers and not to send confidential information via e-mail?
13. Are adequate summary-level reports are made available to management to allow monitoring of:
- a. Web-site usage?
 - b. Transaction volume?
 - c. System problem logs?
 - d. Exceptions?
 - e. Unreconciled transactions?
 - f. Other customer or operational issues?
14. Has management established adequate procedures for monitoring and addressing customer problems regarding e-Banking products and services?
15. Does management accurately reports its primary public web-site address

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on the Report of Condition?

16. Have required Suspicious Activity Reports involving e-Banking, including any computer intrusions, been filed?
17. Is each significant vendor, service provide, consultant, or contractor relationship involved in development and maintenance of the e-Banking services covered by a written, signed contract? Depending on the nature and criticality of the services, do contracts specify:
 - a. Minimum service levels and remedies or penalties for non-performance?
 - b. Liability for failed, delayed, or erroneous transactions processed by the service provider and other transactions where losses may be incurred (e.g. insufficient funds).
 - c. Contingency plans, recovery times in the event of a disruption, and responsibility for back-up of programs and data.
 - d. Data ownership, data usage, and compliance with the bank's information security policies.
 - e. Access by the bank to the service provider's financial information and results of audits and security reviews.
 - f. Insurance to be maintained by the service provider.
18. Has legal counsel has reviewed the contracts to ensure they are legally enforceable and that they reasonably protect the bank from risk?
19. Has the bank ensured that any service provider responsible for hosting or maintaining the bank's web-site has implemented:
 - a. Controls to protect the bank's Web site from unauthorized alteration and malicious attacks?
 - b. Procedures to notify the bank in the event of such incidents?
 - c. Regular back-up of the bank's Web-site information?
20. Depending on the nature and criticality of the services, does the bank conduct initial and periodic due diligence reviews of service providers, including:
 - a. Reviewing the service provider's standards, policies and procedures relating to internal controls, security, and business contingency to

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- ensure they meet the bank's minimum standards?
- b. Monitoring performance relative to service level agreements and communicating any deficiencies to the service provider and to bank management?
 - c. Reviewing reports provided by the service provider relating to response times, availability/ downtime, exception reports, and capacity reports and communicating any concerns to bank management and the vendor?
 - d. Periodically reviewing the financial condition of the service provider and determining whether back-up arrangements are warranted as a result?
 - e. Conducting on-site audits of the service provider if appropriate based on the level of risk?
 - f. Ensuring the bank staff receives adequate training and documentation from the vendor or service provider?
21. If the bank operates a turnkey e-banking software package:
- a. Is software held under an escrow agreement?
 - b. Has the bank established procedures to ensure that relevant program files and documentation held under the software escrow agreements are kept current and complete?
22. If a vendor maintains the bank's electronic banking system, does the bank monitor on-site or remote access of the bank's systems by the vendor, through activity logs or other measures?

Evaluation of Operation System

- 1. Obtain or prepare logical and physical diagrams of the operating system and attached local and wide area networks.
- 2. Document the operating system domain(s), identifying the Primary Domain Controller (PDC), Backup Domain Controller, and any other operating system servers or significant operating system workstations participating in the domain.
- 3. Using the information obtained in the prior steps, document the server and directory location of the significant application programs and data within the network; document the flow of transactions between systems and nodes in

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the network.

4. Using the Server Manager utility, review all trusted domains assigned to the audit domain and include these trusted domains within the audit scope.
5. Assess whether the trusted domains are under the same physical and administrative control and are logically located within the same sub-network.
6. Determine that router filtering is being used to prevent external network nodes from spoofing the IP address of a trusted domain.

User Security

Determine that the user log in identification and authentication process are properly configured and that users are assigned to operating system groups which are consistent with their job requirements for system access:

1. Obtaining the documented security policies and procedures for the operating system server environment. Use the User Manager utility to display the global log in accounts security parameters and review and assess the following settings:
 - a. Forcibly disconnect remote users (forces users to log off the system after a predetermined limit of time).
 - b. Minimum password age in days
 - c. Maximum password age in days
 - d. Minimum password length
 - e. Password uniqueness (number of past passwords disallowed for future use)
 - f. Account lockout after X number of bad log on attempts
 - g. Account lockout—reset the bad log on count after X number of minutes
 - h. Accounting lockout duration—require administrator to unlock or automatically unlock after X number of minutes.
 - i. User must log on to change password (may allow or restrict users with expired passwords from logging on and changing the password themselves or requiring an administrator to change the password for them)
2. Determine that the Administrator (super user) and Guest accounts have

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passwords assigned to them (by attempting to log on without providing a password). Also ascertain that the Administrator account password is well controlled and used/ known by only the system administrator and one backup person.

3. Using the User Manager utility, review the following account properties settings active in each user's individual profile, which may override the global account policy:
 - a. Full name (should be used to facilitate ID management)
 - b. Description (job, department, etc.)
 - c. Change password at next log in (should be used for new users' initial log in)
 - d. User cannot change password (forces administrator to manage the password; may be used for vendor and other third-party accounts)
 - e. Password never expires (may be used to override the global restriction in the Accounts Policy)
 - f. Account disabled
 - g. Account locked out
 - h. Groups (cross-reference to group's audit procedures)
 - i. Profile (each user should have a home directory, path statement, and log in script)
 - j. Hours (log in time restrictions)
 - k. Log on to (restricts workstations from which the user may log in from)
 - l. Account (specifies local or global and may specify an expiration date)
4. Using the User Manager utility, review and assess User Rights assigned to groups and individual users.
5. Use the user manager utility, review and access User Rights assigned to groups and individual users.
6. Use the User Manager utility to view and assess membership in the sensitive built-in groups: Administrators, Domain Administrators, and Account Operators. Assess the appropriateness of users assigned to these groups.

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7. Using the User manager utility, document user membership in groups used to grant access to resources with audit significance (application program and data directories and files), cross-reference to review file system security audit steps, and assess appropriateness of each user's membership in groups.

File System Security

To ensure that significant system and application program and data resources are protected from unauthorized access and modifications.

1. Review the file system directory trees to ensure that only operating system file systems are used on servers within the audit scope (since any other file system type, DOS or other, cannot be controlled by operating system security with the exception of operating system share security).
2. Using the File Manager directory tree directory tree utility, list out the Security Permissions for all system directories and significant application programs and directories; perform the following:
 - a. Determine that the owner of all operating system directories is the Administrator account
 - b. Determine that application program and data directories are owned by a restricted application owner account of the operating system Administrator account
 - c. Review and assess permissions assigned to groups and individual accounts, noting that Full Control (all permissions) and Change (Read, Write, Execute, and Delete) permissions are restricted to authorized users (cross-reference groups to earlier step, identifying users with the groups they belong to)
 - d. Determine that Change permissions and Take Ownership permissions are restricted to Administrative accounts and groups
 - e. Using the File Manager directory, identify all shared directories (directories made available to users the network). Review and assess Share permissions assigned to these directories on a group or user basis.

Operating System Audit and Logging

To determine whether adequate detective controls have been configured and

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that the information generated by these controls is being reviewed and followed upon:

1. Using the User Manager utility, review the Audit Policy options in effect for the domain (and server, if applicable). Normally, all failure conditions should be audited.
2. Using the Event Viewer utility, review the audit log for suspicious events and follow up on these events with the security administrator.

Operating System Services

To ensure that only necessary, secure services are active in the operating system environment:

1. From the control panel, click on the services option and review all active or dormant services. Identify the purpose and necessity of each. Unnecessary services should be disabled.
2. Ensure that each service, logs on as on account other than the system account unless the service requires the system account. Audit the permissions granted to each service account.
3. Determine that each service account has the advanced user right, called logon as a service.

Operating System Networking

To determine that the network and network services are protected against unauthorized access and use:

1. Identify all necessary NetBIOS services offered on each server. Access the propriety of each and if it is running as a non-privileged service account, unless the service requires the system account.
2. Review router configurations for routers that connect the operating system network to external networks. Ensure that the TCP/UDP ports 137, 138 and 139 are blocked or altered to restrict Net BIOS traffic coming into and going out of the network.
3. Identify all active, native, and third-party TCP/IP network services active on the operating system server. Audit the security of each service.

The Operating System Registry

To review the security over system and program control parameters in the operating system registry:

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1. Review the operating system directory and file permissions over system and program control parameters in the operating system registry.
2. View the registry permission for the major system and program keys and sub keys to ensure the following:
 - a. The administrators' local group owns each key
 - b. The owner group and system global group have full access permissions.
 - c. The global group called everyone, has restricted special access permissions.

II. Automatic Teller Machines

More than two decades have elapsed since the introduction of ATMs by Banks in India. Initially, these were installed by larger co-operative Banks and the new private sector Banks. Today, ATM service is offered by even small co-operative Banks making such a service *sin-qua-non* of Banking in India. Seemingly technical in nature, it houses one of the primary asset of the Bank – cash which has to be recognized by the auditor in his scope of work. While verification of cash in the ATM is one aspect, the operational efficacy should be responsive to the policy of the Bank and the standard operating procedures including the directives of the Reserve Bank of India.

Few ATM frauds are reported till date but this has no implication on their occurrence. Banking business deals with money and ATM is one part of its service. The auditor needs to view this service with the same critical eye as any manual cash management. Following aspects of internal control in relation to ATMs may be ascertained and evaluated by the auditor:

Pre-installation Stage

1. Board's sanction of ATM installation service.
2. ATM installation complies with the strategic Information Technology plan of the Bank.
3. Purchase of ATMs need to be driven through the same formality of a purchase of asset of the Bank like flotation of tenders, etc.
4. Location of the ATMs both branch attached as well as independent locations should be finalized to achieve the aim of Bank's investment in this service.
5. All requisite permissions and licenses should be obtained by the Bank including communication to the Reserve Bank of India.

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6. Environmental preparations should be made considering legal, security and operational issues. Environmental policy should be also set in writing to permit standard environment with sufficient provision to permit customization necessitated by location peculiarities.
7. The estate department of the Bank or an independent architect should certify to the Estate department about the quality and appropriateness of translation of set policy at each of the ATM location.
8. Cash replenishment policy needs to be finalized before operating any the ATMs. This can be a set policy or a contingent policy determined by the number of ATMs units set up by the Bank. Cash replenishment can either managed by the Bank itself or it can be outsourced. With the Bank itself it can either be done by a Central or Regional office or a nodal equivalent branch in which case, the ATM cash balance is reflected in the books of this Branch. The various alternatives should be evaluated and selected.
9. If the cash management of ATMs is to be outsourced, similar procedure should be adopted by invitation of either open tenders or inviting tenders.
10. Insurance of cash in ATMs should be negotiated with insurance companies and if the number of ATMs are numerous, select insurance companies may be invited to bid.
11. Application software should be able to communicate with the ATM software and this delicate requirement should be specifically mentioned in the agreement with the ATM vendor and application vendor since their co-operation is essential at this stage.
12. ATM software, its operation and reflection in the main application should be software tested either internally or through a professional firm before operations commence.
13. Cash replenishment policy should be set ensuring the maximum limit set per ATM is not exceeded.

Operational stage

1. Is the security manual in place describing the security measures to ensure at the time of replenishing cash in the ATMs?
2. Are all the staff involved in cash transfers screened thoroughly and their photos and prints taken? In case of a contract, does the service vendor

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follow similar formalities? This should be periodically checked by the Bank and this point needs to be have been specifically made in the agreement with him.

3. Is the process of allocation of ATM cards secure?
 - a. Are the Personal Identification numbers (PIN) generated randomly?
 - b. Are the PIN cards printed in a manner that no staff is able to read them without tearing open the seal?
 - c. Are the cards and PIN numbers sent separately? Popular delivery mode is delivery of card only through a courier agency. The PIN number is physically delivered through the branch. In case the PIN number is also to be delivered, it should be given on a later date and that too through another courier agency.
 - d. Courier agency should be under separate contract to fulfill the extra formality of identification confirmation of the person accepting the card with the strict instruction to hand over the card only to the person to whom the card is allotted.
 - e. Bin filling exercise should be done in the presence of at least two persons who should not only supervise each other to ensure correct denominations are inserted in the correct bins.
 - f. User report if available on the 'special service ATM card' should be obtained and filed for future reference. This should ideally record the time and date of opening the ATM machine presumably to replenish it. Along with this, the cash balance after replenishment should also be printed.
 - g. Cash shortages should be thoroughly investigated with full reference to the server report compared with the ATM's log available on site of ATM.
 - h. All cards should be changed after a period say 2 years to allot cards to only regular users thus diminishing risk of the cards of non users.
4. whether surprise checks are carried out by the vendor or the Bank's departmental officer to ensure the amount and time of currency replenished as reflected in the register is accurately recorded?
5. Whether schedules of currency replenishment are not static and are

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changed on each occasion randomly to ensure that there is no definitive pattern?

6. Whether ATMs providing additional service like refilling phone cards or e-transfers etc. are system audited periodically?
7. Whether the bank has a system to thoroughly report and investigate complaints regarding non-performance of services?
8. Whether Cash in ATM and Cash in transit insurance is kept alive at all times?

PART - III

III-1

Advances

1.01 Lending constitutes a major activity of a bank. The banking business revolves primarily around garnering funds through acceptance of deposits for the purpose of onward lending. As a corollary, advances, generally, constitute the largest item on the assets side of the balance sheet of a bank and are also a major source of its income.

1.02 Amounts disclosed in the balance sheet under the head 'Advances' comprise:

- (a) money lent by the bank to its customers and interest accrued and due thereon (including guarantees invoked/Letters of credit devolved on Bank);
- (b) debit balances in deposit accounts;
- (c) amount of participation on risk-sharing basis under inter-bank participation schemes in capacity as a participating bank (net); and
- (d) amount receivable from Government of India under the Agricultural Debt Waiver Scheme 2008.

Balance Sheet Disclosure

1.03 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
 - (ii) Due from others
 - (iii) Bills purchased and discounted
 - (iv) Syndicated loans
 - (v) Others

Classification Based on Nature of Advance (Section A)

1.04 Different classifications under section A will be as follows:

- (a) In classification under section 'A', all outstandings – in India as well as outside India – less provisions made, will be classified under three heads.
- (b) Outstandings in credit card operations should be shown as part of advances under the head 'cash credits, overdrafts and loans repayable on demand'.
- (c) Term loans will be loans not repayable on demand and would include overdue instalments.
- (d) All interest bearing loans and advances granted by the bank to its employees should be shown as part of advances.

Classification Based on Nature and Extent of Security (Section B)

1.05 Different classifications under section B will be as follows:

- (a) All advances or part of advances, which are secured¹ by tangible assets, whether in India or outside India, should be shown under the heading 'secured by tangible assets'. Advances against book debts may be included under the head 'Secured by Tangible Assets', and presented in Schedule 9 (Advances) as follows:
 - "B Secured by Tangible Assets" (includes advances against book debt)
- (b) Advances in India and outside India to the extent they are covered by guarantees of Indian and foreign governments and Indian and foreign banks and DICGC and ECGC are to be included under the head 'advances – covered by bank/government guarantees'.
- (c) Unsecured advances will include advances not classified under (i) & (ii) of section B.

¹ A 'secured advance', according to section 5(n) of the Banking Regulation Act, 1949 means an advance made on the security of assets the market value of which is not at any time less than the amount of such advance.

Classification based on Place of Making Advances (Section C)

- 1.06 a) Advances to sectors, which are classified as priority sectors according to the instructions of the RBI, are to be classified under the head 'priority sectors'. Such advances should be excluded from, 'Advances to Public Sector'.
- b) Advances to Central and State Governments and other government undertakings including government companies and corporations which are, according to the statutes, to be treated as public sector companies, are to be included in the category 'Public Sector'.
- c) All advances to the banking sector including co-operative banks will come under the head 'Banks'.
- d) All the remaining advances will be included under the head 'Others'; typically this category will include non-priority advances to the private, joint and co-operative sectors.

Commonly Used Terms and Operational Aspects

Funded and Non-funded Credit Facilities

1.07 Funded credit facilities are those where there is an actual transfer of funds from the bank to the borrower whereas non-funded facilities are those, which do not involve such a transfer. Examples of funded facilities are term loan, cash credit and overdraft. Examples of non-funded facilities are letters of credit, bank guarantees, etc. A non-funded facility may subsequently turn into a funded facility, e.g., where the bank makes payment under a letter of credit issued by it due to devolvement.

Demand Loans

1.08 A demand loan is an advance of a fixed amount repayable on demand e.g. cash credit. The repayment of demand loans may be either in one lump sum or by instalments. Interest is calculated on the basis of daily outstandings and applied at stipulated periodic intervals usually on monthly basis. .

Bills Purchased and Discounted

1.09 Bills purchased refer to demand bills and cheques whereas bills discounted refer to usance (time) bills. Banks purchase/discount only *bona fide* trade bills and not accommodation bills. Banks can discount usance bills of any maturity, which is normally, decided in Loan Policy of the Bank.

Primary and Collateral Securities

1.10 The term 'primary security' refers to the security acquired by the borrower with bank finance or the one against which credit has been extended by the bank. Primary security is the principal security for an advance. A collateral security, on the other hand, is additional security, which provides a cushion to the bank in case of need. Banks accept various types of assets as collateral security eg., Residential flat of the promoter, equity shares of promoters, etc.

Personal Security of Guarantor

1.11 The personal security of guarantor comprises a guarantee by a third party for payment of outstandings in the event of default by the borrower. No charge is created on the guarantor's movable or immovable assets. The personal security of guarantor can be enforced only through the competent Court of law.

Fixed and Floating Charges

1.12 A fixed charge (also called 'specific charge') is a charge on some specific and ascertained assets. The creator of the charge (i.e., the borrower) cannot deal with the asset without the specific consent of the holder of the charge (i.e., the lender). A floating charge, on the other hand, is an equitable charge on the assets, present as well as future. A floating charge attaches to assets whose condition varies from time to time in the ordinary course of business (e.g., work-in-process). A floating charge crystallises (i.e., becomes a fixed charge) when money becomes repayable and the holder of the charge (i.e., lender) takes necessary steps for the enforcement of the security.

Margin

1.13 Banks do not provide finance to the extent of the full value of the assets charged to them under a credit facility. A suitable margin, depending upon the risk perception of the bank, is deducted from the value of the charged assets to take care of any downward fluctuations in the market value of the assets. For example, in case of advances against shares, banks are generally required to maintain a uniform margin of 50 per cent on all advances/financing of IPOs/issue of guarantees on behalf of stockbrokers and market makers. For all other types of advances / LCs/ BGs, margin band is prescribed in the Loan policy of the bank, which are generally in the range of 5% to 50%.

Refinance/Subsidy

1.14 Reserve Bank of India, Industrial Development Bank of India (IDBI),

Export-Import Bank of India (EXIM Bank), National Bank for Agriculture and Rural Development (NABARD) and Small Industries Development Bank (SIDBI) are major agencies providing refinance to banks, generally for loans extended to specified sectors. The refinance obtained by a bank from refinancing agencies represents borrowings of the bank.

1.15 The banks, and in some cases, the borrowers, are entitled to subsidies on their loans, particularly in the case of loans granted under government-sponsored schemes. The branches have to lodge claims in the prescribed formats with the designated authority, generally through head office. The procedure to be followed for availing of the subsidy may differ from scheme to scheme.

System of Base Rate

1.16 The RBI vide its Circular No. DBOD. No. Dir. BC 88 /13.03.00/2009-10 dated April 9, 2010 on "Guidelines on the Base Rate" required the banks to switch over from benchmark prime lending rate (BPLR) system to the system of Base Rate. The Base Rate system is aimed at enhancing transparency in lending rates of banks and enabling better assessment of transmission of monetary policy. Accordingly, the following guidelines were issued by RBI for implementation by banks:

- The Base Rate system has replaced the BPLR system with effect from July 1, 2010. Base Rate shall include all those elements of the lending rates that are common across all categories of borrowers. Banks may choose any benchmark to arrive at the Base Rate for a specific tenor that may be disclosed transparently. Banks are free to use any other methodology, as considered appropriate, provided it is consistent and are made available for supervisory review/scrutiny, as and when required.
- Banks may determine their actual lending rates on loans and advances with reference to the Base Rate and by including such other customer specific charges as considered appropriate.
- All categories of loans should be priced only with reference to the Base Rate. In other words, rate of interest should not be below Base Rate. However, the following categories of loans could be priced without reference to the Base Rate: (a) DRI advances (b) loans to banks' own employees including retired employees (c) loans to banks' depositors against their own deposits.
- Changes in the Base Rate shall be applicable in respect of all existing loans linked to the Base Rate, in a transparent and non-discriminatory manner.

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- Reserve Bank of India will separately announce the stipulation for export credit.
- Banks are required to review the Base Rate at least once in a quarter with the approval of the Board or the Asset Liability Management Committees (ALCOs) as per the bank's practice. Banks are required to exhibit the information –regarding Base Rate at all branches and also on their websites. Changes in the Base Rate should also be conveyed to the general public from time to time through appropriate channels. Banks are required to provide information on the actual minimum and maximum lending rates to the Reserve Bank on a quarterly basis, as hitherto.
- The Base Rate system would be applicable for all new loans and for those old loans that come up for renewal. Banks, however, should not charge any fee for such switch-over.
- RBI, *vide* its circular no. DBOD. Dir.BC. 81 /13.03.00/2010-11 dated February 21, 2011 has clarified that lending of subsidised loans by Government of India, Ministry of New and Renewable Energy (MNRE) under a scheme on financing of Off-Grid and Decentralised Solar (Photovoltaic and Thermal) applications as part of the Jawaharlal Nehru National Solar Mission (JNNSM) to entrepreneurs at interest rates not exceeding five per cent where refinance of two per cent from Government of India is available, would not be considered to be a violation of RBI's Base Rate Guidelines.

In this context, attention of the readers is also invited to RBI's Circular No. DBOD.No.Dir.BC.47/13.03.00/2013-14 on "Base Rate - Revised Guidelines" dated September 2, 2013 providing for computation/ revision of Base Rate methodology for a limited period.

Prudential Exposure Limits

Single and Group Borrower Limits*

1.17 With a view to achieve a better risk management and avoidance of concentration of credit risk, the RBI from time to time, prescribes, limits on exposure of a bank to individual borrowers and groups of borrowers in India. The Master Circular No. DBOD. No. Dir. BC.13/13.03.00/2013-14, dated July 1,

* RBI vide its circular No. DBOD.No.BP.BC.96/21.06.102/2013-14 on *Guidelines on Management of Intra-Group Transactions and Exposures* providing guidelines on Intra-Group Transactions and Exposures (ITEs) for banks. The guidelines contain quantitative limits on financial ITEs and prudential measures for the non-financial ITEs to ensure that banks engage in ITEs in safe and sound manner in order to contain concentration and contagion risks arising out of ITEs. These guidelines will become effective from October 1, 2014.

2013 on “Exposure Norms”, lays down the ceiling on exposure to individual/group borrowers in relation to bank’s capital fund as defined under capital adequacy standards (Tier-I and Tier-II Capital). The ceiling on exposure to individual borrowers is 15 per cent of capital funds and 40 per cent in the case of a borrower group. However, exposure to borrowers belonging to a group may exceed the exposure norms of the 40 per cent of the bank’s capital funds by an additional 10 per cent, provided the additional credit exposure is on account of extension of credit for infrastructure projects. Exposure to single borrower may also exceed by 5 per cent, provided the additional exposure is on account of infrastructure projects. Derivative Products such as Forward Rate Agreements and Interest Rate Swaps are also captured for computing exposure by applying the conversion factors to notional principal amounts. Banks should also include forward contracts in foreign exchange and other derivative products like currency swaps, options, etc., at their replacement cost value in determining individual / group borrower exposure. The Master Circular on Exposure Norms contains guidelines on calculation of the credit exposure in derivative products.

1.18 In addition to the exposure limit as permitted above, banks may, in exceptional circumstances, with the approval of their Boards, consider enhancement of the exposure to a borrower (single as well as group) upto a further 5 per cent of capital funds..

1.19 With effect from May 29, 2008, the exposure limit in respect of single borrower has been raised to twenty five percent of the capital funds, only in respect of Oil Companies who have been issued Oil Bonds (which do not have SLR status) by Government of India. In addition to this, banks may in exceptional circumstances, consider enhancement of the exposure to the Oil Companies up to a further 5 percent of capital funds.

1.20 Such exposures where the bank has exceeded the prudential exposure limit should be appropriately disclosed in the “Notes to Accounts” to the Balance Sheet.

Sector Specific Limit

1.21 Apart from limiting the exposures to an individual or a borrower group as indicated above, banks may also consider fixing internal limits for aggregate commitments to specific sectors, e.g. textiles, jute, tea, etc., so that the exposures are evenly spread over various sectors. These limits could be fixed by the banks having regard to the performance of different sectors and the risks perceived. The limits so fixed may be reviewed periodically and revised, as necessary.

Lending to NBFCs

1.22 The exposure (both lending and investment, including off balance sheet exposures) of a bank to a single NBFC / NBFC-AFC (Asset Financing Companies) should not exceed 10% / 15% respectively, of the bank's capital funds as per its last audited balance sheet. Banks may, however, assume exposures on a single NBFC / NBFC-AFC up to 15%/20% respectively, of their capital funds provided the exposure in excess of 10%/15% respectively, is on account of funds on-lent by the NBFC / NBFC-AFC to the infrastructure sector. Exposure of a bank to Infrastructure Finance Companies (IFCs) should not exceed 15% of its capital funds as per its last audited balance sheet, with a provision to increase it to 20% if the same is on account of funds on-lent by the IFCs to the infrastructure sector. Further, banks may also consider fixing internal limits for their aggregate exposure to all NBFCs put together. Infusion of capital funds after the published balance sheet date may also be taken into account for the purpose of computing exposure ceiling. Banks should obtain an external auditor's certificate on completion of the augmentation of capital and submit the same to the Reserve Bank of India (Department of Banking Supervision) before reckoning the additions to capital funds.

Bills Purchased/Discounted under Letter of Credit

1.23 In cases where the bills discounting/purchasing/negotiating bank and LC issuing bank are different entities, bills purchased/ discounted/ negotiated under L/C (where payment to the beneficiary is not "under reserve") is to be treated as an exposure on L/C issuing bank and not on borrower. In the case of negotiations "under reserve", the exposure will be treated as an exposure on the borrower. However, in cases where the bills discounting/purchasing/negotiating bank and LC issuing bank are part of the same bank, i.e. where LC is issued by the Head Office or branch of the same bank, then the exposure should be taken on the third party/borrower and not on the LC issuing bank

Unhedged Foreign Currency Exposure of Corporates

1.24 To ensure that each bank has a policy that explicitly recognises and takes account of risks arising out of foreign exchange exposure of their clients, foreign currency loans above US \$10 million, or such lower limits as may be deemed appropriate *vis-à-vis* the banks' portfolios of such exposures, should be extended by banks only on the basis of a well laid out policy of their Boards with regard to hedging of such foreign currency loans. Further, the policy for hedging, to be framed by their Boards, may consider, as appropriate for convenience, excluding the following:

- Where forex loans are extended to finance exports, banks may not insist on hedging but assure themselves that such customers have uncovered receivables to cover the loan amount.
- Where the forex loans are extended for meeting forex expenditure.

In this context, attention of the readers is also invited to RBI's Circular No. DBOD.No.BP.BC.85/21.06.200/2013-14 on "Capital and Provisioning Requirements for Exposures to entities with Unhedged Foreign Currency Exposure" dated January 15, 2014 providing requirements for exposures to entities with unhedged foreign currency exposure.

Lending for Real Estate

1.25 Banks are required to frame comprehensive prudential norms relating to the ceiling on the total amount of real estate loans, single/group exposure limits for such loans, margins, security, repayment schedule and availability of supplementary finance and the policy should be approved by the banks' Boards. The disbursements in case of these loans should be made only after the borrower has obtained requisite clearances from the government authorities.

1.26 RBI has also required that the banks' Boards may also consider incorporation of aspects relating to adherence to National Building Code (NBC) in their policies on exposure to real estate. The information regarding the NBC can be accessed from the website of Bureau of Indian Standards (www.bis.org.in). Banks should also adopt the National Disaster Management Authority (NDMA) guidelines and suitably incorporate them as part of their loan policies, procedures and documentation.

Financing of Joint Ventures

1.27 Banks are allowed to provide at their discretion, buyer's credit/acceptance finance to overseas parties for facilitating export of goods & services from India. The above exposure will, however, be subject to a limit of 20 percent of banks' Unimpaired Capital Funds (Tier I and Tier II Capital), subject to the conditions prescribed in the Master Circular dated July 1, 2013 on Exposure Norms.

Nature of Advances

1.28 Banks provide advances to their customers in various forms like, cash credit, term loans, overdrafts, and purchase or discounting of bills etc. The principal features of various types of advances are briefly described below.

Cash Credit

1.29 Cash credit facility is provided mainly to individuals or enterprises engaged in manufacturing and trading activities to enable them to meet the gap in their working capital requirements and is repayable on demand. The cash credit facility is generally granted against the security of stocks of goods, standing crops, bills / book debts representing genuine sales – all belonging to the borrower. As regards the quantum of the collateral security to be obtained in relation to the amount secured thereby, there are no hard and fast rules. Nevertheless, in determining the quantum of collateral security, the sanctioning authorities have to adhere to guidelines/norms of the bank concerned.

1.30 The cash credit advances are generally on 'floating' interest rate basis. The rate is reset periodically, depending upon any changes in the bank's base rate / spread in relation to the class of borrower / risk perception about the borrower.

1.31 It is a common practice among banks to obtain third party guarantees for repayment of cash credit facilities. The guarantors may be either directly connected with the borrowing entity (e.g., partners in the case of a partnership firm / directors in the case of a company / holding company for a subsidiary company) or they may be independent persons (individuals – singly or jointly, companies, etc.) who are considered 'good' for the amount involved. Banks prepare reports (called 'opinion reports' in some banks) about the credit worthiness of the guarantors at the time of stipulating their guarantees and update these reports periodically – annually or at the time of review of the credit facility.

Working Capital Demand Loan (WCDL)

1.32 WCDL is granted for a fixed period on the expiry of which it has to be liquidated, renewed or rolled over.

Term Loans

1.33 Term loans are repayable in instalments spread over a period of time generally after the moratorium period. The moratorium (period during which no principal / interests to be paid) is decided based on the requirement and cash generation capability of the borrower. However, if there is a default in meeting the commitments by the borrower, the bank has the right to demand repayment of the entire loan outstanding, including the instalments which have not yet fallen due for payment. The amount and periodicity of repayment is fixed at the time of sanction and is duly recorded in the loan documents. The amount and the periodicity may be uniform throughout the life of the loan, or either or both

of them may differ from instalment to instalment. Besides, repayment schedule may either be drawn only for the principal amount in which case periodic interest has to be paid by the borrower separately as and when due, or a schedule may be fixed with 'equated monthly instalments' which also includes the amount of interest likely to be applied to the account during its entire tenure at the rate of interest applicable at the time of sanction/documentation/first disbursement. The disbursal is by way of a limited number of debits and cheque books are not issued.

1.34 The interest rate for loans may be either on 'fixed' terms in which event the rate contracted originally holds good during the entire currency of the loan, or it may be on 'variable' terms which means that the rate may undergo changes at unspecified periods on happening of certain events as outlined in the loan agreement. This aspect is a subject matter of negotiation between the bank and the borrower.

1.35 The term loans are generally extended for the following purposes:

- For setting up of plants, acquisition of fixed assets like land and building, plant and machinery, furniture, vehicles, implements, houses, consumer durables, etc.
- For meeting expenses on education / medical treatment of self/dependants.
- For meeting other personal expenses.
- For meeting deficit in the net working capital requirements as assessed by the bank.(WCTL)
- For Marketing / Launching / Branding etc.

1.36 Banks give general purpose loans also, i.e., without stipulating any end-use of funds, on the strength of a suitable collateral security (normally mortgage of immovable properties), or even without security based on the credit worthiness of the borrower.

Foreign Currency Loans

1.37 Banks are authorised to lend in foreign currency. These loans are given as per the EXIM Policy and guidelines issued by Reserve Bank of India from time to time. Foreign Currency Loans (including External Commercial Borrowings) may be in nature of Term loans or Working Capital loans.

Overdrafts

1.38 Overdraft facility is granted to a current account holder. Under the arrangement, the customer can draw upto an agreed sum in addition to his credit

balance in the account. The overdraft facility may be either secured or clean (i.e., without security) and does not generally carry a repayment schedule. The most common form of security for an overdraft arrangement is term deposit receipts issued by the same branch where the overdraft is availed of. In some cases, overdraft facility may be granted by a branch against the term deposit receipts issued by other branches of the bank. In such cases, care is taken to ensure that the branch which has issued the term deposit receipt confirms in writing to the lending branch that it has noted a lien on the deposit in favour of the latter in its records. Overdrafts may also be granted against other securities like life insurance policies, shares, bonds, NSCs, Kisan Vikas Patras, Indira Vikas Patras, etc.

Bills

1.39 The finance against bills is meant to finance the actual sale transactions. The finance against bills can be in any of the below mentioned form:

- Purchase of bills by the bank if these are payable 'on demand'.
- Discounting of bills by the bank if these are usance (or time) bills.
- Advance against bills under collection from the drawees, whether sent for realisation through the bank or sent directly by the drawer to the drawees.

1.40 A unique kind of facility under this head is advances against bills drawn on public sector undertakings / government departments which do not accept bills. In such cases, pre-receipted challans are submitted by the borrower to the bank as an evidence for availing finance there against (a pre-receipted challan establishes genuine movement of goods and ensures that the funds of the bank are used for sanctioned purposes only). This facility is commonly known in the banking sector as 'government bills facility' or 'supply bills facility'. It may also be mentioned that the purchase / discounting of bills may be either under a letter of credit issued by another bank (which ensures the realisation of the bill amount) or without a letter of credit. In case of dishonour of bills, banks have the right to recover the amount from the drawer with penalty, additional interest, etc.

1.41 Bills may be either 'documentary', i.e., accompanied by the original documents of title to the goods, or 'clean', i.e., without the original documents of title to the goods. In the case of documentary bills, the bank releases the documents of title to the drawee only against payment (in the case of demand bills purchased) or against acceptance (in the case of usance bills discounted). On release of documents of title after acceptance of usance bills, these also assume the nature of clean bills.

1.42 The RBI has issued guidelines for regulation of discounting and rediscounting of bills (Ref. Master Circular No. DBOD.No.Dir.BC.14/13.03.00/2013-14, dated July 01, 2013, "Loans and Advances-Statutory and other Restrictions")

Export Credit

1.43 Exporters are also granted facilities in the form of cash credit and bills only but, being of a special nature, require a separate mention here. These facilities extended to exporters are in the form of 'pre-shipment credit' and 'post-shipment credit'. All advances required to finance the production cycle – from procurement of raw materials to bringing them to the port for despatch fall under 'pre-shipment credit' category. It also includes financing of working capital expenses towards rendering of services. The advance is given either on the basis of individual order obtained, or the customer is sanctioned an export packing credit (EPC) limit and the advances are disbursed on production of individual orders; in the latter case, EPC becomes a running account. The exporter usually adjusts the account by drawing bills of exchange on the foreign buyer, which are discounted by the bank under the letter of credit and the proceeds collected from the foreign bank. The post-shipment credit relates to financing of bills raised on the overseas buyer upon shipment of goods/services. Another feature of export credit is that the advance may be granted in Indian Rupees or a designated foreign currency. In the latter case, the loan is disbursed in a foreign currency but, for the purpose of accounting, converted into rupees. The export credit is granted at concessional rates of interest. The pre-shipment credit has to be liquidated out of the export proceeds only and cannot be adjusted out of rupee funds (except where the raw materials required for processing exceed the FOB value of the contract, in which the excess advance has to be repaid within a maximum of 30 days from the date of advance). The export proceeds have normally to be received within 180 days from the date of shipment. The period can be extended in genuine cases, with the approval of the bank (within the discretion available to it under the regulations in force at the relevant time) or of the RBI, as permitted by the Exchange Control Manual and the operating instructions issued by the Reserve Bank from time to time. The bills representing the export proceeds can be handled only by branches permitted to act as authorised foreign exchange dealers as they involve handling transactions in a foreign currency and reporting to Reserve Bank.

1.44 Pre-shipment credit granted in a foreign currency is called 'Packing Credit in Foreign Currency' (PCFC) advance and has to be repaid out of the export bills discounted under the Export Bills Rediscounting (EBR) scheme. Each bank designates a few select branches to handle PCFC and EBR

transactions. The Rupee Export credit is also allowed to be shared between export order holders and manufacturer of the goods to be exported. Similarly, bank may extend PCFC also to the manufacturer on the basis of disclaimer from the export order holder through his bank. PCFC granted to the manufacturer can be repaid by transfer of foreign currency from the export order holder by availing of PCFC or by discounting of bills. It should be ensured that no double financing is involved in the transaction and total period of packing credit is limited to the actual cycle of production of the exported goods. (Ref.: Para 5.1.11 of the Master Circular No. DBOD No.DIR.BC.16/04.02.002/2013-14 dated July 01, 2013, "Rupee/Foreign Currency Export Credit & Customer Service to Exporter"). PCFC may be made available to both the supplier of EOU/EPZ/SEZ unit and the receiver of EOU / EPZ / SEZ unit and PCFC for supplier EOU / EPZ / SEZ unit will be for supply of raw material/components of goods which will be further processed and finally exported by receiver EOU / EPZ / SEZ unit. The PCFC extended to the supplier EOU/EPZ/SEZ unit will have to be liquidated by receipt of foreign exchange from the receiver EOU/EPZ/SEZ unit, for which purpose, the receiver EOU/EPZ/SEZ unit may avail of PCFC. The stipulation regarding liquidation of PCFC by payment in foreign exchange will be met in such cases not by negotiation of export documents but by transfer of foreign exchange from the banker of the receiver EOU/EPZ/SEZ unit to the banker of supplier EOU/EPZ/SEZ unit. Thus, there will not normally be any post-shipment credit in the transaction from the supplier EOU/EPZ/ SEZ unit's point of view. In all such cases, it has to be ensured by banks that there is no double financing for the same transaction. Needless to add, the PCFC to receiver EOU/EPZ/SEZ unit will be liquidated by discounting of export bills. Ref Master Circular DBOD. No.DIR.BC.16/04.02.002/2013-14 dated July 01, 2013, "Rupee/Foreign Currency Export Credit & Customer Service to Exporter"). In this context, attention of the readers is also invited to RBI's Circular No. DBOD.Dir.BC.NO.57/04.02.001/2013-14 on "Export Credit in Foreign Currency" dated September 25, 2013.

Security

1.45 A brief reference has been made in the preceding section to the types of securities commonly accepted by banks for granting different kinds of credit facilities. In this section, the aspect will be examined in greater detail.

Mode of Creation of Security

1.46 Depending on the nature of the item concerned, creation of security may take the form of a mortgage, pledge, hypothecation, assignment, or set-off.

Mortgage

1.47 Mortgage has been defined under section 58 of the Transfer of Property Act, 1882, as “the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to a pecuniary liability”.

1.48 Mortgages are of several kinds but the most important are the Registered Mortgage and the Equitable Mortgage. A Registered Mortgage can be affected by a registered instrument called the ‘Mortgage Deed’ signed by the mortgagor. It registers the property to the mortgagee as a security. Equitable mortgage, on the other hand, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof.

Pledge

1.49 A pledge is defined under section 172 of the Indian Contract Act, 1872, as “the bailment of goods as security for payment of a debt or performance of a promise.” A pledge thus involves bailment or delivery of goods by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance. The legal ownership of the goods remains with the pledger while the lending banker gets certain defined interests in the goods. The pledge of goods constitutes a specific (or fixed) charge. In a pledge, the bank has all the liabilities and responsibilities of a bailee of goods. The bank may be held responsible for not carrying out their obligations as bailee.

Hypothecation

1.50 The term ‘hypothecation’ is not defined in law. In commercial parlance, the term refers to the creation of an equitable charge (i.e., a charge created not by an express enactment but by equity and reason), which is created in favour of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower. Neither ownership nor possession is transferred to the bank. However, the borrower holds the physical possession of the goods as an agent/trustee of the bank. The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker on the basis of which the drawing power of the borrower is fixed. From the view point of the lending bank, hypothecation is more risky than pledge since the borrower can dispose of the hypothecated assets or pledge them or create another hypothecation on them without the knowledge of the bank, specially in the case

of borrowers other than companies where there is no requirement for registration of charge.

Assignment

1.51 Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favour of another person. Only actionable claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment. An assignment gives the assignee absolute right over the moneys/debts assigned to him. The transfer of debt, right or property is subject to all the liabilities and equity to which the transferor was subject on the date of transfer. In other words, the assignee cannot get a better title than that of the assignor.

Set-off

1.52 Set-off is a statutory right of a creditor to adjust, wholly or partly, the debit balance in the debtor's account against any credit balance lying in another account of the debtor. A lending bank has the right of set-off in the absence of an agreement, express or implied, to the contrary with the borrower. The right of set-off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and in the same right (i.e., the capacity of the account holder in both the accounts should be the same). For the purpose of set-off, all the branches of a bank are treated as one single entity. The right of set-off can be exercised in respect of time-barred debts also.

Types of Securities

1.53 The characteristics of a good security from the viewpoint of the lending bank are marketability, easy ascertain ability of value, stability of value, and transferability/transportability. The most common types of securities accepted by banks are the following.

Stock Exchange Securities and Other Instruments

1.54 Stock exchange securities include shares, debentures and bonds in which dealings take place on a stock exchange. These securities are easily marketable; their market value is readily ascertainable; it is easy to ascertain the title of the depositor; and they are easy to pledge. In addition to stock exchange securities, banks also make advances against such instruments as gilt-edged securities, National Savings Certificates, Kisan Vikas Patras, Indira

Vikas Patras, Gold Bonds, etc. (It may be noted that the banks are not allowed to provide loans to companies for buy back of shares / securities).

1.55 The above securities are usually in the possession of the bank. Wherever the shares are held as security by a bank (whether as primary or as collateral security), banks are required to have them transferred in their own names if the loan amount exceeds the ceiling prescribed by RBI. The ceiling may be different for shares in dematerialised form and those in physical form. In other cases, (i.e., where the loan amount does not exceed the prescribed ceiling), banks accept the aforesaid securities subject to the following conditions:

- (a) in the case of physical shares, if they are accompanied by blank transfer deeds duly signed by the person in whose name they are registered; in case of shares held in dematerialised form, authorisation slips should be obtained from the borrower and should be passed on to relevant depository participant who immediately marks those shares as pledged or:
- (b) if the bank holds a general power of attorney from the person in whose name they are registered.

1.56 If the person in whose name the securities are registered is other than the borrower, the bank has to particularly satisfy itself that the person has a good title to the security. The bank also obtains a letter of renunciation from the person in whose name the securities are registered.

1.57 In the case of advances against bearer securities (Kisan Vikas Patras/ Indira Vikas Patras), banks obtain independent confirmation of the genuineness of the certificates from issuing authorities. In the case of bearer securities, only possession by the bank is sufficient.

1.58 In the case of government paper and inscribed stock, the banks should get them registered in their own name while accepting them as security.

1.59 Before accepting shares as security, the lending bank has to ensure that the provisions of section 19 of the Banking Regulation Act, 1949 are not contravened. This section prohibits a banking company from holding shares in any company, whether as pledge, mortgagee or absolute owner, of an amount exceeding thirty per cent of the paid up share capital of that company or thirty per cent of its own paid-up share capital and reserves, whichever is less.

Goods

1.60 Goods constitute a significant proportion of the securities taken by banks. They are either the stock-in-trade of its trading customers or the

finished products of manufacturers. Raw materials, work-in-process, etc., are also accepted as security. Banks should have a system in place to ensure that the borrower does not take advantage of double financing on same stock, i.e., in respect of unpaid stocks.

1.61 Goods may be either hypothecated to, or pledged with, the bank. As mentioned earlier, in case of hypothecation of goods, banks obtain periodic statements from the borrowers (generally, monthly), declaring the quantity and value of the goods on the basis of which the drawing power of the borrowers is fixed. The officers of the lending bank pay regular visits to godowns or factories of the borrowers to inspect them and to check the correctness of records maintained by the borrowers on the basis of which, the periodic statements are prepared by them. They also check the value of the goods in stock with reference to sale bills, market quotations, etc. In case of large advances, the inventory are subject to inspection and verification (stock audit) by external agency at stipulated intervals. The branch auditor may go through the same for determining existence and adequacy of security and also to determine the irregularity in the account, if any.

1.62 Stock registers are maintained by the godown keepers of the lending bank in respect of goods pledged with the bank. The godowns are regularly inspected by the inspectors and other officers of the bank. When goods are brought into the godown, the godown keeper has to satisfy himself, by appropriate test checks, regarding the quantity and quality of goods. Banks have to exercise care to ensure that frauds are not perpetrated against them by pledging packages not containing the specified goods and later on holding them responsible for the goods supposed to have been pledged according to the documents.

1.63 The goods are insured against fire and other risks involved and the insurance policies are either in the name of, or endorsed in favour of, the bank.

1.64 In case the borrower is a company, the bank has to ensure that charge on the goods hypothecated is registered with the Registrar of Companies.

Documents of Title to Goods

1.65 A document of title to goods is a negotiable or quasi-negotiable instrument. According to section 2(4) of the Sale of Goods Act, 1930, a document of title is any document used in the ordinary course of business as proof of the possession or control of goods, or authorising or purporting to authorise, either by endorsement or by delivery, the possessor of the document to transfer or receive the goods represented thereby. Documents of title include:

- Bill of lading
- Railway receipt
- Transporter's receipt
- Dock warrant
- Warehouse-keeper's certificate
- Wharfinger's receipt
- Warrant or order for delivery of goods

1.66 Before being pledged with the bank, these documents have to be appropriately endorsed in favour of the bank.

Gold Ornaments and Bullion

1.67 Gold ornaments are accepted by banks as security on the basis of assessor's certificate regarding the content, purity and weight of gold and the value thereof. Valuation, however, keeps changing as a result of market fluctuations. Loans are given only on the basis of gold content of ornaments, no regard being had to labour charges. RBI has *vide* its Master Circular No. DBOD.No.Dir.BC.14/03.03.00/2013-14 on Loan and Advances-Statutory and Other Restrictions dated July 1, 2013, directed banks to give preference to hallmarked jewellery for granting advances. RBI has *vide* its Circular No. DBOD.BP.BC.No.86/21.01.023/2013-14 on "Lending against Gold Jewellery" dated January 20, 2014 issued guidance in respect of Advances against Gold Ornaments and Jewellery for the purpose of Medical Expenses and Meeting Unforeseen Liabilities". In this context, attention of the readers is also invited to RBI's Circular No. DBOD.No.BP.79/21.04.048/2013-14 on "Non-Agriculture Loans against Gold Ornaments and Jewellery" dated December 30, 2013 containing guidelines on bullet repayment of loans extended against pledge of gold ornaments and jewellery for other than agricultural purposes.

Life Insurance Policies

1.68 Life insurance policies have to be assigned in favour of the bank and such assignment has to be registered with the insurer. The surrender value of the policies is taken as the basis of valuation.

Plantations

1.69 Advances are made to agriculturists such as tea gardeners to finance their growing crops. When the produce is harvested, processed and sold, the money is repaid to the bank.

1.70 The basis of calculating the amount of the advance is the estimated crop of the season. This depends upon the area under cultivation, expected yield, etc. Separate advances are made for each season's crop.

1.71 The crop to be produced is hypothecated to the bank. Generally, the fixed assets of the plantation are also mortgaged with the bank as collateral security. Finance is taken from the bank to incur expenditure on the crop. As such, the amount of the advance increases as the crop grows.

Immovable Property

1.72 Before advancing money on mortgage of immovable property, the lending bank has to satisfy itself that the borrower has a clear and unencumbered title to the property, and that the property is marketable and adequately insured. In respect of advances to public companies against the mortgage of a block of assets, it is essential that the provisions of section 293 (1)(a) of the Companies Act, 1956* need to be kept in view.

Third Party Guarantees

1.73 Advances covered only by the personal guarantee of third parties (except banks and government) in addition to the personal security of the borrower are not 'secured' advances and would be classified as 'unsecured' in the balance sheet.

1.74 The guarantee bond executed by the guarantor in favour of the bank may be in bank's own prescribed form or otherwise. Such bonds are generally executed by holding companies, overseas customers, overseas principals, insurance companies, etc. A letter of continuity is also obtained from the guarantor.

1.75 Banks sometimes also require the guarantor to give a collateral security. In such a case, the advance ceases to be an unsecured advance to the extent of the value of the security.

Banker's General Lien

1.76 Besides the above securities, which are created by an agreement between the borrower and the bank, a lending bank also has a general lien under the law. A lien represents the right of retaining the goods/securities unless a debt due by a debtor is paid to the creditor (retainer), provided there is no agreement, express or implied, to the contrary. A lien is a statutory right, which does not require any separate agreement. Under section 171 of the Indian Contract Act, 1872, a banker may, in the absence of an agreement to the contrary, retain as security for a general balance of account, any goods and securities bailed to him. This is called banker's general lien. Two conditions necessary for creating such lien are:

* Corresponding to Section 180(1)(a) of the Company Act, 2013 as notified by the Central Government vide notification dated 12th September, 2013.

- (a) the securities must have been placed in his hands as a banker by his customers; and
- (b) they are not specifically appropriated.

1.77 Examples of securities over which a banker has general lien are credit balance in any other account, bonds and coupons deposited for collection, securities allowed to remain in the banker's hands after repayment of a secured advance, etc. Examples of securities on which a banker does not have a general lien are securities deposited for safe custody, money deposited or earmarked for a specific purpose, documents executed for a special purpose, etc. Lien is applicable even in respect of the borrower's obligations as a surety. The banker's right of general lien over the security is not barred by the law of limitation and can be exercised in the case of unenforceable or time-barred debts also.

Negative Lien

1.78 The term 'negative lien' is commonly used to refer to an undertaking given by the borrower to the bank that he (i.e., borrower) will not create any charge such as lien, pledge, hypothecation, or mortgage, over his immovable and moveable properties and assets including uncalled capital without the prior permission of the bank. A negative lien relates to goods, securities, etc., which are not in the possession of the bank. Negative lien does not require registration with the Registrar of Companies or similar other authorities.

Sectoral Distribution

1.79 Advances are required to be classified, *inter alia*, into those in India and those outside India, with further sub-classification under each category. One such sub-classification that merits discussion from an auditor's perspective is advances in India to priority sectors.

1.80 Priority sector advances include:

- Advances for agriculture and other allied activities – However, RBI, *vide* its circular no. RPCD.CO.Plan.BC. 51 /04.09.01/2010-11 dated February 2, 2011 on "Classification of loans against gold jewellery" clarifies that loans sanctioned to NBFCs for on-lending to individuals or other entities against gold jewellery, are not eligible for classification under agriculture sector. Similarly, investments made by banks in securitised assets originated by NBFCs, where the underlying assets are loans against gold jewellery, and purchase/assignment of gold loan portfolio from NBFCs are also not eligible for classification under agriculture sector.

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- RBI *vide* its master circular no RPCD. FID. BC.No. 10 / 12.01.033/ 2013-14 dated July 01, 2013 has provided details on SHG- Bank linkage Programme. In order to enable the banks to report their SHG lending without difficulty, it was decided that the banks should report their lending to SHGs and/or to NGOs for on-lending to SHGs/members of SHGs under the new segment, *viz.* 'Advances to SHGs' irrespective of the purposes for which the members of SHGs have been disbursed loans. Lending to SHGs should be included by the banks as part of their lending to the weaker sections (under priority section).
- Advances to minority communities
- Advances to micro/small/medium scale enterprises²
- Advances to small road transport operators
- Advances to retail traders and small business enterprises
- Advances to professionals and self employed
- Advances sanctioned to State sponsored organisations for scheduled castes/scheduled tribes
- Educational loans upto the prescribed limit – RBI, *vide* its circular no. RPCD.SME&NFS.BC.No. 69/06.12.05 /2009-10 dated April 12, 2010 on “Collateral Free Loans - Educational Loan Scheme”, clarified that banks must not, mandatorily, obtain collateral security in the case of educational loans upto Rs. 4 lakh.
- Housing loans upto prescribed limits³
- Funds provided to RRBs
- Micro credit⁴
- Any other priority sector advances, such as SEPUP (Self-Employment Programme for Urban Poor), PMRY (Prime Minister's Rozgar Yojana), SEEUJ (Self-Employment Scheme for Educated Unemployed Youth)

² The RBI has issued a master circular no. RPCD.MSME & NFS. BC. No. 05/06.02.31/2013-14 on “Lending to Micro, Small and Medium Enterprises (MSME) Sector” dated July 1, 2013. Also refer to the circular no. RPCD.SME & NFS.BC.No.79/06.02.31/2009-10 dated May 6, 2010 on “Working Group to Review the Credit Guarantee Scheme for Micro and Small Enterprises (MSEs) – Collateral free loans to MSEs”.

³ Attention is also invited to circular no. DBOD.No.BP.BC. 69 /08.12.001/2010-11 dated December 23, 2010 on “Housing Loans by Commercial Banks – LTV Ratio, Risk Weight and Provisioning”, circular no. RPCD.MSME & NFS.BC.No. 30 /06.11.01/ 2012-13 dated September 18, 2012 on “Scheme of 1% interest subvention on housing loans up to Rs. 15 lakh” and Master circular no. DBOD. No.DIR.BC.17/08.12.001/2013-14 dated July 1, 2013 on “Housing Finance”.

⁴ The RBI has issued a master circular no. RPCD.MFFI.BC.No. 05/12.01.001/2010-11 dated July 1, 2010 on “Micro Credit”.

SGSY (Swarnajayanti Gramswaraj Swarojgar Yojana)⁵, SJSRY (Swarnajayanti Sahakari Rozgar Yojana).

1.81 Priority sector advances generally carry an interest rate, which is lower than the normal rate of interest on lending to other sectors. These advances are also known as DRI advances, i.e., advances on which differential rate of interest is applicable. Under the Reserve Bank of India's guidelines, a specified proportion of the total advances of banks are to be made to priority sectors necessarily. Depending upon the nature and type of facilities extended, the bank may get subsidy from the Government to fully or partly offset the shortfall in interest rate and/or get indemnified for bad debts for the whole or a portion of such advances.

Nature of Borrowing Arrangements

1.82 The following paragraphs explain the different ways in which a banking arrangement can be tied up by a borrower.

Sole Banking

1.83 In this arrangement, the borrower obtains credit from a single bank. This is the simplest form of tie-up and is operationally convenient for both the lender and the borrower. Most of the banking tie-ups in India are of this type because the quantum of bank finance in an individual case is usually small. Depending on the nature and extent of credit facility offered, the lending bank itself may stipulate that the borrower will not avail of finance from another bank.

Consortium Arrangement

1.84 In this type of arrangement, the number of lending banks is more than one. The lending banks form a formal consortium. Salient features of the arrangement are:

- The consortium has a formal leader, called the 'lead bank' (normally, the bank with the largest exposure).
- The consortium frames and adopts its own ground rules for conducting its business with the borrower.
- There is a common set of loan documents, which is obtained by the lead bank on behalf of other participating banks also.

⁵Attention is the reader is drawn to a master circular No. RPCD.GSSD. BC. No.1/09.16.01/2013-14 dated July 1, 2013 on "Priority Sector Lending - Special Programmes - Swarnajayanti Gram Swarozgar Yojana (SGSY)" and Circular No. RPCD.GSSD .BC.No.30 /09.01.01/2010 -11 dated December 15, 2010 on "Swarnajayanti Gram Swarozgar Yojana (SGSY) - Group Life Insurance Scheme".

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- The lead bank is responsible for overall monitoring.
- The member banks of the consortium have rights over the security in an agreed proportion.
- The borrower maintains direct business relationship with all member banks of the consortium.
- Minutes of the consortium meetings are circulated amongst the members.

Multiple Banking

1.85 In this type of arrangement, there is no formal arrangement amongst the lending banks. Each of them has its set of loan documents, securities and mode of lending, independent of other lending banks. The borrower has to deal with each of the banks separately.

1.86 The RBI, *vide* its Circular No. DBOD No. BP. BC.46/ 08.12.001/2008-09 dated September 19, 2008 on “Lending under Consortium Arrangement/Multiple Banking Arrangements”, encourages the banks to strengthen their information back-up about the borrowers enjoying credit facilities from multiple banks as under:

- (i) At the time of granting fresh facilities, banks may obtain declaration from the borrowers about the credit facilities already enjoyed by them from other banks, as prescribed in the RBI Circular No. DBOD.No.BP.BC.94 /08.12.001/2008-09 dated December 08, 2008 on “Lending under Consortium Arrangement/Multiple Banking Arrangements”. In the case of existing lenders, all the banks may seek a declaration from their existing borrowers availing sanctioned limits of Rs.5.00 crore and above or wherever, it is in their knowledge that their borrowers are availing credit facilities from other banks, and introduce a system of exchange of information with other banks as indicated above.
- (ii) Subsequently, banks should exchange information about the conduct of the borrowers' accounts with other banks at least at quarterly intervals.
- (iii) Obtain regular certification by a professional, preferably a Company Secretary, regarding compliance of various statutory prescriptions that are in vogue, as per specimen given in the RBI Circular.

Procedure for Sanction, Disbursement, Supervision and Renewal of Advances

1.87 Each bank has its own procedures for sanctioning, disbursing, supervising and renewing advances. However, despite some differences, the following steps are more or less common to all banks.

Sanction

1.88 The starting point is the receipt of a formal request from the applicant. The request may be in the form of a standard format of the bank or in the form of a letter in which case the bank requests the intending borrower to furnish the standard format duly filled in. All applications are entered in a Loan Applications Received Register (the exact nomenclature may vary from bank to bank). The required supporting documents are to be furnished along with the application. The Bank should ensure that the documents are obtained from respective borrowers as per the Loan policy of the Bank.

Assessment of Credit Worthiness of Borrower

1.89 The proposal is evaluated in the context of the directions of the RBI including prudential exposure limits and the bank's own risk management guidelines. Besides, the proposal is appraised on the following parameters to ensure that it is technically feasible, economically viable and commercially acceptable (the degree of scrutiny depends largely on the amount of the advance):

- Performance of the unit *vis-a-vis* other similar units.
- Conduct of its accounts with the lenders.
- Experience, competence and profile of the management of the unit.
- Guarantees and collateral securities offered.
- Trend and ratio analysis to see that the unit's growth is healthy, financials are sound, liquidity is comfortable and the promoters have a reasonable stake in the unit.
- Availability of inputs for production.
- Market.
- Technology in use.
- Unit's capability to achieve the projected operating and performance levels and to service the debt.
- Applicability of norms/benchmarks relating to scale of finance, e.g., Nayak Committee recommendations for SSI units, scale of finance fixed by the bank for agricultural finance to be extended in the local area, etc.
- CIBIL, RBI List of defaulter, Credit report from other banks. These are to be checked from respective websites.
- Latest Govt. policy about particular industry / Locational restriction, etc.

1.90 If the official concerned finds the proposal acceptable, he prepares a detailed appraisal note and submits it along with necessary supporting

documents and its recommendations to the authority having powers to sanction it. Each official who has been vested with powers to sanction advances has a monetary ceiling upto which he can sanction advances to the specified kind of borrowers (like individuals, partnerships, companies, etc.) and/or for the specified activities (like agriculture, industry, professional education, business, etc.) and / or for the type of facility (term loan, overdraft, cash credit, etc.). Such powers are properly documented and circulated by the bank to all its offices. The officials at the branch can sanction only those advances, which fall within their delegated powers. For advances, which require to be sanctioned by higher authorities, the branch has to carry out the appraisal and send the proposal along with its recommendations to its controlling office for necessary sanction. As and when the advance is sanctioned by the competent authority (which could be an official, a committee of officials or the board of directors of the bank, depending on the amount involved), the fact of sanction along with detailed terms and conditions of the sanction are communicated by the controlling office to the branch.

Disbursement

1.91 After the sanction of the advance, the branch communicates the terms and conditions of the sanction to the applicant and obtains their consent for the arrangement. Thereafter, the documents as prescribed by the bank are obtained, charges created and, if required, the bank's charge over the unit's assets noted with the authorities concerned, e.g., Registrar of Companies, Road Transport Authority, insurance company, land records authority, CERSAI, etc. In the case of an advance to a partnership firm, while the account is opened in the trade name of the firm, the security documents are got executed from the partners in both their individual capacity (i.e., without mentioning the name of the firm or affixing the stamp of the firm) and in their capacity as partners of the firm. This is to ensure that the advance may be recovered from the assets of the firm as well as from the individual assets of the partners.

1.92 After the above formalities have been completed, the advance is released in the following manner:

- Term loans (granted generally for acquisition of fixed assets, etc.) are disbursed on the basis of quotations/ proforma invoices obtained by the borrower from the vendors and submitted to the bank either along with the application or later. In case of large projects, the schedule and status of completion of projects have also to be seen. Banks generally stipulate a stated percentage of the cost to be met by the borrower from his own funds. Once the borrower provides his contribution to the bank, the branch debits the Term Loan account with the balance amount and pays the

amount to the vendor directly along with a letter stating the purpose of the funds. The term loan may be released in one or more instalments. As and when the asset is received by the borrower, the bank officials inspect it, record the particulars in their books, and obtain copies of the final invoices for their record from the borrower.

- There may be instances where, on business considerations, the borrower has already acquired the asset. In such a case, he submits the documentary evidence to the branch and seeks reimbursement to the extent permissible. The branch officials inspect the asset and books of account of the borrower and, if satisfied, credit the eligible amount to the borrower's account (current / cash credit, as desired by the borrower) by debiting his term loan account.
- Cash credit advances are released on the basis of the stock statements relating to the security (which may be book debts, stock-in-trade, etc.) submitted by the borrower as per the periodicity laid down in the terms of sanction. The branch officials verify the statements (in some cases, tangible securities like stock-in-trade are also physically verified) and calculate what is called the 'drawing power' based on the stocks of the security held by the borrower and the margin prescribed in the sanction. This 'drawing power' is noted in the system in respect of Cash Credit accounts and is a guide to the official concerned while authorising debits to the account.
- The procedures of many banks require the branch manager to periodically submit a certificate to the controlling authority (i.e., regional or zonal office) that all disbursements during the relevant period have been made only after completion of the necessary formalities.

Monitoring and Supervision

1.93 The following are the procedures usually adopted by banks for monitoring and supervision of advances after disbursement:

- Regular inspection of the borrower's assets and books. The main purposes of inspection are as follows:
 - To ensure that the amounts disbursed have been utilised for purposes for which the advance was sought.
 - To check that the borrower has not acquired / disposed of any asset without the consent / knowledge of the bank, depending upon the terms of the advance. Acquisition of fixed assets from working capital funds may amount to diversion of short-term funds which, from the viewpoint of the bankers, is not a sign of financial prudence.

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- To cross-check the figures declared in the stock statements with the books maintained by the borrower (including excise and other statutory records, if applicable) as well as to physically verify the stock items, to the extent possible.
 - To check that the unit has been working on projected levels particularly in the areas of sales and production and the general working of the unit is satisfactory.
 - To ensure that the borrower has not availed of finance against stocks for which it has itself not made the payment.
 - To ensure that the borrower has not availed of finance from any other lender unauthorisedly.
 - To ensure that the borrower has not made any investment in, or advances to, its associates without the bank's approval, if such approval is required as per the terms of the loan or otherwise diverted the funds.
 - To check that there is a regular turnover of stocks and the unit does not carry any obsolete, unusable stocks. Generally, banks place a limit on the age of stocks which are eligible for bank finance; the items older than such limit are not financed. Similarly, in the case of book debts, debts outstanding beyond a specified period are also not eligible for bank finance.
 - To ensure that the borrower continues to be engaged in the activity for which the loan has been granted.
- Periodic review of the progress in implementation of the project.
 - Review of the conduct of the account.
 - Obtaining and scrutinising stock statements.
 - Obtaining other relevant financial data periodically and analysis of the data. Banks obtain information at monthly / quarterly / half yearly / yearly intervals about on the levels of sales, production, profit, cash accruals, break up of assets and liabilities, cash flows etc. The analysis covers the following points:
 - Comparison of the data with the projections contained in the appraisal note to find out the deviations, the reasons thereof, and the corrective action to be taken, wherever necessary.
 - Comparison of the unit's performance, on an on-going basis, with other similar units.

- Ratio analysis based on the provisional data submitted by the unit to find out the liquidity and solvency position and any diversion of short-term resources towards long term uses.
- Observing the credits to the account.
- Whenever the above analysis indicates weaknesses in operations, or the need for additional documentation or security, a dialogue is held with the borrower, with consequent follow-up.
- RBI, vide its circular no. DBS.CO.PPD.BC.No. 5 /11.01.005/2010-11 dated January 14, 2011 on “End Use of Funds - Monitoring” has advised to evaluate and strengthen the efficacy of the existing machinery in the banks for post-sanction supervision and follow-up of advances. There needs to be a proper process of stock audit of the borrowers. Effective monitoring of the end use of funds lent is of critical importance in safeguarding a bank’s interest. Further, this would also act as a deterrent for borrowers to misuse the credit facilities sanctioned, and in the process, help build a healthy credit culture in the Indian banking system.

Renewal of Advances

1.94 Working capital advances are generally granted for one year at a time and require renewal if the borrower wants continuation of the facility beyond that period at the same level, reduced level or increased level, depending upon the unit’s needs, its ratios, the bank’s perception of risk and so on. Loans repayable over a period of time in instalments are not renewed. However, some banks have a system of reviewing these loans from time to time primarily with the objective of risk evaluation and interest rate resetting.

1.95 The procedure described above for sanction of advances is also followed, to the extent applicable, for renewal of advances already granted to an applicant.

Restrictions on Advances

1.96 The master circular no. DBOD.No.Dir.BC.14/13.03.00/2013-14 dated July 1, 2013, on “Loans and Advances- Statutory and other Restrictions” issued by the RBI contains detailed requirements and guidelines in respect of statutory and other restrictions on loans and advances by banks.

Statutory Restrictions

Advances against Bank’s own Shares

1.97 In terms of Section 20(1) of the Banking Regulation Act 1949, a bank cannot grant any loan or advance against the security of its own shares.

Advances to Bank's Directors

1.98 Section 20(1) of the Banking Regulation Act, 1949 also lays down the restrictions on loans and advances to the directors and the firms in which they hold substantial interest.

1.99 Banks are prohibited from entering into any commitment for granting any loans or advances to or on behalf of any of its directors, or any firm in which any of its directors is interested as partner, manager, employee or guarantor, or any company (not being a subsidiary of the banking company or a company registered under Section 25 of the Companies Act, 1956*, or a Government company) of which, or the subsidiary or the holding company of which any of the directors of the bank is a director, managing agent, manager, employee or guarantor or in which he holds substantial interest, or any individual in respect of whom any of its directors is a partner or guarantor. There are certain exemptions given in the aforesaid Master Circular in this regard.

1.100 For the above purpose, the term 'loans and advances' shall not include the following:

- (a) loans or advances against Government securities, life insurance policies or fixed deposit;
- (b) loans or advances to the Agricultural Finance Corporation Ltd;
- (c) such loans or advances as can be made by a banking company to any of its directors (who immediately prior to becoming a director, was an employee of the banking company) in his capacity as an employee of that banking company and on the same terms and conditions as would have been applicable to him as an employee of that banking company, if he had not become a director of the banking company. The banking company includes every bank to which the provisions of Section 20 of the Banking Regulation Act, 1949 apply;
- (d) such loans or advances as are granted by the banking company to its Chairman and Chief Executive Officer, who was not an employee of the banking company immediately prior to his appointment as Chairman/Managing Director/CEO, for the purpose of purchasing a car, personal computer, furniture or constructing/ acquiring a house for his personal use and festival advance, with the prior approval of the RBI and on such terms and conditions as may be stipulated by it;

* Corresponding to Section 8 of the Company Act, 2013, yet to be notified by the Central Government.

- (e) such loans or advances as are granted by a banking company to its whole time director for the purpose of purchasing furniture, car, Personal Computer or constructing/acquiring house for personal use, festival advance with the prior approval of RBI and on such terms & conditions as may be stipulated by it;
- (f) call loans made by banking companies to one another;
- (g) facilities like bills purchased/discounted (whether documentary or clean and sight or usance and whether on D/A basis or D/P basis), purchase of cheques, other non-fund based facilities like acceptance/co-acceptance of bills, opening of L/Cs and issue of guarantees, purchase of debentures from third parties, etc.;
- (h) line of credit/overdraft facility extended by settlement bankers to National Securities Clearing Corporation Ltd.(NSCCL) / Clearing Corporation of India Ltd. (CCIL) to facilitate smooth settlement; and
- (i) a credit limit granted under credit card facility provided by a bank to its directors to the extent the credit limit so granted is determined by the bank by applying the same criteria as applied by it in the normal conduct of the credit card business.

1.101 Purchase of or discount of bills from directors and their concerns, which is in the nature of clean accommodation, is reckoned as 'loans and advances' for the purpose of Section 20 of the Banking Regulation Act, 1949.

Restrictions on Power to Remit Debts

1.102 Section 20A of the Banking Regulation Act, 1949 stipulates that notwithstanding anything to the contrary contained in Section 293 of the Companies Act, 1956*, a banking company shall not, except with the prior approval of the Reserve Bank, remit in whole or in part any debt due to it by -

- any of its directors, or
- any firm or company in which any of its directors is interested as director, partner, managing agent or guarantor, or
- any individual, if any of its directors is his partner or guarantor.

Any remission made in contravention of the provisions stated above shall be void and have no effect.

* Corresponding to Section 180 of the Company Act, 2013, as notified by the Central Government vide notification dated 12th September, 2013.

Restriction on Holding Shares in Companies

1.103 In terms of Section 19(2) of the Banking Regulation Act, 1949, banks should not hold shares in any company except as provided in sub-section (1) whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30 percent of the paid-upshare capital of that company or 30 percent of its own paid-up share capital and reserves, whichever is less.

1.104 Further, in terms of Section 19(3) of the Banking Regulation Act, 1949, the banks should not hold shares whether as pledgee, mortgagee or absolute owner, in any company in the management of which any managing director or manager of the bank is in any manner concerned or interested.

1.105 Accordingly, while granting loans and advances against shares, statutory provisions contained in Sections 19(2) and 19(3) should be strictly observed.

Restrictions on Credit to Companies for Buy-back of their Securities

1.106 In terms of Section 77A(1) of the Companies Act, 1956*, companies are permitted to purchase their own shares or other specified securities out of their:

- Free reserves, or
- Securities premium account, or
- Proceeds of any shares or other specified securities,

subject to compliance of various conditions specified in the Companies (Amendment) Act, 1999. Therefore, banks should not provide loans to companies for buy-back of shares/securities.

Regulatory Restrictions

Granting Loans and Advances to relatives of Directors

1.107 Without prior approval of the Board or without the knowledge of the Board, no loans and advances should be granted to relatives of bank's Chairman/Managing Director or other Directors, Directors (including Chairman/Managing Director) of other banks and their relatives, Directors of Scheduled Co-operative Banks and their relatives, Directors of Subsidiaries/Trustees of Mutual Funds/Venture Capital Funds set up by the financing banks or other banks. However, banks may grant loan or advance to or on behalf of spouses of their Directors in cases where the spouse has

* Corresponding to Section 68 of the Company Act, 2013, yet to be notified by the Central Government.

his/her own independent source of income arising out of his/her employment or profession and the facility so granted is based on standard procedures and norms for assessing the creditworthiness of the borrower. Such facility should be extended on commercial terms.

Restrictions on Grant of Loans and Advances to Officers and the Relatives of Senior Officers of Banks

1.108 Loans and advances to officers of the bank; - No officer or any Committee comprising, *inter alia*, an officer as member, shall, while exercising powers of sanction of any credit facility, sanction any credit facility to his/her relative. Such a facility shall ordinarily be sanctioned only by the next higher sanctioning authority. Credit facilities sanctioned to senior officers of the financing bank should be reported to the Board. Loans and advances and award of contracts to relatives of senior officers of the bank or proposals for credit facilities to the relatives of senior officers of the bank sanctioned by the appropriate authority should be reported to the Board. Further, when a credit facility is sanctioned by an authority, other than the Board, to -

- any firm in which any of the relatives of any senior officer of the financing bank holds substantial interest, or is interested as a partner or guarantor; or
- any company in which any of the relatives of any senior officer of the financing bank holds substantial interest, or is interested as a director or as a guarantor, such transaction should also be reported to the Board.

Credit facility will not include loans and advances such as housing loans, car advances, consumption loans, etc., granted to an officer of the bank under any scheme applicable generally to officers.

Restriction on Advances against Sensitive Commodities under Selective Credit Control (SCC)

1.109 With a view to prevent speculative holding of essential commodities with the help of bank credit and the resultant rise in their prices, in exercise of powers conferred by Section 21 & 35A of the Banking Regulation Act, 1949, the Reserve Bank of India, issues, from time to time, directives to all commercial banks, stipulating specific restrictions on bank advances against specified sensitive commodities.

1.110 Commodities presently under the Selective Credit Control include:

- a) Buffer stock of sugar with Sugar Mills

- b) Unreleased stocks of sugar with Sugar Mills representing
- levy sugar, and
 - free sale sugar

Restriction on payment of commission to staff members including officers

1.111 Section 10(1)(b)(ii) of Banking Regulation Act, 1934, stipulates that a banking company shall not employ or continue the employment of any person whose remuneration or part of whose remuneration takes the form of commission or a share in the profits of the company. Further, clause (b) of Section 10(1)(b)(ii) permits payment of commission to any person who is employed only otherwise than as a regular staff. Therefore, banks should not pay commission to staff members and officers for recovery of loans.

Restrictions on offering incentives on any banking products

1.112 Banks are also not permitted to offer any banking products, including online remittance schemes etc., with prizes /lottery/free trips (in India and/or abroad), etc., or any other incentives having an element of chance, except inexpensive gifts costing not more than Rs. 250/-, as such products involve non-transparency in the pricing mechanism. Such products, if offered, by banks are considered as violation of the extant guidelines and the banks concerned are liable for penal action.

Restrictions on Other Loans and Advances

Loans and Advances Against Shares, Debentures and Bonds

1.113 Banks are required to strictly observe regulatory restrictions on grant of loans and advances against shares, debentures and bonds which are detailed in the July, 2013 Master Circular on Exposure Norms'. The restrictions, *inter alia*, on Loans and Advances – Statutory and Other Restrictions loans and advances against shares and debentures, are:

- (a) No loans to be granted against partly paid shares.
- (b) No loans to be granted to partnership/proprietorship concerns against the primary security of shares and debentures.

1.114 RBI's Master Circular on "Loans and Advances - Statutory and Other Restrictions" contains guidelines for granting Loan and Advances against Shares, Debentures and Bonds as follows:

Advances to individuals

1.115 Banks may grant advances against the security of shares, debentures or bonds to individuals subject to the following conditions:

(i) **Amount of advance:** Loans against the security of shares, debentures and bonds should not exceed the limit of Rs. 10 lakhs per individual if the securities are held in physical form and Rs. 20 lakhs per individual if the securities are held in dematerialised form.

(ii) **Margin:** Banks should maintain a minimum margin of 50 percent of the market value of equity shares / convertible debentures held in physical form. In the case of shares / convertible debentures held in dematerialised form, a minimum margin of 25 percent should be maintained. These are minimum margin stipulations and banks may stipulate higher margins for shares whether held in physical form or dematerialized form. The margin requirements for advances against preference shares / nonconvertible debentures and bonds may be determined by the banks themselves.

(iv) **Lending policy:** Each bank should formulate with the approval of their Board of Directors, a Loan Policy for grant of advances to individuals against shares / debentures / bonds keeping in view the RBI guidelines.

Advances to Share and Stock Brokers/ Commodity Brokers

1.116

(i) Banks and their subsidiaries are not permitted to undertake financing of 'Badla' transactions. Banks can grant advances only to share and stock brokers registered with SEBI and who comply with capital adequacy norms prescribed by SEBI / Stock Exchanges. This could be towards their need based overdraft facilities / line of credit against shares and debentures held by them as stock in trade. A careful assessment of need based requirements for such finance should be made taking into account the financial position of the borrower, operations on his own account and on behalf of clients, income earned, the average turnover period of stocks and shares and the extent to which the broker's funds are required to be involved in his business operations. Banks may also grant working capital facilities to such stock brokers to meet the cash flow gap between delivery and payment for DVP transactions undertaken on behalf of institutional clients viz. FIs, FII's, mutual funds and banks, the duration of such a facility will be short and would be based on an assessment of the financing requirements keeping in view the cash flow gaps, the broker's funds required to be deployed for the transaction and the overall financial position of the broker. The utilisation is to be monitored on the basis of individual

transactions. Further, Banks may institute adequate safeguards and monitoring mechanisms. A uniform margin of 50 per cent is required to be applied on all advances / financing of IPOs / issue of guarantees on behalf of share and stockbrokers. A minimum cash margin of 25 per cent (within the margin of 50%) shall be maintained in respect of guarantees issued by banks for capital market operations. The above minimum margin will also apply to guarantees issued by banks on behalf of commodity brokers in favour of commodity exchanges viz. National Commodity & Derivatives Exchange (NCDEX), Multi Commodity Exchange of India Ltd. (MCX) and National Multi Commodity Exchange of India Ltd. (NMCEIL), in lieu of margin requirements as per the commodity exchange regulations. These margin requirements will also be applicable in respect of bank finance to stock brokers by way of temporary overdrafts for DVP transactions. Banks may issue guarantees on behalf of share and stock brokers/commodity brokers in favour of stock exchanges in lieu of security deposit to the extent it is acceptable in the form of bank guarantee as laid down by stock exchanges. Banks may also issue guarantees in lieu of margin requirements as per stock exchange regulations.

- (ii) The requirement relating to transfer of shares in bank's name in respect of shares held in physical form mentioned at Sl. No. (ix) of paragraph 2.3.1.8 of the aforesaid Circular would not apply in respect of advances granted to share and stock brokers provided such shares are held as security for a period not exceeding nine months. In the case of dematerialised shares, the depository system provides a facility for pledging and banks may avail themselves of this facility and in such cases there will not be need to transfer the shares in the name of the bank irrespective of the period of holding. The share and stock brokers are free to substitute the shares pledged by them as and when necessary. In case of a default in the account, the bank should exercise the option to get the shares transferred in its name.

Bank Finance for Market Makers

1.117 Banks may provide need based finance to meet the genuine credit requirements of approved Market Makers. For this purpose, they should lay down appropriate norms for financing them including exposure limits, method of valuation, etc. They should also follow the guidelines given below:

- a) Market Makers approved by stock exchange would only be eligible for grant of advances by scheduled commercial banks.
- b) Market Making may be for equity as well as for debt securities including State and Central Government securities.

- c) A uniform margin of 50 per cent shall be applied on all advances / financing of IPOs / issue of guarantees on behalf of market makers. A minimum cash margin of 25 per cent (within the margin of 50%) shall be maintained in respect of guarantees issued by banks for capital market operations.
- d) Banks may accept, as collateral for the advances to the Market Makers, scrips other than the scrips in which the market making operations are undertaken.
- e) Banks should ensure that advances provided for Market Making are not diverted for investment in shares other than the scrip earmarked for Market Making purpose. For this purpose, a suitable follow-up and monitoring mechanism must be evolved.

1.118 Each bank should lay down a detailed loan policy for granting advances to Stock Brokers and Market Makers and also a policy for grant of guarantees on behalf of brokers.

Advances to other borrowers against shares / debentures / bonds

1.119 In this regards, banks may refer to para 2.4.7 of the Master Circular DBOD.No.Dir.BC.13/13.03.00/2013-14 on Exposure Norms dated July 1, 2013.

Bank Loans for Financing Promoters Contribution

1.120 The promoters' contribution towards the equity capital of a company should come from their own resources and the bank should not normally grant advances to take up shares of other companies. However, banks are permitted to extend loans to corporates against the security of shares (as far as possible in dematerialised form) held by them to meet the promoters' contribution to the equity of new companies in anticipation of raising resources subject to the following terms and conditions and as detailed in the loan policy of the bank, in addition to the general guidelines given in para 2.3.1.8 of the Master Circular on Loan and Advances – Statutory and Other restrictions dated July 1, 2013.

- i) The margin and period of repayment of the loans may be determined by the banks.
- ii) Loans sanctioned to corporates against the security of shares (as far as possible, demat shares) for meeting promoters' contribution to the equity of new companies in anticipation of raising resources, should be treated as a bank's investments in shares which would thus come under the ceiling of 40 percent of the bank's net worth as on March 31 of the previous year prescribed for the bank's total exposure including both fund based and non-fund based to capital market in all forms. These loans will also be subject to individual/group of borrowers exposure norms as well as the statutory limit

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on shareholding in companies, as detailed in the Master Circular DBOD.No.Dir.BC. 14/13.03.00/2013-14 dated July 1, 2013 on Loan and Advances – Statutory and Other restrictions .

- iii) Banks may extend financial assistance to Indian companies for acquisition of equity in overseas joint ventures / wholly owned subsidiaries or in other overseas companies, new or existing, as strategic investment, in terms of a Board approved policy, duly incorporated in the loan policy of the banks. Such policy should include overall limit on such financing, terms and conditions of eligibility of borrowers, security, margin, etc. The finance would be subject to compliance with the statutory requirements under Section 19(2) of the Banking Regulation Act, 1949.
- iv) The restriction on grant of bank advances for financing promoters' contribution towards equity capital would also extend to bank finance to activities related to such acquisitions like payment of non compete fee, etc. Further, these restrictions would also be applicable to bank finance to such activities by overseas branches / subsidiaries of Indian banks.

Advances against Units of Mutual Funds

1.121 Banks may refer to para 2.4.6 of the Master Circular on Exposure Norms dated July 1, 2013.

Advances to Agents/Intermediaries Based on Consideration of Deposit Mobilisation

1.122 Banks should desist from being party to unethical practices of raising of resources through agents/intermediaries to meet the credit needs of the existing/prospective borrowers or from granting loans to the intermediaries, based on the consideration of deposit mobilisation, who may not require the funds for their genuine business requirements.

Loans Against Certificate of Deposits (CDs)

1.123 Banks cannot grant loans against CDs. Furthermore, they are also not permitted to buy-back their own CDs before maturity. However, these restrictions on lending and buy back in respect of CDs held by mutual funds are relaxed. While granting such loans to the mutual funds, banks should keep in view the provisions of paragraph 44(2) of the SEBI (Mutual Funds) Regulations, 1996. Further, such finance if extended to equity-oriented mutual funds, will form part of banks' capital market exposure, as hitherto.

Finance for and Loans/Advances against Indian Depository Receipts (IDRs)

1.124 Banks are not permitted to grant any loan / advance for subscription to Indian Depository Receipts (IDRs). Further, no loans/ advances can be granted against security / collateral of IDRs issued in India.

Bank Finance to Non-Banking Financial Companies (NBFCs)

1.125 The RBI, vide its Master Circular No. DBOD.BP.BC.No.6 /21.04.172/2013-14 on Bank Finance to Non-Banking Financial Companies (NBFCs) dated July 1, 2013 provides as follows:

1.126 The ceiling on bank credit linked to Net Owned Fund (NOF) of NBFCs has been withdrawn in respect of all NBFCs which are statutorily registered with RBI and are engaged in principal business of asset financing, loan, factoring and investment activities. Accordingly, banks may extend need based working capital facilities as well as term loans to all NBFCs registered with RBI and engaged in infrastructure financing, equipment leasing, hire-purchase, loan, factoring and investment activities.

1.127 In the light of the experience gained by NBFCs in financing second hand assets, banks may also extend finance to NBFCs against second hand assets financed by them.

1.128 Banks may formulate suitable loan policy with the approval of their Boards of Directors within the prudential guidelines and exposure norms prescribed by the Reserve Bank to extend various kinds of credit facilities to NBFCs subject to the condition that the activities indicated in the Master Circular are not financed by them.

1.129 In respect of NBFCs which do not require to be registered with RBI, viz.:

- i) Insurance Companies registered under Section 3 of the Insurance Act, 1938;
- ii) Nidhi Companies notified under Section 620A of the Companies Act, 1956*;
- iii) Chit Fund Companies carrying on Chit Fund business as their principal business as per Explanation to Clause (vii) of Section 45-I(bb) of the Reserve Bank of India Act, 1934;
- iv) Stock Broking Companies / Merchant Banking Companies registered

* Corresponding to Section 406 of the Company Act, 2013, yet to be notified by the Central Government.

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under Section 12 of the Securities & Exchange Board of India Act; and

- v) Housing Finance Companies being regulated by the National Housing Bank (NHB) which have been exempted from the requirement of registration by RBI],

banks may take their credit decisions on the basis of usual factors like the purpose of credit, nature and quality of underlying assets, repayment capacity of borrowers as also risk perception, etc.

1.130 Banks are prohibited from providing credit for the following activities of NBFCs:

- (i) Bills discounted/rediscounted by NBFCs, except for rediscounting of bills discounted by NBFCs arising from the sale of –
 - (a) commercial vehicles (including light commercial vehicles), and
 - (b) two-wheeler and three-wheeler vehicles, subject to the following conditions:
 - the bills should have been drawn by the manufacturers on dealers only.
 - the bills should represent genuine sale transactions as may be ascertained from the chassis/engine numbers.
 - before rediscounting the bills, banks should satisfy themselves about the bonafides and track record of NBFCs which have discounted the bills.
- (ii) Investments of NBFCs both of current and long term nature, in any company/entity by way of shares, debentures, etc. However, Stock Broking Companies may be provided need-based credit against shares and debentures held by them as stock-in-trade.
- (iii) Unsecured loans/inter-corporate deposits by NBFCs to/in any company.
- (iv) All types of loans/advances by NBFCs to their subsidiaries, group companies/entities.
- (v) Finance to NBFCs for further lending to individuals for subscribing to Initial Public Offerings (IPOs) and for purchase of shares from secondary market.

Bank Finance to Residuary Non-Banking Companies (RNBCs)

1.131 Residuary Non-Banking Companies (RNBCs) are also required to be mandatorily registered with RBI. In respect of such companies registered with RBI, bank finance would be restricted to the extent of their Net Owned Fund (NOF).

Bridge loans / interim finance to NBFCs

1.132 Banks should not grant bridge loans of any nature, or interim finance against capital / debenture issues and / or in the form of loans of a bridging nature pending raising of long-term funds from the market by way of capital, deposits, etc. to all categories of Non-Banking Financial Companies, i.e., equipment leasing and hire-purchase finance companies, loan and investment companies and also Residuary Non-Banking Companies (RNBCs). Banks should strictly follow these instructions and ensure that these are not circumvented in any manner whatsoever by purport and / or intent by sanction of credit under a different nomenclature like unsecured negotiable notes, floating rate interest bonds, etc., as also short-term loans, the repayment of which is proposed / expected to be made out of funds to be or likely to be mobilised from external / other sources and not out of the surplus generated by the use of the asset(s).

Advances against collateral security of shares to NBFCs

1.133 Shares and debentures cannot be accepted as collateral securities for secured loans granted to NBFCs borrowers for any purpose.

Restriction on Guarantees for placement of funds with NBFCs

1.134 Banks should not execute guarantees covering inter-company deposits / loans thereby guaranteeing refund of deposits / loans accepted by NBFCs / firms from other NBFCs / firms. The restriction would cover all types of deposits / loans irrespective of their source, including deposits / loans received by NBFCs from trusts and other institutions. Guarantees should not be issued for the purpose of indirectly enabling the placement of deposits with NBFCs.

Bank Finance to Equipment Leasing Companies

1.135 Banks should not enter into lease agreements departmentally with equipment leasing companies as well as other Non-Banking Financial Companies engaged in equipment leasing.

Bank Finance to Factoring Companies

1.136 Banks are permitted to extend financial assistance to support the factoring business of Factoring Companies which comply with the following criteria:

- (a) The companies qualify as factoring companies and carry out their business under the provisions of the Factoring Regulation Act, 2011 and Notifications issued by the Reserve Bank in this regard from time to time.

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- (b) They derive at least 75 per cent of their income from factoring activity.
- (c) The receivables purchased / financed, irrespective of whether on 'with recourse' or 'without recourse' basis, form at least 75 per cent of the assets of the Factoring Company.
- (d) The assets / income referred to above would not include the assets / income relating to any bill discounting facility extended by the Factoring Company.
- (e) The financial assistance extended by the Factoring Companies is secured by hypothecation or assignment of receivables in their favour.

Restrictions regarding investments made by banks in securities / instruments issued by NBFCs

1.137 Banks should not invest in Zero Coupon Bonds (ZCBs) issued by NBFCs unless the issuer NBFC builds up sinking fund for all accrued interest and keeps it invested in liquid investments / securities (Government bonds).

1.138 Banks are permitted to invest in Non-Convertible Debentures (NCDs) with original or initial maturity up to one year issued by NBFCs. However, while investing in such instruments banks should be guided by the extant prudential guidelines in force, ensure that the issuer has disclosed the purpose for which the NCDs are being issued in the disclosure document and such purposes are eligible for bank finance in terms of instructions given in the preceding paragraphs.

Advances Against Fixed Deposit Receipts (FDRs) Issued by Other Banks

1.139 Banks are prohibited from sanctioning advances against FDRs/ or other term deposits of other banks.

Advances Against Bullion/Primary Gold

1.140 Banks are prohibited from granting any advance against bullion/ primary gold. However, specially minted gold coins sold by banks cannot be treated as "bullion" or "primary gold" and hence there is no objection to the bank granting loans against the coins. Such loans to be granted by the bank, may be covered under the policy framed by the bank's Board, in terms of RBI circular DBOD.No. BC. 138/21.01.023/94 dated November 22, 1994. Further, while granting advances against the gold coins, they may ensure, without fail that the end use of the funds is for approved, non- speculative purposes. Banks are also required to desist from granting advances to silver bullion dealers which are likely to be utilised for speculative purposes.

Loans for Acquisition of KVPs

1.141 The grant of loans for acquiring/investing in KVPs does not promote fresh savings and, rather, channelises the existing savings in the form of bank deposits to small savings instruments and thereby defeats the very purpose of such schemes. Banks should therefore ensure that no loans are sanctioned for acquisition of/investing in Small Savings Instruments including Kisan Vikas Patras.

Advances against Gold(Metal) Loans

1.142 Banks nominated to import gold as per extant instructions of RBI may extend Gold (Metal) Loans to domestic jewellery manufacturers, who are not exporters of jewellery, subject to the condition that any gold loan borrowing or other non-funded commitments taken by them for the purpose of providing gold loans to domestic jewellery manufacturers will be taken into account for the purpose of the overall ceiling (presently 50 % of unimpaired Tier I capital or USD 10 million (or its equivalent), Whichever is higher.) (Master Circular No.5/2012-13 dated July 1, 2013) in respect of aggregate borrowing for non-export purposes. The Gold Loans extended to exporters of jewellery would continue to be out of the 50% ceiling. The Gold (Metal) Loans provided by banks will be subject to the following conditions:

- (i) The tenor of the Gold (Metal) Loans, which nominated banks are permitted to extend to domestic jewellery manufacturers who are not exporters of jewellery, may be decided by the nominated banks themselves provided the tenor does not exceed 180 days and the banks' policy with regard to tenor and monitoring of end use of gold loan is documented in the banks' loan policy and strictly adhered to by the banks.
- (ii) Interest charged to the borrowers should be linked to the international gold interest rate.
- (iii) The loan will be subject to capital adequacy and other prudential requirements.
- (iv) Banks should ensure end-use of gold loans to jewellery manufacturers and adhere to KYC guidelines.
- (v) Any mismatch arising out of the gold borrowings and lendings should be within the prudential risk limits approved by the nominated bank's Board.
- (vi) The banks should carefully assess the overall risks on granting gold loans and lay down a detailed lending policy with the approval of the Board.

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1.143 Presently, nominated banks can extend Gold (Metal) Loans to exporters of jewellery who are customers of other scheduled commercial banks, by accepting stand-by letter of credit or bank guarantee issued by their bankers in favour of the nominated banks subject to authorised banks' own norms for lending and other conditions stipulated by RBI. Banks may also extend the facility to domestic jewellery manufacturers, subject to the conditions as specified by RBI's Master Circular DBOD.No.Dir. BC. 14/13.03.00/2013-14 on Loan and Advances- Statutory and Other restrictions.

1.144 The nominated banks may continue to extend Gold (Metal) Loans to jewellery exporters subject to the following conditions:

- The exposure assumed by the nominated bank extending the Gold (Metal) Loan against the stand-by LC / BG of another bank will be deemed as an exposure on the guaranteeing bank and attract appropriate risk weight as per the extant guidelines.
- The transaction should be purely on back-to-back basis i.e. the nominated banks should extend Gold (Metal) Loan directly to the customer of a non-nominated bank, against the stand-by LC / BG issued by the latter.
- Gold (Metal) Loans should not involve any direct or indirect liability of the borrowing entity towards foreign suppliers of gold.
- The banks may calculate their exposure and compliance with prudential norms daily by converting into Rupee the gold quantity by crossing London AM fixing for Gold / US Dollar rate with the rupee-dollar reference rate announced by RBI.

1.145 Banks should recognise the overall risks in extending Gold (Metal) Loans as also in extending SBLC / BG. Banks should lay down an appropriate risk management / lending policy in this regard and comply with the recommendations of the Ghosh Committee and other internal requirements relating to acceptance of guarantees of other banks to obviate the possibility of frauds in this area.

1.146 Nominated banks are not permitted to enter into any tie up arrangements for retailing of gold / gold coins with any other entity including non-banking financial companies / co-operative banks / non-nominated banks.

Loans and advances to Micro and Small Enterprises (MSEs)

1.147 MSE units having working capital limits of up to Rs. 5 crore from the banking system are to be provided working capital finance computed on the basis of 20 percent of their projected annual turnover. The banks should adopt the simplified procedure in respect of all MSE units (new as well as existing).

Working Capital Finance to Information Technology and Software Industry

1.148 Following the recommendations of the “National Taskforce on Information Technology and Software Development“, Reserve Bank has framed guidelines for extending working capital to the said industry. Banks are, however, free to modify the guidelines based on their own experience without reference to the Reserve Bank of India to achieve the purpose of the guidelines in letter and spirit. The salient features of these guidelines are set forth below:

- (i) Banks may consider sanction of working capital limits based on the track record of the promoter’s group affiliation, composition of the management team and their work experience as well as the infrastructure.
- (ii) In the case of the borrowers with working capital limits of up to Rs 2 crore, assessment may be made at 20 percent of the projected turnover. However, in other cases, the banks may consider assessment of MPBF on the basis of the monthly cash budget system. For the borrowers enjoying working capital limits of Rs 10 crore and above from the banking system, the guidelines regarding the loan system would be applicable.
- (iii) Banks may obtain collateral security wherever available. First/ second charge on current assets, if available, may be obtained.
- (iv) The rate of interest as prescribed for general category of borrowers may be levied. Concessional rate of interest as applicable to pre-shipment/post-shipment credit may be levied.
- (v) Banks may evolve tailor-made follow up system for such advances. The banks could obtain quarterly statements of cash flows to monitor the operations. In case the sanction was not made on the basis of the cash budgets, they can devise a reporting system, as they deem fit.

Guidelines for bank finance for PSU disinvestments of Government of India

1.149 In terms of RBI circular DBOD No. Dir.BC .90/13.07.05/98 dated August 28, 1998, banks have been advised that the promoters’ contribution towards the equity capital of a company should come from their own resources and the bank should not normally grant advances to take up shares of other companies. Banks were also advised to ensure that advances against shares were not used to enable the borrower to acquire or retain a controlling interest in the company/companies or to facilitate or retain inter-corporate investment. It is clarified that the aforesaid instructions of the 1998 circular would not apply in the case of bank finance to the successful bidders under the PSU disinvestment programme of the Government, subject to the following:

- Banks’ proposals for financing the successful bidders in the PSU disinvestment programme should be approved by their Board of Directors.

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- Bank finance should be for acquisition of shares of PSU under a disinvestment programme approved by Government of India, including the secondary stage mandatory open offer, wherever applicable and not for subsequent acquisition of the PSU shares. Bank finance should be made available only for prospective disinvestments by Government of India.
- The companies, including the promoters, to which bank finance is to be extended should have adequate net worth and an excellent track record of servicing loans availed from the banking system.
- The amount of bank finance thus provided should be reasonable with reference to the banks' size, its net worth and business and risk profile.

1.150 In case the advances against the PSU disinvestment is secured by the shares of the disinvested PSUs or any other shares, banks should follow RBI's extant guidelines on capital market exposures on margin, ceiling on overall exposure to the capital market, risk management and internal control systems, surveillance and monitoring by the Audit Committee of the Board, valuation and disclosure, etc. In this regard, banks may be guided by the Master Circular on Exposure Norms dated July 1, 2013.

Stipulation of lock-in period for shares

1.151 Banks may extend finance to the successful bidders even though the shares of the disinvested company acquired/ to be acquired by the successful bidder are subjected to a lock-in period/ other such restrictions which affect their liquidity, subject to fulfillment of following conditions:

- (a) The documentation between the Government of India and the successful bidder should contain a specific provision permitting the pledgee to liquidate the shares even during lock-in period that may be prescribed in respect of such disinvestments, in case of shortfall in margin requirements or default by the borrower.
- (b) If the documentation does not contain such a specific provision, the borrower (successful bidder) should obtain waiver from the Government for disposal of shares acquired under PSU disinvestment programme during the lock-in period.

1.152 As per the terms and conditions of the PSU disinvestments by the Government of India, the pledgee bank will not be allowed to invoke the pledge during the first year of the lock-in period. During the second and third year of the lock-in period, in case of inability of the borrower to restore the margin prescribed for the purpose by way of additional security or non-performance of the payment obligations as per the repayment schedule agreed upon between the bank and the borrower, the bank would have the right to invoke the pledge. The pledgee

bank's right to invoke the pledge during the second and third years of the lock-in period, would be subject to the terms and conditions of the documentation between Government and the successful bidder, which might also cast certain responsibilities on the pledge banks.

1.153 RBI has also clarified that the concerned bank must make a proper appraisal and exercise due caution about creditworthiness of the borrower and the financial viability of the proposal. The bank must also satisfy itself that the proposed documentation, relating to the disposal of shares pledged with the bank, are fully acceptable to the bank and do not involve unacceptable risks on the part of the bank.

1.154 Further, in terms of IECD Circular No. 10/ 08.12.01/ 2000- 2001 dated 8 January 2001, banks are precluded from financing investments of NBFCs in other companies and inter-corporate loans / deposits to/ in other companies. However, the Special Purpose Vehicles (SPVs) which comply with the following conditions would not be treated as investment companies and therefore would not be considered as NBFCs:

- a) They function as holding companies, special purpose vehicles, etc., with not less than 90 per cent of their total assets as investment in securities held for the purpose of holding ownership stake,
- b) They do not trade in these securities except for block sale,
- c) They do not undertake any other financial activities, and
- d) They do not hold/accept public deposits.

Financing Housing Projects

1.155 During the recent period, housing sector has emerged one of the biggest loan portfolios of banks. The focus of the RBI, therefore, is to ensure orderly growth of this portfolio. The Master Circular No. DBOD. No.DIR.BC.17/08.12.001/2013-14 dated July 1, 2013 on Housing Finance provides guidance in respect of the housing finance provided by the banks. Banks could deploy their funds under the housing finance allocation in any of the three categories as per the norms provided in the Master Circular, i.e.

- Direct Finance
- Indirect Finance
- Investment in Bonds of NHB/HUDCO, or combination thereof

1.156 The Master Circular also contains a number of guidelines for this purpose, including conditions wherein a bank cannot extend credit for housing purposes. These conditions are as follows:

- (i) In case of *lending to housing intermediary agencies*, the banks are

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required to ensure that the former have complied with the guidelines of the National Housing Board (NHB). In terms of the NHB guidelines, a housing finance companies' total borrowings, whether by way of deposits, issue of debentures/ bonds, loans and advances from banks or from financial institutions including any loans obtained from NHB, should not exceed 16 times of their net owned funds (i.e., paid up capital and free reserves less accumulated balance of loss, deferred revenue expenditure and intangible assets.)

- (ii) Banks are also not permitted to extend fund based or non fund based facilities to private builders for acquisition of land even as part of a housing project.
- (iii) Banks cannot grant finance for construction of buildings meant purely for Government/Semi-Government offices, including Municipal and Panchayat offices. However, banks may grant loans for activities, which will be refinanced by institutions like NABARD.
- (iv) *Projects undertaken by public sector entities* which are not corporate bodies (i.e., public sector undertakings which are not registered under Companies Act or which are not Corporations established under the relevant statute) also cannot be financed by banks.
- (v) In terms of the orders of the Delhi High Court, banks also can not grant loans in respect of:
 - Properties which fall in the category of *unauthorised colonies* unless and until they have been regularised and development and other charges paid.
 - Properties which are *meant for residential use* but which the applicant intends to *use for commercial purposes* and declares so while applying for the loan.

Loan to Value (LTV) ratio

1.157 In order to prevent excessive leveraging, the LTV ratio in respect of housing loans should not exceed 80 per cent. However, for small value housing loans, i.e., housing loans up to Rs. 20 lakh (which get categorized as priority sector advances), the LTV ratio should not exceed 90 per cent.

1.158 The Master Circular DBOD.No.DIR.BC.17/08.12.001/2013-14 on Housing Finance dated July 1, 2013, lays down that with effect from June 21, 2013 these norms have been revised and the following LTV ratios have to be maintained by banks in respect of individual housing loans.

Category of Loan	LTV Ratio (%)
(a) Individual Housing Loans	
Upto Rs. 20 Lakh	90
Above Rs. 20 lakh & upto Rs. 75 lakh	80
Above Rs. 75 lakh	75
(b) CRE-RH	NA

The LTV ratio should not exceed the prescribed ceiling in all fresh cases of sanction. In case the LTV ratio is currently above the ceiling prescribed for any reasons, efforts should be made to bring it within limits.

Financing of Infrastructure Projects

1.159 The RBI has revised the definition of Infrastructure Lending *vide* Annex 1 of Master Circular on Exposure Norms dated July1, 2013 read with Circular No. RBI/2012 13/297/DBOD.BP.BC.No 58/08.12.014/2012-13 dated 20/11/2012 on “Second Quarter Review of Monetary Policy 2012-13- Definition of ‘Infrastructure Lending’”

1.160 The revised definition of ‘infrastructure lending’ will be effective from the date of this circular. The exposure of banks to projects under sub-sectors which were included under the previous definition of infrastructure, but not included under the revised definition, will continue to get the benefits under ‘infrastructure lending’ for such exposures till the completion of the projects. However, any fresh lending to those sub-sectors from the date of this circular will not qualify as ‘infrastructure lending’.

1.161 The definition of Infrastructure Lending would include credit facility extended by Lenders (i.e., Banks & Selected AIFIs) to a borrower for exposure in the various infrastructure sub-sectors as per Annex 1 of Master Circular on Exposure Norms dated July1, 2013, read with Circular No. DBOD.BP.BC.No.66/08.12.2014/2013-14 on “Financing of Infrastructure – Definition of ‘Infrastructure Lending’” dated November 25, 2013.

1.162 In view of the critical importance of the infrastructure sector and high priority being accorded for development of various infrastructure services, Banks/FIs are free to finance technically feasible, financially viable and bankable projects undertaken by both public sector and private sector undertakings subject to the following conditions:

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- i. The amount sanctioned should be within the overall ceiling of the prudential exposure norms prescribed by RBI for infrastructure financing.
- ii. Banks/ FIs should have the requisite expertise for appraising technical feasibility, financial viability and bankability of projects, with particular reference to the risk analysis and sensitivity analysis.
- iii. In respect of projects undertaken by public sector units, such term loans should not be in lieu of or to substitute budgetary resources envisaged for the project. The term loan could supplement the budgetary resources if such supplementing was contemplated in the project design. Banks/FIs are, advised to follow the above instructions scrupulously, even while making investment in bonds of sick State PSUs as part of the rehabilitation effort.
- iv. Banks may also lend to SPVs in the private sector, registered under the Companies Act for directly undertaking infrastructure projects which are financially viable and not for acting as mere financial intermediaries. Banks may ensure that the bankruptcy or financial difficulties of the parent/ sponsor should not affect the financial health of the SPV.

Guidelines of the Reserve Bank of India on Income Recognition, Asset Classification, Provisioning and Other Related Matters

1.163 In its report submitted in 1992, the Committee on Financial System set up by the RBI under the Chairmanship of Mr. M. Narasimham made several recommendations concerning accounts of banks. The Committee recommended that a policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Likewise, the classification of assets should be done on the basis of objective criteria which would ensure a uniform and consistent application of norms. As regards provisioning, the Committee recommended that provisions should be made on the basis of classification of assets under different categories. Vide its Circular No. BP.BC.129/21.04.043-92 dated April 27, 1992, the Reserve Bank issued guidelines to be followed by all scheduled commercial banks (excluding regional rural banks) for income recognition, asset classification, provisioning and other related matters. These guidelines (commonly referred to as 'prudential guidelines' or 'prudential norms') have since been modified in several respects through various circulars of the Reserve Bank. The latest Master Circular No. DBOD.No.BP.BC.1/21.04.048/2013-14 was issued on July 1, 2013 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances'. The salient points of the guidelines as presently in force are discussed below.

Non-Performing Assets

1.164 Under the guidelines, income recognition, and provisioning in respect of a credit facility are based on its status of classification as performing or non-performing. A credit facility becomes non-performing “when it ceases to generate income for a bank”. Detailed guidelines have been laid down for determining the status of different kinds of credit facilities (term loans, cash credits and overdrafts, bills purchased and discounted, and other credit facilities) as performing or non-performing. These are discussed below.

Criteria for Classification of Various Types of Credit Facilities

1.165 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.

1.166 Banks have been charging interest at monthly rests, from April 1, 2002. However, the banks should 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.

1.167 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 also 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.

1.168 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.
- (f) *Credit Card Accounts*: RBI vide its Circular No. DBOD.No.BP.BC.78/21.04.048/2013-14 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances – Credit Card Accounts" dated December 20, 2013 advised that a credit card account will be treated as non-performing asset if the minimum amount due, as mentioned in the statement, is not paid fully within 90 days from the next statement date. The gap between two statements should not be more than a month. It is further suggested by RBI that banks should follow this uniform method of determining over-due status for credit card accounts while reporting to credit information companies and for the purpose of levying of penal charges, viz., late payment charges, etc., if any.

1.169 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.

1.170 The above norms should be made applicable to all direct agricultural advances as listed in the Master Circular on Lending to Priority Sectors dated July 01, 2013. 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. In this context, attention of the Readers is also invited RBI circular No. DBS.No.OSMOS.9862/22.01.018/2013-14 on "Central Repository of Information on Large Credits (CRILC) – Revision in Reporting" dated February 13, 2014 read with Guidelines on "*Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalising Distressed Assets in the Economy*" issued by RBI on January 30, 2014 providing the Framework outlines a corrective action plan that will incentivise early identification of problem cases, timely restructuring of accounts which are considered to be viable, and taking prompt steps by banks for recovery or sale of unviable accounts.

Classification Norms relating to NPAs

Temporary Deficiencies

1.171 The classification of an asset as NPA should be based on the record of recovery. Bank should not classify an advance account as NPA merely due to the existence of some deficiencies which are temporary in nature such as non-availability of adequate drawing power based on the latest available stock statement, balance outstanding exceeding the limit temporarily, non-submission of stock statements and non-renewal of the limits on the due date, etc. 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, since current assets are first appropriated in times of distress. Drawing power is required to be arrived at based on current stock statement. Proper computation of drawing power is imperative as the advances are to be checked with reference thereto. The creditors should be reduced from the stock and debtors within the stipulated period while calculating the drawing power. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months.
- (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) Regular and ad hoc credit limits need to be reviewed/ regularised not later than three months from the due date/date of ad hoc sanction. In case of constraints such as non-availability of financial statements and other data from the borrowers, the branch should furnish evidence to show that renewal/ review of credit limits is already on and would be completed soon. In any case, delay beyond six months is not considered desirable as a general discipline. Hence, an account where the regular/ adhoc credit limits have not been reviewed/ renewed within 180 days from the due date/ date of adhoc sanction will be treated as NPA.

Regularisation Near About Balance Sheet

1.172 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. In other genuine cases, the banks must furnish satisfactory evidence to the Statutory Auditors/Inspecting Officers about the manner of regularisation of the account to eliminate doubts on their performing status.

Asset Classification to be Borrower-wise not Facility-wise

1.173 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. In case 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 following are given in the master circular in this regard:

- (i) The bills discounted under LC favouring a borrower may not be classified as a Non-performing advance (NPA), when any other facility granted to the borrower is classified as NPA. However, in case documents under LC are not accepted on presentation or the payment under the LC is not made on the due date by the LC issuing bank for any reason and the borrower does not immediately make good the amount disbursed as a result of discounting of concerned bills, the outstanding bills discounted will immediately be classified as NPA with effect from the date when the other facilities had been classified as NPA.
- (ii) The overdue receivables representing positive mark-to-market value of a derivative contract will be treated as a non-performing asset, if these remain unpaid for 90 days or more. In case the overdues arising from forward contracts and plain vanilla swaps and options become NPAs, all other funded facilities granted to the client shall also be classified as nonperforming asset following the principle of borrower-wise classification as per the existing asset classification norms. Accordingly, any amount, representing positive mark-to-market value of the foreign exchange derivative contracts (other than forward contract and plain vanilla swaps and options) that were entered into during the period April 2007 to June 2008, which has already crystallised or might crystallise in future and is /

becomes receivable from the client, should be parked in a separate account maintained in the name of the client / counterparty. This amount, even if overdue for a period of 90 days or more, will not make other funded facilities provided to the client, NPA on account of the principle of borrower-wise asset classification, though such receivable overdue for 90 days or more shall itself be classified as NPA, as per the extant IRAC norms. The classification of all other assets of such clients will, however, continue to be governed by the extant IRAC norms.

- (iii) As the overdue receivables mentioned above would represent unrealised income already booked by the bank on accrual basis, after 90 days of overdue period, the amount already taken to 'Profit and Loss a/c' should be reversed

For NPA classification, Auditors need to examine whether all the loans of a borrower have been tagged under one Customer Id by the bank and also are aggregated properly irrespective of being given from various locations and product teams or business divisions of the bank so as to ensure that all the facilities of the borrowers get classified as NPA if one of the facilities get classified as NPA as required by RBI guidelines.

Advances to Primary Agricultural Credit Society(PACS)Farmers Service Society(FSS) ceded to Commercial Banks

1.174 In case of advances granted under the on-lending system, however, only the particular credit facility granted to PACSs or FSSs, which is in default for a period of two crop seasons in case of short duration crops and one crop season in case of long duration crops, as the case may be, after it has become due will be classified as NPA and not all the credit facilities sanctioned subject to such conditions as specified in the RBI's latest Master Circular on Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances dated July 1, 2013.

Erosion in Value of Securities/ Frauds Committed by Borrowers

1.175 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

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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

1.176 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

1.177 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.

1.178 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.

1.179 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. Advance against gold ornaments, government securities and all other securities are not covered by this exemption.

Agricultural Advances Affected by Natural Calamities

1.180 Paragraph 4.2.13 of the Master Circular deals elaborately with the classification and income recognition issues due to impairment caused by

natural calamities. 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 and the sanctioning of fresh short-term loan, subject to the guidelines contained in RBI's latest Master Circular on Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances dated July 1, 2013. In such cases the NPA classification would be governed by such rescheduled terms.

1.181 In such cases of conversion or re-scheduling, 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. 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" would be treated as "short duration" crops.

1.182 While fixing the repayment schedule in case of rural housing advances granted to agriculturist under Indira AwasYojana 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

1.183 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. This classification cannot be upgraded by the bank unless the package of renegotiated terms has worked satisfactorily for a period of one year. As 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

1.184 In respect of post-shipment credit extended by the banks covering export of goods to countries for which the ECGC's cover is available, EXIM Bank has introduced a guarantee-cum-refinance programme whereby, in the event of default, EXIM Bank will pay the guaranteed amount to the bank within a period of 30 days from the day the bank invokes the guarantee after the exporter has filed claim with ECGC.

1.185 Accordingly, 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

1.186 Takeout finance is the product emerging in the context of the funding of long-term infrastructure projects. Under such an arrangement, the bank or financial institution financing infrastructure projects will have an arrangement with any financial institution for transferring to the latter the outstanding in respect of such financing in their books on a predetermined basis. In view of the time-lag involved in taking-over, the possibility of a default in the meantime cannot be ruled out. The norms of asset classification will have to be followed by the concerned bank/financial institution in whose books the account stands as balance sheet item as on the relevant date. If the lending institution observes that the asset has turned NPA on the basis of the record of recovery, it should be classified accordingly. The lending institution should not recognise income on accrual basis and account for the same only when it is paid by the borrower/ taking over institution (if the arrangement so provides). The lending institution should also make provisions against any asset turning into NPA pending its take over by taking over institution. As and when the asset is taken over by the taking over institution, the corresponding provisions could be reversed. However, the taking over institution, on taking over such assets, should make provisions treating the account as NPA from the actual date of it becoming NPA even though the account was not in its books as on that date.

Export Project Finance

1.187 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

1.188 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

1.189 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

1.190 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.

NPA Management

1.191 The RBI has issued Master Circular on Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances dated July 1, 2013 read with circular no. DBOD.No.BP.BC/ 42/21.04.048/2012-13 dated September 14, 2012 on "NPA Management – Requirement of an Effective Mechanism and Granular Data". The Circular stresses the importance of effective mechanism and granular data on NPA management in the banks and provides as follows:

- Asset quality of banks is one of the most important indicators of their financial health. However, it has been observed that existing MIS on the early warning systems of asset quality, needed improvement. Banks are, therefore, advised that they should review their existing IT and MIS framework and put in place a robust MIS mechanism for early detection of signs of distress at individual account level as well as at segment level (asset class, industry, geographic, size, etc.). Such early warning signals should be used for putting in place an effective preventive asset quality management framework, including a transparent restructuring mechanism for viable accounts under distress within the prevailing regulatory framework, for preserving the economic value of those entities in all segments.

- The banks' IT and MIS system should be robust and able to generate reliable and quality information with regard to their asset quality for effective decision making. There should be no inconsistencies between information furnished under regulatory/statutory reporting and the banks' own MIS reporting. Banks are also advised to have system generated segment-wise information on non-performing assets and restructured assets which may include data on the opening balances, additions, reductions (upgradations, actual recoveries, write-offs etc.), closing balances, provisions held, technical write-offs, etc.

Income Recognition

On Advances Granted

1.192 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

1.193 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.

1.194 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.

1.195 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

1.196 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

1.197 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

1.198 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.

1.199 Interest partly/fully realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.

Memorandum Account

1.200 On an account turning NPA, banks should reverse the interest already charged and not collected by debiting Profit and Loss account, and stop further application of interest. However, banks may continue to record such accrued interest in a Memorandum account in their books for control purposes. For the purpose of computing Gross Advances, interest recorded in the Memorandum account should not be taken into account.

Classification of Advances

1.201 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. Such an asset will have well defined credit weaknesses that jeopardize the liquidation of the debt and are characterized by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

(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 doubtful 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.

1.202 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

1.203 If arrears of interest and principal 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. Upgradation of a restructured/ rescheduled/CDR accounts is governed by the restructuring / reschedulement/CDR norms as discussed later in the Chapter.

Provisioning for Loans and Advances

1.204 The RBI's Master Circular of July 1, 2013 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**

1.205 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**

1.206 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. Auditor should verify whether that the security is considered based on the latest information available with the bank. DICGC/ECGC cover is also taken into account (this aspect is discussed in detail later in this Chapter).
- (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.

<i>Period for which the advance has been considered as doubtful</i>	<i>% of provision on secured portion</i>
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 Rs. 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**

1.207 A general provision of 15% on total outstanding should be made without making any allowance for DICGC/ECGC cover and securities available. Unsecured exposures, which are identified, as sub-standard would attract an additional provision of 10%. (i.e., total 25% of total outstanding). 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 (including all funded and non-funded exposures) where realisable value of the tangible security properly charged to the bank, as assessed by bank/approved valuers/RBI inspectors, is not more than 10%, *ab initio*, of the outstanding exposure. 'Security' means tangible security properly discharged to the bank and will not include intangible securities like guarantees (including State government guarantees), comfort letters, etc.

1.208 In order to enhance transparency and ensure correct reflection of the unsecured advances in Schedule 9 of the banks' balance sheet, the following RBI requirements are 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.

1.209 As per the existing instructions of RBI, in the Balance Sheet of the banks, the amounts comprising Debtors (though not tangible assets), charged as security are grouped as secured by tangible assets and disclosure is made with a remark in parenthesis in the Schedule 9, without any quantification of the advances covered by security of Debtors. The amounts comprising the intangibles as per the RBI's Master Circular on Income recognition and Asset Classification Norms, will need to be culled out of the secured exposures and quantified to be reflected as unsecured advances; which would also require corresponding reclassification of advances for the earlier year. More importantly, in case of NPAs, the unsecured portion would attract a higher provision, when segregated from the secured portion.

(d) **Standard Assets**

1.210 The bank requires to make a general provision for standard assets at the following rates for the funded outstanding on global loan portfolio basis. The general provision towards standard assets as per Master Circular is as follows:

- a) Direct advances to Agricultural and Small and Micro Enterprises (SMEs) sectors - 0.25%
- b) Advances to Commercial Real Estate (CRE) sector – 1.00%
- c) Advances to Commercial Real Estate – Residential Housing Sector (CRE - RH) at 0.75 per cent
- d) Housing loans extended at teaser rates– 2.00% The provisioning on these assets would revert to 0.40 per cent after 1 year from the date on which the rates are reset at higher rates if the accounts remain 'standard'.
- e) Restructured accounts classified as standard advances will attract a higher provision (as prescribed from time to time) in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract the prescribed higher provision for the period covering moratorium and two years thereafter.

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Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a higher provision (as prescribed from time to time) in the first year from the date of upgradation.

The above-mentioned higher provision on restructured standard advances (2.75 per cent as prescribed vide circular dated November 26, 2012) would increase to 5 per cent in respect of new restructured standard accounts (flow) with effect from June 1, 2013 and increase in a phased manner for the stock of restructured standard accounts as on May 31, 2013 as under :

- 3.50 per cent - with effect from March 31, 2014 (spread over the four quarters of 2013-14)
 - 4.25 per cent - with effect from March 31, 2015 (spread over the four quarters of 2014-15)
 - 5.00 per cent - - with effect from March 31, 2016 (spread over the four quarters of 2015-16)
- f) All other loans and advances not included in (a), (b), (c), (d) and (e) above -0.40%

1.211 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 on Lending to Micro, Small & Medium Enterprises (MSME) Sector.

1.212 While the provisions on individual portfolios are required to be calculated at the rates applicable to them, the excess or shortfall in the provisioning, *vis-a-vis* the position as on any previous date, should be determined on an aggregate basis. If the provisions required to be held on an aggregate basis are less than the provisions held as on November 15, 2008, the provisions rendered surplus should not be reversed to P&L account but should continue to be maintained at the level, existed as on November 15, 2008. In case of shortfall determined on aggregate basis, the balance should be provided for by debit to P&L account.

1.213 The provisions on standard assets should not be reckoned for arriving at net NPAs. The provisions towards Standard Assets need not be netted from gross advances but included as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions - Others' in Schedule 5 of the balance sheet.

Provisioning requirements for derivative exposures

1.214 Credit exposures computed as per the current marked to market value of the contract, arising on account of the interest rate & foreign exchange derivative transactions, and gold, shall also attract provisioning requirement as

applicable to the loan assets in the 'standard' category, of the concerned counterparties. All conditions applicable for treatment of the provisions for standard assets would also apply to the aforesaid provisions for derivative and gold exposures.

Provisioning Norms for Leased Assets

1.215

- i) Substandard assets
 - a) 15 percent of the sum of the net investment in the lease and the unrealised portion of finance income net of finance charge component. The terms 'net investment in the lease', 'finance income' and 'finance charge' are as defined in 'AS 19 Leases' issued by the ICAI.
 - b) Unsecured lease exposures which are identified as 'substandard' would attract additional provision of 10 per cent, i.e., a total of 25 per cent.
- ii) Doubtful and
- iii) Loss assets

This is same as for Loan Assets.

Provisioning Coverage Ratio

1.216

- i. Provisioning Coverage Ratio (PCR) is essentially the ratio of provisioning to gross non-performing assets and indicates the extent of funds a bank has kept aside to cover loan losses.
- ii. From a macro-prudential perspective, RBI had required that the banks should build up provisioning and capital buffers in good times i.e. when the profits are good, which can be used for absorbing losses in a downturn. This was aimed at enhancing the soundness of individual banks, as also the stability of the financial sector. It was, therefore, decided that banks should augment their provisioning cushions consisting of specific provisions against NPAs as well as floating provisions, and ensure that their total provisioning coverage ratio, including floating provisions, is not less than 70 per cent. Accordingly, banks were advised to achieve this norm not later than end-September 2010.

1.217 RBI has further advised the banks that:

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- a. the PCR of 70 percent may be with reference to the gross NPA position in banks as on September 30, 2010;
 - b. the surplus of the provision under PCR *vis-a-vis* as required as per prudential norms should be segregated into an account styled as “countercyclical provisioning buffer”, computation of which may be undertaken as per the format given in Annex – 3 to the RBI’s Master Circular on “Prudential Norms on Income Recognition, Asset Classification and Provisioning to Advances” dated July 1, 2013; and
 - c. this buffer will be allowed to be used by banks for making specific provisions for NPAs during periods of system wide downturn, with the prior approval of RBI.
 - d. With reference to RBI circular No. DBOD.No.BP. 95/21.04.048/2013-14 on “Utilisation of Floating Provisions/Counter Cyclical Provisioning Buffer” dated February 7, 2014, banks may utilize upto 33 per cent of countercyclical provisioning buffer/floating provisions held by them as on March 31, 2013, for making specific provisions for non-performing assets. In this context, banks are required to build up ‘Dynamic Provisioning Account’ during good times and utilize the same during downturn. Under the proposed framework, banks are expected to either compute parameters such as probability of default, loss given default, etc. for different asset classes to arrive at long term average annual expected loss or use the standardized parameters prescribed by RBI towards computation of Dynamic Provisioning requirement. Dynamic loan loss provisioning framework is expected to be in place with improvement in the system. Meanwhile, banks should develop necessary capabilities to compute their long term average annual expected loss for different asset classes, for switching over to the dynamic provisioning framework.
- iv. The PCR of the bank should be disclosed in the Notes to Accounts to the Balance Sheet.

Accounting and Provisioning Norms for Equipment Leasing Activity

1.218 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

1.219 The guidelines also deal with provisioning for certain specific types of advances as follows.

Advances Guaranteed by ECGC

1.220 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. (For examples on calculation of the provision, refer the Master Circular on Income Recognition, Asset Classification and Provisioning Pertaining to Advances, dated July 1, 2013)

Advance covered by guarantees of Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) or Credit Risk Guarantee Fund Trust for Low Income Housing (CRGFTLIH)

1.221 In case the advance covered by CGTMSE or CRGFTLIH 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. (For illustrative examples of provisioning in case of advances covered by CGTSE guarantee, refer the paragraph 5.9.5 of the Master Circular No. on Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances, dated July 1, 2013.)

1.222 After statutory audit, RBI conducts annual financial inspection of banks. Auditors may go through the divergence reported by RBI, if any, in terms of classification as well as provisioning and whether the same divergence has been appropriately addressed /clarified, by Banks. Accordingly auditor would be well advised to consider these aspects while take final view on classification /provisioning of such accounts.

Disclosures

1.223 The information with respect to NPAs required to be disclosed under “Notes to Accounts” in the financial statements of banks is discussed in the chapter “Disclosure Requirement in Financial Statements”.

Restructuring/Reschedulement of Loans (Including Under Corporate Debt Structuring (CDR) Scheme)

Prudential Guidelines on Restructuring of Advances by Banks

1.224 The RBI, vide its master circular no. DBOD.No.BP.BC.1/21.04.048/2013-14 dated July 1, 2013 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.

1.225 The guidelines issued by the Reserve Bank of India on restructuring of advances (other than those restructured under a separate set of guidelines issued by the Rural Planning and Credit Department (RPCD) of the RBI on restructuring of advances on account of natural calamities) are divided into the following four categories :

- Guidelines on restructuring of advances extended to industrial units.
- industrial units under the Corporate Debt Restructuring (CDR) Mechanism
- Small and Medium Enterprises (SME)
- all other advances.

This benefit of retention of asset classification on restructuring was not made available to the accounts of borrowers engaged in non-industrial activities except to SME borrowers. The CDR Mechanism was made available only to the borrowers engaged in industrial activities.

1.226 The prudential norms for all categories of debt restructuring mechanisms, other than those restructured on account of natural calamities, which would continue to be covered by the extant guidelines issued by the Rural Planning and Credit Delivery (RPCD) were harmonized in August 2008.

1.227 In the backdrop of extraordinary rise in restructured standard advances, these prudential norms were further revised by taking into account the recommendations of the Working Group under the Chairmanship of , Shri B. Mahapatra, to review the existing prudential guidelines on restructuring of advances by banks/financial institutions. The details of the institutional / organizational framework for CDR Mechanism and SME Debt Restructuring Mechanism are given in Annex - 4 of the circular

1.228 The CDR Mechanism (Annex - 4) of the circular will also be available to the corporates engaged in non-industrial activities, if they are otherwise eligible for restructuring as per the criteria laid down for this purpose. Further, banks are also encouraged to strengthen the co-ordination among themselves in the matter

of restructuring of consortium / multiple banking accounts, which are not covered under the CDR Mechanism.

Key Concepts

1.229 Key concepts used in these guidelines are defined in Annex - 5.

General Principles and Prudential Norms for Restructured Advances

1.230 The principles and prudential norms laid down in this paragraph are applicable to all advances including the borrowers, who are eligible for special regulatory treatment for asset classification

Eligibility criteria for restructuring of advances

1.231 Banks may restructure the accounts classified under 'standard', 'sub-standard' and 'doubtful' categories.

1.232 Banks cannot 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 process of re-classification of an asset should not stop merely because restructuring proposal is under consideration. The asset classification status as on the date of approval of 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.

1.233 Normally, restructuring cannot take place unless alteration / changes in the original loan agreement are made with the formal consent / application of the debtor. However, the process of restructuring can be initiated by the bank in deserving cases subject to customer agreeing to the terms and conditions.

1.234 No account will 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. Any restructuring done without looking into cash flows of the borrower and assessing the viability of the projects / activity financed by banks would be treated as an attempt at ever greening a weak credit facility and would invite supervisory concerns / action. Banks should accelerate the recovery measures in respect of such accounts. 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.

1.235 Illustratively, the parameters may include

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

1.236 The viability should be determined by the banks based on the acceptable viability parameters and benchmarks for each parameter determined by them. The benchmarks for the viability parameters adopted by the CDR Mechanism are given in the Appendix to Part – B of this Master Circular and individual banks may suitably adopt them with appropriate adjustments, if any, for specific sectors while restructuring of accounts in non-CDR cases.

1.237 While the borrowers indulging in frauds and malfeasance will continue to remain ineligible for restructuring.

1.238 Banks may review the reasons for classification of the borrowers as wilful defaulters, 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.

1.239 The restructuring of such cases may be done with Board's approval, while for such accounts the restructuring under the CDR Mechanism may be carried out with the approval of the Core Group only.

1.240 BIFR cases are not eligible for restructuring without their express approval. 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

1.241 Restructuring of advances could take place in the following stages:

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

1.242 The accounts classified as 'standard assets' should be immediately re-classified as 'sub-standard assets' upon restructuring. (except for in certain cases).

1.243 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).

Upgradation of Accounts

1.244 Standard accounts classified as NPA and NPA accounts retained in the same category on restructuring by the bank should be upgraded only when all the outstanding loan/facilities in the account perform satisfactorily during the 'specified period' (Annex - 5), i.e. principal and interest on all facilities in the account are serviced as per terms of payment during that period.

1.245 In case, however, satisfactory performance after the specified period is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule.

1.246 Any additional finance may be treated as 'standard asset', during the specified period(Annex – 5) under the approved restructuring package. However, in the case of accounts where the pre-restructuring facilities were 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 period, the additional finance shall be placed in the same asset classification category as the restructured debt.

Subsequent Restructuring

1.247 If a restructured asset, which is a standard asset on restructuring in terms of para 14.5.2 of the Circular, 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 occasions may be allowed to be upgraded to standard category after the specified period (Annex – 5) in terms of the current restructuring package, subject to satisfactory performance.

Income recognition norms

1.248 Interest income in respect of restructured accounts classified as 'standard assets' will be recognized on accrual basis and that in respect of the accounts classified as 'non-performing assets' will be recognized on cash basis.

Provisioning norms

Provision on restructured advances

Normal provisions

1.249 (i) Banks will hold provision against the restructured advances as per the extant provisioning norms.

(ii) Restructured accounts classified as standard advances will attract a higher provision (as prescribed from time to time) in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract the prescribed higher provision for the period covering moratorium and two years thereafter.

(iii) Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a higher provision (as prescribed from time to time) in the first year from the date of upgradation.

(iv) The above-mentioned higher provision on restructured standard advances (2.75 per cent as prescribed vide circular dated November 26, 2012) would increase to 5 per cent in respect of new restructured standard accounts (flow) with effect from June 1, 2013 and increase in a phased manner for the stock of restructured standard accounts as on May 31, 2013 as under :

- 3.50 per cent - with effect from March 31, 2014 (spread over the four quarters of 2013-14)
- 4.25 per cent - with effect from March 31, 2015 (spread over the four quarters of 2014-15)
- 5.00 per cent - - with effect from March 31, 2016 (spread over the four quarters of 2015-16)

Provision for diminution in the fair value of restructured advances -

1.250 (i) 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 and in an account distinct from that for normal provisions.

For this purpose, the erosion in the fair value of the advance should be computed as the difference between the fair value of the loan before and after restructuring. Fair value of the loan before restructuring will be computed as the present value of cash flows representing the interest at the existing rate charged on the advance before restructuring and the principal, discounted at a rate equal to the bank's BPLR or Base Rate⁶ (whichever is applicable to the borrower) as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring.

The above formula moderates the swing in the diminution of present value of loans with the interest rate cycle and will have to be followed consistently by banks in future. Further, it is reiterated that the provisions required as above arise due to the action of the banks resulting in change in contractual terms of the loan upon restructuring which are in the nature of financial concessions. These provisions are distinct from the provisions which are linked to the asset classification of the account classified as NPA and reflect the impairment due to deterioration in the credit quality of the loan. Thus, the two types of the provisions are not substitute for each other.

- ii) There could be divergences in the calculation of diminution of fair value of accounts by banks. For example, divergences could occur if banks do not appropriately factor in the term premium on account of elongation of repayment period on restructuring. In such a case the term premium used while calculating the present value of cash flows after restructuring would be higher than the term premium used while calculating the present value of cash flows before restructuring.

Further, the amount of principal converted into debt/equity instruments on restructuring would need to be held under AFS and valued as per usual valuation norms. Since these instruments are getting marked to market, the erosion in fair value gets captured on such valuation. Therefore, for the purpose of arriving at the erosion in the fair value, the NPV calculation of the portion of principal not converted into debt/equity has to be carried out separately. However, the total sacrifice involved for the bank would be NPV

⁶ This change has been introduced as a result of the introduction of Base Rate System w.e.f. July 1, 2010 vide circular DBOD.No.Dir.BC.88/13.03.00/2009-10 dated April 9, 2010 on 'Guidelines on the Base Rate'.

of the above portion plus valuation loss on account of conversion into debt/equity instruments.

Banks are therefore advised that they should correctly capture the diminution in fair value of restructured accounts as it will have a bearing not only on the provisioning required to be made by them but also on the amount of sacrifice required from the promoters

Further, there should not be any effort on the part of banks to artificially reduce the net present value of cash flows by resorting to any sort of financial engineering. RBI also advised the banks to put in place a proper mechanism of checks and balances to ensure accurate calculation of erosion in the fair value of restructured accounts.

1.251 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 (i) 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.

1.252 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.

1.253 The diminution in the fair value may be re-computed 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 or base rate(whichever is applicable to the borrower), term premium and the credit category of the borrower. Consequently, banks may provide for the shortfall in provision or reverse the amount of excess provision held in the distinct account.

1.254 If due to lack of expertise / appropriate infrastructure, a bank finds it difficult to ensure computation of diminution in the fair value of advances, as an alternative to the methodology prescribed above for computing the amount of diminution in the fair value, the banks has the option of notionally computing the amount of diminution in the fair value and providing therefor, at five percent of the total exposure, in respect of all restructured accounts where the total dues to bank(s) are less than rupees one crore.

1.255 The total provisions required against an account (normal provisions plus provisions in lieu of diminution in the fair value of the advance) are capped at 100% of the outstanding debt amount.

Risk-Weights

1.256 The RBI circular also provides that:

- a. Restructured housing loans should be risk weighted with an additional risk weight of 25 percentage points.
- b. With a view to reflecting a higher element of inherent risk which may be latent in entities whose obligations have been subjected to restructuring / rescheduling either by banks on their own or along with other bankers / creditors, the unrated standard / performing claims on corporates should be assigned a higher risk weight of 125% until satisfactory performance under the revised payment schedule has been established for one year from the date when the first payment of interest / principal falls due under the revised schedule.
- c. For details on risk weights, Master Circular DBOD.No.BP.MC.2/21.06.201/2013-14 dated July 1, 2013 on 'Basel III Capital Regulations' may be referred.

Prudential Norms for Conversion of Principal into Debt / Equity

Asset classification norms

1.257 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

1.258 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

1.259 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

1.260 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 Re. 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.

Prudential Norms for Conversion of Unpaid Interest into 'Funded Interest Term Loan' (FITL), Debt or Equity Instruments

Asset classification norms

1.261 The FITL / debt or equity instrument created by conversion of unpaid interest will be classified in the same asset classification category in which the restructured advance has been classified. Further movement in the asset classification of FITL / debt or equity instruments would also be determined based on the subsequent asset classification of the restructured advance.

Income recognition norms

1.262 The income, if any, generated by these instruments may be recognised on accrual basis, if these instruments are classified as 'standard', and on cash basis in the cases where these have been classified as a non-performing asset.

1.263 The unrealised income represented by FITL / Debt or equity instrument should have a corresponding credit in an account styled as "Sundry Liabilities Account (Interest Capitalization)".

1.264 In the case of conversion of unrealised interest income into equity, which is quoted, interest income can be recognized after the account is upgraded to standard category at market value of equity, on the date of such upgradation, not exceeding the amount of interest converted into equity.

1.265 Only on repayment in case of FITL or sale / redemption proceeds of the debt / equity instruments, the amount received will be recognized in the P&L Account, while simultaneously reducing the balance in the "Sundry Liabilities Account (Interest Capitalisation)".

Valuation & Provisioning norms

1.266 Valuation and provisioning norms would be as per para 13.3 of the Master Circular No. DBOD.No.BP.BC.1/21.04.048/2013-14 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, dated July 1, 2013. The depreciation, if any, on valuation may be charged to the Sundry Liabilities (Interest Capitalisation) Account.

Special Regulatory Treatment for Asset Classification

1.267 The special regulatory treatment for asset classification, in modification to the provisions in this regard stipulated in para 12 of the Master Circular No. DBOD.No.BP.BC.1/21.04.048/2013-14 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, dated July 1, 2013, will be available to the borrowers engaged in important business activities, subject to compliance with certain conditions as enumerated in para 15.2 of the above mentioned master circular. Such treatment is not extended to the following categories of advances:

- i. Consumer and personal advances;
- ii. Advances classified as Capital market exposures;
- iii. Advances classified as commercial real estate exposures

1.268 The asset classification of these three categories accounts as well as that of other accounts which do not comply with the conditions enumerated in para 15.2 of the Master Circular No. DBOD.No.BP.BC.1/21.04.048/2013-14 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, dated July 1, 2013, are governed by the prudential norms in this regard described in para 12 of the Master Circular No. DBOD.No.BP.BC.1/21.04.048/2013-14 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, dated July 1, 2013.

Elements of special regulatory framework

1.269 The special regulatory treatment has the following two components:

- (i) Incentive for quick implementation of the restructuring package.
- (ii) Retention of the asset classification of the restructured account in the pre-restructuring asset classification category

Incentive for quick implementation of the restructuring package

1.270 As stated in para 12.1.2 of the Master Circular No. DBOD.No.BP.BC.1/21.04.048/2013-14 on Prudential norms on Income

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Recognition, Asset Classification and Provisioning pertaining to Advances, dated July 1, 2013, during the pendency of the application for restructuring of the advance with the bank, the usual asset classification norms would continue to apply. The process of reclassification of an asset should not stop merely because the application is under consideration. However, as an incentive for quick implementation of the package, if the approved package is implemented by the bank as per the following time schedule, the asset classification status may be restored to the position which existed when the reference was made to the CDR Cell in respect of cases covered under the CDR Mechanism or when the restructuring application was received by the bank in non-CDR cases:

- (i) Within 120 days from the date of approval under the CDR Mechanism.
- (ii) Within 120 days from the date of receipt of application by the bank in cases other than those restructured under the CDR Mechanism.

Asset classification benefits

1.271 Subject to the compliance with the undernoted conditions in addition to the adherence to the prudential framework laid down in para 12 of the Master Circular No. DBOD.No.BP.BC.1/21.04.048/2013-14 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, dated July 1, 2013:

- (i) In modification to para 12.2.1 of the of the Master Circular No. DBOD.No.BP.BC.1/21.04.048/2013-14 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, dated July 1, 2013, an existing 'standard asset' will not be downgraded to the sub-standard category upon restructuring.
- (ii) In modification to para 12.2.2 of the Master Circular No. DBOD.No.BP.BC.1/21.04.048/2013-14 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, dated July 1, 2013, during the specified period, the asset classification of the sub-standard / doubtful accounts will not deteriorate upon restructuring, if satisfactory performance is demonstrated during the specified period.

1.272 However, these benefits will be available subject to compliance with the following conditions:

- i) The dues to the bank are 'fully secured' as defined in Annex – 5 of the circular. The condition of being fully secured by tangible security will not be applicable in the following cases:
 - (a) MSE borrowers, where the outstanding is up to Rs.25 lakh.

- (b) Infrastructure projects, provided the cash flows generated from these projects are adequate for repayment of the advance, the financing bank(s) have in place an appropriate mechanism to escrow the cash flows, and also have a clear and legal first claim on these cash flows.
- ii) The unit becomes viable in 8 years, if it is engaged in infrastructure activities, and in 5 years in the case of other units.
- iii) The repayment period of the restructured advance including the moratorium, if any, does not exceed 15 years in the case of infrastructure advances and 10 years in the case of other advances. The aforesaid ceiling of 10 years would not be applicable for restructured home loans; in these cases the Board of Directors of the banks should prescribe the maximum period for restructured advance keeping in view the safety and soundness of the advances.
- iv) Promoters' sacrifice and additional funds brought by them should be a minimum of 20 per cent of banks' sacrifice or 2 per cent of the restructured debt, whichever is higher. This stipulation is the minimum and banks may decide on a higher sacrifice by promoters depending on the riskiness of the project and promoters' ability to bring in higher sacrifice amount. Further, such higher sacrifice may invariably be insisted upon in larger accounts, especially CDR accounts. The promoters' sacrifice should invariably be brought upfront while extending the restructuring benefits to the borrowers. The term 'bank's sacrifice' means the amount of 'erosion in the fair value of the advance'; or "total sacrifice", to be computed as per the methodology enumerated in para 12.4.2 (i) and (ii) of the Master Circular No. DBOD.No.BP.BC.1/21.04.048/2013-14 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, dated July 1, 2013.
- (Prior to May 30, 2013, if banks were convinced that the promoters face genuine difficulty in bringing their share of the sacrifice immediately and need some extension of time to fulfill their commitments, the promoters could be allowed to bring in 50% of their sacrifice, i.e. 50% of 15%, upfront and the balance within a period of one year. However, in such cases, if the promoters fail to bring in their balance share of sacrifice within the extended time limit of one year, the asset classification benefits derived by banks will cease to accrue and the banks will have to revert to classifying such accounts as per the asset classification norms
- v) Promoter's contribution need not necessarily be brought in cash and can be brought in the form of de-rating of equity, conversion of unsecured loan brought by the promoter into equity and interest free loans.

vi) The restructuring under consideration is not a 'repeated restructuring' as defined in para (v) of Annex - 5 of the circular.

1.273 In line with the recommendation of the Working Group under the Chairmanship of Shri B. Mahapatra, to review the existing prudential guidelines on restructuring of advances by banks/financial institutions, the extant incentive for quick implementation of restructuring package and asset classification benefits (paragraph 15.2.1 & 15.2.2 of the Master Circular No. DBOD.No.BP.BC.1/21.04.048/2013-14 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, dated July 1, 2013) available on restructuring on fulfilling the conditions will however be withdrawn for all restructurings effective from April 1, 2015 with the exception of provisions related to changes in DCCO in respect of infrastructure as well as non-infrastructure project loans. It implies that with effect from April 1, 2015, a standard account on restructuring (for reasons other than change in DCCO) would be immediately classified as sub-standard on restructuring as also 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 the extant asset classification norms with reference to the pre-restructuring repayment schedule.

Miscellaneous

1.274 The banks 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.

1.275 Conversion of debt into preference shares should be done only as a last resort and such conversion of debt into equity/preference shares should, in any case, be restricted to a cap (say 10 per cent of the restructured debt). Further, any conversion of debt into equity should be done only in the case of listed companies.

1.276 Acquisition of equity shares / convertible bonds / convertible debentures in companies by way of conversion of debt / overdue interest can be done without seeking prior approval from RBI, even if by such acquisition the prudential capital market exposure limit prescribed by the RBI is breached. However, this will be subject to reporting of such holdings to RBI, Department of Banking Supervision (DBS), every month along with the regular DSB Return on

Asset Quality. Nonetheless, banks will have to comply with the provisions of Section 19(2) of the Banking Regulation Act, 1949.

1.277 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 the RBI in the aforesaid DSB return.

1.278 Banks may consider incorporating in the approved restructuring packages creditor's rights to accelerate repayment and the borrower's right to pre pay. Further, all restructuring packages must incorporate 'Right to recompense' clause and it should be based on certain performance criteria of the borrower. In any case, minimum 75 per cent of the recompense amount should be recovered by the lenders and in cases where some facility under restructuring has been extended below base rate, 100 per cent of the recompense amount should be recovered.

1.279 As stipulating personal guarantee will ensure promoters' "skin in the game" or commitment to the restructuring package, promoters' personal guarantee should be obtained in all cases of restructuring and corporate guarantee cannot be accepted as a substitute for personal guarantee. However, corporate guarantee can be accepted in those cases where the promoters of a company are not individuals but other corporate bodies or where the individual promoters cannot be clearly identified.

Disclosures

1.280 With effect from the financial year 2012-13, banks are required to disclose in their published annual Balance Sheets, under 'Notes on Accounts'; information relating to number of accounts and amount of advances restructured, and the amount of diminution in the fair value of the restructured advances as per the format given in Annex – 6 to the RBI circular. The information would be required for advances restructured under CDR Mechanism, SME Debt Restructuring Mechanism and other categories separately. Banks must disclose the total amount outstanding in all the accounts / facilities of borrowers whose accounts have been restructured along with the restructured part or facility. This means even if only one of the facilities / accounts of a borrower has been restructured, the bank should also disclose the entire outstanding amount pertaining to all the facilities / accounts of that particular borrower. The disclosure format prescribed in Annex-6, *inter-alia*, includes the following:

- i. details of accounts restructured on a cumulative basis excluding the standard restructured accounts which cease to attract higher provision and risk weight (if applicable);
- ii. provisions made on restructured accounts under various categories; and
- iii. details of movement of restructured accounts.

This implies that once the higher provisions and risk weights (if applicable) on restructured advances (classified as standard either *abinitio* or on upgradation from NPA category) revert to the normal level on account of satisfactory performance during the prescribed period, such advances should no longer be required to be disclosed by banks as restructured accounts in the “Notes on Accounts” in their Annual Balance Sheets. However, the provision for diminution in the fair value of restructured accounts on such restructured accounts should continue to be maintained by banks as per the existing instructions.

1.281 It has been reiterated that the basic objective of restructuring is to preserve economic value of units, not ever greening of problem accounts. This can be achieved by banks and the borrowers only by careful assessment of the viability, quick detection of weaknesses in accounts and a time-bound implementation of restructuring packages. (Text of RBI Master circular on “Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances” for Annex 1 to 6 are given in CD.)

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

Securitisation of Standard Assets

1.282 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.

1.283 Securitised 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 securitised 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 securitised 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 securitised asset from its balance sheet.

1.284 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.

1.285 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

1.286 For all projects financed by the FIs/ banks after 28th May, 2002, the date of completion of the project should be clearly spelt out at the time of financial closure of the project.

Project Loans

1.287 There are occasions when the completion of projects is delayed for legal and other extraneous reasons like delays in Government approvals etc. All these factors, which are beyond the control of the promoters, may lead to delay in project implementation and involve restructuring / reschedulement of loans by

banks. Accordingly, the following asset classification norms would apply to the project loans before commencement of commercial operations. These guidelines will, however, not be applicable to restructuring of Advances classified as Commercial Real Estate exposures; Advances classified as Capital Market exposure; and Consumer and Personal Advances which will continue to be dealt with in terms of the extant provisions..

1.288 For this purpose, all project loans have been divided into the following two categories:

- a. Project Loans for infrastructure sector
- b. Project Loans for non-infrastructure sector

'Project Loan' would mean any term loan which has been extended for the purpose of setting up of an economic venture. Banks must fix a Date of Commencement of Commercial Operations (DCCO) for all project loans at the time of sanction of the loan / financial closure (in the case of multiple banking or consortium arrangements).

Project Loans for Infrastructure Sector

1.289(i) A loan for an infrastructure project will be classified as NPA during any time before commencement of commercial operations as per record of recovery (90 days overdue), unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (v) below.

(ii) A loan for an infrastructure project will be classified as NPA if it fails to commence commercial operations within two years from the original DCCO, even if it is regular as per record of recovery, unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (v) below.

(iii) If a project loan classified as 'standard asset' is restructured any time during the period up to two years from the original date of commencement of commercial operations (DCCO), in accordance with the provisions of Part B of this Master Circular, it can be retained as a standard asset if the fresh DCCO is fixed within the following limits, and further provided the account continues to be serviced as per the restructured terms.

- (a) Infrastructure Projects involving court cases

Up to another 2 years (beyond the existing extended period of 2 years i.e total extension of 4 years), in case the reason for extension of date of commencement of production is arbitration proceedings or a court case.

- (b) Infrastructure Projects delayed for other reasons beyond the control of promoters
Up to another 1 year (beyond the existing extended period of 2 years i.e. total extension of 3 years), in other than court cases.
- (iv) It is re-iterated that the dispensation in para 1.365 (iii) is subject to adherence to the provisions regarding restructuring of accounts as contained in the Master Circular which would inter alia require that the application for restructuring should be received before the expiry of period of two years from the original DCCO and when the account is still standard as per record of recovery.
- 1.290 The other conditions applicable would be:
- a. In cases where there is moratorium for payment of interest, banks should not book income on accrual basis beyond two years from the original DCCO, considering the high risk involved in such restructured accounts.
- b. Banks should maintain provisions on such accounts as long as these are classified as standard assets as under:

Particulars	Provisioning Requirement
If the revised DCCO is within two years from the original DCCO prescribed at the time of financial closure	0.40 per cent
If the DCCO is extended beyond two years and upto four years or three years from the original DCCO, as the case may be, depending upon the reasons for such delay	<p>Project loans restructured with effect from June 1, 2013:</p> <p>5.00 per cent – From the date of such restructuring till the revised DCCO or 2 years from the date of restructuring, whichever is later</p> <p>Stock of project loans classified as restructured as on June 1, 2013:</p> <ul style="list-style-type: none"> • 3.50 per cent - with effect from March 31, 2014 (spread over the four quarters of 2013-14) • 4.25 per cent - with effect from March 31, 2015 (spread over the four quarters of 2014-15)

- 5.00 per cent - - with effect from March 31, 2016 (spread over the four quarters of 2015-16)

The above provisions will be applicable from the date of restructuring till the revised DCCO or 2 years from the date of restructuring, whichever is later.

- (v) For the purpose of these guidelines, mere extension of DCCO will also be treated as restructuring even if all other terms and conditions remain the same.

Project Loans for Non-Infrastructure Sector

- 1.291(i) A loan for a non-infrastructure project will be classified as NPA during any time before commencement of commercial operations as per record of recovery (90 days overdue), unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (v) below.
- (ii) A loan for a non-infrastructure project will be classified as NPA if it fails to commence commercial operations within six months from the original DCCO, even if is regular as per record of recovery, unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (v) below.
- (iii) In case of non-infrastructure projects, if the delay in commencement of commercial operations extends beyond the period of six months from the date of completion as determined at the time of financial closure, banks can prescribe a fresh DCCO, and retain the "standard" classification by undertaking restructuring of accounts in accordance with the provisions contained in this Master Circular, provided the fresh DCCO does not extend beyond a period of twelve months from the original DCCO. This would among others also imply that the restructuring application is received before the expiry of six months from the original DCCO, and when the account is still "standard" as per the record of recovery.
- (iv) The other conditions applicable would be:
- a. In cases where there is moratorium for payment of interest, banks should not book income on accrual basis beyond six

months from the original DCCO, considering the high risk involved in such restructured accounts.

- b. Banks should maintain provisions on such accounts as long as these are classified as standard assets as under :

Particulars	Provisioning Requirement
If the revised DCCO is within one year from the original DCCO prescribed at the time of financial closure	0.40 per cent
If the DCCO is extended beyond one year and upto two years from the original DCCO prescribed at the time of financial closure	Project loans restructured with effect from June 1, 2013: 5.00 per cent –From the date of restructuring for 2 years Stock of Project loans classified as restructured before June 01, 2013: <ul style="list-style-type: none">• 3.50 per cent - with effect from March 31, 2014 (spread over the four quarters of 2013-14)• 4.25 per cent - with effect from March 31, 2015 (spread over the four quarters of 2014-15)• 5.00 per cent - with effect from March 31, 2016 (spread over the four quarters of 2015-16) The above provisions will be applicable from the date of restructuring for 2 years.
(v) For this purpose, mere extension of DCCO will also be treated as restructuring even if all other terms and conditions remain the same.	

Other Issues

- 1.292(i) All other aspects of restructuring of project loans before commencement of commercial operations would be governed by the provisions of Part B of Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances. Restructuring of project loans after commencement of commercial operations will also be governed by these instructions.
- (ii) Any change in the repayment schedule of a project loan caused due to an increase in the project outlay on account of increase in scope and size of the project, would not be treated as restructuring if:
- (a) The increase in scope and size of the project takes place before commencement of commercial operations of the existing project.
 - (b) The rise in cost excluding any cost-overrun in respect of the original project is 25% or more of the original outlay.
 - (c) The bank re-assesses the viability of the project before approving the enhancement of scope and fixing a fresh DCCP.
 - (d) On re-rating, (if already rated) the new rating is not below the previous rating by more than one notch.
- (iii) Project loans for Commercial Real Estate

These guidelines would apply to those cases where the modification to terms of existing loans, as indicated above, are approved by banks from the date of this circular.

Income recognition

- 1.293(i) Banks may recognise income on accrual basis in respect of the projects under implementation, which are classified as 'standard'.
- (ii) Banks should not recognise income on accrual basis in respect of the projects under implementation which are classified as a 'substandard' asset. Banks may recognise income in such accounts only on realisation on cash basis. Consequently, 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). As regards the regulatory treatment of 'funded interest' recognised as income and 'conversion into equity, debentures or any other instrument' banks should adopt the following:

- a) **Funded Interest:** Income recognition in respect of the NPAs, regardless of whether these are or are not subjected to restructuring/ rescheduling/ renegotiation of terms of the loan agreement, should be done strictly on cash basis, only on realisation and not if the amount of interest overdue has been funded. If, however, the amount of funded interest is recognised as income, a provision for an equal amount should also be made simultaneously. In other words, any funding of interest in respect of NPAs, if recognised as income, should be fully provided for.
- b) **Conversion into equity, debentures or any other instrument:** The amount outstanding converted into other instruments would normally comprise principal and the interest components. If the amount of interest dues is converted into equity or any other instrument, and income is recognised in consequence, full provision should be made for the amount of income so recognised to offset the effect of such income recognition. Such provision would be in addition to the amount of provision that may be necessary for the depreciation in the value of the equity or other instruments, as per the investment valuation norms. However, if the conversion of interest is into equity which is quoted, interest income can be recognised at market value of equity, as on the date of conversion, not exceeding the amount of interest converted to equity. Such equity must thereafter be classified in the “available for sale” category and valued at lower of cost or market value. In case of conversion of principal and /or interest in respect of NPAs into debentures, such debentures should be treated as NPA, *ab initio*, in the same asset classification as was applicable to loan just before conversion and provision made as per norms. This norm would also apply to zero coupon bonds or other instruments which seek to defer the liability of the issuer. On such debentures, income should be recognised only on realization basis. The income in respect of unrealised interest which is converted into debentures or any other fixed maturity instrument should be recognized only on redemption of such instrument. Subject to the above, the equity shares or other instruments arising from conversion of the principal amount of loan would also be subject to the usual prudential valuation norms as applicable to such instruments.

Provisioning Norms

Normal provisions

1.294 Banks will hold provision against these advances as per the existing provisioning norms.

Income Recognition

1.295 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.

Reserve for Exchange Rate Fluctuations Account (RERFA)

1.296 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 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

1.297 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

1.298 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).

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

- (i) When a bank / FI sells its financial assets to SC/ RC, on transfer the same will be removed from its books.
- (ii) 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.
- (iii) 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.
- (iv) When banks/ FIs invest in the security receipts/ pass-through certificates issued by SC/RC in respect of the financial assets sold by them to the SC/RC, the sale shall be recognised in books of the banks / FIs at the lower of:

- the redemption value of the security receipts/ pass-through certificates, and
- the NBV of the financial asset.

The above investment should be carried in the books of the bank / FI at the price as determined above until its sale or realization, and on such sale or realization, the loss or gain must be dealt with in the same manner as at (ii) and (iii) above.

Other Aspects

1.300 Certain other important aspects of the guidelines relating to provisioning are discussed below.

Floating Provisions

Principle for Creation and Utilisation of Floating Provisions by Banks

1.301 RBI mandates banks to hold floating provisions in respect of “Advances” as well as “Investments” separately. The Master Circular of July 1, 2013 on Income Recognition, Asset Classification and Provisioning Pertaining to Advances, requires the Board of Directors of banks to lay down a policy regarding the level to which floating provisions can be created. 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.

1.302 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.

1.303 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.

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

1.305 A bank may voluntarily make specific provisions for advances at rates which are higher than the rates prescribed under existing regulations, to provide for estimated actual loss in collectible amount, provided such higher rates are approved by the Board of Directors and consistently adopted from year to year. Such additional provisions are not to be considered as floating provisions.

Write-off of NPAs

1.306 The banks should either make full provision as per the guidelines or writeoff the advances and claim the tax benefits as are applicable, by evolving appropriate methodology in consultation with their auditors/tax consultants. Recoveries made in such accounts should be offered for tax purposes as per the rules. 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.

Guidelines on Sale/Purchase of NPAs

1.307 The Master Circular on Advances 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.

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1.308 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.

1.309 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.

1.310 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.

1.311 Banks should ensure that subsequent to sale of the non-performing financial assets to other banks/ARC. 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.

1.312 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.

1.313 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.

1.314 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.

1.315 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.

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

1.317 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.

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

1.319 As per the Master Circular on Prudential Norms on Advances dated July 1, 2013, if the sale is in respect of Standard Asset and the sale consideration is higher than the book value, the excess provisions may be credited to Profit and Loss Account. Excess provisions which arise on sale of NPAs can be admitted as Tier II capital subject to the overall ceiling of 1.25% of total Risk Weighted Assets. Accordingly, these excess provisions that arise on sale of NPAs would be eligible for Tier II status.

Asset Classification Norms

1.320 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

1.321 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

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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

1.322 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

1.323 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

1.324 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

1.325 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.

Disclosure Requirements

1.326 Banks which purchase nonperforming financial assets from other banks shall be required to make the following disclosures in the Notes on Accounts to their Balance sheets:

- A. Details of nonperforming financial assets purchased: (Amounts in Rupees crore)
1. (a) No. of accounts purchased during the year
(b) Aggregate outstanding
 2. (a) Of these, number of accounts restructured during the year
(b) Aggregate outstanding

B. Details of nonperforming financial assets sold: (Amounts in Rupees crore)

1. No. of accounts sold
2. Aggregate outstanding
3. Aggregate consideration received

C. The purchasing bank shall furnish all relevant reports to RBI, Credit Information Company which has obtained Certificate of Registration from RBI and of which the bank is a member etc. in respect of the nonperforming financial assets purchased by it.

Auditor's Report in Case of Bank Borrowers

1.327 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 Rs.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 Approach and Procedures

1.328 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.

1.329 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.

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g. Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

1.330 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;
- 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.

1.331 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 Rs.2 crore or 5% of the aggregate year-end advances of the branch, whichever is less.

1.332 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 audit sample. Besides this new advances sanctioned during the year should be included on selective basis in the sample.

Evaluation of Internal Controls over Advances

1.333 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 by doing KYC compliance ,proper credit appraisal etc. 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.
- Drawing Power Register should be updated every month to record the value of securities hypothecated. 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.

Computation of Drawing Power/Limits in respect of stocks hypothecated

1.334 In respect of credit facilities against hypothecation of stocks (inventories) being the primary security, the Bank's system of appraisal for determining the maximum permissible finance to borrowers and fixing of limits, inter alia, should generally take into consideration the level of sundry creditors

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(comprising 'unpaid for' stocks). The sanction is expected to be in tune with the appraisal so made. While sanctioning such credit facility, the bank is expected to stipulate in the documents, that for computing the Drawing Power, the value of declared stocks is to be considered only net of the stipulated margin; and that the declared stocks shall not cover the borrower's liability outstanding by way of unpaid for stocks (whether in the form of sundry creditors for purchases or covered by LCs/ guarantees/ co-acceptances). The Bank should also insist on such information from borrowers.

1.335 The Reserve Bank of India has been issuing guidelines on the treatment of unpaid stocks while arriving at the drawing power available in the borrowal accounts. The thrust of the guidelines is avoidance of double financing on the unpaid stocks, if such stocks are taken as eligible for computation of drawing power.

1.336 The matter having been re-examined by Reserve Bank of India, *vide* directive No. IECD.No.32/08.10.01/92-93 dated 28th April, 1993 had advised as under:-

- Banks may continue permitting drawing for working capital purpose based on the statements received under the quarterly / monthly information system depending on the regularity / reliability of such information or on the basis of monthly stock statements.
- Banks should ensure the compliance with the Selective Credit Control directives in force in respect of financing sensitive commodities.

1.337 By way of explanation it was added that maximum permissible Bank finance which is arrived at on the basis of the need based build-up of current assets and current liabilities are already adjusted to the extent of trade credits estimated/ projected by the borrowers for the purpose of re-aligning the above mentioned build-up of the current assets. In the circumstances, if the data revealed by the quarterly/ monthly statements do not indicate any divergence from the estimated/projected levels of the sundry creditors, there is no need to separately deduct the unpaid stocks from the value of the stocks as mentioned in the stock statements. The relevant statement for the purpose will be QIS- 1 on the basis of which the quarterly operative limits are fixed. However, if the levels of the sundry creditors as mentioned in QIS-1 exceed the value accepted at the time of appraisal of the credit requirements, the drawing power will have to be adjusted to the extent of such excess amount i.e. in this case the value of unpaid –stocks will be required to be deducted from the gross value of stocks as furnished in the stock statements for the purpose of arriving at the drawing power.

1.338 The auditor should review the policy of the bank in this regard for any inherent weakness in the credit system, where the stringency in appraisal, is relaxed while sanctioning the advances, having consequential effect on monitoring and supervision, and may have effect on the classification status of the Borrower, where the drawing power falls short of the outstanding.

1.339 Banks usually consider credit facilities by way of Hypothecation of stocks and a charge on the sundry debtors. The Drawing Power is required to be computed net of the stipulated margin, based on and applied to the total eligible current assets comprising:

- Net Value of Stock as stated above, and
- Net Value of Debtors (i.e., eligible Trade Debtors Less Bills Discounted with Bank). The bank usually prescribes the conditions as to what comprise eligible trade debtors, and stipulates the period for debts being considered as current and good on which the margin is computed.

1.340 For the purposes of classification of advances, the computation of drawing power based on realistic value of hypothecated stocks (net of unpaid for stocks, whether covered by LCs/ Guarantees/ Co-acceptances or otherwise) and margin as stipulated, is vital, particularly in cases of default, and in border-line cases where the health status of borrowers may be in question, to gauge slippages.

1.341 Due care is required to be exercised by the auditor in case of

- Documents retained in original at centralised offices where these are not available at the branches that are advised the figures of drawing power; and
- consortium advances, where the bank, not being the leader, gets the related figures of drawing power from the leader bank, without the related evidence of computation or appropriateness of the drawing power.

The auditor needs to look into this aspect to verify that there is no slippage of the account into NPA classification.

Long Form Audit Report

1.342 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 detailed directives / guidance with regard to such issues are given in a separate Chapter on Long Form Audit Report. 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

1.343 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.

1.344 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.

Examination of Loan Documents

1.345 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.

Centralisation and location of original loan documents at Loan Processing Centres

1.346 Of late, there is an increasing propensity in banks to process the loans and advances, including appraisal, sanction, documentation, initial disbursements, etc., at Loan Processing Centres/Offices (by whatever name called) and to execute and physically hold all the documents at such locations, that may not be in very close proximity to the branch, where the borrowal accounts are maintained/serviced. The Branch places reliance only on the Sanction letters, on the presumption that all the required legal and documentation formalities are correct and complete at the centralized location.

1.347 In the absence of the original documents (or even authenticated copies thereof) on an updated basis, the auditor would need to request the management for the files identified for examination by him. The branch auditor must be satisfied on the authenticity and terms of the sanction (in case the sanction letters are only computer generated but not authenticated), the completeness of the records, duly updated, for all accounts where the sanction was so conveyed; and further whether the number of accounts and amounts recorded at such centres tally with the corresponding data at the branch. It needs to be confirmed as to whether there are any cheques held by such centres that remain unbanked affecting the borrowal account balance. Reference must also be made to any adverse observations in the related monitoring/supervisory report on the documentation aspects at the centralized location.

Review of Operation of Account

* Corresponding to Section 180 of the Company Act, 2013, notified by Central Government *vide* notification dated 12th September, 2013.

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1.348 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.

1.349 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.

1.350 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 Rs. 10 lakh or above for working capital from the banking system.

1.351 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/Base Rate 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/Base Rate. 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.

1.352 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.

1.353 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.

1.354 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

1.355 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

1.356 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.

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

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1.358 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 Development Corporations, ECGC, DICGC, CGTS, 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) Advances covered by ECGC/DICGC, CGTS guarantees should be treated as covered by guarantees to the extent of guarantee cover available. The amount already received from DICGC/ECGC/CGTS and kept in sundry creditors account pending adjustment should be deducted from advances.
- (h) 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.

- (i) 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'.
- (j) 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.
- (k) Cheques purchased including self-cheques (i.e., where the drawer and payee are one and the same) should be treated as unsecured.
- (l) Advances against supply bills, unless collaterally secured, should be classified as unsecured even if they have been accepted by the drawees.
- (m) 'Security' means tangible security properly discharged to the bank and will not include intangible securities like guarantees (including State government guarantees), comfort letters, etc. Moreover, 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. (Ref Master Circular No. DBOD.BP.BC No.7/21.04.018/2013-14 dt July 1 2013 on Disclosure in Financial Statements- Notes to Accounts)

1.359 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.

1.360 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;

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- 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.

1.361 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

1.362 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. and verify the same with Demat Statement.

1.363 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.

1.364 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 in time by the borrower/bank.

Goods

1.365 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. Auditor should also verify that the Bank has system of maintenance of proper register in this regard as also system of scrutiny of stock/book debt statement furnished by the borrower.

1.366 The auditor should also check nature of goods hypothecated/pledged. If the goods are of perishable nature, it will not have market value.

1.367 In case of goods/book debts, moveable assets hypothecated, auditor should also examine whether the Bank has system in place for periodical inspection of such goods/debts/assets and records of borrowers by its own officer or by external agencies like firm of Chartered Accountants. Whether proper register is maintained in this regard and timely action is taken whenever there is an adverse remark in the inspection report.

1.368 Auditor should also check that there is adequate insurance cover in respect of goods/assets hypothecated and there is a bankers' clause in the policy.

1.369 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.

1.370 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.

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

1.372 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.

1.373 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

1.374 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.

1.375 It should be verified whether the policies are assignable in bank's favour. In certain types of policies the assignment to third party are restricted.

Bank's Own Deposit Certificates

1.376 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 and also in CBS

Hire-purchase Documents

1.377 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

1.378 These advances are classified as secured against the crop and/or the fixed assets (*viz.*, mortgage of land) 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.

1.379 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 after moratorium period, if specifically mentioned in the sanction letter..

Immovable Property

1.380 The auditor should inspect the title deed, the solicitor's/advocate'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.⁷ He should also examine the insurance policies.

1.381 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 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.

1.382 In case the bank has accepted third party property as a security. The owner of the property should also execute guarantee bond in bank's favour. The mortgage value in bank's favour should be equal/in excess of loan amount covered by such mortgage.

Reliance on / review of other reports

1.383 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.

⁷ Reference may be made in this regard to Standards on Auditing (SA) 620, "Using the Work of an Auditor's Expert".

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- 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 should check whether the variations in provisions, etc., reported by RBI have been properly considered by the bank management.

Third Party Guarantees

1.384 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 compromise, 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. If such clause is absent then Auditor has to see that acknowledge to debt from the borrower as well as guarantor is obtained by the Bank.

Verification of Bills Purchased and Discounted

1.385 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.

1.386 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.

1.387 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.

1.388 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.

1.389 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.

1.390 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 examined whether 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

1.391 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 of the limit-sanctioning branch should examine whether it receives particulars of all transactions in the account at sub-limit branches and whether the status of the account has been determined by considering the total position of operation of the

account at all concerned branches. As far as sub-limit branches are concerned, they should follow the classification adopted by the limit-sanctioning branch.

1.392 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'.

1.393 The amounts of advances in India and those outside India are to be shown separately in the balance sheet. This classification will depend upon where the advance was actually made and not where it has been utilised. Generally speaking, figures of Indian branches will be shown as advances in India and figures of foreign branches as advances outside India.

1.394 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*.

1.395 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.

1.396 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 and adequacy of its insurance cover along with Bank's name.
16. Timely submission of stock statement and other statements.

Verification of Provision for Non-performing assets

1.397 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 familiarise himself fully with the norms prescribed by RBI in this regard. 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—provisions of section 15 of the Banking Regulation Act, 1949, which applies to banking companies, nationalised banks, State Bank of India, its subsidiaries, and regional rural banks,—the bank concerned adequate provision for bad debts to the satisfaction of its auditor before paying any dividends on its shares.

1.398 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.

1.399 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.

1.400 It is to be examined whether 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

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

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

1.403 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.

1.404 It needs to be examined whether 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.

1.405 The stock audit should be carried out by the bank for all accounts having funded exposure of more than Rs.5 crores. Auditors can also advise for stock audit in other cases if the situation warrants the same. Branches should obtain the stock audit reports from lead bank or any other member, as decided in consortium 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.

1.406 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 examined whether the mobilization advance being received by the contractors is reduced while calculating drawing power.

Limits not reviewed

1.407 Accounts where regular/*ad hoc* limits are not reviewed within 180 days from the due date/date of *ad hoc* sanction, have to be considered as NPA. Auditors should also verify whether 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

1.408 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'.

1.409 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.

1.410 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

1.411 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.

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

Agricultural Advances

1.413 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.

1.414 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. CO.RRB.BC.No.7/03.05.33/2013-14 dated July 1, 2013. 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. In this context, attention of the readers is also invited to RBI’s Circular No. RPCD.No.FSD.BC.71/05.04.02/2013-14 on “Union Budget – 2013-14 Interest Subvention Scheme” dated December 4, 2013 in pursuance of the budget announcement made by the Finance Minister relating to the Interest Subvention Scheme 2013-14.

Lending under Consortium Arrangement / Multiple Banking Arrangements

1.415 In order to strengthen the information sharing system among banks in respect of the borrowers enjoying credit facilities from multiple banks, the banks are required to obtain regular certification by a professional, preferably a Company Secretary, Chartered Accountants or Cost Accountants regarding compliance of various statutory prescriptions that are in vogue, as per specimen given in Annexure III (Part I and II), to the RBI Circular No. DBOD.No. BP.BC.110/08.12.001/2008-09 dated February 10, 2009. Annexure III is given in CD for reference

1.416 The LFAR should include non compliance of the RBI Circular, indicating the cases in which the reports have not been obtained for review by the auditors.

1.417 Accounts under Consortium arrangements may, notwithstanding that these are classified as Standard, due to servicing thereof in a Bank, may nonetheless be intrinsically weak or may even be NPA in other participating bank(s) , including on the basis of the certificate/report as aforesaid. The auditor

should consider this aspect and classify the account appropriately based on facts and circumstances, particularly based on any serious adverse remarks/comments in the certificate issued pursuant to the RBI circular.

Provisioning Towards Standard Assets

1.418 The auditor should check the latest –Master Circular on IRAC Norms issued by RBI 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

1.419 Many banks have been very aggressive in sanctioning of retail loans lately. The retail assets in various banks at present form a significant part of their portfolio. As there are large numbers of accounts in these cases, the same poses a challenge for the auditors. The classification and provisioning towards the same should, however, be done as in case of other assets.

1.420 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 –NPA. 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.

Restructuring of cases

1.421 RBI has given guidelines for treatment of restructured accounts in part B of the Master Circular dated July 1 2013 The provisions of this Circular has been discussed earlier in the Chapter. The auditor should verify compliance with the requirements of the said circular.

1.422 Once the bank receives an application/proposal in respect of an account for restructuring, it implies that the account is intrinsically weak. Thereby during the time the account remains pending for restructuring, the auditors need to take a view whether provision needs to be made in respect of such accounts pending approval for restructuring.

Funding of Interest

1.423 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

1.424 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/ Base Rate, 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 Re.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.

1.425 In case the bank has agreed to convert existing/future exposure to the borrower in to Funded Interest Term Loan, such interest should be parked under sundry liabilities and should not be reckoned as income.

Upgradation of Account

1.426 The auditor should examine all the accounts upgraded during the year to verify that the upgrading of each account is strictly in terms of RBI guidelines.

1.427 Auditor has to verify 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.

1.428 Recovery in an advance which was rescheduled 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.

1.429 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

1.430 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.

1.431 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.

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1.432 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 Rs.5 crores and above, stock audit at annual interval by external agency is mandatory.

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

1.434 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.

1.435 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.

Method of appropriation of recoveries against principal, interest etc, and analysis of the potential loss of revenue

1.436 Attention is drawn to Part A of the latest Reserve Bank of India Master Circular (DBOD.No.BP.BC.1/21.04.048/2013-14 dated July 1, 2013), relating to Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances.

1.437 As per the prudential norms followed by banks, when a borrower is classified as Non Performing Asset (NPA):

- a. Income (comprising charges and interest), to the extent recorded and recognized as revenue at contractual rates/basis (while the account was classified as "standard"), but remaining unrealized for past periods, is expected to be derecognized, usually by transfer to a separate account called "Interest Suspense" or similar account. This is done by reversal of the amount of the revenue, without reversing the debit in the borrower's account.
- b. Further charges and interest recoverable at the contractual rates/basis (beyond the date on which the borrower was classified as NPA), are not recognized and a memorandum record thereof is maintained for future reference (for recoveries/waiver etc.).

(RBI has no objection to the banks using their own discretion in debiting interest to an NPA account taking the same to Interest Suspense Account or maintaining only a record of such interest in proforma accounts; however most banks follow the above-mentioned procedure.)

1.438 The above action of the banks is based on the following guidelines covered by Para 3.2 of Part A of the said Master Circular, reproduced hereunder:

“3.2 Reversal of income

3.2.1 If any advance, including bills purchased and discounted, becomes NPA, the entire interest accrued and credited to income account in the past periods, should be reversed if the same is not realised. This will apply to Government guaranteed accounts also.

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

1.439 The RBI has guided the banks to adopt an accounting principle and exercise the right of appropriation of recoveries in a uniform and consistent manner, in the absence of any clear agreement between the bank and the borrower in this regard. Para 3.3 of Part A of the said Master Circular is reproduced hereunder:

“3.3 Appropriation of recovery in NPAs

3.3.1 Interest realised on NPAs may be taken to income account provided the credits in the accounts towards interest are not out of fresh/ additional credit facilities sanctioned to the borrower concerned.

3.3.2 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 should adopt an accounting principle and exercise the right of appropriation of recoveries in a uniform and consistent manner.”

1.440 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.

1.441 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.

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1.442 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.

1.443 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 –three months are not considered for valuation purposes.

1.444 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.

1.445 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.

1.446 The bank is not supposed to account unrealised interest in NPA Accounts in the books of account. 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 verify that there are no mistakes in the same.

Audit Procedure for Accounts falling under CDR Programme

1.447 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.

1.448 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.,

1.449 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.

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1.450 Auditor has to examine whether the 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

1.451 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.

1.452 The auditor should examine whether 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.

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

1.454 The auditor should also verify whether the 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

1.455 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.

1.456 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.

1.457 In case of sale of an NPA, the auditor should also examine 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.

1.458 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.

III-2

Cash, Balances with RBI and Other Banks, and Money at Call and Short Notice

2.01 Cash, Balances with RBI and Other Banks, and Money at Call and Short Notice constitutes important items of balance sheet of a bank. Of these items, only a few select branches in each bank handle the transactions relating to money at call and short notice. As such, this item may not appear on the balance sheets of most branches of a bank.

Balance Sheet Disclosure

2.02 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

Balances with Reserve Bank of India, Balances with Other Banks

2.03 Banks maintain accounts with RBI and other Banks. Generally, only select branches maintain account with RBI. The branches also maintain accounts with other banks.

Money at Call and Short Notice

2.04 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'. The lender bank does not get any security for money lent at call or short notice. The participants of call and short-term money market are all scheduled commercial banks (excluding RRBs), all co-operative banks other than land development banks and all primary dealers, both as borrowers and lenders. Non-bank institutions are not permitted to participate in call/notice money with effect from August 6, 2005. Scheduled commercial banks usually borrow from this market to meet the requirements relating to cash reserve or statutory liquidity ratio. The decisions to borrow from, or lend in, the market are taken usually at the head office level and communicated to select branches for effecting the borrowing/lending.

2.05 RBI *vide* its Master Circular no. RBI2013-14/103, IDMD.PCD.03/14.01.01/2013-1434 dated July 1, 2013 on "Call/Notice Money Market Operations" provides the detailed guidelines on the prudential limits in respect of both outstanding and lending transactions in call/notice money market for banks and PDs. The said circular also requires the eligible participant to adopt the documentation suggested by FIMMDA from time to time, and to report the call/market money deals within 15 minutes irrespective of the size of the deal.

Audit Approach and Procedures

Cash

2.06 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 RBI or the State Bank of India or any other bank on the closing day, in which case, the work of

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the auditor is reduced substantially; however, the auditor must request the branch to provide sufficient appropriate evidence for the same.

2.07 Care should be taken to ensure that if cash is kept separately in different departments or at different locations (e.g., at extension counters), all the balances are verified by the auditor simultaneously. He should also ensure that there is no movement of cash till the counting is over.

2.08 The auditor should evaluate the effectiveness of the system of internal controls in branch regarding daily verification of cash, maintenance of cash related registers and vault register, custody of cash, custody of keys, daily cash holding and retention limit of the branch, etc. The auditor should examine whether that a global policy has been taken for safety of cash from theft or burglary and such policy is effective.

2.09 For physically verifying the cash-on-hand, the auditor may proceed as below:

- (a) Physically verify the cash-on-hand. The extent of verification would depend upon the auditor's assessment of the efficacy of internal control system including adherence to cash retention limits fixed by the head office, mode of custody of cash (whether single or joint), and frequency of cash verification by branch officials and/or by internal or concurrent auditors. Normally, in a bank, 100 notes of each denomination and thereafter 10 packets of 100 notes each are bundled together. Wherever sample checking is conducted, it is advisable that number of bundles of 100's is fully counted. Besides, the number of notes in samples of bundles of old notes of different denominations may also be checked, the sample size for larger denomination notes being higher than that in the case of smaller denomination notes. The number of notes in a small sample of bundle of new notes of larger denominations (say, Rs. 100 or more) may also be counted. In any event, care should be taken to ensure that all bundles produced for audit verification are properly sealed. Loose/soiled notes should be counted in full. Coins may be counted, or weighed and converted into monetary value as per RBI guidelines.
- (b) Obtain a certificate indicating denomination-wise cash balance as per physical verification.

2.10 Notes/coins in sealed packets may be accepted based on a written representation from the branch management and cross-checked with subsequent entries in the books of account.

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2.11 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.

2.12 Foreign currency notes should also be verified by actual inspection. When incorporating them in the balance sheet, they should be converted at the market rate prevailing on the closing day as notified by the Foreign Exchange Dealers' Association of India (FEDAI) in accordance with the accounting policy followed by the bank.

2.13 Special care needs to be exercised in cases where the branch operates currency chest and/or Small Coin Deposits. In respect of currency chest operations, the branch merely acts as an agent of the RBI to facilitate the distribution of bank notes and rupee coins. The balance in currency chest at any point of time is the property of the RBI and not of the bank. Therefore, while the auditor may not physically count the balance in currency chest at the year-end, he needs to take sufficient safeguards to ensure that currency chest balance is not mixed up in the cash balances produced to him for physical verification. Also, it should be recognised that the bank may be contingently liable for any shortfall in the currency chest balance. Accordingly, the branch auditor should pay special attention to the system of operation of currency chest transactions, recording of such transactions, method and frequency of counting of cash, and reconciliation with the link office. The auditor should perform compliance tests to evaluate the effectiveness of the system of operation of currency chest. He should examine whether the system is such that the transactions relating to deposits into and withdrawals from, currency chest are recorded promptly. In case the relevant transactions are required to be communicated to a link office of the bank (which maintains the account of RBI) for the purpose of reporting the same to the RBI, the auditor should evaluate the effectiveness of the system of reporting in terms of timeliness and accuracy.

2.14 In terms of the Master Circular No. DCM(CC) No.G - 11 /03.35.01/2013-1434 dated July 1, 2013 on "Levy of Penal Interest for Delayed Reporting/Wrong Reporting/Non-Reporting of Currency Chest Transactions and Inclusion of Ineligible Amounts in Currency Chest Balances", the banks are required to report the minimum amount of deposit into/withdrawal from currency chest of Rs.1,00,000/- and thereafter, in multiples of Rs.50,000/-. Further, the banks are obliged to follow the instructions with regarding timely

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reporting of Currency Chest Transactions by the banks for branches to which Currency chests are attached; and non compliance of the RBI instructions invite Levy of Penal Interest for delayed reporting/wrong reporting/non-reporting of Currency Chest transactions and penal measures for cases involving shortages/inclusion of counterfeit bank notes in chest balances/ chest remittances.

2.15 All currency chest transactions (deposits into /withdrawals from currency chest) at the branch concerned, must be reported through ICCOMS on the same day by 9 PM [by uploading data through the Secured Website (SWS)] to the link office to which the branch is attached for this purpose. Each Link office must, in turn, report to the RBI Issue Office concerned, latest by 11 PM on the same day, the consolidated net position for all the linked branches on value date basis; except in certain exceptional circumstances, like during strike period and on account of genuine difficulties faced by chests especially in hilly/remote areas and other chests affected by natural calamities, etc., where the default may be acceptable to the RBI, at its discretion.

2.16 The said circular covers:

- a. Levy of penal interest for delays
- b. Wrong reporting and levy of penal interest
- c. Maximum penal interest to be charged
- d. Penal interest for inclusion of ineligible amounts in the currency chest balances
- e. Rate of penal interest (to be levied at the rate of 2% over the prevailing Bank Rate for the period of delayed reporting/wrong reporting/non-reporting /inclusion of ineligible amounts in chest balances).
- f. Levy of penal interest in respect of currency chests at treasuries

2.17 The operation of currency chests attached to the various branches of the bank, affects the balances in accounts of RBI maintained by the bank at the designated branches; and it is imperative that the transactions on value date basis are recorded (as it affects the cash balance and that with RBI, on the day of the cash withdrawal from or deposit into the currency chest). Designated branches that maintain the RBI account should pass the entries the day of the transaction for currency chest attached to it; and as the Link Office for other branches operating Currency chests, based on inward communication from such other branches linked to it.

2.18 Due to any delays in communication by such branches to the Link Office, the amount required to be debited or credited to RBI Account, remains

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in a nominal account (Inter branch Adjustments) and affects the RBI account balance in the books of the Link Office. On line communication system should remedy this to ensure recording of entries at the designated Link Office, simultaneously as they take place at all currency chest branches.

2.19 The auditor should examine whether the account of the RBI at the designated branch maintaining the RBI Account has incorporated all the currency chest transactions on a value date basis as at the year end. He should also enquire as to whether the Bank has received any communication from RBI regarding any defaults in the operation of the currency chests, that may have penal consequences and whether during the year, any penalties have been levied on this account.

2.20 RBI Master Circular No. DCM (NE) No. G- 4 /08.07.18/2013-14 on "Facility for Exchange of Notes and Coins" dated July 1, 2013 requires that all designated bank branches should display at their branch premises, at a prominent place, a board indicating the availability of note exchange facility with the legend, "Mutilated notes are Accepted And Exchanged Here". Banks should ensure that all their designated branches provide facilities for exchange of notes and coins. The branches should ensure that the note exchange facility is not cornered by private money changers / professional dealers in defective notes.

2.21 The auditor should verify that the banks have not stapled the notes. Some banks in spite of RBI's instructions continue to follow the practice of stapling of note packets. This practice, apart from damaging notes, reduces the life span of notes and renders it difficult for customers to open note packets easily. Banks should do away with stapling of any note packets and instead secure them with paper bands. Further, RBI has issued Master Circular DCM(FNVD) No. G-5 /16.01.05/ 2013-14 on "Detection and Impounding of Counterfeit Notes" dated July 1, 2013, which provides operational guidance on detection and impounding of Counterfeit notes.

2.22 Increasingly banks are entering into an agreement with third party vendors for management of their ATM operations. These vendors collect amount from bank and is responsible for loading amount in the ATM. They are also responsible for collecting (deposited by customers) amount from ATM and depositing with bank. The auditor should verify an agreement entered with these vendors. The auditor also understand the process of providing, collecting and reconciliation etc. with these vendors and test controls in the process.

At each period end, the auditor should send independent balance confirmation to these vendors about balance held by them and should verify reconciliation statements.

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2.23 Also in respect of ATM operations, banks are centralizing the process of monitoring ATM balance. This division monitors balance as per the books and balance as per ATM machine (commonly termed as Switch balance) and their reconciliation and ensuring timely adjustment of reconciling entries. The auditor should understand the process of monitoring of balance, reconciliation etc. and based on the risk assessment should understand controls in the process and strategy of testing these controls.

At each reporting period end, the auditor should obtain the reconciliation statement and should verify the reconciliation statement.

Balance With RBI

2.24 In a bank, only a few select branches are designated to have account with the RBI. 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 RBI.

2.25 The auditor should understand the bank's reconciliation process and test controls around the process which may include management review controls such as maker checker for preparation of reconciliations, procedures followed for the subsequent clearance of reconciling items between bank's ledger and bank statement etc. The auditor should send independent audit confirmation for accounts maintained with RBI. Where the independent confirmation is not received, the auditor should perform alternate audit procedures such as downloading the bank statement from website in auditor's presence, obtaining the bank statements when bank statements are received by e-mail and obtain sufficient evidence for authenticity of e-mail etc., to gain sufficient comfort over the bank balance. The auditor should also verify the ledger balances in each account with reference to the bank confirmation certificates / statement and reconciliation statements as at year end. The auditor should 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 significant period .

2.26 The auditor should obtain a written explanation from the management as to the reasons for old outstanding transactions in bank reconciliation statements remaining unexplained/ unadjusted for significant period.

2.27 The auditor can also perform analysis of outstanding items and amount based on the number of days overdue with earlier periods. The auditor

should then review trend of outstanding items in comparison with earlier period and document reason for increasing in the trend.

Balance With Banks (Other than Reserve Bank of India)

2.28 The auditor should also apply the procedures described in paragraphs above in examining the balances with banks other than RBI. While reviewing the reconciliation statements, the auditor should pay particular attention to the following:

- (a) 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. This should be particularly observed when the bills collected, etc., are credited with net amount and entries for commission, etc., are not made separately in the statement of account.
- (b) Examine that no cheque sent or received in clearing is outstanding. As per the practice prevalent among banks, any cheques returned unpaid are accounted for on the same day on which they were sent in clearing or on the following day.
- (c) Examine that all bills or outstanding cheques sent for collection and outstanding as on the closing date have been credited subsequently.

2.29 The auditor should also examine the large transactions in inter-bank accounts, particularly towards the year-end, to ensure that no transactions have been put through for window-dressing.

2.30 In respect of balances in deposit accounts, original deposit receipts should be examined in addition to confirmation certificates obtained from banks in respect of outstanding deposits. Balances in deposit accounts are usually (though not necessarily) in round figures. Where such balances are in odd figures, the auditor should enquire whether the account concerned is actually of the nature of a deposit account.

2.31 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.

2.32 Increasingly banks are automating the process of reconciliation with other banks. In case of system process, the auditor should understand the system, system controls and manual controls. The auditor should also assess the system access control and program change controls of the reconciliation system. (refer chapter 3, Special Consideration in a CIS Environment of Part II for system audit).

Money at Call and Short Notice

2.33 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.

2.34 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.

2.35 Like deposits with banks, moneys at call and short notice are also usually (though not necessarily) in round figures. Any odd balances should, therefore, put the auditor to enquiry.

2.36 The auditor should also examine that money market borrowing or lending for more than 14 days are not classified under this head, but are classified as 'deposits' or 'advances', depending on the nature of lending and the parties to whom the moneys have been lent.

2.37 It may be noted that as per the directions of the RBI, banks cannot pay any brokerage on deposit and call loans, except to the extent specified in paragraph 8(e) of the RBI circular dated July 22, 1974.

2.38 The auditor should examine whether interest has been properly accrued and accounted for on year-end outstanding balances of money at call and short notice.

Fixed and Other Assets

Fixed Assets

3.01 Fixed assets comprise premises and other fixed assets such as furniture and fixtures, motor vehicles, office equipment, computers, other intangible assets such as application software and other computer softwares, etc.

3.02 In the case of most banks, fixed assets can be purchased by the head office, regional/zonal offices and branches up to the monetary ceiling specified (though purchase of land and buildings is usually centralised) for themselves as also for offices within their control. However, banks generally prefer to centralise the function of obtaining insurance and obtain a comprehensive policy for assets at numerous locations (to avail the benefit of rebate on bulk business). Fixed assets, particularly furniture and fixture, consumer durables, etc. are provided by banks to the staff and the account for the same is maintained at the office where the employee is posted. For disposal of fixed assets, powers are delegated to various levels in the bank.

3.03 As far as maintenance of records relating to fixed assets is concerned, practices vary among banks. In some banks, the offices acquiring the fixed assets have to maintain proper records including the provision of depreciation thereon whereas in case of some banks, the same is being done at Head Office. In such a case, the acquisitions, disposals, etc. are advised by the branch/other office concerned to the head office through the inter-branch accounting mechanism. A variant of this practice involves the recording of depreciation by branches and other offices based on the advice received from the head office. In recent times, some of the banks have installed Fixed Asset Management Softwares and the information relating to purchase, sale of fixed assets and depreciation thereon (in some cases) is accounted for with the help of such a software. This is usually done at a centralized HO level and reports are generated at branches and/or regional/Zonal offices.

Balance Sheet Disclosure

3.04 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

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shown separately for proper classification and disclosure and also to comply with the requirements of the Accounting Standards (ASs).

3.05 As per the Notes and Instructions for compilation of balance sheet, issued by the RBI, premises wholly or partly owned by the banking company for the purpose of business including residential premises should be shown under the head, 'Premises'. Furniture and fixtures, motor vehicles, office equipments, computers and all other fixed assets except premises should be shown under the head 'Other Fixed Assets'.

3.06 The original cost of fixed assets as on 31st March of the preceding year, additions thereto and deductions therefrom during the year, and total depreciation written off to date are to be disclosed in the financial statements. The Notes and Instructions for Compilation of Balance Sheet, issued by the RBI, require that where sums have been written-off on reduction of capital or revaluation of assets, every balance sheet after the first balance sheet subsequent to the reduction or revaluation should show the revised figures for a period of five years with the date and amount of revision made.

3.07 No rates of depreciation on fixed assets have been prescribed by the Banking Regulation Act, 1949. The provisions of the Schedule II to the Companies Act, 2013, should, therefore, be kept in mind in this respect especially in so far as the banking companies are concerned. Banking Regulation Act, 1949 requires that the auditor should examine whether the rates of depreciation are appropriate in the context of the expected useful lives of the respective fixed assets. In respect of computers and data processing equipments, RBI has directed that depreciation should be provided over three year period. With respect to fixed assets held at foreign offices/branches, depreciation is to be provided as per the regulations/norms of the respective countries.

3.08 An immovable property acquired by the bank in satisfaction of debts due should be included under the head 'fixed assets', if it is held by the bank for its own use.

3.09 The Third Schedule to the Banking Regulation Act, 1949, does not specifically deal with disclosure of land. Land is generally shown under the heading 'premises'.

Other Assets

3.10 The following items broadly are to be disclosed under the head 'Other Assets':

- Inter-office adjustments (net)
- Stationery and stamps
- Interest accrued
- Non-banking assets acquired in

- Tax paid in advance/tax deducted at source
- Others

3.11 As per RBI Circular no. DBOD.BP.BC.24/21.04.048 of March 30, 1999, credit card outstanding is not to be included under 'Other Assets'. Instead, they have to be shown as part of advances.

3.12 As per RBI circular DBOD.BP.BC.83/21.01.002/2000-01 of February 28, 2001, all loans and advances given to staff, which are non-interest bearing should be included in item 'Others' under 'Other Assets' and should not be reflected as 'Advances'.

Audit Approach and Procedures

Fixed Assets

3.13 In carrying out the audit of fixed assets, the auditor is concerned, primarily, with obtaining evidence about their ownership, 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.

3.14 The branch auditor should ascertain whether the accounts in respect of fixed assets are maintained at the branch or centrally. Similarly, the auditor 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

3.15 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 from appropriate authority and

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documents such as, contractors' bills, work order records, record of payments and completion certificate. 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.

3.16 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.

3.17 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 Statutory Central Auditor through a suitable mention in his report. This fact should also be brought in the Long Form Audit Report (LFAR).

3.18 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 verified 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.

3.19 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". The auditor should also check the impairment, if any, by applying the principles laid down in Accounting Standard (AS) 28, "Impairment of Assets".

3.20 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

3.21 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. The auditor 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.

3.22 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.

3.23 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 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.

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3.24 Many a times, 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. In recent times, the fixed asset management softwares are in use. The auditor has to examine the reasonableness of the internal controls with respect to recording such inter branch transfer of assets

3.25 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.

3.26 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.

3.27 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. 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.

3.28 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 must be reviewed with special emphasis on the computer hardware/software.

Leased Assets

3.29 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

3.30 AS 28, Impairment of Assets prescribes 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.

Other Assets

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

Inter-Office Adjustments

3.32 Inter Office Adjustments/Inter Branch Account is dealt separately in Chapter - 12 of Part III on "Inter-office Transactions".

Interest Accrued

3.33 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 borrowers repayment cycle date, there would usually be an amount of interest

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accrued but not due on advances on balance sheet date. 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 whether the interest has been accrued on the entire loans and advances portfolio of the bank. As far as possible, the detailed break up of the loan portfolio and the interest accrual should be obtained and the same should agree with the general ledger balance. This would ensure completeness of the interest accrual of Advances. The auditor should also examine the interest accrued on advances by recomputing it on a test check basis by referring to the loan parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc., from the loan agreements. This would ensure the completeness of the interest accrual on advances. In the current banking scenario the interest accrual setup is automated system driven for most banks and the auditor should verify the in – built logic and controls of the system.

3.34 The auditor should examine whether 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

3.35 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 examine whether 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.

3.36 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 verify the justification of the claim towards such certificates.

Stationery and Stamps

3.37 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 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.

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

3.39 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

3.40 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.

3.41 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.

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3.42 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.

3.43 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. The auditor should verify that the ownership of the property is legally vested in the bank's name. 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

3.44 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

3.45 The auditor should examine non-interest bearing staff advances with reference to the relevant documentation and the bank's policy in this regard. The availability, enforceability and valuation of security, if any, should also be examined. It needs to be examined whether the same relates to employees on the roll of the bank on the date of the preparation of financial statements.

Security Deposits

3.46 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. The auditor should verify that the deposits have 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 should be suggested against the amount where recovery is in doubt.

3.47 The auditor, based on the materiality, should send independent balance confirmation for security deposit at period end and should document for reason in the case of any differences.

Suspense Account

3.48 '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.

3.49 The auditor should pay special attention to any unusual items in suspense account since, these are prone to fraud risk. The auditor should obtain the management policy for provision/write off for old outstanding items. He should obtain from the management, details of old outstanding entries/age-wise balances along with narrations in suspense account. The auditor should also verify the reasons for such 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/written off.

Prepaid Expenses

3.50 The auditor should verify prepaid expenses in the same manner as in the case of other entities. The auditor should examine whether the basis of allocation of expenditure to different periods is reasonable. The auditor 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

3.51 Miscellaneous debit balances on government account in respect of pension, public provident funds, compulsory deposit scheme payments, etc.,

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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 of old outstanding items. The auditor should also examine whether claims for reimbursement have been lodged by the branch in accordance with the relevant guidelines, 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.

3.52 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. 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.

Borrowings and Deposits

Borrowings

4.01 Borrowings usually take place only at head office of the bank. In case of exception there is a borrowing at few designated branches authorised in this behalf by the head office or other controlling authority either generally or specifically in respect of a particular borrowing. As such, this item generally does not figure in the balance sheets of most branches of the bank.

Balance Sheet Disclosure

4.02 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*

RBI vide its circular no. DBOD.BP.BC No.81/ 21.01.002/2009-10 dated March 30, 2010 on "Classification in the Balance Sheet - Capital Instruments" advised that the following classification may be adopted in the balance sheet from the financial year ending March 31, 2010 under Schedule 4 – Borrowings:

1. Innovative Perpetual Debt Instruments (IPDI)
2. Hybrid debt capital instruments issued as bonds/debentures
3. Perpetual Cumulative Preference Shares (PCPS)
4. Redeemable Non-Cumulative Preference Shares (RNCPS)
5. Redeemable Cumulative Preference Shares (RCPS)
6. Subordinated Debt

4.03 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.

4.04 RBI, Export-Import Bank of India (EXIM Bank), National Bank for Agriculture and Rural Development (NABARD) and Small Industries

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Development Bank of India (SIDBI) are the major agencies providing refinance to banks, generally for loans extended to specified sectors. Borrowings from Reserve Bank of India include refinance obtained by the bank from the RBI. Similarly, borrowings from other banks include refinance obtained by the bank from commercial banks, co-operative banks, etc. Refinance obtained by the bank from EXIM Bank, NABARD, SIDBI and other similar institutions and agencies is to be included under 'borrowings from other institutions and agencies'. This head will also include the bank's liability against participation certificates on non-risk sharing basis issued by it to participating banks.

4.05 Credit balances of Nostro accounts are also to be included under the head borrowings.

4.06 'Borrowings outside India' include borrowings of Indian branches abroad as well as borrowings of foreign branches. Funds raised by foreign branches by way of certificates of deposit, notes, bonds, etc. have to be classified as 'deposits' or as 'borrowings' depending upon documentation. The 'Notes and Instructions for Compilation' of balance sheet and profit and loss account, issued by the RBI, clarify that since refinance obtained by a bank from the RBI and various institutions is to be shown under the head 'borrowings', the related advances should be shown on the assets side at the gross amount.

4.07 Money at call or short notice taken by the bank is also shown under this head. RBI through its "Master Circular no. IDMD.PCD.03 /14.01.01/2013-14 on "Call-Notice Money Market Operations" dated July 1, 2013 has set down the prudential limit for transactions in call/notice money market. In terms of the said circular, on a fortnightly average basis, the borrowings should not exceed 100 percent of the capital funds (i.e., sum of Tier I and Tier II capital) of latest audited balance sheet. However, banks are allowed to borrow a maximum of 125 percent of their capital funds on any day, during a fortnight.

Inter Bank Liabilities (IBL)

4.08 Liability side management has its own merits from the point of view of financial stability. Controlling the concentration risk on the liability side of banks is, therefore, as important as controlling the concentration risk on asset side. More particularly, uncontrolled IBL may have systemic implications, even if, the individual counterparty banks are within the allocated exposure.

4.09 Further, uncontrolled liability of a larger bank may also have a domino effect. In view of this, it has become important to put in place a comprehensive framework of liability management so that banks are aware of the risks inherent in following a business model based on large amount of IBL and the systemic risks such a model may entail. In order to reduce the extent of

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concentration on the liability side of the banks, the following guidelines have been prescribed by the RBI (applicable from April 1, 2007) vide its circular no. DBOD.BP.BC.66/ 21.01.002/2006-07 of March 6, 2007.

- (a) The IBL of a bank should not exceed 200% of its net worth as on 31st March of the previous year. However, individual banks may, with the approval of their Boards of Directors, fix a lower limit for their inter-bank liabilities, keeping in view their business model.
- (b) The banks whose CRAR is at least 25% more than the minimum CRARs on March 31, of the previous year, are allowed to have a higher limit up to 300% of the net worth for IBL.
- (c) The limit prescribed above will include only fund based IBL within India (including inter-bank liabilities in foreign currency to banks operating within India). In other words, the IBL outside India are excluded.
- (d) The above limits will not include collateralised borrowings under CBLO and refinance from NABARD, SIDBI etc.
- (e) The existing limit on the call money borrowings prescribed by RBI will operate as a sub-limit within the above limits.
- (f) Banks having high concentration of wholesale deposits should be aware of potential risk associated with such deposits and may frame suitable policies to contain the liquidity risk arising out of excessive dependence on such deposits.

Deposits

4.10 Deposits represent the most important source of funds for a bank. Deposits are received from a large number of constituents, generally in small amounts.

Balance Sheet Disclosure

4.11 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*

Types of Deposits

4.12 Deposits accepted by banks are primarily of two types – those repayable on demand (demand deposits) and those repayable after a fixed term (term deposits), though in this case also, the deposits may be repaid prematurely at the request of the depositor.

Demand Deposits

4.13 Current accounts are the most common form of demand deposits of banks. Though savings bank deposits are also, in substance in the nature of demand deposits, the Third Schedule to the Banking Regulation Act, 1949, does not consider them demand deposits. This may, perhaps, be due to the fact that withdrawals from savings bank accounts in excess of the limits prescribed by the bank can be made only with prior notice to the bank.

4.14 Current accounts can be opened in the names of individuals, associations of persons, corporate bodies, trusts, societies, etc., i.e., for all kinds of customers. The operations on current accounts opened in joint names may be joint, single, by either holder or by surviving holder, depending on the mode of operation chosen by the account holders. The salient features of this type of accounts are:

- There is no restriction on the quantum of funds withdrawn by the account holder at any one time.
- There is no restriction on the number of transactions in the account during any period of time.
- No interest is payable on this deposit except where it may be specifically permitted by the bank / RBI.

Savings Bank Deposits

4.15 Savings accounts are generally in the names of individuals – either singly or jointly, and sometimes, in the names of institutions which are specifically approved by the RBI for maintaining savings bank accounts with banks. In terms of RBI's guidelines, no bank can open a savings bank account for government departments, municipal corporations, municipal committees, any political party, or any trade, business or professional concern, whether such concern is a proprietary or a partnership firm or a company or an association. As in the case of current accounts, savings bank accounts can also be opened in joint names.

4.16 The salient features of this type of accounts are:

- Banks place restrictions on the maintenance of minimum balance (separate for cheque book and without cheque book), amount of funds that

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can be withdrawn by the account holder at any point to time. Beyond this cut-off level, banks require the depositors to give notice of a specified period for withdrawal of the amount.

- Banks also place restrictions on the number of withdrawals from the account during a stated period of time, usually one year. For the number of withdrawals beyond this number, banks have the right to levy service charges. The intention behind putting this restriction is to ensure that the savings bank accounts (on which the account holder is entitled to payment of interest) are used to promote genuine savings and are not used as substitutes for current accounts (on which the account holder usually does not get interest).
- Interest is payable as per the RBI guidelines in force. In the past, interest was paid annually but now, banks pay interest at quarterly / half-yearly intervals on daily outstanding balances.

4.17 In the case of both current and savings bank accounts, if there are no operations on the account by the account holder during a prescribed period (such period may vary from bank to bank), such accounts are identified as 'dormant' or 'inoperative' accounts and may be transferred to a separate ledger. Further, transactions in these accounts are allowed only with authority of the official designated by the bank for this purpose.

Term Deposits

4.18 Term deposits (known by different nomenclature in different banks) are repayable after a specified period of time. The minimum period of these deposits, at present, is 7 days. The salient features of this kind of deposits are given below:

- Interest is payable at periodic intervals to the depositors or as per their instructions.
- In case a depositor so desires, the periodic interest can be reinvested in fresh term deposits. Such schemes are generally called 'reinvestment plans'. In this case, the interest payable is compounded at the specified intervals and the resultant maturity value is indicated on the deposit receipt at the time of issuing the receipt. The head offices of banks issue maturity value charts for the guidance of their branches from time to time.

4.19 Recurring deposit accounts are an important variant of term deposit. In a recurring deposit, a specified sum is deposited at regular intervals, generally once a month, for a pre-determined period. On the expiry of this period, the maturity proceeds, which are known at the time of opening the account, are repaid to the depositors or as per their instructions. No recurring deposit is accepted under FCNR(B) Scheme. Some of the banks are offering

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fixed / flexible recurring deposit accounts in recent times where the customer choose amount of deposit each time based on their convenience.

4.20 Cash certificates and certificates of deposit (CD), in demat form or otherwise, are two other variants of term deposits. Cash certificates are issued at discounted value, e.g., a certificate with face value of Rs. 100 and term of 5 years may be issued at, say, Rs. 49. The certificates of deposit are short-term negotiable money market instruments and are issued in only dematerialised form or as a Usance Promissory Note. However, according to the Depositories Act, 1996, investors have the option to seek certificate in physical form. Further, issuance of CDs will attract stamp duty. In this regard, the RBI has issued Master Circular No. IDMD.PCD. 05/14.01.03/2013-14 on "Guidelines for Issue of Certificates of Deposit" dated July 1, 2013. CDs may be issued at a discount on face value. The rate of interest thereon is negotiable with the depositor and may vary on a daily basis. The maturity period of CDs issued by banks should not be less than 7 days and not more than one year. Banks are allowed to issue CDs on floating rate basis provided the methodology of compiling the floating rate is objective, transparent and market-based. The issuing bank/FI is free to determine the discount / coupon rate. The interest rate on floating rate CDs would have to be reset periodically in accordance with a pre-determined formula that indicates the spread over a transparent benchmark. Minimum amount of a CD should be Rs. 1 lakh, i.e., the minimum deposit that could be accepted from a subscriber should not be less than Rs. 1 lakh and in the multiples of Rs. 1 lakh thereafter. There is no grace period for repayment of CDs. If maturity date happens to be on holiday it should be paid on the immediately preceding working day. Banks may, therefore, so fix the period of deposit that the maturity date does not coincide with a holiday to avoid loss of discount / interest rate. All OTC trades in CDs shall be reported within 15 minutes of the trade on the FIMMDA reporting platform.

4.21 In respect of term deposits, banks issue Deposit Receipts. These receipts are not negotiable, and therefore, deposits cannot be transferred without the consent of the bank. Certificates of deposits are, however, transferable. CDs held in physical form are transferable by endorsement and delivery. CDs in dematerialised form can be transferred as per the procedure applicable to other demat securities. There is no lock-in period for CDs. Banks / FIs cannot grant loans against CDs. Furthermore, they cannot buy-back their own CDs before maturity. However, the Reserve Bank may relax these restrictions for temporary periods through a separate notification.

4.22 Banks should include the amount of CDs in the fortnightly return under Section 42 of the Reserve Bank of India Act, 1934 and also separately indicate

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the amount so included by way of a footnote in the return. Further, banks / FIs should report the data on issuance of CDs on the web-based module under the Online Returns Filing System (ORFS) within 10 days from the end of the fortnight to which it pertains.

4.23 Banks normally allow repayment of the deposits before the due date; however, the rate of interest paid to the depositor in case of premature repayment is lower than the rate contracted initially. Auditor has to verify the scheme of fixed deposits thoroughly. If a depositor does not take repayment on the date of expiry, the interest ceases to run from the date, though the bank continues to be a debtor of the depositor. A matured deposit can be renewed by the depositor for a further period. Where a deposit is renewed some time after its maturity, banks generally allow interest from the date of maturity rather than from the date of renewal. In other words, the renewal is given a retrospective effect. In case the deposit is matured and not renewed by the customer, the interest same as saving bank rate is provided on the same as per RBI Guidelines.

4.24 Rate of interest payable on fixed deposits as well as other deposits depends on current economic conditions, decided by banks from time to time. Interest rates are regulated by an Inter-Bank Agreement which is revised from time to time. The rate of interest on certificates of deposits is negotiable with the depositor, especially in the case of bulk/wholesale deposits.

4.25 Following are important issues in respect of different category of accounts which auditor must consider:

(a) *FCNR Accounts*

- Maintenance of position viz. details of deposits – tallying the position with reference to branches periodically.
- System of reporting to the position maintenance office by the branches including “C” category branch.
- Applicability of notional rate.
- Revaluation is done every reporting Friday for CRR purposes.
- Provisions/payment of interest on a regular basis to reflect the due liability.
- Is it debited to the proper Head of accounts?
- Random check of interest as interest is charged every month based on LIBOR.
- How the payment is effected-expeditiously?
- On payment whether the liability is reversed.
- Method of reconciliation of Nostro account with FCNR (B).

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- It should not be revalued and taken to profit and loss.
- Many banks have a separate Nostro account for FCNR (B) balances converted on a notional basis.

Further, RBI, *vide* its Master Circular No. DBOD.No.Dir.BC.11/13.03.00/2013-14 dated July 1, 2013 on “Instructions relating to deposits held in FCNR (B) Accounts”, provides guidance on the interest rates on deposits held in FCNR (B) accounts. The Circular further prohibit the banks to:

- accept or renew a deposit over five years;
- discriminate in the matter of rate of interest paid on the deposits, between one deposit and another accepted on the same date and for the same maturity, whether such deposits are accepted at the same office or at different offices of the bank, except on the size group basis. The permission to offer varying rates of interest based on size of the deposits will be subject to the following conditions:
 - Banks should, at their discretion, decide the currency-wise minimum quantum on which differential rates of interest may be offered. For term deposits below the prescribed quantum with the same maturity, the same rate should apply.
 - The differential rates of interest so offered should be subject to the overall ceiling prescribed.
 - Interest rates paid by the bank should be as per the schedule and not subject to negotiation between the depositor and the bank.
- pay brokerage, commission or incentives on deposits mobilized under FCNR(B) Scheme in any form to any individual, firm, company, association, institution or any other person.
- employ/ engage any individual, firm, company, association, institution or any other person for collection of deposit or for selling any other deposit linked products on payment of remuneration or fees or commission in any form or manner.
- accept interest-free deposit or pay compensation indirectly.

(b) Resident Foreign Currency Accounts

- Exporters having good track record to open foreign currency account with banks.
- RBI will permit.
- Unit located in SEZ may hold an account in Foreign Currency.
- Diamond Dollar Accounts may be opened with permission from RBI to transact business in Foreign Currency.

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- The returning Indians can have their foreign currency accounts to be covered into RFC same feature as of FCNR.

(c) *EEFC account*

- Non-interest bearing – No credit facilities against the security of the balances.
- 100% of inward remittance for Status Holder Exports, professional service rendered in personal capacity.
- 100% of EOU, STP and EHTP 50% for other payments received from a unit DTA for goods supplied to SEZ.

(d) *Non-resident Bank Accounts*

- Name of such accounts and type of arrangement.
- Funding of these accounts – bonafide transactions – freely convertible balance.
- System of monitoring overseas bank not to take a speculative view on rupees.
- Forward purchase/sale of foreign currencies against rupee for funding is prohibited – offer two ways quote is also prohibited.
- Temporary overdrawals to overseas branch/ correspondent not to exceed Rs. 500.00 lakh in aggregate in all overseas branch/correspondent in the books of the bank.
- Purpose is essential.
- Period not to exceed 5 days.
- Statement to be sent to Forex Market Division of RBI.

Further, RBI, *vide* its Master Circular No. DBOD.No.Dir.BC.10/13.03.00/2013-14 dated July 1, 2013 on “Interest Rates on Rupee Deposits held in Domestic, Ordinary Non-Resident (NRO) and Non-Resident (External) (NRE) Accounts” provides guidance on the interest rates on rupee deposits held in Domestic, Ordinary Non-Resident (NRO) and Non-Resident (External) (NRE) Accounts..

Further, paragraph 2.11 of the master circular No. DBOD.No.Dir.BC.10/13.03.00/2013-14 dated July 1, 2013 on “Interest Rates on Rupee Deposits held in Domestic, Ordinary Non-Resident (NRO) and Non-Resident(External) (NRE) Accounts also provides the guidelines with respect to the conversion of a term deposit, a deposit in the form of daily deposit or a recurring deposit for reinvestment in term deposit and states that a bank, on a request from the depositor, should allow conversion of a term deposit, a deposit in the form of daily deposit or recurring deposit, to enable the depositor

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to immediately reinvest the amount lying in the aforesaid deposits with the same bank in another term deposit. On a review and in order to facilitate better asset-liability management (ALM), with effect from April 20, 2010, banks are permitted to formulate their own policies towards conversion of deposits.

(e) Rupee Accounts (Exchange House)

- Accounts opening require approval from RBI.
- Trade transaction per transaction upto Rs.2.00 lakh is permitted.
- Reconciliation issues and concurrent auditor overseas report.
- Debits/claims outstanding as the branches pending receipt of the credit.
- Method of value dating the transactions and overdraft arisen thereon.
- Collection of overdue interest for such over drawn balances.

Unclaimed Deposits/ Inoperative Accounts

4.26 As per RBI Circular no. DBOD No. Leg.BC.34/ 09.07.005/2008-09 dated August 22, 2008 on "Unclaimed Deposits/in operative accounts in Banks". A bank is required to make an annual review of accounts in which there are no operations (other than crediting of periodic interest or debiting of service charges) for more than one year. A savings as well as current account should be treated as inoperative/ dormant if there are no transactions in the account for over a period of two years. In case any reply is given by the account holder giving the reasons for not operating the account, banks should continue classifying the same as an operative account for one more year within which period the account holder may be requested to operate the account. However, in case the accountholder still does not operate the same during the extended period, banks should classify the same as inoperative account after the expiry of the extended period. If a Fixed Deposit Receipt matures and proceeds are unpaid, the amount left unclaimed with the bank will attract savings bank rate of interest.

Accounting

4.27 Banks may account the CDs at issue price under the Head "CDs issued" and show the same under "Deposits". Accounting entries towards discount will be same as in case of 'Cash Certificate'. Banks should maintain a register of CDs issued with complete particulars.

4.28 The Bank will maintain "CD Redemption Account" represented by specific ISIN.

Combinations of Demand and Term Deposits

4.29 Although the above are the basic types of deposits, these days, most of the banks are also offering combinations of two or more of them. These

blended products are known by different names in different banks.

Procedural Aspects

4.30 Some banks use a single application form for opening various types of accounts, viz., Savings, Current and Term Deposits while some others adopt the system whereby, for each type of account, a different type of form is used. The form essentially provides for particulars of the account holder(s), mode of operation on the account, term of the deposit (if applicable), signatures of the account holder(s), photograph of the account holder(s) etc. In the case of partnership firms, a copy of the partnership deed and in the case of companies, copies of the memorandum and articles of association, certificate of incorporation and resolution passed by the board for opening the account/making the deposit are obtained. Particulars of all new accounts opened are recorded in a register.

Know Your Customer Requirements (KYC)

4.31 Reserve Bank of India *vide* its circular no. DBOD. AML. BC. No. 24 /14 .01.001/2013-14 dated July 1, 2013 namely “Master Circular – Know Your Customer (KYC) norms/Anti-Money Laundering (AML) standards/Combating of Financing of Terrorism (CFT)/Obligation of banks under PMLA, 2002” has laid down certain guidelines to prevent banks from being used, intentionally or unintentionally, by criminal elements for money laundering or terrorist financing activities. The guidelines prescribed in this circular, popularly known as KYC guidelines, also enable banks to know/understand their customers and their financial dealings better which in turn help them manage their risks prudently.

These guidelines contain detailed requirements for banks in respect of customer acceptance policy, customer identification procedures, monitoring of transactions and risk management.

Audit Approach and Procedures

Borrowings

4.32 The auditor should understand process of new borrowing, repayment of borrowing and test controls around these processes.

4.33 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, application form, sanction letter, agreements, interest rate, security, correspondence, etc. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties / lenders 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

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Standard on Auditing (SA) 505 (Revised), "External Confirmations" which contains guidance on designing and performing external confirmation procedures to obtain relevant and reliable audit evidence.

4.34 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.

4.35 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.

4.36 The auditor should similarly examine the relevant correspondence or other documents to verify whether 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.

4.37 The auditor should examine whether the amount shown in the branch accounts is properly classified based on security or otherwise.

4.38 In case of borrowing through bonds and debentures, generally banks appoint the registrar for maintenance of records of borrowing such as bond holders etc. The auditor can obtain the balance confirmation from registrar of the bonds including other parameters of borrowing at each period end.

Deposits

4.39 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.

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

Current Accounts

4.41 The auditor should verify the balances in individual accounts on a test check basis and 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.

4.42 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 test check basis, the confirmations received.

4.43 The auditor should examine whether the debit balances in current

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accounts are not netted out on the liabilities side but are appropriately included under the head 'Advances'.

4.44 Inoperative accounts are a high risk area of frauds in banks. While examining current accounts, the auditor should specifically cover in his sample some of the inoperative accounts revived / closed 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. Ratio analysis and comparatives can be used to select / identify such variation.

Savings Bank Deposits

4.45 The auditor should verify the balances in individual accounts on a test check basis and 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.

4.46 The auditor should also check the calculation of interest on a test check basis. In case of branch under Core Banking Solution (CBS) the product sheet for calculation of interest on saving bank account can be obtained in selected sample and can verify the calculation. In case of manual branches the calculation can be verified as per the work sheets.

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

Term Deposits

4.48 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.

4.49 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.

4.50 The auditor should verify the deposits with reference to the relevant registers. The auditor should also examine, on a test check basis, the registers with the counter-foils of the receipts issued and with the discharged receipts

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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 also examine whether the proper provision for interest payable on deposits is made.

4.51 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.

4.52 Term deposits from banks are usually (though not necessarily) in round figures. Any odd balances in term deposits should, therefore be selected by the auditor for verification on a sample basis.

Deposits Designated in Foreign Currencies

4.53 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

4.54 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

4.55 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

4.56 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

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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

4.57 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.

Capital, Reserves and Surplus

Capital

Balance Sheet Disclosure

5.01 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 Rs. __ each)
Issued Capital	(shares of Rs. __ each)
Subscribed Capital	(shares of Rs. __ each)
Called-up Capital	(shares of Rs. __ each)
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.

RBI *vide* its circular no. DBOD.BP.BC No.81/ 21.01.002/2009-10 dated March 30, 2010 on "Classification in the Balance Sheet - Capital Instruments" advised that under the Schedule 1-Capital, Perpetual Non-Cumulative Preference Share (PNCPS) should be sub – classified in the balance sheet from the financial year ending March 31, 2010.

5.02 If circumstances permit, items which can be combined may be shown under one head, for instance, 'Issued and Subscribed Capital'.

5.03 In case of banking companies incorporated outside India, the amount of deposit kept with the RBI under section 11(2) of the Act has to be

shown under this head; the amount, however, should not be extended to the outer column.

5.04 The RBI's Master Circular no. DBOD.BP.BC No.7/21.04.018/2013-14 dated July 1, 2013 on "Disclosure in Financial Statements – Notes to Accounts" lays down the certain aspects to be disclosed in respect of capital for the current as well as the previous year.

Capital Adequacy Measures in India

5.05 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. DBOD.No.BP.BC. 9./21.06.001/2013-14 dated July 1, 2013 on "Prudential Guidelines on Capital Adequacy and Market Discipline- New Capital Adequacy Framework (NCAF)" (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.

5.06 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. 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.

When returns of the investors of the capital issues are counter guaranteed by the bank, such investments will not be considered as Tier I/II regulatory capital for the purpose of capital adequacy.

5.07 The 2013 Master Circular on Prudential Norms on Capital Adequacy and Market Discipline – New Capital Adequacy Framework (NCAF) has

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introduced a new concept of 'Capital Adequacy Requirement for Credit Default Swap (CDS) Positions in the Banking Book'. Readers may refer to the Circular for detailed guidelines in this regard. (The Circular is given in the CD along with the Guidance Note)

Components of Capital

5.08 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. (Refer to Section on Basel II for further guidance).

Undisclosed Reserves

5.09 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

5.10 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

5.11 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. Excess provisions which arise on sale of NPAs would be eligible Tier II capital subject to the overall ceiling of 1.25% of total Risk Weighted Assets.

Hybrid Debt Capital Instruments

5.12 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 Preference Shares (RNCPS)/ Redeemable Cumulative Preference shares (RCPS) as part of upper Tier II 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 Annexure 4 and Annexure 3 respectively to the Master Circular on Prudential Guidelines on Capital Adequacy and Market Discipline- New Capital Adequacy Framework (NCAF).

Subordinated Debt

5.13 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 Prudential Guidelines on Capital Adequacy and Market Discipline- New Capital Adequacy Framework (NCAF).

Investment Reserve Account

5.14 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 "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.

5.15 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.

Reserves and Surplus

Balance Sheet Disclosure

5.16 The following are required to be disclosed in the balance sheet under the head 'Reserves and Surplus'.

- I. Statutory Reserves

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- II. Capital Reserves
- III. Share Premium
- IV. Revenue and Other Reserves including Investment Reserve Account
(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

5.17 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.

5.18 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

5.19 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.

Securities Premium Account

5.20 According to section 78 of the Companies Act, 1956¹, 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, 1956¹ regarding reduction of

¹ Corresponding to Section 52 of the Company Act, 2013 which is yet to be notified by the Central Government.

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.

5.21 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

5.22 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.

5.23 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 Reserve Account' representing write back of excess provision on investments has to be treated as revenue reserve.

Balance of Profit

5.24 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.

5.25 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 said circular also requires that:

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- (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 Approach and Procedures

Capital

5.26 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. Compliance with section 14 of the Banking Regulation Act, 1949, should also be examined. In case of increase in capital of a nationalised bank through fresh contributions by the government, the auditor should examine correspondence/government notification or order, bank statement, etc.

5.27 In the case of newly formed banking companies/places of business established in India for the first time by a banking company incorporated outside India, the auditor should also examine compliance with the provisions of sections 11 and 12 of the Banking Regulation Act, 1949.

5.28 The auditor should also check the compliance with capital adequacy requirements for banks.

5.29 The auditor should verify the compliance with the RBI reporting and other requirements issued from time to time.

5.30 In case there has been an increase in Share Capital during the year/period under audit, the auditor should verify the effect of such increase on the disclosures in respect of Earnings Per Share (EPS) as well as the percentage of promoter holding.

5.31 In case issuance of new share capital by bank, the auditor should

examine the compliance with section 13 of the Banking Regulation Act, 1949 in respect of restriction on commission, brokerage, discount etc. on sale of shares.

Reserves and Surplus

5.32 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 securities 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, auditor should examine whether the appropriations from securities premium account conform to the relevant legal requirements.

5.33 Where the local laws or regulations governing overseas branches require creation of certain reserves, the auditor should examine compliance with the relevant requirements concerning the quantum and manner of disclosure of such reserves. The auditor should also ascertain that whenever necessary to secure compliance with the local laws of the respective foreign countries, separate identity of such reserves has been maintained in the balance sheet of the bank as a whole. The auditor should also ascertain that all provisions regarding eligibility criteria and quantum of dividend have been fulfilled in respect of dividend paid by the bank, if any, during the year.

5.34 The auditor should examine the nature of various accounts included under this head to examine that only accounts in the nature of reserves are included. The auditor should verify whether the utilisations of reserves are in accordance with regulatory and statutory requirements and whether the reporting requirements have been complied with in terms of the requirements of Banking Regulation Act, 1949 and the Guidelines of the RBI, issued from time to time.

III-6

Other Liabilities and Provisions

Balance Sheet Disclosure

6.01 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 | (c) Interest accrued |
| (b) Inter-office adjustments (net) | (d) Others (including provisions) |

Bills Payable

6.02 Bills payable represent instruments issued by the branch against moneys received from customers, which are to be paid to the customer or as per his order (usually at a different branch). These include demand drafts, telegraphic transfers, mail transfers, traveller's cheques, pay-orders, banker's cheques and similar instruments issued by the bank but not presented for payment till the balance sheet date.

Inter-office Adjustments

6.03 The balance in inter-office adjustments account, if in credit, is to be shown under this head. Chapter 12 of Part III of the Guidance Note provides the detailed guidelines on the aspects of Inter-office Transactions.

Interest Accrued

6.04 Interest due and payable and interest accrued but not due on deposits and borrowings are to be shown under this head. The interest accrued in accordance with the terms of the various types of deposits and borrowings are considered under this head. Such interest is not to be clubbed with the figures of deposits and borrowings shown under the head 'Deposits and Borrowings'.

Others (Including Provisions)

6.05 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.

Other Liabilities and Provisions

- (b) Surplus in bad and doubtful debts provision account (such surplus is in the nature of a reserve).
- (c) Surplus in provisions for depreciation in securities (such surplus is in the nature of a reserve).
- (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) Blocked Account arising from transfer of credit entries in inter-branch accounts outstanding for more than five years.

6.06 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 outstanding).
- (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.

6.07 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.

Audit Approach and Procedures

6.08 The auditor may verify the various items under the head 'other liabilities and provisions' in the following manner.

Bills Payable

6.09 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 examined whether 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.

6.10 Based on auditors' 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

Other Liabilities and Provisions

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)

6.11 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 issue of determining the adequacy of provision for doubtful advances is discussed in detail under advances chapter of this Guidance Note. The auditor should examine other provisions and other items of liabilities in the same manner as in the case of other entities.

Contingent Liabilities and Bills for Collection

Balance Sheet Disclosure

7.01 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*

Contingent Liabilities

7.02 The term 'contingent liabilities' can take two forms. On the one hand, a contingent liability refers to possible obligations arising from past transactions or other events or conditions, the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise. On the other hand, a contingent liability may also take form of a present obligation that arises from past events or transactions but is not recognised due to the fact that either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a reliable estimate of the amount of obligation cannot be made. Thus, contingent liabilities may or may not crystallise into actual liabilities. If they do become actual liabilities, they give rise to a loss or an expense. The uncertainty as to whether there will be any obligation differentiates a contingent liability from a liability that has crystallised. Contingent liabilities should also be

Contingent Liabilities and Bills for Collection

distinguished from those contingencies which are likely to result in an obligation on the entity (i.e., the obligation is not merely possible but probable) and which, therefore, require creation of a provision in the financial statements (*Members may refer to Accounting Standard (AS) 29, "Provisions, Contingent Liabilities and Contingent Assets"*)

Letter of Credit, Bank Guarantees and Letters of Comfort

7.03 The concepts of Letters of Credit, Bank Guarantees and Letters of Comforts have been discussed in "Advances" Chapter of the Guidance Note.

Liability on Partly Paid Investments

7.04 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. This is discussed in detail in "Treasury Operations - Foreign Exchange and Derivative Transactions" Chapter of this Guidance Note.

Liability on Account of Outstanding Forward Exchange Contracts

7.05 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.

Guarantees Given on Behalf of Constituents

7.06 The amount of all guarantees outstanding on the balance sheet is to be shown under the above head after deducting therefrom any cash margin. This is discussed in detail in the Advances Chapter of this guidance note

Acceptances, Endorsements and Other Obligations

7.07 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 or endorsed by the bank (to provide security to the payees).

7.08 The total of all outstanding letters of credit as reduced by the cash margin and after deducting the payments made for the bills negotiated under them should be included in the balance sheet. In case of revolving credit, the maximum permissible limit of letters of credit that may remain outstanding at any point of time as reduced by the cash margin should be shown. If the transactions against which the letter of credit was opened have been

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completed and the liability has been marked off in the books of the bank, no amount should be shown as contingent liability on this account.

Other Acceptances and Endorsements

7.09 Sometimes, a customer of the bank may issue a usance bill payable to his creditor and drawn on the bank. The bank, on accepting such a bill, becomes liable to pay it on maturity. In turn, it has to recover this amount from its customer.

7.10 The total of all outstanding acceptances and endorsements at the end of the year, as reduced by the cash margin, should be disclosed as contingent liability.

Other Items for Which the Bank is Contingently Liable

7.11 Under this head are to be included such items as arrears of cumulative dividends, bills re-discounted, commitments under underwriting contracts, estimated amounts of contracts remaining to be executed on capital account, disputed tax liabilities, credit enhancement in respect of securitised loans to which the assignee or the special purpose vehicle has recourse, etc.

7.12 Underwriting involves an agreement by the bank to subscribe for the shares or debentures which remain unsubscribed in a public issue, in consideration of commission.

7.13 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 re-discounting bank has a right to proceed against the bank as an endorser of the bill.

7.14 Tax demands, which has been disputed are in the nature of contingent liability and should be disclosed. 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 Accounting Standard (AS) 29, "Provisions, Contingent Liabilities and Contingent Assets".

7.15 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.

Contingent Liabilities and Bills for Collection

Bills for Collection

7.16 Bills held by a bank for collection on behalf of its customers are to be shown as a footnote to the balance sheet.

7.17 These bills are generally *hundies* or bills of exchange accompanied by documents of title to goods. Frequently, no bills of exchange are actually drawn; the bank is asked to present invoices and documents of title with instructions to collect the amount thereof from the party in whose name the invoice has been made. The documents of title enclosed with the bills for collection are usually not assigned to the bank.

7.18 A bank may get bills for collection from -

- (a) its customers, drawn on outstation parties; or
- (b) its other branches or other outstation banks or parties, drawn on local parties.

7.19 On receipt of the bills drawn on outstation parties, the bank forwards them to its branch or other correspondent at the place where they are to be collected. Such bills are called Outward Bills for Collection.

7.20 Bills received by the bank from its outstation branches and agents, etc. for collection are called Inward Bills for Collection.

7.21 It may be noted that if a bill is received by one branch of the bank from a customer and sent by it to another branch of the bank for collection, the same bill will be shown as an Outward Bill at the first branch and as an Inward Bill at the other branch. In the consolidated balance sheet of the bank, however, all such bills should be shown only once. Therefore, Inward Bills for Collection are excluded from the balance sheet of each branch.

Co-acceptance of Bills

7.22 In its Master Circular on guarantees and co-acceptances, the RBI had reiterated the need for the banks to be cautious while co-accepting bills of their customers and discounting the same so as to avoid loss to banks arising on account of frauds perpetrated in the guise of bills. The circular requires the banks, *inter alia*, not to extend their co-acceptances to house bills/ accommodation bills drawn by group concerns on one another. In its circular the RBI had also listed a number of safeguards to be undertaken by banks while co-accepting bills.

Audit Approach and Procedures

Contingent Liabilities

7.23 In respect of contingent liabilities, the auditor is primarily concerned

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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 verify whether 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 examine whether 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 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

Contingent Liabilities and Bills for Collection

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 examine the existence of concurrence of existing bankers of such borrowers and enquire regarding financial position of those customers.

7.24 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

7.25 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. Based on the circumstances of each case, the auditor should verify whether the item would remain a claim against the bank not acknowledged as debt or it would be

* 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.

a liability requiring provisioning

Liability on Account of Outstanding Forward Exchange Contracts

7.26 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

7.27 The auditor should ascertain whether there are 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.

7.28 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.

7.29 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.

7.30 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".

7.31 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

7.32 The auditor should evaluate the adequacy of internal controls over

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issuance of letters of credit and over custody of unused LC forms in the same manner as in the case of guarantees.

7.33 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

7.34 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.

7.35 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 disclosure under contingent liability is required on this account.

Common Procedures

7.36 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.

7.37 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 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

7.38 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.

7.39 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

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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.

7.40 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.

7.41 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.

7.42 The auditor should also look into the manner of disclosure of interest rate swaps and other derivative transactions in the financial statements of the bank.

7.43 The auditor as in the case of other entities may verify other items under this head.

Bills for Collection

7.44 The auditor should examine whether the bills drawn on other branches of the bank are not included in bills for collection.

7.45 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.

7.46 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.

Contingent Liabilities and Bills for Collection

7.47 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.

7.48 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

7.49 The auditor should examine whether 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.

Treasury Operations- Foreign Exchange and Derivative Transactions

This Chapter has four sections as follows:

Section A: Overview of Treasury Operations in a Bank

Section B: Investments

Section C: Forex and Derivatives

Section D: Compliance with SLR Requirements

Section A: Overview of Treasury Operations in a Bank

8.01 Today, treasury operations are one of the key areas of a bank, responsible for the processing of all financial market transactions and usually much more, including a crucial role in the control of risk. Treasury comprises two main components – Investments and Forex and Derivatives.

Core functions of treasury operations in Bank

8.02 The core areas of treasury operations in a bank can be functionally divided into the following broad compartments as mentioned below:

- Dealing room operations (Front office operations);
- Back office; and
- Middle Office (Market Risk department / Product Control Group) .

8.03 Increasing regulation and compliance requirements, risk management needs and interactive systems developments, have combined to make 'treasury front and back office efficiency' one of the most critical factors in ensuring the well-being of any bank today. This is certain to continue as the work of the back offices becomes more onerous while financial products become increasingly complex, despite streamlining of processing systems.

Front office Operations

8.04 The front office operations consist of dealing room operations wherein the dealers enter into deal with the various corporate and interbank counterparties. Deals are entered into by dealers with on various trading / communication platform such as Reuters' system, telephonic conversation, brokers or any other private channel with the respective counterparty.

8.05 The dealers are primarily responsible to check for counterparty credit limits, eligibility, and other requirements of the Bank before entering into the deal with the customers. Dealers must ensure that all risk/credit limits are available before entering into a deal. Also, the deal must not contravene the current regulations regarding dealing in INR with overseas banks/counterparties. All counterparties are required to have executed the International Swaps and Derivatives Association ('ISDA') agreement as well as pass a board resolution allowing it to enter into derivatives contract. As soon as the deal is struck with counterparty, the deal details are either noted in a manual deal pad or punched in front office system of the Bank which gets queued in for authorisation.

Back office Operations

8.06 The mainstream role of the back office is in direct support of the trading room or front office. Traditionally, this included the input of deals written and authorized by traders, checking of input, verification by confirmation, settlement, checking existence of a valid and enforceable International Swap Dealers Association ('ISDA') agreement and reconciliation of nostro accounts as soon as possible. However, with the advent of online data capture systems and, more importantly, online trading systems the input of deals has progressively moved to the trading floor as mentioned above.

8.07 An important development in the back office has been the advent of straight-through processing (STP), also called 'hands-off' or exception processing. This has been made possible through enhancement of system to real time on line input in the trading room, which in turn has meant that the back office can recall deals input in the trading room to verify from an external source. In practice this is done automatically, comparing incoming data from brokers and counterparties and investigating exceptions. Indeed, with the introduction of full trading systems, the deal is 'confirmed' as it is done, allowing the back office to concentrate principally on exception reporting, settlement and risk control. This is a completely different approach to the old style input and checking of written paper-based deals that represented only a dealer's version of what the deal was before external verification could even commence.

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8.08 One of the basic tenets for a treasury area in a bank is the strict segregation of duties and location between the front and back office, the latter controlling confirmations and settlement transactions. These rulings are even more important in an era of straight-through processing where the checks are fewer and must essentially be independent. However, while this is straight forward for the processing functions, the independent monitoring and management of complex trading risks can be much more problematical, requiring the ability and market knowledge to understand how the trades and hedges in the dealer's book are structured.

Input and completion

8.09 The first core function for the back office is to recall the deal through the input system and decide what has to be done to complete the details of the deal. Deals input through front-end data capture or agreed on one of the proprietary trading systems will have already been subjected to numerous system checks to ensure that the transaction is technically correct. Some deals will require settlement instructions to be added, but for straightforward foreign exchange and derivative deals done with other banks and large corporates, standard settlement instructions (SSIs) may have already been added as informed in the agreement. This could also be true for derivatives transactions in the larger treasuries. However, these types of transactions generally need more checking and manual intervention because of the wide variety of their use. At this stage the bank normally releases its own confirmation to the counterparty, particularly over the counter ('OTC').

Counterparty confirmation

8.10 The second core function for the back office is to verify the deal from the counterparty as soon as possible after the transaction has been done. For bank-to-bank trading, the verification can take the form of a confirmation of a deal done through Reuters or trading systems, or a broker's confirmation if the deal has been done through a broker. Telephone confirmation and faxed confirmations are also sought for immediate authorisation.

8.11 Deals done with customers (non-banks) will normally be confirmed by telex or mail, with instructions swapped on the telephone, depending on the arrangements. Increasingly, however, corporate customers are using automatic confirmation-matching services. It is essential that the deal is confirmed independently of the trader before any kind of value is given or payment is made.

Settlement

8.12 The third core function in the processing chain is that of settlement. This can take the form of a clean currency payment/receipt at the bank's accounts or through the medium of CCIL. The CCIL settlement process is a multilateral netting system for Inter bank transactions that will net the member's payment and receipts in a currency, even if they are due to or due from him from different counter parties and settles the net position in both legs of the transaction.

Reconciliation

8.13 Operations areas are typically involved in a number of reconciliation processes, including the agreement of traders' overnight positions, nostro accounts and brokerage. This can also mean agreeing positions for margin calls in futures trading or agreeing custody accounts to the underlying securities in securities trading. However, the basic reconciliation function is to agree or reconcile the entries that have passed over an account with an agent bank against those that have been passed internally in the books of the bank to a nostro account. After reconciliation, the unmatched items in both accounts then represent those that have not been responded to in either the books of the bank or its agent and should therefore requires to be investigated.

Middle office operations

8.14 Although the phrase 'the back office' was originally synonymous with the processing functions of input, confirmation, settlement and reconciliation, this has progressively broadened to include many other aspects supporting the trading room. In some banks this includes 'middle office', risk management, immediate responsibility for treasury accounting, documentation of various types, producing the financial results, analysis and budget forecasts for the treasury business unit, input into regulatory reporting, and systems development (including telecommunications), both for the support areas and the trading room itself. The bigger the treasury unit, the more likely it will have some or more of these functions, depending on the level of expertise within the area.

Risk management

8.15 This is a function that can sit well in the middle office provided it is properly staffed by officers who understand fully the business and risks involved – which usually means ex-market practitioners. It can range from agreeing overnight cash positions for the trading room through to full-risk modelling associated with derivatives trading and hedging. In between can come

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monitoring of counterparty, country, dealer and market-related limits that have been set and approved in other areas of the bank such as the credit department.

Section B: Investments

8.16 Investments of banks generally consist of the following:

- (i) Securities of the Central and State Governments;
- (ii) Other approved securities;
- (iii) Shares (both equity as well as preference);
- (iv) Debentures and bonds;
- (v) Subsidiaries/ joint ventures/ Associates
- (vi) Other investments, such as, Commercial Papers, Certificate of Deposits, Security Receipts, Pass Through Certificates, Units of Mutual Funds, Venture Capital Funds and Real Estate Funds.

However, banks are not permitted to make investments in immovable properties for earning rentals, though it can gainfully deploy any business premises, which is not being used for the business. Thus, banks will not have immovable properties as part of their investment portfolio. (Section 6 of Banking Regulation Act, 1949)

Important Terms

8.17 The following are some of the terms, which are commonly used in relation to investments of banks.

Approved Securities

8.18 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.

Prudential Exposure Limits

8.19 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 dated July 1, 2013) can be made for the Prudential Exposure Limits prescribed by the RBI.

Subsidiary General Ledger (SGL)

8.20 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.

Legal Requirements

8.21 For the purposes of section 24 of the Banking Regulation Act, 1949, the valuation of securities is to be done with reference to the cost price, market price, book value or face value, or a combination of these methods, as may be specified by the RBI from time to time.

8.22 Section 19 of the Act places restrictions on overall holding of investments by banks in the shares of companies (except in the shares of subsidiary company. As per Section 19(2) of the Act, no banking company shall hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding thirty per cent of the paid-up share capital of that company or thirty percent of its own paid up share capital and reserves, whichever is less.

8.23 It should be observed that the limit of thirty per cent, as specified in section 19 of the Act, applies to all shares whether held as investments or as pledgee or mortgagee. Securities pledged by borrowers against advances are, therefore, to be taken into account. Securities held for safe custody are, however, not to be taken into account.

8.24 Under section 15(2) of the Act, it is necessary that before distributing dividends, a banking company provides for depreciation in the value of its investments in shares, debentures or bonds (other than the investments in approved securities) to the satisfaction of its auditors. Investments in approved securities are exempted from this requirement provided such depreciation has not actually been capitalised or otherwise accounted for as a loss. In this regard, it may be noted that the RBI guidelines require banks to provide for depreciation in the value of certain approved securities also. Depreciation in respect of such approved securities accounted for, as a loss by the bank would not therefore be covered by the exemption granted under the section.

8.25 In case of banking companies, section 49 of the Companies Act, 1956² is also relevant. This section provides that all investments made by a

² Corresponding to Section 187 of the Company Act, 2013 which is yet to be notified by the Central Government.

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company on its own behalf shall be made and held by it in its own name, except in the following cases:

- (a) If the company appoints or nominates a person as director of another company, qualification shares in the latter company may be held in the joint names of the company and such person or in the name of such person.
- (b) Shares in a subsidiary may be held in the name(s) of the company's nominee(s) to the extent necessary to ensure the minimum number of members as required by law.
- (c) Investments may be deposited with the bankers of the company for collection of dividend or interest.
- (d) Investments may be deposited with, or transferred to, or held in the name of, the State Bank of India or a scheduled bank to facilitate transfer thereof, subject to the conditions laid down in this behalf.
- (e) Investments may be deposited with, or transferred to, any person by way of security for repayment of a loan or performance of an obligation undertaken by the company.
- (f) Investments in the form of securities may be held in the name of a depository.

8.26 In respect of investments not held in the company's own name as per the exceptions made under section 49, a register has to be maintained by the company, stating therein the nature, value and other particulars of the shares or securities, and the name of the banker or the person in whose custody they are held.

8.27 Section 372A of the Companies Act, 1956³, which imposes certain restrictions on the purchase of shares in other companies, does not apply to a banking company.

8.28 The provisions of section 292 of the Companies Act, 1956⁴, also need to be noted. This section provides that normally, the power to invest the funds of a company shall be exercised by its board of directors only by means of resolutions passed at meetings of the Board. The section, however, permits the Board, by means of a resolution passed at a meeting, to delegate this function

³ Corresponding to Section 2 (43) of the Company Act, 2013 as notified by the Central Government vide notification dated 12th September, 2013.

⁴ Corresponding to Section 179 of the Company Act, 2013 which is not yet notified by the Central Government.

to a committee of directors, managing director, manager or any other principal officer of the company or, in the case of a branch office, to a principal officer of the branch office provided that such a resolution for delegation specifies the amount up to which the investments may be made and the nature of the investments.

Balance Sheet Presentation

8.29 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)
- II. *Investments outside India in*
 - (i) Government securities (including local authorities)
 - (ii) Subsidiaries and/or joint ventures abroad
 - (iii) Other investments (to be specified)

8.30 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:

- (a) gross value of investments in India and outside India;
- (b) aggregate of provisions for depreciation, separately on investments in India and outside India; and
- (c) net value of investments in India and outside India.
- (d) movement of provisions held towards depreciation on investments including opening balance by adding provisions made during the year and after deducting write-off/ write-back of excess provisions during the year.

8.31 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.

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8.32 For disclosures relating to investments in notes on accounts, please refer Chapter 10 of Part III of the Guidance Note.

Guidelines of the RBI regarding transactions in Securities

8.33 The Reserve Bank of India has issued the Master Circular dated July 1, 2013 on "Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks", consolidating instructions/guidelines issued to banks on matters regarding prudential norms for classification, valuation and operation of Investment portfolio of banks.

Classification of Investments

8.34 Banks are required to classify their entire investments portfolio (including SLR securities and non-SLR securities) 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.

(ii) *Held-for-trading (HFT)*

The investments classified under HFT would be those from which the bank expects to make a gain by the movement in interest rates/market rates. These securities are to be sold within 90 days

(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.

8.35 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.

8.36 Investments under HTM category should not normally exceed 25 per cent of the total investments of the bank, subject to conditions given in Master Circular. The Banks may hold the following securities under HTM:

- (a) SLR Securities upto 25 percent of their DTL as on the last Friday of the second preceding fortnight. In this context, attention of the readers is also invited to RBI's Circular No. DBOD.BP.BC.No.41/21.04.141/2013-14 dated August 23, 2013 on "Investment portfolio of banks – Classification, Valuation and Provisioning" providing for certain prudential adjustments for a limited period.
- (b) Non-SLR securities included under HTM as on September 2, 2004.

- (c) Fresh re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in Investment portfolio.
- (d) Fresh investment in the equity of subsidiaries and joint ventures.
- (e) RIDF/SIDBI/RHDF deposits.
- (f) Investment in long-term bonds (with a minimum residual maturity of seven years) issued by companies engaged in infrastructure activities.

8.37 The banks will have the freedom to decide on the extent of holdings under HFT and AFS. This will be decided by them after considering various aspects such as basis of intent, trading strategies, risk management capabilities, tax planning, manpower skills, capital position.

Exposure Limits

8.38 The RBI, *vide* its Master Circular dated July 1, 2013 on “Exposure Norms” provides requirements in respect of exposure limits for banks.

Audit Approach and Procedures

8.39 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 impact 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. RBI issues master circular covering regulatory aspects every year on 1st working day of July.

Internal Control Evaluation and Review of Investment Policy

8.40 The auditors should familiarise themselves with the instructions issued by the RBI regarding transactions in investment 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 the auditor should particularly examine whether the same are in consonance with the guidelines of the RBI. The auditor should also judge their efficacy. By efficacy, it is meant that not only the auditor would check the operating

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effectiveness of various internal controls but also at the first place check and evaluate the design of such controls.

8.41 Some of the typical audit procedures would include:

- perusing the investment policy and preparing brief note on key points of compliances.
- examining investments made by the bank are in accordance with the laid down investment policy.
- perusing reports on concurrent audit of treasury transactions and follow-up action taken by the management thereon.
- perusing the half yearly review of portfolio by the Board of Directors of the bank and also reviewing annual inspection report of the RBI carried out under Section 35 of the Banking Regulation Act, 1949.

Process Review, Walk through and Control Testing

8.42 For the purpose of identifying significant processes, the auditor may identify significant accounts and processes linked to significant accounts. He may carry out detailed understanding of process from inception of transaction to its final accounting. The banks normally have documented standard operating procedures (SOPs), hence auditor can peruse SOPs for understanding and documenting significant processes. During the process understanding, auditors may identify various control points in the process like reconciliation, maker checker, segregation of duties, etc. The auditors may carry out walk through of few transactions for validating process understanding and existence of indentified controls. Identified controls needs to be further segregated to manual controls and IT controls for testing of those controls for sample transactions. This sample needs to be selected randomly from total population of transactions.

8.43 In today's scenario, most of the treasury functions of banks are performed in an automated environment (for example, trade booking, settlement and accounting). In such a situation, it becomes imperative for the auditors to test the general information technology controls and system application controls around the functioning of the systems involved and also the interfaces between various systems.

8.44 Some of the typical audit procedures include:

- Identification of specific application controls based on process understanding and walk throughs.

- Perusal of IT application controls and document whether controls are effective and reliance can be placed on same.
- Perusal of IT system audit report, ICG report and action taken thereon.
- Based on out come of IT control testing, further audit strategy need to be formulated.

Substantive Audit Procedures

8.45 Considering that the investments comprise a substantial portion of a bank's balance sheet, a combination of test of operating effectiveness of controls, along with substantive audit procedures (including substantive analytical procedures) would be necessary in order for the auditor to conclude effectively on the completeness, recognition and measurement, accuracy and existence of the banks' investments, related income/ expenses and associated balances.

Examination of Reconciliation

8.46 The auditor should examine the reconciliation of the investment balances as per the financial statements with that of the balances with the custodians (PDO or a depository for investments held in dematerialised form), physically verify the securities on hand, obtain independent confirmations from custodians, counter-party banks for BRs on hand, to examine the control and reconciliation of BRs issued by the bank. In addition to examining the period end reconciliations, the auditor needs to examine such reconciliations at other interim intervals, to ensure that the process is followed throughout the audit period. Needless to add, the actual control and reconciliations etc., are to be carried out by the bank's management; however, the auditor needs to examine the same.

8.47 Some typical audit procedures would include:

- perusing the process, frequency of reconciliation and controls over same.
- perusing the reconciliation (period end as well as interim) and examining whether proper impact has been given for reconciling items
- obtaining direct balance confirmations.

Inspection of Documents

8.48 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

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investments, have been complied with and the investments made by the bank are not *ultra vires* the bank. Apart from the above, the auditor should also ascertain 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.

8.49 The auditor should satisfy himself that the transactions for the purchase/sale of investments are supported by approval of 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 auditors should also check the segregation of duties within the bank staff in terms of booking of trades, approving of such trade, settlement and accounting (generally termed as front office, middle office and back office functions' segregation).

8.50 Some typical audit procedures would include:

- checking compliance with all applicable legal requirements.
- checking approval and all supporting documents for purchase and sale of investments.
- checking segregation of duties.

Examination of Existence of Investments

8.51 The auditor may advise the bank to list out investments held in physical form separately from those held in dematerialised form with the PDO or with a depository.

8.52 The auditor should verify the investments held with PDO, custodians and the depository, at the close of business on the date of the balance sheet with the statement of holdings. The auditor should circulate independent investments' balance confirmation requests to the custodian and other constituents (for example, RBI for SGL and CSDL balances). Furthermore, an auditor should design sufficient alternative audit procedures in situations where the independent confirmation are not received back (after reasonable follow up procedures) before the auditor signs off on the bank's financial statements. These alternative procedures should also be designed in such a way that independent data points are used for corroborating investment balances. An example the auditor gets the bank personnel download the investment statement in its own presence.

8.53 The auditor should peruse banks process of periodic physical verification of investments and satisfy himself with adequacy of process and controls. Based on assessment of physical verification process of bank, the auditor may verify the investment scrips physically at the close of business on

the date of the balance sheet. In exceptional cases, where physical verification of investment scrips on the balance sheet date is not possible, the auditor may 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. In the current environment, where the banks generally have their investment securities in dematerialised form, the importance of independent audit confirmation requests multiplies.

8.54 Investments are normally dealt with at the head office and not at the branches. However, sometimes, for realisation of interest etc., and other similar purposes, some of the investment scrips may be held at branch offices. In such cases, the auditor needs to examine the records maintained at the head office to record details of scrips held at other locations and request the respective branch auditors to physically verify such scrips as a part of their audit. The auditor need to obtain a written confirmation to this effect from the branch auditors. The branch auditors should also be requested to report whether adequate records are maintained by the branch for the securities held by it on behalf of the head office.

8.55 The auditor may specifically request the branch auditors to examine and report any cases of non-receipt of income against investments for a long period or of scrips being held without being redeemed long after the redemption date, as these situations might be indicative of the scrips being forged or otherwise unrealisable.

8.56 In case the investment scrips are held at an unaudited branch, the auditor should request the management to obtain the scrips at the head office for his examination.

Cut-off Procedures

8.57 In terms of testing completeness of investments balances at the reporting date, the auditor should carefully devise cut-off procedures. This should be designed after understanding the bank's procedures for ensuring the appropriate period of accounting for investments. As mentioned above, the banks should follow 'Settlement Date' accounting for recording transactions in government securities.

8.58 Some typical audit procedures would include:

- obtaining list of transactions executed on period end date and examining whether the same is correctly recorded and accounted.
- Checking first few sample transactions of subsequent period and ascertaining whether the same pertains to current reporting period.

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- checking control over transaction numbering by the system and ascertaining whether the transaction with last number for period end is recorded in current period and next transaction is recorded in subsequent period.

8.59 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 BRs. Where any BRs have been outstanding for an unduly long period, the auditor should obtain written explanation from the management for the reasons thereof. This procedure may not, however, be necessary where scrips are received from counterparty banks before the completion of the audit.

8.60 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.

Examination of classification and shifting

8.61 The auditor should examine whether the shifting of the investments to/from HTM category is carried out only once during a financial year and is duly approved by the Board of Directors of the bank. The auditor should also examine whether the shifting of investments from AFS to HFT is duly approved by the Board of Directors / ALCO / Investment Committee. In case of exigencies, the shifting from AFS to HFT may be done with the approval of the Chief Executive of the Bank/ Head of ALCO, but should be ratified by the Board of Directors later.

8.62 Transfer of scrips from AFS / HFT category to HTM category should be made at the lower of book value or market value. In other words, in cases where the market value is higher than the book value at the time of transfer, the appreciation should be ignored and the security should be transferred at the book value. In cases where the market value is less than the book value, the provision against depreciation held against this security (including the additional provision, if any, required based on valuation done on the date of transfer) should be adjusted to reduce the book value to the market value and the security should be transferred at the market value

8.63 Overall, the auditor should ascertain the compliance of the RBI guidelines, issued from time to time, in this regard.

8.64 The auditor should also keep a close eye on sale of investments made by the bank out of its 'held to maturity' portfolio. Such sales are now required to be disclosed in the annual financial statements of the banks.

8.65 The audit procedures in this regard would include:

- obtaining list of shifting of investments during the reporting period.
- checking compliance with RBI guidelines and existence of proper approvals for same.
- checking proper recording/ accounting of book value and depreciation on date of shifting.

Examination of accounting and valuation

8.66 Investments in securities now-a-days constitute a substantial part of total assets of many banks. 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 and in conformity to RBI guidelines as laid down in the Master Circular.

8.67 The auditor should examine the appropriateness of accounting policies followed by the bank. In case any of the accounting policies are 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.

8.68 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 not being fully recoverable. In the latter case, the relevant investment should be written down to recoverable amount.

8.69 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

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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.

8.70 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.

8.71 The auditor should examine the process of valuation followed by the Bank. The auditor should perform checks to examine that the market rates taken by the bank for valuation of investment securities are in accordance with the RBI guidelines. The auditor should also examine the accounting entries passed for marked to market loss, to ascertain, whether RBI guidelines pertaining to netting off have been followed. Further, the auditor should include investment from each class of investment in its sampling technique so as to ensure that the valuation policy of all classes of investments get validated. Particular focus should be on investments which involve management judgement or are not simple rule based valuations (preference shares and pass through certificates). While the auditor checks the valuation of investment securities across products in line with RBI prescribed methodology, he should also carefully focus on assessing the appropriateness of inputs used in various valuation models / formulae. This would include a check of:

- Use of appropriate cash flows (for instruments such as PTCs)
- Use of appropriate risk free rates (depending on maturity of instrument)
- Use of appropriate spreads
- Use of appropriate 'ratings' for bonds
- Arithmetical accuracy of a valuation (using 're-performance' technique)

8.72 In case of banks which have automated means of valuing the

investments (for example, system computes values), the auditor should also check system controls and if deemed necessary, consider involving an expert to check the integrity of system logic (to avoid, 'garbage in garbage out' kind of output).

8.73 In case the bank does not have automated means of valuation of investments (for example, valuation is computed over excel spreadsheets), the auditor should check end user computing controls over such spreadsheet usage. This would include a check of access controls over such files, change management controls, etc. This would help auditor conclude that the files for valuation of investments are not manipulated. This can also be classified as an anti-fraud control.

8.74 The auditor should examine whether the profit or loss on sale of investments has been computed properly. The carrying amount of investments disposed off should be determined consistently on similar basis.

8.75 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.

8.76 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 ascertain that no investments purchased more than 89 days before the balance sheet date have been classified under this category.

8.77 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.

8.78 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.

8.79 If the valuation of Investment is outsourced to an agency, certain audit procedures would need to be applied at such processing agency also.

8.80 Some of the typical audit procedures would include:

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- obtaining list of investment as at reporting period from Bank and ascertaining completeness of the same by reconciliation process as highlighted above.
- checking the carrying amount of investments and ensuring that same is calculated on consistent basis. This is normally calculated by system, hence need to check IT controls and calculation on sample basis for ensuring accuracy.
- In case quote are available, checking source of capturing market price/ fair value as at reporting date.
- In case quotes are not available, checking calculation for fair value as at reporting date to ensure compliance with RBI guidelines.
- checking calculation of Marked to Market Gain/ loss and accounting for same in compliance with RBI guidelines.

Non-Performing Investments (NPI)

8.81 In respect of securities included in any of the three categories where interest/ principal is in arrears, banks should not reckon income on the securities and should also make appropriate provisions for the 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.

8.82 An NPI, similar to a non performing advance (NPA), is one where:

- (i) Interest/ installment (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. If the dividend on preference shares (cumulative or non-cumulative) is not declared/paid in any year it would be treated as due/unpaid in arrears and the date of balance sheet of the issuer for that particular year would be reckoned as due date for the purpose of asset classification.
- (iii) In the case of equity shares, in the event the investment in the shares of any company is valued at Re.1 per company on account of the non availability of the latest balance sheet in accordance with the instructions contained in paragraph 28 of the Annex to the RBI circular DBOD.BP.BC.32/ 21.04.048/ 2000-01 dated October 16, 2000, those equity shares would also be reckoned as NPI.

- (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 principal and / or interest into equity, debentures, bonds, etc., such instruments should be treated as NPA *ab initio* in the same asset classification category as the loan if the loan's classification is substandard or doubtful on implementation of the restructuring package and provision should be made as per the norms.

Classification of State Government guaranteed investments as NPI

8.83 For the year ending March 31, 2005, investment in State Government guaranteed securities would attract prudential norms for identification of NPI and provisioning, if interest and/or principal or any other amount due to the bank remains overdue for more than 180 days. With effect from the year ending March 31, 2006, investment in State Government guaranteed securities, including those in the nature of 'deemed advance', attract prudential norms for identification of NPI and provisioning, when interest/ instalment of principal (including maturity proceeds) or any other amount due to the bank remains unpaid for more than 90 days.

8.84 The prudential treatment for Central Government Guaranteed bonds has to be identical to Central Government guaranteed advances. Hence, bank's investments in bonds guaranteed by Central Government need not be classified as NPI until the Central Government have repudiated the guarantee when invoked. However, this exemption from classification as NPI is not for the purpose of recognition of income.

8.85 The audit procedures would include:

- identifying Non Performing Investments based on RBI guidelines as defined above. In case advances given to a party is classified as NPA,

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investment in securities issued by same party also needs to be classified as NPI.

- ascertaining whether the bank has made appropriate provision for the depreciation in the value of the NPI.
- ensuring that the banks has not off-set the depreciation on NPI against the appreciation in respect of other performing securities.
- obtaining separate list of investments as a result of conversion of interest/principal. These investments need to be classified as NPI *ab initio*, if the loan's classification is NPA on implementation of the restructuring package.

Special Aspects

8.86 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.

8.87 In the case of a right issue, the offer letter should be examined. The auditor should check control over recording, exercising, renouncing of rights and also valuation of rights yet to be exercised. Where the rights have been renounced or otherwise disposed off or not exercised, the auditor should examine that same 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.

8.88 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.

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

8.89 The RBI's 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 over a two year period 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 which have maintained capital of at least 9 per cent of the risk weighted assets for both credit risk and market risks for both HFT (items as indicated at (a) above) and AFS category may treat the balance in excess of 5 per cent of securities included under HFT and AFS categories, in the IFR, as Tier I capital. Banks satisfying the above were allowed to transfer the amount in excess of the said 5 per cent in the IFR to Statutory Reserve.
- (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 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,

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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.

- (viii) The withdrawal from the Investment Reserve Account cannot be used for dividend declaration. Dividends should be payable only out of current year's profit. 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.

8.90 The auditor should also examine whether the bank, as required by the RBI, is maintaining separate accounts for the investments made by it on its 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. (It may be noted that such separate audit of PMS transactions can be carried out by any firm of Chartered Accountants (CAs) including the central statutory auditors.) The auditor should review the report of such external auditors, if available, and check whether the discrepancies pointed out in the report have been adequately dealt with. The auditor should also verify that PMS transactions are carried out through a separate SGL account, and that there is no switching between the bank's own investment account and PMS clients' account except in accordance with the guidelines laid down by the RBI in this regard.

8.91 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. Shares may also be lodged with the companies concerned for transfer etc. When investments are held by any other person on behalf of the bank, the auditor should obtain a certificate from him. The certificate should state the reason for holding the investment (e.g., in safe custody or as

security). The receipt originally issued by such person while taking delivery of the investment is not adequate for audit purposes. In the case of inscribed stock also, a certificate should be obtained which should certify the holding of the bank as at the date of the balance sheet.

8.92 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.

8.93 Where securities lodged for transfer have not been received back within a reasonable period, or where share certificates, etc., have not been received within a reasonable period of the lodging of the allotment advice, the auditor should examine whether adequate follow-up action has been taken. He may, in appropriate cases, also enquire from the issuers, or their registrars, about the reasons for the delay. In cases where the issuer/registrar has refused to register the transfer of securities in the name of the bank, the auditor should examine the validity of the title of the bank over such securities.

8.94 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. The auditor may also check compliance with Section 187C of the Companies Act, 1956 - Declaration by persons not holding beneficial interest in any share.

8.95 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. In case the amount of such investments or the income accrued thereon is material, the auditor should seek an explanation from the management on this aspect. He should also consider whether the income accrued requires reversal as also whether any provision for loss in respect of such investments is required. Similarly, where income on any security is long overdue, the auditor should consider whether provision is required in respect of such income accrued earlier.

Income from investments

8.96 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.

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8.97 Some of the typical audit procedures would include:

- Re-computation of amortisation of premium / discount on investment securities.
- Re-performance of profit / loss on sale of investments keeping into consideration the method of allocating cost to securities (FIFO, LIFO or weighted average).
- Assessing the dividend recognition policy of bank keeping in mind the revenue recognition principles of Accounting Standard 9, Revenue Recognition.
- Re-computation of interest income on investments and checking the treatment of broken period interest.
- Checking of proper recognition of investment valuation loss as at reporting date

8.98 Considering that banks have large investment portfolio, use of substantive analytical procedures may be a useful audit technique for the auditor to conclude income associated with investment balances is free from material misstatement. One of such techniques may include 'yield analysis' for the disaggregated investment portfolio of the bank.

8.99 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

8.100 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).

- (i) 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.
- (ii) 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.

The auditor may consider relying on the work done during the course of audit for the purposes of such certificates.

Dealings in Securities on Behalf of Others

8.101 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:

8.102 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.

8.103 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.

The auditor also needs to give certificate for reconciliation of securities held by the bank as custodian.

The text of Illustrative Checklist of key aspects of master circular on Investments is given in CD.

Section C: Forex and Derivatives

Overview of Forex and Derivative Operations in a Bank

8.104 Banks transact in various treasury instruments with an objective of hedging their risks and also to generate trading profits. Apart from regular proprietary business, the treasury operations of a bank aim to continue to focus on enhancing returns from customer relationships that have been built, and successfully capitalise on this to rapidly increase income from foreign exchange and derivative transactions from customers, as also to assist them in covering and hedging their foreign currency and derivative positions.

8.105 The foreign exchange market encompasses transactions in which funds of one currency are sold for funds in another currency. These transactions take the form of contracts calling for the parties in the contract each to deliver to the other on a fixed date a specified sum in a given currency. The exchange, the

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delivery of one currency on receipt of another, can take place at the time the contract is negotiated or at some future date, as stated in the contract.

8.106 Foreign exchange transactions, to be distinguished from transactions in foreign currencies, consist of contracts in which each party is committed to deliver one currency while, at the same time, receive another. Until the time of delivery, when settlement is to be made on the contract, the contract represents a future commitment of the Bank's resources. Thus, the maturity of a contract culminates in the realisation of the transaction envisaged in the contract, at which time the counterparties are given value for the currencies the contract says they are to receive.

8.107 In foreign exchange contracts, the value date is the date on which the contract matures, that is the date on which settlement is to be made. For loans and borrowings, including those in the money markets, on the other hand, the value date is that date on which the borrower receives constructive use of the funds loaned, while the maturity date is that future date on which it will repay the funds it has borrowed.

Derivatives

8.108 In India, different derivatives instruments are permitted and regulated by various regulators, like Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI) and Forward Markets Commission (FMC). Broadly, RBI is empowered to regulate the interest rate derivatives, foreign currency derivatives and credit derivatives. For regulatory purposes, derivatives have been defined in the Reserve Bank of India Act, vide circular No. DBOD. No. BP.BC. 86/21.04.157/2006-07 dated 20 April 2007 as follows:

8.109 "Derivative" means an instrument, to be settled at a future date, whose value is derived from change in interest rate, foreign exchange rate, credit rating or credit index, price of securities (also called "underlying"), or a combination of more than one of them and includes interest rate swaps, forward rate agreements, foreign currency swaps, foreign currency-rupee swaps, foreign currency options, foreign currency-rupee options or such other instruments as may be specified by the Bank from time to time.

Products offered in Forex and Derivative business

8.110 There are various types of foreign exchange and derivative contracts offered in normal course of banking business including inter-alia Spot, Tom & Cash, Swap, Currency Swap, Credit Default Swap, Currency Option, Forward rate Agreement, Interest rate swap, Interest rate futures, Interest rate cap & floor,

Currency futures, Foreign exchange forward. The following circulars are relevant and give guidance on these products:-

- DBOD.No.BP.BC. 44/21.04.157/2011-12 dated 2 November 2011 modifying the 20 April 2007 circular
- DBOD.BP.BC.No. 61/21.06.203/2011-12 of 30th November 2011 regarding credit default swaps
- IDMC.MSRD.4801/06.01.03 dated June 3, 2003 on Exchange-Traded Interest Rate Derivatives
- IDMD.PDRD.No. 1056/03.64.00/2009-10 dated September 1, 2009 on Guidelines on Exchange Traded Interest Rate Derivatives
- RBI/2010-11/147 A.P. (DIR Series) Circular No. 05 dated July 30, 2010 on "Guidelines on trading of Currency Options on Recognised Stock / New Exchanges
- DBOD.No.BP.BC.51 / 21.06.101 / 2010-11 dated October 28, 2010 on Introduction of Exchange Traded Currency Options – Permitting Banks to Participate in Currency Options on Recognized Stock / New Exchanges

Derivatives Markets

8.111 There are two distinct groups of derivative contracts:

- *Over-the-counter (OTC) derivatives*: Contracts that are traded directly between two eligible parties, with or without the use of an intermediary and without going through an exchange.
- *Exchange-traded derivatives*: Derivative products that are traded on an exchange.

Participants

8.112 Participants of this market can broadly be classified into following two functional categories:

- *User*: A user participates in the derivatives market to manage an underlying risk.
- *Market-maker*: A market-maker provides bid and offer prices to users and other market-makers. A market-maker need not have an underlying risk.

At least one party to a derivative transaction is required to be a market-maker.

Purpose

8.113 Users can undertake derivative transactions to hedge an existing identified risk on an ongoing basis during the life of the derivative transaction or for transformation of risk exposure, as specifically permitted by RBI. *Market-makers* can undertake derivative transactions to act as counterparties in derivative transactions with users and also amongst themselves.

Broad Principles for Undertaking Derivative Transactions

8.114 The major requirements for undertaking any derivative transaction includes:

- In addition to generic derivative products, market-makers may also offer structured derivative products to users as long as they do not contain any derivative instrument as underlying and have been specifically permitted by the RBI. For the purpose of the guidelines contained in RBI's Circular no. DBOD.BP.BC.44/21.04.157/2011-12 dated 2nd November, 2011,
 - a. The following derivative instruments used to hedge an existing interest rate and forex exposure, on a standalone basis, may be treated as generic derivative products:
 - Forex Forward Contracts
 - Forward Rate Agreements
 - Interest rate caps and floors (plain vanilla only)
 - Plain Vanilla Options (call option and put option)
 - Interest Rate Swaps
 - Currency Swaps including Cross-Currency Swaps
 - b. The following derivative products may be treated as structured derivative products:
 - Instruments which are combination of either cash instrument and one or more generic derivative products
 - Instruments which are combination of two or more generic derivative products
- Market-makers should be in a position to arrive at the fair value of all derivative instruments, including structured products on the basis of the following approach:
 - (a) Marking the product to market, if a liquid market in the product exists.
 - (b) In the case of structured products, marking the constituent generic instruments to market.

- (c) If (a) and (b) are not feasible, marking the product to model, provided:
- All the model inputs are observable market variables.
 - Full particulars of the model, including the quantitative algorithm are documented.

8.115 It may be ensured that structured products do not contain any derivative, which is not allowed on a stand alone basis. Further,

- All permitted derivative transactions, including roll over, restructuring and novation can be contracted only at prevailing market rates.
- All risks arising from derivatives exposures should be analysed and documented, both at transaction level and portfolio level.
- The management of derivatives activities should be an integral part of the overall risk management policy and mechanism. It is desirable that the board of directors and senior management understand the risks inherent in the derivatives activities being undertaken.
- Market-makers should have a 'Suitability and Appropriateness Policy' vis-à-vis users in respect of the products offered, on the lines indicated in the guidelines given in the Circular.
- Market-makers may, where they consider necessary, maintain cash margin/liquid collateral in respect of derivative transactions undertaken by users on mark-to-market basis.

Risk Management and Corporate Governance Aspects

8.116 The Master Circular also sets out the basic principles of a prudent system to control the risks in derivatives activities. These include:

- (a) appropriate oversight by the board of directors and senior management;
- (b) adequate risk management process that integrates prudent risk limits, sound measurement procedures and information systems, continuous risk monitoring and frequent management reporting; and
- (c) comprehensive internal controls and audit procedures.

Suitability and Appropriateness

8.117 While undertaking derivative transactions with or selling structured derivative products to a user, a market-maker should:

- (a) document how the pricing has been done and how periodic valuations will be done. In the case of structured products, this document should contain a dissection of the product into its generic components to

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demonstrate its permissibility, on the one hand, and to explain its price and periodic valuation principles, on the other. The following information may be shared with the user:

- (i) Description of the transaction.
 - (ii) Building blocks of the transaction.
 - (iii) Rationale along with appropriate risk disclosures.
 - (iv) Sensitivity analysis identifying the various market parameters that affect the product.
 - (v) Scenario Analysis encompassing both the possible upside as well as the downsides.
- (b) analyse the expected impact of the proposed derivatives transaction on the user.
- (c) Before offering any derivative product to a client, obtain Board resolution from the corporate which:
- explicitly mentions the limit assigned by the corporate to the bank. While monitoring this limit, bank would take into account absolute notional amount of all outstanding derivative contracts entered into by the corporate with the bank. In other words, notionals of long and short positions will not be netted for the purpose of compliance with the limit.
 - mentions the names and designation of the officials of the company authorised to undertake particular derivative transactions on behalf of the company.
 - specifies the names of the people to whom transactions should be reported by the bank. These personnel should be distinct from those authorized to undertake the transactions.
 - mentions the names and designation of person(s) authorised to sign the ISDA and similar agreements;
 - mentions specific products that can be transacted by the designated officials named therein.
- It should also be ensured that the Board resolution submitted by the company is signed by a person other than the persons authorized to undertake the transactions. (Refer RBI's circular no. DBOD.BP.BC.44/21.04.157/2011-12 dated 2nd November, 2011, *Comprehensive Guidelines on Derivatives: Modifications*)
- (d) identify whether the proposed transaction is consistent with the user's policies and procedures with respect to derivatives transactions, as they are known to the market-maker.

- (e) ensure that the terms of the contract are clear and assess whether the user is capable of understanding the terms of the contract and of fulfilling its obligations under the contract.
- (f) inform the customer of its opinion, where the market-maker considers that a proposed derivatives transaction is inappropriate for a customer. If the customer nonetheless wishes to proceed, the market-maker should document its analysis and its discussions with the customer in its files to lessen the chances of litigation in case the transaction proves unprofitable to the customer. The approval for such transactions should be escalated to next higher level of authority at the market-maker as also for the user.
- (g) ensure the terms of the contract are properly documented, disclosing the inherent risks in the proposed transaction to the customer in the form of a Risk Disclosure Statement which should include a detailed scenario analysis (both positive and negative) and payouts in quantitative terms under different combination of underlying market variables such as interest rates and currency rates, etc., assumptions made for the scenario analysis and obtaining a written acknowledgement from the counterparty for having read and understood the Risk Disclosure Statement.
- (h) guard against the possibility of misunderstandings all significant communications between the market-maker and user should be in writing or recorded in meeting notes.
- (i) ensure to undertake transactions at prevailing market rates and to avoid transactions that could result in acceleration/deferment of gains or losses.
- (j) should establish internal procedures for handling customer disputes and complaints. They should be investigated thoroughly and handled fairly and promptly. Senior management and the Compliance Department/Officer should be informed of all customer disputes and complaints at a regular interval.

It may also be noted that the responsibility of 'Customer Appropriateness and Suitability' review is on the market-maker.

Documentation

8.118 The above RBI circular also requires the market participants to ensure that documentation requirements in respect of derivative contracts are complete in all respects.

Identification and Management of Risk

8.119 Market-makers should identify the various types of risk to which they are exposed in their derivatives activities. The main types of risk are:

- credit risk
- market risk
- liquidity risk
- operational risk
- legal risk

The RBI circular requires that all significant risks should be measured and integrated into a entity-wide risk management system.

Risk limits

8.120 Risk limits serve as a means to control exposures to the various risks associated with derivative activities. Limits should be integrated across all activities and measured against aggregate risks. Limits should be compatible with the nature of the entity's strategies, risk measurement systems, and the board's risk tolerance. To ensure consistency between limits and business strategies, the board should annually approve limits as part of the overall budget process.

Independent Risk control

8.121 There should be a mechanism within each entity for independently monitoring and controlling the various risks in derivatives. The inter-relationship between the different types of risks needs to be taken into account.

Operational Controls

8.122 The nature of the controls in place to manage operational risk must be commensurate with the scale and complexity of the derivatives activity being undertaken. The operational controls could in addition to segregation of duties, cover aspects such as:

- trade entry and transaction documentation
- confirmation of trades
- settlement and disbursement
- reconciliations
- revaluation
- exception reports

- accounting treatment
- audit trail

Prudential Norms Relating to Derivatives

8.123 The prudential norms relating to derivatives – minimum capital adequacy requirement, credit exposure norms, ALM etc. will be as prescribed by RBI from time to time. Attention of the reader may be drawn on RBI's Circular No. DBOD.No.BP.BC.48 / 21.06.001/2010-11 dated October 1, 2010 and DBOD.No.BP.BC.31/21.04.157/2008-09 dated August 8, 2008 on "Prudential Norms for Off-Balance Sheet Exposures of Banks" and RBI's Master Circular No. DBOD. No.Dir.BC.13/13.03.00/ 2013-14 dated July 1, 2013 on "Exposure Norms".

Asset Classification of Derivatives

8.124 RBI *vide* its Circular No. DBOD.No.BP.BC.57/ 21.04.157/2008-09 dated October 13, 2008 on "Prudential Norms for Off-Balance Sheet Exposures of Banks" and Circular No. DBOD.No.BP.BC.1/ 21.04.048/2013-14 dated July 1, 2013 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances" advised the banks including foreign branches of Indian banks as under:

- i. The overdue receivables representing positive mark-to-market value of a derivative contract will be treated as a non-performing asset, if these remain unpaid from the specified due date for payment for 90 days or more.
- ii. In case the overdues arising from forward contracts and plain vanilla swaps and options become NPAs, all other funded facilities granted to the client shall also be classified as non-performing asset following the principle of borrower-wise classification as per the existing asset classification norms.
- iii. However, any amount, representing positive mark-to-market value of the foreign exchange derivative contracts (other than forward contract and plain vanilla swaps and options) that were entered into during the period April 2007 to June 2008, which has already crystallised or might crystallise in future and is / becomes receivable from the client, should be parked in a separate account maintained in the name of the client /counterparty. This amount, even if overdue for a period of 90 days or more, will not make other funded facilities provided to the client, NPA on account of the principle of borrower-wise asset classification, though such receivable overdue for 90 days or more shall itself be classified as NPA,

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as per the extant IRAC norms. The classification of all other assets of such clients will, however, continue to be governed by the extant IRAC norms

- iv. If the client concerned is also a borrower of the bank enjoying a Cash Credit or Overdraft facility from the bank, the receivables mentioned at item (i) above may be debited to that account on due date and the impact of its non-payment would be reflected in the cash credit/overdraft facility account. The principle of borrower-wise asset classification would be applicable here also, as per extant norms.
- v. In cases where the contract provides for settlement of the current mark-to-market value of a derivative contract before its maturity, only the current credit exposure (not the potential future exposure) will be classified as a non-performing asset after an overdue period of 90 days.
- vi. As the overdue receivables mentioned above would represent unrealised income already booked by the bank on accrual basis, after 90 days of overdue period, the amount already taken to 'Profit and Loss a/c' should be reversed.

8.125 RBI vide its Circular No. DBOD.No.BP.BC.48 / 21.06.001/2010-11 dated October 1, 2010 on "Prudential Norms for Off-Balance Sheet Exposures of Banks - Bilateral netting of counterparty credit exposures" has decided that since the legal position regarding bilateral netting is not unambiguously clear, bilateral netting of mark-to-market (MTM) values arising on account of such derivative contracts cannot be permitted. Accordingly, banks should count their gross positive MTM value of such contracts for the purposes of capital adequacy as well as for exposure norms.

8.126 RBI vide its Circular No. DBOD.No.BP.BC.1/ 21.04.048/2013-14 dated July 1, 2013 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances" advised banks that credit exposures computed as per the current marked to market value of the contract, arising on account of the interest rate & foreign exchange derivative transactions, credit default swaps, shall also attract provisioning requirement as applicable to the loan assets in the 'standard' category, of the concerned counterparties. All conditions applicable for treatment of the provisions for standard assets would also apply to the aforesaid provisions for derivative exposures.

8.127 RBI vide its circular no. DBOD.BP.BC.28/21.04.157/2011-12 dated August 11, 2011 has further clarified that:

- In cases where the derivative contracts provides for more settlements in future, the MTM value will comprise of (a) crystallised receivables and (b) positive or negative MTM in respect of future receivables.

- If the derivative contract is not terminated on the overdue receivable remaining unpaid for 90 days, in addition to reversing the crystallised receivable from Profit and Loss Account as stipulated in para 1 above, the positive MTM pertaining to future receivables may also be reversed from Profit and Loss Account to another account styled as 'Suspense Account – Positive MTM'. The subsequent positive changes in the MTM value may be credited to the 'Suspense Account – Positive MTM', not to P&L Account.
- The subsequent decline in MTM value may be adjusted against the balance in 'Suspense Account – Positive MTM'. If the balance in this account is not sufficient, the remaining amount may be debited to the P&L Account.
- On payment of the overdues in cash, the balance in the 'Suspense Account-Crystallised Receivables' may be transferred to the 'Profit and Loss Account', to the extent payment is received.
- If the bank has other derivative exposures on the borrower, it follows that the MTMs of other derivative exposures should also be dealt with / accounted for in the manner as described above, subsequent to the crystallised/settlement amount in respect of a particular derivative transaction being treated as NPA.
- Since the legal position regarding bilateral netting is not unambiguously clear, receivables and payables from/to the same counterparty including that relating to a single derivative contract should not be netted.
- Similarly, in case a fund-based credit facility extended to a borrower is classified as NPA, the MTMs of all the derivative exposures should be treated in the manner discussed above.
- These guidelines are applicable to both outstanding derivatives contracts and the derivatives transactions undertaken from the date of the circular.

Re-structuring of derivative contracts

8.128 In cases where a derivative contract is restructured, the mark-to-market value of the contract on the date of restructuring should be cash settled. For this purpose, any change in any of the parameters of the original contract would be treated as a restructuring.

Provisions in case of foreign branches and subsidiaries of the Indian Banks

8.129 The RBI *vide* its circular No. DBOD.No.BP.BC.89 /21.04.141/2008-09 dated December 1, 2008 on "Operations of foreign branches and subsidiaries of the Indian banks – Compliance with statutory/regulatory/administrative prohibitions/ restrictions" provides that transactions by the foreign branches /

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foreign subsidiaries, in financial products which are not available in the Indian market and on which no specific prohibition has been currently placed by the RBI, no prior approval of the RBI would be required for the purpose provided these are merely plain-vanilla financial products. Banks should, however, ensure that their foreign branches / subsidiaries, dealing with such products in foreign jurisdictions, have adequate knowledge, understanding, and risk management capability for handling such products. Such products should also be appropriately captured and reported in the extant off-site returns furnished to the RBI. These products would also attract the prudential norms such as capital adequacy, credit exposure, periodical valuation, and all other applicable norms. In case the current RBI norms do not specify prudential treatment of such financial products, it would be incumbent upon the banks to seek specific RBI guidance in the matter. If, however, the foreign branches / foreign subsidiaries of the Indian banks propose to handle structured financial products, banks should obtain prior approval of the RBI for the purpose by furnishing full particulars of these products including their regulatory treatment prescribed by the host-country regulators (for capital adequacy, valuation, pricing, exposure norms, etc), as also the risk management systems in place in the branch / subsidiary to deal with such products.

Risk management

8.130 This is a function that can sit well in the middle office provided it is properly staffed by officers who understand fully the business and risks involved – which usually means ex-market practitioners. It can range from agreeing overnight cash positions for the trading room through to full-risk modelling associated with derivatives trading and hedging. In between can come monitoring of counterparty, country, dealer and market-related limits that have been set and approved in other areas of the bank such as the credit department.

Risk Identification Process

Price or Rate Risk

Foreign Exchange Rate Movement Risk

8.131 Foreign exchange rate movement risk arises from net exchange position in a currency. If the position is long or overbought and there is depreciation in the currency, a loss occurs. On the other hand, if an appreciation occurs while the dealer is holding a long net position, there will be a profit from such change in exchange rates. The opposite will occur if the net positions were short or oversold in that currency. Price risk of this kind also exists on execution of a swap. This is also known as the 'tail', which arises because in a swap the

effects of two foreign currency amounts, inflow and outflow, are different on account of present valuing all cash flows.

US\$/INR FX Forwards Risk

8.132 Forward points (premia/discount) in the Indian markets are not entirely a function of interest rate differentials but a function of demand and supply of forward currency. As a result, normally banks treat traded forward points (up to 1-year) as a market factor, and use this to compute the implied INR rate (MIFOR) up to the 1-year segment. Beyond 1-year, forward points are computed from the INR currency swap/ MIFOR quotes and US\$ swap curve.

Timing Risk

8.133 As per market practice, FX contracts with timing discretion (Option Period Forwards or OPFs) versus INR are typically for a period of one week to a maximum of one month. The customer has the discretion to pick up the contract on any day of the window period. In case the customer is buying the foreign currency ('FCY'), the swap points/contract rate is fixed based on the last date of the period in case the FCY is at a premium against the INR or the first date in case the FCY is at a discount. Hence, unless the swap points change from premium to discount or vice versa after entering into the contract, the counterparty would not benefit by taking delivery before last date in case of premium or after first date in case of discount. In the unlikely event of this happening and if the bank has not hedged the contract similarly with another contract with discretion period, an adverse impact on Profit and Loss Account could arise. In such a case, the market counterparty could pick up the contract early while the hedge contract would still be outstanding and the gap would have to be covered again at incremental cost.

Credit Risk

8.134 Credit risk is the risk that the counterparty to a financial transaction - here a foreign exchange contract - may become unable to perform its obligation. The extent of risk depends on whether the other party's inability to pay is established before the value date or is on the same value date of the foreign exchange contract.

Pre-Settlement Likely Exposure

8.135 Trading (or pre-settlement) exposure occurs when a counterparty defaults on its contractual obligation before the settlement date and the bank has to defend the position in the market with another counterparty at the then prevailing rate. The

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bank is exposed to possible adverse price fluctuations between the contract price and the market price on the date of default or final liquidation.

Settlement Risk

8.136 This occurs when items of agreed upon original equal value are not simultaneously exchanged between counter parties; and/or when Bank's funds are released without knowledge that counter value items have been received by the bank. Typically, the duration is overnight/over weekend, or in some cases even longer i.e., until bank receives the confirmation of receipt of funds. The risk is that bank delivers but do not receive delivery. In this situation 100% of the principal amount is at risk.

Market risk

8.137 Market risk is the risk of loss due to adverse changes in the market value (the price) of an instrument or portfolio of instruments. Such exposure occurs with respect to derivative instruments when changes occur in market factors such as underlying interest rates, exchange rates, equity prices, and commodity prices or in the volatility of these factors.

Liquidity Risk

8.138 Liquidity risk refers to the ease with which a foreign exchange spot position or gap can be liquidated. The approved spot DV01 limit factors in the liquidity risk associated with the product. Tenor wise DV01 limits in the case of US\$INR gaps factor in the liquidity in the forward markets. Institutions involved in derivatives activity face two types of liquidity risk: market liquidity risk and funding liquidity risk.

Market Liquidity Risk

8.139 Market liquidity risk is the risk that an institution may not be able to exit or offset positions quickly, and in sufficient quantities, at a reasonable price. This inability may be due to inadequate market depth in certain products (e.g. exotic derivatives, long-dated options), market disruption, or inability of the bank to access the market (e.g. credit down-grading of the institution or of a major counterparty).

Funding Liquidity Risk

8.140 Funding liquidity risk is the potential inability of the institution to meet funding requirements, because of cash flow mismatches, at a reasonable cost. Such funding requirements may arise from cash flow mismatches in swap books, exercise of options, and the implementation of dynamic hedging strategies.

Sovereign Risk or Cross Border Risk

8.141 This is the risk that the Government of a particular country may interfere with a payment due to the Bank from a client resident in that country and preclude the client from converting and/or transferring the funds. In such cases, bank's obligor may be economically sound and capable of repaying its obligation, but its country's Government may place an embargo on remittances for political/economic reasons.

Operations Risk

8.142 This can occur if an error in processing results in a loss and/or excess over prescribed risk/regulatory limits.

Legal risk

8.143 Legal risk is the risk of loss arising from contracts which are not legally enforceable (e.g. the counterparty does not have the power or authority to enter into a particular type of derivatives transaction) or documented correctly.

Regulatory risk

8.144 Regulatory risk is the risk of loss arising from failure to comply with regulatory or legal requirements.

Reputation risk

8.145 Reputation risk is the risk of loss arising from adverse public opinion and damage to reputation.

Country Risk

8.146 The following items need consideration in respect of funded and non-funded exposures relating to country risk:

- Funded exposures.
- Investments.
- Nostro mirror debit balances.
- Overdraft in vostro accounts.
- Remittances honoured drawing arrangements.
- Loans and advances.
- Trade credit and receivables.
- Other monetary assets.
- Non-funded exposures.

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- Bid, performance, advance payment, bonds.
- Confirmation of LC issued by a bank abroad.
- Commitment undertaken against the counter guarantee of a bank overseas.
- Provisioning and capital requirements:
 - Determination of Risk category, ECGC provision segments percentage.
 - No provision for home country exposures viz. on India.
 - Lower level of provisioning-25% of requirement in respect of short-term exposures upto 180 day.
- Disclosures on the accounts to the balanced sheet.

Risk Management Limits and Monitoring

8.147 All banks, managements should have a risk management policy, laying down clear guidelines for concluding the transactions and institutionalise the arrangements for a periodical review of operations and annual audit of transactions to verify compliance with the regulations.

Overnight Net Exchange Position Limit/Factor Sensitivity Limits for Spot FX

8.148 The Bank has to apply for a Net Overnight Open Position Limit (NOOPL) with the RBI. This limits the maximum allowable excess of assets plus exchange bought contracts over liabilities plus exchange sold contracts ("overbought" position) and the reverse ("oversold" position) that may be carried overnight in foreign currencies. Moreover banks have to maintain capital adequacy on this approved limit by Reserve Bank of India.

Daylight Limit

8.149 As mentioned for NOOPL these refer to the maximum net positions that can be taken during the trading day in each currency. However, there is no such requirement for RBI approval so long the banks internally have an approved day limit. However, in case of large intra-day flows and positions, it is expected that the desk will keep the risk department informed about the same.

Value at Risk ('VAR') limits

8.150 Spot VAR measures the change in the economic value of a currency position due to a standard deviation adverse change in the spot rates for that currency. The standard deviation for each currency is a measure of the volatility of movements of the spot exchange rate versus the US\$. The Spot VAR along with VAR of other products should be within the VAR limit as stipulated in the Bank's risk guidelines.

8.151 The spot VAR of each currency is computed using the individual currency's volatility and the Factor Sensitivity (DV01) as well as the covariance between currencies. The volatility factors and the covariance coefficients are as per the risk guidelines of the Bank.

Gap DV01 and VAR limits

8.152 The Gap DV01 for USDINR FX forwards is monitored on MIFOR & LIBOR curve. Gap DV01 is computed as the effect of 1 basis point change in the MIFOR/ LIBOR for the tenor on the P&L. The Gap VAR is computed using volatilities for each tenor of the MIFOR/ LIBOR curve and the correlation between them.

8.153 The bank has to apply to Reserve Bank of India for an approved Aggregate Gap Limit for the whole bank. The Banks are also required to compute VAR on a daily basis as per the RBI model on the overall bank gap. The bank has to maintain a separate VAR limit for derivative transactions as mentioned in the RBI Circular No. MPD.BC.187/07.01.279 dated July 7, 1999.

8.154 As of the last reporting Friday of every month, treasury operations has to prepare the GAP report in prescribed format as given by the RBI for the overall gap position of the Bank.

Aggregate Contract Limit

8.155 This limits the gross outstanding spot and future exchange contracts, both bought and sold. It is computed by adding the US\$ equivalents of the sum total of all outstanding contracts across all currencies. It restrains overall trading volume and its monitoring provides an indication of any unusual activity.

Options Limit

8.156 These are specifically designed to control the risks of the options. Options limit may include Delta, Gamma, Vega, Theta and Rho limits. Delta is a measure of the amount an option price would be expected to change for a unit change in the price of the underlying instrument. Gamma is a measure of the amount delta would be expected to change in response to a unit change in the price of the underlying instrument. Vega is a measure of the amount an option's price would be expected to change in response to a unit change in the price of volatility of the underlying instrument. Theta is a measure of the amount of an option's price would be expected to change in response to changes in options time to expiration. Rho is a measure of the amount an option's price would be expected to change in response to changes in interest rates.

Stop Loss Limit

8.157 Stop loss limits can be based on market prices or the losses reflected by those prices. If market prices reach a level where losses on that position equal or are greater than some predetermined limit then the position is closed out.

Management Action Trigger (MAT)

8.158 MAT trigger represents the management's tolerance for accepting the market risk related losses on a daily and cumulative month-to-date basis especially on the trading portfolio.

The P&L for spot trading are monitored as part of the Spot MAT limit while the P&L forwards trading is monitored within the Interest rate products MAT.

Limit Exceptions

8.159 A limit exception is a trade or position specific authorization to exceed a limit for a defined period of time. All limit exceptions must be approved in advance of establishing a position that would exceed a limit.

8.160 Normally Market Risk Management is responsible for maintaining all documentation of the excess including the agreed upon corrective action and the resolution date and is responsible for the ongoing monitoring of the excess to ensure the corrective action is carried out.

Accounting for Forex and Derivative Transactions

8.161 Accounting is generally looked after by the back office and acts as an intermediary between the treasury business unit and the finance department to ensure that the accounting of treasury products is accurate and correct.

8.162 It also enables treasury operations staff to understand the accounting that is peculiar to treasury, such as the 'trading account' and 'base currency' concepts. This is vital as most of the accounting is 'hidden' by being automatically systems generated as a result of deal input of various types. Indeed, this problem is self-perpetuating as the more complex the deals become the more likely a bank will be to automate to prevent errors.

Documentation

8.163 This can range from simple customer mandates through to full legal documentation with both banks and customers. The bank's legal department is responsible for legal agreements depending on what types of business is being

conducted and, crucially, whether the counterparties intend to net payments at settlement. Organizationally, this area can be viewed in a similar way to the accounting function. If documentation forms part of the back office then the business will be more understood by management and better controlled as a result.

Rate Reasonability

8.164 The bank's risk department will perform the rate reasonability process as per the Price Verification Policy of the bank and for any transaction that falls outside the band specified, the same should be enquired into for reasons.

Position and P&L Reconciliation

8.165 This is one of the most important controls on deals position which is carried out by the bank's risk department / back office. The trader's net currency-wise exchange position as per front office system should be matched on a daily basis by risk department / back office with the back office systems position. The position exceptions should be communicated to the front office and an resolution is arrived at.

Month-end Revaluation

8.166 The month-end revaluation rates are prescribed by FEDAI. At times, the spot rates or forward rates specified are different from the market rate at the time the rates are received by the treasury operations/traders. Where the rates prescribed by FEDAI are significantly off compared with market levels, ideally the risk department of the bank should advise the revaluation rates based on market polling and other sources such as Reuters' etc.

Regulatory Reporting requirements

8.167 Derivatives are governed by the Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000. Derivatives are allowed only under the provisions of these regulations and amendments since, or with the prior permission of the Reserve Bank of India. The reporting requirements under RBI Master Circular No. 5 /2013-14 dated July 1, 2013 on "Risk Management and Inter-Bank Dealings" and RBI Circular No. DBOD. No. BP. BC. 86/21.04.157/2006-07 dated April 20, 2007 on "Comprehensive Guidelines on Derivatives" should be adhere to.

8.168 Following are some of the reports to be submitted to RBI:

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- i) Daily statements of Foreign Exchange Turnover in Form FTD and Gaps, Position and Cash Balances in Form GPB.
- ii) Statement of Nostro / Vostro Account balances on a monthly basis.
- iii) Consolidated data on cross currency derivative transactions undertaken by residents.
- iv) Details of exposures in foreign exchange as at the end of every quarter as per that details of exposures of all corporate clients who meet the prescribed criteria have to be included in the report. The AD banks should submit this report based on bank's books and not based on corporate returns.
- v) Details of option transactions (FCY-INR) undertaken on a weekly basis.
- v) Total outstanding foreign currency borrowings under all categories as on the last Friday of every month.
- vi) Monthly report (as on the last Friday of every month) on the limits granted and utilized by their constituents under the facility of booking forward contracts on past performance basis.
- vii) Statement in form BAL giving details of their holdings of all foreign currencies on fortnightly basis through Online Returns Filing System (ORFS).
- viii) A monthly statement, in respect of cover taken by FIIs, indicating the name of the FII / fund, the eligible amount of cover, the actual cover taken, etc.
- ix) List (in triplicate) of all bank's offices/branches, which are maintaining Rupee accounts of non-resident banks as at the end of December every year.
- x) Quarterly report on the forward contracts booked and cancelled by SMEs and Resident Individuals.
- xi) Consolidated data on the transactions undertaken by non-residents under the scheme.
- xii) Doubtful transactions involving frequent cancellation of hedge transactions and / or the underlying trade transactions by non-residents under the scheme.

8.169 Another significant feature of the foreign exchange business of banks in India is the requirement of reporting of transactions, at specified intervals, by the branches to the Reserve Bank of India by means of 'R' returns, as enumerated in the Exchange Control Manual. Those branches which handle foreign exchange transactions and are under obligation to report them directly to Reserve Bank are called the 'Authorised Dealers' (AD—also called 'position maintaining branches'). The ADs can be nominated only with the approval of

the Reserve Bank of India and each AD would have a unique Code Number which must be mentioned in all reports to the Reserve Bank. In addition to these ADs, individual banks may also, subject to report to the Reserve Bank, nominate some other branches to handle the specified type of foreign exchange business but these branches will have to route their transactions through an AD only (such branches are often called 'reporting branches').

8.170 Moreover, treasury operations has to provide forms A2 for all interbank cross-currency deals done with overseas banks which matures during a fortnight to the RBI through the R-Return which is submitted on a fortnightly basis.

8.171 Treasury operations also have to submit a report (MAP/ SIR) in the format as prescribed by the RBI. This is required to be prepared for 4 major currencies (i.e. US\$, GBP, YEN and CHF). MAP will be prepared for the last reporting Friday of each month.

8.172 As required by RBI circular FMD.MSRG.No.67/02.05.002/2011-12 dated March 9, 2012, all inter-bank OTC inter-bank foreign exchange derivatives required to be reported on a platform to be developed by the CCIL. All/selective trades in OTC foreign exchange and interest rate derivatives between the Category-I Authorised Dealer Banks/market makers (banks/PDs) and their clients required to be reported on the CCIL platform subject to a mutually agreed upon confidentiality protocol.

8.173 As per RBI circular FMD.MSRG.No.72/02.05.002/2012-13 dated October 12, 2012, it is decided with effect from November 5, 2012 that following derivative products need to be reported to CCIL by the banks:

- FCY(excluding USD)-INR forwards
- FCY(excluding USD)-INR FX swaps
- FCY-FCY forwards
- FCY-FCY FX Swaps
- FCY-FCY options

Valuation of foreign exchange forwards and derivative products

8.174 Valuation of derivatives, particularly long-tenor derivative products, many of which could be proprietary products of banks, may be difficult to value, as they may be illiquid instruments.

8.175 As part of its normal day to day operations and for managing its interest rate and foreign exchange risk, a bank or financial institution may deal with a number of financial instruments. Depending on the type of financial instrument

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and the purpose for which it was entered into, it is necessary to value the deals periodically. Some of the financial instruments in which banks and financial institutions transact are complex in nature.

8.176 The valuation models used for these financial instruments are sophisticated and involve complex algorithms. Generally, inputs into these models are sourced from market available data points. Given the enormous “leverage” provided by various derivative financial instruments and the track record of significant losses reported in the industry, the valuation of these instruments will generally have a high inherent risk.

8.177 The valuation of derivatives should be based on marked to market (MTM) and on net present value (NPV) basis.

Guidance for Arriving at Fair/Market Value

8.178 As a general rule, for an instrument that is actively traded on a recognized public exchange, the price quoted by the exchange where the instrument is traded is used as an appropriate valuation price to arrive at the fair value of the instrument.

8.179 In case of instruments that are actively traded over the counter, the quoted bid price for long positions and quoted offer price for short positions is used as an appropriate indicative valuation price. These may be obtained through relevant market makers or brokers.

8.180 In case of thinly traded instruments/non-traded OTC derivatives, various techniques are used to determine the best estimate of a market price. This synthetic market price may be derived through use of market data (such as interest/ exchange rates) in appropriate models/systems designed for this purpose.

8.181 In case of the following instruments, fair value can be arrived at using the market data as mentioned there against:

FX spot / forwards	Prices as published by Foreign Exchange Dealers Association of India ('FEDAI')
Exchange traded interest rate futures	Prices quoted on the relevant exchange
Commodity futures	Prices quoted on the relevant exchange
OTC derivatives:	
Options	Black Scholes Merton Method.
Swaps / Forward Rate Agreements	Discounted cash flows using the applicable Interest Curves (ROI can be taken from FIMMDA / NSE / Reuters' site based on the nature and currency of the product.

8.182 The valuation of derivatives is based on exchange rate and the swap rate prevailing on the valuation date. Various banks use different in-house / vendor developed model for valuation of their derivative products. However, the general benchmarks used for valuation are OIS / MIBOR, MIFOR, MITOR, LIBOR and INBMK as per the end of the day quotes appearing on the Bloomberg or Reuters page.

8.183 In case of hedge swaps, the income / expense is accounted for on an accrual basis except the swap designated with an asset or liability that is marked to market or lower of cost or market value in the financial statements. In that case, the swap should be marked to market with the resulting gain or loss recorded as an adjustment to the market value of designated asset or liability. Whereas, the trading swaps are marked to market as per the instructions contained in the RBI circular NO. MPD. BC. 187/07.01.279/1999-2000 dated July 7, 1999.

8.184 The market value of forward financial derivatives contract is derived from the difference between the agreed-upon contract price of an underlying item and the current market price (or market price expected to prevail) of that item, times the notional amount, approximately discounted. The notional amounts - sometimes described as the nominal amount - is the amount underlying a financial derivatives contract that is necessary for calculating payments or receipts on the contract. This amount may or may not be exchanged.

8.185 In the specific case of a swap contract, the market value is derived from the difference between the expected gross receipts and gross payments, appropriately discounted; that is, its net present value.

8.186 The market value for a forward contract can therefore be calculated using available information – market and contract prices for the underlying item, time to maturity of the contract, the notional value, and market interest rates. From the viewpoint of the counter parties, the value of a forward contract may become negative (liability) or positive (asset) and may change both in magnitude and direction over time, depending on the movement in the market price for the underlying item. Forward contract settled on a daily basis, such as those traded on organized exchanges - and known as futures - have a market value, but because of daily settlement it is likely to be zero value at each end-period.

8.187 The price of an option depends on the potential price volatility of the price of the underlying item, the time to maturity, interest rates, and the difference between the contract price and the market price of the underlying item.

8.188 For traded options, whether they are traded on an exchange or not, the valuation should be based on the observable price. At inception the market value of a non-traded option is the amount of the premium paid or received. Subsequently, non-traded options can be valued with the use of mathematical models, such as the Black-Scholes formulae, that take account of the factors mentioned above that determine option prices. In the absence of a pricing model, the price reported for accounting or regulatory purposes might be used. Unlike forwards, options cannot switch from negative to positive value, or vice versa, but they remain an asset for the owner and a liability for the writer of the option.

8.189 It may be mentioned that counter party wise netting is only allowed where specific legally enforceable bilateral netting arrangement such as International Swaps and Derivative Association (ISDA) master agreement, etc., exists.

Examples for the Calculation of Market or Fair Values of Derivative Contracts

8.190 The following examples indicate how to calculate the market or fair value of various derivative contracts.

8.191 For a forward, a contract to purchase USD against EUR at a forward rate of say, 1.00 when initiated has a positive market value if the EUR/ USD forward rate at the time of reporting for the same settlement date is lower than 1.00. It has a negative market value if the forward rate at the time of reporting is higher than 1.00, and it has a zero market value if the forward rate at the time of reporting is equal to 1.00.

8.192 For swaps, which involve multiple (and sometimes two-way) payments, the market or fair value is the net present value of the payments to be exchanged between the counter parties between the reporting date and the contracts maturity, where the discount factor to be applied would normally reflect the market interest rate for the period of the contract's remaining maturity. Thus, a fixed/floating swap which at the interest rates prevailing at the reporting date involves net annual receipts by the reporter of say, 2% of the notional principal amount for the next three years has a positive marked to market (or replacement) value equal to the sum of three net payments (each 2% of the notional amount), discounted by the market interest rate prevailing at the reporting date. If the contract is not in the reporter's favour (i.e., the reporter would have to make net annual payments), the contract has a negative net present value.

8.193 Unlike forwards or swaps, OTC options have a market or fair value at initiation which is equal to the premium paid to the writer of the option.

8.194 Throughout their life, option contracts can only have a positive market or fair value for the buyer and a negative market or fair value for the seller. If a quoted market price is available for a contract, the market value to be reported for that contract is the product of the number of trading units of the contract multiplied by that market price. If a quoted market price is not available, the market or fair value of an outstanding option contract at the time of reporting can be determined on the basis of secondary market prices for options with the same strike prices and remaining maturities as the options being valued, or by using option pricing models.

8.195 In an option pricing model, current quotes of forward prices for the underlying (spot prices for American options) and the implied volatility and market interest rate relevant to the option's maturity would normally be used to calculate the market values. Options sold and purchased with the same counter party should not be netted against each other, nor should offsetting bought and sold options on the same underlying. RBI *vide* its Circular on DBOD. No.BP.BC.76/21.04.157/2013-14 dated December 09, 2013 has issued operational Guidelines on "Novation of OTC Derivative Contracts"

Audit Approach

8.196 While innovative products and ways of trading create new possibilities for earnings for the bank, they also introduce novel and sometimes unfamiliar risks that must be identified and managed. Failure to do so can result losses entailing financial and reputational consequences that linger long after the loss has been recognized in financial statements. Hence, auditor should assess controls as part of audit work.

8.197 It is imperative that an auditor obtains a complete overview of the treasury operations of a bank before the commencement of the statutory audit. After conducting appropriate risk assessment of the treasury processes, the audit program needs to be designed in a manner that it dovetails into not just the control assessments of the treasury process but there is an assurance that the figures appearing in the financial statements as well as the disclosures are true and reflect fairly the affairs of the bank treasury.

Audit Programming and Procedures

8.198 In framing the audit program, an auditor needs to take into consideration his findings of the adequacy of controls within the processes as explained in this Guidance Note. Reserve Bank of India prescribes concurrent audit /internal audit for a 100% verification of treasury transactions. Hence, the selection of samples

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can be influenced by the nature, extent and timings of concurrent/internal audit function including the compliance mechanism of the Bank.

8.199 The following are illustrative audit procedures/ approach that may form part of the audit program.

Product Program and Policy

8.200 The auditor should obtain the approved product policy and procedures of the Bank relating to foreign exchange and derivative business and review them for adequacy and coverage and check whether the policy is commensurate with the nature of operations and adequately covers all the activities of the Bank.

Customer/User Suitability and Appropriateness Policy

8.201 The auditor should obtain approved 'Customer/User Suitability and Appropriateness Policy' and verify that such policy is in line with the comprehensive guidelines and is approved by the Board.

Credit limits

8.202 For the selected samples, the auditor should check whether appropriate credit limits are in place for foreign exchange and derivative transactions. Additionally, the auditor should:

- Check whether the name of the counterparty is in the approved counterparty list for the purpose of treasury transactions.
- Check whether the credit limits are set for different customers and they are adhered to in a consistent manner and for any limit breaches, appropriate sanctions / ratifications are in place.
- Check whether the counterparty exposure limit reports for all brokers, lenders, etc., are generated and monitored on a regular basis.
- Check dealer limits- Maximum amount a dealer can transact without seeking higher-level approval and sanctions/ratifications for any breaches.
- Check product limits- Maximum exposure the entity should have in a particular instrument or product.
- Check sector limits – Maximum investment in a particular sector (for example, exposures to companies incorporated with limited liability in India).
- For the selected samples, confirm and review signed and authorized ISDA agreement, signed and authorized collateral agreement, credit risk assessment of the customer and confirm, whether credit positions are within established limits for each customer.

Deal Initiation and Recording

8.203 For the selected samples, the auditor should check whether deals carried out by the front office are appropriately recorded in the deal slips and whether the same is correctly entered in the front office deal recording system.

- For the selected samples check whether the deal ticket is complete and accurate with respect to all transaction details like counterparty name, contract rate, notional amount, transaction date / maturity date, value date / settlement agent and buy / sell date.
- Check whether deal tickets are generated automatically by front office systems, or trader should use sequentially numbered deal tickets.
- Check whether the dealers use dedicated calling lines and all the telephone lines are linked to a voice recording machine.

Deal Authorisation

8.204 Following audit procedures may be followed by an auditor while checking the procedures for deal authorisation.

- Check whether proper authorization levels are set for treasury operations and observe and verify whether the prescribed procedure is followed.
- For the selected samples, check whether deals entered in front office system are authorised by the back office team after verifying the deal details with external evidences like Reuters' conversation, telephonic conversation with customers' back office, faxed confirmations, etc.
- Examine the selected deals from the front office and establish that they are confirmed by the back office operations.
- Check that all sampled deals are authorised at the proper levels of authority against the deal slip.
- Check whether alterations and cancellations on deal slips are duly authorised.

Segregation of Duties

8.205 For this, the audit procedure may include:

- Checking and ascertaining that segregation of duties is in place. Under no circumstances staff involved in initiating deals should be involved in checking or receiving deal related documents.

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- Verifying that there is clear segregation, functionally and physically, between the front office, back office and middle office in respect of derivative transactions.
- Checking that there is segregation between functions of authorisation, execution and recording of transactions.
- In cases where management override has taken place, ascertain that satisfactory reasons for doing so were recorded and produced for audit verification.
- Checking whether treasury personnel have availed minimum leave during the financial year.

Counterparty confirmations

8.206 For this, the auditor would *inter alia*:

- Verify that confirmations from Bank to counterparty are sent within a reasonable time and there exists a mechanism for follow-ups for pending counterparty confirmations.
- Determine the status of any missing / pending confirmations (currently in the Confirmation Tracking List) and assess whether there are any provisioning concerns on the trades
- Check whether the format of the counterparty confirmation is as approved by the Local Legal Counsel of the Bank from time to time.
- Verify controls implemented by banks to ensure completeness of all deal confirmations.
- Inquire of any exception report or other mechanism of tracking missing confirmations.

Accounting of transaction in the general ledger

8.207 The audit procedures for this aspect include:

- Checking whether there is a direct hands-off between front end system and the accounting system for passing accounting entries in the general ledger.
- Checking whether correct accounting entries are recorded in the general ledger and the back office regularly reviews the accounting entries passed in the general ledger.
- Checking whether the treasury department generates a daily P&L (desk-wise) and same has been reviewed and compared to the general ledger to identify any mismatches.

Position Reconciliation

8.208 The audit procedures include:

- Checking whether daily position reconciliations are performed between front office deal positions and back office deal positions by the treasury back office and position differences if any are appropriately enquired into.
- Checking whether the Bank maintains customer wise, currency wise and deal wise positions on a daily basis in-order to monitor customer limit breaches and sectoral limit breaches.

Deal Settlements

8.209 The audit procedures include:

- Checking whether there exists effective mechanism for settlement of deals on due date and whether deals due for settlement are generated on a daily basis by back office.
- Examining whether customer intimations are sent across as soon as the deal is settled and the respective customer accounts are debited / credited.
- Examining whether the Settlement desk ensures proper settlement of funds through CCIL/RTGS/SWIFT networks. Any deal rejected by CCIL should be examined and settlement through any other means should be taken up only after thoroughly examining the deal/deal confirmation as in most of the cases the rejection is on account of improper deal entry.

Rate Scan

8.210 The audit procedures for this would include:

- Checking whether for the selected deals, the rates taken are the prevailing rates in the market at the time of striking the deal.
- Checking whether in outright deals the back office checks the rate scans for the veracity of the rate at which the dealer has struck the deal. Any deviation should be enquired into Compliance with Accounting Standard (AS) 11.

Assessment of controls

8.211 The audit procedure may include verifying and assessing controls including:

- Existence of comprehensive treasury policy and operating procedures manual (SOP).

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- Review of the policies and procedures document and assess comprehensiveness of the same.
- Determining whether the above document addresses, in granular detail, the framework within which the treasury business and operations have to be conducted.
- Inquiring on the procedures the bank has when there is a change over or new appointment to a 'review' role within the treasury function.
- Understanding the level of detail in which the process of, i.e., handover of responsibilities operates.
- Inquiring whether there has been any change in responsibilities in the current period and in case there are changes, verifying whether there is an appropriate training mechanism and whether signoffs have been regularized after the new superior has taken over the responsibilities.
- On a test check basis, verifying whether the review process and controls were working effectively during the transition period.
- Obtaining and reviewing on test check basis, the daily Profit and Loss prepared for MIS purpose and assessing the granularity and exhaustiveness of the same;
- Assessing whether such Profit and Loss is granular enough to provide desk wise, product wise and various price component wise Profit and Loss.
- Assessing whether gross position reviews are undertaken and also whether such Profit and Loss are prepared and reviewed at a gross trade level.
- Reviewing the Bank's policy on valuation. On a test check basis, verifying whether the material valuation adjustments are reviewed, authorized and are appropriate.
- Verifying whether these valuation adjustments are disclosed / visible in the reconciliation.
- Assessing whether there is an independent 'Valuation Control' team.
- Checking whether dealers have access to adjust or modify trade values .
- Checking whether the reconciliations are prepared on a timely basis and the un-reconciled items are independently inquired by the back office.
- Reviewing the ageing and quantum of the un-reconciled items and inquire for the high value and long outstanding reconciling items.
- Assessing whether the escalations are done in a timely manner for the large / unusual / recurring reconciliation items.

Market Risk System

- Reviewing the key market risk reports generated and verifying that these reports are in sync with risk attributes of the products being traded and convey the risk positions appropriately.

Cancelled / amended / late (C/A/L) booking of futures trades into the Front Office risk system

- Reviewing the policy of the bank as regards the cancelled / amended / late booked trades and whether there is a clear policy describing the Front office supervisor's responsibility in respect of reviewing and signing off on these instances
- Reviewing whether these instances are reported to the senior management as per the policy and are ratified.
- Verifying whether the system is capable to capture the C/A/L and obtaining a complete inventory of these instances.
- Reviewing the frequency of such instances during the period and verifying on a test check basis whether there is a justification of such cancellations / amendments / delays.
- Checking the process relating to late trades – how does these get captured in risk reporting's (if there is a time cut off when such reports are generated).

Fictitious trades with deferred settlement dates and/or at off-market prices and subsequent amendments

- Reviewing the controls over cancellation of trades before reaching settlement dates and check whether these are ratified by the authorized personnel with appropriate justifications.
- Reviewing the "Rate scan" process performed by mid-office and whether the exceptions noted in the rate scan are inquired.
- Reviewing the Day 1 Profit or Loss assessment process and verify whether the Day-1 Profit or Loss is sufficiently assessed and explained.
- Verifying whether the change in pricing / other criterion is approved and confirmed with the counterparty.

Breaches of the net delta limits

- Verifying whether the breaches to the delta limits set by the Bank are monitored on a frequent basis and whether the breaches (if any) are ratified by the authorized personnel and the reason is recorded for such breaches.

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Failure to identify and escalate risk issues

- Verifying whether a process is in place to educate employees about escalation mechanism to report any events that represent a risk to the institution and is embedded in the code of conduct. This may include directly reporting the incidences to the highest authorities on a no name basis, hotline numbers etc.

Quality of supervision

- Assessing and determining the nature of comments and queries that are posed by the reviewer on any reconciliation breaks, long unexplained balances, exceptional trades, follow up on responses, etc.
- Determining and assessing whether the review function is not a mere sign off and it is conducted with appropriate supervisory intent.

Temporary discontinuance of a process or control

- Verifying that the controls identified and tested have been operational throughout the period and where there has been a temporary discontinuance (for any reason) verify whether there were alternative controls.

Rewards and recognition policy not in sync with ideal 'risk and control' culture

- Reviewing the remuneration policy and independently assess how and to what degree it addresses matters relating to risk and compliance with control policies as part of the employee remuneration for treasury staff members.

Outsourced/Hubbed process

- Reviewing the Service Level Agreements (SLAs) and agreements with such agencies and verify the robustness of the controls that reside in house in the bank to review and understand the work undertaken at outsourced / hub locations.
- Reviewing and verifying the documentary evidence of the communication the bank has with these agencies on a regular basis.

NOSTRO and VOSTRO Accounts

8.212 A fundamental feature of foreign exchange transactions is that the useful possession of any currency can be had only in the country in which it is a legal tender or countries in which it is circulated. (e.g., US Dollar is widely

circulated in Russia, CIS countries). Therefore, in order to be able to put through foreign exchange transactions, banks normally maintain stocks of foreign currencies in the form of bank accounts (usually current accounts) with their overseas branches/correspondents. Such a foreign currency account maintained by a bank at an overseas centre is usually designated by it as 'NOSTRO Account' (i.e. "Our account with you"). Thus, banks in India may maintain a pound-sterling account with its London office/correspondent; such account would be called by it as NOSTRO Account. Conversely, if a foreign bank is to deal in a local currency of another country, it would maintain a 'VOSTRO Account' (i.e. 'your account with us') with the local bank, e.g. a bank in England may maintain a 'VOSTRO Account' in Indian Rupee with a correspondent bank in India. A VOSTRO account is in substance no different from any other account in the local currency.

NOSTRO / VOSTRO Reconciliation

8.213 In respect of old unreconciled entries in NOSTRO Accounts, the RBI vide its Circular DBOD No.BP.BC.67/21.04.048/99 dated July 1, 1999 has allowed, as a one time measure, a netting off procedure.

8.214 The auditor may consider the following aspects in respect of NOSTRO reconciliation:

- whether a system of periodical reconciliation is in place.
- whether Information to the controlling office is sent on a timely basis.
- whether long outstanding are taken up and reconciled.
- Random check of the method of reconciliation.
- Debits outstanding both in the mirror account and in the Nostro accounts are to be verified and recommend for provision wherever necessary.
- Set off the credit against debits only at the permission of the head office for long outstanding entries.

8.215 RBI's circular no. DBOD.BP.BC.16/21.04.018/2001-02 of August 24, 2001 has also clarified that the balances carried in "Sundry Debtors/ Unclaimed Deposits Accounts" under NOSTRO Accounts, represent unreconciled entries which may be large in a few cases and hence susceptible to frauds. Accordingly, the banks should transfer the following balances in the "Sundry Debtors/ Unclaimed Deposits Accounts" appearing in the books of the bank as on September 30, 2001 to distinct "Blocked Accounts" and shown under "Other Liabilities and Provisions" (item no. iv of Schedule 5) in the balance sheet:

- (i) the net credit balance arising out of the netting of entries pertaining to the

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period prior to April, 1996; and

- (ii) credit entries originated on or after April 1, 1996 and remaining unreconciled in NOSTRO/ mirror accounts for more than three years.

Further, the balances in the Blocked Accounts will be reckoned for the purposes of maintenance of CRR/ SLR.

8.216 Any adjustment from the Blocked Accounts should be permitted with the authorisation of the two officials, one of whom should be from outside the branch concerned, preferably from the Controlling branch/ head office if the amount exceeds Rs. One lakh.

8.217 The audit considerations for this aspect include:

- Examining whether currency wise NOSTRO / VOSTRO reconciliation is performed on a day-to-day basis and check for long outstanding items.
- Checking whether there exists a policy of following up for outstanding reconciliation items with the counterparties or with the respective banks.
- Outstanding debit items over 90 days attract provisioning under RBI provisioning norms.

Evaluation of Internal Audit/Concurrent Audit

8.218 The audit consideration for this aspect include:

- Examining whether treasury transactions are separately subjected to concurrent audit by internal auditors / external auditors and monthly reports containing their findings are submitted to the management for corrective action.
- Obtaining the monthly concurrent audit reports of the treasury operations and check whether deficiencies if any, mentioned in the report are rectified or noted for corrective action by the management.
- In internal audit reports, examining whether major control weaknesses are highlighted and a management action plan to remedy the weaknesses are agreed with a timeframe.

Management should periodically monitor newly implemented systems and controls to ensure they are working appropriately. Failure of management to implement recommendations within an agreed timeframe should be reported to the Audit Committee.

Risk Management

8.219 The audit consideration for this aspect include:

Treasury Operations

- Checking whether the bank has adequate risk management process, sound risk measurement procedures, sound information systems, continuous risk monitoring and frequent management reporting for treasury operations.
- Examining whether the mid-office monitors the exchange and gap positions for cut loss limits, overnight limits, daylight limit, liquidity, counterparty exposure limit and aggregate gap limit fixed in the banks trading policy/guidelines.
- Reviewing the adequacy and effectiveness of the overall risk management system, including compliance with policies, and procedures.
- Investigating unusual occurrences such as significant breaches of limits, unauthorized trades and unreconciled valuation or accounting differences.
- Inquiring whether there is a 'New Product Approval' process prior to undertaking transactions in new or structured derivative products and verifying whether the 'New Product Paper' for all new derivative products is approved and signed-off by the Chief Compliance Officer of the bank.
- Obtaining the 'Risk Management Policy' of the bank and verifying whether risk management pertaining to derivative transactions is an integral part of the policy.
- Verifying that the 'Risk Management Policy' for derivative transactions has been approved by the Board. Verifying that the policy inter alia covers the following aspects:
 - (i). Defines the approved derivative products and the authorized derivative activities;
 - (ii). Details requirements for the evaluation and approval of new products or activities;
 - (iii). Ensures appropriate structure and staffing for the key risk control functions, including internal audit;
 - (iv). Establishes management responsibilities;
 - (v). Identifies the various types of risks faced by the bank and establish a clear and comprehensive set of limits to control these;
 - (vi). Establishes risk measurement methodologies which are consistent with the nature and scale of the derivative activities;
 - (vii). Requires stress testing of risk positions;

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- (viii). Details the type and frequency of reports for monitoring risks which are submitted to the Board (or committees of the Board);
- (ix). Typical risks and commonly used risk limits in respect of derivative transactions.

Information Technology ('IT') Controls

8.220 The audit considerations for this aspect include:

- Obtain IT related information from the bank for treasury operations and review, as appropriate, minutes of any committees responsible for overseeing and coordinating IT resources and activities to determine user involvement and organizational priorities.
- Review organizational charts, job descriptions, and training programs to ascertain that the bank has a sufficient number of technology personnel and that these personnel have the expertise the bank requires.
- Review MIS reports for significant IT systems and activities to ascertain that risk identification, measurement, control, and monitoring are commensurate with the complexity of the bank's technology and operating environment.
- Evaluate the separation of duties and responsibilities in the operation and data processing of treasury functions.
- Evaluate the adequacy of input/output controls and reconciliation procedures for batch capture and image capture systems.
- Review controls and audit trails over master file change requests (such as address changes, due dates, commission / interest rates, and service charge indicator) and also consider individuals authorized to make changes and potential conflicting job responsibilities and documentation/audit trail of authorized changes and procedures used to verify the accuracy of master file changes.
- Assess adequacy of controls over changes to systems, programs, data files, and PC-based applications and consider procedures for implementing program updates, releases, and changes.
- Check if controls are in place to restrict and monitor use of data-altering utilities and adequate process management to select system and program security settings (i.e., whether the settings were made based on using sound technical advice or were simply default settings).
- Check whether controls are established to prevent unauthorized changes to system and programs security settings.

- Evaluate the effectiveness of password administration for employee and customer passwords considering the complexity of the processing environment and type of information accessed and consider confidentiality of passwords - (whether only known to the employee/customer), procedures to reset passwords to ensure confidentiality is maintained, frequency of required changes in passwords, password design (number and type of characters), security of passwords while stored in computer files, during transmission, and on printed activity logs and reports.
- Determine whether the bank has removed/reset default profiles and passwords from new systems and equipment and determine whether access to system administrator level is adequately controlled.
- Check whether the data hands off process from one product processor to another or to any other system is conducted under a secure environment and without or with least but controlled manual intervention.

Valuation of FX contracts and Derivatives

8.221 The audit procedures for valuation of FX contracts and Derivatives include:

- For spot and tom contracts checking whether correct FEDAI rates are used by the Bank for marking them to market. In case of automatic feed of FEDAI rates, verifying whether the rates are correctly uploaded into the system.
- Re-performing and checking on a sample basis the accuracy of the MTM gain / loss booked by the bank on the outstanding forex contract.

8.222 In case of valuations of swaps, options and other derivative products most of the banks have proprietary valuation models developed by them or standard valuation software installed. In case of proprietary valuation models, a model validation coupled with checking of input parameters would provide reasonable comfort on valuations. In case of standard valuation models, auditors can resort to checking of input parameters along with limited re-performance of derivative valuations.

Section D: Compliance with SLR requirements

8.223 Due to the very nature of their operations, banks need to maintain sufficient liquid assets in the normal course of their business. The failure of a bank to meet its liabilities to depositors, as and when called upon to do so, undermines the confidence of the depositors not in the particular bank alone but in the entire banking system. Recognising the need to safeguard the interests of depositors by ensuring that banks do not over-extend their

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resources and thereby to maintain the confidence of the public in the banking system, Section 24(2A) of the Banking Regulation Act, 1949 requires that a scheduled bank shall maintain in India, in addition to the average daily balance which it is, or may be, required to maintain under Section 42 of the RBI Act, 1934, and every other banking company, in addition to the cash reserve which it is required to maintain under section 18 of the Banking Regulation Act, 1949, assets the value of which shall not be less than such percentage not exceeding forty percent of the total of its demand and time liabilities in India as on the last Friday of the second preceding fortnight in such form and manner as the RBI may by notification in the official gazette, specify from time to time. This is referred to as 'Statutory Liquidity Ratio' (SLR). The Friday with reference to which the amount of liquid assets has to be maintained during a fortnight is determined is commonly, referred to as the 'reporting Friday'. The prescribed percentage of liquid assets has to be maintained as at the close of business on every day. It may be noted that the statutory liquidity ratio is to be maintained with reference to the bank as a whole, and not for individual branches.

8.224 The RBI vide its Master circular No. RBI/2013-14/64 DBOD.No.Ret.BC. 19 /12.01.001/2013-14 on "Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)" dated July 1, 2013, has specified that consequent upon amendment to the Section 24 of the Banking Regulation Act, 1949 through the Banking Regulation (Amendment) Act, 2007 replacing the Regulation (Amendment) Ordinance, 2007, effective January 23, 2007, the Reserve Bank can prescribe the Statutory Liquidity Ratio (SLR) for Scheduled Commercial Banks in specified assets. The value of such assets of a SCB shall not be less than such percentage not exceeding 40 per cent of its total demand and time liabilities in India as on the last Friday of the second preceding fortnight as the Reserve Bank may, by notification in the Official Gazette, specify from time to time.

8.225 Further, Reserve Bank has specified vide notification DBOD.No.Ret.32/12.02.001/2012-13 dated July 31, 2012 that w.e.f. the fortnight beginning August 11, 2012 every Scheduled Commercial Bank shall continue to maintain in India assets as detailed below, the value of which shall not, at the close of business on any day, be less than 23 per cent on the total net demand and time liabilities as on the last Friday of the second preceding fortnight valued in accordance with the method of valuation specified by the Reserve Bank of India from time to time:

(a) Cash or

- (b) Gold valued at a price not exceeding the current market price, or (c) Investment in the following instruments which will be referred to as "Statutory Liquidity Ratio (SLR) securities":
- (i) Dated securities issued up to May 06, 2011 as listed in the Annex to Notification DBOD.No.Ret.91/12.02.001/2010-11 dated May 09, 2011;
 - (ii) Treasury Bills of the Government of India;
 - (iii) Dated securities of the Government of India issued from time to time under the market borrowing programme and the Market Stabilization Scheme;
 - (iv) State Development Loans (SDLs) of the State Governments issued from time to time under the market borrowing programme; and
 - (v) Any other instrument as may be notified by the Reserve Bank of India.

Provided that the securities (including margin) referred to above, if acquired under the Reserve Bank- Liquidity Adjustment Facility (LAF), shall not be treated as an eligible asset for this purpose.

8.226 If a banking company fails to maintain the required amount of SLR, it shall be liable to pay to RBI in respect of that default, the penal interest for that day at the rate of three per cent per annum above the bank rate on the shortfall and if the default continues on the next succeeding working day, the penal interest may be increased to a rate of five per cent per annum above the bank rate for the concerned days of default on the shortfall.

8.227 As section 24 of the Banking Regulation Act, 1949 is also applicable to nationalised banks, State Bank of India and its subsidiaries, and regional rural banks too have to comply with the above requirements.

8.228 According to Section 24(3) of the Banking Regulation Act, 1949, for the purpose of ensuring compliance with this section, every banking company is required to furnish to the RBI, in the prescribed form and manner, a monthly return showing particulars of its assets maintained in accordance with this section and its demand and time liabilities in India at the close of the business on each alternate Friday during the month. In case any such Friday is a public holiday, the computation of SLR is to be done at the close of business on the preceding working day. The return in form VIII is to be furnished within 20 days after the end of the month to which it relates. The banks should also submit a statement as annexure to the form VIII giving daily position of –

- (a) value of securities held for the purpose of compliance with SLR and

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- (b) the excess cash balances maintained by them with RBI in the prescribed format.

8.229 The RBI, *vide* its circulars DBOD No.761-A/08/07/003/93 dated February 8, 1993 and 829/08.07.003/93 dated February 20, 1993, has asked the banks to advise their statutory central auditors to verify the compliance of statutory liquidity ratio on twelve odd dates in different months not being Fridays. The said compliance report by the auditors is to be submitted separately to the top management of the bank and to the RBI.

8.230 The statutory auditor should verify and certify that all items of outside liabilities, as per the bank's books had been duly compiled by the bank and currently reflected under demand and time liabilities (DTL) and net demand and time liabilities (NDTL) in the fortnightly/monthly statutory returns submitted to the RBI for the financial year.

Computation of SLR

8.231 Refer Master circular No. DBOD. No.Ret. BC.19/12.01.001/2013-14 on "Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)" dated July 1, 2013, for guidance on computation of SLR

Audit Approach and Procedures

8.232 The report of the statutory auditors in relation to compliance with SLR requirements has to cover two aspects:

- (a) correctness of the compilation of DTL position; and
(b) maintenance of liquid assets as specified in section 24 of the Act.

8.233 The statutory central auditor should acquaint himself with the circulars/instructions of the RBI regarding composition of items of DTL. For this purpose, he may request the management to provide him a copy of the relevant circulars/instructions. He should keep these circulars/instructions in mind while examining compliance with the SLR requirements.

8.234 To comply with the requirements relating to statutory liquidity ratio, banks have evolved systems whereby all branches send their weekly trial balance as on Friday and these are consolidated at the head office. Based on this consolidation, the DTL position is determined for every reporting Friday. The statutory central auditor should request the branch auditors to verify the correctness of the trial balances relevant to the dates selected by him. The statutory central auditor should also request the branch auditors to verify the cash balance at the branch on the dates selected by him. It should be ensured that such request is communicated to the branch auditors well in advance of

commencement of the audit so that they can draw up their audit programme accordingly.

8.235 As regards weekly returns received from unaudited branches, the statutory central auditor should broadly review the relevant returns on a sampling basis to identify any obvious errors or omissions or inconsistencies.

8.236 Most of the liquid assets for the purpose of compliance with the SLR requirements comprise of approved securities, which are usually dealt with at the head office and a few large branches. The auditors should test check the relevant records maintained by the bank in respect of investments to verify the amount of approved securities held by the bank on the dates selected by him. The auditor should ascertain the valuation basis applicable at the relevant time and examine whether the valuation of securities done by the bank is in accordance with the guidelines prescribed by the RBI.

8.237 The auditor should examine the consolidations prepared by the bank relevant to the dates selected by him. He should test check the figures in the consolidations with the related returns received from the branches. He should also test check the arithmetical accuracy of the consolidations.

8.238 While examining the computation of DTL, the auditor may specifically examine whether the following items have been excluded from liabilities:

- (a) Part amounts of recoveries from the borrowers in respect of debts considered bad and doubtful of recovery.
- (b) Amounts received in Indian currency against import bills and held in sundry deposits pending receipts of final rates.
- (c) Un-adjusted deposits/balances lying in link branches for agency business like dividend warrants, interest warrants, refund of application money, etc., in respect of shares/debentures to the extent of payment made by other branches but not adjusted by the link branches.
- (d) Margins held and kept in sundry deposits for funded facilities.

8.239 Similarly, the auditor may specifically examine whether the following items have been included in liabilities:

- (a) Net credit balance in Branch Adjustment Accounts.
- (b) Interest on deposits as at the end of the first half year reversed in the beginning of the next half-year.

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8.240 The auditor should also, particularly, examine whether the balances in Branch Adjustment Accounts of foreign branches have been taken into account in arriving at the net balance in Branch Adjustment Accounts.

8.241 The auditor should examine whether the consolidations prepared by the bank include the relevant information in respect of all the branches.

8.242 It may be noted that provisions for expenses and liabilities are usually made at the year-end. Similarly, even though interest accrues on a daily basis, it is recorded in the books only at periodic intervals. These items, though liabilities of the bank, are not included in the computation of DTL. The central auditor should state this fact in his report.

8.243 As stated in preceding paragraphs, a considerable part of the information required by the central auditor for reporting on compliance with the SLR requirements will flow from the branches. It is suggested that the relevant information pertaining to the branches within a region may be consolidated at the regional level. The auditor of the region concerned should verify the same in the manner described in the above paragraphs and report on the same. The consolidated statement should also be counter-signed by the regional manager. The auditor at the central level should apply the audit procedures listed in the above paragraphs to the overall consolidation prepared for the bank as a whole. Where such a procedure is followed, the central auditor should adequately describe the same in his report.

8.244 While reporting on compliance with SLR requirements, the auditor should specify the number of unaudited branches and state that he has relied on the returns received from the unaudited branches in forming his opinion.

III-9

Profit and Loss Account

9.01 Sub-section (1) of section 29 of the Banking Regulation Act, 1949, requires the preparation of Profit and Loss Account in Form B of Third Schedule to the Act or as near thereto as the circumstances admit. This sub-section is applicable to Banking Companies, Nationalised Banks, State Bank of India and its Subsidiaries, and Regional Rural Banks.

Disclosures

9.02 The Profit and Loss Account as set out in Form B has four broad heads:

- Income
- Expenditure
- Profit/ Loss
- Appropriations

The information to be provided under each of the above heads is also specified in the Schedule.

Applicability of AS 5 and Materiality

9.03 Accounting Standards are intended to apply only to items that are material. Since materiality is not objectively defined, RBI, vide its Circular No. DBOD.No.BP. BC. 89 /21.04.018/2002-03 dated March 29, 2003 on "Guidelines on compliance with Accounting Standards (AS) by banks", has advised that all banks should ensure compliance with the provisions of accounting standards in respect of any item of prior period income or expenditure, which exceeds one per cent of total income/ total expenditure of the bank if the income or expenditure is reckoned on gross basis or one per cent of the net profit before taxes or net losses as the case may be if the income is reckoned on net of costs.

9.04 Since the format of the profit and loss accounts of banks prescribed in Form B under Third Schedule to the Banking Regulation Act, 1949 does not specifically provide for disclosure of the impact of prior period items on the current year's profit and loss, such disclosures, wherever warranted, may be made in the Notes on Accounts to the balance sheet of banks.

Interest Earned

9.05 The following items are included under this head:

- (a) *Interest/Discount on Advances/Bills:* This includes interest and discount on all types of loans and advances like cash credit, overdrafts, demand loans, term loans, export loans, domestic and foreign bills purchased and discounted (including those rediscounted), overdue interest and interest subsidy, if any, relating to such advances/bills. The amount to be included under this head is net of the share of participating banks under inter-bank participation schemes on risk-sharing basis.
- (b) *Income on Investments:* This includes all income derived from Government securities, bonds and debentures of corporates and other investments by way of interest and dividend, except income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India. Broken period interest paid on securities purchased and amortisation of premium on SLR investments is net off from the interest income on investments.
- (c) *Interest on Balances with RBI and Other Inter-bank Funds:* This includes interest on balances with Reserve Bank and other banks, call loans, money market placements, etc.
- (d) *Others:* This includes any other interest/discount income not included in the above heads. Interest on advances given by the bank to staff member in its capacity as employer rather than as banker should be included under this head.

Income from Investments

9.06 Interest and dividend on investments is usually accounted for at the head office. Such interest and dividend, therefore, may not appear in the profit and loss account of a branch. The related audit procedures described below would be relevant only in cases where interest/ dividend on investments is recorded at the branch under audit. Similarly, since only a few designated branches maintain accounts with RBI or are authorised to lend money at call and short notice, this item would appear in the profit and loss accounts of such branches only.

Other Income

9.07 The following items are included under this head:

- (i) *Commission, Exchange and Brokerage:* This item comprises of the following:
 - (a) Commission on bills for collection

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- (b) Commission/exchange on remittances and transfers, e.g. demand drafts, NEFT, RTGS, etc.
 - (c) Commission on letters of credit and guarantees, letter of comforts
 - (d) Loan processing, arranger and syndication fees
 - (e) Mobile banking fees
 - (f) Credit/Debit card fee income including annual fee income, merchant acquiring income, interchange fees, etc.
 - (g) Rent from letting out of lockers⁵
 - (h) Commission on Government business
 - (i) Commission on other permitted agency business including consultancy and other services.
 - (j) Brokerage on securities.
 - (k) Fee on insurance referral
 - (l) Commission on referral of mutual fund clients
 - (m) Service/transaction banking charges including charges levied for transaction at other branches
 - (n) Income from rendering other services like custodian, demat, investment advisory, cash management and other fee based services
- (ii) *Profit on Sale of Investments:* Investments are dealt in the course of banking activity and hence the net profit or loss on sale of investments is taken to profit and loss account. As investments are dealt with at the head office level, this item will not appear in the profit and loss account of a branch..
- (iii) *Profit/Loss on Revaluation of Investments:* In terms of guidelines issued by RBI, investments are to be valued at periodical intervals and depreciation or appreciation in valuation should be recognised under this head. As investments are dealt with at the head office level, this item will not appear in the profit and loss account of a branch. The net profit or loss on account of the revaluation of investments held by the bank is reported under this head.
- (iv) *Profit on sale of Land, Buildings and Other Assets:* This item includes

⁵ As per the Notes and Instructions for compilation of the profit and loss account, issued by the Reserve Bank, this item should come under this head. There is, however, a contrary view in some quarters that locker rent should be included in miscellaneous income. The latter view seems more plausible.

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profit (net of any loss) on sale of land, buildings, furniture, motor vehicles, gold, silver, etc.

- (v) *Profit on exchange transactions*: This includes revaluation gains/losses on forward exchange contracts and other derivative contracts, premium income/expenses on options, etc.
- (vi) Income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India
- (vii) Miscellaneous income

Profit/Loss on Revaluation of Fixed Assets

9.08 According to the Notes and Instructions for compilation of profit and loss account, issued by the RBI, the net profit/loss on revaluation of the aforesaid assets may also be shown under this item. In this regard, the requirements of AS 10, *Accounting for Fixed Assets*, relating to revaluation of fixed assets assume significance. According to the Accounting Standard, when a fixed asset is revalued in financial statements, the entire class of assets should be revalued, or the selection of assets for revaluation should be made on a systematic basis. It is also provided that an increase in net book value arising on revaluation of fixed assets should be credited directly to owners' interests under the head of revaluation reserve. However, if such increase is related to and not greater than a decrease arising on revaluation which was previously recorded as a charge to the profit and loss account, it may be credited to the profit and loss account. On the other hand, any decrease in net book value arising on revaluation of fixed assets should be charged directly to the profit and loss account except that to the extent that such a decrease is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it may be charged directly to revaluation reserve account.

9.09 From the above, it can be seen that as per AS 10, surplus on revaluation of a fixed asset cannot be credited to the profit and loss account except to the extent that such surplus represents a reversal of a related previous revaluation decrease that was charged to the profit and loss account.

Profit on Exchange Transactions

9.10 This item includes profit (net of loss) on dealings in foreign exchange. All income earned by way of foreign exchange commission and charges on foreign exchange transactions except interest are to be included under this head. As foreign exchange transactions take place only at a few select branches of a bank, this item may not appear in the profit and loss accounts of all branches. The audit procedures in this regard would include:

- a) Checking that the year-end outstanding entries are translated/restated at

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appropriate rates of exchange as communicated by the Controlling-authority, for recording profit/ loss on exchange transactions. After the introduction of CBS, this has become a systems driven adjustment. The auditor should understand the process of foreign exchange rate upload in the system for revaluation of forward contracts and derivative contracts. Each bank has a process to daily upload of day's foreign exchange rate and curves etc. in the system at the specific time. The auditor should verify independently rates on sample basis which are uploaded in the system. The auditor should also obtain the audit trail from the system to understand whether subsequent modification in system has been made and reason for the same.

- b) Obtaining the revaluation report of outstanding forward exchange contracts and other derivative contracts as on the reporting date and agreeing the currency-wise notional amounts of the forward exchange contracts and other derivative contracts with the foreign currency general ledger to ascertain completeness of re valuation report. Further, on a sample basis, recompute the valuation of the forward exchange contracts and other derivative contracts using a valuation tool.
- c) Obtaining the bank's risk policy to understand the bank's process of classification of hedge, assessment of hedge effectiveness and accrual of hedge cost. The auditor should obtain the report of hedge transaction outstanding on reporting date and hedge effectiveness.
- d) Testing large transactions and check whether these are recorded in compliance with the directions of the controlling authority.
- e) Scrutinising transactions recorded in the post-balance sheet period to ascertain that no material items have been ignored up to the year end.
- f) Enquiring and obtaining explanations regarding unusual large transactions/entries involving huge gains/ losses for the year and the same needs to be documented in the work paper.

Income Earned by Way of Dividends, etc. from Subsidiaries and Joint Ventures abroad/in India

9.11 It may be noted that any income derived from the investment portfolio by way of interest and dividend is not to be included under this head but under the sub-head 'income on investments' under the head 'interest earned'. As investments are usually dealt with at the head office level, this item may not appear in the profit and loss account of a branch.

Miscellaneous Income

9.12 This head generally includes following items of income:

- (a) recoveries from the constituents for godown rents;
- (b) income from bank's properties;
- (c) security charges;
- (d) insurance charges recoverable from customers;
- (e) rent.

The auditor can ascertain whether any premises or part thereof is let out, and, if, so, whether rent recoveries are recorded upto the year-end at the rates as applicable. The auditor may verify various items of miscellaneous income in the same manner as in the case of other entities.

9.13 The Notes and Instructions for compilation of profit and loss account, issued by the Reserve Bank, require that in case any item under this head exceeds one per cent of the total income, particulars thereof may be given in the notes.

Expenses

9.14 Expenditure is to be shown under three broad heads: interest expended; operating expenses; and provisions and contingencies.

Interest Expended

9.15 The following items are included under this head:

- (a) *Interest on Deposits:* This includes interest paid/ payable on all types of deposits including deposits from banks and other institutions.
- (b) *Interest on Reserve Bank of India/ Inter-Bank Borrowings:* This includes interest/ discount on all borrowings and refinance from the RBI and other banks.
- (c) *Others:* This includes discount/ interest on all borrowings/ re-finance from financial institutions. All other payments like interest on participation certificates, penal interest paid, etc. may also be included here.

9.16 RBI, vide its circular no. DBOD.Dir.BC.42/13.03.00/2011-12 dated October 25, 2011 (as amended by RBI's Circular No. DBOD.Dir.BC.75/13.03.00/2011-12 dated January 25, 2012), has deregulated the savings bank deposit interest rate. In other words, the banks are now free to determine their savings bank deposit interest rate. The auditor should verify that prior approval of the Board/Asset Liability Management Committee (if powers are delegated by the Board) have be obtained by a bank while fixing interest rates on such deposits.

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9.17 Further, *vide* its Circular No. DBOD.Dir.BC.64/13.03.00/2011-12 dated December 16, 2011, RBI has also deregulated the interest rates on Non Resident (External) Rupee Deposits and Ordinary Non-Resident (NRO) Accounts as follows:

- Banks are free to determine their interest rates on both savings deposits and term deposits of maturity of one year and above under Non-Resident (External) Rupee (NRE) Deposit accounts and savings deposits under Ordinary Non-Resident (NRO) Accounts. However, interest rates offered by banks on NRE and NRO deposits cannot be higher than those offered by them on comparable domestic rupee deposits.
- Prior approval of the Board/Asset Liability Management Committee (if powers are delegated by the Board) needs to be obtained by a bank while fixing interest rates on such deposits. At any point of time, individual banks need to offer uniform rates at all their branches.
- The revised deposit rates apply only to fresh deposits and on renewal of maturing deposits.
- Banks also need to closely monitor their external liability arising on account of such deregulation and ensure asset-liability compatibility from systemic risk point of view.

Operating Expenses

9.18 The following items are included under this head:

- (i) *Payments to and Provisions for Employees:* This item includes salaries and wages of staff, allowances, bonus, other staff benefits like provident fund, pension, gratuity, leave fare concession, staff welfare, medical allowance to staff, etc. It may be noted that provision for terminal benefits like pension and gratuity is usually made only at the head office level. Salaries and allowances payable to the bank's staff and officers are usually governed by agreement with the employee unions or awards of a judicial tribunal. While verifying expense under this head, the provisions of circular DBOD.No. BP.BC.80/ 21.04.018/ 2010-11 February 9, 2011, on Incremental employee benefit liability on account of re-opening of pension option to employees of Public Sector Banks and enhancement in gratuity limits should be kept in mind.
- (ii) *Rent, Taxes and Lighting:* This item includes rent paid by the bank on buildings, municipal and other taxes, electricity charges and other similar charges and levies. It may be noted that income-tax and interest tax are not to be included under this head. Similarly, house rent allowance and other similar payments to staff would not appear under this head.

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- (iii) *Printing and Stationery*: This item includes books and forms and stationery used by the bank and other printing charges except those incurred by way of publicity expenditure. While some stationery may have been purchased by the branch, other stationery (particular security paper like draft forms, cheque books) would have been received by the branch from the head office.
- (iv) *Advertisement and Publicity*: This item includes expenditure incurred by the bank for advertisement and publicity, including printing charges of publicity material.
- (v) *Depreciation on Bank's Property*: This item includes depreciation on bank's own property, motor cars and other vehicles, furniture, electrical fittings, vaults, lifts, leasehold properties, non-banking assets, etc. Depending on the procedure followed in the bank, provision for depreciation may be either centralised at the head office level through fixed asset management software or decentralized and manual at branches and other offices.
- (vi) *Directors' Fees, Allowances and Expenses*: Expenditure incurred in this regard is recorded under this head. This item is dealt with at the head office level and would not therefore be relevant at the branch level.
- (vii) *Auditors' Fees and Expenses*: Remuneration payable to Statutory Auditors and Branch auditors and expenses in connection with audit like reimbursements are recorded under this head. This item is usually dealt with at the head office level and would not therefore be relevant at the branch level.
- (viii) *Law Charges*: All legal expenses and reimbursement of expenses incurred in connection with legal services are to be included here.
- (ix) *Postage, Telegrams, Telephones, etc.*: This item includes all postal charges like stamps, telegrams, telephones, teleprinters, etc.
- (x) *Repairs and Maintenance*: This item includes repairs to bank's property, their maintenance charges, etc.
- (xi) *Insurance*: This item is usually dealt with at the head office level and may not therefore be relevant at the branch level.
- (xii) *Direct Marketing Expenses*: These are the expenses incurred majorly for sourcing of retails loans/credit cards and collection of retail overdue loans.

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- (xiii) *Other Expenditure*: This item includes all expenses other than those included in any of the other heads, like, license fees, donations⁶, subscriptions to papers, periodicals, entertainment expenses, travel expenses, etc. The Notes and Instructions for compilation of profit and loss account, issued by the Reserve Bank, require that in case any particular item under this head exceeds one per cent of the total income, particulars thereof may be given in the notes.

Provisions and Contingencies

9.19 This item represents the aggregate of the provisions made in respect of the following:

- (a) Non-performing assets
- (b) Taxation
- (c) Diminution in the value of investments
- (d) Provisions for contingencies

The most important item included in this head is the provision in respect of non-performing assets. The other provisions are usually made at the head office level.

Deferred Tax Liability on Special Reserve created under Section 36(1)(viii) of the Income Tax Act, 1961

9.20 RBI *vide* its Circular No. DBOD.No.BP.BC.77/21.04.018/2013-14 on

⁶ The Reserve Bank of India, from time to time, prescribes the limits up to which banks can make donations. As per the Reserve Bank of India's circular no. 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 Board of Directors of the banks. While formulating any such policy, the circular requires the directors to take into account *inter alia*, the following principles:

(i) profit making banks, during a financial year, may make donations upto one percent of the published profits for the previous years. This limit of one percent would include contributions made by the bank to any fund created for specific purposes such as encouraging research and development. However, donations/ subscriptions to the Prime Minister's National Relief Fund and to professional bodies related to banking industry, such as the Indian Banks Association, Indian Institute of Banking etc., is excluded from such limit of one percent.

(ii) loss making banks can make donations upto Rs. 5 lakhs in a financial year including donations to the Prime Minister's National Relief Fund and other professional organisations listed in (i) above.

The circular has clarified that the unutilised portion of one percent cannot be carried forward to the next year. The Circular also outlines the procedure for making contribution to the Prime Minister's National Relief Fund.

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“Deferred Tax Liability on Special Reserve created under Section 36(1)(viii) of the Income Tax Act, 1961” dated December 20, 2013 advised banks, as a matter of prudence, DTL should be created on Special Reserve.

9.21 For this purpose, banks may take the following course of action:

- a) If the expenditure due to the creation of DTL on Special Reserve as at March 31, 2013 has not been fully charged to the Profit and Loss account, banks may adjust the same directly from Reserves. The amount so adjusted may be appropriately disclosed in the Notes to Accounts of the financial statements for the financial year 2013-14.
- b) DTL for amounts transferred to Special Reserve from the year ending March 31, 2014 onwards should be charged to the Profit and Loss Account of that year.

In view of the requirement to create DTL on Special Reserve, banks may reckon the entire Special Reserve for the purpose of computing Tier-I Capital.

Appropriations

9.22 Under this head, the net profit/ loss for the year as well as profit/ loss brought forward have to be shown. The appropriations of the aggregate thereof are to be shown under the following heads:

- (a) Transfer to Statutory Reserves
- (b) Transfer to Capital Reserves
- (c) Transfer to Investment Fluctuation Reserve
- (d) Transfer to Debenture Redemption Reserve
- (e) Transfer to Other Reserves
- (f) Transfer to Government/ Proposed Dividend
- (g) Transfer to Tax on Dividend

9.23 The appropriations of profits are decided at the head office level. This item would not therefore appear in the profit and loss account at the branch level. The central statutory auditor should therefore verify compliance with the statutory requirement regarding transfers to reserve accounts and the other appropriation as applicable will have to be taken into consideration while verifying these.

Audit Approach and Procedure

Income

9.24 In carrying out an audit of income, the auditor is primarily concerned

with obtaining reasonable assurance that the recorded income arose from transactions, which took place during the relevant period and pertain to the bank, that there is no unrecorded income, and that income is recorded in proper amounts and is allocated to the proper period. In view of the mandatory requirement of recognition of income, the recognition of revenue will have to be subjected to examination *vis-à-vis* the guidelines.

9.25 The auditor should identify the significant account and significant class of transactions which affects the significant accounts. Based on the identification the auditor should understand the significant class of transactions. In understanding significant class of transactions, the auditor should identify what could go wrong. Once an understanding of the significant class of transactions is obtained and the following strategies can be adopted:

- Controls reliance strategy
- Substantive only strategy

In case auditor decides to adopt the control reliance strategy, the auditor should perform test of controls which mitigate the risk of what could go wrong.

Interest Income

9.26 As a measure of control and also to ensure that the legal remedies against defaulting borrowers are not adversely affected, banks commonly follow the procedure of recording interest on non-performing advances in a separate account styled as 'Interest Suspense' or other similar account. Amounts lying in Interest Suspense Account do not represent income of the bank and have also to be deducted from the relevant advances. The auditor should also check whether, in terms of the income recognition guidelines issued by the RBI, the bank has either reversed or made provision in respect of interest accrued and credited to income account, in respect of an advance (including bills purchased and discounted) that becomes NPA as at the close of any year.

9.27 In case of accounts under Corporate Debt Restructuring (CDR) scheme, the auditor should see whether the income on projects under implementation which have been classified as standard has been accounted for on accrual basis pursuant to the RBI's income recognition norms. Banks are not permitted to recognize income on accrual basis from projects under implementation which have been classified as 'sub-standard' asset. Bank may recognize income in such accounts only on realisation on cash basis. Income in respect of Funded Interest and where loans are converted into equity, debentures or any other instrument is to be recognized on the same basis as in the case of restructuring and rescheduling of loans.

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9.28 The said norms also require that the banks should not recognise income from those projects under implementation which have been classified as sub standard and it should be recognised only on cash basis. The auditor should also, accordingly, see whether any interest on such projects which has been recognised as income in the past is either reversed or a provision for an equivalent amount is made in the accounts.

9.29 The auditor may assess the overall reasonableness of the figure of interest earned by working out the ratio of interest earned on different types of assets to the average quantum of the respective assets during the year. The auditor should obtain an in-depth understanding as to how the bank's management monitor their business, analyse its credit portfolio and the interest income thereon.

9.30 For example, the auditor may obtain from the bank an analysis of sector-wise and segment-wise deployment of credit, including the lending rates of advances in various sectors and figures of advances outstanding at the end of each month/quarter. From such information, the auditor may work out a weighted average lending rate. These analysis can be done for corporate and retail loan portfolio separately. In case of retail loans, the portfolio can be further bifurcated into home loans, auto loans, personal loans, jewel loans, etc. Further, the auditor should understand the process of computation of the average balance and re-compute the average balance on sample basis.

9.31 The auditor should set the expectation for the movement in yield based on the discussion and inquiries made with the management; rate movement observed in the industry, etc., and should obtain explanations for major variances in the yield on month on month basis or quarterly basis.

9.32 To ascertain completeness of interest income in the analysis, the auditor should obtain general ledger break-up for the interest income earned during the respective months/quarter and examine whether the aggregation of the same agrees with the interest income considered for the yield analysis. The auditor should analyse monthly/quarterly yields and document the reasons for the variances as per the expectation set. The auditor may also compare the average yield on advances with the corresponding figures for the previous years and analyse any material differences. The auditor may also compare the reported market yield in percentage terms with market rates, RBI rates, advertised rates and rates across various products of the bank. Interest Income includes interest accrued but not due on investments.

9.33 As per Accounting Standard (AS) 9, "Revenue Recognition", income is recognised on accrual basis, i.e., as it is earned. It is an essential condition for

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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 NPA, banks should not recognize interest on NPA until it is actually received. Further, recognition of interest should be deferred where there is uncertainty regarding its collection.

9.34 These norms are also applicable to all Government guaranteed accounts, i.e., if Government guaranteed advances become NPA, interest on such advances should not be taken to income account unless interest has been realised.

9.35 The auditor should, on a test check basis, verify the rates of interest as per terms of sanction in the CBS as well as the calculation of interest through product rate sheets generated by CBS to satisfy himself that –

- (a) Interest has been charged on all the performing accounts upto the date of the balance sheet;
- (b) Interest rates charged are in accordance with the bank's internal regulations, directives of the RBI and agreements with the respective borrowers. The scrutiny of interest rates charged is particularly important in the case of advances made on floating interest rate basis;
- (c) Discount on bills outstanding on the date of the balance sheet has been properly apportioned between the current year and the following year;
- (d) Interest on inter-branch balances has been provided at the rates prescribed by the head office; and
- (e) Any interest subsidy received (or receivable) from RBI in respect of advances made at concessional rates of interest is correctly computed.

9.36 The auditor should also understand the process of accrual of interest income on credit card portfolio. The auditor should understand the assumption taken for accrual of interest income such as revolving portfolio, standard assets etc. and independently assess the reasonableness of these assumptions.

9.37 The auditor should also satisfy himself that interest on non-performing assets has not been recognised unless realised.

9.38 As per AS 9, "*Revenue Recognition*", dividends should be recognised when the right to receive payment is established, i.e., dividend has been declared by the corporate body at its Annual General Meeting and the owner's right to receive payment is established. The auditor should test

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certain samples of the dividend income booked during the period by obtaining the counterfoils of dividend warrants and the amount credited in the bank account.

9.39 In the case of bill discounting, interest income is received in advance hence, the auditor should examine whether the interest income for the period has been accounted for properly and the balance is treated as other liabilities. In CBS, the interest on bill discounted is system driven and the auditor should verify the in-built logic of the system. For the sample cases, the auditor should verify the interest income on bill discounted by obtaining the underlying documents like purchase order, letter of credit, etc.

9.40 The auditor should also understand the process of increase or decrease in base rate and process of updating in the system. The auditor should also ascertain compliance with RBI guideline in respect of increase in tenor of retail loan due to increase in base rate. The auditor should also verify on sample basis to whether the increase/decrease in base rate are effected in the system on the effective date.

9.41 Interest income includes interest accrued but not due on assets. However, as banks normally debit the borrower's account with interest due on the month end, at balance sheet date there would not usually be any amount of interest accrued but not due on advances on balance sheet date.

9.42 The auditor should examine the completeness of accrual of the interest by obtaining a detailed break-up of the loan portfolio (scheme wise or segment wise) and the interest accrual on the same. The aggregation of loan portfolio should be agreed to the general ledger.

9.43 The auditor should examine whether interest has been accrued on the entire investment and money market lending portfolio by obtaining the detailed break-up of the investment and money market lending portfolio along with the interest accrued thereon and agree the same with the general ledger. The auditor should re-compute the interest accrual on sample basis considering parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc., from the term sheet, deal ticket, agreements, etc.

9.44 The auditor should obtain the list of the dividend income booked during the period and agree the total with the general ledger.

Income on Investments has been explained in detail in Chapter 8 of the Part III of the Guidance Note.

9.45 In determining the extent of sample checking, the auditor should take into account, *inter alia*, the results of the analytical procedures and the reports, if any, on income and expenditure/ revenue audit as well as other internal and RBI

inspection reports. The auditor's assessment of the effectiveness of concurrent audit would also affect the extent of his detailed checking of interest earned. In determining the extent of sample checking, the auditor may place greater emphasis on examining interest on large advances.

Commission Income

9.46 Auditor may check the items of commission, exchange and brokerage on a test check basis. Such examination can be done for commission earned on bills sent for collection, commission on letters of credit, guarantees and letter of comforts. The auditor should examine whether the commission on non-funded business (e.g., letters of credit, guarantees and bills for collection) has been properly apportioned between the current year and the following year.

9.47 The auditor should obtain details of loans sanctioned and disbursed during the period as well as verify the policy of the bank for booking the processing fee income on such loans. For corporate loans, the processing fee income for the material loans sanctioned and disbursed should be re-computed and verified on test check basis by obtaining the loan agreements, sanction letter, etc. Further, for loans sanctioned but not disbursed wherein the processing fee income has been booked on accrual basis, the auditor should verify the subsequent receipt of the same and enquire for subsequent reversals. For retail loans, the auditor should perform analytical procedures for computing the processing fee percentage for different ticket size loans.

9.48 The auditor should obtain an understanding of the various types of fee income earned on credit cards and debit cards. Further, the auditor should obtain the rate matrix for various fees charged to the customer. On a sample basis, the auditor should verify whether the fees charged, accounted is as per the rate matrix. Interchange fees is earned from service providers namely Visa, Master card, Amex proportionate to the transactions entered by the customer. On a sample basis, the auditor should verify whether the interchange fees have been received and accounted as per the agreement. Merchant acquiring income is earned on the transactions entered by the customers of other banks on the bank's terminal. The auditor should perform analytical procedures for such income and obtain the explanation for the variances, if any.

9.49 The auditor should understand how management monitors non funded business and use their analysis for analytical procedures. The auditor should understand the relation with fee income with the business. For, e.g., month on month /quarter loan processing fees with sanction value to arrive at average processing fees on monthly/quarterly basis/. The auditor should analyse monthly/quarterly fee percentage and document the reasons for the variances as

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per the expectation set. Similarly auditor can perform analysis of other fee income by doing monthly/quarterly guarantee fees with average monthly/quarterly guarantee amount, interchange credit card fees *vis a vis* inter charge transactions etc.

9.50 The auditor may also compare the average fee income with the corresponding figures for the previous years and analyse any material differences.

9.51 The auditor should also check whether any fees or commission earned by the banks as a result of re-negotiations or rescheduling of outstanding debts has, in terms of the income recognition guidelines issued by the RBI, have been recognised on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit.

9.52 According to the guidelines for income recognition, asset classification, etc., issued by the RBI, if interest income from assets in respect of a borrower becomes subject to non-accrual, fees, commission and similar income with respect to same borrower that have been accrued should cease to accrue for the current period and should be reversed or provided for with respect to past periods, if uncollected. The auditor should examine whether the bank has accordingly made suitable adjustments for de-recognition/ reversal of uncollected commission, etc.

9.53 Fee on insurance referral is fast emerging as a major source of income for banks. In terms of the RBI Master Circular No. DBOD. No.FSD.BC 05/24.01.001/2013-14 dated July 1, 2013 on para banking activities, banks are permitted to undertake insurance business as agents of insurance companies on fee basis or referral arrangement without any risk participation subject to the conditions prescribed under the Master Circular. The auditor should carefully examine the agreement entered into by the bank and the concerned insurance company to see the basis for calculation of the said fee, time when the referral fees becomes due to the bank. Normally, as an industry practice, such agency arrangements also contain clauses known as "claw back" of agency fee, whereby if the client referred to the insurance company by the bank fails to pay the insurance premium for a stipulated amount of time, the agency fees paid or due to the bank becomes recoverable from the bank or is frozen. Such clauses have a direct impact on the recognition of income from the agency fees in terms of Accounting Standard 9, Revenue Recognition and may, therefore, require creation of a corresponding provision in the accounts.

9.54 *Profit on Sale of Investments:* Investments are dealt in the course of banking activity and hence the profit or losses in sale of investments are taken to Profit & Loss account. The auditor should obtain the investment policy of the

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bank and understand whether the bank is using FIFO method or weighted average cost method for computing the profit/loss on sale of investments. As investments are usually dealt with at the head office level, this item may not appear in the profit and loss account of a branch.

9.55 *Profit/ Loss on Revaluation of Investments:* In terms of guidelines issued by RBI investments are to be valued at periodical intervals and depreciation or appreciation in valuation is to be recognised under this head. As investments are usually dealt with at the head office level, this item may not appear in the profit and loss account of a branch.

9.56 *Profit on sale of Land, Buildings and Other Assets:* This item includes profit (net of any loss) on sale of land, buildings, furniture, motor vehicles, gold, silver, etc.

9.57 The auditor can check authority for disposal of:

- fixed assets, if any, sold during the year under audit; and
- non banking assets acquired in satisfaction of claims.

The auditor should also vouch transactions in evidence of profit/ loss recorded by the Branch in respect of assets, as aforesaid.

Profit/ Loss on Revaluation of Fixed Assets

9.58 The auditor should satisfy himself about the appropriateness and proper application of the basis of revaluation of fixed assets adopted by the bank. Where revaluation is based on an appraisal/report/certificate by approved valuers, the auditor should examine the appraisals to the extent possible and satisfy himself about their adequacy for audit purposes.

9.59 The revaluation of fixed assets can be done on the basis of appraisals by competent valuers such as engineers or architects, or on the basis of indexation of historical cost, or with reference to current prices. The auditor should satisfy himself about the appropriateness and proper application of the basis of valuation adopted by the bank. Where revaluation is based on an appraisal by valuers, the auditor should examine the appraisals to the extent possible and satisfy himself about their adequacy for audit purposes.

9.60 The auditor should also examine that the bank has complied with the provisions of AS 28, Impairment of Assets. In terms of paragraph 58 of AS 28, an impairment loss should be immediately recognised as an expense in the Profit and Loss Account, unless the asset is carried at revalued amount in accordance with AS 10. In such a case, any impairment loss of a revalued asset should be

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treated as a revaluation decrease under AS 10.

9.61 The Notes and Instructions for compilation of profit and loss account, issued by the Reserve Bank, require that in case any item under this head exceeds one per cent of the total income, particulars thereof may be given in the notes.

Interest on Deposits

9.62 The auditor may assess the overall reasonableness of the amount of interest expense by analysing ratios of interest paid on different types of deposits and borrowings to the average quantum of the respective liabilities during the year. For example, the auditor may obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material. The auditor may also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences. The auditor should obtain general ledger break-up for the interest expense incurred on deposits (savings and term deposits) and borrowing each month/quarter. The auditor should analyse month on month (or quarter) cost analysis and document the reasons for the variances as per the benchmark stated. He should examine whether the interest expense considered in the cost analysis agrees with the general ledger. The auditor should understand the process of computation of the average balance and re-compute the same on sample basis.

9.63 The auditor should, on a test check basis, verify the calculation of interest. He should satisfy himself that:

- (a) interest has been provided on all deposits and borrowings upto the date of the balance sheet; and verify whether there is any excess or short credit of material amount.
- (b) interest rates are in accordance with the bank's internal regulations, of the RBI directives, and agreements with the respective depositors;
- (c) in case of Fixed Deposits it should be examined whether the Interest Rate in the accounting system are in accordance with the Interest Rate mentioned in the Fixed Deposit Receipt/Certificate.
- (d) interest on Savings Account should be checked on a test check basis in accordance with the rules framed by the bank in this behalf.
- (e) discount on bills outstanding on the date of the balance sheet has been properly apportioned between the current year and the following year;
- (f) payment of brokerage is properly authorised; and

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- (g) interest on inter-branch balances has been provided at the rates prescribed by the head office.
- (h) interest on overdue/ matured term deposits should be estimated and provided for.

9.64 The auditor should ascertain whether there are any changes in interest rate on saving deposits and term deposits during the period. The auditor should obtain the interest rate card for various types of term deposits and analyse the interest cost for the period. The auditor should examine the completeness that there has been interest accrued on the entire borrowing portfolio by obtaining the detailed break up the money market borrowing portfolio and the interest accrued and the same should agree with the GL code wise break up. The auditor should re-compute the interest accrual on sample basis i.e., by referring to the parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc from the term sheet, deal ticket, agreements, etc.

Expenditure

Operating Expenses

9.65 Generally the audit procedures followed by auditors in any entity are to be followed.

Payments to and Provisions for Employees

9.66 The auditor should ascertain the procedure followed by the bank in this regard while verifying this item. The auditor should obtain the human resource policy and identify the benefits available to employees. Auditor should understand the compensation structure and process of payment of salary, benefits like employee stock options, car assistance, leave encashment, asset assistance, etc. to the various grades of employees. He should obtain the standard compensation structure for each grade of employee. In case, where payment is made on production of evidence or incurrence by employee, auditor should ascertain whether provision for the same has been made in the books.

9.67 The auditor should perform an overall analytical review for the payments and provisions for employees by month on month grade-wise analysis of the employees cost and number of employee in that grade to identify per employee cost month on month and enquire about the variances, if any. The auditor should examine whether all the benefits for all the employees have been appropriately accounted for.

9.68 The auditor should also check the calculation of salaries and

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allowances, etc. on a test check basis with reference to appointment/awards/offer letters. He may also assess the reasonableness of expenditure on salaries, allowances, etc. by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.

9.69 Auditor should also obtain an understanding of the provision for payment of bonus and other incentive and ascertain adequacy of the amount recorded by the bank.

Rent, Taxes and Lighting

9.70 The auditor may check the following on a test check basis:

- Rent paid and verify whether adjustments have been made for the full year on account of rent at the rates as applicable and as per agreement in force.
- Rent does not include House Rent Allowance to employees.
- Whether municipal rates/ taxes are duly paid/ adjusted for the year under audit.
- Enquire whether any disputed liability exists on this account upto the year-end.
- Further, the auditor should obtain the listing of the premises which have been obtained on lease. If the lease agreements have escalation clause, lease equalization should be performed.
- In addition, the auditor should perform month on month rent analysis and verify major variance in the average rent per month per branch.

Printing and Stationery

9.71 The auditor should verify this item with reference to documents evidencing purchase/debit note received.

Advertisement and Publicity

9.72 Expenditure incurred by the bank for advertisement and publicity, including printing charges of publicity material be verified with the documents.

Depreciation on Bank's Property

9.73 The auditor should ascertain the exact procedure followed by the bank while verifying this item.

9.74 This item includes depreciation on bank's own property, motor cars and other vehicles, furniture, electrical fittings, vaults, lifts, leasehold properties, non-banking assets, etc. Depending on the procedure followed in the bank, provision

Profit and Loss Account

for depreciation may either be centralised at the head office level or decentralised.

9.75 The auditor should check head office instructions as regards adjustments of depreciation on the fixed assets of the Branch.

9.76 The auditor should also check whether depreciation on fixed assets has been adjusted at the rates and in the manner required by head office.

9.77 The auditor may also report unadjusted depreciation on assets acquired but not capitalised.

9.78 The auditor should ascertain the exact procedure followed by the bank while verifying this item.

9.79 The auditor should re-compute the depreciation for the period, perform depreciation rationalisation and agree the amount with the general ledger.

9.80 The auditor may also verify and obtain explanation for the unadjusted depreciation on assets acquired but not capitalised.

- (i) *Directors' Fees, Allowances and Expenses:* Expenditure incurred in this regard are recorded under this head. This item is dealt with at the head office level and would not therefore be relevant at the branch level.
- (ii) *Auditors' Fees and Expenses:* Remuneration payable to Statutory Auditors and Branch auditors and expenses in connection with audit like reimbursements are recorded under this head. This item is usually dealt with at the head office level and would not therefore be relevant at the branch level.
- (iii) *Law Charges:* All legal expenses and reimbursement of expenses incurred in connection with legal services are to be included here. The auditors should verify the legal charges payable by the bank in respect of all legal disputes/ cases currently being fought at various courts of laws, etc are accounted for in the accounts. For this purpose, the auditor may go through the list of contingent liabilities prepared by the bank as at the year end to verify the disputes/ cases which the bank is contesting.
- (iv) *Postage, Telegrams, Telephones, etc.:* This item includes all postal charges like stamps, telegrams, telephones, teleprinters, etc.
- (v) *Repairs and Maintenance:* This item includes repairs to bank's property, their maintenance charges, etc.
- (vi) *Insurance:* This item is usually dealt with at the head office level and may not therefore be relevant at the branch level

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- (vii) *Other Expenditure:* This item includes all expenses other than those included in any of the other heads, like, licence fees, donations, subscriptions to papers, periodicals, entertainment expenses, travel expenses, etc. The Notes and Instructions for compilation of profit and loss account, issued by the Reserve Bank, require that in case any particular item under this head exceeds one per cent of the total income, particulars thereof may be given in the notes.

Provisions and Contingencies

9.81 The auditor should ascertain compliance with the various regulatory requirements for provisioning as contained in the various circulars.

9.82 Obtain an understanding as to how the Bank computes provision on standard assets and non-performing assets. It will primarily include the basis of the classification of loans and receivables into standard, sub standard, doubtful, loss and non-performing assets. For verification of provision on standard assets, the auditor should verify the loan classification on a sample basis. The auditor should obtain the detailed break up of standard asset loans, non-performing loans and agree the outstanding balance with the general ledger. The auditor should examine whether by performing re-computation the provisions in respect of standard loans, NPA and NPI comply with the regulatory requirements.

9.83 The auditor should obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation. The auditor should re-compute the provision for tax by applying the applicable tax rate after considering the allowances and disallowances as per Income Tax Act, 1961. The other provisions for expenditure should be examined *vis a vis* the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

Disclosure Requirements in Financial Statements

10.01 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. Sub-section (1) of section 29 requires every banking company to prepare a balance sheet and a profit and loss account in the forms set out in the Third Schedule to the Banking Regulations Act, 1949 (hereinafter referred to as 'the Act'). Form A of the Third Schedule to the Act contains the form of balance sheet and Form B contains the form of profit and loss account.

10.02 The disclosures requirement for disclosure in the financial statements can be broadly classified in the following four categories:

- (i) Prescribed by regulatory authorities
- (ii) Prescribed by Accounting Standards
- (iii) Requirement emanating from Statues
- (iv) Requirement emanating from Listing Agreement

10.03 *Disclosures Prescribed by RBI:* 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, *vide* its Master Circular no. DBOD.BP.BC No.7 /21.04.018/2013-14 dated July 1, 2013 on "Disclosure in Financial Statements- Notes to Accounts", prescribed disclosures to be made in the Notes to Accounts in respect of certain significant aspects of the items of financial statements of banks. The Banks should, at a minimum, disclose the items listed in the circular in the 'Notes to Accounts'. However, banks are also encouraged to make more comprehensive disclosures than the minimum required under the circular if they become significant and aid in the understanding of the financial position and performance of the bank. The disclosure listed is intended only to supplement, and not to replace, other disclosure requirements under relevant legislation or accounting and financial reporting standards. Where relevant, a bank should comply with such other disclosure requirements as applicable.

10.04 RBI has issued circular DBOD.No.BP.BC.78/C.686/91-92, dated February 6, 1992 giving the format of Balance sheet and Profit and Loss

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Account. The Circular also gives notes and instructions for compilation of each line item of Balance Sheet and Profit and Loss Account.

10.05 *Disclosures Required Under Accounting Standards:* The disclosure requirements under the various Accounting Standards, issued by the Central Government under the Companies (Accounting Standards) Rules, 2006 (as amended) as well as any other Accounting Standards issued by the ICAI, as may be applicable, are also to be complied with.

10.06 *Requirements of Statutes:* 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 Act, also apply to the balance sheet or profit and loss account of a banking company [sub-section (3) of section 29 of the Act]. It may be noted that this provision applies only to those banks which have been incorporated as companies.

10.07 *Requirement of Listing Agreement:* Banks listed on a stock exchange have to also comply with the requirements of the Listing Agreement as amended from time to time.

Disclosure of Summary of the Significant Accounting Policies

10.08 Banks should disclose the accounting policies regarding key areas of operations at one place, i.e., under Schedule 17, along with notes to accounts in their financial statements. This may include disclosure, such as, Basis of Accounting, Transactions involving foreign exchange, Investments – classification, valuation, etc, Derivative Transactions, Advances and Provisions thereon, Fixed Assets and Depreciation, Revenue Recognition, Employee Benefits, Provision for Taxation, etc.

10.09 The Form A and B of the Third Schedule contains 16 schedules, which is to be uniformly used by all the banks. In addition to the 16 detailed prescribed schedules, banks are required to furnish the 'Summary of Significant Accounting Policies' and 'Notes to Accounts' under Schedule 17 and Schedule 18 respectively, to maintain uniformity. This Chapter deals with disclosure requirements in Notes to Accounts as laid down in the abovementioned RBI circular. The disclosures requirement contained in the Master Circular are minimum disclosure requirements. The banks may consider disclosing significant additional information for enhancing the

* Now Companies Act, 2013.

Disclosure Requirements in Financial Statements

understanding of the users of the financial statements. Further, the disclosures listed herein intended only to supplement, and not replace, other disclosure requirements under relevant legislation or accounting and financial reporting standards. Where relevant, a bank should comply with such other disclosure requirements as applicable.

10.10 The previous year's comparatives should also be disclosed along with the disclosures for the current year.

Audit Approach

10.11 The auditor's primary objective in audit of disclosures made in the notes to accounts is to satisfy himself that such disclosures are free from material misstatement. Examination of compliance with statutory, regulatory and accounting standard's requirements is also an important objective in as much as non-compliance may have a direct and material affect in understanding the financial statements. The auditor should keep this in view while designing his audit procedures relating to disclosures.

Disclosures Prescribed by RBI⁷

10.12 Banks are also required to comply with the Accounting Standard 1 on "Disclosure of Accounting Policies" issued by the Institute of Chartered Accountants of India (ICAI). In addition to the 16 detailed prescribed schedules to the balance sheet, banks are required to furnish the information as discussed in the following paragraphs in the "Notes to Accounts":

10.13 Capital⁸

- (i) The Capital to Risk-weighted Assets Ratio (CRAR) as assessed by the Bank on the basis of the guidelines issued by the RBI for implementation of the Capital Adequacy Framework should be computed and disclosed in Notes to accounts.
- (ii) CRAR should be computed on over all basis (i.e. Total Capital) and also for Tier I and Tier II capital.

⁷ The RBI vide its Master Circular No. DBOD.BP.BC No.7 /21.04.018/2013-14 dated July 1, 2013 on "Disclosure in Financial Statements - Notes to Accounts" prescribes the disclosures to be made by the banks in the notes to accounts.

⁸ For the format of disclosures please refer to the relevant paragraphs of "Master Circular-Disclosure in Financial Statements-Notes to Accounts", which is given in the CD.

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- (iii) Amount of equity capital raised
- (iv) Amount of Additional Tier 1 capital raised; of which
 - a. PNCPS
 - b. PDI
- (v) Amount of Tier 2 capital raised; of which
 - a. Debt capital instrument
 - b. Preference Share Capital Instrument: [Perpetual Cumulative Preference Shares (PCPC)/Redeemable Non-Cumulative Preference Shares (RNCPS)/ Redeemable Cumulative Preference Shares (RCPS)]
- (vi) For nationalised banks percentage of the shareholding of the Government of India should also be disclosed.

Audit Approach

10.14 The final consolidation of Capital to Risk Weighted Assets Ratio (CRAR) is done at the head office. For this purpose, apart from consolidation of the Capital Adequacy returns related to risk weighted assets received from various audited and unaudited branches and other offices, the auditor should examine the records maintained at head office relating to various components of Tier I and Tier II capital and other items of risk weighted assets which are compiled at Head Office. The branch auditors should also be requested to report their observations on the risk weighted assets at the branches. The Central Statutory Auditor should examine whether the consolidation of branch returns of risk weighted assets has been correctly done.

10.15 The items eligible for the Tier I and Tier II capital and risk weights assigned to various assets are dealt in Chapter 5 of Part III of the Guidance Note.

10.16 Investments

- (i) The details of investments and the movement of provisions held towards depreciation of investments of the bank should be stated under following heads:
 - (a) gross value of investments in India and outside India;
 - (b) aggregate of provisions for depreciation, separately on investments in India and outside India;

Disclosure Requirements in Financial Statements

- (c) net value of investments in India and outside India; and
 - (d) Movement of provision held towards depreciation on investment stating opening balance, provisions made during the year, write-off/ write back of excess provisions and closing balance.
- (ii) 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.

Audit Approach

10.17 The Central Statutory Auditor should verify the provision for depreciation in the value of investments as well as provision for non performing investments. The provision to be reduced from gross value of investments includes provision for depreciation in the value of investments as well as provision for non performing assets.

10.18 The auditor should verify that the opening balance of the provision should correspond with the closing balance of the previous year. Further, the closing balance of provision plus net value of investments should correspond with the gross value of investments.

Repo Transactions

10.19 The details of Securities sold under repo and Securities purchased under reverse repo for Government and Corporate debt securities during the year should be disclosed stating minimum and maximum outstanding balance daily average outstanding balance of securities and Outstanding as on March 31.

Audit Approach

10.20 The auditor should examine the deal register to verify the details disclosed. Care should be taken that balances and average of all the days should be taken and not only of days when there was outstanding balance.

10.21 Non-SLR Investment Portfolio

- (i) The composition of issuer of Non SLR investments should be disclosed in notes to account categorising the issuer into PSUs, FIs, Banks, Private Corporates, Subsidiaries/Joint Ventures and Others.

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- (ii) The Grand total of the issuer wise details of Non-SLR investment should tally with the total of Investments included under the following categories in Schedule 8 to the balance sheet:
 - a. Shares
 - b. Debentures & Bonds
 - c. Subsidiaries/joint ventures
 - d. Others
- (iii) The investments held with each category of issuer should be classified into extent of private placement, below investment grade security, unrated securities and unlisted securities. Amounts reported under the above classification may not be mutually exclusive.
- (iv) Provision held towards depreciation of investments should be shown separately.
- (v) The movement in gross non-performing Non-SLR investments (i.e. securities other than government and other approved securities) should also be disclosed separately along with total provision thereof.

Audit Approach

10.22 The auditor should examine the letter of offer or other relevant documents to verify the classification into private placement, unrated securities, issuer type and listing. To facilitate the work of verification, the auditor may advise the bank to list out non SLR investments in different classification and also make available letter of offer and confirmation from rating agencies about the rating assigned by them.

Sale and transfers to/from HTM Category

10.23 If the value of sales and transfers of securities to / from HTM category exceeds 5 per cent of the book value of investments held in HTM category at the beginning of the year, the bank should disclose the market value of the investments held in the HTM category and indicate the excess of book value over market value for which provision is not made. This disclosure is required to be made in 'Notes to Accounts' in the bank's audited Annual Financial Statements. The 5 per cent threshold referred to above will exclude the one - time transfer of securities to / from HTM category with the approval of Board of Directors permitted to be undertaken by banks at the beginning of the accounting year and sales to the Reserve Bank of India under pre-announced OMO auctions.

Audit Approach

10.24 The auditor should examine the sale and transfer of securities to / from HTM category. If it exceeds 5 per cent of the book value of investments held in HTM category at the beginning of the year, the auditor should see whether necessary disclosures have made in the Notes to Accounts.

10.25 Derivatives

- (i) *Forward Rate Agreement/ Interest Rate Swap*: Following details are required to be disclosed with respect to Forward Rate Agreement/Interest Rate Swap:
 - (a) Notional principal of swap agreements,
 - (b) Losses which would be incurred if counterparties failed to fulfil their obligations under the agreements,
 - (c) Collateral required by the bank upon entering into swaps,
 - (d) Concentration of credit risk arising from the swaps (for e.g. exposures to particular industries or swaps with highly geared companies) and,
 - (e) Fair value of the swap book.
- (ii) Nature and terms of the swaps including information on credit and market risk and the accounting policies adopted for recording the swaps should be disclosed.
- (iii) Examples of concentration could be exposures to particular industries or swaps with highly geared companies.
- (iv) If the swaps are linked to specific assets, liabilities, or commitments, the fair value would be the estimated amount that the bank would receive or pay to terminate the swap agreements as on the balance sheet date. For a trading swap the fair value would be its mark to market value.
- (v) *Exchange Traded Interest Rate Derivatives*: With respect to Exchange Traded Interest Rate Derivatives instrument-wise disclosure of Notional principal amount of Exchange Traded Interest Rate Derivatives undertaken during the year, derivatives outstanding as on March 31, derivatives outstanding and not "highly effective" should be disclosed. Mark-to-market value of exchange traded interest rate derivatives outstanding and not "highly effective instrument-wise should also be disclosed.

Audit Approach

10.26 The auditor should examine the list of outstanding derivative contracts. To facilitate the work of verification, the auditor should obtain the list of all outstanding derivative contracts along with their marked to market value as on the balance sheet date. For the purpose of verifying the losses which would be incurred if counterparties failed to fulfil their obligations under the agreements, the auditor should verify the existence of right of set off of losses in one contract against the gains in other contract. In the absence of such right of set off, the only contracts with positive marked to market value should be considered.

10.27 Disclosures on risk exposure in derivatives

- (i) *Qualitative Disclosure:* Banks should discuss their risk management policies pertaining to derivatives with particular reference to the extent to which derivatives are used, the associated risks and business purposes served. The discussion shall also include:
 - a) the structure and organisation for management of risk in derivatives trading,
 - b) the scope and nature of risk measurement, risk reporting and risk monitoring systems,
 - c) policies for hedging and/or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges/mitigants, and
 - d) accounting policy for recording hedge and non-hedge transactions; recognition of income, premiums and discounts; valuation of outstanding contracts; provisioning, collateral and credit risk mitigation.
- (ii) *Quantitative Disclosure:* Quantitative disclosure with regard to currency and interest rate derivatives should be disclosed in notes to accounts stating:
 - a) The notional principal amount of derivatives both for hedging and trading.
 - b) Mark to market position separately for positive and negative marked to market position.
 - c) Credit Exposure.
 - d) Likely impact of one percentage change in interest rate on hedging and trading derivatives and maximum and minimum change in interest rate observed during the year.

Audit Approach

10.28 The auditor should examine the list of outstanding derivative contracts. To facilitate the work of verification, the auditor should obtain the list of all outstanding derivative contracts along with their marked to market value and credit exposure as on the balance sheet date. Besides, Accounting Standard (AS) 30, "Financial Instruments: Recognition and Measurement"⁹ issued by the Institute of Chartered Accountants of India deals with principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Requirements for presenting information about financial instruments are dealt in Accounting Standard (AS) 31, "Financial Instruments: Presentation". Requirements for disclosing information about financial instruments are in Accounting Standard (AS) 32, "Financial Instruments: Disclosures"

10.29 Asset Quality

- (i) *Non-performing assets:* Banks are required to disclose Net NPA as percentage to net advances and the details of movement of gross NPAs, net NPAs and provisions during the year.
- (ii) *Information in respect of Loan Assets subjected to Restructuring:* RBI has revised the disclosure requirements on Advances restructured by Banks *vide* its Circular No. DBOD.BP.BC.No.80/21.04.132/2012-13 dated January 31, 2013. As per this Circular the following details are to be disclosed:
 - i. details of accounts restructured on a cumulative basis excluding the standard restructured accounts which cease to attract higher provision and risk weight (if applicable);
 - ii. provisions made on restructured accounts under various categories; and
 - iii. details of movement of restructured accounts.Above details are classified under different categories as under:
 - i. Type of restructuring- Under CDR Mechanism, Under SME Debt Restructuring Mechanism and Others

⁹ AS 30, AS 31 and AS 32 issued by the ICAI, comes into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. The Standards will become mandatory in respect of accounting periods commencing on or after 01.04.2011 for all commercial, industrial and business entities except small and medium-sized entity

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- ii. Asset Classification of restructured accounts- Standard, Sub-standard, Doubtful and Loss assets
- iii. Movement under different each of the above disclosing No. of borrowers, Amount outstanding and Provision thereon

These details are to be disclosed in a tabular format as given in the Annex to the Circular referred to above.

Banks must disclose the total amount outstanding in all the accounts / facilities of borrowers whose accounts have been restructured along with the restructured part or facility. This means even if only one of the facilities / accounts of a borrower has been restructured, the bank should also disclose the entire outstanding amount pertaining to all the facilities / accounts of that particular borrower.

- (iii) *Financial assets transferred during the year to securitisation company (SC)/reconstruction company (RC)* - With regards to financial assets transferred by the bank to securitisation/reconstruction company the bank is required to disclose the number of accounts transferred, aggregate value (net of provisions) of accounts sold to SC/RC, aggregate consideration and additional consideration realized in respect of accounts transferred in earlier years. Aggregate gain/loss over net book value is also required to be computed and disclosed.
- (iv) Details of non-performing financial assets purchased/sold - Banks which purchase/ sold non-performing financial assets from/to other banks shall be required to make the following disclosures in the Notes on Accounts to their Balance sheets:
 - A. Details of non-performing financial assets purchased:
 - (a) No. of accounts purchased during the year
 - (b) Aggregate outstanding
 - Of these, number of accounts restructured during the year
 - Aggregate outstanding
 - B. Details of non-performing financial assets sold:
 - (a) No. of accounts sold during the year
 - (b) Aggregate outstanding
 - (c) Aggregate consideration received
- (v) Provisions on Standard Asset: Provisions made towards Standard Assets should be disclosed separately in notes to account. It may be

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noted that the amount need not be netted of from gross advances but shown separately as ' Provisions against Standard Assets', under 'Other Liabilities and Provisions - Others' in Schedule No. 5 of the balance sheet.

Audit Approach

10.30 The gross non performing advances represents outstanding amount of all non performing accounts. The net non performing advances are gross non performing advances as reduced by (i) provision for such non performing advances (provision made against standard assets should not be considered), (ii) interest debited to borrowers account but unrealised, by whatever name called, (iii) amount received from borrowers and parked in a separate account and (iv) amount of claim received from DICGC, EGCG etc. and not appropriated to the borrowers account.

10.31 The auditors should obtain the list of accounts restructured under various categories and financial assets sold from the branch management and should verify the same with reference to approval from the appropriate authority. The list of assets restructured under CDR is generally centralized at HO of the bank. The list of the same should be obtained from HO and compared with the consolidation statement prepared based on the statements received from the branches. The details to be disclosed relates to restructuring, rescheduling, renegotiation etc. Accordingly, if there are changes in terms of payment, the same should be included under the same. The auditor should understand what records have been maintained by the bank so that it can determine the values as required to be disclosed as per RBI Circular No. DBOD.BP.BC.No.80/21.04.132/2012-13 dated January 31, 2013.

10.32 The auditors should also obtain the list of non performing advances purchased/sold from the bank's management and should verify the same with reference to approval from the appropriate authority and documents executed for purchase/sale of such non performing advances.

10.33 *Business Ratios:* RBI has prescribed following ratios to be computed by the bank to be disclosed in the notes forming part of the balance sheet:

- (i) *Interest Income as a percentage to Working Funds-* Working funds is to be reckoned as average of total assets (excluding accumulated losses, if any) as reported to RBI in Form X under Section 27 of the Banking Regulation Act, 1949, during the 12 months of the financial year.
- (ii) *Non-interest income as a percentage to Working Funds-* Non-interest income is to be reckoned as income reported under Schedule 14.

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- (iii) *Operating Profit as a percentage to Working Funds-* Operating Profit is to be reckoned as profit before making provisions, i.e., Total income as per Schedule 13 and Schedule 14 less Total expenditure as per Schedule 15 and Schedule 16.
- (iv) *Return on Assets (it should be with reference to average working funds i.e., total of assets excluding accumulated losses, if any):* The return is to be reckoned as the net profit for the year after making all the provisions.
- (v) *Business (Deposits plus advances) per employee (inter- bank deposits may be excluded):* This ratio may be computed based on the average business and average no. of employees during the year.
- (vi) *Profit per employee:* This ratio may be computed based on the average no. of employees during the year.

10.34 *Asset Liability Management:* Banks are required to disclose the maturity pattern of Deposits, Advances, Investments, Borrowings, Foreign Currency assets, Foreign Currency liabilities as on balance sheet date. The maturity pattern needs to be disclosed in following time buckets-

- (i) Day 1
- (ii) 2 to 7 days
- (iii) 8 to 14 days
- (iv) 15 to 28 days
- (v) 29 days to 3 months
- (vi) Over 3 months & upto 6 months
- (vii) Over 6 months & upto 1 year
- (viii) Over 1 year & up to 3 years
- (ix) Over 3 years & upto 5 years
- (x) Over 5years

The maturity pattern of demand deposits and demand loans (including in foreign currency) is to be based on empirical study carried by the bank. Based on such study, such deposits and loans should be classified under different buckets.

10.35 *Exposures:* The Reserve Bank of India, vide its Master Circular DBOD. No.Dir.BC. 13/13.03.00/2013-14 of July 1, 2013 on "Exposure Norms" provides requirements in respect of exposure limits for banks. Under the master circular on Disclosure in Financial Statements the RBI has prescribed the details which need to be disclosed with respect to Banks exposure to real estate sector and capital market:

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- (A) *Exposure to Real Estate Sector*- Banks are required to disclose direct and indirect exposure to real estate sector in the below mentioned format
- a) *Direct exposure*
 - (i) *Residential Mortgages*: Includes lending fully secured by mortgages on residential property that is or will be occupied by the borrower or that is rented; (Individual housing loans eligible for inclusion in priority sector advances may be shown separately)
 - (ii) *Commercial Real Estate*- Both fund and non-fund based lending secured by mortgages of commercial real estate (office buildings, retail space, multi-purpose commercial premises, multi-family residential buildings, multi-tenanted commercial premises, industrial or warehouse space, hotels, land acquisition, development and construction, etc.).
 - (iii) Investments in Mortgage Backed Securities (MBS) and other securitised exposures-
 - a. Residential,
 - b. Commercial Real Estate.
 - b) *Indirect Exposure*: Fund based and non-fund based exposures on National Housing Bank (NHB) and Housing Finance Companies (HFCs).
- (B) *Exposure to Capital Market*- Banks are required to disclose the total exposure to capital market under the following heads:
- a. direct investment in equity shares, convertible bonds, convertible debentures and units of equity-oriented mutual funds the corpus of which is not exclusively invested in corporate debt;
 - b. advances against shares/bonds/debentures or other securities or on clean basis to individuals for investment in shares (including IPOs/ESOPs), convertible bonds, convertible debentures, and units of equity-oriented mutual funds;
 - c. advances for any other purposes where shares or convertible bonds or convertible debentures or units of equity oriented mutual funds are taken as primary security;
 - d. advances for any other purposes to the extent secured by the collateral security of shares or convertible bonds or convertible debentures or units of equity oriented mutual funds i.e. where the

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- primary security other than shares/convertible bonds/convertible debentures/units of equity oriented mutual funds does not fully cover the advances;
- e. secured and unsecured advances to stockbrokers and guarantees issued on behalf of stockbrokers and market makers;
 - f. loans sanctioned to corporates against the security of shares / bonds/ debentures or other securities or on clean basis for meeting promoter's contribution to the equity of new companies in anticipation of raising resources;
 - g. bridge loans to companies against expected equity flows/issues;
 - h. underwriting commitments taken up by the banks in respect of primary issue of shares or convertible bonds or convertible debentures or units of equity oriented mutual funds. However, RBI, *vide* its Master Circular No. DBOD. No.Dir.BC. 13/13.03.00/2013-14 dated July 1, 2013 on "Exposure Norms" has clarified that with effect from April 16, 2008, banks may exclude their own underwriting commitments, as also the underwriting commitments of their subsidiaries, through the book running process for the purpose of arriving at the capital market exposure of the solo bank as well as the consolidated bank.
 - i. financing to stockbrokers for margin trading;
 - j. all exposures to Venture Capital Funds (both registered and unregistered).

The exposure is to be reckoned with reference to higher of outstanding and sanctioned limit. Exposure to the sensitive sector would include lending which is primarily secured against such sensitive sector.

Audit Approach

10.36 The Statutory Central Auditors should check the consolidation of returns being obtained from the respective branch auditors for compiling the above figures. Further, the auditors should also verify the same based on the mechanism in place at HO of the bank to cross verify the figures reported by branches.

10.37 *Risk category-wise country-wise exposure:* As per the extant RBI guidelines, the country wise net exposure of the Bank and the provision held thereof is categorised into various risk categories listed below:

- (i) Insignificant
- (ii) Low

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- (iii) Moderate
- (iv) High
- (v) Very High
- (vi) Restricted
- (vii) Off-credit
- (viii) Total

10.38 Till the banks move over to own internal rating systems, they may use the seven category classification followed by Export Credit Guarantee Corporation of India Ltd. (ECGC) for the purpose of classification and making provisions for country risk exposures. ECGC shall provide to banks, on request, quarterly updates of their country classifications and shall also inform all banks in case of any sudden major changes in country classification in the interim period.

10.39 *Details of Single Borrower Limit (SGL), Group Borrower Limit (GBL) exceeded by the bank:* The bank should make appropriate disclosure in respect of cases where it had exceeded the prudential exposure limits during the year. The sanctioned limit or entire outstanding, whichever is high, shall be reckoned for arriving at exposure limit and for disclosure purpose. The same needs to be verified from the minutes of Board meeting of the bank.

10.40 Unsecured Advances - In order to enhance transparency and ensure correct reflection of the unsecured advances in Schedule 9 of the banks' balance sheet, it is advised as under:

- 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.
- 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.

10.41 Provision made for income tax during the year.

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10.42 *Disclosure of Penalties imposed by RBI:* At present, Reserve Bank is empowered to impose penalties on a commercial bank under the provision of Section 46 (4) of the Banking Regulation Act, 1949, for contraventions of any of the provisions of the Act or non-compliance with any other requirements of the Banking Regulation Act, 1949; order, rule or condition specified by Reserve Bank under the Act. Consistent with the international best practices in disclosure of penalties imposed by the regulator, it has been decided that the details of the levy of penalty on a bank in public domain will be in the interests of the investors and depositors. It has also been decided that strictures or directions on the basis of inspection reports or other adverse findings should be placed in the public domain. The penalty should also be disclosed in the "Notes on Accounts" to the Balance Sheet.

10.43 *Provisions and Contingencies:* To facilitate easy reading of the financial statements and to make the information on all Provisions and Contingencies available at one place, banks are required to disclose in the 'Notes to Accounts' the following information:

- (i) Provisions for depreciation on Investment
- (ii) Provision towards NPA
- (iii) Provision towards Standard Asset
- (iv) Provision made towards Income tax
- (v) Other Provision and Contingencies (with details)

10.44 *Floating Provisions-* Banks should make comprehensive disclosures on the movement of floating provisions in the "notes to accounts" to the balance sheet as follows:

- Opening balance in the floating provisions account
- The quantum of floating provisions made in the accounting year
- Amount of draw down made during the accounting year
- Closing balance in the floating provisions account

For draw down of provision during the year, purpose of draw down may be mentioned.

10.45 *Draw Down from Reserves:* Suitable disclosures should be made regarding any draw down of reserves in the 'Notes to Accounts'.

10.46 *Disclosure of complaints-* Banks are also advised to disclose the following brief details along with their financial results:

- (i) *Customer Complaints*
 - (a) No. of complaints pending at the beginning of the year

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- (b) No. of complaints received during the year
- (c) No. of complaints redressed during the year
- (d) No. of complaints pending at the end of the year
- (ii) *Awards passed by the Banking Ombudsman*
 - (a) No. of unimplemented Awards at the beginning of the year
 - (b) No. of Awards passed by the Banking Ombudsmen during the year
 - (c) No. of Awards implemented during the year
 - (d) No. of unimplemented Awards at the end of the year

10.47 *Disclosure of Letter of Comforts (LOCs) issued by banks*- The banks should disclose full particulars of all the Letter of Comforts (LoCs) issued by them during the year, including their assessed financial impact, as also their assessed cumulative financial obligations under the LoCs issued by them in the past and outstanding at the end of current year.

10.48 *Provisioning Coverage Ratio PCR* - The PCR (ratio of provisioning to gross non-performing assets) should be disclosed in the Notes to Accounts to the Balance Sheet.

10.49 *Bancassurance Business* - Banks should disclose in the 'Notes to Accounts', from the year ending March 31, 2010, the details of fees/remuneration received in respect of the bancassurance business undertaken by them.

10.50 *Concentration of Deposits* - Total Deposits of twenty largest depositors and Percentage of Deposits of twenty largest depositors to Total Deposits of the bank should be disclosed by the bank in the notes to accounts.

10.51 *Concentration of Advances* - Total Advances of twenty largest borrowers and Percentage of Advances to twenty largest borrowers to Total Advances of the bank should be disclosed by the bank in the notes to accounts. Advances should be computed as per definition of Credit Exposure including derivatives furnished in the Master Circular on Exposure Norms.

10.52 *Concentration of Exposures* - Total Exposure to twenty largest borrowers/customers and Percentage of Exposures to twenty largest borrowers/customers to Total Exposure of the bank on borrowers/customers should be disclosed by the bank in the notes to accounts. Exposures should be computed based on credit and investment exposure as prescribed in the Master Circular on Exposure Norms.

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10.53 *Concentration of NPAs* - Total Exposure to top four NPA accounts should be disclosed by the bank in the notes to accounts.

10.54 *Sector-wise NPAs* – Percentage of NPAs to Total Advances in the sectors, such as, Agriculture & allied activities, Industry (Micro & small, Medium and Large), Services, Personal Loans, should be disclosed by the bank in the notes to accounts.

10.55 *Movement of NPAs* – Movement in NPAs during the year including opening balance, additions during the year, less up gradations, recoveries (excluding recoveries made from upgraded accounts) and write off during the year, should be disclosed by the bank in the notes to accounts.

10.56 *Overseas Total Assets, Total NPAs and Total Revenue* should be disclosed by the bank in the notes to accounts.

10.57 *Off-balance Sheet SPVs* sponsored (which are required to be consolidated as per accounting norms) both domestic and overseas should be disclosed by the bank in the notes to accounts.

10.58 *Unamortised Pension and Gratuity Liabilities*: Appropriate disclosures of the accounting policy followed in regard to amortization of pension and gratuity expenditure may be made in the Notes to Accounts to the financial statements.

10.59 *Disclosures on Remuneration*: Private sector banks and foreign banks (to the extent applicable) are advised to disclose remuneration as specified in the Master Circular on “ Disclosure in Financial Statements- Notes to Accounts”.

10.60 *Disclosures relating to Securitisation*: The Notes to Accounts of the originating banks should indicate the outstanding amount of securitized assets as per books of the SPV sponsored by the bank and total amount of exposures retained by the bank as on the date of balance sheet to comply with the Minimum Retention Requirement(MRR). These figures should be based on the information duly certified by the SPV's auditors obtained by the originating bank from the SPV.

10.61 *Credit Default Swaps*: Banks using a proprietary model for pricing CDS, shall disclose both the proprietary model price and the standard model price in terms of extant guidelines in the Notes to the Accounts and should also include an explanation of the rationale behind using a particular model over another.

Disclosures prescribed by Accounting Standards

10.62 The Accounting Standards issued by the Central Government under the Companies (Accounting Standards) Rules, 2006 (as amended) as well as any other Accounting Standards issued by the ICAI prescribes various

Disclosure Requirements in Financial Statements

disclosures to be made in financial statements. Banks are defined as Level I enterprises by ICAI and as such all Accounting Standards are applicable to banks unless specifically excluded (Certain provisions of Accounting Standard 11 (Revised 2003), Accounting Standard 13). This Guidance Note deals with only those disclosure requirements where RBI has issued guidelines in respect of disclosure as per Accounting Standards.

10.63 As the format of the profit and loss account of banks prescribed in Form B under Third Schedule to the Banking Regulation Act 1949 does not specifically provide for disclosure of the impact of prior period items on the current year's profit and loss, such disclosures, wherever warranted, may be made in the Notes on Accounts of banks. (AS-5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies")

10.64 Disclosure with regards to the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.(AS-9, "Revenue Recognition")

10.65 Banks may follow the disclosure requirements prescribed under AS 15 (revised), 'Employees Benefit' issued by ICAI. (AS-15, "Employee Benefits")

10.66 While complying with AS-17, "Segment Reporting", banks are required to adopt the following:

- i) The business segment should ordinarily be considered as the primary reporting format and geographical segment would be the secondary reporting format.
- ii) Reported business segments should be 'Treasury', 'Corporate/Wholesale Banking', 'Retail Banking' and 'Other banking operations'.
- iii) 'Domestic' and 'International' segments will be the geographic segments for disclosure.
- iv) Banks may adopt their own methods, on a reasonable and consistent basis, for allocation of expenditure among the segments.

For the formats relating to the segment reporting disclosures, readers may refer to the above Master Circular.

10.67 *Related Parties:* Related parties for a bank are its parent subsidiary(ies), associates/joint ventures, Key Management Personnel (KMP) and relatives of KMP. KM are the whole time directors for an Indian bank and the chief executive officer for a foreign bank having branches in India Banks need to report related party relationships and transactions between a reporting enterprise and its related parties. No disclosure is required in respect of related parties which are

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"State-controlled Enterprises" as per paragraph 9 of Accounting Standard (AS) 18. Further, in terms of paragraph 5 of AS 18, transactions in the nature of Banker-customer relationship are not required to be disclosed in respect of Key Management Personnel and relatives of Key Management Personnel. Further, where there is only one entity in any category of related party, banks need not disclose any details pertaining to that related party other than the relationship with that related party. RBI has modified illustrative disclosure format recommended by the ICAI to suit banks. (AS-18, "Related Party Disclosures").

10.68 As regards disclosures in the 'Notes on Accounts' to the Consolidated Financial Statements (AS-21, "Consolidated Financial Statements"), banks may follow the general clarifications issued by Institute of Chartered Accountants of India from time to time. A parent company, presenting the CFS, should consolidate the financial statements of all subsidiaries - domestic as well as foreign, except those specifically permitted to be excluded under the AS-21. The reasons for not consolidating a subsidiary in CFS should be disclosed in the CFS. The responsibility of determining whether a particular entity should be included or not for consolidation would be that of the Management of the parent entity. In case, its Statutory Auditors are of the opinion that an entity, which ought to have been consolidated, has been omitted, they should incorporate their comments in this regard in the "Auditors Report".

10.69 Adoption of AS 22, "Accounting for Taxes on Income", may give rise to creation of either a deferred tax asset (DTA) or a deferred tax liability (DTL) in the books of accounts of banks. This would give rise to certain issues which have a bearing on the computation of capital adequacy ratio and banks' ability to declare dividends. In this regard RBI has clarified as under:

- (i) DTL created by debit to opening balance of Revenue Reserves on the first day of application of the Accounting Standards 22 or to Profit and Loss account for the current year should be included under item (vi) 'others (including provisions)' of Schedule 5 - 'Other Liabilities and Provisions' in the balance sheet. The balance in DTL account will not be eligible for inclusion in Tier I or Tier II capital for capital adequacy purpose as it is not an eligible item of capital. In this context, attention of the readers is also invited to RBI's Circular No. DBOD.No.BP.BC.77/21.04.018/2013-14 on "Deferred Tax Liability on Special Reserve created under Section 36(1)(viii) of the Income Tax Act, 1961" dated December 20, 2013.
- (ii) DTA created by credit to opening balance of Revenue Reserves on the first day of application of Accounting Standards 22 or to Profit and Loss account for the current year should be included under item (vi) 'others' of Schedule 11 'Other Assets' in the balance sheet.

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- (iii) The DTA computed as under should be deducted from Tier I capital:
- DTA associated with accumulated losses; and
 - The DTA (excluding DTA associated with accumulated losses), net of DTL. Where DTL is in excess of the DTA (excluding DTA associated with accumulated losses), the excess shall neither be adjusted against item (i) nor added to Tier I capital.

10.70 A bank may acquire more than 20% of voting power in the borrower entity in satisfaction of its advances and it may be able to demonstrate that it does not have the power to exercise significant influence since the rights exercised by it are protective in nature and not participative. In such a circumstance, such investment may not be treated as investment in associate under AS 23, "Accounting for Investments in Associates in Consolidated Financial Statements". Hence the test should not be merely the proportion of investment but the intention to acquire the power to exercise significant influence.

10.71 Merger/ closure of branches of banks by transferring the assets/ liabilities to the other branches of the same bank may not be deemed as a discontinuing operation and hence AS 24, "Discontinuing Operations", will not be applicable to merger / closure of branches of banks by transferring the assets/ liabilities to the other branches of the same bank. Disclosures would be required under the Standard only when:

- (i) discontinuing of the operation has resulted in shedding of liability and realization of the assets by the bank or decision to discontinue an operation which will have the above effect has been finalised by the bank and
- (ii) the discontinued operation is substantial in its entirety.

10.72 With regards to Accounting Standard (AS) 25, "Interim Financial Reporting", the half yearly review prescribed by RBI for public sector banks, in consultation with SEBI, vide circular DBS. ARS. No. BC 13/ 08.91.001/ 2000-01 dated 17th May 2001 is extended to all banks (both listed and unlisted) with a view to ensure uniformity in disclosures. Banks may also refer to circulars DBS.ARS.No.BC.4/08.91.001/2001-02 dated October 25, 2001 and DBS.ARS.No.BC.17/08.91.001/2002-03 dated June 5, 2003 and adopt the format prescribed by the RBI for the purpose.

10.73 Other Accounting Standards - Banks are required to comply with the disclosure norms stipulated under the various Accounting Standards issued by the Institute of Chartered Accountants of India.

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10.74 With regards to Accounting Standard (AS) 26, "*Intangible Assets*" an enterprise discloses the change in an accounting estimate or accounting policy such as that arising from changes in the amortisation method, the amortisation period or estimated residual values, in accordance with AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies. The financial statements should also disclose:

- (a) if an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset; (b) a description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole; (c) the existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities; and (d) the amount of commitments for the acquisition of intangible assets.

10.75 With regard to Accounting Standard (AS) 27, "*Financial Reporting of Interests in Joint Ventures*" disclosure of relating to joint venture given in AS 27 need to be given in standalone financial statements as well as in Consolidated Financial Statements.

10.76 With regard to Accounting Standard (AS) 28, "*Impairment of Assets*" amount of impairment loss recognized and reversed during the period need to be disclosed.

10.77 With regard to Accounting Standard (AS) 29, "*Provisions, Contingent Liabilities and Contingent Assets*" if any provision is created as per AS 29, disclosure need to be given as per para 66 and 67 of AS 29. With respect to contingent liability following disclosure need to be given in financial statements: Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable: (a) an estimate of its financial effect, (b) an indication of the uncertainties relating to any outflow; and (c) the possibility of any reimbursement. (para 68 of AS 29).

III-11

Consolidation of Branch Accounts

11.01 One of the important functions of the statutory central auditors of banks is to examine the consolidation of accounts of branches and divisions – those which have been audited by branch auditors as well as those which are unaudited. The procedures followed for consolidation of accounts vary from bank to bank. , The accounts of branches pertaining to a region/zone/circle are consolidated at that level. The accounts of all such regions/zones/circles are consolidated at the Head Office. Due to CBS and greater advantage of Technology the work of consolidation is centralised at the Head Office.

11.02 Preparation of the financial statements of the bank as a whole (after consolidation of accounts of branches) is the responsibility of the bank's management.

11.03 The RBI *vide* its Circular No. DBOD.No.BP.BC.72/21.04.018/2001-02 dated February 25, 2003 has issued guidelines to banks on consolidated accounting and other quantitative methods.

11.04 The process of consolidation involves the consolidation of balance sheet, profit and loss account, other schedules and returns (e.g., returns relating to advance classification, fixed assets, bills payable, sundries, suspense, etc.), Capital Adequacy Returns, various certificates, LFARs, branch statutory audit reports and returns of various types received from audited and unaudited branches as per the closing instructions issued by respective banks. Considering the increased use of technology proper care must be taken to ensure the correctness of various sub-heads under main head in consolidation process.

11.05 In most of the banks the pre-audited accounts as per Core Banking Solution System and various statements and returns prepared by the branch are sent to the head office through regions/zones/circles. After the completion of the audit of branches, the accounts of the branches along with the audit report thereon and a memorandum of changes (MOCs) showing distinctly the changes to be made in the pre-audited accounts in the light of the observations made by the branch auditors are forwarded to the head office (through regions/zones/circles). Also a copy of audited statements of branches are forwarded to Statutory Central Auditors directly.

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11.06 The MOCs generally specify:

- (a) the changes required in account head ;
- (b) recommendations for provision for expenses and/or recognition of income;
- (c) changes relating to classification of advances and provisions thereon;
- (d) changes regarding any other information relating to certificates/returns/statements.
- (e) As advised by ICAI, Statutory auditor have to give the total number and amount of debits/ credits arising pursuant to the Memorandum of Changes submitted by them in their audit reports under the "Other Matters" paragraph.

11.07 Generally, the pre-audited returns are consolidated without any change at the finance department of bank at head office. The MOCs received from branches are consolidated separately and finally, the consolidated accounts of the bank are prepared by giving effect to such MOCs.

11.08 The Statutory Central Auditors (SCA) should examine whether the consolidation of branch returns has been correctly done at the head office. The SCA should particularly examine whether the Head Office interest, inter-branch balances and other similar items have been reversed / netted off during consolidation.

11.09 Apart from examining the consolidation of figures in the financial statements, the SCA should also consider the items representing information related to accounting policies and notes on accounts from these branch returns, as well as the observations made by the branch auditors, in the main audit report as well as the Long Form Audit Report (LFAR) regarding such financial information. Further, the statutory branch auditors have been advised by ICAI to give the total number and amount of debits/ credits arising pursuant to the Memorandum of changes submitted by them in their statutory audit reports under the "Other Matters" paragraph.

11.10 It is not possible for the SCA to re-examine the audited returns or to conduct an audit of the unaudited returns to determine the correctness of income recognition and asset classification. However, they may review any large advances showing sign of weakness for detailed discussions with the bank management.

11.11 RBI has advised banks to ensure that the identification of NPAs and provision against the same is carried out by the system driven and the core accounting system of the bank should generate the same to avoid any manual errors

Consolidation of Branch Accounts

and manipulation. The auditor should comment on any manual intervention in software that is used for preparation of statements related to NPAs.

11.12 There may be cases where the returns received from some of the unaudited branches are incomplete or incorrectly filled up or have improper grouping of accounts. The SCA has to be careful in examining the consolidation of such unaudited returns. They should particularly examine the internal controls in relation to preparation of such returns, especially those which seek to minimise the possibility of incorrect recognition of revenue in respect of non-performing advances as also incorrect classification of advances. The SCA should ensure that the NPA/ NPI are classified borrower wise and not facility wise. Further, if an account of a borrower is classified as NPA in any of the branch (Indian or foreign) then all his accounts across the bank will be classified as NPA. In case the auditor find that the total amount relating to unaudited branches is material and that the returns from such branches indicate incorrect recognition of revenue or wrong classification of items, the auditor should consider the impact of the same on the auditor's opinion on the financial statement in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

11.13 There are various certificates issued by the statutory branch auditors which are consolidated at head office for certain disclosure purpose or for making adequate provisions at Head Office level. The SCA need to review the formats suggested through closing instructions to branches and statutory branch auditors for such certificates to ensure that all the necessary information is captured during the process of consolidation.

11.14 The SCAs have to ensure that the returns of all the audited and unaudited branches have been consolidated and that no branches are left out. In case of non-receipt of returns from any branch, a suitable qualification/disclaimer should be made appropriately.

Special Considerations in Case of Returns of Overseas Branches

11.15 While consolidating the overseas branches the auditor should examine the following:

- a. The various reports of the overseas branches would be received in the local currencies of the reporting countries which need to be converted in to the Indian currency.
- b. The effect of reinstatement of assets and liability which is given in Accounting standard 11 (The Effects of Changes in Foreign Exchange

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Rates). RBI has also issued a circular for compliance of the AS 11. DBOD.BP.BC.No.76/21.04.018/2005-06) dated April 5, 2006.

- c. Examination of the foreign exchange gain and loss.
- d. As per AS 11 (revised 2003), the method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise. For this purpose, foreign operations are classified as either "integral foreign operations" or "non-integral foreign operations".
- e. In terms of its circular no DBOD.BP.BC.76/ 21.04.018/2004-05 dated March 15, 2005, the RBI has prescribed that with the issuance of the said circular, there should normally be no need for any statutory auditor for qualifying financial statements of a bank for non-compliance with Accounting Standard 11 (revised 2003). Hence, it is essential that both the banks and the statutory central auditors adopt the guidelines and the procedures prescribed. Whenever specific difference in opinion arises among the auditors, the statutory central auditors would take a final view. Continuing difference, if any, could be sorted out in prior consultation with RBI, if necessary.
- f. It may be noted that the branches of bank operates in Indian country have to operate in foreign counties in accordance with the rules and regulation of that countries. Hence the auditor should examine the compliance of the same.
- g. The Council of ICAI has, however, clarified that AS 11 (Revised 2003) does not apply to accounting of exchange difference arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction. The Standard does apply, however, to other foreign exchange transactions of banks and also for translation of financial statements of foreign branches of banks.

11.16 The transactions between position-maintaining and reporting branches during the year are accounted for as inter-branch transactions. The auditor should examine whether the relevant transactions have been correctly recorded.

11.17 The auditor should also examine whether any profit or loss arising from foreign exchange transactions has been accounted for correctly.

11.18 The overseas branches of banks established in India have to operate in a foreign country in accordance with the rules and regulations prescribed by the regulator of the respective country. Such rules and regulations may include maintenance of a fixed capital and other measures for protection of local depositors' money, etc. For example, the local regulations in many countries

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require that to the extent of erosion or probable erosion of net assets, replenishment of funds to the extent required under the regulations should be made by way of remittances. Therefore, in addition to the fixed capital sent at the time of opening of the branches, additional capital remittances towards eroded funds are also to be made from time to time. This is commonly known as 'Assigned Capital'. SCAs should examine whether the bank holds sufficient provision against such eroded assets of such overseas branches if it was required to remit fresh capital for replenishment of the eroded net assets.

11.19 The overseas branch accounts as well as the report of the auditor indicate separately the element of doubtful assets as per the remittance requirement. The auditors should keep in mind the fact that the requirement of the quantum of remittance against eroded net assets varies from country to country. Therefore, in many cases, the amount of provision required for doubtful assets may be higher than the quantum of remittance. In case of classification of advances it must be ensured that NPA is classified borrower wise and hence a borrower whose account is classified as NPA in an Indian Branch should also be classified as NPA in foreign branch and vice versa.

11.20 Where an overseas branch is required to reduce its capital pursuant to local regulation, the figure of capital so reduced should be incorporated in the consolidated accounts of the bank.

11.21 LFAR of Foreign Branches as per the format prescribed in Part IV of this Guidance Note is required to be consolidated at Head Office.

Investments

11.22 Provision for depreciation on investments of foreign offices should be made scrip wise keeping in view the policy followed by the bank as a whole. Thus, in case depreciation on investments of a foreign office is not in accordance with the policy followed by the bank, additional provision for depreciation may have to be accounted for at Head Office. Accordingly, the auditor should examine whether uniformity is maintained in classification of investments in the manner maintained by the Indian operations of the bank and wherever a deviation is observed, the difference in depreciation should be calculated and provided for at the Head Office.

Inter - Office Transactions and Balances

11.23 During the process of consolidation, special attention is required for examination of inter office accounts and balances.

11.24 Ideally, all inter-office transactions should reconcile (though with a

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certain time lag in the case of some types of transactions like drafts issued). The unreconciled inter-office transactions indicate the existence of errors or, more seriously, of frauds.

11.25 Considering the fact that almost all banks are under CBS system and the new age products of online banking, internet banking, mobile banking etc., there are large volume of transactions in inter-office adjustments account and the extent of non-reconciliation, this area is fraud-prone. The SCA should bear this fact in mind while designing his audit procedures relating to this area.

11.26 Vide circular No. BP.BC.73/21.04.018/98 dated July 27, 1998, banks have been advised by the RBI to segregate the credit entries outstanding for more than five years in inter-branch accounts and transfer them to a separate Blocked Account which should be shown in the balance sheet under the head 'Other Liabilities and Provisions – Others' (Schedule 5). While arriving at the net amount of inter-branch transactions for inclusion in the balance sheet, the aggregate amount of Blocked Account should be excluded and only the amount representing the remaining credit entries should be netted against debit entries. Banks have been advised that any adjustment from the Blocked Account should be permitted only with the authorisation of two officials, one of whom should be from outside the branch concerned, preferably from the controlling/head office, if the amount exceeds Rs.1 lakh.

11.27 The banks have been required to reconcile the entries outstanding in their inter branch accounts within a period of six months (Circular DBOD No.Fol.BC.114/16.01.001-93 dated April 28, 1993). The Reserve Bank of India vide its circular DBOD.No.BP.BC.73/21.04.018/2002-03 dated February 26, 2003 has reduced the time period allowed to banks for making provision against the net debit balance in the inter-branch account from one year to six months from the year ending March 31, 2004.

11.28 Accordingly, banks are required to arrive at the category-wise position of unreconciled entries outstanding in the inter-branch accounts for more than six months as on March 31, 2004 and make provision equivalent to 100 percent of the aggregate net debit under all categories. While doing so, the banks are required to ensure that:

- (a) The credit balance in the Blocked Account created is also taken into account (Circular DBOD.No.BP.BC.73/ 21.04.018/98 dated July 27, 1998); and
- (b) The net debit in one category is not set-off against net credit in another category.

11.29 While designing its audit procedures relating to this item, the SCA

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should also take into consideration the requirements of the Long Form Audit Report. The SCA is required to report on the following aspects in relation to inter-branch reconciliation:

- Comments on the system/ procedure and records maintained.
- Test check for any unusual entries put through inter-branch/ head office accounts.
- Position of outstanding entries; system for locating long outstanding items of high value.
- Steps taken or proposed to be taken for bringing the reconciliation up-to-date.
- Compliance with the RBI guidelines with respect to provisioning for old outstanding entries.

11.30 The existence and effective operation of adequate internal controls is of utmost significance in the case of banks to prevent the occurrence of errors and frauds in branch daily statements and to ensure expeditious reconciliation of inter-office transactions. The SCA should study and evaluate these controls by examination of the existence and effective operation of internal controls relating to the following aspects:

- System of ensuring timely dispatch of the daily statements by the branches. The procedures instituted for this purpose may include identification of branches that are habitually late in sending the statements and advising the controlling office of such branches to follow-up with the branches concerned.
- System of checking the opening balance of the daily statement of the branches to ensure that it tallies with the closing balance of the previous statement. As the entire system of inter-office reconciliation is usually computerised, the computer program itself may contain an instruction to check this aspect.
- System of pre-edit scrutiny of data to ensure the following:
 - Continuity of the branch daily statements.
 - Detection of obvious errors in the branch daily statements and initiation of immediate action for correction of such errors.
- System for segregation of the error data from the accepted data and editing of the error data to make it acceptable for processing.

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- System of follow-up with branches regarding outstanding entries till they are cleared/ reconciled. Also indicate the date up to which various accounts pertaining to Inter Branch Transactions (e.g. Demand draft paid/ payable) is available with the bank. A year wise break up of outstanding entries in inter branch accounts, together with the statement of reasons for their remaining outstanding and the steps being taken by the management in respect thereof, should be obtained from the management and examined.
- System of review by the Board of Directors of the bank (half-yearly or at even shorter intervals) as desired by RBI.
- System to restrict originating debits to head office account to cash/funds transfer, purchase of securities/capital assets, withdrawals from Provident Fund, advances to inspection and other staff members, etc. as advised by the RBI vide its circular DBS.CO.SMC.BC. No.54/22.09.001 dated 13th June, 1999.

11.31 In evaluating the efficacy of the system for reconciliation of inter-office transactions, the auditor should also take into account the following factors:

- (a) Application of the concept of A-B-C analysis to reconciliation of inter-office transactions, e.g., segregation of bulk transactions, high value items, cash and other items that are vulnerable to frauds.
- (b) Special procedures, if any, evolved by the bank to expedite clearance of the arrears, particularly in respect of large-value entries.
- (c) Action taken by the head office regarding any entries (particularly debit entries) not being responded by the branch concerned within a reasonable time.

11.32 The auditor should test check the reconciliation statements prepared by the bank throughout the year. All the high value items and items outstanding beyond reasonable period (say 3 months) should be thoroughly examined. SCA should also examine the process of clearing / rectifying the transactions appearing in such accounts at regular intervals. SCA should review the steps taken or proposed to be taken by the management for clearing the outstanding entries in inter-branch accounts.

11.33 In respect of drafts, the auditor should examine whether there are old debits which have not been reported/reconciled.

11.34 The auditor should consider the extent of non-reconciliation in forming his opinion on the financial statements. He should obtain from the bank

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management, information about the unreconciled entries in inter-branch accounts, showing separately the gross debit amount and the gross credit amount, in respect of such entries together with their year-wise break up. Where the amounts involved are material, the auditor should suitably qualify his audit report. The qualification in this regard should explain the matter with sufficient details (including the gross debit and gross credit amounts which remain unreconciled as aforesaid together with the year-wise break up of outstanding entries) so that the readers can assess the significance of this qualification.

III-12

Inter Office Transactions

12.01 Inter office transactions mostly takes place at branches. The balances can be Debit balance or credit balances in balance Sheet of the branches. Branches have number of transactions of lacs of rupees with the other branches and head office, hence it become very important to monitor the same. It is the responsibility of the bank to reconcile the transaction on daily basis and keep a track on un-reconciled transactions.

12.02 Each branch of a bank has a number of transactions with other branches/ offices as well as with the head office of the bank. In many transactions undertaken by the branch, one leg of the transaction involved is Inter Office Account. The major types of transactions are:

- Issue of remittance instruments like drafts/TTs/MTs on other branches.
- Payment of remittance instruments like drafts/TTs/MTs drawn by other branches.
- Payment to / receipts from other branches of the proceeds of instruments received/sent for collection/realisation/clearing.
- Payments made under LCs of other branches.
- Cash sent to/received from other branches.
- Payment of instruments like gift cheques/banker's cheques/interest warrants/dividend warrants/repurchase warrants/refund warrants / travellers cheques, etc., which are paid by the branch on behalf of other branches which have received the amount for payment of these instruments from the customers concerned.
- Head office interest receivable and payable by the branches.
- Profit/loss transferred by the branch to head office.
- Government receipts and payments handled by the branch either as the nodal branch or as an agent of the nodal branch.
- Operations by the authorised branches on the bank's NOSTRO accounts.
- Foreign exchange transactions entered into by the branch for which it has to deal with the nodal forex department of the bank for exchange of rupees with foreign currency.

Inter-Office Transactions

- Deposits into and withdrawal of money, by branches into currency chest maintained by another branch.
- Gold Banking Transactions at the branch on behalf of nodal branches.
- Transactions through NEFT, ECS and RTGS.
- ATM transactions of the customer either at ATM linked with other branches or with merchant establishments.
- Internet based transactions other than inter account transfers with the same branch.
- Credit card related transactions of the customers.
- Nostro Accounts of Indian branches maintained with overseas branches of the bank.
- Capital Funds with the Overseas Branches.
- Head Office balances with the overseas branches including subordinated debt lent to the overseas branches.
- Transactions from any other office through CBS/ABB Network.
- Transactions from Overseas Branches
- Transactions through payment gateways of ATM, etc.

12.03 In recent years, banks have implemented the concept of 'service branches'. These branches merely provide the services of collection of instruments through clearing, centralised payments of DD/PO etc.

12.04 In the current scenario of virtual banking/core banking and also off-site banking like ATMs, mobile banking facilities etc., the use of technology gains immense importance. Unlike traditional banking where bank officials originate the transactions between inter-branch or inter-bank (both within and outside the country), the customer triggers such transactions automatically from e-banking/ATM usage, etc.

12.05 The high volume of inter-branch transactions makes their reconciliation a tedious task. Lack of reconciliation causes these accounts to be sensitive and susceptible to frauds. Recognising this, RBI has taken a number of measures to achieve an expeditious reconciliation of these transactions by the banks concerned. Non-reconciliation results in a 'fraud risk factor' as defined in SA 240 (Revised) "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements". This Standard further provides that in such situation, auditor needs to modify his audit procedures to reduce the effect of the constituents of fraud risk.

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12.06 Considering the large volume of transactions relating to demand drafts, RBI had advised the banks (vide its circular dated April 28, 1993) to segregate inter-branch transactions relating to demand drafts from other inter-branch transactions.

12.07 Further, vide its circular no. DBS.CO.SMC.BC No. 28/22.09.001 dated 20th August, 1998, RBI has directed the banks to introduce the system of segregating DD/TT/MT transactions, with reconciliation at weekly intervals and close monitoring of large amounts.

12.08 The transactions which remain unmatched/unreconciled appear as inter-office adjustments balance in the balance sheet of the bank – under the head, 'Other Assets' if in debit, and under the head, 'Other Liabilities and Provisions' if in credit.

12.09 As the branch daily statements constitute the basis for reconciliation of inter-branch transactions, it is important to ensure that they are error-free and sent to the reconciliation department without delay. It has been observed that the following are the most common types of errors in branch daily statements.

- Wrong identification of the type of transaction.
- Recording of particulars in incorrect fields.
- Wrong accounting of bank charges, commission, etc.
- Errors in writing the amounts.
- Incorrect branch code nos.
- Incorrect schedule nos.
- Recording the same transaction twice.
- Difference between the closing and opening balances in successive daily statements.

12.10 Banks have been advised by RBI to segregate the credit entries outstanding for more than five years in inter-branch accounts and transfer them to a separate Blocked Account which should be shown in the balance sheet under the head 'Other liabilities and provisions—Others' (Schedule 5). While arriving at the net amount of inter-branch transactions for inclusion in the balance sheet, the aggregate amount of Blocked Account should be excluded and only the amount representing the remaining credit entries should be netted against debit entries. Banks have been advised that any adjustment from the Blocked Account should be permitted only with the authorisation of two officials, one of whom should be from outside the branch concerned, preferably from the controlling/head office if the amount exceeds Rs.1 lakh.

12.11 RBI vide its Circular DBOD No.BP.BC.73/21.04.018/2002-03, dated February 26, 2003, requires banks to make 100 per cent provision for net debit

position in their inter-branch accounts arising out of the unreconciled entries, both debit and credit, outstanding for more than six months from the year ending March 31, 2004.

12.12 RBI has also advised the banks to maintain, beginning April 1, 1999, category-wise (head-wise) accounts for various types of transactions put through inter-branch accounts so that the netting can be done category-wise.

Audit Approach

12.13 While examining the inter-branch accounts, the SCA should ascertain the procedures followed by the bank for recording inter-branch transactions. The procedure followed by the bank for maintaining inter-branch accounts should be such, as to facilitate early disposal / accounting of unrecorded/ unresponded/ unreconciled transactions and compliance with the regulatory requirements.

12.14 The SCA should ascertain the internal control procedures instituted at the branch, whether the branch responds quickly to queries received from the reconciliation department of the head office in respect of errors in branch daily statements and long outstanding items.

12.15 The auditor may pay special attention to the following points in the conduct of audit of inter-branch transactions:

- (a) While verifying the closing balance, special attention should be paid to the origin and validity of old outstanding unmatched entries, particularly debit entries.
- (b) Whether there are any reversal entries indicating the possibility of irregular payments or frauds.
- (c) Whether the balances include any items in the nature of cash-in-transit (e.g., cash meant for deposit into currency chest) included in this head which remain pending for more than a reasonable period, say, one week. This is because such items are not expected to remain outstanding beyond a very small period during which they are in transit.
- (d) 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 may also seek explanations from the management in this regard in appropriate cases.

12.16 The SCA should test check the computation of interest on inter-branch transactions by the branch, wherever such interest is computed on outstanding balance in the inter branch account. Such interest is calculated on the basis of

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daily inter-branch balances and is advised to head office under the inter-branch accounting system by debiting or crediting the profit and loss account of the branch depending on whether the interest is payable or receivable.

12.17 A group of inter-branch transactions which deserves special attention of the SCA relates to encashment of dividend warrants/interest warrants/refund orders, etc.

12.18 The SCA is required to specify, in his long form audit report, the date up to which the reconciliation in various accounts pertaining to inter-branch transactions is available with the branch. Year-wise break-up of outstanding entries in the inter-branch accounts is also required to be obtained from the management in the prescribed format, along with a statement of the reasons for their remaining outstanding and the steps being taken by the management in respect thereof. The auditor should insist that the information as to the reasons for outstanding entries and steps being taken in respect thereof is specific. The auditor should pay special attention to large/old outstanding items.

12.19 Even if the entries are not old and constitute for last few days of the end of year, the SCA should check if there are any material entries which are shown in inter branch account and has an impact on the other major heads of accounts. In such case, the auditor shall advise the bank to account the same in natural head of account.

12.20 The following procedures may be adopted by the SCA for the audit of the reconciliation process:

- i. review the all material transactions accounted in inter branch account just before the year end and rectify the same by accounting in the correct account head.
- ii. review all material transactions outstanding in inter branch account even if it is outstanding for more than 6 month for which 100% provision is made.
- iii. Understand and map the different transactions affecting inter office adjustment and their triggers including the scheme of accounting entries both at originating branch and final respondent branch office.
- iv. Understand the reconciliation process of the Bank and the persons responsible towards this including mechanism of elimination of contra entries.
- v. Check the periodicity / effectiveness of such reconciliations and handling of the exception reports.
- vi. Understand the ageing of the reconciliation and action taken towards the same including necessity of provisioning as per norms.

PART - IV

IV-1

Long Form Audit Report in Case of Bank Branches

1.01 In the case of branches, the auditors have to answer a detailed questionnaire formulated by the RBI. Such a report is usually termed as Long Form Audit Report (LFAR).

1.02 In the year 1985, RBI advised the Public Sector Banks to obtain LFAR from the auditors. The LFAR is not a substitute for the statutory report and is not deemed to be a part of the said report. The operations and audits of a bank are mainly based on the effective internal controls and this report serves the purpose of bringing to the notice of the management. The lacunae, shortcomings and failures in respect of compliance or adherence to the internal control measures adopted by the Banks. The main report is to be submitted as per the requirements of the Banking Regulations Act, 1949. LFAR is a separate report to be submitted to the Management, the format of which is prescribed by the RBI. The latest format of LFAR has been revised in the year 2003 and was made effective from 31st March, 2003.

1.03 LFAR is a questionnaire, which asks specific questions for which replies should be specific. Auditor should give specific comments and should refrain from answering issues for which replies were never sought unless relevant. The replies so prepared would reveal some facts which may be required to be looked into by the management for improving the working of the bank. It is advisable to discuss the contents of the LFAR with the branch head and get his responses before finalising the same. The object is to ensure correct presentation so as to state facts which have been verified during the course of audit.

1.04 It should be noted that specific disclosure, such as, in respect of extent of checking, manner of sample selection, limitations of documents verified, representations received, etc., should be made in the LFAR. The reliance placed on the computer system, which the auditor has not tested in depth for its reliability, should be clearly brought out in the LFAR. The auditor should also seek written representation from the management regarding any changes in CIS (Computer Information System) that have taken place during

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the year. In the preparation of the LFAR, the auditor should call for and look into the previous reports to ascertain whether in respect of the accounts for the year under audit, there are any matters, which deserve the attention of the management, particularly as regards adverse comments of a material nature in which remedial action was warranted.

1.05 The main report is a self-contained document and should not make any reference to the LFAR. However, matters in the main report may be elaborated in the LFAR. Where any of the comments made by the auditor in the LFAR is adverse, he should consider whether a qualification in the main report is necessary. Situations where relevant instances are giving rise to reservation/adverse remarks should be given along with reasons. It should not, however, be assumed that every adverse comment in the LFAR would necessarily result in a qualification in the main report. In deciding whether a qualification in the main report is necessary, the auditor should use his judgement in the facts and circumstances of each case.

1.06 In designing his audit program the auditor should take into consideration the requirement of the LFAR questionnaire and should, accordingly, plan his audit work so as to cover the areas mentioned in the LFAR simultaneously. This would enable the auditor to appreciate and consider the effect of various matters to be reported in his LFAR and his main audit report. As far as possible both the report should be submitted simultaneously. LFAR should not be finalised after the main audit report is signed but should be completed simultaneously in the case of a branch. However, the submission of the main report should not be delayed merely because the LFAR is pending for completion.

1.07 LFAR in respect of bank branches is prepared in such a manner so as to enable the expeditious completion and submission of the LFAR by the statutory auditors. It would also be desirable that the branch auditor familiarise themselves with the questionnaire applicable to the statutory auditors. In response to a question, the statutory auditor has to take into account comments made by the branch auditors in their LFAR with respect to such question. He should use his judgement to determine whether or not comments/observations made in the branch LFAR is material enough to be incorporated in his own report.

1.08 Some of the matters dealt with in the LFAR need compilation of detailed information/statements. It should be recognised that the responsibility for such compilation is that of the bank/branch concerned.

IV.2

Long Form Audit Report in Case of Bank Branches

Further, the auditor may also give disclaimer in LFAR with respect to any significant problem faced by him in the preparation of LFAR. Some of such problems are as follows:

- (a) Lack of availability of necessary information;
- (b) Lack of availability of computer systems to conduct audit;
- (c) Instructions of Controlling Authorities not recorded or not shown to the auditors;
- (d) Reliance placed on the computer system in operation should be stated if a system audit has not been done; and
- (e) Reliance placed, if any, on the previous year's LFAR/concurrent and other audit reports.

1.09 In the LFAR, replies are given only to questions enumerated in the LFAR. The LFAR is only indicative in nature and additional areas like, KYC compliance/Demat accounts/ Lockers/ Security arrangements/ Risk based audits/ BCTT/ Service/ ATM's/ TDS, etc., can also be covered.

1.10 Some important areas to be noted while preparing LFAR are as follows:

- (a) The auditor should be aware of the limits fixed or of various Instructions given by the controlling authorities of the bank with respect to various aspects covered in the LFAR.
- (b) The auditor should note that in certain questions he has to specifically give an opinion.
- (c) In certain questions replies are to be given specifically based on the cases examined/test checks done.
- (d) In certain cases he has to study the system presently in operation in the bank so as to give his reply.
- (e) In certain questions he has to specifically give suggestions, especially, regarding improvement in computerised information system and minimising possibility of frauds.

An illustrative list of data which is to be collected by the Auditor from the Branch for the purpose of compiling LFAR

- Branch closing instructions.
- Instructions of Controlling Authorities w.r.t. various issues.
- Organisation chart.
- Authorisation level and powers of branch officials.

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- Previous years audit report/ LFAR/ Tax audit report inspection report of the branch, concurrent audit report and compliance thereon.
- Cash Retention Limit.
- Bank confirmations/Bank reconciliations.
- Insurance for Cash/Cash-in-transit.
- In case of advances of more than Rs. 2 crore sanctioned limit and outstanding balance (both funded and non-funded)
- List of NPA's and provisioning thereon.
- List of overdues/overdrawings.
- Stock audit reports/Unit inspection reports.
- Valuation reports of NPA Accounts where outstanding is more than Rs.1 crore and valuation has been done prior to three years.
- List of Frauds and follow-up action.
- Break up of Suspense A/c's.
- List of Provisions/Prepaid expenses.
- List of Security items as at 31st March.
- List of all Advances party-wise and limit-wise.
- List of Outstanding facility-wise.
- List of Contingent liabilities.
- List of fixed assets.
- Status of claims lodged with ECGC/DICGC/CGST
- Cases of overdue proposals for review/renewal.
- Cases of sanctions not disbursed.
- Yearly break-up of matured deposits.
- Schedule of Charges (for booking of Income).
- System audit report, conducted, if any.
- List of Non corporate entities enjoying limit more than Rs.10 lakh.
- List of Sundry deposits/Bills payables.
- Report in desired format of Advances of more than Rs. 2 Crore.
- Stock register/ Insurance register/ Stationery draw power register/ Cheque book issuance register/ Cash book/ Sanction register/ Custody register/ DD issued register/ Document register.

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- Head office/ Inter-branch reconciliation/ Cheque bouncing register.
- Financial Statements of all the quarters of the year under audit.
- List of Computer system (configuration-wise) and Accounting system in operation.
- List of MIS reports>Returns submitted to various authorities.
- Overdue locker rents/Vacant lockers.
- Cash withdrawals/deposits of more than Rs.10 lakhs.
- ATM Cards/Pin Cards not issued and lying in stock.
- Cheque books not issued and lying in stock.
- Status of PC virus upgrades.
- Number of inoperative accounts.
- Number of accounts maintaining balances below prescribed minimum.
- Listing of Expired Guarantees.
- Details of Customers complaints.
- System generated statement for documents time barred by limitation.
- System generated list of accounts which were due for review and not reviewed/renewed.

1.11 Management Representation Letter should be demanded for matters as considered appropriate by the auditor, and which may include matters as enumerated below:

- a) Use of fixed assets.
- b) Effective operation of the internal control system throughout the year.
- c) Maintenance of effective joint custody of cash at all times during the year.
- d) Proper recording of all customer complaints.
- e) Notice and reporting of frauds during the year.
- f) Adherence to branch timings.
- g) Non-sharing of passwords.
- h) Nil window dressing of accounts.
- i) Genuineness of credits, if any, in NPA accounts at the year end.

IV.5

Long Form Audit Report of Bank Branches

1.12 The clauses in the LFAR questionnaire to be dealt with by the branch auditors are discussed in the following paragraphs. The key word used in these paragraphs is 'Controlling Authority'. The auditor should refer the relevant circulars issued by the relevant controlling authority, as in the case of a branch any authority which is in a position to control its affairs can be called as a Controlling Authority, e.g., head office/zonal office or regional office.

1.13 It should be noted that replies are sought specifically in conjunction with the relevant bank instructions. A branch may be observing a system of control which may be perfectly in order but if the same is contrary to the instructions of the controlling authority on the same then it has to be specifically stated as a violation in the report.

I. Assets

Cash

(a) *Does the branch generally carry cash balances, which vary significantly from the limits fixed by the controlling authorities of the bank?*

1.14 The letter received from the controlling office to be perused by the branch auditor to ascertain the cash retention limit allotted to the branch. The reporting in LFAR could be as under:

- We have been informed that Controlling Office had fixed Cash Retention Limit of Rs.----- lakhs.
- During the year under audit the cash balance was in excess of Retention Limit on many / few occasion. The instances are as under:-

Date	Balance in Rs.

The above data can be obtained from system generated report.

Long Form Audit Report in Case of Bank Branches

(b) *Does the branch hold adequate insurance cover for cash-on-hand and cash-in-transit?*

1.15 The branch auditor should ascertain whether the Branch cash balance has been covered under the Bankers' Indemnity Policy. The details may be obtained from Head Office in the form of copy of the original policy issued by the Insurance Company.

(c) *Is cash maintained in effective joint custody of two or more officials, as per the instructions of the controlling authorities of the bank?*

1.16 Generally, the cash is held in the joint custody of cashier and officer of the branch. The auditor should obtain the name of the concerned persons.

(d) *Has the cash balances at the branch been checked at periodic intervals as per the procedure prescribed by the controlling authorities of the bank?*

1.17 The branch auditor should confirm, whether the branch is under Concurrent Audit as the Concurrent Auditors carry out the Cash verification every month. In addition, bank officials who not dealing with cash also normally, undertake such verification on a monthly basis. The branch auditor should enquire about the Bank policy in this behalf and incorporate the same in the report.

Balances with Reserve Bank of India, State Bank of India and Other Banks

(a) *Were balance confirmation certificates obtained in respect of outstanding balances as at the year-end and whether the aforesaid balances have been reconciled? If not, the nature and extent of differences should be reported.*

1.18 The branch auditor should ascertain whether balance confirmation certificates have been obtained by the branch in respect of outstanding balances as at the end of every month. The branch auditor should also go through the reconciliation statement, which is prepared on the monthly basis.

If any difference is observed, the same is to be reported.

(b) *Your observations on the reconciliation statements may be reported in the following manner:*

(i) *Cash transactions remaining unresponded (give details)*

1.19 The branch auditor should give details of such transactions.

(ii) *Revenue items requiring adjustments/ write-off (give details)*

1.20 The branch auditor should give details of such items.

IV.7

Guidance Note on Audit of Banks (Revised 2014)

(iii) *Old outstanding balances remaining unexplained/ unadjusted. Give details for:*

➤ *Outstanding between six months and one year; (including Receivable or payable)*

➤ *One year and above (including Receivable or payable)*

1.21 The branch auditor should give necessary details.

(c) *In case any item deserves special attention of the management, the same may be reported.*

1.22 The branch auditor should carefully list out such items.

Money at Call and Short Notice

Has the Branch kept money-at-call and short notice during the year? If so, whether instructions/ guidelines, if any, laid down by the controlling authorities of the bank have been complied with?

1.23 The auditor should examine the balances held at the branch in the above-mentioned account with reference to the general or specific authority from the controlling authority. He should also examine whether the instructions/guidelines laid down by the controlling authority in this regard have been complied with. Unauthorised deposits including those made in excess of the authorised limits arising in this account should be reported by the auditor, indicating dates on which the deposits were so made, the period for which these continued and the name(s) of the bank(s) with which such deposits were held. Similarly, cases of non-compliance with the relevant instructions/guidelines should also be reported.

Investments

1.24 Generally, investment function is undertaken by the Treasury Department at the Head Office level. Hence, such types of transactions are not appearing in Branch's books. However, the branch auditor should confirm that no such Investments are appearing in the Branch Trial Balance. If Investments are appearing in the Trial Balance, physical verification thereof should be conducted and reported accordingly.

(A) For Branches in India

a) *Are there any investments held by branches on behalf of Head Office/ other offices of the bank? If so, whether these have been made*

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available for physical verification or evidences have been produced with regard to the same where these are not in possession of the branch?

1.25 The auditor should obtain a certificate from the branch head regarding the investments held by the branch on behalf of Head Office, with full details of the investments and dates of maturity. A 'Nil' certificate may be obtained in case no investments are held. The auditor should carry out physical verification of investments held by the branch on behalf of the Head Office/ other branches. Where any such investment is not made available to the auditor for physical verification and there is also no certificate/ acknowledgement of its having been deposited/ lodged with another office/ branch, etc., the auditor should report the nature and amount of the relevant investments.

b) *Whether any amounts received as income on such investments have been reported to the Head Office?*

1.26 The auditor should examine whether the income received on investments held by the branch on behalf of the Head Office/ other branch is promptly reported to the Head Office/other branch.

c) *In respect of investments held by branches on behalf of Head Office/ other offices of the bank whether any income is accrued/ received and recognised as income of the branch contrary to the instructions of the controlling authorities of the bank?*

1.27 Auditor should verify that income received/ accrued on investment held by it on behalf of Head Office is recognised as income of the branch only if specific instructions are received from the controlling authorities of the bank in this regard. Auditor should report cases where income accrued/ received is recognised wrongly as income of the branch contrary to the instructions of the controlling authorities of the bank.

d) *Whether there are any matured or overdue investments, which have not been encashed? If so, give details?*

1.28 The auditor should verify the cases where investments are matured or overdue and have not been encashed. The auditor should report the nature, amount, maturity date, and reason for which the overdue investments are not encashed. The auditor should verify the same with the Investment Register maintained and correspondences of the branch and Head Office in this regard.

e) *Whether the guidelines of the Reserve Bank of India regarding Transactions in Securities have been complied with.*

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1.29 The RBI has issued a number of guidelines for regulation of investments of banks. The auditor in his audit procedure has to verify whether the guidelines relating to transaction in securities have been complied (Refer Chapter III-8 on "Treasury Operations"). If any deviation is observed, the same has to be reported with details.

f) *Whether the guidelines of the Reserve Bank of India regarding valuation of Investments have been complied with.*

1.30 The auditor should enquire the mode of valuation of investments followed by the branch and examine whether it is following the guidelines issued by the RBI (Master Circular on "Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by banks" DBOD No. BP. BC.08/21.04.141/2013-14 dated July 1, 2013). The auditor should also obtain from the branch management, a statement showing the basis of valuation of investments and state such valuation in his report. If the aforesaid statement is not made available to the auditor, he should report this fact. Impact of the same on the profit should also be reported. In case of any deviation in the mode of valuation, the auditor should report this fact, stating the nature of deviation, basis of valuation and amount of relevant investments.

(B) For Branches outside India

1.31 The audit of Branches outside India is not allotted to Indian Chartered Accountants Firms; hence not applicable.

a) *In respect of purchase and sale of investments, has the branch acted within its delegated authority, having regard to the instructions/guidelines in this behalf issued by the controlling authorities of the bank?*

1.32 Normally, the central/head office of the bank deals with the investment portfolio. However, in case of any regulatory requirements of the country in which the branch is located, the transactions of purchase and/or sale of investments should be verified with reference to the delegated authority from the controlling authority. Any unauthorised investments, including those made in excess of the specific limits or in contravention of the instructions/guidelines issued by the controlling authority, should be reported, stating the date of transaction, nature of investment and the amount involved in respect of each such transaction.

b) *Have the investments held by the branch whether on its own account or on behalf of the Head Office/ other branches been made available for physical verification? Where the investments are not in the possession of the branch, whether evidences with regard to their physical verification have been produced?*

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1.33 The audit procedure should include physical verification of investments available with the branch, including those held by it on behalf of the Head Office/ other branches. Where any such investment is not made available to the auditor for physical verification and there is also no certificate/ acknowledgement of its having been deposited/ lodged with another office/ branch, etc., the auditor should report the nature and amount of the relevant investments.

c) *Is the mode of valuation of investments in accordance with the RBI guidelines or the norms prescribed by the relevant regulatory authority of the country in which the branch is located, whichever are more stringent?*

1.34 The auditor should enquire into the mode of valuation of investments followed by the branch and examine whether it is consistent with the practice as laid down by the relevant regulatory authority of the country in which branch is located. In case of any deviation, the auditor should report this fact, stating the nature of deviation, basis of valuation and amount of relevant investments. In case the mode of valuation of investments as laid down by the relevant regulatory authority of the country is different from the mode of valuation of investments followed by the head office, the auditor should state this fact along with the valuation. If the aforesaid statement is not made available to the auditor, he should report this fact.

d) *Whether there are any matured or overdue investments, which have not been encashed? If so, give details?*

1.35 The auditor should verify the cases where investments have matured or are overdue but have not been encashed. The auditor should report the nature, amount, maturity date, and reason for which the overdue investments have not been encashed.

Advances

(a) Credit Appraisal

In your opinion, has the branch generally complied with the procedures/ instructions of the controlling authorities of the bank regarding loan applications, preparation of proposals for grant/ renewal of advances, enhancement of limits, etc., including adequate appraisal documentation in respect thereof.

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1.36 The branch auditor should peruse the circular issued by Head Office regarding Credit Appraisal and enquire whether specific facility wise loan application form is prescribed by the Bank.

- He should also confirm that the instructions are followed by the Branch while accepting the loan application form.
- The branch auditor should peruse the circular issued by Head Office regarding preparation of proposals for grant / renewal of advances, enhancement of limits, etc., including adequate appraisal documentation in respect thereof to ascertain compliance therewith.

(b) Sanctioning/ Disbursement

(i) *In the cases examined by you, have you come across instances of credit facilities having been sanctioned beyond the delegated authority or limit fixed for the branch? Are such cases promptly reported to higher authorities?*

1.37 The branch auditor should enquire about the sanctioning / disbursement discretionary power regarding advances and Report the cases where credit facilities having been sanctioned beyond the delegated authority or limit fixed for the branch.

1.38 The branch auditor should also examine whether such type of cases promptly reported to higher authorities. Such type of cases can be reported in the following format.

Sr. No.	Name of the borrower	Account Number	Type of facility	Sanction date Authority	Sanction limit	Balance outstanding on 31.03.20XX	Amount sanctioned exceeding the delegated authority	Date of sanction / ratification from Higher Authority

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- (ii) *In the cases examined by you, have you come across instances where advances have been disbursed without complying with the terms and conditions of the sanction? If so, give details of such cases.*

1.39 The branch auditor should report the cases where advances have been disbursed without complying with the terms and conditions of the sanction letter along with deviations in the following format.

(c) Documentation

- (i) *In the cases examined by you, have you come across instances of credit facilities released by the branch without execution of all the necessary documents? If so, give details of such cases.*

1.40 The branch auditor should report the cases where credit facilities released by the branch without execution of all the necessary documents. The exact nature of irregularity / document not obtained may be provided in the following format.

Sr. No.	Name of the borrower	Account Number	Type of facility	Sanction date / Authority	Sanction limit	Balance outstanding on 31.03.20XX	Nature of irregularity / documents not obtained

- (ii) *In respect of advances examined by you, have you come across cases of deficiencies in documentation, non-registration of charges, non-obtaining of guarantees, etc.? If so, give details of such cases.*

1.41 The branch auditor should report cases of deficiencies in documentation, non-registration of charges, non-obtaining of guarantees, etc. He should ascertain whether the documents have been adequately stamped and also executed within six months of purchasing the stamp paper.

1.42 The instances of deficiencies may be reported in the following format.

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Sr. No.	Name of the borrower	Account Number	Type of facility & a/c no.	Sanction date / Authority	Sanction limit	Balance outstanding	Remarks
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1.43 The list of time barred documents may be furnished as under:

Sr. No.	Name of the borrower	Account Number	Outstanding balance	Sanction limit / Authority	Date of document
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1.44 The auditor should obtain a list of time barred accounts/documents, which can be generated through the system. When a document becomes time barred, no legal action can be initiated against the borrower. Hence, these accounts need to be classified as per IRAC norms.

(iii) *Whether advances against lien of deposits have been properly granted by marking a lien on the deposit in accordance with the guidelines of the controlling authorities of the bank.*

1.45 The branch auditor should refer the guidelines issued by the Head Office in this regard and report the cases, where the deposits / NSCs, paper securities etc., are matured, but not adjusted against the respective advances. Such instances can be given in the following format.

Sr. No.	Name of the borrower	Account Number	Sanction limit / Authority	Outstanding balance	Date of document	Particulars of Security
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(d) ***Review/Monitoring/ Supervision***

(i) *Is the procedure laid down by the controlling authorities of the bank, for periodic review of advances including periodic balance confirmation/ acknowledgement of debts, followed by the branch?*

Provide analysis of the accounts overdue for review/ renewal

- *between 6 months and 1 year, and*
- *over 1 year*

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1.46 Refer the guidelines issued by Head Office in this regard. He should also review the statement of accounts. Such statement can be generated through system. The instances of overdues may be given in the following format.

Sr. No.	Name of the Borrower	Account Number	Balance outstanding as on 31.03.20XX	Last date of review

(ii) *Are the stock/ book debt statements and other periodic operational data and financial statements, etc., received regularly from the borrowers and duly scrutinised? Is suitable action taken on the basis of such scrutiny in appropriate cases?*

1.47 The branch auditor should obtain age – wise analysis of stock / book debt. The borrower wise / month wise record showing receipt of security statement be confirmed in the system. The branch auditor should verify the working of drawing power based thereon.

(iii) *Whether there exists a system of obtaining reports on stock audits periodically? If so, whether the branch has complied with such system?*

1.48 The branch auditor should refer the guidelines issued by Head Office in this regard and verify compliance therewith.

(iv) *Indicate the cases of advances to non-corporate entities with limits beyond Rs.10 lakhs where the branch has not obtained the accounts of borrowers, duly audited under the RBI guidelines with regard to compulsory audit or under any other statute.*

1.49 The branch auditor should obtain list of non corporate borrowers enjoying facilities in excess of Rs.10.00 lakhs and report only where audited statements are not on record. A list of such cases can be given in the following format.

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Date of last audit completed

(v) *Has the inspection or physical verification of securities charged to the Bank been carried out by the branch as per the procedure laid down by the controlling authorities of the bank?*

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1.50 The branch auditor should refer the guidelines issued by Head Office in this regard and ascertain compliance therewith. A list of such cases can be given in the following format.

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Last date of inspection or physical verification

(vi) *In respect of advances examined by you, have you come across cases of deficiencies in value of securities and inspection thereof or any other adverse features such as frequent/unauthorised overdrawn beyond limits, inadequate insurance coverage, etc.?*

1.51 The branch auditor should note the remarks regarding deficiencies in the value of securities and inspection report as submitted by the concerned officer. He should also confirm whether insurance is in favor of Bank.

1.52 The cases where frequent / unauthorized over drawings beyond limits are granted can be given in the following format.

Sr. No.	Name of the Borrower	Account number	Sanction Limit	Balance Outstanding	Drawing power	Irregularity

1.53 Cases of no insurance can be given in the following format.

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Value of Security

1.54 Cases of inadequate insurance can be given in the following format.

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Value of Security	Insured for Rs.	Inadequate Insurance

(vii) *In respect of leasing finance activities, has the branch complied with the guidelines issued by the controlling authorities of the bank relating to security creation, asset inspection, insurance, etc? Has the branch complied with the accounting norms prescribed by the controlling authorities of the bank relating to such leasing activities?*

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1.55 The branch auditor should refer the guidelines issued by Head Office in this regard and ascertain compliance therewith.

(viii) *Are credit card dues recovered promptly?*

1.56 The branch auditor should refer the guidelines issued by Head Office in this regard and ascertain compliance therewith.

1.57 He should also examine whether the branch maintains debit balances in the card dues customers and confirm, whether such debit balances are included in Advances Classification Statements.

(ix) *Has the branch identified and classified advances into standard/sub-standard/ doubtful/ loss assets in line with the norms prescribed by the Reserve Bank of India*

1.58 The branch auditor should verify compliance with the guidelines issued by Head Office in this regard. Wherever, such guidelines are not followed Memorandum of Changes be given with reason.

(x) *Where the auditor disagrees with the branch classification of advances into standard/ sub-standard/ doubtful/ loss assets, the details of such advances with reasons should be given. Also indicate whether suitable changes have been incorporated/ suggested in the Memorandum of Changes.*

1.59 The branch auditor should verify compliance with wherever, such guidelines are not followed Memorandum of Changes be given with reason.

(xi) *Have you come across cases where the relevant Controlling Authority of the bank has authorised legal action for recovery of advances or recalling of advances but no such action was taken by the branch? If so, give details of such cases.*

1.60 The branch auditor should verify compliance with the guidelines of the Head Office in this regard. Wherever, such guidelines are not followed such cases can be reported in the following format.

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Instructions to take legal action on	Present Status
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(xii) *Have all non-performing advances been promptly reported to the relevant Controlling Authority of the bank? Also state whether any rehabilitation programme in respect of such advances has been undertaken, and if so, the status of such programme.*

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Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Rehabilitation programme sanctioned	Present Status
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1.61 The branch auditor should verify compliance with the guidelines of the Head Office in this regard.

(xiii) *Have appropriate claims for DICGC/CGSTE and Export Credit Guarantee/ Insurance and subsidies, if any, been duly lodged and settled? The status of pending claims giving year wise break-up of number and amounts involved should be given in the following format:*

1.62 DICGC may not be applicable, as most of the Banks have opted out of DICGC.

1.63 The branch auditor should report the claims if any outstanding on account of ECGC/CGST and the cases not accepted / rejected by ECGC/CGST.

Particulars	Number	Amount (Rs.)
Claims as at the beginning of the year (Give year-wise details)		
Further claims lodged during the year		
Total A	_____ _____	_____ _____
Amounts representing:		
(a) Claims accepted/ settled (give year-wise details)		
(b) Claims rejected (give year-wise details)		
Total B	_____ _____	_____ _____
Balance as at the year-end (give year-wise details)	_____	_____
A-B	==== =====	===== =====

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- (xiv) *In respect of non-performing assets, has the branch obtained valuation reports from approved valuers for the fixed assets charged to the bank, once in three years, unless the circumstances warrant a shorter duration?*

1.64 The branch auditor should ascertain compliance with the guidelines issued by the Head Office in this regard. Wherever, such guidelines are not followed such cases may be reported in the following format.

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Balance Outstanding	Security	Value of Security	Latest Valuation Report date
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- (xv) *In the cases examined by you has the branch complied with the Recovery Policy prescribed by the controlling authorities of the bank with respect to compromise/ settlement and write-off cases? Details of the cases of compromise/ settlement and write-off cases involving write-offs/ waivers in excess of Rs.50 lakhs may be given.*

1.65 The branch auditor should ascertain compliance with the guidelines issued by the Head Office in this regard. Wherever, such guidelines are not followed such cases may be reported in the following format.

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Balance Outstanding	Compromised / Settlement Amt.	Recovery Effected	Recovery To be effected
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(e) Guarantees and Letters of Credit

1.66 Guarantees and Letters of Credit are normally handled at Corporate or Head Office level. The branch auditor should, however, inquire whether such type of cases are handled at Branch and report accordingly.

- (i) *Details of outstanding amounts of guarantees invoked and funded by the branch at the end of the year may be obtained from the management and reported in the following format:*

- (a) Guarantees invoked, paid but not adjusted:

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Sr. No.	Date of invocation	Name of the party	Name of beneficiary	Amount	Date of Recovery	Remarks
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(b) Guarantees invoked but not paid:

Sr. No.	Date of invocation	Name of the party	Name of beneficiary	Amount	Date of Recovery	Remarks
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(ii) *Details of the outstanding amounts of letters of credit and co-acceptances funded by the Branch at the end of the year may be obtained from the management and reported in the following format:*

Sr. No.	Date of funding	Name of the party	Nature (LC/ co-acceptance, etc.)	Amount	Date of Recovery	Remarks
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Other Assets

(a) Stationery and Stamps

(i) *Does the system of the Bank ensure adequate internal control over issue and custody of stationery comprising security items (Term Deposit Receipts, Drafts, Pay Orders, Cheque Books, Traveller's Cheques, Gift Cheques, etc.)? Whether the system is being followed by the branch?*

1.67 The branch auditor should see the Head Office instructions and confirm whether internal control is in existence. He should carry out the physical verification of security items including stamps.

1.68 The branch auditor should ascertain whether lost security items are reported to controlling authority.

1.69 The branch auditor should also peruse the accounting treatment given to Stationery items as Bank may have different policy in this regard.

1.70 The branch auditor should report lacunas observed in the system at the branch as this is a fraud prone area.

(ii) *Have you come across cases of missing/ lost items of such stationery?*

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1.71 Missing / lost items may be reported by the branch auditor in the following format.

Sr. No	Description of the security item	Consecutive No. of the item	Date of Loss	Missing Reported on
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(b) Suspense Accounts/ Sundry Assets

(i) *Does the system of the Bank ensure expeditious clearance of items debited to Suspense Account? Details of old outstanding entries may be obtained from the branch and the reasons for delay in adjusting the entries may be ascertained. Does your scrutiny of the accounts under various sub-heads reveal balances, which in your opinion are not recoverable and would require a provision/ write-off? If so, give details in the following format:*

Year	Amount (Rs.)	Remarks

1.72 The branch auditor should ascertain compliance with the guidelines issued by the Head Office in this regard.

1.73 Such Debit entries which in branch opinion are not recoverable should be reported for making adequate provision. Age wise analysis report through the system may be referred for the same.

(ii) *Does your test check indicate any unusual items in these accounts? If so, report their nature and the amounts involved.*

Information may be given in the following format by the branch auditor

1.74 In case of long outstanding entries over a period of one year, the details thereof should be seen with regard to its nature and possibility of recovery if the branch auditor is of the opinion that such items are not recoverable, he should suggest necessary in Memorandum of Changes (MOC)

Sr. No.	Particulars of debit entry	Outstanding balance as on 31.03.20XX	Whether provision is necessary, reasons there of.
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1.75 The branch auditor may follow the above said procedure in this regard also.

II. Liabilities

Deposits

(i) *Have the controlling authorities of the bank laid down any guidelines with respect to conduct and operations of Inoperative Accounts? In the cases examined by you, have you come across instances where the guidelines laid down in this regard have not been followed? If yes, give details thereof.*

1.76 The branch auditor should ascertain whether the branch has complied with the Head Office' guidelines in this regard. Wherever the guidelines have not been followed the branch auditor should report the same along with full details.

1.77 The branch auditor should also verify whether the system identifies the inoperative accounts and converts the status of such accounts to inactive.

1.78 The branch auditor should also understand the procedure for making such inoperative account, operative.

(ii) *After the balance sheet date and till the date of audit, whether there have been any unusual large movements (whether increase or decrease) in the aggregate deposits held at the year-end? If so, obtain the clarifications from the management and give your comments thereon.*

1.79 The branch auditor should compare the aggregate deposits as on 15th March, 20XX, 31st March, 20XX and last day of audit to ascertain the reason for large variation other than due to application of interest / provision as on 31st March, 20XX.

(iii) *Are there any overdue/ matured term deposits at the end of the year? If so, amounts thereof should be indicated.*

1.80 The branch auditor should ascertain compliance with the guidelines issued by the Head Office in this regard. He should also verify whether interest is provided on matured deposit as per RBI guidelines.

Other Liabilities

Bills Payable, Sundry Deposits, etc.

(i) *The number of items and the aggregate amount of old outstanding items pending for three years or more may be obtained from the branch and reported under appropriate heads. Does the scrutiny of the accounts under various sub-heads reveal old balances? If so, give details in the following format:*

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Year	No. of items	Amount (Rs.)	Remarks

1.81 The branch auditor should ascertain compliance with the guidelines issued by the Head Office in this regard.

(ii) *Does your test check indicate any unusual items or material withdrawals or debits in these accounts? If so, report their nature and the amounts involved.*

1.82 The branch auditor should refer the exceptional transaction report generated through system.

Contingent Liabilities

List of major items of the contingent liabilities (other than constituents' liabilities such as guarantees, letters of credit, acceptances, endorsements, etc.) not acknowledged by the branch?

1.83 The branch auditor should verify the list of contingent liabilities and compare the same with last year's list. The items not appearing in the current year's list should be enquired with reasons thereof.

III. Profit and Loss Account

(a) *Whether the branch has a system to compute discrepancies in interest/ discount and for timely adjustment thereof in accordance with the guidelines laid down in this regard by the controlling authorities of the bank? Has the test checking of interest revealed excess/ short credit of a material amount? If so, give details thereof.*

1.84 The branch auditor should refer to the concurrent audit / internal inspection audit/ income and expenditure audit reports. He should also test check interest/ discount calculations. Generally, interest application is a system-generated entry; hence test check may be applied for confirming interest calculations. Wherever excess / short credit of material amount is noticed, such cases may be reported in the following format.

Sr.No	A/c No	Interest calculated by the system	Interest calculated by us	Difference
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(b) *Has the branch complied with the Income Recognition norms prescribed by the RBI?*

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1.85 The branch auditor should verify whether as required by RBI circular, asset classification is being done through system and no manual intervention is expected in this regard.

Confirm whether IRAC norms are followed strictly through system.

(c) *Whether the branch has a system to compute discrepancies in interest on deposits and for timely adjustment of such discrepancies in accordance with the guidelines laid down in this regard by the controlling authorities of the bank? Has the test check of interest on deposits revealed any excess/ short debit of material amount? If so, give details thereof.*

1.86 The branch auditor should verify compliance with the Head Office' Guidelines in this regard.

1.87 Generally, interest application is a system-generated entry; hence test check may be applied for confirming interest calculations. Wherever excess / short credit of material amount is noticed, such cases may be reported in the following format.

Sr. No	A/c No	Interest calculated by the system	Interest calculated by us	Difference

(d) *Does the bank have a system of estimating and providing interest accrued on overdue/ matured term deposits?*

1.88 The branch auditor should verify compliance with the Head Office' Guidelines in this regard. Though in most of the Banks such exercise is carried out at Head Office through system.

(e) *Are there any divergent trends in major items of income and expenditure, which are not satisfactorily explained by the branch? If so, the same may be reported upon. For this purpose, an appropriate statement may be obtained from the branch management explaining the divergent trends in major items of income and expenditure.*

1.89 The divergent trends can be located on the basis of previous quarters/ half year/previous year figures compared with business mix and business mix at the end of the year. The branch auditor should compare the aggregate figures as on 15th March, 20XX, 31st March, 20XX and last day of audit.

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IV. General

Books and Records

(a) *In case any books of account are maintained manually, does general scrutiny thereof indicate whether they have been properly maintained, with balances duly inked out and authenticated by the authorised signatories?*

1.90 Now a day's CBS is followed hence question of maintaining manual books of accounts does not arise. The balancing is also done through system. Balancing report may be generated to confirm that no difference is appearing in the balancing report.

(b) *In respect of computerised branches:*

- *Whether hard copies of accounts are printed regularly?*
 - *Indicate the extent of computerisation and the areas of operation covered through manual intervention.*
 - *Are the access and data security measures and other internal controls adequate?*

Whether regular back-ups of accounts and off-site storage are maintained as per the guidelines of the controlling authorities of the bank?

Whether adequate contingency and disaster recovery plans are in place for loss/ encryption of data?

Do you have any suggestions for the improvement in the system with regard to computerised operations of the branch? [

Reconciliation of Control and Subsidiary Records

1.91 The branch auditor should enquire at the branch the system of reconciliation followed.

1.92 The branch auditor should also enquire into the reasons for and report the same any long outstanding debit entries are appearing in the reconciliation statement.

Have the figures, as at the year-end, in the control and subsidiary records been reconciled? If not, the last date upto which such figures have been reconciled should be given under the respective heads, preferably in the following format:

Account	Date	General Ledger Balance (Rs.)	Subsidiary Balance (Rs.)	Last Date on which balanced

Inter-Branch Accounts

1.93 Now a day's CBS is implemented hence question of reconciliation of Inter – Branch Accounts does not arise at Branch.

- (i) *Does the branch forward on a daily basis to a designated cell/ Head Office, a statement of debit/ credit transactions in relation to other branches?*
- (ii) *Does a check of the balance in the Head Office Account as shown in the said statement during and as at the year-end reveal that the same is in agreement with the Head Office Account in the general ledger?*
- (iii) *Are there any outstanding debits in the Head Office Account in respect of inter-branch transactions?*
- (iv) *Does the branch expeditiously comply with/ respond to the communications from the designated cell/ Head Office as regards unmatched transactions? As at the year-end are there any unresponded/ uncomplained queries or communications? If so, give details?*
- (v) *Have you come across items of double responses in the Head Office Account? If so, give details.*
- (vi) *Are there any old/ large outstanding transaction/ entries at debits as at year-end which remain unexplained in the accounts relating to inter-branch adjustments?*

Audits/Inspections

- (i) *Is the branch covered by concurrent audit or any other audit/ inspection during the year?*
- (ii) *In framing your audit report, have you considered the major adverse comments arising out of the latest reports of the previous auditors, concurrent auditors, stock auditors or internal auditors, or in the special audit report or in the inspection report of the Reserve Bank of India? State the various adverse features persisting in the branch, though brought out in these audit/ inspection reports.*

Frauds

Furnish particulars of frauds discovered during the year under audit at the branch, together with your suggestions, if any, to minimise the possibilities of their occurrence.

1.94 The branch auditor should enquire about any fraud reported to controlling authority/vigilance dept. Head Office during the financial year.

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Miscellaneous

(i) *Does the examination of the accounts indicate possible window dressing?*

1.95 The branch auditor should compare the aggregate figures as on 15th March, 20XX, 31st March, 20XX and last day of audit.

(ii) *Does the branch maintain records of all the fixed assets acquired and held by it irrespective of whether the values thereof or depreciation thereon have been centralised? Where documents of title in relation to branch or other branches are available at the branch, whether the same have been verified.*

1.96 The branch auditor should verify compliance with the Head Office' Guidelines in this regard.

(iii) *Are there any other matters, which you as a branch auditor would like to bring to the notice of the management or the Central Statutory Auditors?*

1.97 The illustrative instances are given as under

- Connectivity issues.
- System related issues
- ATM related issues
- Whether AMC's terms are followed strictly
- Security related issues.

Chartered Accountants

Partner

Firm Registration Number -----

Membership No.-----

Branch:

Date :

Questionnaire Applicable to Specialised Branches

For Branches dealing in Foreign Exchange Transactions

1.98 It should be noted that certain branches do not deal in foreign exchange transactions but foreign currency accounts are maintained there and all records of account opening documentation are held at these branches. In such cases, checking and reporting should be done of the account opening documentation and commented upon in this section of LFAR.

1. *Are there any material adverse features pointed out in the reports of concurrent auditors, internal auditors and/ or the Reserve Bank of India's inspection report which continue to persist in relation to NRE/ NRO/ NRNR/ FCNR-B/ EEFC/ RFC and other similar deposit accounts. If so, furnish the particulars of such adverse features.*

1.99 The auditor should make a written request to the branch management for furnishing him the latest available reports of the statutory auditors and of the concurrent auditor or stock auditor or internal auditors, as also of the RBI where inspection or special audit has taken place for the branch. The auditor should scrutinise the contents of such reports in relation to NRE/ NRO/ NRNR/ FCNR-B/ EEFC/ RFC and other similar deposit accounts and take a note of relevant major adverse comments. In case adverse features are observed to persist at the branch or where no remedial action has been initiated or taken by the branch management, he should report the same.

2. *Whether the Branch has followed the instructions and guidelines of the controlling authorities of the bank with regard to the following in relation to the foreign exchange and, if not, state the irregularities.*
 - (a) *deposits*
 - (b) *advances*
 - (c) *export bills*
 - (d) *bills for collection*
 - (e) *dealing room operations (where a branch has one)*
 - (f) *any other area*

1.100 The auditor also has to make himself familiar with the relevant aspects of the Exchange Control Manual and its compliance. The auditor

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should verify whether the instruction and guidelines of the controlling authorities of the bank in relation to the foreign exchange have been followed by the branch in respect of these areas. If any irregularity is observed the same should be reported with details.

3. *Obtain a list of all NOSTRO Accounts maintained/ operated by the Branch from the branch management.*

1.101 The auditor should obtain a list of all NOSTRO Accounts for the purpose of verification from the branch management.

(a) *Are the NOSTRO Accounts regularly operated?*

1.102 The auditor should verify whether the NOSTRO Accounts are being regularly operated. If not give the list of NOSTRO Accounts with balances outstanding, which are not operated regularly, the date of last transaction, etc. The auditor should specifically comment on overdrafts in Nostro accounts, if any.

(b) *Are periodic balance confirmations obtained from all concerned overseas branches/ correspondents?*

1.103 The auditor should verify whether the balance confirmation from all concerned overseas branches/ correspondents have been obtained on a periodic basis. He should report the names of the bank and the period wise outstanding balances, which remain unconfirmed.

(c) *Are these accounts duly reconciled periodically? Your observations on the reconciliation may be reported.*

1.104 While examining the transaction in foreign exchange, the auditor should also pay attention to reconciliation of NOSTRO Accounts with the respective minor account. The amount in the NOSTRO account is stock of foreign currency in the form of bank accounts with the overseas branches and correspondents. Un-reconciled NOSTRO Accounts, on an examination, may reveal unauthorised payments from the foreign currency account, unauthorised withdrawals, and unauthorised debit to minor account. The auditor should also evaluate the internal control with regard to inward/outward messages. The inward/outward messages should be properly authenticated and discrepancies noticed should be properly dealt with in the books of accounts. In case balance confirmation certificate have been received but the same have not been reconciled, the auditor should report, in respect of each bank, the balances as per books maintained by the branch and the balance as per the relevant balances confirmation certificate, stating in either case whether the balance is debit or credit.

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4. *Does the Branch follow the prescribed procedures in relation to maintenance of Vostro Accounts?*

1.105 The auditor should verify whether prescribed procedure in relation to inter bank confirmation in the Vostro account is followed or not. In case balance confirmation certificate have been received but the same have not been reconciled, or where confirmation has not been received the same should be reported, in respect of each Vostro Account. The RBI has also issued the Master circular on “Memorandum of Instructions for Opening and Maintenance of Rupee/Foreign Currency Vostro Accounts of Non-resident Exchange Houses” No. 4/2013-14 dated July 1, 2013.

For branches dealing in very large advances, such as, Corporate Banking Branches and Industrial Finance Branches or branches with advances in excess of Rs. 100 crores

1. *In respect of borrowers with outstanding of Rs. 2 crores and above, the information in the enclosed format should be obtained from the Branch Management. Comments of the Branch Auditor on advances with significant adverse features and which might need the attention of the Management/Central Statutory Auditors should be appended to the Long Form Audit Report.*

1.106 The branch auditor should obtain details and other information, in respect of all advances, which are in excess of Rs.2 Crores, which would be relevant to complete the enclosed format from branch manager.

1.107 Any advances account with significant adverse features like, non-operative for quite a long time, renewed without adequate credit appraisal, fresh advances granted without obtaining necessary approval, etc., on which branch auditor has commented and which is of such a nature that central statutory auditor is required to consider it for qualifying and/or disclosing in main report, should be attached as an annexure to LFAR.

2. *What, in your opinion, are the major shortcomings in credit appraisal, monitoring, etc.?*

1.108 Major shortcomings in credit appraisal will have to be disclosed in the LFAR which could either be stated on the face of the report or could be reference to an annexure. Examples of major shortcomings in credit appraisal are stated below:

- Loan application not on record at Branch.
- The appraisal form was not filled up correctly and thereby the appraisal and assessment was not done properly.

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- Loan application is not in the form prescribed by Head Office.
 - The Bank did not receive certain necessary documents and annexures required with the application form.
 - Basic documents such as Memorandum and Articles of Association, Partnership deed, etc., which are pre-requisite to determine the status of the borrower have not been obtained.
 - Certain adverse features of the borrower not incorporated in the appraisal note forwarded to the management.
 - Industry/ group exposure and past experience of the Bank is not dealt in the appraisal note sent to the management for sanction.
 - The level for inventory/ book-debts/ creditors for finding out the working capital is not properly assessed.
 - Techno-economic feasibility report, which is required to know the technical aspects of the borrower's business, is not obtained from Technical Cell.
 - Credit report on principal borrowers and confidential report from their banks are not insisted from the borrowers.
 - The opinion reports of the associate and/or sister concerns of the borrower are not scrutinised/ called for/ not updated/ not satisfactory.
 - The procedure/ instructions of Head Office regarding preparation of proposals for grant or proposals for renewal of advances or proposals for enhancement of limits, etc., are not followed.
 - No exposure limits are fixed for forward contract for foreign exchange sales/ purchase transactions.
 - No adequate security obtained/ charge created.
 - The director/borrower's names do not appear in RBI/CIBIL defaulters list.
3. *List the accounts (with outstanding in excess of Rs.1 crore), which have either been downgraded or upgraded with regard to their classification as Non Performing Asset or Standard Asset during the year and the reasons therefore.*

1.109 For advance accounts where outstanding balance is in excess of Rs. 1 crore and which have been re-classified from non-performing asset to standard asset or *vice-a-versa*, the list will have to be attached to the report specifying the reasons with brief explanations for such re-classification.

For branches dealing in recovery of Non Performing Assets such as Asset Recovery Management Branches

1. *In respect of every advance account in excess of Rs. 2 crores, the*

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information in the enclosed format should be obtained from the Branch Management. Comments of the Branch Auditor on advances with significant adverse features and which might need the attention of the Management/Central Statutory Auditors should be appended to the Long Form Audit Report.

1.110 The Branch auditor should obtain details and other information, in respect of all advances, which are in excess of Rs. 2 crores, which would be relevant to complete the format (given in the Annexure) obtained from branch management.

1.111 Any advances account with significant adverse features like, non-operative for quite a long time, renewed without adequate credit appraisal, fresh advances granted without obtaining necessary approval, etc., on which branch auditor has commented and which is of such a nature that attention of central statutory auditor requires to consider it for qualifying and/ or disclosing in main report, should be attached as an annexure to LFAR.

2. *List the accounts (with outstanding in excess of Rs. 2 crores), which have been upgraded from Non Performing to Standard Assets during the year and the reasons therefor.*

1.112 For advance accounts where outstanding balance are in excess of Rs. 2 crores which have been reclassified from Non Performing Assets to Standard Assets, the list will have to be attached to the report specifying the reasons with brief explanations for such re-classification.

3. *Whether the Branch has a system of updating periodically, the information relating to the valuation of security charged to the bank?*

1.113 The branch auditor should enquire as to the existence of the system, if any, pertaining to the valuation of security charged to the bank. If the system is in existence, the auditor should examine whether the system periodically updates the information pertaining to the value of such security and takes necessary steps for increase/diminution in the value of such security.

4. *Age-wise analysis of the recovery, suits-filed and pending may be furnished.*

1.114 Age-wise analysis of the recovery suits filed and pending should be given along with the current status of each recovery suit.

5. *Is the Branch prompt in ensuring execution of decrees obtained for recovery from the defaulting borrowers? Also list the time-barred decrees, if any, and reasons therefor.*

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1.115 In case decrees have been obtained for recovery from the defaulting borrowers, the auditor should check whether the branch is prompt in execution of decrees like, drawings from the account and payment from these accounts have been stopped. If not, the same should be reported. The list should be given in the case of time barred decrees with the reasons therefor.

6. *List the recoveries and their appropriation against the interest and the principal and the accounts settled/ written off/ closed during the year.*

1.116 A list will have to be annexed which will specify the non-performing advances recovered and the amounts adjusted towards interest and principal. A list of the accounts settled, written closed, if any, will also have to be attached. The auditor should satisfy himself whether the recoveries appropriated against interest are in accordance with the RBI guidelines and normal accounting principles.

7. *List the new borrower accounts transferred to the Branch during the year. Have all the relevant documents and records relating to these borrower accounts been transferred to the Branch? Has the Branch obtained confirmation that all the accounts of the borrower (including non-fund based exposures and deposits pending adjustment/ margin deposits) been transferred to the Branch?*

1.117 A list of new borrower accounts transferred to the branch from the other branches during the year should be annexed. The auditor should verify whether the documents and records relating to the transferred accounts have been obtained like, letter from the transferor branch, detail of the accounts, etc. The branch should also obtain a confirmation that all the accounts of the borrower (including non-fund based exposures and deposits pending adjustment/ margin deposits) have been transferred to the branch. In case any adverse features have been observed in such transfer, the same should be reported.

For branches dealing in Clearing House Operations, normally referred to as Service Branches

1. *Does the branch have a system of periodic review of the outstanding entries in clearing adjustments accounts? In your view has the system generally been complied with?*

1.118 The auditor should verify whether the branch is having system of periodic review of the outstanding entries in clearing adjustments accounts. On a test check, auditor should verify whether the system, generally, has been complied with.

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2. *Whether review of the clearing adjustments accounts (inwards/outwards) reveals any old/ large/ unusual outstanding entries, which remain unexplained? Give year-wise break-up of outstanding in number and value:*

1.119 If the review of clearing adjustments accounts (inwards/outwards) reveals any old/large/unusual outstanding entries, which remain unexplained, the auditor should report the same. Year-wise break up should be given of outstanding clearing in number and value in the following format.

- Inward Clearing

	Number	Value
Normal Clearings		
High Value Clearings		
Inter-Branch Clearings		
National Clearings		
Returned/ Dishonored Clearings		

- Outward Clearing

	Number	Value
Normal Clearings		
High Value Clearings		
Inter-Branch Clearings		
National Clearings		
Returned/ Dishonored Clearings		

3. *Has the Branch strictly followed the guidelines of the controlling authority of the bank with respect to operations related to clearing transactions? Comment on the systems and procedures followed by the Branch in this regard.*

1.120 Auditor should verify whether the guidelines of the controlling authority of the bank with respect to operations related to clearing transactions has been strictly followed. In case the same has not been followed, the auditor should report the same. The auditor should report on the system and procedures followed by the branch in this regard.

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Annexure

LFAR (For Large/ Irregular/ Critical Advance Accounts)

(To be obtained from the branch management by the Branch Auditors of branches dealing in large advances/ asset recovery branches)

1. Name of the Borrower
2. Address
3. Constitution
4. Nature of business/ activity
5. Other units in the same group
6. Total exposure of the branch to the Group+
Fund Based (Rs. in lakhs)
Non-Fund Based (Rs. in lakhs)
7. Name of Proprietor/ Partners/ Directors
8. Name of the Chief Executive, if any
9. Asset Classification by the Branch
(a) during the current year
(b) during the previous year
10. Asset Classification by the Branch Auditor
(a) during the current year
(b) during the previous year
11. Are there any adverse features pointed out in relation to asset classification by the Reserve Bank of India Inspection or any other audit.
12. Date on which the asset was first Classified as NPA (where applicable)

Facilities sanctioned:

Date of Sanction	Nature of facilities	Limit (Rs. in Lakhs)	Prime Security	Collateral Security	Margin %	Balance outstanding at the year-end	
						Current Year	Previous Year

Provision made: Rs. _____ lakhs

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13. Whether the advance is a consortium advance or an advance made on multiple-bank basis.
14. If Consortium,-
- (a) names of participating banks with their respective shares
 - (b) name of the Lead Bank in Consortium
15. If on multiple banking basis, names of other banks and evidence thereof.
16. Has the Branch classified the advance under the Credit Rating norms in accordance with the guidelines of the controlling authorities of the Bank.
17. (a) Details of verification of primary security and evidence thereof;
- (b) Details of valuation and evidence thereof

Date verified	Nature of Security	Value	Valued by
Insured for Rs. _____ lakhs (expiring on _____)			

18. (a) Details of verification of collateral security and evidence thereof
- (b) Details of valuation and evidence thereof

Date verified	Nature of Security	Value	Valued by
Insured for Rs. _____ lakhs (expiring on _____)			

19. Give details of the Guarantee in respect of the advance
- (a) Central Government Guarantee;
 - (b) State Government Guarantee;
 - (c) Bank Guarantee or Financial Institution Guarantee;
 - (d) Other Guarantee

Provide the date and value of the Guarantee in respect of the above.

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20. Compliance with the terms and conditions of the sanction

Terms and Conditions	Compliance
(i) Primary Security a) Charge on primary security b) Mortgage of fixed assets c) Registration of charges with Registrar of Companies d) Insurance with date of validity of Policy	
(ii) Collateral Security a) Charge on collateral security b) Mortgage of fixed assets c) Registration of charges with Registrar of Companies d) Insurance with date of validity of policy	
(iii) Guarantees - Existence and execution of valid guarantees	
(iv) Asset coverage to the branch based upon the arrangement (i.e., consortium or multiple-bank basis)	
(v) Others: a) Submission of Stock Statements/ Quarterly Information Statements and other Information Statements b) Last inspection of the unit by the Branch officials: Give the date and details of errors/ omissions noticed c) In case of consortium advances, whether copies of documents executed by the company favouring the consortium are available. d) Any other area of non compliance with the terms and conditions of sanction	

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21. Key financial indicators for the last two years and projections for the current year (Rs. in lakhs)

Indicators	Audited year ended 31 st March____	Audited year ended 31 st March____	Estimates for year ended 31 st March ____
Turnover			
Increase in turnover % over previous year			
Profit before depreciation, interest and tax Less: Interest Net Cash Profit before tax Less: Depreciation Less: Tax Net Profit after Depreciation and Tax			
Net Profit to Turnover Ratio			
Capital (Paid-up)			
Reserves			
Net Worth			
Turnover to Capital Employed Ratio (The term "Capital Employed" means the sum of Net Worth and Long Term Liabilities)			
Current Ratio			
Stock Turnover Ratio			
Total Outstanding Liabilities/Total Net Worth Ratio			
In case of listed			

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companies, Market Value of Shares (a) High; (b) Low; and (c) Closing			
Earnings Per Share			
Whether the accounts were audited? If yes, upto what date; and are there any audit qualifications			

22. Observations on the operations in the account:

	Excess over drawing power	Excess over limit
1. No. of occasions on which the Balance exceeded the drawing power/ sanctioned limit (give details)		
Reasons for excess drawings, if any		
Whether excess drawings were reported to the Controlling Authority and approved		

	Debit Summation (Rs. in Lakhs)	Credit Summation (Rs. in Lakhs)
2. Total summation in the account during the year Less: Interest Balance		

23. Adverse observations in other audit reports/ Inspection Reports/ Concurrent Auditor's Report/ Internal Audit Report/ Stock Audit Report/ Special Audit Report or Reserve Bank of India Inspection with regard to:

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- (i) Documentation; (ii) Operations;
- (iii) Security/Guarantee; and (iv) Others.

24. Branch Manager's overview of the account and its operation.

25. (a) In case the borrower has been identified/ classified as Non-performing Asset during the year, whether any unrealised income including income accrued in the previous year has been accounted as income, contrary to the Income Recognition Norms.

(b) Whether any action has been initiated towards recovery in respect of accounts identified/ classified as Non-performing Assets.

Date:

Signature and Seal of Branch-in-Charge

IV-2

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2.01 The statutory auditors should address their LFAR to the Chairman of the bank concerned and also a copy thereof should be forwarded to the designated office of the RBI. Many of the matters to be dealt with by the statutory auditors in their LFARs are, normally, based on the LFARs received from the branch auditors. In dealing with such matters, the statutory auditors are expected to make their observations on the basis of review of branch auditors' LFARs.

2.02 Where any of the comments made by the auditor in his LFAR is adverse, the statutory central auditor should consider whether a qualification in his main report is necessary. It should not, however, be assumed that every adverse comment in the LFAR would necessarily result in a qualification in the main audit report. In deciding whether a qualification in the main report is necessary, the auditor should use his professional judgement having regard to the facts and circumstances of each case.

2.03 Where the auditors have any reservation or adverse remarks with regard to any of the matters to be dealt with in their LFARs, they should give the reasons for the same.

2.04 The matters to be dealt with by the statutory auditors in their LFARs are discussed in the following paragraphs.

I. Advances

2.05 Lending activities constitute an important part of a bank's operations. The statutory auditors are expected to offer their comments on various aspects of lending activities in their LFARs. The format of LFAR requires the statutory auditors to offer their comments on the following aspects:

(a) Loan policy	(e) Review/monitoring/ supervision
(b) Credit appraisal	(f) Bad/doubtful advances
(c) Sanctioning/ disbursement	(g) Large advances
(d) Documentation	

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2.06 The statutory auditors are expected to offer their comments on the adequacy and effectiveness of the internal control systems relating to the above aspects of credit administration. In order to form an opinion on these matters, the statutory auditors would also need to consider the branch auditors' LFARs. In cases where sanctions are accorded otherwise than at the branch level (i.e., by higher/controlling authorities), the auditors should carry out, on a selective basis, an examination of the specified matters at the head office and/or other controlling offices of the bank.

2.07 Every bank usually has a written manual of instructions which describes in detail the procedures to be followed for executing various types of transactions and also lays down limits on delegated powers in respect of various operations of the bank. The auditor should examine such manual of instructions and report his views as to the adequacy of the relevant instructions in the LFAR.

2.08 Further, as per the "Master Circular – Loans and Advances – Statutory and Other Restrictions" dated July 1, 2013, DBOD.No.Dir.BC.14/13.03.00/2013-14 issued by the RBI, all banks are required to frame "Fair Practices Code for Lenders" based on the Guidelines contained in the Master Circular. The Fair Practices Code Covers areas, such as, applications for loans and their processing, loan appraisal and terms/conditions, disbursement of loans including changes in terms and conditions, post disbursement supervision, general aspects, etc. Further, the RBI vide its circular no. DBOD. Leg. BC. 61 /09.07.005/2010-11 dated November 12, 2010 on "Guidelines on Fair Practices Code for Lenders – Disclosing all information relating to processing fees / charges" requires the banks to disclose 'all in cost' inclusive of all such charges involved in processing / sanction of loan application in a transparent manner to enable the customer to compare the rates / charges with other sources of finance. It should also be ensured that such charges / fees are non-discriminatory.

Loan Policy

2.09 In respect of loan policy, the auditor is expected to give his observations on –

- *Existence of Loan Policy – specifying the prudential exposure norms, industry-wise exposures, regular updation of the policy, system of monitoring and adherence thereto.*

2.10 Each bank has its own policy for sanctioning, disbursing, supervising and renewing loans. The policy usually includes the terms and conditions for granting loans, limits upto which loans may be disbursed to individual clients,

industry wise exposure, i.e., different exposure limits for different industries, etc. The policy should specifically include the prudential norms given by the RBI. The auditor should report whether the policy is in existence and the same is regularly updated depending on the guidelines issued by the RBI. The Master Circular on “Loans and Advances – Statutory and other Restrictions” DBOD.No.Dir.BC.14/13.03.00/2013-14) dated July 1, 2013, provides a framework of the rules/ regulations/ instructions issued to Banks on statutory and other restrictions on loans and advances. The Master Circular on “Lending to Micro, Small & Medium Enterprises (MSME) Sector” RPCD.MSME & NFS. BC. No. 5/06.02.31/2013-14 dated July 1, 2013, contains guidelines/ instructions/ directives issued by the RBI to banks in regard to matters relating to lending to Micro, Small & Medium Enterprises sector. The auditor should also enquire whether there is any system followed by the bank for regularly monitoring the policy laid down by the bank.

Credit Appraisal

2.11 In respect of credit appraisal, the auditor is expected to give his observations on –

- *Existence of a well-laid system of appraisal of loans/credit proposals, including adequacy of information for appraising the creditworthiness of the applicant, and adherence thereto.*

2.12 Credit appraisals require a detailed analysis of the borrower’s or, counterparties financial position and debt-servicing ability, a thorough understanding of their background and the purpose of the credit and an evaluation of the collateral pledged, if any. The auditor should review the system of credit appraisal followed by the bank. He should examine whether the system facilitates a proper evaluation of the credit risk. In order to facilitate collection and analysis of all the relevant data for evaluating creditworthiness of a prospective borrower, banks generally use standardised loan application forms. The factors considered in evaluating loan applications normally include the purpose of loan, prospects of the business, the sources and period of repayment (in case of term loans), the borrower’s stake and security, etc. Further, information in the form of financial statements, costing analyses, market information, tax status, project reports (in case of new projects), etc., is also usually obtained from prospective borrowers and analysed.

2.13 The auditor should also satisfy himself that the system of credit appraisal is actually in force. For this purpose, he should review the relevant observations of the bank’s branch auditors contained in their LFARs. Where the

auditor has serious reservations about the quality of credit appraisal, he may also give his observations in this regard.

Sanctioning/Disbursement

2.14 In respect of sanctioning/disbursement of advances, the auditor is expected to comment on –

- *Delegation of powers/authority at various levels; adherence to authorised limits; whether limits are disbursed after complying with the terms and conditions of sanction.*

2.15 The auditor should familiarise himself with the system of sanctioning and disbursement of advances. He should also familiarise himself with the relevant directives of RBI. Normally, the system in a bank provides for limits on the sanctioning powers of authorities at various levels. The auditor should examine the documents prescribing such limits, e.g., operation manual, circulars from head office, etc. Where the branch auditors' reports indicate cases of credit facilities sanctioned beyond the aforesaid limits, the auditor should draw attention to this fact in his LFAR. The auditor should also examine the branch auditors' report to ascertain whether such cases have been promptly reported to higher authorities as per the procedure laid down in this regard. If not, he should report the fact, giving illustrations of non-compliance with the laid down procedure in his LFAR.

2.16 The auditor should also review the sanctions made at different levels. For this purpose, the auditor should randomly select a sample of sanctions made at various levels and review whether the procedure laid down for the concerned level has been followed. Where the auditor has serious reservations about any of the aspects thereof, he should give his observations in this regard in his LFAR. Where the branch auditors' reports indicate cases where limits have been disbursed without complying with the terms and conditions of the relevant sanctions or cases of frequent overdrawing beyond sanctioned limits, the auditor should state this fact in his LFAR, giving illustrations.

Documentation

2.17 The auditor is expected to comment on the following aspects of documentation in respect of advances:

- *System of ensuring that documents are executed as per the terms of sanction.*
- *Nature of documentation defects observed during audit and suggestions to avoid such defects.*

- *System of documentation in respect of joint/consortium advances.*
- *Renewal of documents.*

2.18 Generally, the system of a bank prescribes the specific documents to be executed in respect of various types of credit facilities, including special documentation required in cases of consortium advances, advances to companies, statutory corporations and government undertakings, etc. It may be noted that in case of consortium advances, original documents are held by the lead bank, however, copies of such documents are available with each of the participating banks. Banks also usually have a system of renewal of documents and of periodically obtaining confirmation of balances to ensure that the documents do not become time-barred.

2.19 The auditor should review the system of obtaining the loan documents, including renewal thereof. He should examine whether the system provides for obtaining all such loan documents which are required to protect the interests of the bank.

2.20 Where the branch auditors' reports indicate cases of credit facilities accorded without proper documentation, the auditor should state this fact in his report, giving illustrations.

2.21 The auditor is also required to comment on the nature of documentation defects observed during the audit and to make suggestions to avoid such defects. The auditor can obtain the relevant information substantially from the branch audit reports and from records maintained at the head office/regional or zonal offices of the bank.

Review/ Monitoring/ Supervision

2.22 In respect of review, monitoring and supervision of advances, the auditor is required to comment on the following aspects:

- Periodic balance confirmation/ acknowledgement of debts.
- Receiving regular information, Stock/Book Debt statements, Balance Sheet, etc.
- Receiving audited accounts in case of borrowers with limits beyond Rs.10 lakhs.
- System of scrutiny of the above information and follow-up by the bank.
- System of periodic physical verification or inspection of stocks, equipment and machineries and other securities.

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- System and periodicity of stock audits.
- Inspection reports and their follow-up.
- Norms and awarding of Credit Rating.
- Review/renewal of advances including enhancement of limits.
- Monitoring and follow-up of overdues arising out of other businesses such as leasing, hire purchase, credit cards, etc.
- Overall monitoring of advances through maturity/ aging analyses; Industry-wise exposures and adherence to the Loan Policy.
- System of monitoring of off-balance sheet exposures including periodic reviews of:
 - (a) claims against the bank not acknowledged as debts
 - (b) letters of credit
 - (c) guarantees
 - (d) ready forward transactions
 - (e) co-acceptances
 - (f) swaps, etc.
- The auditor should examine whether the internal credit rating system has linkage with pricing of advances with various products.

2.23 Generally, banks have a system of periodic review of each advance. The primary purpose of such a review is to ensure that the assumptions on the basis of which the loan had been sanctioned continues to hold good; the loan is used for the purpose for which it was sanctioned and in case of deviation in respect of any aspect of the sanction, approval of appropriate authority has been obtained; the project has been implemented as per the approved lines; there are no unexplained overruns in cost of the project; the borrowing unit is functioning properly; the stipulated installments/interest are being paid regularly and promptly and, in case of default or delay in payment, the reasons are looked into; the terms and conditions of the loan, particularly restrictive covenants, are being duly complied with; the required margins have been maintained in the account at all times; the properties mortgaged/hypothecated/ pledged are maintained in good order by the borrower and adequately insured, etc. The auditor should examine whether the system of periodic review is functioning effectively. He should review the LFARs given by the branch auditors to identify any weaknesses in the design of the system and in its implementation.

2.24 The auditor should examine whether there is an effective system of obtaining confirmations/ acknowledgement of debts periodically. For this purpose, the auditors should also review the branch audit reports.

2.25 The RBI has issued a circular (dated April 12, 1985) advising all scheduled banks to ensure that non-corporate borrowers enjoying aggregate working capital limit of Rs.10 lakhs or more from the banking system get their accounts audited by chartered accountants in the prescribed manner. The auditor is expected to report on compliance with this requirement in case of sanction or renewal of limits, primarily on the basis of a review of branch audit reports. The auditor should report the number of branches and the total number of accounts in respect of which audited accounts have not been placed on record.

2.26 The auditor is also expected to comment on the effectiveness of system of physical verification or inspection of stocks, machineries and such other securities which have been charged to the bank. The auditor's comments will be based primarily on a review of branch audit reports.

2.27 In 1985, the RBI advised banks to introduce a comprehensive and uniform Health Code System indicating the quality or health of individual advances. At present the health code system is not in operation.

2.28 However, in the wake of the introduction of guidelines for income recognition, assets classification and provisioning vide RBI's Circular No. DBOD.BP.BC.129/ 21.04.043-92 dated April 27, 1992, the RBI reviewed the need to continue to require the classification of advances as per the Health Code System. Based on the review, the RBI made the continuance of the Health Code System discretionary for banks. The Master Circular on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances" (DBOD.No.BP.BC.1/21.04.048/2013-14) dated July 1, 2013 lays down that "With the introduction of prudential norms, the Health-Code based system for classification of advances has ceased to be a subject of supervisory interest. As such, all related reporting requirements, etc., under the Health Code System also cease to be a supervisory requirement. Banks may, however, continue the system at their discretion as a management information tool".

2.29 The auditor should examine whether the bank has continued to classify the advances as per the Health Code System. If so, the auditor should familiarise himself with the procedure followed by the bank for classifying advances as per the Health Code System. Any defects or inadequacies in the procedure should be dealt with in the report along with recommendations/ suggestions for improvement or for remedial action to be taken on the existing procedure by the management. The auditor should also review whether the classification of advances as per the Health Code System has been made on the basis of a realistic assessment. Where, in the opinion of the auditor, the classification

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should have been different from that made by the bank, he should report the same.

2.30 Where the bank has discontinued the Health Code System the auditor should state this fact.

2.31 The auditor may review the statistical and analytical reports on advances which are often placed for information before the Board of Directors or submitted to the RBI. Based on this data, the Board assesses the bank's exposure to various industries. The auditor is expected to comment on the effectiveness of such reporting system in vogue in the bank.

2.32 Generally, banks have a system of periodic review of credit rating awarded to various clients. The purpose is to review whether the rating which had been awarded to a particular client continues to hold good as per the norms or whether a review of the credit rating was required. The auditor should examine whether the system of periodic review is functioning effectively as per the norms fixed by the bank. He should review the LFARs given by the branch auditors to identify whether the norms for credit rating are being followed consistently. Where the branch auditors have pointed out any weaknesses in the review/monitoring/supervision of such norms, the auditor should, if the weaknesses are material, comment and find out the impact.

2.33 Apart from conducting the normal banking business, banks also undertakes other activities like, leasing, hire purchase, etc. The auditor should examine whether the bank has a system for monitoring the overdue arising out of this business. The auditor should also examine whether for the purpose of overdue, regular follow-up is done with the customers from which the funds are due.

Recovery Policy in Respect of Bad/Doubtful Debts/ NPAs

2.34 The auditor is expected to report on the following aspects of the recovery period:

- *Existence of a recovery policy; regular updation thereof; monitoring and adherence thereto; compliance with the RBI guidelines.*
- *System of monitoring of recovery from credit card dues in respect of credit cards issued.*
- *Effectiveness of the system for compiling data relating to the bad and doubtful debts and the provision in respect thereof.*
- *System for identification, quantification and adequacy of provision (including that at foreign branches).*
- *System for suspension of charging of interest and adherence thereto.*

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- *Ascertaining the realisable value of securities (including valuation of fixed assets) and the possible realisation from guarantors including DICGCI/ ECGC/CGST.*
- *Assessment of the efficacy of rehabilitation programmes.*
- *Method of appropriation of recoveries against principal, interest, etc.*
- *System of compromise/ settlement. Review such cases and cases of recovery of over Rs.1.00 crore and also the cases wherein limit of sacrifices laid down in the Recovery Policy is exceeded. Compliance with RBI guidelines.*
- *Provision/write-offs under proper authority.*
- *Recovery procedures including those relating to suit filed and decreed accounts.*
- *System of identifying and reporting of willful defaulters.*

2.35 The Bank should have a policy for recovery of the bad and doubtful debts and NPAs. The auditor should examine whether the policy framed complies with the RBI guidelines and also that the same policy is followed by the branches. The policy should be regularly monitored and updated keeping in view the RBI guidelines where the bank gives credit to its customers by way of credit card also, the auditor should examine whether proper procedure is adopted to recover the credit card dues. The RBI has issued a Master Circular on "Credit Card, Debit Card and Rupee Denominated Cobranded Prepaid Card Operations of Banks" (DBOD.No.FSD.BC. 4/ 24.01.011/ 2013-14) dated July 1, 2013. The circular provides general guidelines to banks on their credit card operations, and the systems and control expected of them in managing their credit card business.

2.36 The RBI has issued detailed guidelines for income recognition, asset classification, provisioning and other related matters (*Master Circular on "Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances (DBOD.No.BP.BC.1/21.04.048/2013-14) dated July 1, 2013*). Under the guidelines, the quantum of provision as also the charging of interest is dependent upon the classification of advances into performing or non-performing. The non-performing advances are required to be further classified into sub-standard, doubtful and loss assets. The auditor should satisfy himself that there exists a system of ensuring correct classification of advances as per the RBI guidelines. For this purpose, the auditor should review the adequacy and appropriateness of the instructions issued to the branches.

2.37 According to the aforesaid guidelines, income from Non-performing Advances (NPAs) is not recognised on accrual basis but is booked as income only when it is actually received. However, interest 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. As a measure of control and also to ensure that the legal remedies against defaulting borrowers are not adversely affected, banks normally follow the procedure of recording interest on non-performing advances in a separate account styled as 'Interest Suspense' or maintaining only a record of such interest in proforma accounts. It may be noted that the amounts held in Interest Suspense Account (or other similar account) cannot be reckoned as part of provision in respect of non-performing advances. Amounts lying in Interest Suspense Account are to be deducted from the relevant advances, and provisions (as required by the RBI norms) is to be made on the balances after such deduction.

2.38 The auditor should enquire into the procedure followed by the bank for recording interest on non-performing advances. Any departures from the laid down procedure which comes to the auditor's attention should be reported. The auditor should also comment on the increase/ decrease during the year in the aggregate balance held in Interest Suspense Account.

2.39 Realisable value of securities is relevant in determining provisioning against doubtful debts. Therefore, the auditor should examine whether there is a system of having realistic estimates of the value of security available, such as immovable properties, plant and machinery and stocks. The availability of security or net worth of borrower/guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise, as income recognition is based on record of recovery.

2.40 Every bank usually has a procedure for the write-off of bad debts, including the limits on authority to deal with/approve such write-offs. These limits are normally sanctioned by the Board of Directors or other similar authority. The auditor should examine the relevant procedure as also whether the provisions/write-off conform to the laid down procedures.

2.41 At times, the management may opt for one-time settlement or an out-of-court settlement with the defaulting borrowers on agreed stipulations as to down payment and installment over a period. The auditor should verify the authority for write-off, if any, arising out of such settlement and the system for proper accounting thereof.

2.42 As regards advances to sick units which are under rehabilitation programmes, the auditor should examine whether the bank has adhered to the broad parameters for grant of relief/ concessions as per the RBI guidelines. The auditor should examine the efficacy of rehabilitation programs by comparing the actual performance with the estimates contained in the rehabilitation programme.

On the basis of such assessment, the auditor should examine whether any further provision is required in respect of the units concerned. In this regard, it may be pointed out that the Guidelines require that provision should continue to be made in respect of the dues to a bank in respect of existing credit facilities sanctioned to a unit under rehabilitation, as per their classification as sub-standard or doubtful asset. 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. Further, in respect of additional credit facilities granted to SSI units which are identified as sick and where rehabilitation packages/nursing programs have been drawn by the bank themselves or under consortium arrangements, no provision need to be made for a period of one year.

2.43 The auditor is also expected to comment on the efficacy of the procedure for recovery of bad/doubtful advances, including that relating to suit-filed and decreed accounts. The auditor can get the relevant information from the branch audit reports and from the records maintained at head office/regional or zonal offices. The auditor should particularly review the efficacy of procedure for recovery in cases where decrees have been obtained in favour of the bank. Where there are significant doubts about the execution of the decrees, the auditor should take this fact into account in determining the adequacy of the provision.

Large Advances

2.44 In respect of large advances, the auditor's responsibility is as under:

- *Comments on adverse features considered significant and which need management's attention.*

2.45 In the normal course of audit, the auditor would obtain from the management a list of problem accounts and discuss the same to determine whether any such account is doubtful of recovery. On the basis of information and explanations provided by the management, the auditor may be satisfied that certain problem accounts need not be considered doubtful of recovery and, therefore, not be provided for beyond the provision required under the guidelines for provisioning issued by the RBI. In respect of such major accounts, the auditor should give relevant details in the LFAR. The details to be given in respect of each such account should include the name of the borrower, the amount outstanding and a brief history and statement of facts. It would be desirable for the auditor to obtain the relevant explanations from the management in writing.

2.46 As regards adverse features in large accounts, the auditor can obtain relevant information substantially from the branch LFARs and from records maintained at the head office/regional or zonal offices. Banks usually have a

system of reporting to the Board on large accounts (e.g., accounts where the borrowings are of Rs 2 crores or 5% of aggregate year-end advances of the branch whichever is lower) where the adverse features have been observed, including accounts which require a review or close monitoring to ensure that they do not become sub-standard or doubtful at a later stage. Unhealthy features in such accounts include frequent over-drawing beyond sanctioned limits, non-furnishing of data relating to security, defaults in furnishing of the information relating to the security charged to the bank, non-registration of charge in the case of companies, default in the matter of various stipulations for borrowings (for example, keeping the security uninsured, accumulation of old/obsolete stocks, etc.), non-renewal of documents, defaults in complying with the repayment schedules, frequent returning of bills in bill-discounting facility, and non-observance of the covenants between the bank and the borrower which may have a significant impact on the realisability of the advance or which may cause detriment to the security charged. The auditor should review the relevant reports submitted to the Board, where available.

2.47 The auditor should indicate the name of the branch, the name of the borrower, the balance as at the year-end and the general nature of adverse features noticed during the year. In case the adverse features have been persistent over a period of time and adverse comments have been made by the previous auditor(s) on these accounts, the same should also be reported.

II. Liquidity and Funds Management

Investments

2.48 The auditor is expected to comment on the following aspects of investments:

- *Existence of investment policy and adherence thereto; compliance with RBI guidelines.*
- *System of purchase and sale of investments; delegation of powers; reporting system; segregation of back office function, etc.*
- *Controls over investments, including periodic verification/ reconciliation of investments with book records.*
- *Valuation mode; changes in mode of valuation compared to previous year; shortfall and provision thereof.*
- *Investments held at foreign branches; valuation mode; regulatory reserve requirements; liquidity.*
- *Composition of investment portfolio as per RBI guidelines and the depreciation on investments, if any, not provided for.*

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- *System relating to unquoted investments in the portfolio and the liquidity of such investments.*
- *System relating to SGL/BRs; control over SGL/BRs outstanding at the year end and their subsequent clearance.*
- *System and periodicity of concurrent and internal audit/ inspection of investment activities; follow up on such reports.*
- *System of recording and accounting of income from investments.*
- *System of monitoring of income accrued and due but not received.*
- *System of monitoring matured investments and their timely encashment.*
- *Average yield on investments.*
- *System related to Repos*

For guidance on above matters refer to Chapter 8 Treasury Operations of Part III.

2.49 The auditor is required to comment whether there exists any investment policy in accordance with RBI guidelines and whether the same has been properly implemented. For that purpose, the auditor should not only familiarise himself with the investment policy of the bank, including broad investment objectives, authorities competent to make investments, procedure to be followed to put through deals, procedure to be followed for obtaining sanction of the appropriate authority, prescribed exposure limits and the system of reporting but also report whether the same is in existence in accordance with the RBI Guidelines and whether the same is being properly implemented. The RBI has issued detailed guidelines concerning investment portfolio of banks (*Master Circular on "Prudential Norms for Classification, Valuation and Operation of Investment portfolio by Banks" DBOD No. BP. BC.8/21.04.141/2013-14 dated July 1, 2013*). These guidelines include instructions in respect of ready forward or buy-back deals, transactions in government securities for which Subsidiary General Ledger (SGL) facility is available, issue of bank receipts (BRs) and related records, internal control system for buying and selling securities, dealings through brokers and uniform accounting for Repo/Non-Repo transactions. The RBI has also issued detailed guidelines in respect of accounting of investments, including their classification under permanent and current categories. The auditor should familiarise himself with these guidelines and examine whether the bank has complied with them.

2.50 The auditor should examine the efficacy of various controls over investments, including the functional separation of various operations, custody of investment scrips, periodic physical verification of investments and reconciliation with book records. Any shortcomings in the prescribed system or non-compliance

with the prescribed system should be reported.

2.51 The auditor should enquire into the mode of valuation of investments and ascertain whether the mode of valuation followed during the year is same as that followed in the previous year. The auditor's reporting requirements include: (a) the mode of valuation of year-end investments, and (b) any change in the mode of valuation of investments as compared to that of the previous year.

2.52 The auditor should ascertain the method followed for recording of the shortfall (depreciation) in the value of investments which is arrived at by comparing the market value of Investments with their book value as at the year end. If bank has not provided for depreciation on investments then the auditor should state the fact.

2.53 While reporting on the shortfall in value as at the year-end, the auditor may give the relevant information separately in respect of various kinds of investments (e.g., government securities, other approved securities, etc.). The manner of arriving at the shortfall in the value of securities should be indicated particularly in the case of non-traded or unquoted securities. Further, the auditor should also verify entries made in "Investment Reserve Account" and proper utilisation of the same, if any.

2.54 The auditor should carefully scrutinize the entire investment portfolio keeping in mind the RBI guidelines and comment whether investment portfolio is as per the RBI guidelines. The auditor should also verify that the accounting methodology for Repo/ Reverse Repo transactions is appropriate and uniform throughout the year. For this purpose, the auditor should thoroughly familiarise himself with the RBI guidelines. A brief discussion of RBI guidelines is already given in chapter 8 Treasury Operations of Part III.

2.55 In case of unquoted investments, reporting requirements of the auditor include:

- *Whether appropriate system is followed for valuation of the unquoted investment in the portfolio. The basis of valuation is different depending on the type of investment.*
- *Whether the unquoted investments are liquid in nature, i.e., they are easily saleable in the open market. This depends on the trend of the sale price, net-worth of the enterprise, the market condition, etc.*

2.56 Amongst internal audit of various areas and departments, internal audit of investment activities is one of the important requirements. While not only the scope and frequency of various types of internal audits in different banks varies,

their form also varies, one of which is concurrent audit. Concurrent audit is to be regarded as bank's early-warning system to ensure timely detection of irregularities and lapses which helps in preventing fraudulent transactions. It also refers to examination of the transactions by an independent person not involved in its documentation. The emphasis is in favour of substantive checking in key areas rather than test checking.

2.57 Auditor is expected to report whether the bank has a proper system of conducting concurrent and internal audit of investment activities either through its own staff or external auditors. The option to consider bank's own staff or external auditors is at the discretion of the individual banks. The auditor is expected to comment on the system in existence. The auditor should also enquire whether the bank has appropriate system for carrying out the inspection of investment activities on a regular basis. The auditor should report whether the bank has undertaken a follow up of the report and implemented relevant suggestions.

2.58 Income from investments includes all income derived from the investment portfolio by way of interest and dividend etc., from subsidiaries and joint ventures abroad/ in India. The bank should have an appropriate system of recording income so that all the incomes which arose from the transaction which took place during the relevant period and pertain to the bank are actually recorded. The auditor should report whether there are no unrecorded incomes and that income is recorded in proper amounts and that it is allocated to the proper period.

2.59 The auditor should report whether there is a proper system for monitoring income accrued and due but not received and whether appropriate steps have been taken by the bank to recover the same.

2.60 The bank should have a system of keeping a track of investments which would mature in the near future so that its encashment can be done as soon as they mature. The auditor is required to report whether investments are encashed on time. The auditor should also report whether the bank has a system of monitoring the matured investment, i.e, the matured investments and depending on the requirement for funds, reinvestment of the same. The funds should be reinvested taking into consideration the risk-return analysis.

2.61 In case of investments held at foreign branches, the auditor should satisfy himself for existence of such investments. The auditor should examine that such investments are as per the rules and regulations set out by the bank and the RBI. Valuation policy of such investment should be on same line as of investments held in India. Such investment should be critically examined from the

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point of view of their liquidity.

2.62 Auditor should find out average yield on investments made by the bank. Such yield should be compared with the previous year as well as with industry norms. In case of investment where average yield is not adequate, such investment should be scrutinized for their continuity.

SLR/CRR Requirements-System of Ensuring Compliance

2.63 The auditor is expected to comment on the following aspects of the system for ensuring compliance with the SLR/CRR requirements:

- *System of compiling weekly DTL position from branches.*
- *Records maintained for the above purpose.*

For guidance on above matters refer to Chapter 8 Treasury Operations of Part III.

Cash

2.64 The auditor is required to comment on cash operations as under:

- *System of monitoring of cash at branches; and management of cash through currency chest operations.*
- *Insurance cover (including insurance for cash in transit).*
- *System and procedure for physical custody of cash.*

2.65 The auditor is supposed to comment whether the bank has an appropriate system of monitoring the cash at the branches. For this purpose, the auditor should ascertain whether the bank has the system of verifying that the norms for cash-holding followed by the branch are the same which are fixed by the bank.

2.66 The cash is normally maintained under joint custody of the branch manager and the cashier. The main key to the safe is with the branch manager while the second and the third keys are with the accountant and/ or cashier. Each branch should maintain the records showing the details of keys and key-holders. Further, the bank should have a system of verifying whether the instructions of the bank in this regard have been complied with consistently throughout the year.

2.67 In the normal course, cash balances are expected to be verified on a daily basis and recorded in the cash book under the signature of the branch manager and another authorised signatory, since cash is under dual charge at the branch level. The auditor should examine whether the bank has a system for

verifying the same. The system should include general scrutiny of the cash book to ascertain whether it is in accordance with the instructions given by the bank, physical verification of cash and agreeing the same with the books maintained, with due authentication of such balances by the authorised signatories. For this purpose, the auditor should review the LFARs of the branches.

2.68 The auditor should examine whether the bank has the system of checking the cash balance at the branches at periodic intervals by the authorised officials of the bank.

2.69 The auditor is also supposed to comment whether the system relating to management of the cash through currency chest operations is appropriate. The currency chest operations are those where the bank holds cash as an agent of RBI. The auditor should report whether the bank has a system of regularly monitoring the currency chest operations. The balances in the chest should be periodically verified by the bank officials.

2.70 The auditor should examine and report on the adequacy of the insurance cover for cash with reference to the cash balance generally carried by the bank. He should also examine whether the insurance policy is in force. The auditor should examine and comment whether the bank has obtained a global insurance policy in respect of cash at all the branches. The auditor is also supposed to report whether the insurance obtained includes the insurance for cash-in-transit.

2.71 The auditor should ensure about the system followed for the physical custody of cash. The system may include as to maintenance of cash will be in joint custody of which two or more officials, verification of the cash balance on daily basis and tallying the same with the books maintained, etc. The system should also include the names of the person who will have the custody of the keys. The auditor should properly examine the system and procedure and report whether the same is appropriate or there are any loopholes.

Call Money Operations

2.72 The auditor is required to make comments on system relating to call money operations as under:

- *System related to inter-bank call money.*

2.73 The auditor should verify that aspects relating to call money operations, viz., prudential limits in respect of outstanding borrowing and lending transactions, reporting requirement, documentation, etc., are adhered to in accordance with the guidelines of RBI Master Circular on "Call-Notice Money

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Market Operations” dated July 1, 2013 (IDMD.PCD. 03/14.01.01/2013-14) Any changes made to the rules and regulation during the year should be scrutinised. Auditor should check that all the above changes are promptly and correctly conveyed to all the branches and whether any branch LFAR contains any negative remarks for the above system.

Asset Liability Management

2.74 Regarding asset liability management, the auditor is expected to make comment on the following aspects:

- *Existence of Policy on Asset – Liability Management and monitoring thereof; compliance with the RBI guidelines.*

Functioning of Asset-Liability Management Committee

2.75 RBI has issued guidelines on ALM system vide circular no BP.BC.8/21.04.098/99 dated February 10, 1999 advising banks to give adequate attention to put in place an effective ALM system. Bank should set up an internal Asset-Liability Committee, headed by CEO/CMD or ED. The Management Committee or any specific Committee of the Board should oversee the implementation of the system and review its functioning periodically. The auditor should ascertain whether the bank has a policy on Asset-Liability Management and whether the same complies with the RBI guidelines. As per the RBI guidelines the ALM process rests on three pillars:

- *ALM Information Systems*
 - Management Information Systems
 - Information availability, accuracy, adequacy and expediency
- *ALM Organisation*
 - Structure and responsibilities
 - Level of top management involvement
- *ALM Process*
 - Risk parameters
 - Risk identification
 - Risk measurement
 - Risk management
 - Risk policies and tolerance level

The auditor should also report whether the ALM policy is regularly monitored.

2.76 As per the circular No.BP.BC.8/21.04.098/99 dated February 10, 1999

Asset Liability Management Committee consists of the bank's senior management including CEO. This committee should be responsible for ensuring adherence to the limits set by the Board as well as deciding the business strategy of the bank (on the asset-liability sides) in line with the bank's budget and decided risks, management objectives. As per the circular, each bank is supposed to decide on the role of its Asset Liability Committee, its responsibility as also the decisions to be taken by it. The auditor should examine and report whether the committee is functioning as per the decisions formed by the bank. The functioning of the committee should be useful and helpful to the Bank.

- *Structural liquidity at periodical intervals.*

2.77 The final guidelines issued in circular no BP.BC.8/21.04.098/99 dated February 10, 1999 suggest the bank to prepare Statements of Structural Liquidity by placing all cash inflows and outflows in the maturity ladder according to expected timing of cash flows. As a measure of liquidity banks are required to monitor their cumulative mismatches across all time buckets in their Statement of Structural Liquidity by establishing internal prudential limits with the approval of the Board/ Management Committee. As per the guidelines, the mismatches (negative gap) during the time buckets of 1-14 days and 15-28 days in the normal course, are not to exceed 20% of the cash outflows in the respective time buckets. The RBI has issued "Guidelines on Asset-Liability Management (ALM) system – amendments" (DBOD. No. BP.BC. 38/21.04.098/2007-08) dated October 24, 2007 wherein the time buckets for preparation of Statement of Structural Liquidity has been revised. The banks are required to adopt a more granular approach to measurement of liquidity risk by splitting the first time bucket in to three time buckets viz., next day, 2-7 days and 8-14 days. Accordingly, format of Statement of Structural Liquidity has been revised and also guidance for slotting the future cash flows of banks in the revised time buckets has also been suitably modified. However, the frequency of supervisory reporting of the Structural Liquidity position shall be fortnightly, with effect from the fortnight beginning April 1, 2008. In this regard, RBI, vide its circular on "Guidelines on Asset Liability Management (ALM) System (DBOD.No.BP.BC.68/21.04.098/2007-08 dated April 9, 2008), has advised banks to submit the Statement of Structural Liquidity as on the first and third Wednesday of every month to RBI. The auditor is required to report whether the bank is preparing the Statement on Structural Liquidity at the prescribed periodical intervals.

III. Internal Control

2.78 The auditor is expected to comment on the following aspects of internal control:

- *Written guidelines/instructions/manual for accounting aspects.*
- *Balancing of Books/Reconciliation of control and subsidiary records*
- *Inter-branch Reconciliation*
- *Branch Inspections*
- *Frauds/Vigilance*
- *Suspense Accounts, Sundry Deposits, etc.*

Written Guidelines/Instructions/Manual for Accounting Aspects

2.79 Generally, every bank has a written guidelines/manual/ instructions, which describes in detail, the procedures to be followed for executing various types of transactions. The manual normally also includes guidelines for accounting of various types of transactions. The auditor should examine whether there exists a written manual or other compilation in relation to various accounting aspects in the bank. The auditor should also examine whether there is a system of updating the manual or other compilation periodically. He should particularly enquire whether the directions/ instructions of the RBI relating to accounting aspects are incorporated in the manual promptly. The auditor should also examine the system of communicating any changes in the manual to the branches.

Balancing of Books/Reconciliation of control and subsidiary records

2.80 These are:

- *System of monitoring the position of balancing of books/ reconciliation of control and subsidiary records.*
- *Follow-up action.*

2.81 The auditor's comments would cover the head office/regional or zonal offices as well as the branches. The auditor can get the requisite information in respect of branches substantially from the LFARs pertaining to branches. The auditor is also expected to comment on the balancing of the books of account, e.g., whether the primary books of account have been tallied and the general ledger balanced. The auditor should examine the position relating to balancing of books which form the basis of the financial statements. The status as at the year-end relating to books not balanced should be clearly indicated by stating the

relevant particulars and indicating the extent to which these remain to be balanced.

2.82 The auditor should state the number of branches in respect of which the control and subsidiary records have not been reconciled. Where such records have been reconciled after the year-end, the auditor should exercise his judgment as to whether such cases need to be reported.

2.83 In so far as the head office is concerned, the auditor should give his observations on the unreconciled balances between the control and subsidiary records. It is suggested that, in respect of the relevant heads of account, the report should show the amount appearing in the general ledger, the aggregate amount appearing in the subsidiary records, and the difference between the two. The observations of the auditor would cover non-balancing of subsidiary records at the head office and persistent defaults observed in reconciliation of control and subsidiary records.

2.84 The auditor should critically examine the system for reporting the status of balancing/reconciliation by branches and offer his comments and suggestions, if any.

Inter-branch Reconciliation

2.85 These are:

- *Comments on the system/ procedure and records maintained.*
- *Test check for any unusual entries put through inter-branch/ head office accounts.*
- *Position of outstanding entries; system for locating long outstanding items of high value.*
- *Steps taken or proposed to be taken for bringing the reconciliation up-to-date.*
- *Compliance with the RBI guidelines with respect to provisioning for old outstanding entries.*

2.86 Inter-branch accounts are normally reconciled by each bank at the central level. While practices with various banks may differ, the inter-branch accounts are normally sub-divided into segments or specific areas, e.g., 'Drafts paid/ payable', 'inter-branch remittances', 'H.O. A/c', etc. The auditor should report on the year-end status of inter-branch accounts indicating the dates up to which all or any segments of the accounts have been reconciled. The auditor should also indicate the number and amount of outstanding entries in the inter-branch accounts, giving the relevant information separately for debit and credit entries. The auditor can obtain the relevant information primarily from branch

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audit reports. Where, in the course of audit, the auditor comes across any unusual items in inter-branch/head office accounts, he should report the details of such items, indicating the nature and the amounts involved. The auditor should examine the procedure for identifying the high-value items remaining outstanding in inter-branch reconciliation. He should review the steps taken or proposed to be taken by the management for clearing the outstanding entries in inter-branch accounts, particularly the high-value items. If he has any specific suggestions for expeditious reconciliation of inter-branch accounts including any improvements in the systems to achieve this objective, the same may be incorporated in the report. In the new CBS environments the branch reconciliation is done of IT department at H.O. in most of the banks.

2.87 Considering the extent of arrears in inter-branch accounts, the RBI, vide its circular no. DBOD No. BP.BC. 73 /21.04.018/2002-03 dated February 26, 2003 has advised banks to arrive at the category-wise position of unreconciled entries outstanding in the inter-branch accounts for more than six months as on March 31, 2004 and make provision equivalent to 100 percent of the aggregate net debit under all categories. While doing so, it may be ensured that:

- (i) The credit balance in the Blocked Account created in terms of instructions contained in circular DBOD No. BP.BC.73/21.04.018/98 dated July 27, 1998 is also taken into account; and
- (ii) The net debit in one category is not set-off against net credit in another category.

Branch Inspections

2.88 These are:

- *System of branch inspections: frequency; scope/ coverage of inspection/ internal audit, concurrent audit or revenue audit; reporting.*
- *System of follow-up of these reports; position of compliance.*

2.89 The auditor should acquaint himself with the scheme of various internal inspections existing in the bank, viz., internal audit, concurrent audit, revenue audit, etc. He should consider whether the frequency and coverage of various types of audit are adequate having regard to the size of the bank. He should also examine the system of follow-up and compliance with reports of various auditors.

Frauds/Vigilance

2.90 These are:

- *Observations on major frauds discovered during the year under audit.*
- *System of follow-up of frauds/ vigilance cases. (Reported to RBI in FMR1.)*

2.91 The auditor is expected to give his observations on major frauds discovered during the year under audit. He is also expected to comment on the efficacy of the system of follow-up on vigilance reports.

2.92 Banks normally maintain a record, usually in separate register, of the frauds that have taken place at any branch or other office which have been brought to the notice of the head office/controlling authority of the bank. A brief history of each of the frauds discovered is also available to the statutory auditor, through reports by the management to the Board of directors as also to the RBI. The RBI has issued Master Circular on "Frauds-Classification and Reporting" (DBS.FrMC.BC.No.1/23.04.001/2013-14) dated July 1, 2013. The circular requires the banks to report to RBI complete information about frauds and the follow-up action taken thereon.

2.93 The auditor should look into the cases of major frauds which have been discovered and recorded including those which have been reported after the year-end. He should report on major frauds discovered and recorded by the bank. He should also examine the quarterly and annual review of frauds done by the bank and ascertain the number of frauds where final action has been taken by the banks and cases disposed of.

2.94 In case the auditor observes weaknesses in the internal control system which have resulted in frauds, or where the *modus operandi* is common, he may give his suggestions for overcoming such weaknesses by taking preventive steps to reduce/minimise incidence of frauds.

Suspense Accounts, Sundry Deposits, etc.

2.95 These are:

- *System for clearance of items debited/credited to these accounts.*

2.96 The auditor should look into the procedure of the bank to determine whether entries raised in nominal heads of account including 'Suspense Accounts' and 'Sundry Deposits' or 'Sundries Account' are cleared expeditiously.

2.97 In the course of audit, the auditor would have examined large items and also old outstanding entries included in the year-end balances in such accounts. It is possible that whereas a debit entry has been raised to 'Suspense Account', the corresponding credit may be lying in 'Sundry Deposits'; or other similar account and an exercise may not have been carried out by the bank to adjust these transactions on matching, after proper scrutiny thereof. In his report, the auditor should bring out large and old outstanding entries which deserve the attention of the management for expeditious clearance. He may also make his

suggestions to the management for expeditious clearance of these entries by adjustment thereof after making a thorough scrutiny of the transitions. The auditor may also point out any adjustments of large outstanding in these accounts which have not been specifically explained to him in the course of his audit, for example, for want of relevant documents/evidence or vouchers, etc., and where he is not satisfied with the nature of adjustments made.

2.98 Where, in the course of audit, the auditor comes across any unusual items in 'Suspense' or 'Sundry Deposits Account', he should report the details of such items, indicating the nature and the amounts involved. The relevant information will be available to the auditor primarily from the branch audit reports.

IV. Capital Adequacy

2.99 The auditors are required to enclose a copy of the capital adequacy certificate or reproduce the certificate in the body of the LFAR. The auditor should verify whether the certificate is as per the requirements of the circular and the figures given in the certificate matches with the books of account of the bank.

2.100 The auditor should provide in the LFAR an overview of the approach and mechanism put in place by the Bank for computation of capital adequacy. This would cover the policies, management structure, methodology, processes etc. In specific, the following may be commented upon with regard to computation of capital charge and the capital adequacy ratio:

- Policies adopted by the Bank
- Systems, processes and procedures used for computation of capital charge for market risk, credit risk and operational risk
- Systems and processes in use for aggregation of capital charges and computation of capital adequacy ratio
- In case the Bank has adopted standardized approach or advance measurement approach the auditor should comment on management approach to key estimates / judgment / assumptions for the computation of capital charge. E.g. assumptions used for computation of probability of default, loss given default, exposure at default, use of historical data for computation of default rates etc.
- Rating used by the bank i.e. whether the bank uses issue specific rating or issuer's rating for computation of capital charge on credit risk
- Comment on observations raised by RBI in its latest AFI
- Bank's preparedness to migrate to advance measurement approach

- Any other reportable observations arising in the course of audit of the capital adequacy ratio

V. Automation and Computerisation

2.101 Computerisation results in changes in the processing and storage of information and affects the organisation and procedures employed by the entity to achieve adequate internal control. The auditor should examine whether there exists any policy for computerisation and automation. The auditor is also required to comment whether any progress has been made during the period under review. Progress may be in the nature of conversion of partially computerised bank into fully computerised, or increasing the level of computerisation and thereby making the work simpler.

2.102 Some of the key aspects as regards to automation and computerisation which should be covered are discussed below:

2.103 Regarding computerisation, the auditors are required to comment on the following aspects:

- *Existence of Computerisation and Automation Policy; progress made during the year under review.*
- *Critical areas of operations not covered by automation.*
- *Number of branches covered by computerisation and the extent of computerisation.*
- *Procedures for back-ups, off-site storage, contingency and disaster recovery and adherence thereto.*
- *Existence of Systems/ EDP audit; coverage of such audit.*
- *Electronic Banking; existence of systems and procedures; monitoring; regular updation of technology; method of review and audit of procedures.*
- *Suggestions, if any, with regard to computerisation and automation.*

2.104 The central statutory auditor, in addition to performing specific work to comment on the above points, may also review the adequacy and appropriateness of the Information Security Policy and report any shortcomings or suggestions for improvement in the computerisation and automation in the LFAR based on the discussions with the Management and IT personnel and leveraging on the work performed whilst undertaking audit procedures. The auditor may also report in his LFAR whether the approved Information Technology Security Policy is in place and communicated to all the branches for implementation.

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2.105 The auditor is also required to comment whether the critical areas are covered by automation and the application used therein together with the fact as to whether the systems are developed in-house or acquired from external vendors. Generally, critical areas like treasury and loans are supported by sub-systems which are interfaced to the General Ledger. The auditor needs to make sure that there is a formal process of reconciliation of these sub-systems with the GL on a periodical basis. Further, the relevant application and access controls as prevalent to the CBS should also be followed for these sub-systems.

2.106 The auditor should also report the number of branches covered by computerisation and the extent of computerisation. The extent of computerisation may include inquiring whether the branch is fully or partially computerised. For this purpose, auditor will have to go through the LFARs of the branches. In case of private sector banks and foreign branches, the central statutory auditor may inquire and verify about the level of branch automation when he conducts branch visits.

2.107 The bank should have a documented procedure for off-site backup. The auditor should enquire about the adequacy of the procedures followed for the recovery of data in case of contingency and disaster including details of the data backup policies for its systems and data, disaster recovery plans, periodicity of backups and details of offsite locations.

2.108 The auditor should report whether the bank has the system of conducting systems audits periodically to assess the effectiveness of the software, hardware and operations to identify any changes required therein. The auditor also needs to review these reports to assess the impact of IT issues, if any, on the audit of the bank and his scope of work.

2.109 Further in case of computerised bank branches, the branch auditor needs to comment on the following:

- *Whether hard copies of accounts are printed regularly?*
- *Indicate the extent of computerization and the areas of operation covered.*
- *Are the access and data security measures and other internal controls adequate?*
- *Whether regular back-ups of accounts and off-site storage are maintained as per the guidelines of the controlling authorities of the bank?*
- *Whether adequate contingency and disaster recovery plans are in place for loss/encryption of data?*
- *Do you have any suggestions for the improvement in the system with regard to computerized operations of the branch?*

Reconciliation of Control and Subsidiary Records

2.110 Have the figures, as at the year end, in the control and subsidiary records been reconciled? If not, the last date upto which such figures have been reconciled should be given under the respective heads, preferably in the following format:

Account	Date	General Ledger Balance (Rs.)	Subsidiary Balance (Rs.)	Last Date on which balanced

VI. Profitability

2.111 The auditor is required to comment on the profitability aspects as under:

- *Analysis of variation in major items of income and expenditure compared to previous year.*
- *Important ratios such as ROA, ROE etc; comparison and analysis in relation to previous year.*
- *Policy relating to general provisions/ reserves.*

2.112 The auditor is expected to present an analysis of variations in major items of income and expenditure compared to previous year, along with important ratios. This information is normally compiled by banks as per the requirements of the RBI. Wherever feasible, the auditor may also comment on the extent of income generated through non-traditional and specialized activities, such as, merchant banking, consumer banking, etc., as also on any unusual items of income and expenditure which may have had a significant impact on the profit/loss for the year.

2.113 The effects of any changes in accounting policies on the profit/loss for the year should be reported by the auditor.

VII. Systems and Controls

2.114 The auditor is required to comment on systems and controls as under:

- *Existence of systems and procedures for concurrent and internal audits, inspections, EDP audit of computer systems/software, etc.; monitoring and follow - up on such reports;*

2.115 Internal audit is an important constituent of the system of internal control

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in banks. Banks should generally have well organised system of internal audit. The internal audit is carried out either by separate departments within the bank or by firms of chartered accountants. The scope and frequency as also the form of various types of internal audits in different banks varies, and one of which is concurrent audit.

2.116 A system of concurrent audit at large and other selected branches has been in vogue in most banks for quite long. Recognising the importance the concurrent audit in the banking sector, the RBI, vide its circular no BC.182/16.13.108/93-94 dated October 11,1993 addressed to all scheduled commercial banks (except regional rural banks) formally advised such banks to institute an appropriate system of concurrent audit. It may be also noted that the RBI vide its circular no DOS. NO.8.C.16/08-91-021/96 dated August 14, 1996 has incorporated new guidelines for concurrent audit system in commercial banks. The system includes scope of concurrent audit, coverage of business/branches, types of activities covered, appointment of auditors, facilities for effective concurrent audit, remuneration and the reporting systems. Concurrent audit is regarded as bank's early-warning system to ensure timely detection of irregularities and lapses which helps in preventing fraudulent transactions. It also refers to examination of the transactions by an independent person not involved in its documentation. The emphasis is in favour of substantive checking in key areas rather than test checking.

2.117 The auditor should enquire whether the bank has a system of conducting concurrent and internal audit, inspections of various departments inside the bank, etc. either through its own staff or external auditors. The option to consider bank's own staff or external auditors to undertake audit is at the discretion of the individual banks. The auditor is required to comment on the system in existence. The auditor should report whether the follow-up of the reports of internal and concurrent audits, etc. is carried out and relevant suggestions implemented timely. For this purpose, the auditor should refer to the internal/ concurrent/ inspection audit reports.

- *Existence of Management Information System; method of compilation and accuracy of information.*
- *Reliability of regulatory reporting under the Off Site Surveillance System of the RBI.*

2.118 The management of banks requires database information for taking policy decisions as well as for taking other corrective measures. Banks operate their business through network of their branches spread over a vast geographical

area. Thus, auditor should check that an effective management information system exists which generates timely, accurate, reliable, relevant and complete information.

VIII. Other Matters

2.119 Besides the above matters, the auditor is also expected to comment on the following:

- *Comments on accounting policies, if any, including comments on changes in accounting policies made during the period.*
- *Policies and systems for monitoring activities such as underwriting, derivatives, etc.*
- *Adequacy of provisions made for statutory liabilities such as Income Tax, Interest Tax, Gratuity, Pension, Provident Fund, etc.*
- *Adequacy of provisions made for off-balance sheet exposures and other claims against the bank.*
- *Any major observations on branch returns and process of their consolidation in final statement of accounts.*
- *Balances with other banks - observations on outstanding items in reconciliation statements.*
- *Procedure for revaluation of NOSTRO accounts and outstanding forward exchange contracts.*
- *Observations on the working of subsidiaries of the bank:*
 - (a) reporting system to the holding bank and*
 - (b) major losses of the subsidiary, if any.*
- *Any other matter, which the auditor considers should be brought to the notice of the management.*

2.120 The Long Form Audit Report (LFAR) issued by the RBI clarifies that the matters required to be reported by the auditor therein are illustrative and not exhaustive. Therefore, if it is felt that if there is any other important matter which deserves to be included in the LFAR the statutory auditor may do so. The LFAR format was drafted in 2003. There have been significant changes in the banking industry ever since. As a result certain additional areas which have not been considered in any of the above paragraphs can also be considered. The following is an illustrative list of few such matters:

<ul style="list-style-type: none">• Corporate Governance• Borrowings	<ul style="list-style-type: none">• Legal departments (Details relating to suit filed and decreed)
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<ul style="list-style-type: none">• Premises• Stationery department• Jilani and Ghosh Committee Compliances• Implementation of recommendation of Mitra Committee• Service Tax• Fringe Benefit Tax	<ul style="list-style-type: none">accounts)• Merchant banking activity• Inter Office adjustments• Planning department• Raj Bhasha• Voluntary retirement scheme• Demat accounts and Loan against Shares• Legal Compliance Certificate• Stress Testing
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2.121 The auditor should examine whether the Income Tax liability is computed as per the provisions of the Income Tax Act, 1961. Apart from that the auditor should review the appellate orders received during the year and consider the need for any additional provision/ reversal. If there is no requirement to retain a provision, it can be reversed.

2.122 Provisions for certain employee costs, such as, bonus, ex-gratia in lieu of bonus, and gratuity, pension and other retirement benefits are usually made at the head office level. The auditor should examine whether the liability for bonus is provided for in accordance with the Payment of Bonus Act, 1965 and/or agreement with the employees or an award of a competent authority.

2.123 The auditor should examine whether provisions in respect of termination benefits; retirement benefits such as gratuity, pension, post-employment life insurance and post-employment medical care; and other long term employee benefits like, long-service leave, bonuses, deferred compensation, etc., are made in accordance with the requirements of Accounting Standard (AS) 15, "Employee Benefits". The auditor should examine the adequacy of the provisions made with reference of such documentary evidence as reports of actuaries or certificates from the LIC, as appropriate under the facts and circumstances of the case.

2.124 Auditor should reassess all off-balance sheet exposures and other claims against the bank for its contingency and chances of accrual. Auditor can go through the relevant files, papers and documents related to legal case.

PART - V

V-1

Basel II

Introduction

1.01 Capital is the starting point for any business and, similarly, in a bank, capital is one of the critical factors which decide its financial soundness. In the banking industry basically there are three types of risks – Credit, Market and Operational. Based on the risk appetite, each bank executes its business plans. It is important to monitor its financial soundness on a regular basis. Apart from enhancing the shareholder value, the bank's management is equally responsible to ensure that the bank's financial standing is not crippled by irrational decisions, led by market factors. A sufficiently justifiable capital level is fair yard stick for a stakeholder, including the regulator, to assess the overall financial position of the bank. Also from the bank's perspective, there is always a cost of capital. Hence, it will try to leverage by maintaining sufficient capital only. Having said that it is important for the bank to maintain sufficient capital for foreseeable future, else it will impact the future growth of the business plans.

1.02 Basel II is more risk-sensitive than the erstwhile regime and aims to significantly reduce the incentive for capital arbitrage. Higher risks will at least, in principle, result in higher risk weights and, thus, higher capital requirements.

The underlying purpose of Basel

1.03 Accord is the protection of depositors and shareholders by prescriptive rules for measuring capital adequacy, thereby evolving a common language to assess the quality of assets and liabilities of the banks and evolving methods of determining regulatory capital and ensuring efficient use of capital.

1.04 Basel II has been implemented in most of the banks in India with effect from March 31, 2008. In this regard, the RBI has also issued a Master Circular no. DBOD.No.BP.BC. 9/21.06.001/2013-14 dated July 1, 2013 on "Prudential Guidelines on Capital Adequacy and Market Discipline- New Capital Adequacy Framework (NCAF)".

Capital Risk Adequacy Ratio (CRAR)

1.05 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

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guidelines on calculation of risk weighted assets and off-balance sheet items and CRAR.

1.06 The CRAR is computed as follows:

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

Migration to other approaches under the Revised Framework

1.07 Having regard to the necessary up-gradation of risk management framework as also capital efficiency likely to accrue to the banks by adoption of the advanced approaches envisaged under the Basel II Framework and the emerging international trend in this regard, it was considered, in July 2009, desirable to lay down a timeframe for implementation of the advanced approaches in India. This would enable banks to plan and prepare for their migration to the advanced approaches for credit risk and operational risk, as also for the Internal Models Approach (IMA) for market risk. Keeping in view the likely lead time that may be needed by banks for creating the requisite technological and the risk management infrastructure, including the required databases, the MIS and the skill up-gradation, etc., the following time schedule laid down for implementation of the advanced approaches for the regulatory capital measurement:

Sr. No.	Approach	The earliest date of making application by banks to the RBI	Likely date of approval by the RBI
a.	Internal Models Approach (IMA) For Market Risk	April 1, 2010	March 31, 2011
b.	The Standardised Approach (TSA) for Operational Risk	April 1, 2010	September 30, 2010
c.	Advanced Measurement Approach (AMA) for Operational Risk	April 1, 2012	March 31, 2014
d.	Internal Ratings-Based (IRB) Approaches for Credit Risk (Foundation-as well as Advanced IRB)	April 1, 2012	March 31, 2014

1.08 The banks deciding to migrate to the advanced approaches were also required necessary approvals from RBI, in due course, as per the stipulated time schedule.

Change Management

1.09 Significant features of Basel II are:

- Significantly more risk sensitive capital requirements, and takes into account operational risk of banks apart from credit and market risks. It also provides for risk treatment on securitization.
- Greater use of assessment of risk provided by banks' internal systems as inputs to capital calculations.
- Provides a range of options for determining the capital requirements for credit risk and operational risk to allow banks and national regulators to select the approaches that are most suitable.
- Capital requirement under new accord is the minimum. It has a provision for supplementary capital that can be adopted by national regulators.
- The accord in fact promotes stronger risk management practices by banks by providing capital incentive for banks with better risk management practices.
- Capital requirement under Basel II does not include liquidity risk, interest rate risk of banking book, strategic and business risks. These risks would be under 'Supervisory Review Process', if supervisors feel that the capital held by a bank is not sufficient, they could require the bank to reduce its risk or increase its capital or both. In the matter of interest rate risk on a bank's books, it has put in place a criteria for 'Outliers'. Where a bank under 200 basis point interest rate shock faces reduction in capital by 20% or more, such banks would be outliers.
- Return on capital is one of the most significant measures used by the market in assessing the value of an organisation.
- The current revision of the regulatory capital requirements will have fundamental impact on the markets and the major banks strategies.
- Explicit recognition of non-credit risks.
- Embedded sophisticated risk management.
- Enhance the levels of internal controls.
- Capital requirements will become volatile.
- Significant reduction in risk weights for assets rated 'A'/P2' or higher, resulting into capital relief for the banks.

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- Cost of equity or subordinate debt is higher than the cost of deposits. Capital relief will result in cost savings for banks, which can possibly be shared with the corporates.
- High quality of data – granular level and accuracy.
- Convergence of risk and finance data.

Capital Funds

1.10 The foreign banks in India and Indian banks having operational presence outside India would have to ensure that their Basel II minimum capital requirement is higher than 80 per cent of the minimum capital requirement computed as per Basel I framework for credit and market risk. All other commercial banks would also continue to ensure compliance with the prescribed prudential floor in terms of the paragraph above. The need for continuing with the prudential floor.

Capital—What Constitutes Tier 1 and Tier 2 – a Representative Sample

1.11 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 equity capital (ordinary shares)	Interest free funds from Head Office ¹
	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-	Capital reserves representing

¹ Kept in a separate account in Indian books specifically for the purpose of meeting the capital adequacy norms.

	cumulative preference shares eligible for inclusion as Tier I capital subject to laws in force from time to time ²	surplus arising out of sale proceeds of assets
		Interest free funds remitted from abroad for the purpose of acquisition of property
		Head office borrowings in foreign currency by foreign banks operating in India
Tier II Capital		
	Revaluation reserves	Revaluation reserves
	General provisions and loss	General provisions and loss
	Reserves	Reserves
	Hybrid 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	Hybrid 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
	Innovative Perpetual Debt Instruments (IPDI) and Perpetual Non-Cumulative Preference Shares (PNCPS)	

² The annexure to Master Circular on Prudential Norms on Capital Adequacy-Basel I Framework provides guidelines for Perpetual non-cumulative preference shares eligible for inclusion as Tier I capital.

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1.12 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 funds to be maintained by such banks.

In this context, attention of the readers is also invited to RBI's Circular No. DBOD.No.BP.BC.77/21.04.018/2013-14 on "Deferred Tax Liability on Special Reserve created under Section 36(1)(viii) of the Income Tax Act, 1961" dated December 20, 2013.

Deductions from Tier I and Tier II

1.13 The deductions from Tier I and Tier II are tabulated below:

Item	Extent of Deduction (in %)	
	Tier I	Tier II
Intangible assets	100	---
Losses in the current period	100	---
Losses brought forward from previous periods	100	---
Deferred tax asset associated with accumulated losses	100	----
Gain-on-sale arising at the time of securitisation of standard assets	100	
Securitization exposure	50	50
Investment in financial subsidiaries and associates which is above 30 per cent in the paid up equity of entity and not consolidated for the capital adequacy purposes	50	50
Shortfall in the regulatory capital requirements in the de-consolidated entity	50	50
Such amount of investment in the following which is in excess of 10% of investing bank's capital funds: <ul style="list-style-type: none">• Equity shares;• Perpetual Non- Cumulative Preference Shares;• Innovative Perpetual Debt Instruments;• Upper Tier II Bonds;	50	50

<ul style="list-style-type: none"> • Upper Tier II Preference Shares; • Subordinated debt instruments; and • Any other instrument approved as in the nature of capital. 		
Investments made by a banking subsidiary/associate in the equity or non-equity regulatory-capital instruments issued by its parent bank	50	50
If net overseas placements with Head Office/other overseas branches/other group entities exceed 10% of the bank's minimum CRAR requirement, the amount in excess of this limit would be deducted from Tier I capital	100	---

1.14 A special dispensation of amortising the expenditure arising out of second pension option and enhancement of gratuity was permitted to Public Sector Banks as also select private sector banks who were parties to the 9th bipartite settlement with Indian Banks Association (IBA). In view of the exceptional nature of the event, the unamortised expenditure pertaining to these items need not be deducted from Tier I capital.

1.15 Attention of the reader is drawn on RBI circular no. DBOD.BP.BC.No. 69 / 21.01.002/ 2009-10 dated January 13, 2010 on "Retail Issue of Subordinated Debt for Raising Tier II Capital" that requires banks issuing subordinated debt to retail investors to adhere to the following conditions:

- The requirement for specific sign-off as quoted below, from the investors for having understood the features and risks of the instrument may be incorporated in the common application form of the proposed debt issue.

"By making this application, I/We acknowledge that I/We have understood the terms and conditions of the Issue of [insert the name of the instruments being issued] of [Name of The Bank] as disclosed in the Draft Shelf Prospectus, Shelf Prospectus and Tranche Document".

- For floating rate instruments, banks should not use its Fixed Deposit rate as benchmark.
- All the publicity material, application form and other communication with the investor should clearly state in bold letters (with font size 14) how a subordinated bond is different from fixed deposit particularly that it is not covered by deposit insurance.

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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.

ICAAP process (Internal Capital Adequacy Assessment Process)

1.16 The objectives of Internal Capital Adequacy Assessment Process (ICAAP) process are as follows:

- (i) Create a transparent and consensual general framework for assessment and for internal risk management of all material risks, thus, securing the organisation's objective in the long run.
- (ii) Enable bank to understand capital requirement under different scenarios.
- (iii) Build and support linkage between risk and capital.
- (iv) Strengthen bank's position on capital management.
- (v) Support the bank's long-term goal to move away from regulatory capital model to a regime of internal models that addresses both regulatory and economic capital.
- (vi) Move eventually to a system of 'on-line' calculation of Capital, both under Pillar 1 and Pillar 2.

1.17 The components of ICAAP process are appropriate identification and measurement of various risks, appropriate level of internal capital in relation to bank's risk profile and enhanced level of Risk Management System. Further, capital adequacy under ICAAP needs to be seen from two angles – regulatory capital under Pillar 1, which explicitly covers minimum capital for Credit, Market and Operational Risk; and capital cushion to cover other risks dealt in Pillar 2.

Disclosure (Pillar 3)

1.18 Pillar 3 aims primarily at disclosure of a bank's risk profile and capital adequacy. It is recognised that the Pillar 3 disclosure framework does not conflict with requirements under accounting standards, which are broader in scope. The bank's in India has to follow Pillar 3 disclosure over and above the RBI master circular on "Disclosure in Financial Statements - Notes to Accounts". Information would be regarded as material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information. Pillar 3 disclosure will be required to be made by the individual banks on a standalone basis when they are not the top consolidated entity in the bank.

Role of auditors of banks

1.19 Chartered Accountants, by serving the banking industry, contribute to the country's financial system as bank managers, financial executives, analysts, internal and external auditors, and advisers. Their role in strengthening the internal control and transparency of banking organisations is a major one that RBI, as banking supervisor, is increasingly recognising in its risk-focused examination policies, capital adequacy approaches, and disclosure initiatives.

1.20 Currently the external auditors of the bank are required to provide a certification on the capital adequacy ratio computation. The auditor needs to understand more comprehensively the approach and mechanism adopted by the bank, and accordingly certify the computation. Considering the intricacies involved in the computation itself further supplemented by enhanced judgement factor, it would be prudent for the certifying auditor to obtain an adequate understanding of the Basel II norms as prescribed by RBI and also deploy more senior members of its staff to audit the capital adequacy computations.

1.21 Further, some banks may also avail services of their external auditors to review the quality of internal controls and systems, and assess the scope and adequacy of the internal audit function.

Role of branch auditors

1.22 The concept of Basel II is primarily aimed from central/head office perspective, i.e., the underlying decisions will be top-down driven. This should be the logical approach so as to ensure a consistent implementation across the bank, of the regulatory requirements. Accordingly, the statutory central auditors should primarily look into the capital adequacy computation as part of their attest function. As per requirements set by the RBI, the statutory central auditors are required to certify the capital adequacy computation. This requirement has been there in Basel I regime and continues to exist in Basel II regime. The underlying requirements from the auditor's perspective have not changed. It is only that the computation methodology has changed due to the change in parameters as defined in Basel II. Having said that Basel II is not only about capital adequacy but is all about creating a robust risk management structure. Hence, apart from the capital adequacy computation, the auditors should verify the robustness of the risk management structure embedded in the bank, across its branches. This risk management spreads across all the types of risk, i.e., credit risk, market risk and operational risk. Hence, the branch auditors also play a critical role in ensuring that the bank has adopted a consistent practice across its branches and as part of their attest function report on its appropriateness to the statutory central auditors.

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1.23 In case of credit risk management the underlying computation for Basel II is based on credit ratings, which primarily is driven centrally and passed onto branches such that branches follow head office instructions in its entirety. This way the bank branch auditors check only the computation process and test check the source rather than getting into the credit rating process. Similarly, for operational risk computation, the simplified approach currently approved by the RBI requires computation based on gross revenues of the bank as a whole and not dependent on branch revenues. The branch auditors can assess any issues relating to completeness and correctness of the data which is used to compute the underlying risks emanating from credit, market and operational risk. It is finally the pyramid approach whereby all the data from branches will get consolidated at head office. The statutory central auditors may choose to test check certain source data and also verify the basis considered at the head office. The statutory central auditors may review the work done by internal auditors, as may be stipulated by the management or the regulators. The Basel Accord does provide specific areas where internal auditors play a role.

1.24 It will not be practical to expect the branch to comprehensively understand the Basel II requirements in its entirety. The bank branch auditor should assess the sufficiency of the instructions provided to the branch by the head office and its adherence at the branch level. Any errors at bank branch level can have a cascading effect at the head office, especially when a large number of branches are involved.

Basel III

1.25 The Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB) has undertaken an extensive review of the regulatory framework in the wake of the sub-prime crisis. In the document titled 'Basel III: A global regulatory framework for more resilient banks and banking systems', released by the BCBS in December 2010, it has inter alia proposed certain minimum set of criteria for inclusion of instruments in the new definition of regulatory capital. One of the criteria is that instruments should not have step-ups or other incentives to redeem. However, the BCBS has proposed certain transitional arrangements, in terms of which only those instruments having such features which were issued before September 12, 2010 will continue to be recognized as eligible capital instruments under Basel III which was scheduled to become operational beginning January 1, 2013 in a phased manner. The RBI has rescheduled the start date for implementation of Basel III to April 1, 2013 from January 1, 2013 vide its Press Release 2012 – 2013 / 1092 dated 28.12.2012.

1.26 In view of the above, RBI vide its circular no. DBOD.BP.BC.No.75/21.06.001/2010-11 dated January 20, 2011 on "Regulatory

Capital Instruments – Step up option” advised the banks that henceforth, banks should not issue Tier 1 or Tier 2 capital instruments with ‘step-up option’ so that these instruments continue to remain eligible for inclusion in the new definition of regulatory capital. However, such instruments can be issued with only ‘call option’ as per existing rules contained in the circulars issued by RBI from time to time.

Guidelines on BASEL III Capital Regulations

1.27 The RBI has issued a circular no. DBOD.No.BP.BC.98 /21.06.201/2011-12 dated May 2, 2012 on the subject “Guidelines on Implementation of Basel III Capital Regulations in India”. Vide this circular, the RBI has prescribed the final guidelines on Basel III capital regulations. Subsequently, RBI issues a master circular DBOD.No.BP.BC.2/21.06.201/2013-14 dated 1 July 2013 on Basel III Capital Regulations. Following are main features of these guidelines:

- These guidelines became effective from April 1, 2013 in a phased manner. The Basel III capital ratios will be fully implemented as on March 31, 2018.
- The capital requirements for the implementation of Basel III guidelines may be lower during the initial periods and higher during the later years. While undertaking the capital planning exercise, banks should keep this in view.
- The banks are required to disclose capital ratios under Basel III from quarter ending June 30, 2013.

Components of Capital

1.28 Total regulatory capital will consist of the sum of the following categories:

- (i) Tier 1 Capital (going-concern capital)
 - (a) Common Equity Tier 1
 - (b) Additional Tier 1
- (ii) Tier 2 Capital (gone-concern capital)

Limits and Minima

	Regulatory Capital	As % to RWAs
(i)	Minimum Common Equity Tier 1 Ratio	5.5
(ii)	Capital Conservation Buffer (comprised of Common Equity)	2.5
(iii)	Minimum Common Equity Tier 1 Ratio plus Capital Conservation Buffer [(i)+(ii)]	8.0

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(iv)	Additional Tier 1 Capital	1.5
(v)	Minimum Tier 1 Capital Ratio [(i) +(iv)]	7.0
(vi)	Tier 2 Capital	2.0
(vii)	Minimum Total Capital Ratio (MTC) [(v)+(vi)]	9.0
(viii)	Minimum Total Capital Ratio plus Capital Conservation Buffer [(vii)+(ii)]	11.5

Summary of Basel III Capital Requirements

Improving the Quality, Consistency and Transparency of the Capital Base

1.29 Presently, a bank's capital comprises Tier 1 and Tier 2 capital with a restriction that Tier 2 capital cannot be more than 100% of Tier 1 capital. Within Tier 1 capital, innovative instruments are limited to 15% of Tier 1 capital. Further, Perpetual Non-Cumulative Preference Shares along with Innovative Tier 1 instruments should not exceed 40% of total Tier 1 capital at any point of time. Within Tier 2 capital, subordinated debt is limited to a maximum of 50% of Tier 1 capital. However, under Basel III, with a view to improving the quality of capital, the Tier 1 capital will predominantly consist of Common Equity. The qualifying criteria for instruments to be included in Additional Tier 1 capital outside the Common Equity element as well as Tier 2 capital are strengthened.

1.30 The transparency of capital base has been improved, with all elements of capital required to be disclosed along with a detailed reconciliation to the published accounts. This requirement will improve the market discipline under Pillar 3 of the Basel framework.

Enhancing Risk Coverage

1.31 At present, the counterparty credit risk in the trading book covers only the risk of default of the counterparty. The reform package includes an additional capital charge for Credit Value Adjustment (CVA) risk which captures risk of mark-to-market losses due to deterioration in the credit worthiness of a counterparty. The risk of interconnectedness among larger financial firms (defined as having total assets greater than or equal to \$100 billion) will be better captured through a prescription of 25% adjustment to the asset value correlation (AVC) under IRB approaches to credit risk. In addition, the guidelines on counterparty credit risk management with regard to collateral, margin period of risk and central counterparties and counterparty credit risk management

requirements have been strengthened. RBI vide its circular dated 31 December 2013 has deferred capital requirement for CVA on OTC derivatives and for bank's exposure to central counterparties charge to 1 April 2014 instead of 1 January 2014.

Capital Conservation Buffer

1.32 The capital conservation buffer (CCB) is designed to ensure that banks build up capital buffers during normal times (i.e. outside periods of stress) which can be drawn down as losses are incurred during a stressed period. The requirement is based on simple capital conservation rules designed to avoid breaches of minimum capital requirements. Therefore, in addition to the minimum total of 8%, banks will be required to hold a capital conservation buffer of 2.5% of RWAs in the form of Common Equity to withstand future periods of stress bringing the total Common Equity requirement of 7% of RWAs and total capital to RWAs to 10.5%. The capital conservation buffer in the form of Common Equity will be phased-in over a period of four years in a uniform manner of 0.625% per year, commencing from January 1, 2016. For other guidelines readers may refer to part V of this Guidance Note and to the Basel III circular. (The comparison of requirements of Basel II and Basel III is given in CD)

Annexure 1

Illustrative Audit Checklist for Capital Adequacy

The checklist is only illustrative in nature. Members are expected to exercise their professional judgement while using the checklist depending upon facts and circumstances of each case.

Audit Procedures	
Tier I and Tier II Capital	
1. Tally the balances in the various elements from the audited accounts	
2. Check whether the various instruments comply with the guidelines as laid down in the Master Circular by referring to the Terms of Offer and whether the same are approved by the Board or other appropriate committee	
3. In case of foreign banks examine whether the undertaking has been obtained that the bank would not remit abroad the funds received and shown as Capital Reserve or Remittable Surplus	
4. Examine whether the various limits upto which individual elements are to be included in Tier I and II capital as laid down in the Master Circular are adhered to.	
5. Verify the various deductions with the balances in the audited accounts and check the same for limits and eligibility (e.g. securitisation exposure) as laid down in the Master Circular.	

Capital Charge on Credit Risk	
<p>The capital charge for credit risk is the sum total of the capital charge to be maintained in respect of the following:</p> <ul style="list-style-type: none"> • On balance sheet items • Off balance sheet items • Failed transactions • NPAs • Securitisation transactions <p>duly adjusted for haircuts based on the nature of the collateral.</p>	
Risk Weights – On Balance Sheet Items	
<p>The risk weights for all on balance sheet items need to be determined based on the credit ratings assigned by the rating agencies chosen by the RBI.</p>	
<p>1. Reconcile the balances of various advances and other operating receivables where there is a credit risk and which are considered for calculation with the following schedules in the financial statements to ensure completeness:</p> <ul style="list-style-type: none"> • Schedule 6 – Cash and balances with Reserve Bank of India • Schedule 7- Balances with Banks and Money at Call and Short Notice • Schedule 9- Advances • Schedule 11(vi) – Other Assets - Others 	

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<p>1. Review and document the process of compilation and mapping of the various on balance sheet item based on the categories and their risk weights together with the appropriate ratings and / or other conditions, as applicable.</p>	
<p>2. For a sample of transactions verify the ratings with the letters issued by the rating agencies and accordingly check the correctness of the risk weights assigned..</p>	
<p>3. In cases where the risk weights are dependent on the fulfilment of certain conditions (other than ratings) verify the compliance therewith based on the appropriate documentary evidence. (E.g. claims on banks, regulatory retail portfolio, claims against residential property etc.)</p>	
<p>Risk Weights – Off Balance Sheet Items</p>	
<p>The risk weight for all off balance sheet credit exposures is generally calculated as a two step process as under, separately for market and non-market related exposures:</p> <ul style="list-style-type: none">• The notional amount is converted into a credit equivalent amount by multiplying the amount by the specified credit conversion factor (for non	

<p>market transactions) or by applying the current exposure method (for market related transactions).</p> <ul style="list-style-type: none"> • The resulting credit equivalent amount is multiplied by the risk weight applicable to the counterparty or the purpose for which finance is extended or the type of asset, whichever is higher. <p>Where the exposure is secured by eligible collateral or guarantee the credit risk mitigation guidelines may be applied.</p>	
<p>1. Reconcile the balances of the various off balance sheet exposures which are considered for calculation with the financial statements, especially the schedule of contingent liabilities.</p>	
<p>2. Review and document the process of compilation and mapping of the various off balance sheet item based on the nature of the instruments.</p>	
<p>3. For a sample of non market transactions check the calculations of the credit equivalent amount with specified credit conversion factor based on the nature of the instrument. Check the necessary documentation to confirm the nature of the instrument.</p>	

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4. For a sample of market related transactions check the necessary documentation to confirm the nature of the contract and accordingly check the calculations for the current credit exposure and the potential future exposure.	
Capital Charge – Failed Transactions	
1. Review and document the procedures for tracking and monitoring the credit risk exposure arising from unsettled transactions, both on DVP and non DVP basis.	
2. For a sample of DVP transactions examine whether the settlement has taken place on a timely basis. In case of delays, check the calculation of the capital charge by multiplying the positive current exposure by the prescribed factor depending upon the number of days delayed.	
3. For a sample of non DVP transactions examine whether the settlement has taken place as per the contracted maturity. In case of delays, ascertain whether any payment made is considered as a loan and the appropriate risk weight is considered. In case of settlement beyond five days ascertain whether the full amount is deducted from the capital.	

Risk weights – NPAs	
1. Review and document the procedures for identifying the unsecured portion of NPAs separately for qualifying residential mortgages and others.	
2. For a sample of residential mortgages which are NPAs, examine whether they meet with the qualifying criteria with regard to the LTV ratio and other factors and accordingly check the assignment of the risk weight for the unsecured portion depending upon the level of provisioning.	
3. For a sample of NPAs other than residential mortgages check the assignment of the risk weight based on the level of provisioning.	
4. In respect of 3 above for identifying the secured portion examine whether only eligible collateral are considered and the same are properly documented and the bank has a clear and marketable title to realise the same.	
Capital Charge – Securitisation transactions	
Banks are required to hold regulatory capital after adjusting the prescribed deductions eligible against all securitisation exposures including those arising from provision of credit mitigants, investment in asset backed securities, retention of subordinated tranche and extension of liquidity facility or credit enhancement.	

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Examine whether the securitisation transactions fulfil the requirements as prescribed in the guidelines dated February 1, 2006 and Annex 7A (extract of the 'Revision to the Guidelines on Securitisation Transactions', issued vide circular DBOD.No.BP.BC.103/ 21.04.177/ 2011-12 dated May 07, 2012) to be eligible for deduction from capital.	
1. Based on the above, for a sample of transactions / deals examine whether the prescribed deduction from both Tier I and II capital has been correctly done based on the rating and the level of provisions. Review the necessary documentation in support of the same.	
2. Based on the above ascertain whether the appropriate risk weights have been assigned,	
Collateral Risk Management and Credit Risk Mitigation	
The objective of collateral management is to ensure that only the eligible collateral are considered for netting off which are adjusted for volatility depending upon the nature of the capital and further subjected to various types of hair cuts for different categories of mismatches like currency and tenor mismatches.	
1. Review and document the process for collateral risk management as appropriate and relevant including but not limited to: <ul style="list-style-type: none">• Ageing reports	

<ul style="list-style-type: none"> • Confirmation procedures. • Control of documents • Compliance with covenants • Audit of collateral by independent agencies 	
<p>2. Examine whether the bank has complete legal rights to enforce the security including specific lien and is subject to hair cuts for residual tenor mismatch and currency mismatch. Check the necessary documentation in respect thereof.</p>	
Capital Charge for Market Risk	
<p>Capital charge for market risk involves computation of the capital charge on interest rate related instruments and equities in the trading book and foreign exchange risk, including gold and other precious metals. Accordingly, the following would be covered:</p> <ul style="list-style-type: none"> • Securities under the HFT and AFS category • Open gold and FX position limits • Trading position in derivatives • Derivatives entered into for hedging trading book exposures 	
Interest Rate – General Market Risk	
<p>The capital requirement for general market risk is the sum of the following four components:</p> <p>(i) Net short (only derivatives) or long position in the trading book</p>	

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<p>(ii) Small proportion of matched position for each time band (vertical disallowance)</p> <p>(iii) A larger proportion of the matched positions across different time bands (horizontal disallowance)</p> <p>(iv) Net change for positions in options where applicable</p>	
<p>1. Reconcile the balances considered for calculation of the general interest rate risks trading book positions with the figures reported in the financial statements.</p>	
<p>2. Review and document the process for computation of the price sensitivity (modified duration) for each instrument and test check the calculations for a sample of instruments.</p>	
<p>3. Review the process of capturing the above data into different time bands based on the maturity and accordingly apply the prescribed change in yield and check the calculations for the resulting capital charge and the consequential vertical and horizontal disallowances</p>	
Interest Rate – Specific Risk	
<p>The specific interest rate capital charge for different types of debt securities / issuers is prescribed separately for the following categories:</p> <ul style="list-style-type: none"> • Central, State and Foreign government bonds under 	

<p>HFT and AFS category</p> <ul style="list-style-type: none"> • Banks bonds under HFT and AFS category • Corporate bonds and securitised debt under HFT and AFS category 	
<p>1. Reconcile the balances of government securities under AFS and HFT considered for computation of specific interest rate capital charge with the financial statements.</p>	
<p>2. Review and document the process of compilation of data in respect of various types of government securities under AFS and HFT based on the type of investment and the residual maturity.</p>	
<p>3. For a sample of transactions in respect of the above, verify the allocation percentage of the specific risk capital based on the type of investment and residual maturity based on the verification of the relevant documentation.</p>	
<p>4. Reconcile the balances of bonds issued by banks under AFS and HFT considered for computation of specific interest rate capital charge with the financial statements.</p>	
<p>5. Review and document the process of compilation of data in respect of various types of bonds issued by banks held as investments under AFS and HFT based on the following parameters:</p> <ul style="list-style-type: none"> • Level of capital adequacy 	

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<ul style="list-style-type: none">• Nature of the bank (scheduled or non scheduled)• Residual maturity	
6. For a sample of transactions in respect of the above, verify the allocation percentage of the specific risk capital based on the various parameters based on the verification of the relevant documentation.	
7. Reconcile the balances of corporate bonds and securitised debt under AFS and HFT considered for computation of specific interest rate capital charge with the financial statements.	
8. Review and document the process of compilation of data in respect of corporate bonds and securitised debt instruments held as investments under AFS and HFT based on the following parameters: <ul style="list-style-type: none">• Rating assigned• Nature of the investment• Residual maturity	
9. For a sample of transactions in respect of the above, verify the allocation percentage of the specific risk capital based on the various parameters based on the verification of the relevant documentation.	
Equity – General and Specific Market Risk	
A uniform percentage of 9% is currently attracted for the gross	

equity position for both specific and general risks	
Foreign Exchange and Gold	
These currently attract a risk weight of 100% which is in addition to the capital charge for credit risk for on and off balance sheet items	
<p>1. Check the computation of the net open position in each currency as a summation of the following:</p> <ul style="list-style-type: none"> • Net spot position • Net forward position • Guarantees and similar instruments • Net future expenses / incomes not yet accrued but fully hedged 	
<p>2. Based on the calculations of the market risk for each of the above check the computation of the aggregate capital charge of market risks</p> <p>Interest rate risk</p> <p>a) General market risk</p> <ul style="list-style-type: none"> • Net position • Horizontal disallowance • Vertical disallowance <p>b) Specific market risk</p> <p>Specific and general market equity risk Foreign Exchange and gold</p>	
Capital Charge for Operational Risk	
Currently banks are required to maintain capital charge for operational risk at 15% of the average gross income for the last three financial years	
1. Obtain the computation of the	

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gross total income and verify the same from the respective years audited financial statements. 2. Examine whether the various deductions from the net profit are appropriately considered.	
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Tier I Capital		
	Interest free funds from Head Office kept in a separate account in Indian books specifically for the purpose of meeting the capital adequacy norms	
	Remittable surplus retained in Indian books which is not repatriable as long as the bank functions in India	
	Capital Reserve representing surplus arising from sale of assets in India held in a separate account and which is not eligible for repatriation as long as the bank functions in India	
	Interest free funds remitted from abroad for the purpose of acquisition of property and held in a separate account in Indian books	
	Head Office borrowings in foreign currency eligible for inclusion in Tier I Capital	
	Treatment of Head Office Debit balance for Foreign Banks vide RBI notification dated 9 July, 2012	

- General Provisions for the purpose of Tier II Capital would henceforth also include floating provisions as per the RBI circular dated 9th April, 2009.
- In respect of foreign banks operating in India, the RBI Master Circular also lays down the following additional provisions:

- There are certain specific clarifications with regard to the use of credit rating by banks for the purpose of assignment of risk weights. These deal with the following aspects:
- Care should be taken to ascertain that the Bank does not use any other rating which the borrower would have obtained for the purposes of assigning risk weights. As directed by the RBI guidelines, the credit rating should be available in the public domain which the bank has access to. While considering the credit rating, the bank has to consider its exposure and not just go by the overall credit rating i.e. in the credit rating letter the name of the bank, the underlying products, and the limits covered.
- For computing the gross income for determining the capital to be held against operational risk, there is a clarification that the same should be considered based on the average of the last three financial years. However, there is no clarity as to whether this includes the current financial year though the better practice would be to consider the average of the preceding three years.

Special-Purpose Reports and Certificates

Reporting of Frauds

2.01 The Reserve Bank of India *vide* its Circular No: DBS.FrMC.BC.No.1/23.04.001/2013-14 Dated July 01, 2013 on “Frauds-Classification and Reporting”, issued guidelines for classification of frauds and reporting of frauds to RBI, Central Office as well as the concerned regional office of the Department of Banking Supervision / Financial Conglomerate Monitoring Division (FCMD) (12 banks listed in the Annex) at Central Office under whose jurisdiction the bank’s Head Office/branch is situated. The reporting requirements for various categories of frauds based on financial exposure are specified in Para 3.1.4 of the circular. Banks need not report cases of attempted frauds of Rs. 1 crore and above to Reserve Bank of India, in terms of circular DBS.FrMC.BC.No.04/ 23.04.001/2012-13 dated November 15, 2012.

Audit Approach

2.02 The branch auditors may verify the contents of certificates to be issued at branch level. All the Returns submitted by the branch to various higher authorities of the respective bank and also to various authorities of the regulators as per the Master Circular dated 01.07.2013 would need to be verified. Branch Auditors should verify the correctness of financial implication caused due to such frauds and confirm that the adequate provision for the same has been made.

2.03 The statutory central auditors (SCAs) of the bank may verify the compilation of all such reports received from the branch auditors regarding the frauds and check whether adequate provision for the same has been made at Head Office. The SCA should also verify the returns submitted by the bank to regulators regarding such frauds during the year under audit.

2.04 SCA may verify the methodology used by the bank in reporting of such frauds from branches to regional / zonal / circle offices and to head office. SCA should also verify the existence of internal control mechanism in place for such reporting and classification of frauds in the bank.

2.05 SCA would also check the reporting and classifications of frauds at the Head Office level, where the cases other than those reported through reports branch auditors are considered.

2.06 SCA would also need to check that the Board of Directors and Audit Committee of bank are being regularly updated with reporting and classification on frauds throughout the year under audit.

2.07 In addition to their audit reports, the SBAs and SCAs may also be required by their terms of engagement or statutory or regulatory requirements to issue other reports or certificates. For example, presently, the branch auditors are required to issue reports/certificates on the following matters besides their main audit report:

- Long Form Audit Report for Branch. (Discussed in detail in Part IV of the Guidance Note)
- Report on whether the income recognition, asset classification and provisioning have been made as per the guidelines issued by the RBI from time to time.
- Report on audit of DICGC items, wherein auditors have to specifically verify and certify the correctness of the data in various returns and the insurance premiums paid to DICGC.
- Report on status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to frauds and malpractices and of the recommendations of the Jilani Committee on internal control and inspection/credit system.
- Certificate for Prime Minister Rozgar Yojna for Unemployed Youth.
- Certificate of cash and bank balances.
- Certificate relating to MOCs entries of the previous year being accounted for.
- Certificate relating to credit/ deposit ratio.
- Certification of technology up gradation fund scheme (TUFS) – non SSI textile centre.
- Certification for advances to infrastructure project and income generated thereon.
- Statement of accounts Re-structured/ Re-scheduled/ Re-negotiated related to CDR and non-CDR accounts.
- Certificate of advances exceeding Rs.10 Crores.
- Certificate regarding Special Deposit Scheme, 1975.

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- Certificate regarding Compulsory Deposit (Income-tax Payers) Scheme, 1974.
- Certificate relating to recoveries in claim paid accounts under Small Loans Guarantee Scheme 1971/Small Loans (SSI) Guarantee Scheme, 1981.
- Certification of Borrowal Companies by Chartered Accountants/Company Secretaries (as per RBI circular on "Lending under Consortium Arrangements/ Multiple banking Arrangements" dated December 08, 2008.
- Certificate on Capital Adequacy

2.08 Besides this, SCAs are required to give following certificates/reports:

- Certificate on Corporate Governance.
- Report on whether the treasury operations of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.
- Certificate on reconciliation of securities by the bank. (both on its own investment account as well as PMS clients' account).
- Certificate on compliance by the bank in key areas of prudential and other guidelines relating to such transactions issued by the RBI.
- Certificate on Capital Adequacy
- Certificate in respect of custody of unused BR forms and their utilisation. (as such banks do not use BR forms any more. Further it is difficult to certify unused forms as they are not available for verification. This certificate should be strictly based on and against the management representation. The auditor is advised to bring out this fact clearly in the certificate.)
- Various ratios and statements in the "Notes on Accounts".
- Report on instances of adverse credit- deposit ratio in the rural areas.
- Report on compliance with SLR requirements.
- Certification in respect of subsidy claimed by the bank under the PMRY Scheme during the financial year.
- Certificate on compliance by bank on recommendations of:
 - Ghosh Committee, regarding frauds and malpractices in banks.
 - Jilani Committee, regarding internal control system in banks.
 - Dr. N. L. Mitra Committee, regarding maintenance of legal compliance certificate for credit sanction and other transactions of Rs. 1 crore and above.

Special Purpose Reports and Certificates

- Long Form Audit Report of Head Office and Bank as a whole. (Discussed in Part IV of the Guidance Note)
- In line with the Master Circular on frauds, the SCAs have to ensure that all the branches have complied with the reporting as required by the said circular and respective branch auditors' certificates are being received. A separate Report should be given on any matter susceptible to be a fraud or a fraudulent activity or any foul play in any transaction. In cases where the amount of fraud brought to the notice during audit and has remained to be reported, the auditors are advised to report such instances directly to the CGM, Central Office of Department of Banking Supervision, RBI, Mumbai.

2.09 While issuing a special purpose report or certificate, the auditors should bear in mind the following recommendations made in the Guidance Note on Audit Reports and Certificates for Special Purposes issued by the Institute of Chartered Accountants of India (ICAI):

- (a) A reporting auditor should have a clear understanding of the scope and nature of the terms of assignment, it is desirable for the auditor to obtain the terms in writing to avoid any misunderstanding.
- (b) In many cases, a reporting auditor can choose the form and contents of the report or certificate. In other cases the form and contents of the report or certificate are specified by statute or notification and cannot be changed.
- (c) Where a reporting auditor is free to draft the report or certificate, the auditor should consider the following:
 - (i) Specific elements, accounts or items covered by the report or certificate should be clearly identified and indicated.
 - (ii) The report or certificate should indicate the manner in which the audit was conducted, e.g., by the application of generally accepted auditing practices, or any other specific tests.
 - (iii) If the report or certificate is subject to any limitations in scope, such limitations should be clearly mentioned.
 - (iv) Assumptions on which the special purpose statement is based should be clearly indicated if they are fundamental to the appreciation of the statement.
 - (v) Reference to the information and explanations obtained should be included in the report or certificate. In certain cases, apart from a

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general reference to information and explanations obtained, a reporting auditor may also find it necessary to refer in his report or certificate to specific information or explanations on which auditor has relied.

- (vi) The title of the report or certificate should clearly indicate its nature, i.e., whether it is a report or a certificate. Similarly, the language should be unambiguous, i.e., it should clearly bring out whether the reporting auditor is expressing an opinion (as in the case of a report) or whether auditor is only confirming the accuracy of certain facts (as in the case of a certificate). For this, the choice of appropriate words and phrases is important.
- (vii) If the special purpose statement is based on general purpose financial statements, the report or certificate should contain a reference to such financial statements. However, the report or certificate should not contain a reference to any other statement unless the same is attached therewith. It should be clearly indicated whether or not the statutory audit of the general purpose financial statements has been completed and also, whether such audit has been conducted by the reporting auditor or by another auditor. In case the general purpose financial statements have been audited by another auditor, the reporting auditor should specify the extent to which it has been relied upon. Auditor may communicate with the other auditors for securing their cooperation and in appropriate circumstances, discuss relevant matters with them, if possible.
- (viii) Where a report requires the interpretation of a statute, the reporting auditor should clearly indicate the fact that auditor is merely expressing his opinion in the matter. Auditor should take sufficient care to ensure that in respect of matters which are capable of more than one interpretation; Auditor's report is not misconstrued as representing a settled legal position.
- (ix) An audit report or certificate should ordinarily be a self-contained document. It should not confine itself to a mere reference to another report or certificate issued by the reporting auditor but should include all relevant information contained in such report or certificate.
- (x) The reporting auditor should clearly indicate in the report or certificate, the extent of responsibility, which he assumes. Where

Special Purpose Reports and Certificates

the statement on which auditor is required to give the report or certificate, includes some information, which has not been audited, details of such issues shall be clearly indicated in the report or certificate..

- (d) In certain cases, the form and contents of the report or certificate, as prescribed by a statute or a notification, may not be appropriate or adequate. In such situations, the reporting auditor may consider modifying the report or certificate on the basis of the suggestions made earlier, to the extent applicable. In case this is not possible, auditor should clearly indicate the limitations in the report or certificate..
- (e) Where a special purpose engagement is undertaken after the statutory audit has been completed, a reporting auditor should invariably review the statutory audit report to ascertain whether there are any matters which have a bearing on the report or certificate.
- (f) In cases, where a reporting auditor is required to report or certify certain specific matters arising from the financial statements taken as a whole, auditor should not normally issue the report or certificate until the statutory audit has been completed. Where an audit report or certificate is required before the statutory audit is completed, a reporting auditor should clearly state in the audit report or certificate that auditor is reporting on or certifying specific matters arising out of the financial statements of the enterprise, the statutory audit of which has not been completed.
- (g) Where the reporting auditor prepares the report or certificate on the basis of duly audited general purpose financial statements auditor may take the following precautions:
 - (i) Auditor may clearly state in the report or certificate that the figures from the audited general purpose financial statements have been used and relied upon.
 - (ii) Auditor may include in the report or certificate a statement showing the reconciliation between the figures in the general purpose financial statements and the figures appearing in the report or certificate.

Compliance with Implementation of Ghosh & Jilani Committee Recommendations

3.01 The RBI in its efforts towards ensuring a strong, efficient and resilient banking system in the country, vide its Circular No. DBS.Co.PPP.BC.No.39/ND-01.005/99-2000 dated November 1, 1996, issued instructions relating to frauds and malpractice in banks. The Circular was issued for the implementation of the 44th report of the Committee on Government Assurances – Ghosh and Jilani Committees' Recommendations.

Implementation of the Ghosh Committee Recommendations

3.02 The RBI set up a High Level Committee on Frauds and Malpractices in Banks under the Chairmanship of Shri A. Ghosh, the then Dy. Governor, to enquire into various aspects of frauds and malpractices in banks with a view to make recommendation to reduce such incidence. The Committee submitted its Report in June, 1992. The recommendations contained in the report are related to frauds and malpractices in banks.

3.03 The RBI has divided all the recommendations into four groups as under:

- (i) *Group-A*: Recommendations, which have to be implemented by the banks immediately.
- (ii) *Group-B*: Recommendations requiring RBI's approval.
- (iii) *Group-C*: Recommendations requiring approval of Government of India.
- (iv) *Group-D*: Recommendations requiring further examination in consultation with IBA.

3.04 The RBI has summarised each of these recommendations for the purpose of reporting of their implementation by the banks, in a 'yes' or 'no' format. The RBI has also categorised these recommendations into (i) applicable to branches (ii) applicable to Controlling Offices like, Regional and Zonal Offices (some banks may have some other name for controlling offices), (iii) applicable to Head Office and (iv) applicable to Treasury Operations.

Compliance with Implementation of Ghosh & Jilani Committee

3.05 The report of the Ghosh Committee deals mainly with the issues related to day-to-day administrative functions that take place in a bank. The main objective behind the recommendations contained in the Ghosh Committee Report is to ensure that there exists a proper system in banks to ensure the safety of assets, compliance with the laid down policies and procedures, accuracy and completeness of the accounting and other records, proper segregation of duties and responsibilities of the staff and also timely prevention and detection of frauds and malpractices.

Implementation of Jilani Committee Recommendations

3.06 The RBI had set up a “Working Group to Review the Internal Control and Inspection and Audit System in Banks” under the Chairmanship of Mr. Rashid Jilani. The Working Group was constituted in February, 1995 to review the efficiency and adequacy of internal control and inspection and audit system in banks with a view to strengthening the supervision system, both on-site and off-site, and ensuring reliability of data. The Group submitted its reports in July, 1995 and made recommendations to strengthen the internal control system of banks. The RBI had been issuing circulars from time to time to ensure implementation of the recommendations. The RBI, *vide* its circular on “Reducing burden on Banks Rationalisation of returns submitted by banks to RBI” (DBS. CO. PP. BC. 12/11.01.005/2004-05) dated December 30, 2004, has discontinued submission of quarterly progress report on the implementation of the recommendations of the working group to review the internal control and inspection/audit systems in banks (Jilani Committee).

3.07 The 44th Report of the Committee on Government Assurances expressed concern that despite reporting of the compliance with recommendations of the Jilani Committee, by the controlling office/branches, the same might have not been implemented. Accordingly, RBI laid down the following procedure to ensure the implementation of recommendations:

- A format containing 25 questions was issued to indicate the answer as either “Implemented” or “Not Implemented”.
- Information received from all branches and ROs/ZOs to be consolidated at Head Office level and submission of consolidated statement to RBI.
- Implementation of recommendations to be verified during concurrent audit/inspection of branches/controlling offices and comment on the same to be included in their report.

3.08 The report of the Jilani Committee contains twenty five recommendations which can broadly be divided into three categories, (i) dealing with the EDP environment in the banks,(ii) dealing with the

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inspection/internal audit system in the bank and (iii) dealing with other miscellaneous aspects of functioning of a bank. The RBI has summarised each of these recommendations for the purpose of reporting of their implementation by the banks, in a 'Implemented' or 'not implemented' format. Some of the recommendations of Jilani Committee are to be implemented by the banks at the branch office level, whereas some others are applicable to the regional/zonal/head office level. However, some recommendations find applicability at all levels.

Responsibility of the Management

3.09 The RBI, vide its subsequent Circular dated June 28, 2002, issued to the banks has required the concurrent auditors and inspectors of the bank branches/controlling offices to verify and comment in their reports as to the status of implementation of the recommendations of the Ghosh and the Jilani Committees in the banks.

3.10 In terms of the letters issued to the banks regarding appointment of the statutory central auditors by the RBI, the auditors are also required to verify and comment upon the compliance by the bank in regard to the status of the implementation of the recommendations of the Ghosh and the Jilani Committees.

3.11 From the above it is clear that the implementation of the recommendations of the Ghosh and the Jilani Committees is the responsibility of the management of the banks. The responsibility of the statutory auditors is to verify and report on the status of implementation of these recommendations, thus far and no further. The results of the verification carried out by the statutory auditor and his comments thereon would be given in a separate report.

3.12 RBI through its "Master Circular - Guarantees and Co-acceptances" (DBOD. No.Dir.BC.12/13.03.00/2013-14) dated July 1, 2013 has required that Banks should implement the following recommendations made by the Ghosh Committee:

- (i) In order to prevent unaccounted issue of guarantees, as well as fake guarantees, as suggested by IBA, bank guarantees should be issued in serially numbered security forms.
- (ii) Banks should, while forwarding guarantees, caution the beneficiaries that they should, in their own interest, verify the genuineness of the guarantee with the issuing bank.

Compliance with Implementation of Ghosh & Jilani Committee

3.13 RBI through its Master Circular “Loans and Advances – Statutory and Other Restrictions” (DBOD.No.Dir.BC.14/13.03.00/2013-14) dated July 1, 2013 requires that banks should ensure compliance with the recommendations of the Ghosh Committee and other internal requirements relating to issue of guarantees to obviate the possibility of frauds in this area.

3.14 In this regard, it may be noted that the RBI has also issued Master Circular on “Frauds- Classification and Reporting” (DBS..FrMC.BC.No.1/23.04.001/2013-14 dated July 1, 2013). This circular deals with Classification of Frauds, Reporting of Frauds to RBI, Quarterly Returns, Reports to the Board, Fraud Monitoring Returns, etc.

3.15 The RBI has issued a Master Circular on “Willful Defaulters” (DBOD No. CID.BC. 3 /20.16.003/2013-14 dated July 01, 2013) which also specifies the role of auditors. It states that:

“In case any falsification of accounts on the part of the borrowers is observed by the banks / FIs, and if it is observed that the auditors were negligent or deficient in conducting the audit, they should lodge a formal complaint against the auditors of the borrowers with the Institute of Chartered Accountants of India (ICAI) to enable the ICAI to examine and fix accountability of the auditors.

With a view to monitoring the end-use of funds, if the lenders desire a specific certification from the borrowers’ auditors regarding diversion / siphoning of funds by the borrower, the lender should award a separate mandate to the auditors for the purpose. To facilitate such certification by the auditors the banks and FIs will also need to ensure that appropriate covenants in the loan agreements are incorporated to enable award of such a mandate by the lenders to the borrowers / auditors.”

3.16 In order to ensure that directors are correctly identified and in no case, persons whose names appear to be similar to the names of directors appearing in the list of willful defaulters appearing in the list of willful defaulters, are wrongfully denied credit facilities on such grounds, bank/FI have been advised to include the Director Identification Number (DIN) as one of the fields in the data submitted by them to RBI/CIC.

3.17 In terms of Para 2.9 of Master Circular on Willful Defaulters dated July 1, 2013, Banks / FIs have already been advised to submit the list of suit-filed accounts of willful defaulters of Rs. 25 lakh and above as at end-March, June, September and December every year to credit information company which has

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obtained Certificate of Registration from RBI and of which that bank is a member.

3.18 With a view to monitoring the end-use of funds, if the lenders desire a specific certification from the borrowers' auditors regarding diversion / siphoning of funds by the borrower, the lender should award a separate mandate to the auditors for the purpose. To facilitate such certification by the auditors the banks and FIs will also need to ensure that appropriate covenants in the loan agreements are incorporated to enable award of such a mandate by the lenders to the borrowers / auditors.

Audit Procedures

3.19 The RBI has prescribed separate formats to be filled in by the banks for reporting on compliance with/ implementation of the recommendations of the Ghosh and Jilani Committees. The responsibility of the statutory auditors is to certify the status of compliance with/ implementation of the recommendations of the Ghosh and Jilani Committees. Accordingly, the following procedures may be adopted by the statutory auditors of branches as well as the central statutory auditors for certifying the compliance/ implementation status of the Ghosh and Jilani Committees recommendations.

- In case of the branch, the branch auditors shall enquire from the management of the branch whether it has prepared the prescribed report on the implementation status of the recommendations of the Ghosh and Jilani Committees. If yes, then whether the same has been forwarded to the Head Office for necessary action. If no, then the auditor should obtain necessary representation from the management as to why the report has not been prepared and/ or submitted and should appropriately qualify his report.
- In case of the Head Office, the SCA should obtain a confirmation from the management whether it has received the report on the implementation status of the recommendations of the Ghosh and Jilani Committees from all the branches, regional/ zonal offices, etc. and also whether it has prepared the status report as applicable to the Head Office level. The SCA shall obtain a list of the branches, regional/ zonal offices which have not submitted the prescribed report. Such a list would help the SCA to have a broad idea as to the extent of implementation of the recommendations by the bank as a whole.
- The SCA should obtain and review a copy of the implementation status report(s) so prepared and submitted. Such a review would help the auditors identify areas which are susceptible to fraud/ malpractices. The

Compliance with Implementation of Ghosh & Jilani Committee

results of such a review may also require the auditor to re-consider the nature, timing and extent of the procedures adopted by him for carrying out the audit as well as his audit findings.

- In case of Branch audit, where the concerned branch has been subjected to a concurrent audit, then the report of the concurrent auditor on the status of implementation of the recommendations of the Ghosh and Jilani Committees should also be obtained. In case, the branch is not subject to a concurrent audit, the branch auditor should enquire whether it had been subjected to any inspection either by the in-house inspection department or by the inspectors of the RBI. The auditor should review the comments, if any, of the concurrent auditor or such inspectors on the said implementation status report.
- The SCA may also request the management to provide a list of branches which had been subject to a concurrent audit/ inspection by the in-house inspection department or the inspectors from the RBI. He may, if considered necessary, select some such branches and review the comments of the concurrent auditors/ inspectors on the status of implementation of the recommendations. This would help to identify any common cause of concern among the bank branches.
- Where the status report, as prepared by the management indicates that any of the recommendations have not been implemented, the auditor should request the concerned management to give a written representation as to why the particular recommendation(s) has/have not been implemented.
- The auditor may also consider it necessary to carry out test checks to examine whether the recommendations which have been said to have been implemented in the status report have indeed been implemented by the management.

3.20 In case, auditors examination reveals that any of the recommendations indicated as having been implemented have in fact not been implemented by the management, or where there is a failure to comply with any of the recommendations of the two Committees, could not only indicate a weakness in the internal control system in the bank but also raise doubts as to the integrity of the management. The auditor may, accordingly, also need to re-consider the nature, timing and extent of other audit procedures as also the truth and accuracy of any other management representations obtained by the auditor.

Certificate of the Statutory Auditor on the Status of Compliance

3.21 Based on the work done, the auditor should assess whether any information obtained during the verification indicates that any of the recommendations of the Ghosh and Jilani Committees have not been implemented, either in full or in part. The auditor may consider expressing either disclaimer or appropriate comments in respect of certain clauses such as Item Nos. 1.1 and 1.11 of Part II of Group A of Ghosh Committee..

3.22 The above-mentioned Certificate should describe the scope of the verification undertaken to enable the readers to understand the nature of work performed and make it clear that a full fledged investigation had not been undertaken. The Certificate of the auditor should also draw attention to the following facts:

- That the responsibility for the implementation of the recommendations of the Ghosh and the Jilani Committees is solely that of the management of the bank.
- That the auditor has also considered the reports of all or certain, as the case may be, concurrent auditors/inspectors of the bank branches on the status of implementation of the recommendations of the Ghosh and Jilani Committees at the branch office and controlling offices.
- That the verification was limited primarily to enquiries and obtaining confirmations from the management and other appropriate persons.
- That the auditor has carried out test checks to assess the status of implementation of the recommendations of the Ghosh and Jilani Committees.

3.23 An illustrative format of the auditor's certificate w.r.t. compliance with/ implementation of the recommendations of the Ghosh and Jilani Committees is given in the Annexure to this Guidance Note..

Other Aspects

Head Office

4.01 Apart from examination of consolidation of branch returns, verification of capital and reserves, and verification of investments and provisioning in respect thereof, the central auditors also usually deal with the following items:

- provision for non-performing assets;
- depreciation on assets like, premises, etc. where the recording of the relevant fixed assets is centralised at the head office;
- provisions for certain employee costs, such as, bonus/ex-gratia in lieu of bonus, gratuity, pension and other retirement benefits;
- provision for taxation;
- provision for audit fee;
- provisions to meet any other specific liabilities or contingencies the amount of which is material, for example, provision for revision in pay-scales of employees, provision for foreign exchange fluctuations, etc; and
- dividends.

Provisioning for Non-performing Assets

4.02 The prudential norms issued by the RBI prescribe the percentage of provision to be made in respect of advances classified under different categories, viz., standard, sub-standard, doubtful and loss assets. In this context, the RBI has issued “Master Circular – Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances” (DBOD.No.BP.BC.1 /21.04.048/2013-14) dated July 1, 2013. The primary responsibility for making adequate provisions for any diminution in the value of loan assets, investment or other assets is that of the bank management and the statutory auditors. The assessment made by the inspecting officer of the RBI is furnished to the bank to assist the bank management and the statutory auditors in taking a decision in regard for making adequate and necessary provisions in terms of prudential guidelines. It may be emphasised that the percentages prescribed by the RBI reflect the minimum proportion of an advance that a bank ought to provide for to comply with the guidelines. A bank can, at its discretion, make a higher provision than that required under the prudential guidelines.

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4.03 It has also been mentioned earlier that provisions in respect of non-performing assets are usually not made at the branch level but at the head office level. The amount of provision (or minimum amount) to be made at the head office level is based on classification of assets into standard, sub-standard, doubtful and loss assets. Branch returns contain analysis of the advances into these categories. The central auditor examines *prima facie* the correctness of the classification as a part of his examination of consolidation of branch returns. The branch auditors' reports may also point out cases where in their opinion, there are threats to recovery that warrant a higher amount of provision than that arrived at on the basis of the percentages specified by the RBI.

4.04 The auditor should examine whether the provision made by the management at the head office level meets the minimum provisioning requirements prescribed by the RBI and also takes into account the threats to recovery in specific cases. With regard to the latter, the auditor should ascertain that the provision made by the management is not less than that recommended by the respective branch auditors unless, based on the information and explanations, which were not available to the branch auditors, he holds a contrary view, or unless he otherwise believes that the branch auditors' objections have been met or are not of such nature and significance as to warrant a provision in the overall context of the bank as a whole.

4.05 The Third Schedule to the Banking Regulation Act, 1949 lays down the requirements of disclosure concerning advances. Accordingly, advances are required to be classified under various heads (Notes and Instructions for Compilation' of Balance Sheet and Profit and Loss Account, issued by the RBI require that provisions made to the satisfaction of the auditors should be excluded from advances under each head). The concern of the auditor is with the overall adequacy of provisions in respect of each of the heads under which advances are required to be shown in the balance sheet of a bank. Thus, for example, the auditor has to examine the adequacy of the overall provisions recommended by the bank separately in respect of (a) bills purchased and discounted, (b) cash credits, overdrafts and loans repayable on demand, and (c) term loans. Similarly, the auditor should examine the overall adequacy of the provisions recommended under each of the other heads of advances in the balance sheet. If, in his opinion, the overall provision recommended by the bank in respect of any of the heads is inadequate, he should make a suitable disclosure in his report.

4.06 The RBI has specified that advances against book debts may be included under the head 'secured by tangible assets'. Where the amount of

advances covered by book debts is significant, the auditor should make a suitable qualification in his audit report.

Recognition of Certain Expenses

4.07 Certain expenses, such as the following, are usually recognised at the head office level (or at zonal or regional level):

- (a) directors' fees, allowances and expenses;
- (b) insurance;
- (c) auditors' fees and expenses fee; and
- (d) service tax, etc.

Directors' Fees, Allowances and Expenses

4.08 This item includes sitting fees and all other items of expenditure incurred in relation to directors. The daily allowance, hotel charges, conveyance charges, etc., though in the nature of reimbursement of expenses incurred, may be included under this head. Similar expenses of the local Committee members may also be included under this head. Under the Companies Act, 1956* a director may receive remuneration by way of a fee for each meeting of the Board or a Committee attended by him. Local Committees are appointed by banks as advisory bodies in respect of the areas allotted to them. Their members are also paid fees or allowances.

4.09 The auditor may check the sitting fees and allowances with reference to the articles of the banking company, agreements, minutes of the Board and Local Committees, etc. It may be noted that in the case of nationalised banks, the fees and the basis of reimbursement of travelling expenses are fixed by the Central Government in consultation with the RBI. Copies of the relevant orders may be examined in this regard.

Insurance

4.10 This item includes insurance charges on bank's property. It also includes insurance premium paid to DICGC, etc., to the extent they are not recovered from the parties concerned.

4.11 Banks submit a Return on Total Insurable Deposits to RBI on a periodic basis. Insurance premium is payable on such deposits. The auditor should check the basis of computation of insurable deposits and the insurance premium paid on same.

* Now Companies Act, 2013.

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4.12 The DICGC guarantee fees payable by banks are based on the outstanding amount of priority sector advances covered by DICGC as on 31st March every year. The auditor should check the basis of payment/provision for such guarantee fees.

Auditors' Fees and Expenses

4.13 This item includes the fees paid to the statutory auditors and auditors for professional services rendered and all expenses for performing their duties, even though they may be in the nature of reimbursement of expenses. If external auditors have been appointed by banks themselves for internal inspections and audits and other services, the expenses incurred in that context including fees incurred for such assignments may not be included under this head but shown under 'Other Expenditure'.

Provision for Depreciation

4.14 As mentioned earlier, practices differ amongst banks with regard to accounting for fixed assets and provision for depreciation thereon. In case these accounting aspects in respect of all or certain categories of fixed assets are centralised at the head office level, the central auditor should examine the same. The procedures to be followed by the auditor in this respect would be similar to those discussed in the Chapter III-3 on "Fixed and Other Assets" at the branch level, except that the central auditor may request the respective branch auditors to examine the evidence of physical existence of fixed assets that, as per the records, are located at the branch or have been provided to employees for use (such as residential premises).

Provisions for Certain Employee Costs

4.15 Provisions for certain employee costs such as bonus/ex-gratia in lieu of bonus, and gratuity, pension and other retirement benefits are usually made at the head office level.

4.16 The auditor should examine whether the liability for bonus is provided for in accordance with the Payment of Bonus Act, 1965 and/or agreement with the employees or award of competent authority.

4.17 The auditor should examine whether provisions in respect of employee benefits are made in accordance with the requirements of Accounting Standard (AS) 15, "Employee Benefits", the auditor should particularly examine whether provision for leave encashment has been made by the bank. As per AS 15, employee benefits includes all forms of consideration given by an enterprise in exchange for services rendered by employees. It includes short-term employee benefits such as wages, salaries

and social security contributions and non-monetary benefits, post-employment benefits, other long-term employee benefits and termination benefits. The auditor should examine the adequacy of the provisions made with reference to such documentary evidence such as reports of actuaries or certificates from the LIC, as appropriate under the facts and circumstances of the case.

4.18 In the case of employee benefits, the Master Circular on “Disclosure in Financial Statements – Notes to Accounts” (DBOD.BP.BC No. 7/21.04.018/2013-14) dated July 1, 2013 issued by the RBI with reference to Accounting Standard 15, specifies that Banks may follow the disclosure requirements prescribed under AS 15 (revised), ‘Employees Benefit’ issued by ICAI.

Provision for Taxation

4.19 Provision for taxation relates to income-tax, (including corporate dividend tax) and wealth tax. The auditor must ensure compliance with AS 22, “Accounting for Taxes on Income”.

Income-tax

4.20 Some of the items which have an effect on the liability of a bank for income-tax and therefore, need to be specifically considered by the auditor, are discussed in the following paragraphs.

Bad Debts and Provision for Bad and Doubtful Debts

4.21 Section 36(1)(vii) of the Income-tax Act, 1961 deals with the allowability of bad debts and section 36(1)(viii) deals with the allowability of provision for bad and doubtful debts. According to section 36(1)(vii), bad debts written off are admissible deduction subject to the conditions prescribed under section 36(2), i.e.,—

- (i) no such deduction shall be allowed unless such debt or part thereof has been taken into account in computing the income of the assessee of the previous year in which the amount of such debt or part thereof is written off or of an earlier previous year, or represents money lent in the ordinary course of the business of banking or money-lending which is carried on by the assessee;]
- (ii) if the amount ultimately recovered on any such debt or part of debt is less than the difference between the debt or part and the amount so deducted, the deficiency shall be deductible in the previous year in which the ultimate recovery is made;

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- (iii) any such debt or part of debt may be deducted if it has already been written off as irrecoverable in the accounts of an earlier previous year, but the [assessing] Officer had not allowed it to be deducted on the ground that it had not been established to have become a bad debt in that year;
- (iv) where any such debt or part of debt is written off as irrecoverable in the accounts of the previous year and the [Assessing] Officer is satisfied that such debt or part became a bad debt in any earlier previous year nor falling beyond a period of four previous years immediately preceding the previous year in which such debt or part is written off, the provisions of sub-section (6) of section 155 shall apply;
- (v) where such debt or part of debt relates to advances made by an assessee to which clause (viia) of sub-section (1) applies, no such deduction shall be allowed unless the assessee has debited the amount of such debt or part of debt in that previous year to the provision for bad and doubtful debts account made under that clause.

4.22 The said deduction is limited to the amount by which the bad debts exceed the credit balance in the provision for bad and doubtful debts account made under section 36(1)(viia). According to section 36(1)(viia), a specified percentage of the total income and a specified percentage of the aggregate average advances made by the rural branches of the bank, both computed in the prescribed manner, is allowable as a deduction in respect of provision for bad and doubtful debts made by banks other than foreign banks.

4.23 A scheduled bank/non-scheduled bank has the option to claim a further deduction for an amount not exceeding the income derived from redemption of securities in accordance with a scheme framed by the Central Government. This is in addition to the deduction specified in paragraphs above with respect to section 36(i)(viia). However, for the purpose of claiming this deduction, it is necessary that such income should be disclosed in the return of income under the head 'Profit and gains of business or profession'.

4.24 Section 36(1)(vii) requires the amount of any bad debt or part thereof to be written off as irrecoverable in the accounts of the assessee for the previous year. It is sufficient compliance of the section if the write off is done at Head Office level.

Special Reserve

4.25 Deduction in respect of a special reserve created and maintained by a banking company –

- (a) Section 36(1)(viii) provides deduction in respect of any special reserve

created and maintained by a specified entity, which includes a banking company.

- (b) The quantum of deduction, however, should not exceed 20% of the profits derived from eligible business computed under the head "Profits and Gains of Business or Profession" (before making any deduction under this clause) carried to such reserve account.
- (c) The eligible business, in case of a banking company, means the business of providing long-term finance for –
 - (i) industrial or agricultural development or development of infrastructure facility in India; or
 - (ii) development of housing in India.
- (d) However, where the aggregate amount carried to such reserve account exceeds twice the amount of paid up share capital and general reserve, no deduction shall be allowed in respect of such excess.

Interest on Non-Performing Accounts (NPAs)

4.26 According to section 43D, read with Rule 6EA of the Income-tax Rules, 1962, the income of a scheduled bank by way of interest in relation to such categories of bad or doubtful debts as may be prescribed having regard to the guidelines issued by the RBI in relation to such debts, shall be chargeable to tax only in the previous year in which it is credited to the Profit and Loss Account or in the year of actual receipt, whichever is earlier.

Transactions with Foreign Banks/Foreign branches of Indian banks

4.27 The applicability of any Double Taxation Avoidance Agreement is to be taken into account for the purpose of computation of tax in respect of transactions with foreign banks or foreign branches of Indian banks.

4.28 Similarly, the applicability of Transfer Pricing Regulations is to be taken into account for the purpose of computation of tax in respect of international transactions with Associated Enterprises covered under section 92E of the Income-tax Act, 1961. Reference may also be made to the "Guidance Note on Report on International Transactions under section 92E of the Income-tax Act, 1961 (Transfer Pricing)" issued by ICAI.

4.29 In respect of any provision for bad and doubtful debts made by a foreign bank, an amount not exceeding 5% of the total income (computed before making any deduction under Chapter VI-A) is allowable as deduction.

Corporate Dividend Tax

4.30 A holding company receiving dividend from its subsidiary company

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can reduce the same from dividends declared, distributed or paid by it. For this purpose, a holding company is one which holds more than 50% of the nominal value of equity shares of the subsidiary.

4.31 There are certain conditions to be fulfilled to avail this benefit. They are -

- the subsidiary company should have actually paid the dividend distribution tax;
- the holding company should be a domestic company; and
- it should not be a subsidiary of any other company.

4.32 It may be noted that the matching principle does not apply, i.e., dividend received from the subsidiary company during the year can be reduced from the dividend distributed by the holding company during the same year, irrespective of the period to which the dividends relate to. Even if the dividend received and dividend distributed relate to different periods, the same can be adjusted and tax can be paid by the holding company on the net figure. However, the dividend shall not be taken into account for reduction more than once.

4.33 According to the "Guidance note on Accounting for Corporate Dividend Tax", issued by the Institute of Chartered Accountants of India (ICAI), the liability for such tax should be recognised in the accounts of the same financial year as appropriation of profit and not as a charge against profit in which the dividend concerned is recognised.

Tax Refunds/Demands

4.34 Where an assessment order is received during the year, the auditor should examine the assessment order and if any interest is determined on the amount of refund, the same should be considered as income. In case where the assessment results in fresh demand, the auditor should consider the need for additional provisioning. Where an assessment order is received during the course of audit, the auditor should examine the same and consider its impact, if any, on the accounts under audit.

4.35 It is not prudent to recognise interest on possible refund which is not determined by any order from tax authorities.

Pending Proceedings

4.36 The auditor should review the appellate orders received during the year and consider the need for any additional provision/reversal.

Method of Accounting

4.37 Many banks account for commission, exchange, brokerage, interest on bills, locker rent and other fees as income upon realisation. Section 145 of the Income-tax Act, 1961 provides, *inter alia*, that income chargeable under the head "Profits and Gains of Business and Profession" shall be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. Therefore, the auditor should consider the impact of this section on provision for taxation and also the need for appropriate disclosure in this regard.

Reversal of Earlier Year's Provision

4.38 It is possible that subsequent judicial pronouncements/ appellate orders may make the provisions of earlier years excessive.

4.39 As per Accounting Standard (AS) 29, "Provisions, Contingent liabilities and Contingent Assets", a provision should be recognised only when (a) an enterprise has a present obligation as a result of a past event, (b) it is possible that an outflow of resources embodying economic benefits will be required to settle the obligation, and (c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision should be recognised.

4.40 Only in rare cases, e.g., a law suit, it may not be clear whether an enterprise has a present obligation. In such a case, an enterprise determines whether a present obligation exists at the balance sheet date by taking into account all available evidence. On the basis of such evidence, if it is more likely than not that a present obligation exists at the balance sheet date a provision is recognised (if other recognition criteria are also met). However, where it is more likely that no obligation exists at the balance sheet date, a contingent liability is disclosed unless the possibility of an outflow of resources embodying economic benefits is remote.

4.41 On the above considerations, if there is no requirement to retain a provision, it can be reversed and the amount of liability is included in contingent liability. A suitable note on the following lines is recommended:

- (a) Provision for Income Tax is arrived at after due consideration of decisions of the Appellate authorities and advice of counsels; and
- (b) No provision is made for the disputed demands of Income tax keeping in view the judicial pronouncements and/or legal counsels' opinion.

Items Requiring Special Consideration

Tax Implications of Valuation of Investments

4.42 The RBI has issued various circulars on valuation of investments, according to which the difference between the market value/value as per yield to maturity method (YTM) will have to be provided in the books of accounts for certain types of investments. The various judicial decisions on the allowability of depreciation in valuation of investments should be considered while provisioning.

Notional Gain/Loss on Foreign Exchange Translations

4.43 Banks are required to translate their foreign exchange balances / obligations in foreign currency as per FEDAI Guidelines. The following decisions may be considered by the auditor while recognising gains or loss for tax purposes:

- The Madras High Court in the case of *Indian Overseas Bank Vs. Commissioner of Income-tax (1990) 183 ITR 200* has held that notional profits on translation of foreign exchange forward contracts is not taxable.
- The Madras High Court in the case of *Commissioner of Income-tax Vs. Indian Overseas Bank (1985) 151 ITR 446* has held that notional loss on translations of foreign exchange contracts is not tax deductible.

Broken Period Interest

4.44 The RBI, vide its Master Circular No. DBOD No. BP. BC. 8/ 21.04.141 / 2013-14 on, "Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks" dated July 1, 2013, advised that the banks should not capitalise the broken period interest paid to the seller as part of the cost, but treat it as an item of expenditure under Profit & 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 banks will have to comply with the requirements of Income-tax Authorities in the manner prescribed by them.

4.45 However, a number of judicial decisions support the view that the interest is allowable as a business deduction consequent to deletion of sections 18 to 21 of the Income tax Act, 1961. Honourable Bombay High Court in case of *American Express International Banking vs. CIT [2002] 258 ITR 601 (Bom)* supports this view. The said judgement has been followed in case of *CIT vs. Citi Bank N.A. [2003] 264 ITR 18 (Bom)*, *CIT vs. Nedungadi Bank Ltd [2003] 264 ITR 545 (Ker)* and by Honourable Bombay High Court in case of Union Bank of India in judgement dated October 9, 2002 in I.T.R. No.28 of 1998. The Special Leave Petition (SLP) filed by the Department against the

judgement in case Union Bank of India has been dismissed by the Supreme Court. [Refer 268 ITR (St) 216]

Disallowance of expenditure incurred in earning income which is exempt from tax

4.46 Section 14A has been inserted by the Finance Act, 2001, with retrospective effect from 1-4-1962, to provide that no deduction shall be allowed in respect of expenditure incurred by an assessee in relation to income which does not form part of the total income under the Income-tax Act, 1961. This principle will have application in the matter of exempted income earned by banks also, e.g., income from tax-free securities and dividend from shares of domestic companies.

4.47 Section 14A(2) empowers the Assessing Officer to determine the amount of expenditure incurred in relation to such income which does not form part of the total income in accordance with such method as may be prescribed. The method for determining expenditure in relation to exempt income is to be prescribed by the CBDT for the purpose of disallowance of such expenditure under section 14A. Such method should be adopted by the Assessing Officer if he is not satisfied with the correctness of the claim of the assessee, having regard to the accounts of the assessee. Further, the Assessing Officer is empowered to adopt such method, where an assessee claims that no expenditure has been incurred by him in relation to income which does not form part of total income [section 14A(3)].

4.48 The CBDT has, vide Notification No.45/2008 dated 24.3.2008, inserted a new Rule 8D which lays down the method for determining amount of expenditure in relation to income not includible in total income.

4.49 If the Assessing Officer, having regard to the accounts of the assessee of a previous year, is not satisfied with –

- (a) the correctness of the claim of expenditure by the assessee; or
- (b) the claim made by the assessee that no expenditure has been incurred in relation to exempt income for such previous year,

he shall determine the amount of expenditure in relation to such income in the manner provided hereunder -

4.50 The expenditure in relation to income not forming part of total income shall be the aggregate of the following:

- (i) the amount of expenditure directly relating to income which does not form part of total income;
- (ii) in a case where the assessee has incurred expenditure by way of

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interest during the previous year which is not directly attributable to any particular income or receipt, an amount computed in accordance with the following formula, namely :

$$A \times \frac{B}{C}$$

Where,

A = amount of expenditure by way of interest other than the amount of interest included in clause (i) incurred during the previous year;

B = the average of value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year;

C = the average of total assets as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year;

(iii) an amount equal to one-half per cent of the average of the value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year.

4.51 'Total assets' means total assets as appearing in the balance sheet excluding the increase on account of revaluation of assets but including the decrease on account of revaluation of assets.

4.52 The various judicial decisions on disallowance of expenses U/s.14A should be considered while making a provision for Income-tax. Reference may also be made to the, "Supplementary Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961" issued by ICAI for detailed discussion.

Share Issue Expenses

4.53 The Supreme Court in the case of *Brooke Bond India Ltd. Vs. Commissioner of Income-tax*, 224 ITR 798, has held that expenditure incurred on issue of shares is a capital expenditure for the purpose of taxation.

4.54 However, the expenditure incurred by a banking company on account of stamp duty and registration fees for the issue of bonus shares is allowable as revenue expenditure as held by the Supreme Court in *CIT v. General Insurance Corporation (2006) 286 ITR 232*.

4.55 Preliminary expenses are allowed as deduction under section 35D

over a period of 5 successive years starting from the year of commencement of business, i.e., one-fifth of the expenditure is allowed as deduction in each year. Such preliminary expenses include the following:

- (a) expenditure in connection with:
 - (i) preparation of feasibility report;
 - (ii) preparation of project report;
 - (iii) conducting market survey or any other survey necessary for the business of the assessee;
 - (iv) engineering services relating to the business of the assessee:

Provided that the work in connection with the preparation of the feasibility report or the project report or the conducting of market survey or of any other survey or the engineering services referred to in this clause is carried out by the assessee himself or by a concern which is for the time being approved in this behalf by the Board;

- (b) legal charges for drafting any agreement between the assessee and any other person for any purpose relating to the setting up or conduct of the business of the assessee;
- (c) Where the assessee is a company, also expenditure:
 - (i) by way of legal charges for drafting the Memorandum and Articles of Association of the company;
 - (ii) on printing of the Memorandum and Articles of Association;
 - (iii) by way of fees for registering the company under the provisions of the Companies Act, 1956;
 - (iv) in connection with the issue, for public subscription, of shares in or debentures of the company, being underwriting commission, brokerage and charges for drafting, typing, printing and advertisement of the prospectus;
- (d) such other items of expenditure (not being expenditure eligible for any allowance or deduction under any other provision of this Act) as may be prescribed.

Where the aggregate amount of the expenditure referred to above exceeds an amount calculated at five per cent:

- (a) of the cost of the project; or
- (b) where the assessee is an Indian company, at the option of the company, of the capital employed in the business of the company,

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The excess shall be ignored for the purpose of computing the deduction allowable for the preliminary expenses.

4.56 Such preliminary expenses incurred before commencement of business is allowed as deduction to companies in both the manufacturing and service sector. However, so far, such expenses incurred after commencement of business for extension of an industrial undertaking or for setting up a new industrial unit was allowed only for the companies in the manufacturing sector. This benefit has now been extended to the companies in the service sector as well. Consequently, the banking sector would also be benefited. This amendment has been effected by the Finance Act, 2008.

Depreciation

4.57 Generally, in respect of buildings, pending registration of documents of title, a note is given mentioning this fact. The Supreme Court has held in the case of *Mysore Minerals Ltd., (1999) 106 Taxman 166*, that “anyone in possession of property in his own title exercising such dominion over the property as would enable others being excluded therefrom and having the right to use and occupy the property and/or to enjoy its usufruct in his own right would be the owner of the building though a formal deed of title may not have been executed and registered as contemplated by the Transfer of Property Act 1882, Registration Act, etc.” The judgement clarifies that an assessee will be entitled to depreciation under section 32 of the Income tax Act, 1961 even where documents of title are pending registration.

4.58 The Courts have held in the case of *Syndicate Bank Vs. Commissioner of Income tax (1988) 172 ITR 561* and in the case of *Commissioner of Income-tax Vs. Central Bank of India Ltd. (1976) 103 ITR 196* that lockers (including, air - conditioners in locker rooms) are plant and machinery.

4.59 Where banks enter into sale and lease back transactions, according to Explanation 4A to Section 43(1), the written down value (as per the provisions of the Income Tax Act, 1961) of the original seller will be the cost to the bank for the purpose of depreciation.

Carry forward of unabsorbed business loss and depreciation on amalgamation of a banking company with a banking institution

4.60 With a view to provide for carry forward and set-off of accumulated loss and unabsorbed depreciation allowance of a banking company against the profits of a banking institution under a scheme of amalgamation sanctioned by the Central Government, section 72AA has been inserted in the Income-tax Act, 1961. This section provides that where a banking company has been

amalgamated with a banking institution under a scheme sanctioned and brought into force by the Central Government under sub-section (7) of section 45 of the Banking Regulation Act, 1949, the accumulated loss and unabsorbed depreciation of the amalgamating banking company shall be deemed to be the loss or the allowance for depreciation of the banking institution for the previous year in which the scheme of amalgamation is brought into force. It is to be noted that all the provisions contained in the Income-tax Act, 1961, relating to set-off and carry forward of loss and unabsorbed depreciation will apply accordingly in such a case.

4.61 The *Explanation* to this section defines the expressions “accumulated loss”, “banking company”, “banking institution” and “unabsorbed depreciation”, for the purposes of this section as follows—

- (i) “accumulated loss” means so much of the loss of the amalgamating banking company under the head “Profits and gains of business or profession” (not being a loss sustained in a speculation business) which such amalgamating banking company, would have been entitled to carry forward and set-off under the provisions of section 72 if the amalgamation had not taken place;
- (ii) “banking company” shall have the same meaning assigned to it in clause (c) of section 5 of the Banking Regulation Act, 1949;
- (iii) “banking institution” shall have the same meaning assigned to it in sub-section (15) of section 45 of the Banking Regulation Act, 1949;
- (iv) “unabsorbed depreciation” means so much of the allowance for depreciation of the amalgamating banking company which remains to be allowed and which would have been allowed to such banking company if amalgamation had not taken place.

4.62 Any transfer of a capital asset by a banking company to a banking institution in a scheme of amalgamation of such banking company with such banking institution sanctioned and brought into force by the Central Government under sub-section (7) of section 45 of the Banking Regulation Act, 1949 shall not be regarded as a transfer for the purposes of capital gains.

4.63 The cost of acquisition of the capital asset transferred to the banking institution, under the scheme of amalgamation of a banking company with the banking institution, shall be deemed to be the cost for which the banking company acquired it.

Wealth tax

4.64 Banks are liable to pay wealth tax in relation to specified assets mentioned in section 2(a) of the Wealth-tax Act, 1957. The auditor should

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examine whether the computation of net wealth and of the wealth tax payable is correctly made.

Gold Deposit Scheme

4.65 A Gold Deposit Scheme was introduced by the then Finance Minister in his budget for the year 1999. The incidence of wealth-tax on the gold held by the bank will have to be examined. Explanation 2 to section 2(ea) clarifies that 'jewellery' does not include the gold deposit bonds issued under the Gold Deposit Scheme, 1999 notified by the Central Government.

Service Tax

4.66 With effect from 01-07-2012, the category wise taxability of services has been done away with and the negative list regime has been introduced wherein all services provided by banks are covered under the service tax net unless specifically excluded vide inclusion in the negative list or exempted vide the various exemption notifications issued by CBEC from time to time.

4.67 Negative List based service taxation (w.e.f. 01.07.2012):

- Section 65B(44) of Finance Act 1994 (duly amended by Finance Act, 2012) defines the service to mean -
 - Any activity
 - carried out by a person for another
 - for consideration
 - and includes a declared service.
- The said definition further provides that 'Service' does not include –
 - any activity that constitutes only a transfer in title of goods or immovable property by way of sale, gift or in any other manner
 - a transfer, delivery or supply of goods which is deemed to be a sale of goods within the meaning of clause (29A) of article 366 of the constitution
 - A transaction only in money or actionable claim
 - A service provided by an employee to an employer in the course of the employment
 - Fees payable to a court or a tribunal set up under a law for the time being in force.
- Section 66D covers following services in the negative list. Hence following banking sector related services are out of the service tax net:
 - services provided by the Reserve Bank of India

- services by way of—
 - (a) extending deposits, loans or advances in so far as the consideration is represented by way of interest or discount,
 - (b) inter-se sale or purchase of foreign currency amongst banks or authorised dealers of foreign exchange or amongst banks and such dealers.
- Following banking sector related services are exempt from levy of service tax vide Entry No.29 of Notification No. 25/2012-ST dated 26.06.2012:
 - a mutual fund agent or distributor to mutual fund or asset management company for distribution or marketing of mutual fund,
 - a business facilitator or a business correspondent to a banking company or an insurance company in a rural area.
 - Except above referred services, all services provided by banks are liable to service tax.

4.68 Rate of Service Tax from inception to till date:

Period	Service Tax	EC	SHEC	Net Rate
01-07-1994 to 13-05-2003	5%	-	-	5.00%
14-05-2003 to 09-09-2004	8%	-	-	8.00%
10-09-2004 to 17-04-2006	10%	2%	-	10.20%
18-04-2006 to 10-05-2007	12%	2%	-	12.24%
11-05-2007 to 23-02-2009	12%	2%	1%	12.36%
24-02-2009 – 31-03-2012-	10%	2%	1%	10.30%
01-04-2012 onwards	12%	2%	1%	12.36%

4.69 Some banks have opted for centralized registration for service tax at their head office, zonal office, regional office or at branch office. This is known as Centralized Registration. Many banks are taking separate registrations for individual branches providing the services. This is known as a single premises registration. The statutory auditors auditing above referred units are required to ensure the service tax compliance.

4.70 An Illustrative checklist for Central Statutory Auditors is given below for:

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In case of Branch-wise Registration:

- Whether the head office, regional offices, zonal offices have properly availed the CENVAT Credit of the tax/duty paid on the input services, input, capital goods as the case may be.
- Whether the head office, regional offices, zonal offices has properly distributed the amount of service tax in the manner as specified in the CENVAT Credit Rules.
- Whether the banks have sought registration as input service distributor under Service Tax (Registration of Special Category of Persons) Rules, 2005 for distribution of CENVAT to its various branches where such banks are having branch wise registration.

In all such cases Auditor also needs to examine whether the office registered as 'input service distributor' is issuing invoice for distributing the CENVAT Credit as per rule 4A (2) of Service Tax Rules, 1994.

Further auditor examine whether the returns are being regularly filed as input service distributor.

In Case of Centralized Registration of Head Office/Regional Office/Zonal Offices

- Whether the permission of the Commissioner has been obtained for seeking centralized registration for the Head Office/Regional Office / Zonal Offices on the basis of Centralised Accounting?
- Whether the head office have filed the periodical return of service tax within the due dates. If the return is filed after the due date, whether the late filing fee has been paid?
- Whether the head office have made the payment of service tax monthly, by 6th day of the following month, if the duty is deposited electronically through internet banking and in accordance to Point of Taxation Rules, 2011? In the case of month of March, the payment should be made by 31st day of March?
- Whether the bank is discharging the liability under reverse charge mechanism as required under Notification No. 30/2012-ST dated 20.06.2012 duly amended till date on input services received by it?
- Whether bank has discharged the interest liability under section 75 of Finance Act, 1994 on late payment of service tax made by bank?
- Whether the appropriate amount of CENVAT Credit of the tax/duty paid on the eligible inputs, capital goods and input services have been availed?

Other Aspects

- Whether the CENVAT Credit have been taken on the basis of proper documents containing all particulars as prescribed by Rule 4A of Service Tax Rules, 1994 or relevant Central Excise Rules, 2002, i.e., serially numbered invoice/bill, etc. containing the requisite information like, Name and address of the service provider, Service Tax/Central Excise Registration Number, description of the services / goods, Amount of the service tax / excise duty, Name, address and the registration number of the bank, etc?
- Whether the head office has not availed depreciation U/s 32 of the Income Tax Act, 1961 on the amount of duty on the capital goods on which CENVAT Credit has been availed?
- Where the credit in respect of input services is taken on receipt of invoices, whether the payment of the value of input services and service tax payable thereon (as shown in invoice issued by input service provider) is made within three months of the date of invoice?
- Whether the credit on input services where the service tax is paid on reverse charge is taken on or after the day of payment of value of input service and deposit of service tax?
- Whether the credit availed has not been more than the payment made for service tax, which has been made available on the last day of the respective month?
- Whether an amount equivalent to 50% of the CENVAT credit availed on input goods and services availed during the month has been paid, as specified in sub-Rule 3B of Rule 6 of Cenvat Credit Rules, 2004?
- Whether the Bank has made repayment of CENVAT Credit availed in respect of capital goods sold, discarded, disposed off or removed for any reason by the bank as specified in Rule 3(5A) of the CENVAT Credit Rules, 2004?
- Whether the bank has submitted (in compliance of requirement of provision of Rule 5(2) of Service Tax Rules, 1994) a list of records maintained by branch to the concerned Superintendent, Service Tax. Whether bank maintains the records specified by it in said submission submitted in terms of Notification no. 45/2007 dated 28.12.2007?
- Whether effective system of data collation and collection from branches is in place to ensure proper compliance of service tax obligation?
- Whether the branches have followed the proper procedure? If any discrepancy is noticed by the branch auditor, the same has been properly considered at the head office level.

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- Whether the Head Office / Regional Office / Zonal Offices have issued the proper guidelines in respect of taxable and exempted services?
- Auditor also needs to examine whether the office registered as 'input service distributor' is issuing invoice for distributing the CENVAT Credit as per Rule 4A (2) of Service Tax Rules, 1994.

Branch

Service Tax

4.71 An Illustrative Check List for Bank Branch Auditors with respect to Service Tax is given below:

- Whether the branches have taken the Registration of Service Tax within 30 days from the date of levy of service tax or the date of start of business of the branch, whichever is later?
- Whether the bank has submitted (in compliance of requirement of provision of Rule 5(2) of Service Tax Rules, 1994) a list of records maintained by branch to the concerned Superintendent, Service Tax. Whether bank maintains the records specified by it in said submission submitted in terms of Notification No. 45/2007 dated 28.12.2007?
- Whether the bank has followed the uniform policy of collection and payment of service tax in respect of all the branches?
- Whether the branches have collected the service tax separately from the customers on the value of the taxable services. If it is inclusive of service tax, has the amount of service tax been properly calculated?
- Whether the branches have made the payment of service tax monthly, by 6th day of the following month, if the duty is deposited electronically through internet banking and in accordance to Point of Taxation Rules, 2011? In the case of month of March, the payment should be made by 31st day of March?
- Whether the branch is discharging the liability under reverse charge mechanism as required under Notification No. 30/2012-ST dated 20.06.2012 duly amended till date on input services received by it?
- Whether the branch has discharged the interest liability under section 75 of Finance Act, 1994 on late payment of service tax made by the branch?
- Whether the branch has filed the periodical return of service tax within the due dates? If the return is filed after the due date, whether the late filing fee has been paid?
- Whether branches have taken appropriate credit of CENVAT of the tax/duty paid on the eligible inputs, capital goods and input services?

Other Aspects

- Whether the CENVAT Credit have been taken on the basis of proper documents containing all particulars as prescribed by Rule 4A of Service Tax Rules, 1994 or relevant Central Excise Rules, 2002, i.e., serially numbered invoice/bill, etc. containing the requisite information like, Name and address of the service provider, Service Tax/Central Excise Registration Number, description of the services / goods, Amount of the service tax / excise duty, Name, address and the registration number of the bank, etc?
- Where the credit in respect of input services is taken on receipt of invoices, whether the payment of the value of input services and service tax payable thereon (as shown in invoice issued by input service provider) is made within three months of the date of invoice?
- Whether the credit on input services where the service tax is paid on reverse charge is taken on or after the day of payment of value of input service and deposit of service tax?
- Whether the branches have not availed the credit more than the payment made for service tax, which has been made available on the last day of the respective month?
- Whether an amount equivalent to 50% of the CENVAT credit availed on input goods and services availed during the month has been paid, as specified in sub-Rule 3B of Rule 6 of Cenvat Credit Rules, 2004?
- Whether the branches have made repayment of CENVAT Credit availed in respect of capital goods sold, discarded, disposed off or removed for any reason by the branch as specified in Rule 3(5A) of the CENVAT Credit Rules, 2004?
- Whether the branches have taken the appropriate credit on the invoice / challan / bill or any other documents issued by the Head Office, Regional Office, Zonal Office as an input service distributor?
- Whether the branches have mentioned their service tax registration number on the statement, slips, challan, bill, invoice or any other documents issued to the customer for the services rendered by the Bank?
- Whether the branches have made arrangements to ensure that service tax is not collected on the interest amount?

