

# Guidance Note on Audit of Banks (2023 Edition)

## Attention

Members' attention is invited to relevant directions/circulars issued by the Reserve Bank of India up to February 28, 2023 available at ICAI website 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, 2023.

Members are also advised to read this Guidance Note in conjunction with other two publications (Technical Guide on Audit of Internal Financial Controls in Case of Public Sector Banks and Technical Guide on Revised Formats of Long Form Audit Report) of AASB.



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

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First Edition	:	November, 1994
Second Edition	:	March, 2001
Third Edition	:	March, 2005
Fourth Edition	:	March, 2006
Fifth Edition	:	February, 2008
Sixth Edition	:	February, 2009
Seventh Edition	:	March, 2011
Eighth Edition	:	March, 2013
Ninth Edition	:	February, 2014
Tenth Edition	:	February, 2015
Eleventh Edition	:	January, 2016
Twelfth Edition	:	February, 2017
Thirteenth Edition	:	March, 2018
Fourteenth Edition	:	February, 2019
Fifteenth Edition	:	March, 2020
Sixteenth Edition	:	March, 2021
Seventeenth Edition	:	February, 2022
Eighteenth Edition	:	March, 2023

Committee/ Department	:	Auditing and Assurance Standards Board
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Price	:	Rs. 700/-
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ISBN	:	978-81-8441-690-9
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Published by	:	The Publication Department on behalf of the Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002.
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# Foreword

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An efficient and robust banking system is a key indicator of economic strength of a country, and for a developing country like India, it is one of the fundamental metrics of the economic stability. With the effective prudential norms followed by Indian banking system duly supported by effective bank audit practices, India has ably withstood the financial crisis of the past.

Over the past few decades, the Indian banking system has witnessed a radical shift in its functioning and way of operations as it is increasingly a technology and data driven business now. With the advent of increasing technological changes, there has been an increased focus on the spectrum of risk management, information systems and internal financial controls in banks by the regulatory authorities.

These developments have significant implications on functioning of banks and simultaneously have more expectations from the auditing profession than before. Thus, it is essential that the banks statutory auditors are well equipped in terms of their knowledge and keep themselves abreast with the latest developments in banking sector.

The Institute of Chartered Accountants of India (ICAI) provides members with adequate facilities and guidance by continuously enhancing their knowledge, skills and professional values to meet the challenging environment and maintain quality and ethics in all their professional endeavors.

The Auditing and Assurance Standards Board (AASB) of ICAI under the authority of the Council of ICAI brings out revised version of *Guidance Note on Audit of Banks* every year with the objective to provide detailed guidance to the members on statutory audit of banks and bank branches. I am happy that the AASB of ICAI has come out with this revised 2023 edition of the “Guidance Note on Audit of Banks” for the benefit of the members and other stakeholders.

I compliment CA. (Dr.) Sanjeev Kumar Singhal, Chairman, CA. Vishal Doshi, Vice-Chairman and other members of the Auditing and Assurance Standards Board for bringing out this revised edition of the Guidance Note to assist members in updating their knowledge and laying down audit procedures relating to bank audits.

I am confident that the Guidance Note would be of immense use to members and other stakeholders.

New Delhi  
March 13, 2023

**CA. Aniket Sunil Talati**  
President, ICAI



# Preface

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Banking sector is the backbone of any economy as it helps in sustainable socio-economic growth of the economy. Like other economic activities, banking sector is also exposed to various risks in its operations. For financial stability in the economy, it is essential that banking sector stays healthy, safe and sound. It is needless to state that the annual statutory audit plays pivotal role in establishing the credibility of the financial statements of banks.

The Auditing and Assurance Standards Board (AASB) of ICAI has also been contributing in the above said objective by helping the members in maintaining quality in bank audits. The AASB brings out the publication "Guidance Note on Audit of Banks" every year to provide detailed guidance to the members conducting audits of banks and their branches. The Guidance Note is updated every year to incorporate the recent updates, impact of amendments and changes in banking environment, such as, master directions/circulars of RBI, relevant advisories, pronouncements of ICAI having bearing on bank audits and amendments/changes in applicable laws or regulations.

We are happy to place in your hands this revised 2023 edition of the Guidance Note on Audit of Banks. The Guidance Note is divided into two Sections i.e. Section A - Statutory Central Audit and Section B - Bank Branch Audit. For benefit of the members, the Guidance Note also contains various Appendices like illustrative formats of engagement letter, illustrative formats of auditor's report both in case of nationalized banks and banking companies, illustrative formats of management representation letter, the text of master directions, master circulars and other relevant circulars issued by the RBI. The revised Guidance Note was initially developed by eight study groups and one consolidating group constituted for this purpose and thereafter it was finalised with the contribution of the Board members and the Council members.

The members may note that the Auditing and Assurance Standards Board has also issued two separate publications i.e. "Technical Guide on Audit of Internal Financial Controls in case of Public Sector Banks" and "Technical Guide on Revised Formats of Long Form Audit Report" which are relevant for bank audits. Accordingly, we request the members to use this Guidance Note in conjunction with the aforesaid publications.

At this juncture, we wish to place on record our sincere gratitude to all Convenors viz., CA. Abhay Kumar Chhajed, CA. Cotha S. Srinivas, CA. Gyan Chandra Misra, CA. Piyush S. Chhajed, CA. Priti Paras Savla, CA. Purushottamlal H. Khandelwal, CA. (Dr.) Raj Chawla, CA. Umesh Ramnarayan Sharma, and all members of eight study groups for their contribution in revising the Guidance Note. We also acknowledge the contribution made by members of consolidating group in finalising the Guidance Note.

We express our sincere thanks to CA. Aniket Sunil Talati, Honourable President, ICAI, CA. Ranjeet Kumar Agarwal, Honourable Vice-President, ICAI and CA. (Dr.) Debashis Mitra, Honourable Immediate Past President, ICAI for their guidance and support in various endeavours of the Board.

We are thankful to all the Board members and Council members for their guidance and support in finalizing this Guidance Note. We appreciate the efforts made by CA. Megha Saxena, Secretary, AASB and other staff of AASB in giving the Guidance Note its final shape.

We are sure that the members would find the Guidance Note useful while conducting audits of banks and bank branches.

**CA. Vishal Doshi**  
Vice Chairman  
Auditing and Assurance Standards Board

**CA. (Dr.) Sanjeev Kumar Singhal**  
Chairman  
Auditing and Assurance Standards Board

# Acknowledgement

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The Board acknowledges the contribution made by the following members of the Study Groups constituted for the purpose of revising the Guidance Note on Audit of Banks and we place on record our gratitude for their contribution in enrichment of knowledge of the members:

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**Section A**  
**Statutory Central Audit**



# Personal Banking Department

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## Introduction

1.01 The area of operation / function of the Personal Banking Department is typically confined to resource mobilization, i.e., source of funds (for the bank) in the form of CASA deposits, term deposits and customer service and operations. This Department is responsible for monitoring the deposit portion which is the major contributor for the bank as resource of funds.

1.02 In today's new age banking, there are various innovative products which are launched by every bank which has its own unique characteristics and customisation based on the need for funds and customer portfolio of the bank. For example, the bank may have deposit products as well as products / services linked with categorisation of customers based on predefined criteria offering privileged banking services to certain section of customers. In the era of interest rate liberalisation, every bank is expected to be proactive in terms of decision making in respect of rate of interest. Further, the banks do have specified policies w.r.t. bulk deposits and a bank may offer need-based special rates on such deposits.

1.03 Personal banking is responsible for handling the needs of retail customers. Each Bank will have its own threshold for defining who is a retail customer based on the products and services offering criteria. Banks may have assigned relationship manager for each customer based on his/her deposit placement (or any other parameters) with the bank, who is a single point of contact for all their needs of banking services, be it loans, cards, deposits, insurance and other investments. This is also referred to as Wealth Management Division in some banks. This is covered in Chapter 3 on "Financial Services provided by Banks" of Section A of the Guidance Note on Audit of Banks (2023 Edition).

1.04 The Operations Department of a bank oversees various functions. At a broad level the Banking Regulation Act defines, what functions a bank can conduct. Within this overarching framework, banks conduct a variety of operations which can be centralized or decentralized which would vary from bank to bank.

1.05 Due to increased competition, customer service plays a key role and the operations Department has to ensure that the team does things right. Any error

## **Guidance Note on Audit of Banks (Revised 2023)**

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in operations pose a risk to the bank as a result of the loss caused to the customer or the reputational risk involved.

1.06 Banks may have adopted Citizen's Charter/ Charter for Customer Service, which would have elaborate details of the bank's committal approach towards customer service.

### **Preparation / Planning**

1.07 The Statutory Central Auditor (SCA) should obtain an understanding of various types of deposit products of the bank and the process of determination of interest rate and other charges on these deposits as per rules and regulations framed by the bank. The bank may have various methodologies adopted for interest payment; the deposits can be non-cumulative or cumulative and in certain cases the bank may launch schemes wherein there is a bullet payment of interest at the end of the tenure of deposits without compounding of interest.

The auditor should also obtain an understanding of the organizational structure more specifically the functions of relationship managers.

### **Conduct / Execution**

1.08 The auditor is required to carry out the following:

- Verify the compliance of KYC norms at the time of opening of CASA or term deposit accounts. This should synchronise with the bank's policy on customer acceptance.
- Verify the application of rate of interest as per the interest table to every product of deposits by taking sample accounts of each type of deposit product including instances of premature withdrawal of deposits, and retrospective renewal of deposits.
- Verify whether the TDS flag is correctly configured wherever Form 15G/15H has been received by the bank and that TDS as per the rates in force has been deducted on interest payments made during the year.
- Verify application of various charges on CASA, e.g. minimum balance charges etc., on test check basis and compliance thereof in terms of Reserve Bank of India's (RBI) circulars and instructions related thereto.
- Verify whether the accounting effects of interest payable in the form of interest accrued but not due and interest accrued and due are correctly given as also TDS compliance thereon.



- Verify compliance with internal circulars of the bank in terms of categorisation of customers, and application of the said terms in the master data of such deposit holders by reviewing the internal audit reports.
- Verify the compliance with the rules and regulations formulated by the bank related to the deposit products based on sample checks and review of concurrent audit report.
- Verify the complaints lodged w.r.t. the customer services and contingent liability / liability arising thereon and disclosures stipulated by RBI circular related thereto.
- Verify the special rate deposits (those deposits where rate of interest is deviated as compared to the interest table) as regards the eligibility and approval of the same as per the internal policy of the bank.
- Verify major movements in interest expenses and movements in interest bearing deposit (savings accounts and term deposits).
- Verify the foreign currency deposits accounts opened and the norms set for utilization and repatriation of funds.
- Services offered to senior citizens like higher interest rates, terms of fixed deposits products need to be verified on parameter levels.

### **Reporting / Conclusion**

1.09 Check whether the appropriate presentation of deposits is made in financials of the bank with reference to the classification of deposits between demand, savings and term deposits, interest accrued thereon and also verify the requirement for disclosure of contingent liability, if any, arising out of consumer court and other cases, related to deposits. Based on audit issue, appropriate reporting of adversities observed in the Deposit section and customer services needs to be made.

1.10 The auditor should also verify the correct classification of Credit balances in overdrafts, cash credit accounts under deposit and the correctness of depositor disclosure of top 20 largest depositors in the notes to accounts.

1.11 The auditor should look for transactional errors pointed out in the concurrent / internal audit reports and ensure that operational deficiencies or gaps are rectified by process improvements. The key is to correct the root cause that led to the operational error.

# 2

## Retail Banking and Marketing Department

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### Introduction and Bank's process

2.01 Banks generally provide the following retail advances:

- Home loans and loans against property or mortgage loans
- Vehicle/automobile loans
- Education loans
- Personal loan
- Consumer durable loans
- Credit cards
- Micro finance loans
- Jewel loans or gold loans
- Loan against securities
- Mudra loans

2.02 Generally, loans are either sourced through direct selling agents, relationship executives or officers (may be outsourced officials, depending on bank's policy) or through bank's own branches targeting existing bank customers, as well as new customers. The bank has a credit policy which specifies the process to be followed for sanction and disbursement of loans, and the various documents required. Sanction for retail loans and management of retail loans cannot be outsourced.

2.03 The RBI has prohibited banks from deploying Direct Selling Agents (DSAs) to sell retail loans and verifying borrowers' documents. KYC procedures, involving verifying borrowers' original documents should be performed by bank officials and cannot be outsourced<sup>1</sup>.

2.04 Generally, the credit assessment process is different from corporate loans. The bank generally collects following documents:

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<sup>1</sup> RBI Notification No. RBI/2006/167 DBOD.NO.BP. 40/ 21.04.158/ 2006-07 on Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by banks dated November 03, 2006.

- Completely filled Loan Application Form with customers' signature.
- Income proof like salary slip, financial statements, Income tax returns, bank statement.
- Photograph.
- Business continuity proof (e.g. Form D of Maharashtra Shops and Establishments Act/ Any other govt. certificate for doing business).
- Residence proof.
- Identification proof.
- Contact point – Mobile number of applicants is mandatory.
- Age proof.
- PAN Card.
- Aadhaar Card.
- Property documents (in case of mortgage).
- Udyam Registration certificate (in case the applicant is MSME).
- End use declarations.
- Documents relating to beneficial ownership<sup>2</sup>.
- Proof of residence if different from Aadhaar (if Aadhaar does not have updated address<sup>3</sup>).

Banks may undertake Video based Customer Identification Process (V-CIP) as an alternate method of customer identification with facial recognition and customer due diligence by an authorised official of the bank by undertaking seamless, secure, live, informed-consent based audio-visual interaction with the customer to obtain identification information required for Customer Due Diligence (CDD) purpose, and to ascertain the veracity of the information furnished by the customer through independent verification and maintaining audit trail of the process. Such processes complying with prescribed standards and procedures shall be treated on par with face-to-face Customer Identification Process. (Ref: RBI Master Direction No. RBI/DBR/2015-16/18; DBR.AML.BC.No.81/ 14.01.001/ 2015-16 on "Know Your Customer (KYC) Direction, 2016" dated February 25, 2016 (Updated as on May 10, 2021).

### **Credit Due Diligence for Retail Financing**

2.05 Credit due diligence for a retail financing is different from the wholesale financing since the quantum of loan and the complexity of

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<sup>2</sup> Master Direction - Know Your Customer (KYC) Direction, 2016 (Updated as on May 10, 2021).

<sup>3</sup> Master Direction on KYC (Updated as on May 10, 2021).

transaction are different. Retail finance credit due diligence is parameterised/ score card driven wherein if the borrower fits into a pre-defined credit matrix / parameters and gets a score which is above the threshold/ fulfills all criteria defined in the bank's system, the loan is approved / sanctioned. The scorecard parameter would be suitably deliberated and considered based on historical experience and keeping in view the dynamic environment like minimum income criteria, employment details, age, property details, purpose of the loan, type and value of commodities to be hypothecated, if any, telephone number etc. Once the score is generated the bank would also run CIBIL score and if CIBIL score is above the specific score then the bank considers further sanction. Apart from the CIBIL score, the bank officials also tend to consider/ analyse any adverse remarks mentioned in the CIBIL report or any overdue balances reflected in the CIBIL report. The scorecard based approved portfolio is closely monitored at regular frequency and the parameters are suitably modified based on portfolio's performance.

2.06 For example, for farm / tractor loan, parameters / factors like soil fertility, area under cultivation, produce per acre, rainfall / reservoirs levels, make and model of the tractor and geography are pre-defined and weightages are assigned to each parameter depending on the criticality which will throw up a score for each borrower. These models/ score cards are embedded in the loan management system of the banks which result into auto approval of the loan subject to any deviations from the policy parameters which needs to be approved by the designated authority as per the DOP matrix before the loan application moves to the sanction stage. Where the quantum of the loan is small, the number of retail borrowers is significantly large and therefore it is time consuming for banks to evaluate credit for each borrower. Hence credit loan approval for retail financing is primarily score card driven. The parameters could be qualitative and quantitative in nature.

2.07 Banks, generally, have systems in which various bits of information are collected and are keyed into the system under various stages for processing. Generally, the system automatically runs a credit filter report which states the eligibility of the prospective borrower for the requested loan, along with a maximum limit of loan which can be sanctioned to the said borrower. The same forms the basis on which credit managers prepare the Credit Appraisal Note/Memorandum. The credit filter report is based on pre-defined criteria as per the credit policy like minimum income criteria, employment details, age, telephone number etc. and the scores are generated from the system.

2.08 As a part of sanction process of the loan, the bank also checks CIBIL score and if the CIBIL score is above the specified score then the bank proceeds for further sanction.

2.09 The bank also conducts field investigations on the proposed customer which generally involve residential and office visits. Some banks also have Fraud Containment Units (FCU) for screening the selected sample file. The FCU officer examines the genuineness and authenticity of the documents from the perspective of any traces of a fraud. FCU officials may also conduct visits in order to confirm whether the “declared” activity, for the purpose of which funding is required, is, in actuality being carried out.

2.10 Post such verification by FCU, the bank also initiates the Positive de-duplication check for positive database, wherein if the customer is an existing customer of the bank, the system gets the popup of such links on his screen. This activity is performed mainly to avoid creating multiple Customer Ids, and consequently multiple databases for the same borrower.

2.11 The credit officer initiates the negative de dupe check on the negative database through the system, Negative De dupe check against RBI defaulter list, terrorists list, Anti Money Launderers list and earlier declined applications. Such list is uploaded in the system by central team of the bank. If the customer is traced under such negative listing then the loan application is either rejected by the credit officer in the system or an appropriate deviation is taken for the same. Once, all the processes are completed, based on the results, the bank sanctions the loan.

### **Post Disbursement Monitoring**

2.12 Once the funds are disbursed, periodic reviews on the portfolio/borrowers/assets are conducted by the relevant Business and Credit Departments. Notwithstanding sound appraisal processes and risk management, some portfolios / accounts may develop weakness on account of changes in the internal or external conditions. Mechanisms for monitoring and identifying early warning signals (EWS) should be in place to review the portfolio and identify such weak accounts before they turn NPA. These monitoring mechanisms will help the bank to take remedial measures and limit losses. Such monitoring can be undertaken through the following:

#### *Retail Financing*

Roll forward / roll back rates – (deterioration on days past due / improvement in days past due).

Infant/ early delinquencies–non-payment of first EMI/ instalments.

Performance review across branch/ scheme/ program/ Relationship Manager etc., Score card parameter reviews.

The audit procedure for retail loans has been explained in detail in Chapter 11 “Reporting for Advances” of Section B of the Guidance Note on Audit of Banks (2023 Edition).

### **Other Aspects**

2.13 The auditor should review the compliance of Master Direction No. RBI/DBR/2015-16/20 Master Direction DBR.Dir. No.85/13.03.00/2015-16 dated March 03, 2016 (Updated as on June 10, 2021) on “Reserve Bank of India (Interest Rate on Advances) Directions, 2016”. It provides:

- (a) All new floating rate personal or retail loans (housing, auto, etc.) and floating rate loans to micro and small enterprises extended by banks from October 01, 2019 and floating rate loans to medium enterprises from April 01, 2020 shall be benchmarked to one of the following:
  - RBI policy repo rate;
  - Government of India 3-Months Treasury Bill yield published by the Financial Benchmarks India Private Ltd. (FBIL);
  - Government of India 6-Months Treasury Bill yield published by the FBIL;
  - Any other benchmark market interest rate published by the FBIL.
- (b) Banks are free to offer such external benchmark-linked loans to other types of borrowers as well. However, the interest rate under external benchmark shall be reset at least once in three months.
- (c) In order to ensure transparency, standardisation, and ease of understanding of loan products by borrowers, a bank must adopt a uniform external benchmark within a loan category; in other words, the adoption of multiple benchmarks by the same bank is not allowed within a loan category.

### **Digital Banking Units (DBUs)**

2.14 As a part of efforts to accelerate and widen the reach of digital banking services, the Reserve Bank of India has introduced the concept of “Digital Banking Units” (DBUs)<sup>4</sup>. The detailed guidelines on the Digital Banking Units and Digital Lending have been given in Chapter 6, ‘Audit of Information Technology and Digital Banking Division’ of Section A of Guidance Note on Audit of Banks (2023 Edition).

### **Securitisation of Standard Assets/Pool Accounts**

2.15 In terms of RBI Master directions RBI/DOR/2021-22/85 DOR.STR.REC.53/21.04.177/ 2021-22 ‘dated September 24, 2021 (Updated as

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<sup>4</sup> RBI Notification No. RBI/2022-23/19 DOR.AUT.REC.12/22.01.001/2022-23 on Establishment of Digital Banking Units (DBUs) dated April 07, 2022.

on December 5, 2022) on Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021', "securitisation" means a structure where a pool of assets are transferred by an originator to a SPE and the cash flow from this pool of assets is used to service securitisation exposures of at least two different tranches reflecting different degrees of credit risk, where payments to the investors depend upon the performance of the specified underlying exposures, as opposed to being derived from an obligation of the originator. Assets eligible for securitisation are detailed in the Master Directions.

2.16 The originators of such exposures shall satisfy the minimum holding period requirement as per Clause 39 of the Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021 dated September 24, 2021 (Updated as on December 5, 2022).

2.17 Wherever a third-party servicing agent service have been availed, the originator shall ensure robust and legally binding information sharing mechanisms are in place to comply with stipulated reporting requirements with requisite frequency and rigor. In such cases of obtaining data from third-party entities, the originator must get information duly certified by the respective third-party auditors.

2.18 Only those loans/receivables will be eligible for securitisation where a borrower (in case of agricultural loans) or a drawee of the bill (in case of trade receivables) has fully repaid the entire amount of last two loans/receivables (one loan, in case of agricultural loans with maturity extending beyond one year) within 90 days of the due date. Since the liquidity facility is meant to smoothen temporary cash flow mismatches, the facility will remain drawn only for short periods, preferably not used for two consecutive repayments to investors. If the drawings under the facility are outstanding for more than 90 days it should be classified as NPA and fully provided for.

2.19 The auditor may obtain an understanding of internal control procedures adopted by the bank to ensure classification of individual loan accounts received is as per IRAC norm. Further the auditor may review the procedure followed to ensure that classification of all accounts with different originator within the bank is the same.

2.20 The auditor may review security trustee report wherever a security trustee is appointed by bank or the concurrent audit report to monitor the liquidity of the receivable.

2.21 The auditor may review bank procedure to ensure that Reserve Bank of India (Priority Sector Lending – Targets and Classification) Directions, 2020 are adopted, receivable wise and not originator wise.

### **Direct Marketing Expenses**

2.22 These are expenses incurred mainly for sourcing of retail loans/credit cards and collection of retail overdue loans. The auditor should verify the controls around the determination of quantum of commission and eligibility based on the sanction/disbursement made during the period. Further, the auditor should also review the policy adopted by the bank to evaluate the performance of these sourcing agents. The RBI vide circular no. RBI/2006/167/DBOD.NO.BP. 40/21.04.158/2006-07 dated 3<sup>rd</sup> November, 2006 on “Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by banks” clearly states that activities of internal audit, compliance function and decision making functions like compliance with KYC norms for opening deposit accounts, according sanction for loans (including retail loans) and management of investment portfolio cannot be outsourced.



# 3

## Financial Services provided by Banks

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### Introduction

3.01 Banks can undertake certain eligible financial services or para-banking activities either departmentally or by setting up subsidiaries. Banks may form a subsidiary company for undertaking the types of businesses which a banking company is otherwise permitted to undertake, with prior approval of the RBI and subject to fulfilment of certain stipulated eligibility criteria. The instructions issued by the RBI to banks for undertaking various financial services are stated in RBI Master Direction No. DBR.FSD.No.101/ 24.01.041/ 2015-16 dated May 26, 2016 (Updated as on August 10, 2021) on "Reserve Bank of India (Financial Services provided by Banks) Directions, 2016".

3.02 A bank can undertake business permitted under Section 6(1) of Banking Regulation Act 1949 provided:

- There shall be a Board approved policy for the activity that shall comprehensively cover the said activity including the various risks associated with it and suitable risk mitigation measures.
- The instructions/ guidelines on KYC/AML/CFT applicable to banks, issued by the RBI from time to time, shall be complied with.
- The general principles as enunciated in the Charter of Customer Rights issued by the RBI shall be adhered to.
- Specific conditions of IRDA, SEBI, PFRDA and Accounting Standards issued by ICAI need to be complied.
- No bank shall engage in a financial activity without prior approval of the RBI other than approved activities.
- Investment by a bank in a subsidiary or in a financial services company not being a subsidiary or a non-financial services company are required to be within the stipulated prudential regulations and require prior approval of the RBI as stipulated in the above said Master Direction.
- The bank may ensure compliance of regulatory requirement to maintain an "arm's length" relationship with the subsidiary sponsored by the bank as stipulated in the above said Master Direction. Bank may ensure compliance with SEBI Act/ Companies Act provisions regarding Related Party transactions.

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3.03 Following are some examples of Financial Services Provided by the banks:

- Insurance Business
- Mutual Funds Business
- Collection of Utility Bills and Taxes
- Investment Advisory Services
- Government Bonds/Securities
- Demat Accounts
- Portfolio Management Services
- Referral Services
- Equipment Leasing and Hire Purchase Business
- Sponsoring Infrastructure Debt Funds
- Underwriting Activities
- Primary Dealership Business
- Pension Fund Management Business
- Agency Business
- Retailing of Government Securities
- Acting as Executors and Trustees
- Factoring Services
- Broking Services

3.04 The auditor should note the following aspects while conducting audit of Financial Services provided by the bank:

- 1) A bank that is a trading/clearing member shall keep its and clients' position distinct from one another.
- 2) Professional Clearing Member of the commodity derivatives segment of SEBI recognised exchanges needs to satisfy the prudential criteria.
- 3) Bank shall take exposure on its trading members as per the policy approved by its Board.
- 4) Banks shall ensure strict compliance with various margin requirements as may be prescribed by the bank's Board or the Commodity Exchanges as also the extant RBI guidelines regarding guarantees issued on behalf of commodity brokers.
- 5) Banks holding custody of MF units on behalf of their customers should ensure that their own investments and investments made by/belonging to their customers are kept distinct from each other.
- 6) Banks may invest in other equipment leasing/ hire purchase/factoring companies within the limits specified in Section 19(2) of Banking Regulation

Act, 1949, with prior approval of the RBI but they shall not act as promoters of such companies.

- 7) Banks may act as a sponsor to Infrastructure Debt Funds – Mutual Funds (IDF- MF) or Infrastructure Debt Funds – Non-Banking Finance Companies (IDF- NBFCs), subject to adherence to SEBI/RBI regulations and prior approval of RBI.
- 8) Bank may undertake Primary Dealership business through a subsidiary registered as an NBFC or departmentally subject to authorisation from IDMD.
- 9) Bank may undertake Pension Fund Management/ Investment Advisory Services business/ Insurance business with risk participation through a subsidiary/joint venture, subject to fulfilment of the eligibility criteria.
- 10) Bank may act as a broker departmentally subject to the conditions mentioned under Section 18(d) of the Master Direction No. DBR.FSD.No.101/ 24.01.041/ 2015-16 dated May 26, 2016 (Updated as on August 10, 2021) on “Reserve Bank of India (Financial Services provided by Banks) Directions, 2016 on insurance agency business.
- 11) There is an approved policy in place detailing the products and the manner in which they can be and are sold. The policy should be in conformity with extant RBI and other regulatory guidelines. Adherence to the policy should be strictly ensured.
- 12) Bank’s staff who are designated to sell these products should have the necessary prescribed qualifications and training. The sale should be done by the designated employees only. The suitability and appropriateness of the product to the customer to whom it is sold must be ensured. Extreme care should be taken to ensure that the products are not mis-sold. The bank may suffer a huge credibility risk as a result of erosion of trust due to mis-selling. The bank should have zero tolerance for such violations and due sensitization of the employees must be done on an ongoing basis.
- 13) It shall be ensured that performance assessment and incentive structure for staff is not violative of Section 10(1) (ii) of the Banking Regulation Act, 1949 or the guidelines issued by IRDA in the payment of commissions/brokerage/ incentives. It shall also be ensured that no incentive (cash or non-cash) is paid to the staff engaged in insurance broking/corporate agency services by the insurance company.
- 14) Complaints, if any, on mis-selling of these products or deficiency in service should be looked into for proper redressal and closure. These complaints may pose both a regulatory and a reputational risk to the bank. Necessary

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disciplinary action against the concerned staff should be initiated as per bank's internal policy.

- 15) For any outstanding receivables from these third parties, balance confirmations should be called for and be on record. Any old outstanding should be verified for disputes, appropriate provisioning or write-off.
- 16) The auditor should verify the income recognized by cross checking data received from principals (such as Mutual Funds/Insurance Companies) with their internal systems. The auditor should also insist on regular income statements and balance confirmations from such parties.
- 17) General IT controls and controls over Management Information including contingency plans to ensure business continuity.
- 18) For Portfolio Management / Investment advisory services undertaken by the bank, the auditor should check:
  - a. Client service agreement with wealth management clients and ensure that the bank is complying with all terms contained in the agreement.
  - b. The auditor should check that the portfolio funds are not deployed by bank for lending in call money/bills market and lending to/placement with corporate bodies.
  - c. The auditor should also check that the terms of such service agreements are in compliance with the requirements/provisions of other market regulators like SEBI, IRDA, etc.
  - d. The auditor should check fee income recognized by the bank with charges mentioned / agreed with the clients. Further, the fee income shall be independent of the return to the client.
  - e. The auditor should ensure that these charges are recovered as per the terms and old outstanding recoverable balances are dealt with accordingly by the bank's management.
  - f. The auditor should carry out cut-off procedures and ensure completeness of fee income recognized for the year and accrue the earned income/commission and defer income received in advance based on services rendered.
  - g. The auditor should check that the bank has maintained client wise account/record of funds accepted and investments made there against, and all credits (including realised interest, dividend, etc.) and debits (tax deducted at source in respect of interest/dividend on securities) shall reflect in such account.

- h. The auditor should check that there is a clear functional separation of trading and back office functions relating to banks' own investment accounts and PMS clients' accounts.

### **Outsourcing of Financial Services**

3.05 Banks may undertake to outsourcing certain eligible financial services or para-banking activities as per the instructions issued by the RBI to banks for undertaking various financial services are stated in RBI Master Direction No. DBR.FSD.No.101/24.01.041/2015-16 dated May 26, 2016 (Updated as on August 10, 2021) on "Reserve Bank of India (Financial Services provided by Banks) Directions, 2016", in compliance with RBI guidelines No. RBI/2006/167 DBOD.NO.BP. 40/ 21.04.158/ 2006-07, November 3, 2006 dated November 3, 2006 on Managing Risks and Code of Conduct in Outsourcing of Financial Services by banks.

3.06 The auditor should note the following aspects while conducting audit of outsourcing of Financial Services, in addition to the above mentioned audit points;

- 1) Agreements are entered into with reputed third-party product providers do not involve outsourcing of core management functions (as laid down by Board / Governance Outsourcing policy).
- 2) Agreements are entered into with reputed third-party product providers. Due diligence on the financial credentials and the reputation of the third party is comprehensively done before the tie-up. Detailed diligence testing and validation documents should be in place.
- 3) The original agreements must be on record, properly filed and stored. Compliance with the terms and conditions of the agreement from both parties must be ensured. Timely renewal of these agreements should be ensured.
- 4) Revenue earned on sale of these products is properly accounted and received as per the contractual rates specified in the agreement entered into between these parties. These rates could change from time to time. Correct applicable rates should be accounted. The point of accounting of Income is critical and it should be consistently applied. The auditor should also verify compliances with GST and withholding tax provisions of the Income-tax Act while recognising revenue from distribution of third-party products.
- 5) General IT controls and controls over Management Information including contingency plans to ensure business continuity.

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6) Agreements cover the Data privacy, Data sharing clauses with clearly defined responsibilities and Data Localisation as per the RBI Notification issued vide RBI/2017-18/153 DPSS.CO.OD No.2785/06.08.005/2017-2018 dated April 6, 2018 on 'Storage of Payment System Data'.

7) Off-shore outsourcing of Financial Services.

3.07 The engagement of service providers in a foreign country exposes a bank to country risk - economic, social and political conditions and events in a foreign country that may adversely affect the bank. Such conditions and events could prevent the service provider from carrying out the terms of its agreement with the bank.

3.08 In addition to the above, the auditor should note the following aspects while conducting audit of offshore third-party product operations:

- a) Agreements covering the governing law of the arrangement should be clearly specified.
- b) Agreements cover clauses to manage the country risk involved in such outsourcing activities i.e. the bank had taken into account and closely monitor government policies and political, social, economic and legal conditions in countries where the service provider is based, during the risk assessment process and on a continuous basis, and establish sound procedures for dealing with country risk problems. This includes having appropriate contingency and exit strategies. In principle, arrangements should only be entered into with parties operating in jurisdictions generally upholding confidentiality clauses and agreements.
- c) Agreements covering analysis of any contingency event shall be mentioned in line with host country regulation and its impact consideration in India / bank's own country along with accounting impacts, if any.

# 4

## **International Banking Division**

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### **Functions**

4.01 The functions of International Banking Division (IBD) include the following:

- Monitoring of Overseas Branches
- Monitoring of advances accounts of Foreign branches
- Obtaining Audit Reports of Overseas Branches
- Annual Budgeting of Overseas Branches
- Sanctioning of Expenses of Overseas Branches
- Review of policies for foreign branches such as ORM Policy, IBO Policy, Premises Policy
- Compilation of Unhedged Foreign Currency Exposure and country risk exposure
- Conversion of the Branch Balance Sheet for consolidation into bank's Balance Sheet
- ECGC claims
- Returns filing
- Investments held by Foreign Branches - Monitoring the limits set by Treasury
- GST compliances
- Cash management, fund and wire transfers

4.02 The auditor should understand the organization structure and the functionalities of the specialized centralized division. If there is a Manual of operations in place, then he should obtain the latest updated version. The auditor should also obtain copies of inspection or other internal audit reports of this division which covers the efficiency of various functional operations. The auditor should seek and peruse the inspection report by the local central bank or regulatory or monitoring authority. The audit scope, frequency of audit and the accuracy of MIS generated and communicated should be looked into. Open issues should be followed up for closure and the reasons as to why these issues were not addressed till date, should also be understood.

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4.03 Appointment of competent staff to handle overseas operations, appointment of overseas statutory auditors, sanction of expenses, obtaining timely audit reports in compliance with local laws, MIS, ensuring integration of these accounts with local accounts are key functions and the SCA who is allocated this responsibility should ensure that these are conducted as per due process laid down in accordance with the regulations.

4.04 The auditor should understand the process of preparation of the Trial Balance, Profit and Loss Account, Balance Sheet and the internal financial controls therein. Generally, this division would operate as a cost centre.

4.05 There may be cases where local branches would have given guarantees for overseas borrowers in foreign branches which is a funded liability in the foreign books in which case, care needs to be taken to ensure that these are netted off at the consolidation level and a funded / non-funded liability is not shown for the same borrower in the consolidated accounts.

4.06 Where the borrower is an NPA in India but is either standard or credit impaired overseas, the amount of provision held overseas should also be synced to higher as per local laws. Normally this is handled by the NPA team at the head office, however the statutory auditor having the responsibility of IBD should ensure compliance of this policy by verification of provisions for earlier period.

4.07 Besides the adjustment in provision as mentioned above, the auditor should ensure that accounting policies of foreign branches/offices which are being consolidated are in line with the accounting policies of the parent bank in India. If not, the accounting policies of foreign branches/offices should be aligned with the accounting policies of the parent bank in India and effect given in the financial statements accordingly.

4.08 Any significant or material amounts also having a bearing on consolidated operations need to be disclosed separately or appropriately disclosed as policies / notes on accounts at the consolidated level.

4.09 The auditor should satisfy that the translations of such overseas operations are in accordance with the requirements of AS 11 (Revised), "The Effects of Changes in Foreign Exchange Rates". The auditor should also ensure compliance of RBI circular no. RBI/2016-17/281 DBR.BP.BC.No.61/21.04.018/2016-17 dated April 18, 2017 on "Guidelines on compliance with Accounting Standard (AS) 11 [The Effects of Changes in Foreign Exchange Rates] by banks – Clarification", which requires the banks not to recognise in the profit and loss Account the proportionate exchange gains or losses held in the foreign currency translation reserve on repatriation of profits from overseas operations.

4.10 The auditor should also refer Annexure-II of RBI Master Direction No.



RBI/DOR/2021-22/ 83 DOR.ACC.REC.No.45/21.04.018/2021-22 dated August 30, 2021 (Updated as on February 20, 2023) on “Financial Statements - Presentation and Disclosures”, which provides guidance on conversion of the financial statement of the foreign branches for the purpose of consolidating with the bank.

4.11 The auditor should note the methodology and approach to audit, the extent of coverage and any good practices that can be benchmarked or adopted locally should also be noted for incorporation.

4.12 Deviations or discrepancies noted should be appropriately reported in the Long Form Audit Report.

4.13 The auditor should also refer the relaxation provided by the RBI vide circular no. RBI/2021-22/136 DOR.CAP.REC.No.72/21.06.201/2021-22 dated December 08, 2021 on “General permission for infusion of capital in overseas branches and subsidiaries and retention/ repatriation/ transfer of profits in these centres by banks incorporated in India”, which exempts prior RBI approval for capital infusion/ transfers (including retention/ repatriation of profits), by banks which meet the regulatory capital requirements (including capital buffers). Instead, the banks shall seek approval of their Boards for the same.

#### **International Banking –IFSC Banking Units (IBUs)**

4.14 As regards setting up of IFSC Banking Units by Indian banks and by foreign banks already having a presence in India, the auditor should do the following:

- Verification should be carried out as per RBI Notification No. RBI/2014-15/533 DOR.IBD.BC.14570/23.13.004/2014-15 on Setting up IFSC Banking Units (IBUs) dated April 01, 2015 (Updated as on January 21, 2020), read with Notification No. FEMA.339/2015-RB dated March 02, 2015 under FEMA 1999 on Foreign Exchange Management (International Financial Services Centre) Regulations, 2015 and International Financial Services Centres Authority (Banking) Regulations, 2020 [As amended upto 6th July, 2021].
- The auditor should cover verification covering the following important aspects:
  - I. Licensing
  - II. Capital & reserve requirements
  - III. Permissible activities of IBUs
  - IV. Prudential regulations and compliances to IFSC Authority

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- V. Anti-Money Laundering measures
- VI. Reporting requirements
- VII. Priority sector lending
- VIII. Remittances system review
- IX. Loans and advances
- X. Finance, accounting and reconciliations
- XI. Treasury operations review
- XII. Information technology general controls

<b>Section</b>	<b>Verification</b>	<b>Documents to be verified</b>
<b>Licensing</b>	Eligible banks interested in setting up IBUs will be required to obtain prior permission of the Reserve Bank for opening an IBU under Section 23 (1)(a) of the Banking Regulation Act, 1949 . For most regulatory purposes, an IBU will be treated on par with a foreign branch of an Indian bank.	Licence issued from IFSC authority
<b>Capital &amp; Reserve Requirements</b>	With a view to enabling IBUs to start their operations, the parent bank will be required to provide a minimum capital of USD 20 million or equivalent in any foreign currency to its IBU which should be maintained at all times. However, the minimum prescribed regulatory capital, including that for the exposures of the IBU, shall be maintained on an on-going basis at the parent level.  The liabilities of the IBU are exempt from both CRR and SLR requirements of Reserve Bank of India.	BR, SWIFT for the Capital Transfer USD 20 MN, Balance sheet from banking core system and Capital GL having share capital maintained through out the year
<b>Permissible activities of IBUs</b>	The IBUs will be permitted to engage in the form of business mentioned in Section 6(1) of the Banking Regulation Act as given below, subject to the conditions, if any, of the licence issued	Licence where permission for various activities available, list of product codes

	<p>to them.</p> <ol style="list-style-type: none"> <li>i. IBUs can undertake transactions with resident (for deployment of funds) and non-resident (for both raising of resources and deployment of funds) entities other than individuals including HNIs / retail customers as indicated in paragraph 2.5.1 and 2.5.2 of Notification No. RBI/2014-15/533 DOR.IBD.BC.14570/23.13.004/2014-15 on "Setting up IFSC Banking Units (IBUs)" dated April 01, 2015 (Updated as on January 21, 2020).</li> <li>ii. All transactions of IBUs shall be in currencies other than INR.</li> <li>iii. IBUs can deal with the Wholly Owned Subsidiaries /Joint Ventures of Indian companies registered abroad.</li> <li>iv. RBI will not prescribe any limit for raising short-term liabilities from banks. However, the IBUs must maintain LCR as applicable to Indian banks on a stand-alone basis and strictly follow the liquidity risk management guidelines issued by RBI to banks. Further, NSFR will also be applicable to IBUs as and when it is applied to Indian banks.</li> <li>v. IBUs are not allowed to open savings accounts. They can open foreign currency current accounts of units operating in IFSC and of non-resident institutional investors to facilitate their investment transactions. They can also open foreign currency current accounts (including escrow accounts) of their corporate borrowers subject to the</li> </ol>	<p>opened / permissible at IFSC branch to deal with.</p>
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	<p>provisions of FEMA, 1999 and regulations issued thereunder, wherever applicable in addition to provisions of para 2.5 of Notification no. RBI/2014-15/533 DOR.IDB. BC.14570/23.13.004/2014-15 on “Setting up IFSC Banking Units (IBUs)” dated April 01, 2015 (Updated as on January 21, 2020). However, IBUs cannot raise liabilities from retail customers including high net worth individuals (HNIs). Also, no cheque facility will be available for holders of current accounts in the IBUs. All transactions through these accounts must be undertaken via bank transfers.</p> <p>vi. IBUs are permitted to undertake factoring/forfaiting of export receivables.</p> <p>vii. With the prior approval of their Board of Directors, IBUs may undertake derivative transactions including structured products that the banks operating in India have been allowed to undertake as per the extant RBI directions. However, IBUs shall obtain RBI’s prior approval for offering any other derivative products. Before seeking RBI’s approval, banks shall ensure that their IBUs have necessary expertise to price, value and compute the capital charge and manage the risks associated with the products / transactions intended to be offered and should also obtain their Board’s approval for undertaking such transactions. This is subject to the provisions of</p>	
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	<p>Paragraph 2.6(xiv) of Notification No. RBI/2014-15/533 DOR.IBD.BC.14570/23.13.004/2014-15 on “Setting up IFSC Banking Units (IBUs)” dated April 01, 2015 (Updated as on January 21, 2020).</p> <p>viii. IBUs are allowed to open foreign currency escrow account of Indian resident entities to temporally hold subscriptions to the GDR/ADR issues until issuance of the receipts. After GDRs/ADRs are issued, the funds should immediately be transferred to the client’s account outside the IBU and cannot be retained by the bank in any form including in long term deposits.</p> <p>ix. IBUs are allowed to act as underwriter / arranger of Indian Rupee (INR) denominated overseas bonds issued by Indian entities in overseas market in terms of extant RBI instructions contained in FED CO AP Dir Circular No 17 dated September 29, 2015. However, in cases where part of the issuance underwritten by an IBU devolves on it, efforts must be made to sell the underwritten holdings and after 6 months of the issue date these holdings must not exceed 5 per cent of the issue size.</p> <p>x. Subject to para 2.5 of Notification No. RBI/2014-15/533 DOR.IBD. BC. 14570/23.13.004/2014-15 on “Setting up IFSC Banking Units (IBUs)” dated April 01, 2015 (Updated as on January 21, 2020), the IBUs can accept fixed deposits</p>	
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	<p>in foreign currency of tenor less than one year from non-bank entities and can also repay fixed deposits prematurely without any time restrictions.</p> <p>xi. An IBU can be a trading member of an Exchange in the IFSC for trading in interest rate and currency derivatives segments that the banks operating in India have been allowed to undertake as per the extant RBI directions.</p> <p>xii. An IBU can become a Professional Clearing Member (PCM) of the exchange in the IFSC for clearing and settlements in any derivative segments. This shall be subject to the following conditions:</p> <p>a. The parent bank of the IBU (“the bank”) shall fulfil the prudential requirements as set out in Para 21 of the Master Direction No. RBI/DBR/2015-16/25 DBR.FSD. No.101/24.01.041/2015-16 dated May 26, 2016 (Updated as on August 10, 2021) on Reserve Bank of India (Financial Services provided by Banks) Directions, 2016.</p> <p>b. The IBU shall, with the approval of the bank’s Board, put in place effective risk control measures, prudential limits on risk exposure in respect of each of its trading clients, taking into account their net worth, business turnover, etc.</p> <p>c. The IBU may, as a PCM of</p>	
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	<p>derivatives segments, guarantee trades executed by its clients as trading members of the exchanges subject to the condition that the total exposure which the bank would take on its registered clients should be determined by the Board in relation to the net worth of the bank and monitored regularly. However, the IBU should not guarantee any transaction other than what is required in its role as a PCM.</p> <p>d. The IBU shall ensure strict compliance with various margin requirements as may be prescribed by the bank's Board as also the extant RBI guidelines regarding guarantees issued on behalf of commodity brokers.</p> <p>e. The IBU shall comply with all the conditions, if any, stipulated by other regulatory bodies that may be relevant for their role as a PCM.</p> <p>xiii. IBUs are allowed to extend the facility of bank guarantees and short term loans to IFSC stock broking/ commodity broking entities, subject to the terms and conditions contained in Paragraph 2.3.1.2 of Master Circular on Statutory Restrictions on Loans and Advances dated July 1, 2015.</p> <p>xiv. IBUs are allowed to participate in exchange traded currency</p>	
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	<p>derivatives on Rupee (with settlement in foreign currency) listed on stock exchanges set up at IFSCs. Banks shall ensure that their IBUs have necessary expertise to price, value and compute the capital charge and manage the risks associated with the products / transactions intended to be offered and should also obtain their Board's approval for undertaking such transactions. IBUs shall follow all other risk mitigation and prudential measures as applicable and detailed in this circular while participating in these products. Further, IBUs may also be guided by A.P (DIR Series) Circular No. 17 on "Introduction of Rupee derivatives at International Financial Services Centers (IFSCs)" dated January 20, 2020.</p>	
<p><b>Prudential regulations and Compliances to IFSC Authority</b></p>	<p>i. All prudential norms applicable to overseas branches of Indian banks would apply to IBUs. Specifically, these units would be required to follow the 90 days' payment delinquency norm for income recognition, asset classification and provisioning as applicable to Indian banks. The bank's Board may set out appropriate credit risk management policy and exposure limits for their IBUs consistent with the regulatory prescriptions of the RBI.</p> <p>ii. The IBUs would be required to adopt liquidity and interest rate risk management policies prescribed by</p>	<p>List of compliances and adherence to the same</p>



	<p>the Reserve Bank in respect of overseas branches of Indian banks and function within the overall risk management and ALM framework of the bank subject to monitoring by the Board at prescribed intervals.</p> <p>iii. The bank's Board would be required to set comprehensive overnight limits for each currency for these Units, which would be separate from the open position limit of the parent bank.</p> <p>iv. Exposure ceiling Exposure ceiling for IBUs shall be 5 percent of the parent bank's Tier 1 capital in case of a single borrower and 10 percent of parent bank's Tier 1 capital in the case of a borrower group.</p> <p>v. Liquidity ratios: Provided that with the Authority's permission, the Liquidity Coverage Ratio may be maintained by the Parent Bank.</p> <p>vi. Net Stable Funding Ratio: Shall be made applicable to a banking unit as and when determined by the Authority and shall be maintained by a Banking Unit. Provided that with the Authority's permission, the Net Stable Funding Ratio may be maintained by the Parent Bank.</p> <p>vii. Lender of Last Resort: The lender of Last Resort support shall not be available to a banking unit.</p>	
<p><b>Anti-Money Laundering measures</b></p>	<p>The IBUs will be required to scrupulously follow Know Your Customer (KYC), Combating of Financing of Terrorism (CFT) and other</p>	<p>List of pending KYC for IBU (From Project Report of Intranet</p>

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	anti-money laundering instructions issued by the Reserve Bank from time to time, including the reporting thereof, as prescribed by the Reserve Bank /other agencies in India. IBUs are prohibited from undertaking cash transactions.	server of the bank), Sample verifications for loans / Trade Limits provided or any client relationship on liability products offerings.
<b>Reporting requirements</b>	The IBUs will be required to furnish information relating to their operations as prescribed by the Reserve Bank from time to time. These may take the form of offsite reporting, audited financial statements for IBUs, etc.	List of Compliance and adherence to the same
<b>Priority sector lending</b>	The loans and advances of IBUs would not be reckoned as part of the net bank credit of the parent bank for computing priority sector lending obligations.	IT system shall be updated with “not to be allowed” option to mark PSL at IBU.  All advances shall not be marked as PSL
<b>Remittances System Review</b>	Review and evaluate the adequacy of control in handling SWIFT incoming / outgoing messages including undelivered messages  Review and evaluate the effectiveness of checking inward/outward remittances and disposals for accuracy and timelines.  Review the Inward/outward handling in line with compliance to the OFAC/FAFT/SDN / Sanctions lists.	Check SWIFT system is standalone for the IBU and samples verification for inward and outward payments
<b>Loans and Advances</b>	Review will be carried out in line with Loans & Advances Verification as per Domestic Branch Audit or review of advances.	Approval document for Sanctioning Authority

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		applicable at IBU and verification of Advance Accounts
<b>Finance, Accounting and Reconciliations</b>	<p>Review current accounting function / activities are in line with segregation of duties.</p> <p>Review the CGL architect / chart of accounts for all GL active for the branch and ensure that the same are authorized as per the Bank guidelines.</p> <p>Check that the bank account (NOSTRO) is opened and all transactions are carried out with authorized bank account as per RBI GIFT guidelines.</p> <p>Check whether reconciliation at the branch is performed and recorded between SWIFT inward (financial messages) with bank account (Nostro) credit and CBS bank book (Nostro Mirror) debit. Check reconciliation is performed and recorded between SWIFT outward (financial messages) with bank account (Nostro) debit and CBS bank book (Nostro Mirror) credit. Report any mismatch observed.</p>	<p>SOP / document containing role &amp; responsibility for the IBU chart of accounts / List of GL enabled for IBU</p> <p>Bank accounts (NOSTRO) and reconciliation, Balance Confirmations</p> <p>SWIFT Reconciliation Report</p>
<b>Treasury Operations Review</b>	<p>Check whether Treasury operations manual / operating guidelines including Investment policy is in place and approved by the management.</p> <p>Check Segregation of Duty (SOD) is defined and followed in each activity at operations, as per the regulatory guidelines.</p> <p>Check whether Borrowing/Lending are carried out as per eligible entity /within Counterparty Exposure Caps/ lenders &amp; borrowers and are at bench Mark rate and within policy norms.</p>	<p>Approved Treasury Operation policy for IBU, List of borrowing and list of Investment, Balance confirmations for Investments</p>

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	<p>Check if ratios, ALM guidelines as prescribed by the regulatory are maintained, recorded and available for evidence.</p> <p>Check if all investments are made as per regulatory norms for eligible securities, quantum of volume and in timelines as prescribed by the regulators.</p>	
<p><b>Information Technology General Controls</b></p>	<p>Check whether approved IT policy (including user's policy, back up, Disaster Recovery Policies) for GIFT Operations are in line with RBI &amp; GIFT IFC regulatory guidelines available</p> <p>Check user access is reviewed at regular intervals by the branch for all IT systems installed at branch / for carrying out operations:</p> <ul style="list-style-type: none"> <li>• User IDs of transferred/retired/resigned employees are disabled promptly</li> <li>• No multiple user IDs are created for the same person</li> <li>• No two employees are having user IDs</li> <li>• All nodes and standalone PCs are operated by authorized users</li> <li>• Determine that DRP / BCP testing is carried out as per pre-defined frequency, by the branch</li> <li>• Review the password management process</li> </ul>	<p>User report from CBS system Review the report and match with physical employee or staff.</p> <p>BCP/DRP Testing Documents and Confirmations</p>
<p><b>FIMMDA Code of Conduct</b></p>	<p>Was the requisite undertaking sought from the dealer under FEDAI and FIMMDA Code of Conduct?</p>	

## Treasury Operations

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### (A) Introduction and Bank's Process

5.01 Treasury operations is one of the most important functions of a bank, responsible for the processing of all financial market transactions and usually much more, including a crucial role in managing risk. Treasury comprises of two main components – Investments (comprising of transactions related to domestic investments and money market operations) and Forex & Derivatives. In a well-functioning risk management system, banks broadly position their treasury balance sheet into Trading and Investment or Banking Books. While the assets in the trading book are held primarily for generating profits on short-term differences in prices/yields, the banking book comprises of assets and liabilities, which are contracted basically on account of relationship or for steady income and statutory obligations and are generally held till maturity. Thus, while the price risk is the prime concern of banks in trading book, the earnings or economic value changes are the main focus of banking book.

### Core functions of Treasury Operations

5.02 The core areas of treasury operations in a bank can be functionally divided into the following broad compartments:

- Front Office Operations (Dealing room operations);
- Middle Office Operations (Market Risk Department / Product Control Group);
- Back Office Operations (Deal Confirmation, Settlement, Accounting and Reconciliation).

5.03 Some of the main functions of Front Office, Mid-Office and Back-office operations are detailed in the following paragraphs:

#### Front Office (Dealing Room)

- Money and fixed income dealings
- Forex and derivatives
- Treasury sales
- Equities
- Primary dealers

- Debt sales
- Credit default swaps

### **Mid Office (Risk)**

- Identification, measurement and monitoring of risk
- Monitoring counter party, product and dealer limits
- Preparation and assimilation of MIS to various stakeholders
- Equity and debt research

### **Back Office**

- Settlement and follow up
- Reconciliations
- Accounting
- Valuation

5.04 Increasing regulatory and compliance requirements and the need for risk management have made '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 operations of treasury become more onerous while financial products become increasingly complex, despite streamlining the processing systems.

### **Front Office Operations**

5.05 The front office operations consist of dealing room operations wherein the dealers transact deals with the various approved counterparties. Deals are transacted by dealers on various anonymous order matching platforms such as NDS-OM, CROMS, NDS-CALL, FX-CLEAR, FX-SWAP, TREPS, E-Kuber and over communication platforms such as Reuters', Bloomberg, telephonic conversation with counterparties or through empanelled brokers.

5.06 The dealers are primarily responsible for checking counterparty exposure limits, eligibility, and other requirements of the bank before initiating any deal. Dealers must ensure that all risk/ credit limits are available before transacting a deal. Also, the deal must not contravene the current regulations regarding dealing in INR with overseas banks/ counterparties. All counterparties are required to execute the International Swaps and Derivatives Association ('ISDA') agreement as well as pass a Board resolution allowing them to enter into derivative contract. As soon as the deal is struck with counterparty, the deal

details are noted in a dealers' deal pad and thereafter captured in front office system of the bank which gets queued in for authorization by back office.

### **Middle Office Operations**

5.07 Middle Office is responsible for online risk measurement, monitoring and management reporting. The other functions of Middle Office are:

- Limit setting and monitoring exposures in relation to limits.
- Assessing likely impact of market movements based on internal assessments and external/ internal research.
- Evolving hedging strategies for assets and liabilities.
- Interacting with the bank's Risk Management Department on liquidity and market risk.
- Monitoring open currency positions.
- Calculating and reporting value at risk (VAR).
- Stress testing and back testing of investment and trading portfolios.
- Risk-return analysis.
- Marking open positions to market to assess unrealized gain and losses.

### **Back Office Operations**

5.08 The mainstream role of the Back Office is to provide direct support to the dealing room or front office. Traditionally, this included the input of deal details in the settlement system, checking of deal input details, verification by confirmation from counterparty, settlement, verifying existence of a valid and enforceable International Swap Dealers Association (ISDA) agreement and reconciliation of positions and NOSTRO accounts. However, with the advent of online front office systems and, more importantly, online trading platforms, the input of deals have progressively moved to the dealing room as mentioned above.

5.09 An important development in the back office has been the advent of "Straight-Through Processing (STP)", also called 'hands-off' processing. This has been made possible through improved technology and real time online input in the trading platform, which in turn has meant that the back office can authorise/ confirm deals pending for authorisation in the trading platform. In practice this is done automatically by matching incoming data from counterparties thereby focussing on investigating exceptions. With the introduction of online trading systems, the deal is 'confirmed' as it is done, allowing the back office to concentrate principally on handling exceptions, settlement and monitoring and risk control. This is a completely different approach than the earlier system of

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.

5.10 One of the basic tenets for the treasury department in a bank is the strict segregation and allocation of duties between the front, middle and back offices, the latter controlling confirmations, settlement and accounting of transactions. These 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 problematic, requiring the ability and market knowledge to understand how the trades and hedges in the dealer's book are structured.

### **Functions of Back Office**

#### ***Input and Completion***

5.11 The first core function of the back office is to extract details of the deal either through the input system or by accessing the online platform and authorise/ confirm the same after verifying the deal details with external evidence i.e. incoming data from counterparty - Reuters'/ Bloomberg's conversation, broker notes. Deals input through front-end data capture or agreed on one of the proprietary trading systems are subjected to numerous system checks to ensure that the transaction details are 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 per the agreement. This could also be true for derivative 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. A bank normally releases its own confirmation to the counterparty, particularly for "Over The Counter" (OTC) deals.

#### ***Counterparty Confirmation***

5.12 The second core function for the back office is to verify the deal from the counterparty at the earliest 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 conversation or trading systems, or a broker's confirmation if the deal has been done through a broker. Telephone confirmations are also sought for immediate authorisation. Further, the banks have entered into bilateral agreements with counterparty banks who are members of CCIL whereby exchange of confirmations for Forex Inter bank deals (matched on CCIL) have been discontinued.



5.13 Deals done with customers (non-banks) will normally be confirmed by e-mail, with instructions swapped on the telephone, depending on the arrangement. 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.

*F-TRAC (FIMMDA Trade Reporting and Confirmation) System*

5.14 It is to be noted that all entities regulated by RBI, IRDA and PFRDA have to mandatorily report secondary market corporate bond trades on F-TRAC. Other entities regulated by SEBI or any other regulator have been mandated to report OTC secondary market corporate bond on F-TRAC, or any other SEBI authorised reporting platform. All entities have to report CPs & CDs only on F-TRAC.

**Settlement**

5.15 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 counterparties and settles the net position in both legs of the transaction.

**Reconciliation**

5.16 Operations areas are typically involved in a number of reconciliation processes, including the reconciliation of dealers' overnight positions, NOSTRO accounts and brokerage payments. This can also mean reconciling positions for margin calls in futures trading or reconciling custody accounts to the underlying securities in securities trading. However, the basic reconciliation function is to agree or reconcile the entries that have been passed over an account with correspondent 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 represent those that have not been responded to in either the books of the bank or its correspondent and therefore requires to be investigated.

**Important Terms**

5.17 Following are some of the terms, which are commonly used in relation to investments of banks.

**Approved Securities**

5.18 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 of 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.

***Subsidiary General Ledger (SGL)***

5.19 This is a ledger maintained by the Public Debt Office (PDO) of the RBI in which accounts of different banks are maintained regarding their holding of Government securities. The transactions through SGL accounts should be in compliance with Classification, Valuation and Operation of Investment Portfolio of Commercial Banks (Directions), 2021 dated 25<sup>th</sup> August, 2021 (Updated as on December 08, 2022) read with Revised Subsidiary General Ledger (SGL) Account Guidelines and Constituents' Subsidiary General Ledger (CSGL) Account Guidelines dated 5<sup>th</sup> October, 2021.

***Repo and Reverse Repo Transactions***

5.20 Repo and Reverse Repo is one of the mechanisms of lending and borrowing, wherein 'Repo' means borrowing of money (against placing of Government security as collateral) and 'Reverse Repo' means lending of money (against receipt of Government security as collateral) at a transaction value equivalent to the market rate of the security as on the date on which the transaction is made, at an agreed rate of interest and tenure. In case of the underlying security though it is transferred from one beneficiary to other counterparty, the risk/rewards related to such underlying security remains with the lender of the security.

5.21 The RBI has issued a circular on "Repurchase Transactions (Repo) (Reserve Bank) Directions, 2018" vide circular no. FMRD.DIRD.01/14.03.038/2018-19 dated 24<sup>th</sup> July, 2018 and in supersession of all earlier instructions on this subject. The aforesaid circular has been further amended vide circular no. FMRD.DIRD.21/14.03.038/2019-20 dated 28<sup>th</sup> November, 2019. The RBI has decided to align the accounting norms to be followed by market participants for repo/reverse repo transactions under Liquidity Adjustment Facility (LAF) and Marginal Standing Facility (MSF) of the RBI with the accounting guidelines prescribed for market repo transactions. Accordingly, all repo/ reverse repo transactions are required to be accounted for as lending and borrowing transactions.

5.22 Banks shall classify the balances in Repo accounts under Schedule 4 (Borrowing). Similarly, the balances in reverse repo accounts shall be classified under Schedule 7 (Balances with banks and money at call and short notice). The balances in Repo interest expenditure account and reverse repo

interest income account shall be classified under Schedule 15 (Interest expended) and under Schedule 13 (Interest earned) respectively.

5.23 Repo transactions are now allowed between the permitted entities, namely, (a) SGL A/c holders; (b) SGL A/c holder and its own gilt account holder (GAH); (c) SGL A/c holder and GAH under another custodian; (d) GAHs under the same custodian; and (e) GAHs under two different custodians, subject to the conditions as specified in the said notification.

### **Short Sale**

5.24 Short sale is defined as sale of securities which one does not own, i.e., selling of a security without possessing stock of such securities. A bank can also undertake 'notional short sale' wherein it can sell a security short from HFT even though the stock of the said security is held under HFT / AFS / HTM category. Thus, short sales include actual as well as 'notional' short sale. A short sale can be undertaken by the bank subject to certain conditions as stipulated by the RBI and within the specified limits. Securities which are sold short are invariably required to be delivered on the settlement. A bank may meet the delivery obligation for a security sold short, by utilising the securities acquired under 'reverse repo' mechanism (except under RBI's Liquidity Adjustment Facility). However, as announced in paragraph 13 of the Statement on Developmental and Regulatory Policies, of the Fourth Bi-monthly Monetary Policy Statement for 2017-18 dated October 04, 2017, it has been decided that market participants undertaking 'notional' short sale need not compulsorily borrow securities in the repo market. While the short selling entity may ordinarily borrow securities from the repo market, in exceptional situations of market stress (e.g. short squeeze), it may deliver securities from its own HTM/AFS/HFT portfolios. If securities are delivered out of its own portfolio, it must be accounted for appropriately and reflect the transactions as internal borrowing. All 'notional' short sales must be closed by an outright purchase in the market. It may be ensured that the securities so borrowed are brought back to the same portfolio, without any change in the book value. The short selling entity must adhere to the extant regulations and accounting norms governing sale or valuation of securities in its portfolios. The bank may frame a Board approved policy for this purpose. Even though reverse repos can be rolled over, short sale position needs to be covered within a maximum period of three months including the day of trade.

### **STRIPS**

5.25 STRIPS stand for "Separate Trading of Registered Interest and Principal Securities". Stripping is a process of converting periodic coupon payments of an existing Government security into tradable zero-coupon securities, which will usually trade in the market at a discount and are redeemed

at face value. For instance, stripping a five-year Government security would yield 10 coupon securities (representing the coupons), maturing on the respective coupon dates and one principal security representing the principal amount, maturing on the redemption date of the five-year security. 'Reconstitution' is the reverse process of stripping, where, the Coupon STRIPS and Principal STRIPS are reassembled into the original Government security. Detailed guidelines outlining the process of stripping/ reconstitution and other operational procedures regarding transactions in STRIPS are given in Classification, Valuation and Operation of Investment Portfolio of Commercial Banks (Directions), 2021 dated 25<sup>th</sup> August, 2021 (Updated as on December 08, 2022).

***"When Issued" Securities***

5.26 'When, as and if issued' (commonly known as 'when-issued' (WI)) security refers to a security that has been authorized for issuance but not yet actually issued. 'WI' trading takes place between the time a new issue is announced and the time it is actually issued. All 'when issued' transactions are on an 'if' basis, to be settled if and when the actual security is issued. The NDS-OM members have been permitted to transact on 'When Issued' basis in Central Government dated securities, subject to the guidelines of the RBI.

***Certificate of Deposit (CD)***

5.27 It is a negotiable money market instrument and issued in dematerialized form or as a usance promissory note against funds deposit at a bank or eligible Financial Institution for a specified time period. CDs can be issued by a bank with a maturity period which is not less than 7 days and not more than one year, from the date of issue and should have a minimum deposit size from a single subscriber not less than Rs. 1 lakh. CDs may be issued at a discount to face value or at a fixed / floating coupon rate.

5.28 Banks have to maintain appropriate reserve requirements, i.e., CRR and SLR, on the issue price of the CDs. There is no lock-in period for the CDs. Though, NRIs may also subscribe to CDs (but only on non-repatriable basis), such CDs cannot be endorsed to another NRI in the secondary market. Banks/FIs may account the issue price under the Head "CDs issued" and show it under deposits. Accounting entries towards discount will be made as in the case of "Cash Certificates". Detailed guidelines are given in the Master Direction on "Reserve Bank of India (Certificate of Deposit) Directions, 2021" dated 4<sup>th</sup> June, 2021.

***Commercial Paper (CP)***

5.29 It is an unsecured money market instrument issued in the form of a promissory note by corporates, PDs, FIs subject to compliance with Part II of

RBI Master Direction on Money Market Instruments: Call / Notice Money Market, Commercial Paper, Certificates of Deposit and Non-Convertible Debentures (original maturity up to one year) dated July 7, 2016. The tenure of CP should not be less than 7 days and not more than one year, from the date of issue.

5.30 Options (call/put) are not permitted on CP as per the above referred Master Directions of 7<sup>th</sup> July 2016. Also, underwriting or co-acceptance to the issue of CP is not allowed. The minimum credit rating shall be 'A3' as per the rating symbol and definition prescribed by SEBI, which should be ensured by the issuers.

***Non-Convertible Debentures (NCDs)***

5.31 It is a debt instrument issued by a corporate (including NBFCs) with original or initial maturity up to one year and issued by way of private placement, in denominations with a minimum of Rs. 5 lakhs (face value) and in multiples of Rs. 1 lakh, subject to the eligibility criteria as specified by the RBI.

5.32 An eligible corporate intending to issue NCDs shall obtain credit rating from one of the rating agencies registered with SEBI or other credit rating agencies as may be specified by the RBI. NCDs shall not be issued for maturities of less than 90 days from the date of issue and the exercise date of option (put/call), if any, attached to the NCDs shall not fall within the period of 90 days from the date of issue. The tenor of the NCDs shall not exceed the validity period of the credit rating of the instrument i.e. minimum 'A2' as per the rating symbol and definition prescribed by SEBI.

***REITs & InvITs***

5.33 Infrastructure Investment Trust (InvITs) and Real Estate Investment Trusts (REITs) are like mutual funds, which enable investment by individual/institutional investors in income earning assets to receive periodic return consisting of return of principal as well as income.

5.34 The RBI vide circular no. RBI/2016-17/280 DBR. No. FSD. BC. 62/24.01.040/2016-17 dated April 18, 2017 on "Prudential Guidelines – Banks' investment in units of REITs and InvITs" read with Master Direction No. DBR.FSD.No.101/24.01.041/2015-16 dated May 26, 2016 (Updated as on August 10, 2021) on "Reserve Bank of India (Financial Services provided by Banks) Directions, 2016", has allowed banks to participate in Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs) within the overall ceiling of 20 per cent of their net worth permitted for direct investments in shares, convertible bonds/ debentures, units of equity-oriented mutual funds and exposures to Category I and II Alternative Investment Funds (AIFs). Before making investments, Banks are required to put in place a Board

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approved policy on exposures to REITs/ InvITs which should lay down an internal limit on such investments within the overall exposure limits in respect of the real estate sector and infrastructure sector. Banks are not permitted to invest more than 10 per cent of the unit capital of a REIT/ InvIT. Banks need to ensure adherence to the prudential guidelines issued by the RBI from time to time on “Equity investments by banks, Classification and Valuation of Investment Portfolio, Basel III Capital requirements for Commercial Real Estate Exposures and Large Exposure Framework”, as applicable.

### **Prudential Regulation for Banks’ Investments**

5.35 The RBI *vide* Master Direction No. RBI/DBR/2015-16/25 Master Direction/DBR.FSD.No.101/24.01.041/2015-16 dated May 26, 2016 (Updated as on August 10, 2021) on “Reserve Bank of India (Financial Services provided by Banks) Directions, 2016”, stipulates prudential regulation for Banks’ Investments w.r.t. Investment by a bank in a subsidiary or in a financial services company not being a subsidiary or a non-financial services company as follows:

(A) Limits on investments:

- i. Equity investment by a bank in a subsidiary company, or a financial services company, not being a subsidiary, individually, shall not exceed 10 per cent of the bank’s paid-up share capital and reserves as per the last audited balance sheet or a subsequent balance sheet, whichever is lower.
- ii. The aggregate of equity investment in factoring subsidiaries and factoring companies shall not exceed 10 per cent of the bank’s paid up capital and reserves.
- iii. No bank shall contribute more than 49 per cent of the equity of Infrastructure Debt Fund set up as a Non-banking Finance Company (IDF-NBFC).
- iv. A bank contributing less than 30 per cent of the equity of IDF-NBFC shall not be a sponsor.
- v. No bank shall –
  - a. Hold more than 10 per cent in the equity of a deposit taking NBFC. Provided that this does not apply to a housing finance company.
  - b. Make an investment of more than 10 per cent of the unit capital of a Real Estate Investment Trust/Infrastructure Investment Trust subject to overall ceiling of 20 per cent of its net worth permitted for direct investments in shares, convertible bonds/ debentures, units of equity oriented mutual funds and exposures to Alternative Investment Funds.

- c. Hold more than 10 per cent of the paid up capital of a company, not being its subsidiary engaged in non-financial services or 10 per cent of the bank's paid up capital and reserve, whichever is lower.

Provided that investments in excess of 10 per cent but not exceeding 30 per cent of the paid up share capital of such investee company shall be permissible in the following circumstances:

- (i) the investee company is engaged in non-financial activities permitted for banks in terms of Section 6(1) of the Banking Regulation Act, 1949; or
  - (ii) the additional acquisition is through restructuring of debt or to protect the banks' interest on loans/investments made to a company. The bank shall submit a time bound action plan for disposal of such shares within a specified period to the RBI.
- d. Hold along with its subsidiaries, associates or joint ventures or entities directly or indirectly controlled by the bank; and mutual funds managed by Asset Management Companies (AMCs) controlled by the bank, more than 20 per cent of the investee company's paid up share capital engaged in non-financial services. However, this cap doesn't apply to the cases mentioned at A(v)(c)(i) and (ii) above.
  - e. Make any investment in a Category III Alternative Investment Fund (AIF). Investment by a bank's subsidiary in a Category III AIF shall be restricted to the regulatory minima prescribed by SEBI.

- vi. The aggregate equity investments made in all subsidiaries and other entities engaged in financial services and non-financial services, including overseas investments shall not exceed 20 per cent of the bank's paid-up share capital and reserves.

Provided that for calculating the aggregate investment for compliance with the limit of 20 per cent of paid up capital and reserves, the following investments shall be excluded:

- a. investments held under 'Held for Trading' category that are not held beyond 90 days as envisaged in the Master Directions on Prudential Norms for Investments.
- b. investments in excess of 10 per cent in non-financial companies acquired in circumstances as mentioned at para 5.35 A(v)(c)(ii) of this Chapter.

- (B) The circular further stipulates requirement for approval of the RBI w.r.t.

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specified investments as stipulated in para 5(b) of the said circular as follows:

No bank shall, without the prior approval of the RBI, make:

- i. investment in a subsidiary and a financial services company that is not a subsidiary.

Provided that such prior approval shall not be necessary in the following circumstances:

- a. The investment is in a company engaged in financial services.
- b. The bank has the minimum prescribed capital (including Capital Conservation Buffer) and has also made a net profit in the immediate preceding financial year.
- c. The shareholding of the bank including the proposed investment is less than 10 per cent of the investee company's paid up capital.
- d. The aggregate shareholding of the bank along with shareholdings, if any, by its subsidiaries or joint ventures or other entities directly or indirectly controlled by the bank, is less than 20 per cent of the investee company's paid up capital.

Explanation: Prior approval of the RBI shall not be required if the investments in the financial services companies are held under the 'Held for Trading' category and are not held beyond 90 days.

- ii. investment in a non-financial services company in excess of 10 percent of such investee company's paid up share capital as stated at para 5.35 A(v)(c)(i) of this Chapter.
- iii. investment of more than 10 per cent of the paid up capital/ unit capital in a Category I/ Category II Alternative Investment Fund.

(C) Further, the circular stipulates that banks shall ascertain the risks arising on account of equity investments in Alternative Investment Funds done directly or through their subsidiaries, within the Internal Capital Adequacy Assessment Process (ICAAP) framework and determine the additional capital required which will be subject to supervisory examination as part of Supervisory Review and Evaluation Process. This shall also be applicable to sponsoring of Infrastructure Debt Funds by banks.

### **State Development Loans**

5.36 Paragraph 2 of the Statement on Developmental and Regulatory Policies, issued as part of the Second Bi-monthly Monetary Policy Statement for 2018-19 dated June 06, 2018 states that with effect from September 30, 2018, securities issued by each State Government, i.e., State Development



Loans (SDL's), shall be valued in a manner which would objectively reflect their fair value based on observed prices/ yields made available by Financial Benchmarks India Pvt Ltd (FBIL).

### **TREPS**

5.37 In terms of the Repurchase Transactions (Repo) (Reserve Bank) Directions, 2018 dated 24<sup>th</sup> July, 2018, "Tri-party repo" means a repo contract where a third entity (apart from the borrower and lender), called a Tri-Party Agent, acts as an intermediary between the two parties to the repo to facilitate services like collateral selection, payment and settlement, custody and management during the life of the transaction.

5.38 Triparty repo i.e. TREPS facilitates borrowing and lending of funds, in Triparty Repo arrangement. CCIL is the Central Counterparty to all trades from Tri Party Repo Dealing System (TREPS) and also performs the role and responsibilities of triparty repo agent, in terms of Repurchase Transactions (Repo) (Reserve Bank) Directions, 2018 as amended from time to time. TREPS dealing system is an anonymous order matching system provided by Clear Corp Dealing Systems (India) Ltd (CCDS) to enable members to borrow and lend funds. It also disseminates online information regarding deals concluded, volumes, rate etc., and such other notifications as relevant to borrowing and lending under triparty tepo by the members.

5.39 The eligible securities deposited by a member as collateral towards borrowing limit as Triparty Repo Collateral are subjected to a valuation exercise at the end of each business day. The valuation is carried out using CCIL's mark-to-mark price for such securities. The aggregate value of securities contributed by a member, net of haircut, rounded downwards to the nearest rupee is set as permissible borrowing limit for such member. Any security deposited during the day as collateral towards borrowing limit is also revalued at last available MTM price of the security and such a value, net of haircut, is made available as borrowing limit. The value of any security withdrawn during the day is reduced from the available borrowing limit. Apart from the end of the day valuation, CCIL undertakes such valuation on multiple times during the day also.

5.40 The RBI has made the reserve requirements for triparty repo borrowing similar to borrowing in market repo and no CRR is required to be maintained for triparty repo borrowings outstanding in the books of member.

### **(B) Audit Approach, Procedures including Regulatory Requirements/ Restrictions & Updates**

5.41 The auditor's primary objective in audit of investments is to satisfy himself as to their existence, ownership 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.

5.42 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 their audit procedures relating to investments.

### **Process Review, Walk through and Control Testing**

5.43 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. Banks normally have documented standard operating procedures (SOPs) and hence the auditor can peruse SOPs for understanding and documenting significant processes. During the process understanding, the auditors may identify various control points in the process like reconciliation, maker checker, segregation of duties, etc. The auditor may carry out walk through of few transactions for validating process understanding and existence of identified 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 as per the methodology.

5.44 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 auditor 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.

5.45 Some of the typical audit procedures include the following:

- Identification of specific application controls based on process understanding and walkthroughs.
- Perusal of IT application controls and document whether controls are effective and reliance can be placed on the same.
- Perusal of IT system audit report, Internal Control Guidance report and action taken thereon.
- Based on outcome of IT control testing, further audit strategy need to be formulated.

An auditor should verify the controls put in place to ensure appropriate functioning of the treasury operations from off premise locations without compromising safety and security of the data. The auditor should ensure that appropriate approvals have been taken from the respective authorities before enabling and allowing dealing from off-premise locations. The RBI vide circular no. FE.CO.FMD. No. 18380/02.03.137/2010-11 dated 3<sup>rd</sup> February 2011 on "Internal Control Guidelines" had prescribed the requirements for off premise dealings.

### **Substantive Audit Procedures**

5.46 Considering the fact that the investments comprise a substantial portion of a bank's balance sheet, a combination of test of operating effectiveness of controls and substantive audit procedures (including substantive analytical procedures) would be necessarily carried out by 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**

5.47 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), account statements of mutual fund, 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 same process is followed throughout the audit period. Needless to add that the actual control and reconciliations etc., are to be carried out by the bank's management; however, the auditor needs to examine the same.

5.48 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**

5.49 The auditor should ascertain whether the investments made by the bank are within its authority. In this regard, the auditor should examine whether

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the legal requirements governing the bank, relating to investments, have been complied with and the investments made by the bank are not *ultra vires* the relevant regulations. 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.

5.50 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 auditor may also check whether brokers note is dated and time stamped or not. The auditor should also check the segregation of duties within the bank staff in terms of executing trades, settlement and monitoring of such trades, and accounting of the same (generally termed as front office, middle office and back office functions' segregation).

5.51 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.
- Ensure that the inherent risk of management overriding controls is mitigated.

### **Examination of Existence of Investments**

5.52 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. Banks are permitted to make fresh investments and hold bonds and debentures, privately placed or otherwise, and equity instruments only in dematerialised form.

5.53 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 and maintain control over independent investments' balance confirmation requests to the custodian and other constituents (for example, RBI for SGL and CSDL balances) in accordance with SA 505, "External Confirmations" issued by ICAI. Furthermore, the auditor should design sufficient alternative audit procedures in situations where the independent confirmations 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 (E.g. the auditor gets the bank personnel download the investment statement in his/her presence e.g. from E-Kuber for Government Securities, DP's website for Shares and Bonds etc.). In case of securities pledged with other entities, such as Stock Exchanges etc, balance confirmations shall be obtained.

5.54 The auditor should peruse bank's 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, they 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 multiply. Auditors may also check the feasibility of converting physical shares in dematerialised form. If feasible, the auditors may suggest banks to convert physical shares into dematerialised form.

5.55 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 Statutory Branch Auditors (SBAs) to physically verify such scrips as a part of their audit. The auditor needs to obtain a written confirmation to this effect from the SBAs. The SBAs should also be requested to report in the appropriate section of the Long Form Audit Report whether adequate records are maintained by the branch for the securities held by it on behalf of the head office.

5.56 The auditor may specifically request the SBAs 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. 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**

5.57 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. Banks should follow 'Settlement Date' accounting for recording transactions in Government securities. In respect of transactions other than in Government securities, the bank should follow the accounting policy consistently either 'Trade Date' or 'Settlement Date' accounting.

5.58 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.
- 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.

### **Examination of Classification and Shifting**

5.59 The auditor should examine whether the shifting of the investments to/from HTM category is carried out only once during a financial year and at the beginning of the financial year unless otherwise stipulated by the RBI under special dispensation. Such shifting is required to be duly approved by the Board of Directors of the bank. As regards shifting of investments from AFS to HFT, the auditor should verify the same as having been 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. Shifting of investments from HFT to AFS is generally not allowed. However, it will be permitted only under exceptional circumstances like not being able to sell the security within 90 days due to tight liquidity conditions, or extreme volatility, or market becoming unidirectional. Such transfer is permitted only with the approval of the Board of Directors/ ALCO/ Investment Committee. In the case of transfer of securities from AFS to HFT category or vice-versa, the securities need not be re-valued on the date of transfer and the provisions for the accumulated depreciation, if any, held shall be transferred to the provisions for depreciation against the HFT securities and vice-versa.

5.60 Transfer of scrips from AFS / HFT category to HTM category should be made at the lower end 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. The auditor should examine the memo (or internal note) on the periodic review of SLR / non-SLR investments carried out and reported to the Board, as specified in Para 16(i) and 13(v)(b) respectively of RBI Master Direction No. RBI/DOR/2021-22/81 DOR.MRG.42/21.04.141/2021-22 dated August 25, 2021 (Updated as on December 08, 2022) on Classification, Valuation and Operation of Investment Portfolio of Commercial Banks (Directions), 2021.

5.61 In the case of transfer of securities from HTM to AFS / HFT category the following should be noted:

- a. If the security was originally placed under the HTM category at a discount, it may be transferred to AFS / HFT category at the acquisition price / book value (It may be noted that as per existing instructions banks are not allowed to accrue the discount on the securities held under HTM category and, therefore, such securities would continue to be held at the acquisition cost till maturity). After transfer, these securities should be immediately re-valued and the resultant depreciation, if any, may be provided.
- b. If the security was originally placed in the HTM category at a premium, it may be transferred to the AFS / HFT category at the amortised cost. After transfer, these securities should be immediately re-valued and the resultant depreciation, if any, may be provided.

5.62 It is to be noted that if the bank is following 'Weighted Average Method', the cost of acquisition of the security is not relevant and instead the book value (which would be weighted average value) needs to be considered for the purpose of the above mentioned clauses.

5.63 If the value of sale or transfer (excluding one-time shifting and additional shifting explicitly permitted by the RBI), exceeds 5 per cent of the book value of HTM investments as at the beginning of the year, the bank should disclose market value of the investments under HTM category along with disclosure of excess of book value over market value for which provision is not made.

5.64 The audit procedures in this regard would include:

- Obtaining the list of shifting of investments during the reporting period.
- Checking compliance with the 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**

5.65 Investments in securities now-a-days constitute a substantial part of total assets of many banks. The 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, consistent and in conformity with RBI guidelines.

5.66 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 the audit report. In this regard, it may be noted that Accounting Standard (AS) 13, "Accounting for Investments", does not apply to banks.

5.67 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 break-up value (excluding Revaluation Reserves, if any) as per the latest balance sheet of the company (which should not be more than one year prior to the date of valuation). In case the latest balance sheet is not available the shares are to be valued at Re.1 per 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 deterioration in the value.

5.68 RBI guidelines require that individual scrip in the available-for-sale (AFS) 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 and net appreciation should be ignored. As regards the scrips in Held for Trading (HFT) category, the same should be marked to market at monthly or at more frequent intervals in similar manner, except in the following cases:



- i) Equity shares should be marked to market preferably on daily basis. If not, at least on a weekly basis;
- ii) Where the banks undertake short sale transactions, the entire HFT portfolio including the short position should be marked to market on daily basis.

The book value of the individual scrip would not undergo any change after mark to market exercise is conducted at the balance sheet date.

5.69 It is pertinent to note that though intra-category netting off of depreciation and appreciation is permitted, the same (netting off) is not permitted inter-category. Provision for depreciation would be made on an aggregate basis for HFT and AFS category separately without changing the book value of individual scrips.

5.70 Investments in HTM category, need not be marked to market except where the diminution in the value is other than temporary in nature or impairment of the investments due to specified circumstances. As regards the other HTM securities, if the acquisition cost / book value is more than the face value, the premium should be amortised over the period of residual maturity period using constant yield method or straight line method.

5.71 Investments in special securities received from the Government of India towards bank's recapitalisation requirement from FY 2021-22 onwards shall be recognised at fair value / market value on initial recognition in HTM. The fair value / market value of these securities shall be arrived at on the basis of the prices / YTM of similar tenor Central Government securities put out by Financial Benchmarks India Pvt. Ltd. (FBIL). Any difference between the acquisition cost and fair value arrived as above shall be immediately recognized in the Profit and Loss Account.

5.72 In determining the market value of debt securities under HFT and AFS 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 double counting of interest - first as accrued interest and secondly as a part of the market value.

5.73 The auditor should examine the process of valuation followed by the bank and perform checks to examine that the market rates taken by the bank for valuation of investment securities are in accordance with RBI guidelines. The auditor should also examine the accounting entries passed for marked to market depreciation, to ascertain, whether RBI guidelines pertaining to inter-category netting off are followed. Further, the auditor should include investment from each class of investment in his sampling technique in accordance with SA 530, "Audit Sampling" so as to ensure that the valuation policy of all classes of investments

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gets validated. Audit sampling can be applied using either statistical or non-statistical sampling approach which is a matter of auditor's judgment. Particular focus should be on investments which involve management judgment 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 methodology prescribed by the RBI, he should also carefully focus on assessing the appropriateness of inputs used in various valuation models/formulae. This would include checking the following:

- Use of appropriate cash flows (for instruments such as PTCs).
- Use of appropriate risk free rates (depending on maturity of instrument).
- Use of appropriate risk spreads.
- Use of appropriate 'ratings' for bonds.
- Receipt of dividend (for preference shares).
- Validity of various inputs like call/put option date, redemption premium, staggered redemption, etc.
- Arithmetical accuracy of a valuation (using 're-performance' technique).

5.74 In case of banks which have automated means of valuing the investments, the auditor should also check the system controls and if deemed necessary, consider involving an expert to check the integrity of the system logic (to avoid, 'garbage in garbage out' kind of output).

5.75 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 the auditor to conclude that the files for valuation of investments are not manipulated. This can also be classified as an anti-fraud control.

5.76 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. In case of HTM investments, Net Profit on sale of investments in this category should be first taken to the Profit and Loss Account, and thereafter be appropriated to the 'Capital Reserve Account' net of taxes; Net Loss will then be recognised in the Profit and Loss Account.

5.77 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 in either of the three categories at the time of acquisition based on such intention as evidenced by dealers' pad or equivalent, along with reference to the decision of the competent authority such as Board of directors, ALCO or Investment Committee.

5.78 Equity, debentures and other financial instruments acquired by way of conversion of outstanding principal and / or interest should be classified in the AFS category and valued in accordance with the extant instructions on valuation of banks' investment portfolio. 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 where equity is not quoted, it should be valued at Re.1. Depreciation on the instruments acquired by way of conversion, whether classified as standard or NPA, should not be offset against the appreciation in any other securities held under the AFS category. Auditors should examine the accuracy of computation of break-up value, especially in situations where the auditors' reports of investee companies are modified, indicating unadjusted audit observations of material nature, affecting the computation of break-up value. In case such observations are quantified by respective auditors, break up value computation shall be suitably adjusted.

5.79 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.

5.80 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.

5.81 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. If the valuation of investment is outsourced from an agency, certain audit procedures need to be applied at such processing agency also.

5.82 Some of the typical audit procedures would include:

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- Obtaining list of investment as at reporting period from the bank and ascertaining completeness of the same by reconciliation process as highlighted above.
- Checking the carrying amount of investments and ensuring that the same is calculated on a consistent basis. This is normally calculated by the system and hence the auditor needs to check IT controls and calculation on sample basis for ensuring accuracy.
- In case quotes are available, checking the source of capturing market price/ fair value as at reporting date.
- In case quotes are not available, checking calculation for fair value as at the 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.

5.83 The following Table gives the basis of marked to market procedure based on the type of investments (unquoted):

<b>Type of Investment</b>	<b>Basis of Valuation</b>
Unquoted Central Government Securities	Price / YTM rates put out by FBIL
Treasury Bills	Carrying cost (acquisition cost plus discount accrued)
State Government Securities	YTM method by marking it up by 25 basis point above Central Government Securities' Yield as put in by FBIL
Other Approved Securities	YTM method by marking it up by 25 basis point above Central Government Securities' Yield as put in by FBIL
Debentures / Bonds	Valued with appropriate mark-up (which would be graded based on the rating assigned to the security, and subjected to minimum of 50 basis point) over Central Government Securities' Yield as put in by FBIL
Bonds issued by State Distribution Companies (DISCOM) under Financial Restructuring Plan	Same as above except that the mark-up would be 50, 75 and 100 basis points, when the liability is with the respective State Government, guaranteed by respective State

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<b>Type of Investment</b>	<b>Basis of Valuation</b>
	Government or not guaranteed by State Government, respectively
Zero Coupon Bonds (ZCBs)	Present Value (PV) to Face Value (FV) of ZCBs to be calculated by using 'Zero Coupon Yield Curve (ZCYC)' with appropriate mark up as per zero coupon spread put out by FBIL
Preference Shares	Valued with appropriate mark-up (which would be graded based on rating assigned to the security) over Central Government Securities' Yield as put in by FBIL, subject to an upper cap of redemption value of preference shares
Equity Shares	Valued at break-up value without considering 'revaluation reserves', if any
Units of Mutual Funds	(i) Latest re-purchase price (ii) during lock-in period or if repurchase price is not available at NAV (iii) if NAV is not available during lock-in period, at cost
Commercial Papers	Carrying cost (acquisition cost plus discount accrued)
Investments in RRBs	Carrying cost (i.e., at book value)
Security Receipts issued by Asset Reconstruction Companies (ARCs)	Lower of redemption Value or Net Book Value (NBV) subject to provisions under para 77 and 77A of RBI Master Direction No. RBI/DOR/2021-22/86 DOR.STR.REC.51/21.04.048/2021-22 dated September 24, 2021 (Updated as on December 05, 2022) [Refer Para 25.29 of Chapter 25, "Recovery of Non-Performing Assets by Assets Recovery Branches' and Para 11.203 of Chapter 11, 'Reporting for Advances' of Section B of the Guidance Note on Audit of Banks (2023 Edition)]
Category I and II Alternative Investment Funds (AIFs)	For the first three years, AIF category I and II may be classified under HTM and

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Type of Investment	Basis of Valuation
	subsequently under AFS and valued for Units / Equity / Bonds as per specified norms given below: Units: NAV Equity: Book value except revaluation reserves Bonds: Same as given for quoted/unquoted bonds given in the Master Direction

Note: If the debentures/bonds/preference shares are quoted and are transacted within 15 days prior to the valuation date, the valuation adopted as per above mentioned method, should not be higher than the said transaction rate. For further additional elaborate guidance, FIMMDA guidelines in this regard may be referred to.

### Non-Performing Investments (NPI)

5.84 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. Banks should not set-off the depreciation requirement in respect of these non-performing securities against the appreciation in respect of other performing securities.

5.85 An NPI, similar to a Non Performing Assets (NPA), is one where:

- (i) Interest/ instalment (including maturity proceeds) is due and remains unpaid for more than 90 days.
- (ii) The above would apply *mutatis-mutandis* to preference shares where the fixed dividend is not paid. 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, if 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 Para 19 of RBI Master Direction No. RBI/DOR/2021-22/81 DOR.MRG.42/21.04.141/2021-22 dated August 25, 2021 (Updated as on December 08, 2022) on "Classification, Valuation and Operation of Investment Portfolio of

Commercial Banks (Directions), 2021”, the equity shares would also be reckoned as NPI.

- (iv) If any credit facility availed by the issuer is shown as 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. The auditor should review the mechanism adopted by the bank for classifying the investments as NPI where the credit facility has been classified as NPA and *vice versa* and test the effectiveness of the mechanism followed particularly the timeliness of such classification.
- (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. Further movement in the asset classification of these instruments would also be determined based on the subsequent asset classification of the restructured advance.
- (vii) When a bank restructures credit facilities in accordance with RBI Master Direction No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 dated April 01, 2022 on “Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances”, the investments made by the bank in the instruments of such borrowers will also be dealt with in accordance with these norms. Also, the acquisition of shares due to conversion of debt to equity during a restructuring process will be exempted from regulatory ceilings / restrictions on capital market exposures, investment in para-banking activities and intra-group exposure. However, these will require reporting to the RBI (reporting to DBS, CO every month along with the regular DSB Return on Asset Quality) and disclosure by banks in the Notes to Accounts in the Annual Financial Statements. Nonetheless, banks will have to comply with the provisions of Section 19(2) of the Banking Regulation Act, 1949.

### **Classification of State Government Guaranteed Investments as NPI**

5.86 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.

5.87 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 has repudiated the guarantee when invoked. However, this exemption from classification as NPI is not for the purpose of recognition of income.

5.88 The audit procedures would include:

- Identifying non-performing investments based on RBI guidelines as defined above. In case where advances given to such a party it will have to be classified as per IRAC norms.
- The auditors should examine whether in terms of extant RBI guidelines, the bank has put in place the 'Straight Through Process' mechanism for identification of NPIs corresponding to NPAs and vice versa. The STP shall ensure that there is seamless integration between the treasury application, CBS and application for ensuring compliance with IRACP norms (if independent of CBS), without any manual intervention. Any manual intervention or gaps in automation should be appropriately highlighted in the LFAR.
- Ascertaining whether the bank has made appropriate provision for depreciation in the value of the NPI.
- Ensuring that the banks have not offset 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**

5.89 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. The auditor should check whether appropriate adjustments in this regard have been made in the cost/sales value of securities purchased or sold.



5.90 In the case of a rights 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 whether the same have been duly accounted for. Similarly, the auditor should examine the relevant documents in the case of detachable warrants. He should also examine if these have been properly accounted for.

5.91 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)**

5.92 The RBI had specified the following guidelines with respect to IFR and IRA:

#### ***Investment Fluctuation Reserve***

5.93 Para 18 of RBI Master Direction No. RBI/DOR/2021-22/81 DOR.MRG.42/21.04.141/2021-22 dated August 25, 2021 (Updated as on December 08, 2022) on Classification, Valuation and Operation of Investment Portfolio of Commercial Banks (Directions), 2021 specifies that banks shall create an IFR until the amount of IFR is at least 2 per cent of the HFT and AFS portfolio, on a continuing basis by way of transferring to the IFR an amount not less than the lower of the following: (i) Net profit on sale of investments during the year (ii) Net profit for the year less mandatory appropriations. The para further specifies details for IFR being eligible for inclusion in Tier-II capital. Banks are permitted to draw down the balance available in IFR in excess of 2 per cent of its HFT and AFS portfolio, for credit to the balance of profit/loss as disclosed in the Profit and Loss Account at the end of any accounting year. In the event of the balance in the IFR being less than 2 per cent of the HFT and AFS investment portfolio, a draw down shall be permitted subject to the following conditions: (i) The drawn down amount is used only for meeting the minimum CET1/Tier 1 capital requirements by way of appropriation to free reserves or reducing the balance of loss. (ii) The amount drawn down shall not be more than the extent the MTM provisions made during the aforesaid year and shall not exceed the net profit on sale of investments during that year.

#### ***Investment Reserve Account***

- (i) Provisions created for depreciation on investments in the AFS and HFT categories if found excessive should be credited to the Profit and Loss

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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 capital within the overall ceiling of 1.25 per cent of the total risk weighted assets prescribed for general provisions/ Loss Reserves.

- (ii) The Investment Reserve Account can be utilised in the prescribed manner.
- (iii) The amounts debited to the Profit and Loss Account towards provision should be debited under the head "Expenditure - Provisions & Contingencies". The amount transferred from the Investment Reserve Account to the Profit and Loss 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, 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.

- (iv) Withdrawals 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 and Loss Account would be eligible to be reckoned as Tier I capital.

5.94 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 RBI guidelines, banks are required to get their investments under PMS separately audited by external 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.

5.95 Investments should not normally be held by any other person. 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.

5.96 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.

5.97 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 whether an undertaking has been obtained from them to the effect that they hold the securities on behalf of the bank. The auditor may also check compliance with Section 89 of the Companies Act, 2013 regarding declaration in respect of beneficial interest in any share.

5.98 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. The

auditor 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.

5.99 The auditor should check whether the overdue amount in respect of matured investment is disclosed as investment or other assets. Since the investments had already matured, the overdue amount should be disclosed as Other Assets and not as 'investments'.

### **Income from Investments**

5.100 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/online medium.

5.101 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 or weighted average).
- Assessing the dividend recognition policy of bank considering revenue recognition principles of Accounting Standard 9, 'Revenue Recognition'.
- Re-computation of interest income on investments and checking the treatment of broken period interest, and ensuring proper cut-offs at reporting period ends.
- Checking of proper recognition of investment valuation loss as at reporting date.
- Checking of interest accrual in respect of interest-bearing investment outstanding at reporting date.

5.102 Considering that banks have large investment portfolio, use of substantive analytical procedures may be a useful audit technique for the auditor to conclude that income associated with investment balances is free from material misstatement. One such techniques is to include 'yield analysis' for the disaggregated investment portfolio of the bank.

5.103 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. The auditor may also review Form 26AS (Income-tax Rules, 1962) to ensure that proper credit will be made available to the bank.

5.104 Part of the outstanding principal amount can be converted into debt or equity instruments by way of restructuring. In the case of restructured accounts classified as 'standard', the income, if any, generated by these instruments may be recognised on accrual basis. 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. The auditor should verify that recognition of assets on conversion / restructuring does not exceed the amount restructured.

### **Legal Requirements**

5.105 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, carrying cost or face value, or a combination of these methods, as may be specified by the RBI from time to time.

5.106 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 per cent of its own paid up share capital and reserves, whichever is less.

5.107 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.

5.108 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 statutory auditors. Investments in approved securities are exempt 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 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.

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5.109 In the case of banking companies, Section 187 of the Companies Act, 2013 is also relevant. This section provides that all investments made by a company on its own behalf shall be made and held by it in its own name, except in the following cases:

- (a) Shares in a subsidiary may be held in the name(s) of the company's nominee(s) to the extent necessary to ensure minimum number of members as required by law.
- (b) Investments may be deposited with the bankers of the company for collection of dividend or interest.
- (c) 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.
- (d) 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.
- (e) Investments in the form of securities may be held in the name of a depository.

5.110 In respect of investments not held in the company's own name as per the exceptions made under Section 187 of the Companies Act, 2013, a register has to be maintained by the company, as per the format prescribed from time to time. Section 186 of the Companies Act, 2013, which imposes certain restrictions on the purchase of securities in other companies, does not apply to a banking company.

5.111 The provisions of Section 179 of the Companies Act, 2013, 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 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.

### **Guidelines of the RBI regarding Transactions in Securities**

5.112 The RBI *vide* Master Direction No. RBI/DOR/2021-22/81 DOR.MRG.42/21.04.141/2021-22 dated August 25, 2021 (Updated as on December 8, 2022) on "Classification, Valuation and Operation of Investment

Portfolio of Commercial Banks (Directions), 2021”, has consolidated the instructions/guidelines issued to banks on matters regarding prudential norms for classification, valuation and operation of Investment portfolio of banks. It may be noted that the RBI issues amendments/clarifications through various notifications and circulars and accordingly auditors are advised to refer various circulars and notifications related to treasury operations issued after 25<sup>th</sup> August, 2021.

### **Classification of Investments**

5.113 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.

5.114 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. Investments under HTM category should not exceed 25 per cent of the total investments of the bank, except as specified in the Master Directions, wherein the limit of 25 per cent can be exceeded subject to the conditions/admissible securities as mentioned in Para 6 (iv) of the extant direction are complied with.

5.115 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. The RBI vide circular no. DBR.BP.BC.No.31/21.04.018/2015-16 dated 16<sup>th</sup> July, 2015 on “Deposits placed with NABARD/SIDBI/NHB for meeting shortfall in Priority Sector Lending by Banks-Reporting in Balance Sheet” decided that for accounting periods commencing on or after April 1, 2015, deposits placed with NABARD/SIDBI/ NHB on account of shortfall in priority sector targets should be included

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under Schedule 11- 'Other Assets' under the subhead 'Others' of the Balance Sheet instead of disclosing under Schedule 8 "Investments".

5.116 Vide RBI circular no. DoR.No.BP.BC.9/21.04.141/2020-21 dated September 1, 2020 on SLR holdings in HTM category (Amended), banks were allowed to hold under HTM category, SLR securities acquired on or after September 1, 2020 up to an overall limit of 22 per cent of NDTL, up to March 31, 2021 which was further amended vide circular no. DoR.No.BP.BC.22/21.04.141 2020-21 dated October 12, 2020 and circular no. RBI/2020-21/94 DOR.No.MRG.BC.39/21.04.141/2020-21 dated February 5, 2021. Subsequently, it was further relaxed vide circular no RBI/2022-23/21 DOR.MRG.REC.14/21.04.141/ 2022-23 dated April 08, 2022 and RBI/2022-23/150 DOR.MRG.REC.89/21.04.141/2022-23 dated December 08, 2022 on SLR holdings in HTM category to extend the dispensation of enhanced HTM of 23 per cent to March 31, 2024 and to include SLR securities acquired between April 1, 2020 and March 31, 2024. Thus, banks may exceed the limit specified w.r.t. total SLR securities held under HTM category (as specified in paragraph 2(b) of the above circular) up to 23 per cent of NDTL (instead of 19.5 per cent of NDTL) till March 31, 2024, provided such excess is on account of SLR securities acquired between September 1, 2020 and March 31, 2024. Thereafter, it shall be progressively reduced such that the total SLR securities held in the HTM category as a percentage of the NDTL does not exceed:

- a. 22.00 per cent as on June 30, 2024.
- b. 21.00 per cent as on September 30, 2024.
- c. 20.00 per cent as on December 31, 2024.
- d. 19.50 per cent as on March 31, 2025.

### **Exposure Limits**

5.117 The RBI, vide Master Circular No. RBI /2015-16/70 DBR.No.Dir.BC.12 /13.03.00/2015-16 dated July 1, 2015 on "Exposure Norms" provides the requirements in respect of exposure limits for banks. Further, the RBI vide circular no. RBI/2018-19 /196 DBR.No.BP. BC.43/21.01.003/2018-19 dated June 03, 2019 on "Large Exposures Framework" has issued guidelines on Large Exposure Framework (LEF). These guidelines came into effect with effect from April 1, 2019. Further amendments to these guidelines have also been made vide circular no. DOR.No.BP.BC.70/21.01.003/2019-20 dated May 23, 2020 on "Large Exposures Framework – Increase in Exposure to a Group of Connected Counterparties" and circular no. RBI/2021-2022/97 DOR.CRE.REC.47/21.01.003/ 2021-22 dated September 09, 2021 on "Large Exposures Framework – Credit Risk Mitigation (CRM) for offsetting – non-centrally cleared derivative transactions of foreign bank branches in India with their Head Office".



5.118 As per guidelines these banks cannot participate in the equity of financial services ventures including stock exchanges, depositories, etc., without obtaining the prior specific approval of the RBI, notwithstanding the fact that such investments may be within the ceiling prescribed under Section 19(2) of the Banking Regulation Act. The RBI *vide* circular no. DBR.No.FSD.BC.37/24.01.001/2015-16 dated September 16, 2015 on “Equity Investment by Banks – Review” has provided that banks which have CRAR of 10 per cent or more and have also made net profit as of March 31 of the previous year need not approach the RBI for prior approval for equity investments in cases where after such investment, the holding of the bank remains less than 10 per cent of the investee company’s paid up capital, and the holding of the bank, along with its subsidiaries or joint ventures or entities continues to remain less than 20 per cent of the investee company’s paid up capital. Financial services companies have been defined in Annex I to the Master Circular No. DBR.No.FSD.BC.19/24.01.001/2015-16 dated July 1, 2015 on ‘Para-banking Activities’. The investment will continue to be subject to prudential limits as mentioned in Para 3.1 (a) and (c) of Master Circular No. DBR.No.FSD.BC.19/24.01.001/2015-16 on ‘Para-banking Activities’ dated July 1, 2015.

5.119 The auditor needs to check compliance with the above mentioned circular no. DBR.No.FSD.BC.37/24.01.001/2015-16 dated September 16, 2015 on “Equity Investment by Banks – Review”, while auditing equity investments in financial services company by the bank.

### **(C) Certificate/ Reports (Covering the Requirements and Approach/ Procedures)**

#### **Special-purpose Certificates Relating to Investments**

5.120 It may be noted that pursuant to circulars issued by RBI from time to time, banks require their SCAs 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 RBI.

5.121 The auditor may consider relying on the work done during the course of audit for the purposes of such certificates. The certificate should reach the Regional Office of the DBS, RBI, under whose jurisdiction the bank’s head

office is located within one month from the close of the accounting year and thus banks whose accounts have not been audited by the stated period may issue the certificate based on the unaudited books of account.

## **(D) Accounting Aspects**

### **Disclosure Requirements**

5.122 Investments of banks should be disclosed as per the following classifications:

- (i) Governments Securities
- (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 (SR), Pass Through Certificates (PTC), Units of Mutual Funds, Category I and II Alternative Investment Funds (AIFs), Real Estate Funds, Real Estate Investment Trust (REITs), Infrastructure Investment Trust (InvITs) etc.

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).

### **Balance Sheet Presentation**

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

#### **I. Investments in India**

- (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**

- (i) Government securities (including local authorities)
- (ii) Subsidiaries and/or Joint Ventures Abroad
- (iii) Other Investments (to be specified)

5.124 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;
- (c) net value of investments in India and outside India; and
- (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.

5.125 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.

5.126 The auditor should consider the following points in respect of Investments held outside India:

- a. Review the delegation of authority to confirm that in respect of branches outside India holding investments, whether the foreign branches are authorised to transact and hold investments in their books of accounts and that the transactions have been duly executed as per the said delegation matrix.
- b. Physically verify these investments held by branches outside India. In case it is not possible to verify these physically, undertake alternative audit procedures to verify the existence and ownership of these investments as at the reporting date.
- c. Verify the valuation of these investments. The same should be in line with RBI requirements. Similarly, local regulations in the country in which the investments are made should also be referred to. The valuations should be in line with the regulations that are more stringent.

## **(E) Internal Financial Controls Over Financial Reporting including IT Controls**

5.127 The auditors should familiarise themselves with the instructions/ directions issued by the RBI regarding transactions in investment securities. Banks should frame Internal Investment Policy Guidelines and obtain the Board's approval. The investment policy may be suitably framed / amended to include Primary Dealer (PD) activities also. Further, the RBI has issued Master Directions No. RBI/IDMD/2016-17/29 IDMD.PDRD.01/03.64.00/ 2016-17 dated July 1, 2016 (Updated November 22, 2018) on "Operational Guidelines for Primary Dealers", which should be complied by banks. The auditor 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.

5.128 Banks' management should ensure that there are adequate internal control and audit procedures for ensuring proper compliance in regard to the conduct of the investment portfolio. The banks should institute a regular system of monitoring compliance with the prudential and other guidelines issued by the RBI. While examining the internal controls over investments the auditor should particularly examine whether the same are in consonance with the guidelines of the RBI a gist of which has also been included in RBI Master Direction No. RBI/DOR/2021-22/81 DOR.MRG.42/21.04.141/2021-22 dated August 25, 2021 (Updated as on December 08, 2022) on Classification, Valuation and Operation of Investment Portfolio of Commercial Banks (Directions), 2021. They should also judge their efficacy. By efficacy, it is meant that not only the auditor would check the operating effectiveness of various internal controls but also in the first instance check and evaluate the design of such internal controls.

5.129 Any deficiencies noted during the audit procedures should be reported by the auditor to the Management/ Those charged with Governance in accordance with SA 265 "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management".

5.130 Some of the typical audit procedures would include:

- Perusing the investment policy and preparing brief note on key points of compliances.
- Examining whether the Investment policy has been periodically reviewed by the Management and adequate corrective actions have been taken.
- Verifying whether investment policy lays down clear parameters for stop loss limits or there exists any separate stop loss policy.

- Perusing the minutes of Board/Board appointed committee for approval of investment policy and obtain the list of modifications made in the policy compared to earlier approved policy.
- Examining whether the investments made by the bank are in accordance with the laid down investment policy and are also in compliance with RBI guidelines w.r.t. exposure norms.
- Verification of valuation of investments as per the method and frequency as defined by the RBI.
- Perusing reports on concurrent audit of treasury transactions, system audit report, if any 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.
- Verification of voice recording mechanism and to ensure user ids of dealers left / transferred/ on leave are deactivated / suspended on timely basis.

### **Dealings in Securities on Behalf of Others**

5.131 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 the RBI. These activities of banks are in the nature of trust or fiduciary activities. The accounting implications of the trust activities of banks may be noted. Banks commonly act as trustees and in other fiduciary capacities that result in holding or placing of assets on behalf of individuals, trusts, retirement benefit plans and other institutions. If 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.

5.132 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. An Illustrative Checklist for the verification of the aspects of the Treasury/ Investments of the Bank in Statutory Audit is given as an Annexure to this Chapter.

## **(F) Compliance with CRR and SLR requirements**

### **Introduction**

5.133 Due to the 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. While ensuring some liquid money against deposits is the primary purpose of CRR, its secondary purpose is to allow the RBI to control liquidity and interest rates in the economy. In the short term, interest rates swing up or down depending on how much liquidity is available for lending. Too much money leads to a collapse in rates, and too little, a spike. For further guidance, RBI Master Circular No. RBI/DOR/2021-22/80 DOR.No.RET.REC.32/12.01.001/2021-22 dated July 20, 2021 (Updated as on April 06, 2022) on Reserve Bank of India [Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)] Directions – 2021 may be referred.

### **Regulatory Requirements**

5.134 Recognising the need to safeguard the interests of depositors by ensuring that banks do not over-extend their resources and 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 per cent of the total of its demand and time liabilities (DTL) 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.

5.135 Consequent to the amendment of Section 24 of the Banking Regulation Act, 1949 through the Banking Regulation (Amendment) Act, 2007 replacing the Banking Regulation (Amendment) Ordinance, 2007, effective January 23, 2007, the RBI 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 of its total demand and time

liabilities in India as on the last Friday of the second preceding fortnight as the RBI may, by notification in the Official Gazette, specify from time to time.

5.136 Further, the RBI has specified *vide* RBI Master Direction No. RBI/DOR/2021-22/80 DOR.No.RET.REC.32/12.01.001/2021-22 dated July 20, 2021 (Updated as on April 06, 2022) on Reserve Bank of India [Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)] Directions - 2021 on Section 24 and Section 56 of the Banking Regulation Act, 1949 – “Maintenance of Statutory Liquidity Ratio (SLR) that 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 a specified percentage of the total net demand and time liabilities (NDTL) as on the last Friday of the second preceding fortnight valued in accordance with the method of valuation specified by the RBI from time to time:

- (a) Cash; or
- (b) Gold as defined in Section 5(g) of Banking Regulation Act, 1949 valued at a price not exceeding the current market price; or
- (c) Unencumbered investment in the following instruments which will be referred to as "Statutory Liquidity Ratio (SLR) securities":
  - (i) Dated securities of the Government of India issued from time to time under the market borrowing programme and the Market Stabilization Scheme;
  - (ii) Treasury Bills of the Government of India; and
  - (iii) State Development Loans (SDLs) of the State Governments issued from time to time under the market borrowing programme;
- (d) The Deposits and unencumbered approved securities required, under sub-section (2) of Section 11 of the Banking Regulation Act, 1949 (10 of 1949), to be made with the RBI by a banking company incorporated outside India; and
- (e) Any balance maintained by a scheduled bank with the RBI in excess of the balance required to be maintained by it under Section 42 of the Reserve Bank of India Act, 1934 (2 of 1934).

5.137 The RBI vide circular no. DBR.No.Ret.BC.10/12.02.001/2018-19 dated December 5, 2018 on “Section 24 and Section 56 of the Banking Regulation Act, 1949 - Maintenance of Statutory Liquidity Ratio (SLR)”, has reduced the SLR by 0.25 per cent in a phased manner beginning from 5.1.2019 till it reaches 18 per cent by 11.4.2020 as follows:

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Effective date (from the fortnight beginning)	SLR on net demand and time liabilities (per cent)
October 14, 2017	19.50
05.01.2019 <sup>5</sup>	19.25
13.04.2019 <sup>5</sup>	19.00
06.07.2019 <sup>5</sup>	18.75
12.10.2019 <sup>5</sup>	18.50
04.01.2020 <sup>5</sup>	18.25
11.04.2020 <sup>5</sup>	18.00

5.138 Provided that the instruments referred to in items (i) to (iii) above that have been acquired under reverse repo with the RBI, shall not be included as SLR securities for the purpose of maintenance of SLR assets up to October 2, 2016. From October 3, 2016 such securities acquired from the RBI shall be considered as eligible assets for SLR maintenance.

5.139 However, in terms of Master Direction No. RBI/DOR/2021-22/80 DOR.No.RET.REC.32/12.01.001/2021-22 dated July 20, 2021 on Reserve Bank of India [Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)] Directions – 2021, the funds borrowed under repo will continue to be exempt from CRR/SLR computation and the security acquired under reverse repo shall continue to be eligible for SLR.

5.140 In respect of repo transactions in corporate debt securities, the amount borrowed by a bank through repo shall be reckoned as part of its DTL and the same shall attract CRR/SLR. Encumbered SLR securities are not to be included for the purpose of computing the percentage specified herein above, to the extent of outstanding liabilities against the same.

5.141 If a banking company fails to maintain the required SLR, it shall be liable to pay to the RBI in respect of that default, 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.

5.142 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. According to

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<sup>5</sup> Vide RBI notification no. RBI/2018-19/86/DBR.No.Ret.BC.10/12.02.001 dated 05.12.2018.



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. If any such Friday happens to be 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. Banks should also submit a statement as Annexure to Form VIII giving daily position of –

- (a) value of securities held for the purpose of compliance with SLR; and
- (b) the excess cash balances maintained by them with the RBI in the prescribed format.

5.143 As per RBI circular no. RBI/2016-17/302 Ref: DBR.CO.No.Ret.BC /66/12.07.144/2016-17 dated May 11, 2017 on “Submission of Statutory returns (SLR-Form VIII) in XBRL platform”, the reporting of SLR has been moved from PCRPCD to XBRL (Extensible Business Reporting Language) platform from April 2017 onwards.

5.144 The RBI, *vide* circular no. DBOD No.761-A/08/07/003/93 dated February 8, 1993 and circular no. 829/08.07.003/93 dated February 20, 1993, has asked the banks to advise their SCAs to verify the compliance of statutory liquidity ratio on twelve odd dates in different months not being Fridays. The said compliance report by the auditor is to be submitted separately to the top management of the bank and to the RBI.

5.145 The statutory auditor should verify and certify that all items of outside liabilities, as per the bank’s books had been duly compiled with 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.

5.146 The RBI, *vide* its circulars no. DOR.No.Ret.BC.52/12.01.001/2019-20 dated March 27, 2020 on Section 24 of the Banking Regulation Act, 1949 – Maintenance of Statutory Liquidity Ratio (SLR) – Marginal Standing Facility (MSF), DOR.RRB. No.28/31.01.001/2020-21 dated December 4, 2020 on Introduction of Liquidity Adjustment Facility (LAF) and Marginal Standing Facility (MSF) for Regional Rural Banks (RRBs), RBI/2020-21/91 DOR.No. Ret.BC.36/12.01.001/2020-21 February 05, 2021 on Section 24 of the Banking Regulation Act, 1949 – Maintenance of Statutory Liquidity Ratio (SLR) – Marginal Standing Facility (MSF) - Extension of Relaxation and Press Release No.2020-2021/401 dated September 28, 2020 on Marginal Standing Facility

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(MSF), allowed banks to avail of funds under the MSF by dipping into the Statutory Liquidity Ratio (SLR) up to an additional one per cent of their net demand and time liabilities (NDTL), i.e., cumulatively up to three per cent of NDTL. The said MSF relaxation was extended up to December 31, 2021 vide RBI circular no. RBI/2021-22/82 DOR.RET.REC.36/12.01.001/2021-22 dated August 09, 2021. Subsequently, the said MSF relaxation was dispensed off vide RBI circular no. RBI/2021-22/138 DOR.RET.REC.73/12.01.001/2021-22 dated December 10, 2021, which specified that the banks will be able to dip into the Statutory Liquidity Ratio (SLR) up to two per cent of NDTL instead of three per cent for overnight borrowing under the MSF with effect from January 1, 2022.

### **Computation of CRR**

5.147 The RBI introduced the system of lag of one fortnight in the maintenance of stipulated CRR by banks w.e.f. November 06, 1999 to improve cash management by banks. Further, the daily minimum CRR maintenance requirement has been reduced to 90 per cent effective from the fortnight beginning from April 16, 2016.

5.148 The RBI circular no. RBI/2020-21/92 DOR.No.Ret.BC.37/12.01.001/2020-21 dated February 05, 2021 on "Credit to MSME Entrepreneurs" read with circular no. RBI/2021-22/30 DoR.RET.REC.09/12.01.001/2021-22 dated May 5, 2021 on "Credit to MSME Entrepreneurs", provides that Scheduled Commercial Banks will be allowed to deduct the amount equivalent to credit disbursed to 'New MSME borrowers' from their Net Demand and Time Liabilities (NDTL) for calculation of the Cash Reserve Ratio (CRR). For the purpose of this exemption, 'New MSME borrowers' shall be defined as those MSME borrowers who have not availed any credit facilities from the banking system as on January 1, 2021. This exemption will be available only up to Rs. 25 lakhs per borrower disbursed up to the fortnight ending December 31, 2021, for a period of one year from the date of origination of the loan or the tenure of the loan, whichever is earlier.

5.149 The RBI reduced the CRR to 3 per cent vide circular no. DOR.No.Ret.BC.49/12.01.001/2019-20 dated March 27, 2020 on Maintenance of Cash Reserve Ratio (CRR) up to a period of one year ending March 26, 2021. The said dispensation would be restored in two phases - banks will be required to maintain the CRR at 3.50 per cent of their NDTL effective from the reporting fortnight beginning March 27, 2021 and 4.00 per cent of their NDTL effective from fortnight beginning May 22, 2021. Refer RBI circular no. DOR.No.Ret.BC.35/12.01.001/2020-21 dated February 5, 2021 for details.

### **Computation of SLR**

5.150 Refer Master Direction No. RBI/DOR/2021-22/80 DOR.No.RET.REC. 32/12.01.001/2021-22 dated July 20, 2021 (Updated as on April 06, 2022) on Reserve Bank of India [Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)] Directions – 2021 read with notification no. RBI/2016-17/83 DBR.No.Ret.BC.15/ 12.02.001/2016-17 dated October 13, 2016 on “Section 24 and Section 56 of the Banking Regulation Act, 1949 - Maintenance of Statutory Liquidity Ratio (SLR)”, for guidance on computation of SLR.

### **Audit Approach and Procedures**

5.151 The certificate of the statutory auditors in relation to compliance with CRR and 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.

5.152 The SCA 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. In terms of extant RBI guidelines<sup>6</sup>, SCAs are required to issue a certificate regarding bank's compliance with SLR/CRR guidelines on 12 odd dates, i. e. dates which do not fall on reporting Fridays.

5.153 The SCA should carry out a process walk-through of NDTL and CRR/SLR calculation process to identify risks associated with calculation and probability of error. The same should be noted in the working papers of the auditor.

5.154 To comply with the requirements relating to statutory liquidity ratio, banks have evolved a system of consolidating trial balances of all branches and head office to compile consolidated trial balance of bank as a whole at its head office. Based on this consolidation, the DTL position is determined for every reporting Friday. The SCA should request the SBAs to verify the correctness of the trial balances relevant to the dates selected by him. The SCA should also request the SBAs to verify the cash balance at the branch on the dates selected by him. It should be ensured that such request is

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<sup>6</sup> RBI circular no. DBS.ARS.No.BC. 08/ 08.92.001/ 2012-13 dated June 25, 2013 on Remuneration payable to the Statutory Central and Branch Auditors of Public Sector Banks from the year 2012-13.

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communicated to the SBAs well in advance of the commencement of the audit so that they can draw up their audit programme accordingly.

5.155 In many banks, the consolidated trial balance (related to branches) for selected dates can be generated through core banking system and hence, verification by SBAs may not be warranted.

5.156 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 auditor 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.

5.157 The auditor should examine the consolidations prepared by the bank relevant to the dates selected by him. The auditor 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.

5.158 While examining the computation of DTL, the auditor may specifically examine whether the following items have been excluded from the liabilities:

- a) Paid up capital, reserve, any credit balance in Profit and Loss Account of the bank, amount of any loan taken from the RBI and amount of refinance taken from EXIM Bank, NHB, NABARD, SIDBI.
- b) Bills discounted by a bank with eligible financial institutions as approved by the RBI.
- c) Net Income tax provision.
- d) Amount received from DICGC towards claims held by banks pending adjustments thereof.
- e) Amount received from ECGC by invoking the guarantee.
- f) Amount received from insurance companies for adhoc settlement of claims pending judgement of court.
- g) Amount received from court receiver.
- h) Net unrealized gain/loss arising from derivatives transactions under trading portfolio.
- i) Income flows received in advance such as annual fees and other charges which are not refundable.
- j) Liabilities arising on account of utilisation of limit under Bankers Acceptance Facility (BAF).

- k) Part amounts of recoveries from the borrowers in respect of debts considered bad and doubtful of recovery.
- l) Amounts received in Indian currency against import bills and held in sundry deposits pending receipt of final rates.
- m) 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 payments made by other branches but not adjusted by the link branches.
- n) Margins held and kept in sundry deposits for funded facilities.

5.159 Similarly, the auditor may specifically examine whether the following items have been included in liabilities:

- (a) Net credit balance in Branch Adjustment Accounts. The credit entries in branch adjustment account which are outstanding for more than 5 years are required to be considered at gross.
- (b) Interest accrued on deposits should be calculated on each reporting fortnight (as per the interest calculation methods applicable to various types of accounts), whether or not such interest is accounted for in books of accounts, so that the bank's liability in this regard is fairly reflected in the total NDTL of the same fortnightly return.

Cash collaterals received under collateralized derivative transactions as these are in the nature of 'outside liabilities'.

- (c) Borrowings from abroad by banks in India need to be considered as 'liabilities to others' and should be considered at gross level unlike 'liabilities towards banking system in India', which are permitted to be netted off against 'assets towards banking system in India'. Thus, the adverse balances in Nostro Mirror Account should be considered as 'Liabilities to other'.
- (d) The reconciliation of Nostro accounts (with Nostro Mirror Accounts) needs to be scrutinized carefully to analyse and ascertain if any inward remittances are received on behalf of the customers / constituents of the bank and have remained unaccounted and / or any other debit (inward) entries have remained unaccounted and are pertaining to any liabilities for the bank.

5.160 While examining the computation of DTL, the auditor may specifically examine the details of exempted categories of the following items:

- a) Minimum eligible credit (EC) and outstanding Long term bonds (LB) to finance Infrastructure loans and affordable housing loan, as per RBI

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circular no. DBOD.BP.BC.No.25/08.12.014/2014-15 dated July 15, 2014 on “Issue of Long Term Bonds by Banks – Financing of Infrastructure and Affordable Housing” and further amended by circular no. DOR.No.BP.BC.41/08.12.014/2019-20 dated March 17, 2020.

- b) The eligible amount of incremental FCNR(B) and NRE deposits of maturities of three years and above.

5.161 The auditor should also verify loans out of FCNR(B) deposits and inter- bank Foreign Currency (IBFC) deposits for reporting in Form A return. Banks should convert their foreign exchange assets/liabilities (including borrowings) in USD, GBP, JPY and Euro into INR at RBI reference rate. For other currencies consider the New York rate for conversion into USD.

5.162 As per RBI circular no. RBI/2018-19/34/DBR.Ret.BC.No.01/ 12.01.001 /2018-19 dated August 02, 2018 on “Maintenance of CRR/SLR on Foreign Currency Assets/Liabilities – Reference rate for INR/USD and exchange rate of other major currencies”, for conversion of foreign Currency Assets/ Liabilities reference rate from FBIL should be taken. If reference rate is not available from FBIL, banks may continue to use New York closing rate for conversion of such currency into USD.

5.163 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.

5.164 The auditor should examine whether the consolidations prepared by the bank include the relevant information in respect of all the branches.

5.165 The auditor should examine the correctness of data in Form A return for CRR and Return in Form VIII for SLR purposes on sample basis.

5.166 As stated in the preceding paragraphs, a considerable part of the information required by the SCA 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 SCA should adequately describe the same in his certificate.

5.167 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. Necessary audit procedures should be developed based on introduction of Automated Data Flow (ADF) for CRR & SLR reporting.

### **Treasury Operations-Foreign Exchange and Derivative Transactions**

5.168 Banks transact in various treasury instruments with the 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.

5.169 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 to deliver to each other on a fixed date a specified sum in a given currency. The exchange, the 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.

5.170 Foreign exchange transactions, as 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.

5.171 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**

5.172 In India, different derivative instruments are permitted and regulated by various regulators, like Reserve Bank of India (RBI) and the Securities and

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Exchange Board of India (SEBI). Broadly, the 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, 1934, vide circular no. DBOD. No. BP.BC. 86/21.04.157/2006-07 dated 20 April 2007 on “Comprehensive Guidelines on Derivatives” read with Master Direction No. RBI/FMRD/2021-22/84 FMRD. FMD.07/ 02.03.247/ 2021-22 dated September 16, 2021 on “RBI Market-Makers in OTC Derivatives Directions, 2021”.

5.173 “Derivative” is a contract that changes in value in relation to the price movements of related or underlying securities like change in interest rate, foreign exchange rate, credit rating or credit index, price of securities 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 RBI from time to time.

5.174 A derivative is traded between two parties, who are referred to as the counterparties. These counterparties are subject to a pre-agreed set of terms and conditions that determine their rights and obligations.

### **Products offered in Forex and Derivative Business**

5.175 There are various types of foreign exchange and derivative contracts offered in normal course of banking business including inter-alia Cash, Tom & Spot, Foreign exchange forward, Swap, Currency Swap, Credit Default Swap, Currency Option, Forward rate Agreement, Interest rate swap, Interest rate futures, Interest rate cap & floor, Currency futures and Interest Rate Options. The following circulars are relevant and provide guidance on these products:

- IDMC.MSRD.4801/06.01.03 dated June 3, 2003 Guidelines on Exchange-Traded Interest Rate Derivatives.
- IDMD.PDRD.No. 1056/03.64.00/2009-10 dated September 1, 2009 Guidelines on Exchange Traded Interest Rate Derivatives.
- RBI/2010-11/147 A.P. (DIR Series) Circular No. 05 dated July 30, 2010 “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 Introduction of Exchange Traded Currency Options – Permitting Banks to Participate in Currency Options on Recognized Stock / New Exchanges.
- DBOD.No.BP.BC. 44/21.04.157/2011-12 dated 2 November 2011 “Comprehensive Guidelines on Derivatives: Modifications” modifying the 20



April 2007 circular; and further amended vide circular no. DBR.No.BP.BC.103/21.04.157/2017-18 dated April 6, 2018.

- DBOD.BP.BC.No. 61/21.06.203/2011-12 of 30th November 2011 “Prudential Guidelines on Credit Default Swaps (CDS)” regarding credit default swaps.
- RBI/2016-17/199 FMRD.DIRD.12/14.01.011/2016-17, December 29, 2016 Introduction of Interest Rate Options in India, detailed directions of which are given in Notification No. FMRD-DIRD.11/2016 dated December 28,2016 as amended vide circular no.FMRD.DIRD.20/2019 dated June 26, 2019.
- FMRD.DIRD.19/14.03.046/2018-19 dated June 26, 2019 (Updated as on August 8, 2022) on “Rupee Interest Rate Derivatives (Reserve Bank) Directions, 2019”.
- Master Direction No. FMRD.FMD.07/02.03.247/ 2021-22 dated September 16, 2021 on- Reserve Bank of India - Market-makers in OTC Derivatives Directions 2021.

**Derivatives Markets**

5.176 Derivatives can be traded on or off an Exchange and are known as:

Exchange-Traded Derivatives (ETDs):	Contracts traded on a recognised Exchange, with the counterparties being the holder and the Exchange.
Over-the-Counter Derivatives (OTCs):	Bespoke contracts traded off-Exchange with specific terms and conditions determined between two eligible parties, with or without the use of an intermediary. As a result OTC derivatives are more illiquid, eg forward contracts and swaps.

5.177 The RBI vide its circular no. RBI/2017-18/134 A. P. (DIR Series) Circular No. 18 dated February 26, 2018 on “Risk Management and Inter-bank Dealings: Revised guidelines relating to participation of a person resident in India and Foreign Portfolio Investor (FPI) in the Exchange Traded Currency Derivatives (ETCD) Market” has permitted persons resident in India and FPIs to take positions (long or short), without having to establish existence of underlying exposure, up to a single limit of USD 100 million equivalent across all currency pairs involving INR, put together, and combined across all Exchanges. The above said circular, along with other requirements has been consolidated in Master Direction No. RBI/FMRD/2016-17/31 FMRD No. 1/2016-17 dated July 5, 2016 (Updated as on September 01, 2020) on ‘Risk Management and Inter-Bank Dealings’.

### **Participants**

5.178 Participants of this market can broadly be classified into the 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**

5.179 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 the RBI. Market-makers can undertake derivative transactions to act as counterparties in derivative transactions with users and also amongst themselves. Banks use derivatives to hedge, that is, to reduce the risks involved in the bank's operations. The major objectives/purpose for undertaking derivative transactions has been explained in the following Table:

<b>Objectives/Purpose</b>	<b>Reasons</b>
Balance Sheet Management	<ul style="list-style-type: none"><li>• Use of derivatives by the bank to manage its balance sheet exposures.</li><li>• The bank will use derivatives as a means for managing the interest rate, liquidity and foreign exchange risks arising from its banking operations.</li></ul>
Client servicing	<ul style="list-style-type: none"><li>• Offering derivative products to existing and new clients as an additional product from the bank.</li><li>• The bank will offer derivative products to enhance product offerings to its existing clients as well as to build new client relations.</li></ul>
Proprietary Trading	<ul style="list-style-type: none"><li>• The Bank will undertake derivative transactions to earn trading profits.</li><li>• The bank's treasury may take view-based transactions as well as offer two-way quotes on derivatives within the limits prescribed by this policy.</li></ul>
Hedging On-Balance	<ul style="list-style-type: none"><li>• Banks are exposed to interest-rate risk from their</li></ul>

sheet transactions	on-balance-sheet activities when their assets do not reprice at the same time as their liabilities. Hence banks undertake derivative transactions to hedge their balance sheets transactions e.g., banks may use swaps to hedge on-balance-sheet interest-rate risk.
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### **Bank's Process, Regulatory Requirements/ Restrictions and Updates**

5.180 The major requirements for undertaking any derivative transaction include the following:

- 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 vide Master Direction No. RBI/FMRD/2016-17/31 FMRD No. 1/2016-17 dated July 5, 2016 (updated September 01 2020) on 'Risk Management and Inter-Bank Dealings' and circular no. DBOD.No.BP.BC.86/21.04.157/2006-07 dated 20<sup>th</sup> April, 2007 on "Comprehensive Guidelines on Derivatives" and further amendments issued by the RBI vide circulars no. DBOD.No.BP.BC. 27 / 21.04.157/2011-12 dated 2<sup>nd</sup> August, 2011 and circular no. DBOD.BP.BC.44/21.04.157/2011-12 dated 2<sup>nd</sup> November, 2011 on "Comprehensive Guidelines on derivatives –Modifications".
  - 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
    - Exchange traded Currency Futures
    - Exchange traded currency options
    - Interest Rate Options
  - b. The following derivative products may be treated as "structured derivative products":

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- 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.

5.181 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.
  - It may be ensured that structured products do not contain any derivative, which is not allowed on a standalone basis.
  - 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 'User Classification Framework' 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**

5.182 The Comprehensive Guidelines on derivatives 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.
- (c) Comprehensive internal controls and audit procedures.

**Suitability and Appropriateness – User Classification Framework**

5.183 While undertaking any derivative transactions with 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 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) While selling structured products, the selling banks should make available a calculator or at least access to a calculator (say on the market-maker's website) which will enable the users to mark to market these structured products on an ongoing basis.

5.184 Before offering any derivative product to a client the bank should adopt the following measures:

- (a) Obtain Board resolution from the corporate which contains the details specified in the comprehensive guidelines on derivatives. 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.
- (b) 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.

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- (c) Inform the customer of its opinion, where the market-maker considers that a proposed derivative 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.
- (d) Ensure that 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 pay outs 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.
- (e) Guard against the possibility of misunderstanding all significant communications between the market-maker and user should be in writing/email or recorded in meeting notes.
- (f) Ensure to undertake transactions at prevailing market rates and avoid transactions that could result in acceleration/deferment of gains or losses.
- (g) 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.
- (h) The market-makers should carry out proper due diligence regarding 'user appropriateness' and 'suitability' of products before offering derivative products to users. Each market-maker should adopt a Board-approved 'Customer Appropriateness & Suitability Policy' for derivatives business. Authorised Dealers shall classify a user as per the User Classification Framework (provided at Annex XXI of the Master Direction on- Risk Management and Inter-Bank Dealings dated July 05, 2016 (Updated as on September 01, 2020) and shall comply with the guidelines applicable in each case. It may also be noted that the responsibility of 'Customer Appropriateness and Suitability' review is on the market-maker.

5.185 As per RBI circular no. RBI/2017-18/151 DBR.No.BP.BC.103/21.04.157/2017-18 dated April 6, 2018 on "Comprehensive Guidelines on Derivatives: Modifications", it has now been decided that standalone plain vanilla forex options (without attached structures) purchased by clients will be exempt

from the 'user suitability and appropriateness' norms, and the regulatory requirements will be at par with forex forward contracts. For detailed guidelines on user classification framework members may refer Annex XXI of the Master Direction on Risk Management and Inter-Bank Dealings dated July 5, 2016 (Updated as on September 01, 2020).

## **Documentation**

5.186 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 type of business is being conducted and, crucially, whether the counterparties intend to net payments at settlement. Organizationally, this area can be viewed in a way similar 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.

5.187 The circular on the Comprehensive Guidelines on Derivatives requires the market participants to ensure that documentation requirements in respect of derivative contracts are complete in all respects. The following instructions in this regard may, therefore, be strictly adhered to:

- (i) For the sake of uniformity and standardisation in respect of all derivative products, participants may use ISDA documentation, with suitable modifications. Counterparties are free to modify the ISDA Master Agreement by inserting suitable clauses in the schedule to the ISDA Master to reflect the terms that the counterparties may agree to, including the manner of settlement of transactions and choice of governing law of the Agreement.
- (ii) It may be mentioned that besides the ISDA Master Agreement, participants should obtain specific confirmation for each transaction which should detail the terms of the contract such as gross amount, rate, value date, etc. duly signed by the authorised signatories.
- (iii) It is also preferable to make a mention of the Master Agreement in the individual transaction confirmation.
- (iv) Participants should further evaluate whether the counterparty has the legal capacity, power and authority to enter into derivative transactions.
- (v) Participants must ensure that ISDA Master Agreement is signed with the counterparty prior to any derivatives business with them being undertaken.
- (vi) Participants shall obtain documentation regarding customer suitability, appropriateness/user classification etc. as specified.

## **Identification and Management of Risk**

5.188 Market-makers should identify the various types of risks to which they are exposed in their derivatives activities. The main types of risks are:

- Credit risk
- Market risk
- Liquidity risk
- Interest risk
- Operational risk
- Legal risk

The RBI circular requires all significant risks to be measured and integrated into an entity-wide risk management system.

### **Risk limits**

5.189 Risk limits serve as a means to controlling 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**

5.190 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.

5.191 Entities which are market-makers in derivatives should maintain a unit which is responsible for monitoring and controlling the risks in derivatives. This unit should report directly to the Board or to senior management who are not directly responsible for trading activities. Where the size of the entity or its involvement in derivatives activities does not justify a separate unit dedicated to derivative activities, the function may be carried out by support personnel in the back office (or in a middle office) provided that such personnel have the necessary independence, expertise, resources and support from senior management to do the job effectively.

### **Operational Controls**

5.192 Operational risk arises as a result of inadequate internal controls, human error or management failure. This risk in derivatives activities is



particularly important, because of the complexity and rapidly evolving nature of some of the products. 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**

5.193 The prudential norms relating to derivatives – minimum capital adequacy requirement, credit exposure norms, ALM etc. will be as prescribed by the RBI from time to time. Attention of the readers may be drawn to RBI circular no. DBOD.No.BP.BC.48 / 21.06.001/2010-11 dated October 1, 2010; circular no. DBOD.No.BP.BC.31/21.04.157/2008-09 dated August 8, 2008; circular no. DBOD.No. BP.BC.57/21.04.157/2008-09 dated October, 13 2008; circular no. DBOD.No.BP.BC. 28/21.04.157/2011-12 dated August 11, 2011; circular no. DBOD.No.BP.BC.31 /21.04.157/2012-13 dated July 23, 2012; circular no. RBI/2016-17/45 DBR.No.BP.BC.7/ 21.04.157/2016-17 dated August 25, 2016 on “Prudential Norms for Off-Balance Sheet Exposures of Banks - Restructuring of derivative contracts” and RBI Master Circular No. RBI/2015-16/70/DBR.No.Dir.BC. 12/13.03.00/2015-16 dated July 1, 2015 on “Exposure Norms”.

### **Asset Classification of Derivatives**

5.194 The RBI *vide* 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. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 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 for a period of 90 days from the specified due date for payment.

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- 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 had 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 receivables overdue for 90 days or more shall 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.
- 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 Account should be reversed and held in a ‘Suspense Account-Crystalised Receivables’ in the same manner as done in the case of overdue advances.

5.195 The RBI *vide* 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.

5.196 The RBI *vide* Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 dated April 1, 2022 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances" has advised banks that credit exposures computed as per the current marked to market value of the contract, arising on account of the interest rate and 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.

5.197 The RBI *vide* circular no. DBOD.BP.BC.28/21.04.157/2011-12 dated August 11, 2011 on Prudential Norms for Off-balance Sheet Exposures of Banks has further clarified as under:

- In cases where the derivative contracts provide 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 of aforementioned circular, 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' and not to Profit and Loss 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 Profit and Loss 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.

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- 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 also be classified as NPA.
- These guidelines are applicable to both outstanding derivatives contracts and the derivatives transactions undertaken from the date of the circular.

5.198 Also, the RBI *vide* circular no. RBI/2012-13/139 DBOD.No.BP.BC.31/21.04.157/2012-13 dated July 23, 2012 on Prudential Norms for Off-balance Sheet Exposures of Banks clarifies that there may be situations where the clients of banks may like to reduce the notional exposure of the hedging derivative contract. In such cases, banks may partially or fully terminate the contract before maturity, at their discretion, thereby reducing the notional exposure of the contract. This reduction in notional exposure would not be treated as restructuring of the derivative contract provided all other parameters of the original contract remain unchanged.

5.199 In such cases, if the MTM value of the derivative contract is not cash settled, banks may permit payment in instalments of the crystallized MTM of such derivative contracts (including Forex Forward Contracts), subject to the following conditions:

- i. Banks should have a Board approved policy in this regard.
- ii. Banks should permit repayment in instalments only if there is a reasonable certainty of repayment by the client.
- iii. The repayment period should not extend beyond the maturity date of the contract.
- iv. The repayment instalments for the crystallized MTM should be uniformly received over the remaining maturity of the contract and its periodicity should be at least once in a quarter.
- v. If the client is permitted to pay the crystallized MTM in instalments:
  - a. if the amount becomes overdue for 90 days from the date of partial / full termination of the derivative contract, the receivable should be classified as NPA.
  - b. if the amount becomes overdue for 90 days from the due date of payment of subsequent instalments, the receivable should be classified as NPA.
- vi. Banks should reverse the entire MTM which has been taken to Profit and Loss account on accrual basis in case of Paragraphs 5.199(v)(a) and (b)

above. For the accounting of reversed MTM in these cases, banks should follow an approach similar to the one stipulated in circular no. DBOD.No.BP.BC.57/ 21.04.157/2008-09 dated October 13, 2008 and circular no. DBOD.No.BP.BC.28/ 21.04.157/2011-12 dated August 11, 2011 on 'Prudential Norms for Off-balance Sheet Exposures of Banks'. Accordingly, the crystallized MTM of these derivative contracts should be reversed from Profit and Loss Account and credited to another suspense account styled '*Suspense Account - Crystallised Receivables*'.

5.200 If the client is not granted the facility of paying the crystallised MTM value in instalments and the amount becomes overdue for 90 days from the date of partial / full termination of the derivative contract, the entire receivable should be classified as NPA and banks should follow the instructions stipulated in RBI circulars dated October 13, 2008 and August 11, 2011, referred to above.

5.201 There may be cases, where the derivative contract has been terminated either partially or fully, and crystallized MTM has been permitted to be repaid in instalments but the client subsequently decides to hedge the same underlying exposure again by entering into new contract with same or other bank (provided such re-booking is permissible as per extant RBI guidelines). In such cases, banks may offer derivative contracts to the client provided the client has fully repaid the entire outstanding instalments corresponding to the derivative contract that was used to hedge the underlying exposure previously.

### **Re-structuring of Derivative Contracts**

5.202 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. The RBI vide Notification RBI/2016-17/45 DBR.No.BP. BC.7/21.04.157/ 2016-17 dated August 25, 2016 on "Prudential Norms for Off-balance Sheet Exposures of Banks – Restructuring of derivative contracts" has clarified that cash settlement is required of the change in mark-to-market value of the restructured derivative contract. Banks are permitted to restructure derivative contract at prevalent market rates, and not on the basis of off-market rates.

### **Facilities for Hedging Trade Exposures, Invoiced in Indian Rupees in India**

#### **Purpose**

5.203 To hedge the currency risk arising out of genuine trade transactions involving exports from and imports to India, invoiced in Indian Rupees, with AD Category I banks in India.

## **Products**

5.204 Forward foreign exchange contracts with rupee as one of the currencies, foreign currency-INR options.

## **Operational Guidelines, Terms and Conditions**

5.205 The AD Category I banks can opt for either Model I or Model II as mentioned in RBI circular no. RBI/2017-18/75 A.P. (DIR Series) Circular No. 08 dated October 12, 2017 on Risk Management and Inter-Bank Dealings – Facilities for Hedging Trade Exposures invoiced in Indian Rupees. The said circular has been consolidated in Master Direction No. FMRD No. 1/2016-17 dated July 05, 2016 (Updated as on September 01, 2020) on –“Risk Management and Inter-Bank Dealings”.

## **Provisions in case of Foreign Branches and Subsidiaries of the Indian Banks**

5.206 The RBI *vide* 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 in respect of transactions by the foreign branches / 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, 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. RBI *vide* Notification No./2013-14/588 DBOD.No.BP. BC.111/21.04.157/2013-14 dated May 12, 2014 had clarified that if foreign branches / subsidiaries of Indian banks propose to offer structured financial and derivative products that are not specifically permitted by the RBI in the domestic market, they may do so only at the established financial centers outside India like New York, London, Singapore, Hong Kong, Frankfurt, Dubai, etc. subject to compliance with the conditions stipulated therein.

## **Risk Management**

5.207 Banks are highly sensitive to treasury risk, as risks arrive out of high leverage treasury business enjoys. The risks of losing capital are much more than credit business.

5.208 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. Banks shall comply with guidelines issued by the RBI with regard to Internal Controls vide circular no. FE.CO.FMD. No. 18380 /02.03.137/2010-11 dated February 3, 2011 on “Internal Control Guidelines”.

## **Risk Identification Process**

### **Foreign Exchange Rate Movement Risk**

5.209 Foreign exchange risk may be defined as the risk that a bank may suffer losses as a result of adverse exchange rate movements during a period in which it has open position, either spot or forward or combination of two, in an individual foreign currency. The banks are also exposed to interest rate risk which arises due to maturity mismatching of foreign currency positions, default of counter parties or settlement risk.

5.210 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.

5.211 Three important issues that need to be addressed in this regard are:

- a) Nature and magnitude of exchange risk.
- b) Strategy to be adopted for hedging or managing exchange risk.
- c) Tools of managing exchange risk.

### **US\$ / INR FX Forwards Risk**

5.212 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**

5.213 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**

5.214 Credit risk is defined as the possibility of losses associated with diminution in the credit quality of borrowers or counterparties. In a bank's portfolio, losses stem from outright default due to inability or unwillingness of a customer or counterparty to meet commitments in relation to lending, trading, settlement and other financial transactions. Alternatively, losses result from reduction in portfolio value arising from actual or perceived deterioration in credit quality. Credit risk emanates from a bank's dealings with an individual, corporate, bank, financial institution or a sovereign.

5.215 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 as that of the foreign exchange contract.



### **Pre-Settlement Exposure**

5.216 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 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**

5.217 This occurs when items of agreed upon original or 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 the bank receives the confirmation of receipt of funds. The risk is that bank delivers but does not receive delivery. In this situation 100 per cent of the principal amount is at risk.

### **Market risk**

5.218 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**

5.219 Liquidity risk refers to the ease with which a foreign exchange spots 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**

5.220 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**

5.221 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**

5.222 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**

5.223 Basel I defined operational risk as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events". Basel II, however, defined operational risk as, "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events". As per RBI Guidelines on Basel III Capital Regulations, operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk. Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements. For emergence of such a risk four causes have been mentioned and they are people, process, systems and external factors.

- (a) **People Risk** – Lack of key personnel, lack of adequate training/experience of dealer (measured in terms of opportunity cost/employee turnover), unauthorised access to the dealing room, tampering voice recorders, nexus between the front and back offices, etc.
- (b) **Process Risk** - Wrong reporting of important market developments to the management resulting in faulty decision making, errors in entry of data in deal slips, non-monitoring of exposure in positions, loss of interest owing to the liquidity beyond prescribed limits, non-revision of card rates in cases of volatility, non-monitoring of closing and opening positions, wrong funding of accounts (wrong currency, wrong way swap), lack of policies, particularly in respect of new products.
- (c) **Systems** - Losses due to systems failure, hardware and software failures, telecommunication problems, and utility outages such as CCIL- not maintaining secrecy of system passwords, failure of dealing platforms, valuation engines, system issues with deal blotters interrupting deal flows to back-office etc.

- (d) **Legal and Regulatory Risk** - Treasury activities should comply with the regulatory and statutory obligations. As per RBI Guidelines, Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.

### **Risk Management Limits and Monitoring**

5.224 All bank 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**

5.225 Net Overnight Open Position Limit (NOOPL) may be fixed by the Boards of the respective banks and communicated to the RBI immediately. However, such limits should not exceed 25 per cent of the total capital (Tier I and Tier II capital) of a bank as per Master Direction on Risk Management and Inter Bank Dealings dated July 5, 2016 (Updated as on September 01, 2020). 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.

### **Daylight Limit**

5.226 As mentioned for NOOPL, daylight limit refers to the maximum net positions that can be taken during the trading day in each currency. 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**

5.227 These limits are designed to restrict the amount of potential loss from certain types of derivatives products or the whole trading book to levels (or percentages of capital or earnings) approved by the Board and senior management. To monitor compliance with the limits, the management calculates the current market value of positions and then uses statistical modelling techniques to assess the probable loss (within a certain level of confidence) given historical changes in market factors.

5.228 The advantage of VAR limits is that they are related directly to the amount of capital or earnings which are at risk. The level of VAR limits should reflect the maximum exposures authorized by the Board and senior management, the quality and sophistication of the risk measurement systems and the performance of the models used in assessing potential loss by

comparing projected and actual results. A drawback in the use of such models is that they are only as good as the assumptions on which they are based (and the quality of the data which has been used to calculate the various volatilities, correlations and sensitivities).

### **Gap or Matured Band Limits**

5.229 These limits are designed to control loss exposure by controlling the volume or amount of the derivatives that mature or are repriced in a given time period.

5.230 For example, the management can establish Gap limits for each maturity band of 3 months, 6 months, 9 months, one year, etc. to avoid maturities concentrating in certain maturity bands. Such limits can be used to reduce the volatility of derivatives revenue by staggering the maturity and/or repricing and thereby smoothening the effect of changes in market factors affecting price. Maturity limits can also be useful for liquidity risk control and the repricing limits can be used for interest rate management. Similar to notional and stop loss limits, Gap limits can be useful to supplement other limits, but are not sufficient to be used in isolation as they do not provide a reasonable proxy for the market risk exposure which a particular derivatives position may present to the institution.

5.231 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. Gap VAR is computed using volatilities for each tenor of the MIFOR/ LIBOR curve and the correlation between them.

### **Aggregate Contract Limit**

5.232 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**

5.233 These are specifically designed to control the risks of options. Options limits should include Delta, Gamma, Vega, Theta and Rho limits:

- Delta is a measure of the amount an option's 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 volatility of the underlying instrument.

- Theta is a measure of the amount an option's price would be expected to change in response to changes in the 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.
- The auditor should check the limit setting and its monitoring process along with exception handling measures.

The auditor is expected to make efforts and be aware of these concepts.

### **Stop Loss Limit**

5.234 These limits are established to avoid unrealized loss in a position from exceeding a specified level. When these limits are reached, the position will either be liquidated or hedged. Typical stop loss limits include those relating to accumulated unrealized losses for a day, a week or a month.

5.235 Some institutions also establish management action trigger (MAT) limits in addition to stop loss limits. These are for early warning purposes. For example, the management may establish a MAT limit at 75 per cent of the stop loss limit. When the unrealized loss reaches 75 per cent of the stop loss limit, the management will be alerted to the position and may trigger certain management actions, such as close monitoring of the position, reducing or early closing out of the position before it reaches the stop loss limits. The above loss triggers complement other limits, but they are generally not sufficient by themselves. They are not anticipatory; they are based on unrealized losses to date and do not measure the potential earnings at risk based on market characteristics. They will not prevent losses larger than the stop loss limits if it becomes impossible to close out positions, e.g., because of market illiquidity.

### **Limit Exceptions**

5.236 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. 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 that corrective action is carried out. The auditor should check whether all exceptions along with the reasons are reported to senior management and approvals (Limit Breach Ratifications) were taken for the same.

### **Regulatory Reporting Requirements**

5.237 Derivatives are governed by the Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000. Derivatives are

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allowed only under the provisions of these regulations and amendments, or with the prior permission of the RBI. The reporting requirements under RBI Master Direction No. RBI/FMRD/2016-17/31, FMRD No. 1/2016-17 dated July 5, 2016 (Updated as on September 01, 2020) 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 adhered to.

5.238 Following are some of the reports to be submitted to the RBI:

- 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.
- iii) Details of exposures in foreign exchange as at the end of every quarter as per the 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.
- iv) 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) Statement in Form BAL giving details of their holdings of all foreign currencies on fortnightly basis through Online Returns Filing System (ORFS).
- vii) 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.
- viii) 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.
- ix) Consolidated data on the transactions undertaken by non-residents under the scheme.
- x) Doubtful transactions involving frequent cancellation of hedge transactions and / or the underlying trade transactions by non-residents under the scheme.
- xi) Report of Commodity Hedging in Overseas Market on Quarterly basis.

5.239 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 RBI by means of 'R' returns, as enumerated in the

Exchange Control Manual. Those branches which handle foreign exchange transactions and are under an obligation to report them directly to the RBI are called the 'Authorised Dealers' (AD—also called 'position maintaining branches'). The ADs can be nominated only with the approval of the RBI and each AD would have a unique Code Number, which must be mentioned in all reports to the RBI. In addition to these ADs, individual banks may also, subject to report to the RBI, nominate some other branches to handle the specified type of foreign exchange business. These branches will, however, have to route their transactions through an AD only (such branches are often called 'reporting branches').

5.240 Moreover, ADs have to provide Form A2 for all interbank cross-currency deals done with overseas banks maturing during a fortnight to the RBI through R-Return which is submitted on a fortnightly basis. ADs also have to submit a report (MAP/ SIR) in the format as prescribed by the RBI. This is required to be prepared for four major currencies (i.e. US\$, GBP, YEN and CHF). MAP will be prepared for the last reporting Friday of each month.

5.241 As required by RBI circular no. FMD.MSRG.No.67/02.05.002/2011-12 dated March 9, 2012 on "Reporting Platform for OTC Foreign Exchange and Interest Rate Derivatives", all inter-bank OTC foreign exchange derivatives are required to be reported on a platform to be developed by the Clearing Corporation of India (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 are required to be reported on the CCIL platform subject to a mutually agreed upon confidentiality protocol. This circular was further updated vide circular no. FMD.MSRG.No. 75/02.05.002/2012-13 dated March 13, 2013.

5.242 As per RBI circular no. FMD.MSRG.No.72/02.05.002/2012-13 dated October 12, 2012 on "Reporting Platform for OTC Foreign Exchange and Interest Rate Derivatives", it was decided that with effect from November 5, 2012, the 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.

5.243 Further, the RBI vide circular no. RBI/2013-14/400 FMD.MSRG.No.94/02.05.002/2013-14 dated December 4, 2013 on "Reporting Platform for OTC Foreign Exchange and Interest Rate Derivatives" stated that the CCIL had

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completed development of the platform for reporting of the following transactions in OTC derivatives (with effect from December 30, 2013):

- Inter-bank and client transactions in Currency Swaps.
- Inter-bank and client transactions in FCY FRA/IRS.
- Client transactions in INR FRA/IRS.

### **Accounting**

5.244 Accounting is generally handled by the back office which 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.

5.245 Attention of the readers is invited to Paragraphs 36 to 39 of Accounting Standard 11 (Revised), whereby a forward exchange contract or another financial instrument that is in substance a forward exchange contract is entered into, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction, the premium or discount arising at the inception of such a forward exchange contract should be amortized as expense or income over the life of the contract. Exchange differences on such a contract should be recognized in the Statement of Profit and Loss in the reporting period in which the exchange rates change.

5.246 Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognized as income or as expense for the period in line with RBI guidelines. Such contracts should not be marked to market.

5.247 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. Also the accounting framework for option contracts will be as per FEDAI circular no. SPL-24/FC-Rupee Options/2003 dated May 29, 2003.

### **Rate Reasonability**

5.248 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. This process is also known as 'Rate Scan' or 'Market Conformity Check'.



### **Position and P&L Reconciliation**

5.249 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 a resolution arrived at.

### **Valuation of Foreign Exchange Forwards and Derivative Products**

5.250 Valuation of derivatives, particularly long-tenor derivative products, many of which could be proprietary products of banks, may be difficult, as they may be illiquid instruments.

5.251 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 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.

5.252 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.

5.253 Valuation of derivatives should be based on marked to market (MTM) and on net present value (NPV) basis.

### **Audit Approach**

5.254 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 in losses entailing financial and reputational consequences that linger long after the loss has been recognized in financial statements. Hence, the auditor should assess controls as part of the audit work.

5.255 It is imperative that the 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's treasury operations.

### **Audit Programming and Procedures**

5.256 In framing the audit program, the auditor needs to take into consideration the findings of the adequacy of controls within the processes as explained in this Guidance Note. The RBI prescribes concurrent audit /internal audit for a 100 percent verification of treasury transactions. Hence, the selection of samples can be influenced by the nature, extent and timings of concurrent/internal audit function including the compliance mechanism of the bank. Further, the RBI requires compliance reports on derivatives separately to be prepared by the bank as per RBI circular no. DBOD.No.BP.BC.44/21.04.157/2011-12 dated November 2, 2011 on "Comprehensive Guidelines on Derivatives: Modifications" which the auditor should take into consideration. This circular was further updated vide circular no. DBR.No.BP.BC.103/21.04.157/2017-18 dated April 06, 2018.

5.257 The following paragraphs illustrate the audit procedures/ approach that may form part of the audit program.

### **Product Program and Policy**

5.258 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.

5.259 Further, in accordance with the Comprehensive Guidelines on derivatives, the auditor should obtain and verify full particulars of the model used for valuation and the documented algorithms used by the bank through its Valuation Policy and operating procedure manual for valuations.

### **Customer/User Suitability and Appropriateness Policy**

5.260 The auditor should obtain approved 'Customer/User Suitability and Appropriateness Policy'/'User Classification Framework' and verify that such policy is in line with the Comprehensive Guidelines on derivatives and is approved by the Board.

5.261 The auditor should also verify the process followed by the bank for classification of customers into different grades/classification and the customers who have been permitted to deal in the products applicable to their respective grades.

### **Credit Limits**

5.262 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 (both pre settlement and settlement) 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 whether the limits are properly entered in the bank's system.
- Check dealer limits-Maximum amount a dealer can transact without seeking higher-level approval and sanctions/ratifications for any breaches. It includes individual deal (deal ticket) size limit and open position limit for a dealer as well.
- 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 the established limits for each customer.
- Check whether the above limits are entered into the software system being used by the branch for conducting the said transactions.

### **Deal Initiation and Recording**

5.263 For deal initiation and recording, the auditor should check the following:

- 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,

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contract rate, notional amount, transaction date / maturity date, value date / settlement agent and buy / sell date.

- Check the flow of transaction from initiation of deal to the verification and approval.
- Check whether deal tickets are generated automatically by the 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.
- Verify the adherence to the voice recording mechanism.
- Check whether the proper back-up of voice recordings is being maintained.
- Verify whether user IDs of dealers left / transferred/ on leave is deactivated / suspended on timely basis.
- Verify whether, the Use of Mobile Phones is restricted in the Dealing Room and the mechanism for ensuring adherence thereto.
- Verify the recordings for few of the selected samples to ascertain that the recording machine is working in order.
- Check whether there is access of unauthorized persons in the dealing room. If yes, whether proper approvals have been taken.
- Check whether dealers entering the deals have signed the code of conduct for respective segment in which trades dealt in (e.g. FIMMDA, FEDAI, FX Global etc).

### **Deal Authorisation**

5.264 Following audit procedures may be followed by the auditor while checking the procedures for deal authorisation:

- Check the process flow of authorizations of deals in the system and check areas of manual intervention in the system.
- 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, etc.
- Examine the selected deals from the front office and establish that they are confirmed by the back office operations.
- Check that all sample deals are authorised at proper levels of authority

against the deal slip.

- Check whether alterations and cancellations on deal slips are duly authorised.
- Check whether bank is preparing trade amendments sheets and whether the reasons for such amendments are mentioned in the sheet.
- Check whether any exceptional reports are being generated.

### **Segregation of Duties**

5.265 For this aspect, the audit procedure may include:

- There will be complete segregation between dealing room, market risk group and back office.
- 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.
- Verify whether there is any overlapping of duties.
- Verify that there is clear segregation, functionally and physically, between the front office, back office and middle office in respect of derivative transactions.
- Check 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.
- Check whether treasury personnel have availed minimum leave during the financial year.
- Check whether any duties have been outsourced from external parties.

### **Counterparty Confirmations**

5.266 For this aspect, the auditor should inter alia:

- Understand the process of sending and tracking the confirmations including follow – up procedures.
- Exchange of deal confirmations is mandatory. The counterparties should exchange the rate fixing notices. However, in the case of an OTC Overnight Index Swap (OIS) the trades are reported to CCIL. If the counterparties have a bilateral agreement waiving the requirement to exchange of confirmations, then exchanging of physical confirmations may not be required for such IRS deals.

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- Understand the process of MIS reporting to the senior management in respect of the non-receipt of counterparty confirmations.
- 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 the bank to ensure completeness of all deal confirmations.
- Check whether there is any persisting non-receipt of counterparty confirmation.
- Inquire of any exception report or other mechanism of tracking missing confirmations.

### **Customer Complaints**

5.267 As per the comprehensive guidelines on derivatives, while undertaking derivative transactions with or selling structured derivative products to a user, a market-maker 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. For this, the auditor should verify controls over recording and handling of customer disputes and complaints and ensure the Bank's adherence to RBI requirements.

### **Underlying Document**

5.268 The audit procedures for this, would include:

- Understanding the process and policy of the bank in respect of the underlying documents.
- The auditor should ensure that the bank should obtain the original documents from the client and/or certified document by the person who is authorised to do the derivative deal. The auditor should check the details in client master page by checking the Board resolution.
- Understand the process of MIS reporting to the senior management in respect of the non-receipt of underlying documents.

- The auditor should ascertain whether the bank has a mechanism whereby, if the documents are not submitted by the customer within 15 days, the contract gets cancelled, and the exchange gain, if any, is not passed on to the customer. The primary responsibility for ensuring this remains with the bank and the auditor should verify controls around the same.
- The auditor should ensure that the bank has a mechanism to ensure that if the underlying is not provided three times a year, then the client will have to produce upfront underlying and the 15 days grace will not be allowed to the client.
- For the selected samples, review and check the underlying documents duly received by the bank.
- In cases, where the underlying documents with regard to the forex transactions are maintained at branches, then, the auditor may obtain confirmation from such branches about the existence of the underlying documents and review sudden spurt in foreign exchange transactions of any branch in a particular month/period, if any, and test adherence to RBI guidelines relating to merchant transactions.
- The auditor should check whether any transaction was undertaken without execution of one time documents and approval for deferral of the same is held on record and the said documents were received before the expiry of such deferral approval.
- The auditor should check whether the bank has a process of tracking deferrals.

### **Accounting of Transactions in the General Ledger**

5.269 The audit procedures would 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 the same has been reviewed and compared with the general ledger to identify any mismatches.
- Understand the accounting scheme for the various products. Further, inquire about the routine and non-routine accounting entries with the bank.
- Check whether any exceptional reports are being generated by the system.
- For the selected samples, verify the accounting entries passed.

### **Position Reconciliation**

5.270 The audit procedures would 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.
- Checking whether the inter branch reconciliations between the Treasury Branch and the Authorised Branches are carried out periodically and there are no old and long outstanding items uncleared.

### **Deal Settlements**

5.271 The audit procedures would 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.
- Check whether separate responsibilities are in place between authorization and release of settlement.
- 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.
- Examining whether deal is settled / cancelled in case no confirmation is received from customers till expiry dates.
- Check whether any settlement defaults were made.

### **Realised Profit / Loss on Derivative Transactions**

5.272 The audit procedures would include:

- Recalculating the profit or loss for sample trades selected and tally with the general ledger.
- Test the general and IT application controls for automated computation of profit or loss.



- Vouch to cash settlement in the case of realized gains and losses.
- Verify if the bank is reckoning only the NOSTRO balances for adjustment of the profit / loss revealed in mirror account or did it also consider the outstanding forward transactions as at the date of valuation.
- The increase / decrease in profit is in line with increase / decrease in volume of transactions.
- Check marking-to-market of risk exposures and reconciliation of risk positions and profit/loss between the front and back offices.
- Verify preparation of management reports, including daily profit/loss results and gross and net risk positions.
- Verify exceptional reports showing details of deals resulting in exceptional profits and losses.
- In case of early termination/cancellation of contracts, check whether the amount of profit/loss is properly arrived at and paid to /recovered from customer as per bank's policy.

### **Valuation of FX Contracts and Derivatives**

5.273 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. At the end of the reporting period, sight the process and verify the process of downloading rates from external source and the process of uploading of rates in the system by the middle/back office for all FX contracts and derivatives.
- Process of computation of net present value of rates.
- Re-performing and checking on a sample basis the accuracy of the MTM gain / loss booked by the bank on the outstanding forex contract.

5.274 In case of valuation 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, the auditor can resort to checking of input parameters along with limited re-performance of derivative valuations. In such cases, the auditor should also check the system controls and if deemed necessary, consider involving an expert to check the integrity of the system logic. Further, the auditor can select certain

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samples as per the methodology or depending upon the nature, timing and extent for getting it revalued from the valuation expert. The auditor should also obtain the understanding of rate upload process and verify the timing of rates upload in the system for valuation of derivative contracts. The auditor should carry out the valuation of the samples selected in a spreadsheet and compare the end results with the valuation as provided by the software system. Sometimes the software systems are not capable of valuing certain treasury products such as partly redeemable perpetual bonds, Security Receipts etc., for which the bank has to value such products manually. As such, the auditor should gain sufficient knowledge to understand and confirm their valuation.

### **Guidance for Arriving at Fair / Market Value**

5.275 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.

5.276 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.

5.277 In case of infrequently traded instruments/non-traded OTC derivatives, various techniques are used to determine the best estimate of market price. This synthetic market price may be derived through the use of market data (such as interest/ exchange rates) in appropriate models/systems designed for this purpose.

5.278 In the 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'). With effect from 31 December 2014, these are further required to be adjusted for arriving at the net present value.
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.

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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).
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5.279 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, SOFR and INBMK as per the end of the day quotes appearing on the Bloomberg or Reuters page. RBI has issued circular no. on RBI/2021-22/69 CO.FMRD.DIRD.S39/ 14.02.001/2021-22 on July 8, 2021 on the "Roadmap for LIBOR Transition. Further, the RBI issued Master Direction No. RBI/FED/2018-19/67 FED Master Direction No.5/2018-19 dated March 26, 2019 (Updated as on September 30, 2022) on External Commercial Borrowings (ECB), Trade Credits (TC) and Structured Obligations, which provides – Changes due to LIBOR transition, whereby the following changes were made to the all-in-cost benchmark and ceiling for FCY ECBs/ TCs:

- i. Redefining Benchmark Rate for FCY ECBs and TCs: Currently, the benchmark rate is defined in Paragraph 1.5 of the Master Direction No. RBI/FED/2018-19/67 FED No.5/2018-19 dated March 26, 2019 (Updated as on September 30, 2022) on "External Commercial Borrowings, Trade Credits and Structured Obligations", as "benchmark rate in case of FCY ECB/TC refers to 6-months LIBOR rate of different currencies or any other 6-month interbank interest rate applicable to the currency of borrowing, e.g., EURIBOR". Henceforth, benchmark rate in case of FCY ECB/TC shall refer to any widely accepted interbank rate or alternative reference rate (ARR) of 6-month tenor, applicable to the currency of borrowing.
- ii. Change in all-in-cost ceiling for new ECBs/ TCs: To take into account differences in credit risk and term premia between LIBOR and ARR, the all in-cost ceiling for new FCY ECBs and TCs has been increased by 50 bps to 500 bps and 300 bps, respectively, over the benchmark rates. All-in-cost ceiling has been temporarily increased by 100 bps for ECBs raised till December 31, 2022. The Auditor should refer to the guidelines prevailing during the financial year. The enhanced all-in-cost ceiling shall be available only to eligible borrowers of investment grade rating from Indian Credit Rating Agencies (CRAs). Other eligible borrowers may raise ECB within the existing all-in-cost ceiling as hitherto.
- iii. One Time Adjustment in all-in-cost ceiling for existing ECBs/ TCs: To enable smooth transition of existing ECBs/ TCs linked to LIBOR whose benchmarks are changed to ARR, the all-in cost ceiling for such ECBs/

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TCs has been revised upwards by 100 basis points to 550 bps and 350 bps, respectively, over the ARR. AD Category-I banks should ensure that any such revision in ceiling is only on account of transition from LIBOR to alternative benchmarks.

5.280 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, trading swaps are marked to market as per the instructions contained in RBI circular No. MPD. BC. 187/07.01.279/1999-2000 dated July 7, 1999 on "Forward Rate Agreements/ Interest Rate Swaps". Circular no. RBI/2018-19/222 FMRD.DIRD.19/14.03.046/2018-19 dated June 26, 2019 (Updated as on August 08, 2022) on "Rupee Interest Rate Derivatives (Reserve Bank) Directions, 2019" has been issued in supersession of the above referred circular dated 7<sup>th</sup> July, 1999 and has consolidated the instructions issued earlier.

5.281 The marked to market gain/ loss on 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, which at times is 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.

5.282 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.

5.283 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.

5.284 The price of an option depends on the potential 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.

5.285 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.

5.286 It may be mentioned that counter party wise netting is allowed only 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**

5.287 The following examples indicate how to calculate the market or fair value of various derivative contracts.

5.288 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 net present value 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 net present value 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.

5.289 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 per cent 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 per cent 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.

5.290 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.

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5.291 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.

5.292 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 the bought and sold options on the same underlying be resorted to. The RBI *vide* its circular no. DBOD. No.BP.BC.76/21.04.157/2013-14 dated December 09, 2013 has issued operational guidelines on "Novation of OTC Derivative Contracts".

### **Rate Scan**

5.293 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. In doing so the auditor needs to assess the process of advising card rates to customers, through its branches or relevant operating departments.
- 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 for compliance with AS 11 (Revised).
- Check whether any exceptional reports are being generated in this respect and analysed by an independent team like Mid-Office or Risk Management.
- In case of deviations, reasons should be obtained and it should be checked whether the same have been reported to the senior management.

### **Margins held with Exchanges / Margins held under Credit Support Annex (CSA)**

5.294 Forward contracts in banks are now a days increasingly being collateralized using Customer Support Annex (CSA) margins which form part of the ISDA agreement. The audit procedures for this would include:

- Sending independent third party confirmations to confirm the balances held as at the reporting date.

- Agreeing the balances to underlying supporting such as margin statements.

Check whether margin statements are being sent to the clients and check the correctness of the same.

### **Assessment of Controls**

5.295 The audit procedure may include verifying and assessing controls including:

- Existence of comprehensive treasury policy and operating procedures manual (SOP).
- Review of the policies and procedures document and assess comprehensiveness of the same.
- Determining whether the above document addresses, in granular details, the framework within which the treasury business and operations have to be conducted.
- Inquiring on the procedures the bank follows when there is a change over or new appointment to a 'review' role within the treasury function.
- Check whether proper system of rotation of dealer is in place.
- Understanding the level of detail in which the process of handover of responsibilities operates.
- Check whether mandatory leave and sudden leave policy is being compiled in the bank.
- 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, verify 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, verify

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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 inquiring 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 for such cancellations / amendments / delays.
- Checking the process relating to late trades – how do these get captured in risk reporting (if there is a time cut off when such reports are generated).
- Check the approval and control process of the said transactions.
- Sample check of the same can be done by making dummy entries for verification purpose.



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 checking 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 into and reasons are obtained for them.
- Reviewing the Day 1 Profit or Loss assessment process and verifying 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 of 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.

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.
- Verification of training sessions conducted by the bank.

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.

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Rewards and recognition policy not in sync with ideal 'risk and control' culture

- Reviewing the remuneration policy and independently assessing 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. The forward contracts in banks are now a days increasingly being collateralized and using Customer Support Annex (CSA) margins, which form part of the ISDA agreement. The auditor should devise audit procedures required to be performed for verification of these margin balances as per the underlying agreements.

### **NOSTRO and VOSTRO Accounts**

5.296 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**

5.297 In respect of old unreconciled entries in NOSTRO Accounts, the RBI *vide* circular no. DBOD No.BP.BC.67/21.04.048/99 dated July 1, 1999 on

Reconciliation of NOSTRO account and treatment of outstanding entries has allowed, as onetime measure, a netting off procedure.

5.298 The auditor may consider the following aspects in respect of NOSTRO reconciliation:

- Whether a system of periodical reconciliation is in place and is upto date.
- Whether the reconciliation process followed ensures matching of each item and not for overall matching of total amount.
- Whether logs are generated for any change made in entry and whether maker checker is implemented for authorising changes made in entry, if any, for reconciliation.
- Whether confirmations from the foreign banks are obtained on a periodic basis. This may be through physical confirmations, swift messages, emails, etc.
- Whether information to the controlling office is sent on a timely basis.
- Whether long outstanding are taken up and cleared.
- Random check of the method of reconciliation.
- Debits outstanding in the NOSTRO accounts are to be verified and recommended for provision wherever necessary.
- Set off the credit against debits only at the permission of the head office for long outstanding entries.
- Whether payments are promptly advised and effected and receipts are suitably recorded in the “Nostro” account.
- Whether large balance has been held in an inoperative account, for a long period and if so, the reasons thereof.
- Whether bank has been submitting the BAL Statements periodically to the RBI.

5.299 RBI circular no. DBOD.BP.BC.16/21.04.018/2001-02 dated August 24, 2001 on “Reconciliation of Nostro Accounts - Old Outstanding Credit Entries” 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:

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- (i) the net credit balance arising out of the netting of entries pertaining to the 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.

5.300 Further, the balances in the Blocked Accounts will be reckoned for the purposes of maintenance of CRR/ SLR.

5.301 Any adjustment from the Blocked Accounts should be permitted with the authorisation of two officials, one of whom should be from outside the branch concerned, preferably from the controlling branch/ head office if the amount exceeds Rs.1 lakh. Further, vide circular no. RBI/2008-09/475 DBOD.BP.BC.No.133/ 21.04.018/2008-09 dated May 11, 2009 on Reconciliation of nostro account and treatment of outstanding entries, the RBI has advised accounting treatment for old outstanding entries in NOSTRO Mirror Accounts. It further stated that banks are advised to minimize the number of Nostro accounts to have a better control over reconciliation and put in place a system of fast reconciliation and close monitoring of pending items in Nostro accounts by top management at short intervals. Banks are also advised to leverage technology to avoid building up of such unreconciled balances.

5.302 The audit considerations for this aspect include:

- Examining whether currency wise NOSTRO reconciliation is performed on a day-to-day basis and check for long outstanding items along with review of reasons related thereto.
- Checking whether there exists a policy of following up for outstanding reconciliation items with the counterparties or with the respective banks.
- Checking outstanding debit items over 90 days that attract provisioning under RBI provisioning norms.
- Examining whether the statement of account is sent to the Vostro account holder and periodic confirmation is obtained and discrepancies, if any, is properly dealt in the books of accounts.
- Verify the bank submitted statement of Nostro / Vostro account balances on monthly basis to the RBI.
- Verifying if reconciliation is done by separate department and not by treasury department which operates Nostro accounts.
- Checking for write off any un-reconciled item / number / amount and see if details are sent to the RBI for approval.
- Checking whether MIS of unreconciled entries of NOSTRO account is being sent to senior management periodically and does the senior management review the same.

- Reviewing the process of reconciliation of NOSTRO and NOSTRO Mirror Account.

### **Evaluation of Internal Audit/Concurrent Audit**

5.303 The audit considerations for this aspect include:

- Examining whether treasury transactions are separately subjected to concurrent audit by internal auditors / external auditors and whether monthly reports containing their findings are being submitted to the management for corrective action.
- Obtaining the monthly concurrent audit reports of the treasury operations and checking whether deficiencies if any, mentioned in the report are being 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 agreed with a time frame.
- Checking whether any persisting irregularities are being highlighted in the audit reports.

The 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**

5.304 The audit considerations for this aspect include:

- 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 through the system reports.

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- 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 whether the Policy is updated periodically in line with the dynamic market and regulatory changes.
- The Board should have overall responsibility for management of risks and should decide the risk management policy of the bank and set limits for liquidity, interest rate, foreign exchange and equity price risks and verifying that the policy inter alia covers the following aspects:
  - i. Defines the approved derivative products and the authorized derivative activities.
  - ii. Details the 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 establishes 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.
  - 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.
  - x. It is essential that banks have interest rate risk measurement systems that capture all material sources of interest rate risk and that assess the effect of interest rate changes in ways that are consistent with the scope of their activities. The assumptions underlying the system should be clearly understood by risk managers and bank management.

## Information Technology ('IT') Controls

5.305 The audit considerations for this aspect include:

- Check controls over creation of all masters Like counterparty, broker, limit, dealer, etc.
- Check the integration of various treasury application with Core Banking Application.
- Check interface controls between various applications used in treasury department (viz. SWIFT and CBS, Finacle Treasury, Calypso, Murex etc. and Finacle core, etc.).
- Verify the integration of CBS, including Trade Finance and/or aligned software/modules, with SWIFT system and status of automation thereon.
- The auditor should specifically verify whether any special privileges or rights are given for operating SWIFT system allowing direct initiation of transactions through SWIFT without initiating the transactions through CBS. And whether such transactions are reflected correctly in CBS.
- 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.
- Check functional separation in the system.
- Verification of limit system and determination and reconciliation of positions and results.
- Check whether there were any changes in EDP systems.
- Review organizational charts, job descriptions, and training programs to ascertain that the bank has 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

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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.
- Check whether any system audit has been conducted by the bank.
- 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.
- Check whether proper backup of records is being maintained.
- Whether any dealer/employee has accessed the dealing room on holidays. If yes, verify the reasons and approvals for the same.
- Check whether mandatory leave and sudden leave policy has been adhered to.
- Check BCP details of the bank in relation to Treasury activities.
- Check whether the voice recording systems are periodically tested by the operations team and process to tag trades and corresponding unique voice records. Concurrent auditors are also required to verify this periodically.
- Check compliance with Internal Control Guidelines issued by the RBI vide FE.CO.FMD. No. 18380 /02.03.137/2010-11 dated February 3, 2011.



### **Asset Liability Management (ALM)**

5.306 The Management of a bank has to base its business decisions on a dynamic and integrated risk management system and process, driven by corporate strategy. Banks are exposed to several major risks in the course of their business like credit risk, interest rate risk, foreign exchange risk, equity / commodity price risk, liquidity risk and operational risk. It is, therefore, important that banks introduce effective risk management systems that address the issues related to interest rate, currency and liquidity risks. Banks need to address these risks in a structured manner by upgrading their risk management and adopting more comprehensive Asset-Liability Management (ALM) practices than has been done hitherto. ALM, among other functions, is also concerned with risk management and provides a comprehensive and dynamic framework for measuring, monitoring and managing liquidity, interest rate, foreign exchange and equity and commodity price risks of a bank that needs to be closely integrated with the banks' business strategy. It involves assessment of various types of risks and altering the asset-liability portfolio in a dynamic way in order to manage risks.

5.307 Banks should give adequate attention on putting in place an effective ALM System. Banks should set up an internal Asset-Liability Committee (ALCO), headed by the CEO/CMD or the ED. The Management Committee or any specific Committee of the Board should oversee the implementation of the system and review its functioning periodically.

5.308 In order to capture the maturity structure of the cash inflows and outflows, the Statement of Structural Liquidity should be prepared. Also, in order to enable the banks to monitor their liquidity on a dynamic basis the statement of Short-term Dynamic Liquidity should be prepared.

5.309 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

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- Risk measurement
- Risk management
- Risk policies and tolerance levels.

5.310 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 several time buckets.

5.311 Measuring and managing liquidity needs are vital for effective operation of commercial banks. By assuring a bank's ability to meet its liabilities as they become due, liquidity management can reduce the probability of an adverse situation developing. The importance of liquidity transcends individual institutions, as liquidity shortfall in one institution can have repercussions on the entire system. Banks management should measure not only the liquidity positions of banks on an ongoing basis but also examine how liquidity requirements are likely to evolve under different assumptions. Experience shows that assets commonly considered as liquid like Government securities and other money market instruments could also become illiquid when the market and players are unidirectional. Therefore liquidity has to be tracked through maturity or cash flow mismatches. For measuring and managing net funding requirements, the use of a maturity ladder and calculation of cumulative surplus or deficit of funds at selected maturity dates is adopted as a standard tool.

### **Auditor's Approach**

5.312 The approach of the auditor should be as under:

- Auditors should obtain the Board approved policies for Asset Liabilities Management (ALM), Liquidity Risk Management and Liquidity Coverage Ratio (LCR) and NSFR adherence.
- Auditors should examine the process manuals across risk management units and ALM/ALCO functionaries.
- Auditors should carry out complete process walkthrough, including that related to stress tests carried out by the banks factoring in various current and probably scenarios.

Auditors should obtain and examine all the key ALM, ALCO and Risk Management Committee meeting details and analyze the minutes of meetings.

**Annexure****Illustrative Checklist for the Verification of the Aspects of the Treasury/Investments of the Bank in Statutory Audit**

SN	Area	Description
1.	Investment Policy	Verify if the bank has a Board Approved Investment Policy in place and the same has been reviewed on annual basis. Verify if the Investment policy has been framed in concurrence with RBI guidelines and adequately covers the permissible products.
2.	Prudential Limits	Verify if the bank has adhered to the prudential limits relating to investments as prescribed by the RBI from time to time and Internal Policies.
3.	Income Calculation & Accounting	Verify if the Income on various Investments has been correctly calculated and recorded in the Books of Account taking into consideration RBI guidelines issued from time to time and Accounting Policies followed by bank.
4	Verification of Investments	Verify the investments physically and/or with the available holding statements/confirmations.
5.	Classification/ Valuation	Refer RBI Master Direction No. DOR.MRG.42/21.04.141/2021-22 dated August 25, 2021 (Updated as on December 08, 2022) on "Classification, Valuation and Operation of Investment Portfolio of Commercial Banks (Directions), 2021". <b>Classification:</b> Check if entire investment portfolio is classified under three categories viz: AFS, HFT & HTM. <b>Sale/Transfer/Shifting:</b> Verify there are no securities held in the HFT for more than 90 days. Verify there has been no shifting of securities to/from HTM Portfolio without the approval of the

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		<p>Board and allowed only in the beginning of the year.</p> <p>For Sales/Shifting in excess of 5 per cent of the HTM Portfolio, the bank should disclose in the Notes to Accounts the Market Value of Investments held in HTM and also indicate the Book Value in excess of Market Value to the extent not provided for, subject to certain exclusion specified in RBI guidelines.</p> <p>Profit and Loss from the HFT and AFS Category of Investments is taken to P&amp;L Account.</p> <p><b>Valuation:</b></p> <p>Check if the valuation of various securities has been made in line with RBI Master Circular on Prudential Norms for Classification, Valuation &amp; Operation of Investment Portfolio of Banks.</p> <ul style="list-style-type: none"> <li>• HTM Portfolio is carried at acquisition cost unless it is more than the face value, in which case the premium should be amortised over the period remaining.</li> <li>• AFS has to be marked to market on quarterly or frequent intervals. To arrive at net appreciation or net depreciation in the portfolio, the securities under same classification can be aggregated to arrive at the net appreciation or net depreciation. No set off can be done for the depreciation of one classification against the other.</li> <li>• Net depreciation to be provided for and net appreciation to be ignored.</li> <li>• HFT also has to be marked to market on monthly basis or at more frequent intervals.</li> </ul>
6	Verification of Non-Performing Investments (NPI)	Verify that the investments are classified as NPI as per the extant guidelines issued by the RBI from time to time.
7.	Regulatory Returns	Verify the accuracy of all the Regulatory Returns submitted to the RBI and also verify whether the same have been submitted within the deadlines.

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8.	Computation of SLR & CRR	Verify the mechanism and accuracy of the computation of NDLT and SLR & CRR and compliance thereof.
9.	Disclosure Requirements	<p>Verify the following disclosures required to be made to the Notes to Accounts have been made and made accurately.</p> <ol style="list-style-type: none"><li>1. Details regarding securities sold under Repo and Purchased against Reverse Repo.</li><li>2. Details of the issuer composition of non-SLR investments and the non-performing non-SLR investments.</li><li>3. Details of corporate debt securities lent or acquired under repo or reverse repo transactions.</li><li>4. In respect of the non-SLR Securities portfolio, the issuer details in the format prescribed by the RBI Master Circular on "Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks".</li><li>5. Penalty paid to the RBI during the financial year.</li></ol>

# 6

## **Audit of Information Technology and Digital Banking Division**

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### **Introduction**

6.01 Over the past decade, the complexion of the financial services industry has changed considerably, as constantly-evolving Information Technology (IT) has had a huge impact on the industry, creating numerous new opportunities, and also bringing in newer challenges. The technology driven changes coupled with regulatory and demographic factors are cutting through the entire value chain of the banking system resulting in a continuing state of flux. Therefore, it is important for banks to adapt to new technologies trending around the world.

6.02 Risks arising from the use of information technology can affect banks at strategic, tactical and operational levels. Technology risk is pervasive and continually changing. As we know, Information Systems (IS) increasingly underpin a bank's financial and operational progress. Under these circumstances, effectively controlling IT/ IS risks has become very important for sound financial and operational processes.

6.03 These risks are on account of threats and vulnerabilities ranging from hacking, viruses, obsolescence, unpatched systems, unavailability of talent, loss of key skills, inadequate testing of patches / software components, non-compatibility of the hard ware, inadequate control implementation, lack of monitoring, natural disasters and frauds. The targeted cyber-attacks on banks like SWIFT incidents, data theft/ loss, Distributed Denial of Service (DDoS), etc. have led to greater regulatory focus and demand for robust cyber security readiness.

6.04 Hence, banks must build capabilities to assess important Information Technology risks, to mitigate these and demonstrate the same to all stakeholders. Banks must keep abreast, and wherever possible anticipate, fast-moving developments in Information Technology.

6.05 In the context of the above, IT audit needs to continually evolve to effectively cover the relevant Information Technology risks. The IT audit also requires professionals to have appropriate technical skills and experience to meet the demands of a complex and constantly changing IT environment and compliance with evolving legislation and regulations.

6.06 IS audit may cover, but be not limited to, the following aspects:

- Entity level IS Controls
  - Governance and Organization
  - Policies and Standards
  - Procedures and Guidelines
  - Strategy and Plan
- Automation of Business Process and Controls
- Access Controls, both logical and physical
- Change Management
- IT Asset Management including cloud storage
- System Acquisitions/Development and/or Migration
- IT Services Management Controls
- Incident Management
- IT Capacity and Performance Management
- Backup Management and disaster recovery management
- Cyber Security Controls (including Physical, Network, Application and Database Security)
- Payment Systems (including SWIFT) Controls

Other areas to be covered:

- Digital Banking - Key considerations
- Cryptography Key Management Controls
- Consumer Identity and Access Management
- Data Protection/ Privacy
- Mitigation of Outsourcing Risks
- RPA and AI
- Aadhaar Controls
- Blockchain

## **Scope**

6.07 The range of activities that are to be subjected to an IT audit are discussed in the following paragraphs:

## **Business Process Controls**

6.08 Applications and systems such as loan management system, core banking applications, treasury systems, asset classification system (NPA marking system), CRM (Customer Relationship Management), SWIFT system and other applications shall be identified to audit processes with reference to the following:

*Banking:* Retail, Corporate and Investment Banking, Treasury

*Customer Relationship:* Lead, Relationship, Service Management

*Finance and Accounts:* General Ledger, Accounts Payable/Receivable, Fixed Assets

*HR Processes:* Hire to Retire

It shall also include the test of the adequacy of: system configuration controls, process controls, maker checker controls, master data controls, reporting controls, data upload/ interface controls, Information produced by the Entity (IPE) controls, controls around end user computing sheets and information security controls.

## **User Access Management**

6.09 User access management controls are put in place to protect organization's internal and client confidential information by controlling who has the rights to use or access information resources as per permissible responsibilities' / roles matrix. "Need to know, Need to do" principle should be followed in user access management.

### **Policies and Procedures for User Access Management**

6.10 Robust policies and procedures shall be framed and reviewed periodically for the user access management which will provide guidelines for the user access provisioning and de-provisioning, user access review, generic user ids and authentication controls.

### **User Access Creation including Administrative and Vendor IDs**

6.11 Access to information resources are granted based on user privilege and on a 'need to know' principle. Individuals should be granted access to systems and/or data aligned to their job responsibilities.

Administrative accounts are accounts with access rights that may override controls that exist at the assertion level, database level and at the application level (e.g., system administrators, security administrators, database administrators).



Administrative access should be restricted to a small group of individuals and to personnel/teams who require administrative access as a part of their job responsibilities.

Activities performed by users having administrative access should be monitored and reviewed for appropriateness.

User access provisioning and de-provisioning should be done based on the organization's access control policy.

### **User Access Modification including Administrative and Vendor IDs**

6.12 The transition of a user to a new role/department/location must be agreed with the users existing reporting manager and with the new reporting manager (if there are any changes) for the following points:

- A review of the existing permission should be performed to check what access permissions are needed to be preserved during transition period and when completed, these permissions must be removed (if applicable). Ideally, no cross functioning access should be available with that user.
- New permissions required by the user as per his/her job responsibilities in their new role.

### **User Access Revocation including Administrative and Vendor IDs**

6.13 When an individual/group of individuals leave the organization due to termination, resignation, retirement, absconding etc., their system accounts (including Active Directory access) should be disabled at the earliest to avoid unauthorized access to the systems and data. It shall be ensured that user access are temporarily disabled in case of leaves to ensure that the user ids of employee who leave the jobs are deactivated and the newly inducted are activated under proper control mechanism.

### **Review of Role – Right Matrix**

6.14 Access rights should be reviewed periodically to determine deviations from role baselines and to validate rights in alignment to the job responsibilities. Moreover, the system of review of validity of approval granted in exceptional cases should be reviewed periodically.

### **Segregation of Duties/Conflicting Access**

6.15 Segregation of duties (SOD) is the concept of having more than one person to complete a task end to end. In business, the separation by sharing of

more than one individual in one single task is an internal control intended to prevent fraud and error. SOD and critical access review shall be performed on a periodic basis along with the assessment of the appropriateness of access to critical transactions. Core application transactions shall be reviewed along with the master data to determine instances of SOD violation and related risk amounts.

## **Change Management**

6.16 Change Management is the process of planning, documenting, coordinating, approving, implementing and monitoring changes affecting the Development, Quality Assurance, Staging and Production platform within the organization environments.

The objectives of the Change Management processes are to:

- Ensure that changes are implemented with minimum disruption to the services IT has committed to its users.
- Support the efficient and prompt handling of all changes.
- Provide accurate and timely information about all changes.
- Ensure all changes are consistent with business and technical plans and strategies.
- Ensure that a consistent approach is used.
- Provide additional functionality and performance enhancements to systems while maintaining an acceptable level of user services.
- Reduce the ratio of changes that need to be backed out of the system due to inadequate preparation.
- Ensure that the required level of technical and management accountability is maintained for every change.
- Monitor the number, reason, type, and associated risk of the changes.

6.17 Activities of the Change Management Process should include, but not be limited to the following:

- Receiving change requests from requesters.
- Assessing the risk factor to bank's existing IT environment for proposed change.
- Assigning the change to resources within organization for solution.
- Identification, sizing and risk analysis.
- Accepting or rejecting the requested change.

- Assigning the change to solution development resources.
- Segregation between the production and test environment.
- Reviewing the solution prior to implementation.
- Scheduling the change.
- Coordinating the change activities, including:
  - Planning the change
  - Documenting the change
  - Developing back out plan
  - Acquiring change approvals
  - Change Implementation
  - Post implementation testing
- Communicating change implementation date as required to all concerned parties.
- Closing the change.

6.18 Change management policies and procedures shall be framed along with the change requisition procedures where any change will involve requirement analysis, change authorization and development, testing of changes in User Acceptance Testing environment (UAT), segregation of the UAT and production environment, change approval and migration controls, monitoring of changes post implementation and segregation of duties for the changes. Sign off from the user / user groups who has initiated the Change Requisition is very essential. Procedures shall also be defined for emergency changes highlighting implementation and approval mechanism which shall be followed for the same.

### **IT Service Management**

6.19 IT service management involves effective management of the following areas where the organization should design, build, implement, operate and manage these processes effectively.

### **Incident Management**

6.20 Policies, procedures and guidelines for incident management shall be defined and all the incidents should be classified, managed, monitored, reported and tracked to closure as per the defined guidelines.

### **System Acquisition, Development and Maintenance**

6.21 System requirements as part of the system acquisition / development, System Requirement Study (SRS) and its maintenance shall be formulated as a

part of the Information Security policy. Due care should be taken while executing change control procedure including correct processing techniques such as input data validation, control of internal processing, output data validation and securing application services on public networks. Also, technical review of application shall be conducted after operating platform changes.

### **Information Security Risk Management**

6.22 Risk management program shall be documented along with the information security risk assessment policy and procedures. Information security risk assessments should be performed on a periodic basis which would include remediation of the identified gaps as well. Review of the business continuity preparedness, business continuity policy and awareness and disaster recovery testing shall also be performed as a part of the risk management program.

### **Capacity Management**

6.23 Policy and procedures around capacity and performance monitoring shall be framed along with the threshold metrics for capacity management. Management shall define frequency to review the capacity management reports and controls to address any deviation from the defined metrics.

### **Backup Management**

6.24 Policies and procedures around backup management, backup failures, offsite backup management and degaussing mechanism shall be framed along with the implementation of technical controls around backup solution, secure backup solution configuration, encryption and access restriction of the management console. Policies and procedures shall also address periodic restoration of the backups.

### **Information Asset Management**

6.25 A repository of all assets shall be maintained, and the process shall be documented and followed for assigning an ownership to all assets, asset return, denial of access in case of user termination, information classification/ labeling and secure media disposal among other areas. The organization shall formulate an 'acceptable user policy' in respect of physical and logical IT Assets, and its implementation shall be monitored periodically.

### **Disposal of IT Asset**

- Does proper policy for disposal of IT asset exists.
- At the time of disposal of data storage equipments the binary data is removed by overwriting zeros to ensure the data is completely wiped out.

- Disposal of IT assets is done according to legal requirements and environmental regulations.

## Information and Cyber Security Review

6.26 Security controls are safeguards or countermeasures to avoid, detect, counteract, or minimize security risks to physical property, information, computer systems, or other assets. There are various guidelines, circulars and mandates released by the RBI and other regulatory bodies for information technology, cyber security and information security. It is advisable to check the latest RBI guidelines on Information and Cyber Security aspect before conducting the statutory audit. The RBI vide circular no. RBI/2015-16/418 DBS.CO/CSITE/BC.11/ 33.01.001/ 2015-16 dated June 2, 2016 on Cyber Security Framework in Banks has provided as follows:

- Review of cyber security policy.
- *Cyber Crisis Management Plan (CCMP)* - CCMP should address the following four aspects: (i) Detection (ii) Response (iii) Recovery and (iv) Containment. Banks need to take effective measures to prevent cyber-attacks and to promptly detect any cyber-intrusions so as to respond / recover / contain the fall out.
- *Cyber security preparedness indicators* - The adequacy of and adherence to cyber resilience framework should be assessed and measured through development of indicators to assess the level of risk/preparedness. These indicators should be used for comprehensive testing through independent compliance checks and audits carried out by qualified and competent professionals.
- Vulnerability assessment.
- *Information sharing initiatives* - banks need to report all unusual cyber security incidents (whether they were successful or were attempts which did not fructify) to the RBI. Banks are also encouraged to actively participate in the activities of their CISOs' (Chief Information Security Officer) Forum coordinated by IDRBT and promptly report the incidents to Indian Banks – Center for Analysis of Risks and Threats (IB-CART) set up by IDRBT (Institute for Development and Research in Banking Technology).
- *Baseline Cyber Security and Resilience Requirements* - An indicative but not exhaustive list of requirements to be put in place by banks to achieve baseline cyber-security/resilience is given. This may be evaluated periodically to integrate risks that arise due to newer threats, products or processes. To ensure adequate cyber-security preparedness among banks on a continuous basis and to enhance the resilience of the banking system

following shall be followed but not limited to, putting in place an adaptive incident response, management and recovery framework to deal with adverse incidents/disruptions, preventing execution of unauthorized software, environmental controls, network management and security, application security life cycle, secure configuration, vendor risk management, removable media, data leakage prevention strategy, maintenance, monitoring, and analysis of audit logs, advanced real time threat defense and management and user/employee/management awareness.

- *Organizational arrangements* - Banks shall review the organizational arrangements so that the security concerns are appreciated, receive adequate attention and get escalated to appropriate levels in the hierarchy to enable quick action.
- *Cyber-security awareness among stakeholders / Top Management / Board* – As management of the cyber risk requires the commitment of the entire organization to create a cyber-safe environment, a high level of awareness among staff at all levels shall be ensured. Top Management and Board should also have a fair degree of awareness of the fine nuances of the threats and appropriate familiarization may be organized. Banks shall proactively promote, among their customers, vendors, service providers and other relevant stakeholders an understanding of the bank's cyber resilience objectives and ensure appropriate action to support their synchronized implementation and testing. It is well recognized that stakeholders' (including customers, employees, partners and vendors) awareness about the potential impact of cyber-attacks helps in cyber-security preparedness of banks. Banks are required to take suitable steps to bring about this awareness.

## **Application Security**

6.27 Application security mechanisms such as structural analysis, input validation, application and user control, data transaction analysis along with review of password policy controls, user access management, root/admin access controls, SOD matrices, system administration and change management process shall be taken into consideration for an application security review. It is expected that the auditor will review the control framework as established by the bank as part of general IT Control Testing.

6.28 As per RBI requirement, end to end process of classification of assets, income recognition and provisioning on Advances should be automated and manual intervention is not allowed. If changes are made in system-based classification, then audit log of changes should be generated for verification purpose.

## **Enterprise Security**

6.29 Policy and standards, strategy and governance framework shall be framed as a part of enterprise security. Roles and responsibilities of the CISO, Board, head of functional departments, Technology/Operations/Admin/HR/functional teams, business owners, senior Management, information users, internal audit and functional technology teams along with the conduct of information security training and awareness.

## **Physical and Environmental Security**

6.30 Secure physical access procedures shall be framed and implemented which includes physical security, clear desk policy, cabling security, secure disposal or re-use of equipment, security of equipment off-premises, physical security, securing offices, room and facility, environmental controls such as mock drills and security of the equipment off-premises.

## **Human Resource Security**

6.31 Human resource security shall include defined activities, processes and checks for the different phases - pre-employment, during employment and termination of employment which would include background checks, terms and conditions of employment to be agreed upon, defining the roles and responsibilities of the personnel and management and return of assets and removal of access rights post leaving the organization.

## **Platform/ Infrastructure Security and Network Security**

6.32 Secure configuration documents for operating system, web server, application server, database server and network components shall be framed and implemented along with a periodic review of these documents. Regular scheduled assessments such as vulnerability scans, hardening checks and secure configuration review shall be performed, and exception approval process needs to be in place for exceptions in configuration.

## **Cryptography and Key Management**

6.33 Policy on use of cryptographic controls shall have to be framed along with implementation of processes around accountability for management of master keys, security of master keys, key management process, key backup, retention of keys and verification of digital certificates.

## **Aadhaar Guidelines Review for Banks based on AADHAAR ACT, 2016**

6.34 Evaluate the applicability of the AADHAAR considering the Supreme Court's Judgment on the use of AADHAAR.

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- Review of the IT Landscape based on the following applicable guidelines of UIDAI (Unique Identification Authority of India) for AUA's
- The Aadhaar (Targeted Delivery of Financial and Other Subsidies, Benefits and Services) Act, 2016
- AADHAAR (Authentication) Regulations, 2016
- AADHAAR (Data Security) Regulations, 2016
- AADHAAR (Sharing of Information) Regulations, 2016
- Updated UIDAI Information Security Policy in respect of AUA (Authentication User agency)/ KUA (KYC User Agency) for circulation
- Instruction for providing Authentication or eKYC Services by AUA KUA to Sub-AUA
- Circular on AADHAAR Data Vault
- Procurement of Registered Devices for AADHAAR Authentication
- Registered Device Certification of Biometric Devices along with STQC (Standardization Testing and Quality Certification) certificate
- Circular on Registered Devices (Implementation Timelines)
- Circular on AUA/KUA and ASA (Authentication Service Agency) Agreements V 4.0
- Delta Certification process of Biometric Devices for Registered Devices
- Implementation of HSM (Hardware-based security module) by AUA/KUA/ASA

### **SWIFT Review (vide RBI Press Release 2017-2018/2249)**

6.35 The RBI, as part of its ongoing efforts for strengthening of the supervisory framework in the country, has been issuing necessary instructions to banks from time to time on a variety of issues of prudential supervisory concern, including the management of operational risks inherent in the functioning of banks. The risks arising from the potential malicious use of the SWIFT infrastructure, created by banks for their genuine business needs, has always been a component of their operational risk profile. The RBI had, therefore, confidentially cautioned and alerted banks to such possible misuse, advising them to implement the safeguards detailed in RBI's communications, for pre-empting such occurrences.

6.36 In the wake of SWIFT-related fraud involving significant amount, reported by Punjab National Bank, the RBI has reiterated its confidential instructions and mandated the banks to implement, within the stipulated



deadlines, the prescribed measures for strengthening the SWIFT operating environment in banks.

SWIFT review primarily includes –

- SWIFT process-based reviews based on the RBI mandate.
- Review of pre and post transmission of SWIFT messages.
- Review of logging and session controls.
- Review of network controls in place to support the application.

### **Audit Approach**

6.37 This section provides description of the audit approach that will be adopted to perform the IT audit for the applications having an impact on the financial statements of a bank and for the support applications (such as change management tool, incident management tool, user access management tool, ticketing tool) that aid to assist the IT processes for such financial statements impacting applications or the overall bank security processes. During audit planning and risk assessment stage, audit engagement teams are required to determine the scope and extent of audit procedures for their IT audit based on the following set of illustrative factors:

- Whether the IT application system is used in the financial statements preparation or passing accounting entry- such as CBS, NPA (Non-Performing Asset) module, Loan and Treasury systems etc.
- The auditor needs to ensure that each customer of the bank is tagged under one single Customer ID / Unique Customer Identification Code (UCIC) in respect of all its accounts, including those to which credit facilities are granted, irrespective of their location, to enable the bank, (subject to the relaxations/exceptions for the time being applicable to any account/facility), to accord the same NPA classification status to the customer/borrower, based on the most adverse classification determined for any of its account/facility. The NPA classification of an entity in a group as such does not automatically extend to other related / group entities, since the classification would have to be judged independently, i.e., at the entity level and not at a group level.
- Whether the IT application system directly or indirectly assists the processes which are relevant in the preparation of financial statements or for ensuring adequate control framework and governance over the financial statements preparation and reporting process e.g. transaction processing systems, Reconciliation systems etc. It is important to see to what level these

application systems are integrated / interfaced with each other.

- Whether the IT application system is used for generation of reports or data elements which will be used as audit evidence for the financial statements. They may also include reports which are used by management for the purpose of passing an accounting entry or for making a decision having impact on financial statements e.g. applications systems used for preparation of disclosures in the financial statements etc.
- IT systems not having direct impact on financial statements but necessary for overall security posture of the bank e.g. applications systems used for compliance with RBI requirements around cyber security where auditor also needs to provide a certificate.
- Any other IT application system or IT processes which the auditor believes are relevant for the audit.

A summary of the activities that will follow are outlined in this section:

## **Strategic Anchoring**

6.38 Strategic anchoring require the following:

- Identify key stakeholders responsible and accountable for the preparation of financial statements / statutory audits.
- Perform interviews with process owners, stakeholders and various other functional teams.
- Understand the bank's strategic goals, their competitors and identify what is considered the major business risks within the bank.
- Walkthrough the internal and external service catalogue and map services to strategic goals.
- Walkthrough of the operating model for different functions and validate with leadership.
- Define capability characteristics and agree to a desired target operating model.
- Understand if the current set-up is capable of achieving the desired state.
- Understand the requirements of Long Form Audit Report pertaining to IT systems and control and take due consideration to the reporting responsibilities.

## Functional Review

6.39 Functional review would cover the following:

- Processes and procedures for the management and administration of the security architecture, implementation of security solution controls in place to protect data, network and systems against any kind of attack, the monitoring and incident response efforts to ensure continuous compliance with security requirements.
- Interviews will be followed by document review and sample-based testing.
- The security capability model will be used for leveraging the technical security domain to assess operating models while the detailed Control Security methodology will be used to assess content and detailed operational processes.

## Report and Roadmap

6.40 This would require the following:

- Define findings to close the identified gaps by:
  - Reviewing current capabilities and desired operating model.
  - Following factors need to be considered when assessing the risk of failure:
    - Nature and materiality of the misstatements which the control is designed to prevent or detect;
    - Inherent risk of error associated with relevant significant account and assertions addressed by the control;
    - Competence of the personnel who perform the control or monitor its performance and whether there have been changes in the personnel;
    - Nature of the control and frequency with which it operates;
    - Whether the related significant account has a history of errors;
    - Degree to which the control relies on the effectiveness of other controls.
  - Hold workshops with key stakeholders identified in the earlier phases to:
    - Walk through the findings ensuring input and insights from within the bank;
    - Validate results and incorporate insights.

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- Basis of the risk of the identified gaps e.g. low risk finding (control failed to discover an error, the amount of the error is likely to be only a portion of the total amount of the transaction being controlled) or a high risk finding (control failed to detect or prevent an error, there is a greater likelihood that the amount of the error could be the total transaction amount, or, in case of the completeness assertion, greater than the transaction amount), adequate impact analysis will be performed.

## Reporting

### Long Form Audit Report (LFAR)

6.41 Given below is the general flow and critical sections covered as a part of the Long Form Audit Report as amended on September 5, 2020 under “Long Form Audit Report (LFAR) – Review”:

- **Asset Quality:** Special emphasis should be given on continuous monitoring of classification of accounts into Standard, SMA, Sub-standard, Doubtful or loss as per IRAC Norms by the system, without manual intervention, correct recognition of income, and adequacy of provision thereof. Effectiveness of the system for compiling data relating to NPA and their provision, data integrity, system of suspension of charging of interest and adherence thereto, should be examined and commented upon. Deviations observed, if any, should be provided along with requisite examples.
- **Management Information System:** Review of Management Information System for existence and adequacy, method of compilation and accuracy of information, appropriateness of procedures for preparation of supervisory returns and its reliability under the Off Site Surveillance System of the RBI, reliability of information flow for the internal risk management system. Moreover, review of effective system of preparation and consolidation of branch returns and financial statements.
- **Robustness of IT Systems:** Auditors should comment on the robustness of IT systems covering all the software used by the bank along with functions thereof, inter-linkage/interface between different IT Systems, ATM network and its security, payment system products and services among others. Further, it should be examined whether the software used by the bank were subjected to Information System & Security Audit, Application function testing and any other audit mandated by the RBI. Adequacy of IS Audit, migration audit (as and where applicable) and any other audit relating to IT and cyber security system and bank’s compliance to the findings of those audits should be commented upon.

- **IT Security and IS Policy:** The auditor should comment on whether the bank has duly updated and approved IT Security and IS Policy and whether the bank has complied with RBI advisory/directives relating to IS environment/cyber security, issued from time-to-time.
- **Critical Systems / Processes:** It should be examined whether there is an effective system integration including seamless flow of data under Straight Through Process (STP) amongst various software / packages deployed. Special emphasis should be placed on outsourced activities and bank's control over them, including bank's own internal policy for outsourced activities.

In addition to the above, Point No. iii of "Guiding Principles on objective, strategy, scope and coverage of LFAR for branch auditors under LFAR to Management and SCAs by SBAs in case of bank branches" provides that "*Verification of data integrity and data related control systems and processes should be carried out and commented upon, with the special thrust on those data inputs which are to be used for MIS at corporate office level and for supervisory reporting purposes.*"

## **Outsourcing<sup>7</sup>**

6.42 Technology outsourcing framework of the bank should be documented which must include IT related outsourcing process. This process should be formulated after considering all the guidance and circulars issued by regulatory authorities such as the RBI e.g. RBI circular no. RBI/2010-11/494 DBS.CO.ITC.BC.No.6/31.02.008/2010-11 dated 29 April 2011 on "Working Group on Information Security, Electronic Banking, Technology Risk Management and Cyber Frauds- Implementation of recommendations". Key areas to be covered as per the framework are (but not limited to):

- Broad category of IT activities outsourced by the bank.
- Governance structure for IT outsourcing e.g. role of the Board and IT Steering Committee.
- Audit coverage and annual compliance certificate.
- Assessment of outsourced IT activities i.e. materiality, risks & controls and data sensitivity assessments.
- Periodic review of service providers.
- Business continuity and agreement covering legal obligations.
- Verify the restrictions pertaining to outsourcing of activities as stipulated by the RBI from time to time.

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<sup>7</sup> Refer RBI circular no. RBI/2021-2022/76 CO.DPSS.POLC.No.S-384/02.32.001/2021-2022 dated August 03, 2021 on Framework for Outsourcing of Payment and Settlement-related Activities by Payment System Operators.

## **Other Aspects**

### **Digital Banking - Key Considerations**

6.43 The auditor's key considerations on digital banking are the following:

- Digital Banking has completely changed the way banks function in today's times. With Digital Banking, the customer can transact with higher speed, ease and convenience. By definition, digital banking is the banking done through the digital platform, doing away with all the paperwork like cheques, pay-in slips, Demand Drafts, and so on. It means availability of all banking activities online. The first phase of the Digital Banking revolution was through the internet. The second phase of Digital Banking involves mobile phone platforms. After smart phones came into the market, Digital Banking has taken off in a big way.
- Bank offers various services such as Internet banking, Mobile banking, Credit Card/Debit Card, IMPS, RTGS, NEFT, ATM, Aadhaar based payment and Prepaid Instruments. Digital banking involves high levels of process automation, web-based services and may include APIs enabling cross institutional services, use of payment gateway. Seamless flow of transaction within fraction of a second supported by integration of various applications is possible only with the help of third-party service providers.
- RBI circular no. RBI/2021-22/146 CO.DPSS.POLC.No.S1264/02-14-003/2021-2022 dated January 03, 2022 on Framework for Facilitating Small Value Digital Payments in Offline Mode, details the framework to enable small value digital payments in offline mode using cards, wallets, mobile devices, etc.
- RBI vide circular no. RBI/2022-23/95 CO.DPSS.POLC.No.S-760/02-14-003/2022-23 dated July 28, 2022 has put restriction on Storage of Actual Card Data [i.e. Card-on-File (CoF)] In terms of the above circulars, with effect from October 1, 2022, no entity in the card transaction / payment chain, other than the card issuers and / or card networks, shall store CoF data, and any such data stored previously shall be purged.
- RBI has vide circular no. RBI/2022-23/111 DOR.CRE. REC.66/21. 07. 001 /2022-23 dated September 02, 2022 on "Digital Lending" reiterated that outsourcing arrangements entered by Regulated Entities (REs) with a Lending Service Provider (LSP)/ Digital Lending App (DLA) do not diminish the REs' obligations and they shall continue to conform to the extant guidelines on outsourcing. The REs are advised to ensure that the LSPs engaged by them and the DLAs (either of the RE or of the LSP engaged by

the RE) comply with the guidelines contained in this circular till November 30, 2022.

- RBI vide circular no. RBI/2022-23/92 DoR.AUT.REC.No.27/24.01.041/2022-23 dated April 21, 2022 had issued Master Directions on “Credit Card and Debit Card – Issuance and Conduct Directions, 2022” for security standard, charges, billing etc. for credit card and debit card business.

6.44 The auditor should get an understanding of the following:

1. List of digital products offered by banks.
2. Involvement of third-party service providers, National Payments Corporation of India (NPCI), VISA, master, aggregator, payment gateways, debit card/ credit card manufacturing company.
3. Flow of transactions of each product.
4. Security of transaction flow, data confidentiality.
5. Customer on-boarding process, authentication and OTP generation.
6. Daily reports generated from bank’s own system and received from vendors.
7. Bank’s mechanism of monitoring vendors.
8. RBI guidelines on digital products and for third party service providers.

6.45 The dependence of banks on third party service providers may expose bank’s data in public domain and cyber risks. At the same time, data entered in CBS for digital mode transactions are also generated from third party service providers system. In this case the Bank needs to have a strong mechanism to verify internal controls and cyber security controls at service providers.

6.46 Though the bank is providing services through digital mode that cannot absolve it from regulatory compliance such as KYC, Anti Money Laundering (AML) and Combating the Financing of Terrorism (CFT). The bank shall file suspicious transactions report (STR) with Financial Intelligence unit (FIU-IND) for mobile banking and internet banking transactions.

6.47 Customer Protection rights are also applicable to mobile and internet banking services. Liability arising out of cyber events, insuring events from third party should be considered while executing agreement between the payee and payee’s bank, the participating banks and service provider.

**(i) Role of NPCI in Digital Payment**

6.48 NPCI provides National Financial Switch (NFS) platforms to route all transactions. NFS is a shared ATM network that interconnects NFS members

and ATM switches. It also supports card plus PIN transactions on Micro ATMs. NPCI provides services such as networking of ATMs, switching of ATM transactions and settlement of transactions and charges. In return of such services, the card issuing banks pay transaction fees to NPCI and interchange fees to card acquiring members. Members may refer to the directions issued by the RBI vide Master Direction No. RBI/2020-21/74 DoS.CO.CSITE.SEC.No.1852/ 31.01.015/2020-21 dated February 18, 2021 on "Digital Payment Security Controls" in this regard.

**(ii) Settlement Process<sup>8</sup>**

6.49 NPCI maintains settlement account for all members participating in NFS network. This account is the current account / RTGS settlement account maintained by all members with RBI through which the inter-bank transactions are routed in the day-to-day banking activity. NPCI carries out settlements pertaining to NFS transactions and sends daily reports to all member banks for reconciliation and adjustments for discrepant transactions.

In this context, the auditor should examine control over:

- Settlement accounts, suspense or office accounts maintained for such transactions,
- Daily reconciliation process, three-way matching of data from ATM switch files, CBS files and NFS files,
- Chargeback, dispute resolution procedure.

RBI vide circular no. RBI/2017-18/153 DPSS.CO.OD No.2785/06.08.005/2017-2018 dated 6 April 2018 has issued requirements related to Storage of Payment System Data, which require banks/ all system providers to ensure that the entire data relating to payment systems operated by them are stored in a system only in India. This data should include the full end-to-end transaction details / information collected / carried / processed as part of the message / payment instruction. For the foreign leg of the transaction, if any, the data can also be stored in the foreign country, if required.

**(iii) Third Party Service Provider**

6.50 As already mentioned, banks are heavily dependent upon third party application service providers for shared services such as:

- ATM switch applications;

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<sup>8</sup> Refer RBI circular no. RBI/2021-2022/52 DPSS.CO.OD.No.S-182/06.07.011/2021-22 dated June 10, 2021 on Usage of Automated Teller Machines / Cash Recycler Machines – Review of Interchange Fee and Customer Charges.



- Credit/ debit card printing and issuance;
- ATM switch monitoring, Uptime monitoring;
- ATM daily reconciliation.

6.51 These service providers have exposure to the payment system landscape and therefore, they become exposed to the associated cyber threats. Hence, the agreement between banks and third-party application service providers should cover necessary cyber security controls. In case of outsourcing of digital payment transaction processing and reconciliation, incomes and expenses recordings are also based on the reports submitted by third party vendors. In this situation, internal controls at service providers' locations is important. At the same time, Bank's verification mechanism of vendor supplied reports and control over suspense, sundry deposits accounts are critical.

6.52 The auditor should consider:

- Bank's mechanism of monitoring service providers.
- Audit reports (Internal and External) to check compliance with relevant controls.
- Third party service provider's compliance with relevant standards- PCI DSS, ISO 27001, PA-DSS.
- Confirmation on various RBI requirements.
- Third Party assurance report.

#### **Digital Banking Units (DBUs)**

6.53 In pursuance of announcements made in the Union Budget 2022-23, guidelines have been prepared for setting up of Digital Banking Units (DBUs) by commercial banks. The RBI vide RBI/2022-23/19 DOR.AUT.REC.12/22.01.001/2022-23 dated April 7, 2022 requires banks to set up a specialised fixed point business unit / hub housing certain minimum digital infrastructure for delivering digital banking products and services as well as servicing existing financial products and services digitally, in both self-service and assisted mode, to enable customers to have cost effective/ convenient access and enhanced digital experience to/ of such products and services in an efficient, paperless, secured and connected environment with most services being available in self-service mode at any time, all year round.

Digital banking products and services would generally mean those financial products/services whose designs and fulfilments have nearly end-to-end digital life cycle with the initial customer acquisition / product delivery necessarily taking place digitally through self-service or assisted self-service.

A Digital Banking Segment, for the purpose of disclosure under Accounting

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Standard 17 (AS-17), is a sub-segment of the existing 'Retail Banking' Segment which will now be sub-divided in to (i) Digital Banking and (ii) Other Retail Banking. The business involving digital banking products acquired by DBUs or existing digital banking products would qualify to be clubbed under this segment.

Banks shall report the Digital Banking Segment as a sub-segment within the existing "Retail Banking Segment" in the format as specified under paragraph 4 of Annexure II (Part B) of the Reserve Bank of India (Financial Statements – Presentation and Disclosures) Directions, 2021.

The auditor shall review the compliance with Master Direction No. RBI/2022-23/92 DoR.AUT.REC.No.27/24.01.041/2022-23 dated April 21, 2022 on "Credit Card and Debit Card – Issuance and Conduct Directions, 2022". As per the directions, banks shall put in place a mechanism for review of their credit card operations on half-yearly basis by the Audit Committee of the Board of Directors. The review shall include, inter-alia, customer service, frauds, complaints and grievance redressal, card usage analysis including cards not used for long durations and the inherent risks therein.

### **Digital Lending Guideline**

6.54 The RBI vide circular no. RBI/2022-23/111 DOR.CRE.REC.66/21.07.001/2022-23 dated September 2, 2022 issued guidelines on Digital Lending to enhance customer protection making the digital lending ecosystem safe and sound while encouraging innovation.

The outsourcing arrangements entered by Regulated Entities (REs) with a Lending Service Provider (LSP)/ Digital Lending App (DLA) do not diminish the REs' obligations and they shall continue to conform to the extant guidelines on outsourcing. The REs are advised to ensure that the LSPs engaged by them and the DLAs (either of the RE or of the LSP engaged by the RE) comply with the guidelines contained in this circular.

### **Consumer Identity and Access Management**

6.55 As organizations conduct more business online, they need to provide customers with a personalized experience. This means recognizing, storing and utilizing customer information. With consumer Identity and Access Management (IAM), people are associated with information, facilitating rich digital relationships between providers and consumers.

6.56 Important aspects of Consumer IAM:

- Promoting access to products and services.
- 'Know Your Customer', personalization, preferences and privacy (consent).

- Customer experience and ease of use.
- Access anywhere, anytime, on any device.
- Omni-channel relationships including real-world and digital services.
- Advanced authentication including multifactor, biometrics and behavioral.

6.57 “Consumer IAM” provides a platform that leverages identity information to enhance a customers’ experience, while building loyalty, trust and business. This platform must be agile and able to continuously adapt to changes in consumer expectations and risks while supporting new capabilities such as adaptive authentication.

6.58 By associating multi-sourced data about a customer with a digital identity – often aided by data analytics – organizations can mirror the sort of customer insight they enjoy in the physical world. In return, they can delight customers with contextually relevant services, offers and personalization, and even how an individual’s landing page is populated. Because the experience is consistent across all channels, your systems can add value anywhere, anytime, from any device.

6.59 Review of controls around, but not limited to privacy, customer identification programs (CIP), information security and access management, Know Your Customer (KYC), segregation of duties, role/attribute-based controls, access governance, privileged access and data access governance shall be conducted for evaluation of this area.

### **RPA (Robotics Process Automation) Assessment**

6.60 RPA is the simplest form of digital labour. Its significance is that it enables data to be collected, analyzed or calculated at a speed and scale far greater than a human or team of humans could manage. RPA has enormous implications for the audit and is already bringing huge benefits.

6.61 In the analogue world where accounting was done with manual tools like physical ledgers, the auditor would validate processes and transactions using statistically valid sampling or similar techniques. In today’s digital world, where data is proliferating across digital networks and systems, we are bringing new capabilities to mine the mountain of data to identify audit risk, highlight anomalies and outliers, and perform further analysis. Already, new technology is dramatically enhancing the analytical power of our audits. Using RPA, we can analyze 100 per cent of certain datasets through various audit lenses. This means that we can quickly identify the outliers that need further examination. Areas such as audit confirmations, reconciliations, generation of emails,

automated emails, both internally and with the organization's data, can all be facilitated with RPA.

6.62 A key use of RPA is to gather audit evidence by collecting information where there is data in different organizations' systems that are not integrated. This information can then be subjected to data analytics to inform the auditor to enhance risk assessment procedures or provide audit evidence. RPA is not in itself 'intelligent' but is a vital part of the process of gathering information that can then be intelligently analyzed. RPA helps with collecting data, combining data from different sources and applying a basic order to the data. The auditor may consider SA 620, "Using the Work of an Auditor's Expert" to arrive at necessary comfort in this regard.

6.63 It is to be seen how RPA is having an impact on the transaction capturing and processing level including its impact on accounting.

6.64 Review of following controls shall be covered to evaluate the effectiveness of controls in this domain:

- Entity Level controls
  - RPA program governance and assurance
  - RPA policies and procedures
  - RPA ownership and responsibilities
- Technology risk controls
  - Bot access management
  - Bot process changes management
  - Bot logging and monitoring
- Bot logic and functionality
  - Security by design
  - Privacy by design
  - Algorithm and logic review
  - Secure code review
  - Vulnerability assessment
  - Bot process documentation and user stories

## **Blockchain**

6.65 In the current digital era, businesses across the world are running transactions of humongous volumes. Blockchain technology is a step towards

modernization of digital infrastructure and allows the reorganization of data and assets. Blockchain solutions across industries are helping to solve complex problems with the use of their platform and technology qualities. But it remains a question whether we are ready to handle the risks that these solutions can bring in. Traditional models of audit fail to take into consideration many of the risks associated with blockchain enabled processes, and hence there is a need to understand the specific set of risks and develop an evolved auditing approach for blockchain based solutions.

6.66 Auditing blockchain solutions have been developed keeping in mind specific risks that block chain models entail. Following are the key areas which can be covered as part of the audit:

- Interoperability and integration - Consistent communication between multiple blockchain platforms and integration with organizations' enterprise and legacy systems.
- Consensus mechanism - Blocks in the chain are validated by nodes to maintain a single version of the truth to keep adversaries from derailing the system and forking the chain.
- Heterogeneous regulatory compliance - Compliance with laws and regulations across various country and state legislations that will govern information and transactions processed.
- Key Ownership and management - Secure storage, maintenance, review and governance of cryptographic private keys used for authentication and validation by nodes.
- Network and nodes governance - Monitoring of network for information compliance and node reputation checks to handle and resolve disputes.
- Infrastructure and application management - Secure software development practices and testing of blockchain applications, platform, infrastructure and communication interfaces.
- Access and permissions management - Permissions configured for defined roles for access, validation and authorization of blockchain transactions by internal and external participants.

### **Information Technology related frauds in Banks**

6.67 Banking sector has grown by leaps and bounds during the last few years, and this has also increased the need for more governance, accountability and transparency. The pace of changes puts great challenges for banks as they

grapple with multiple fraud related issues, forcing them to develop comprehensive fraud risk management controls that will help in prevention as well as detection of frauds as soon as they occur. E-banking, internet banking and internet fraud are the major fraud risks that are currently posing highest concern for the banks.

### **Types of Frauds possible in Banks**

6.68 Some of the possible frauds in banks are enumerated in the following paragraphs:

- Frauds in banks – Cash lending during working hours, Missing notes in bundles, use of same note bundles by two branches, Posting in wrong accounts, Misuse of sensitive stationery, etc. These frauds are committed by Bank's Staff itself.
- Frauds on banks – Include Technology related frauds, Deposit related frauds, and Advances portfolio frauds.

6.69 Technology related frauds - The fraudsters employ hostile software programs or malware attacks, phishing (mails), vishing (voice-mail), Smishing (Text messages), whaling (Targeted phishing on high net worth individuals), Card duplication techniques apart from stealing confidential data to perpetrate Frauds.

6.70 Deposit related frauds - Lack of compliance with KYC Guidelines, misuse of operative accounts. Non-reconciliation of Suspense and Sundry accounts and lack of control over transactions, in these accounts, result in frauds.

6.71 Advances portfolio frauds - Majority of credit related frauds are on account of deficient appraisal system, poor post- disbursement supervision and inadequate follow-up. Most of the frauds relating to advances come to light only during the recovery process initiated after the accounts have been classified as NPA. Fabricated/fudged Financial Statements, inflated security valuation reports, defective search report for title deeds of mortgaged property are the commonly discovered frauds.

### **Fraud Risks involving Digital Banking**

6.72 Information Technology (IT) plays a significant role in the development of Digital banking to make the banking operations fast, effective and efficient. Use of IT in banking system made banking more customer oriented, quality driven and easy to use for both banks and customers. Various initiatives have been taken by the banks to convert themselves from their traditional banking to Digital banking. The initiatives by the banks are as follows:

- Core Banking Systems (CBS)

- Digital Payment System
- Credit / Debit Cards
- ATMs/ POS Terminals/CDMs
- Internet Banking like NEFT/RTGS
- Mobile Banking
- Branchless Banking
- Digital Wallet
- Digital Banking unit
- Digital lending

6.73 The following are the most common ways in which exploitation of IT is being done on the most popular initiatives:

- **Fraud Risk on CBS:** When the letter of understanding (LOU) is issued, message for the credit transfer is conveyed by the sending bank to the overseas banks through SWIFT (Society for Worldwide Interbank Financial Telecommunication) system and this message through SWIFT is termed as sending bank's consent and guarantee to the overseas bank. The sending bank official must log into its CBS system to route the transaction on SWIFT. Fraud on CBS occurs when SWIFT is not integrated with CBS and a perpetrator can easily send LOUs to overseas bank simply bypassing the CBS.
- **Fraud Risk on Digital Payment System:** Digital payment system has spread across the globe due to its scalability and acceptability by all class of users. Handling of account by a user either through online or through mobile is increasing day by day and so they are the common target for the fraud perpetrator. The perpetrator may deploy different techniques to make fraud happen.

Some techniques are explained below:

**Phishing:** The perpetrator sends emails to lure users saying that he has won a lottery, or some money needs to be deposited in his account and then requesting user to provide the details of his bank account.

**Device Compromise:** Devices through which the bank customer is operating his account either through online or through mobile is usually prone to be compromised by the perpetrator for execution of the fraud. Compromising the operating system of the smart phone or any other status change like firewall setting etc. may lead to fraud.

**Man in the Middle Attack:** The perpetrator, in this case alters the communication between the two legitimate parties to execute the fraud. The legitimate parties think that they are communicating with one another but in the real scenario their communication is received and altered by the perpetrator.

**Spoofing Attack:** This attack is used to disguise the user by sending fraudulent communication from the fraud site as legitimate site. For example, instead of sbionline.com, the perpetrator may use sblonline.com for the user and force the user to enter the credentials in the fraudulent site.

**APT Attacks:** Advance persistence threat used for the infiltration of credentials of the customers of a bank. The perpetrator generally uses botnets (malicious software) to infect the computers in the bank network for the infiltration of the credentials.

**Location Manipulation:** The perpetrator generally manipulates the actual location of the device for the outstation account fraud.

- **Credit / Debit Cards:** There are two types of Credit / Debit Cards frauds as detailed below:

**Card Not physically Present Fraud:** This type of Credit / Debit Cards fraud is committed by the perpetrator by sending phishing emails to the card holder and luring him to enter the card information in the email or disguised portal directed by the link in the email. When all the information is available related to the Credit / Debit Card the perpetrator uses the information to make illegal transaction online without having the physical possession of the card.

**Fraud with Card physically Present:** This type of Credit / Debit Cards fraud is executed by the perpetrator by using some device either at swiping machine at sales counter or parallel reader in an ATM. Skimming money from the Credit / Debit card in the later stages would follow the departure of the Credit / Debit Card holder from the said venue.

- **Internet Banking Fraud:** Internet banking used by the bank customer to make the transaction to purchase from the E-Commerce websites, transfer the money from his account to other accounts, to submit the EMI for loans to the lending banks, instalments of PPF, RD etc. Bank customer logs into the bank portal by providing the credentials to open his account page. The perpetrator tries to crack the credentials of the users by different tricks which are explained hereunder:

**Social Engineering:** The perpetrator projects himself to be the person



which he is not, to get the credentials of the user. He exploits the emotions and traits of the human like fear, greed, curiosity etc. as his tools to force the user to disclose his credentials.

**Shoulder Surfing:** Shoulder surfing happens when a perpetrator tries to look over other person in the hope to see his credentials at the time when the said person is about to place his credentials in the bank portal. Once the perpetrator is able to see the credentials, he will use the same to divert the money from the user account.

**Key Logger:** Key logger is surveillance software installed by the perpetrator in such a way that every keystroke by the user (including credentials) in his computer is captured in an encrypted file. The perpetrator using other means collects this file and figures out the credentials in the long text.

**Spoofing Attack:** As discussed above this is used to obtain the credentials of the user.

**APT Attacks:** As explained above, advance persistence threat is used for the infiltration of the credentials of the customers of a bank.

6.74 These are the most common frauds that occur in Digital banking, although banks are making considerable and continuous efforts to arrest such fraudulent activities by putting proper controls, customers trainings and sending alerts but it is also the responsibility of the customer to follow the guidelines issued by the bank from time to time. However an auditor is expected to review the Fraud Reporting and Monitoring mechanism within the bank and adequacy of provision / penalties / compensations.

### **Key Take Aways**

1. As technology is fast moving the auditor needs to show resilience and adapt to the technology and its impact on the auditee.
2. Map the technology with any of the financial monitoring mechanisms of the bank.
3. Data integrity is at the core of any IT platform.
4. When technology can be good, it creates numerous challenges for the auditor in the risk assessment of the auditee. [The auditor should do this risk assessment on the basis of the risk monitoring framework of the bank, internal audit coverage on the IT and Network security of the bank, system auditors' comments, Bank's business needs and objectives.

# 7

## **Human Resources Department**

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7.01 Human Resources (HR) Department is one of the most important departments of a bank. It plays a vital roles including the drawing up of HR policy for the bank and getting it vetted by the Management.

7.02 The HR policy would normally cover the following aspects:

- 1) Organizational and functional structure and chart including reporting obligations.
- 2) Background checks – pre-employment medical checks – fixing turnaround times for various activities related to recruitment.
- 3) Interviews, Selection and Recruitment processes.
- 4) Issuing Appointment Letters – fixing job roles, responsibilities and designations.
- 5) Induction, awareness, sensitization and training.
- 6) Salary Fixation, structure and payment, TDS calculations, deductions and payment, Issuance of Form 16, Salary slips, Profession tax payments, fixing perks and privileges including insurance entitlements.
- 7) Provident Fund recoveries and contributions.
- 8) Grant of staff Loans and Advances, interest rates thereon and recovery from salary.
- 9) Banking Holidays, Leave and attendance record management.
- 10) Performance appraisal process, transfers and promotions.
- 11) Skill set gap assessment and development.
- 12) Succession planning.
- 13) Disciplinary mechanism in case of any wrongdoings including issuance of warnings and show cause notices.
- 14) Complaint/grievance resolution.
- 15) Conflicts of interest and bribery.
- 16) Investigation mechanism for determining staff accountability in case of frauds.

- 17) Handling employee retirements, resignations, retrenchments, terminations.
- 18) Full and Final settlements, Exit interviews.
- 19) Handling deviations from policy and ratifications, escalations thereof.
- 20) MIS – generation, circulation list and frequency.
- 21) Rotation of staff – frequency, designation, preference, exception handling.

7.03 HR department will also be responsible for the following for which there might be specific policies:

- a) Code of Conduct and Ethics.
- b) Dispute resolution mechanism.
- c) Whistle blower policy and hotlines.
- d) Prevention of Sexual Harassment Policy.

7.04 Each bank may have its own organizational structure. While the policy framing, sign off and periodical reviews would happen centrally, monitoring and implementation could be decentralized at the Zonal, Regional or Cluster level as the case may be, which will also depend on the size of the bank in terms of the number of employees, branches and geographical spread.

7.05 The HR department is generally headed by a Chief Human Resource Officer who would also be designated separately. He could be assisted by functional experts who would be individually and separately responsible for:

- 1) Recruitment
- 2) Training
- 3) Payment
- 4) Compliance

7.06 Each of these functional heads would have individual teams centrally and at zonal, regional or cluster levels. This may vary from bank to bank. These functional heads would be responsible for executing and enforcing various activities as stated in the bank's HR policy.

7.07 The auditor will have to ensure that:

- 1) There is a comprehensive HR policy in place encompassing in detail all the issues mentioned above. Such policy is periodically updated, reviewed and signed-off.

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- 2) The policy is not in violation of existing applicable laws especially labour laws.
- 3) The policy has been adhered to and this is monitored / validated independently either internally by a distinct HR team or by internal audit or internal audit conduct by external professionals.
- 4) Parameters are set to generate Exception Reports to capture deviations. These Exception Reports are generated, monitored and reviewed for closure / resolution at defined intervals normally daily.
- 5) Any deviation or non-adherence to the policy should be appropriately approved, addressed and closed. Ageing of open deviations is duly monitored. Classification of deviations is done risk-wise into 'High', 'Medium' and 'Low' categories as per pre-defined classification norms. High-risk deviations are stringently monitored for closure and open items duly escalated.
- 6) Proper documentation is in place, stored and retained.
- 7) Tax calculations are done as per current tax laws, salary payments are in adherence to labour laws and internal policy, issuance of appropriate tax forms – loan recoveries, interest charge, etc., are in order.
- 8) Process of Appointment – Induction – Performance and appraisal reviews, Trainings, Complaints etc., are in order.
- 9) Impact on account of cash outflow is accrued / reflected in appropriate heads.
- 10) Ensure strict adherence to the Code of Ethics, Whistle Blower Policy and Prevention of Sexual Harassment Policy.
- 11) Verify that Actuarial valuation of Gratuity, Leave Encashment (generally obtained by HR) has been duly obtained on record and the assumptions considered are reasonable. The auditor should also verify whether the salary and employee data provided to the actuary are consistent with the data maintained by the bank. Further, the auditor should also carry out reasonableness test of various non-financial assumptions such as expected return on plan assets, discount rate etc. considered at the time of actuarial valuation.
- 12) Where payroll processing is done through a specialised software, whether adequate IT controls are in place to ensure correctness of data input,

validations, processing, output and appropriate accounting thereof in the accounting system of the bank.

- 13) In case the HR aspect is subjected in internal or other audits, the auditor would have to peruse the reports of such audits to identify any audit issues already flagged off.
- 14) In case the payroll process is outsourced to third party vendor, the auditor should evaluate the process of the bank in ensuring proper internal control in carrying out such activities in accordance with Standard on Auditing (SA) 402, "Audit Considerations Relating to an Entity Using a Service Organisation".
- 15) Check effective compliance of RBI circular no. RBI/2021-22/70 DoR.ORG.REC.31/ 21.06.017/2021-22 dated July 09, 2021, on "Mandatory Leave for Employees Posted in Sensitive Positions or Areas of Operation".

7.08 While most of the issues stated above will not have a direct quantitative impact, indirectly they make a big impact on the employee motivation, engagement, performance and productivity and hence, it is imperative that the auditor reviews the process end to end. Any issues noted therein should be appropriately discussed for resolution and necessary reporting should be made in the LFAR.

7.09 Profit per employee / Business per employee figures needs to be stated in the Notes to Accounts by the banks. The Employee number and the methodology for allotting this number will have to be certified by the HR department.

7.10 In September 2020, the Code on Social Security, 2020 was passed by the Parliament. Though the effective date has not yet been notified, the auditor would want to comment in the LFAR on the adequacy of the process followed by the bank to quantify the impact of the said enactment on the overall employee cost of the bank. Some of the banks have started creating provision towards the liability, the auditor should evaluate the appropriate accounting and tax implication thereon in the financial statements.

7.11 The auditor should also verify the impact of RBI circular no. RBI/2021-22/95 DOR.GOV.REC.44/29.67.001/2021-22 dated August 30, 2021 on Guidelines on Compensation of Whole Time Directors/ Chief Executive Officers/ Material Risk Takers and Control Function staff – Clarification, which requires share-linked instruments to be fair valued on the date of grant using Black-

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Scholes model as against the Intrinsic value method. The fair value thus arrived at should be recognised as expense beginning with the accounting period for which approval has been granted. As part of the transition approach, these guidelines are applicable for all share-linked instruments granted after the accounting period ending March 31, 2021. Banks are required to make disclosure on remuneration of WTDs/CEOs/MRTs on an annual basis at the minimum, in their Annual Financial Statements.

7.12 To improve clarity on disclosure, banks should make the disclosures in table or chart format and make disclosures for previous as well as the current reporting year (previous year's disclosure need not be made when the disclosures are made for the first time). Further, banks should also comply with the disclosure requirements for remuneration as prescribed by RBI *vide* Master Circular No. RBI/2022-23/12 DOR.CAP.REC.3/21.06.201/2022-23 dated April 1, 2022 on Basel III Capital Regulations.

7.13 The auditor should also verify the compliance with RBI circular no. RBI/2021-22/105 DOR.ACC.REC.57/21.04.018/2021-22 dated October 4, 2021 on Enhancement in family pension of employees of banks - Treatment of additional liability, which allowed all Member Banks of the Indian Banks' Association to amortise additional liability on account of revision in family pension consequent to the 11th Bipartite Settlement over a period not exceeding five years beginning with the financial year ending March 31, 2022, subject to a minimum of 1/5th of the total amount involved being expensed every year. The Notes to Accounts shall also disclose the amount of unamortised expenditure and the consequential net profit if the unamortised expenditure had been fully recognised in the Profit and Loss Account. The auditor should also evaluate the appropriate comment in the auditors' report on the financial statements.

7.14 The auditor should ensure that employee union agreements are in force. In case the agreements have expired and the negotiations with the unions are on, the provision relating to the period between expiry date and the balance sheet date should be checked for adherence to AS 29, "Provisions, Contingent Liabilities and Contingent Assets (Revised 2016)".

7.15 The auditor should enquire whether there are any changes in the employment laws which may impact the year-end provision.

# 8

## Large Corporates and Loan Syndication

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### Introduction

8.01 All corporates require large amount of funds by way of debt and equity for timely financial closure of their projects. Loan syndication most often occurs when a borrower requires an amount too large for a single lender to provide or when the loan is outside the scope of a lender's risk-exposure levels. Thus, multiple lenders form a syndicate to provide the borrower with the requested capital. The bank which spearheads the process is called the "Lead bank". The Lead Bank carries out most of the due diligence in this regard. The Lead Bank in most of the cases is responsible for the initial transaction and its review, fees, documentation, compliance reports, loan monitoring, and overall reporting for all lending parties. Hence, the lead bank has more responsibility as compared to other members of the syndication. Any laxity in any stage of the loan i.e. Sanctioning, Documentation, Disbursement, Monitoring by lead bank may increase the risk associated with the borrower for all syndicate members. Normally in Loan Syndication a single agreement is entered into between all members of the syndicate and the borrower. Though the lead banker is the single point for correspondence, other banks / lenders have the right in proportion to their share in loan. The other banks can also ask for specific details from the borrowers as per their requirement. The Lead Bank charges fees for the syndication arrangement which are normally higher than the normal loan processing fees.

8.02 The auditor of the lead bank in the case of Loan Syndication should verify:

- Whether the bank has Board approved policy for business of Loan syndication. Whether this policy has been updated and reviewed annually.
- Whether the bank has processes in place for loan syndication business.
- Whether the bank has underwritten any loan which it has syndicated; if yes whether the same has been considered as Contingent Liability.
- Whether the bank has collected and accounted fees in all cases of syndication.

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- Whether Loan Syndication Department is adequately staffed having required skill sets as required to carry out due diligence.
- Whether the bank has passed on the relevant information promptly to other banks.
- Whether meetings with all banks in the syndicate are held as per schedule and the minutes of the meeting are timely and properly prepared and circulated.
- Whether issues raised by member banks are replied to in time and satisfactorily.
- Whether the correspondences are duly filed in order.
- Whether post sanction reports have been submitted to Regulators.
- Whether the Information Memorandum or Appraisal Note prepared captures all the critical items.
- Whether the share of other lenders, if received by the Lead Bank, has been expeditiously shared with the other lenders.
- Whether the defaults or any other critical matters relating to the borrower have been timely informed to all other lenders.

8.03 The auditor of other banks (Member banks) should verify the following:

- Whether the bank has a Board approved policy for participation in a syndicate. Whether this policy has been updated and reviewed annually.
- Whether the bank has carried out its own due diligence on information provided by the Lead Bank and raised queries, if any to the Lead Bank and whether the same are resolved satisfactorily.
- Whether the share of the bank is clearly mentioned in correspondence with Lead Bank and other syndicate members.
- Whether the bank has put in place loan system for Delivery of bank credit.
- Whether the bank has received the minutes of the consortium meetings in time from the Lead Bank.
- Whether the bank is getting communication from the Lead Bank on all critical matters.



## Micro, Small and Medium Enterprises Department

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### Introduction

9.01 RBI Master Direction on “Lending to Micro, Small and Medium Enterprises (MSME) sector as updated from time to time defines the framework for lending to MSME and other operational guidelines. Advances to the MSME sector are categorised as Priority Sector Advances as per existing guidelines issued by the RBI. The target for the MSME Sector advances is 7.5 per cent of ANBC or credit equivalent amount of “Off Balance Sheet exposure”, whichever is higher.

9.02 Considering that the Micro, Small and Medium Enterprises (MSME) sector is a significant contributor towards building up of a strong and stable national economy and considering that the present thresholds in MSME definition has created an apprehension among MSMEs of graduating out of the benefits of MSME and dampens the urge to grow, the Government of India vide notification No: S.O. 2119(E) dated 26.06.2020 published in the Gazette of India, Extraordinary, Part II, Section 3 sub-section (ii), has changed the definition criteria of MSME as under:

	<b>Sector</b>	<b>Definition</b>
A	Micro Enterprises	Investment in Plant & Machinery or Equipment does not exceed one crore rupees and the annual turnover does not exceed five crore rupees.
B	Small Enterprises	Investment in Plant and Machinery or Equipment does not exceed ten crore rupees and annual turnover does not exceed fifty crore rupees.
C	Medium Enterprises	Investment in Plant and Machinery or Equipment does not exceed fifty crore rupees and annual turnover does not exceed two hundred and fifty crore rupees.

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9.03 The revised definition as above is effective from 1<sup>st</sup> July, 2020. All existing enterprises and new enterprises are required to register by filing a memorandum known as “Udyam Registration” in the Udyam Registration Portal based on self-declaration and can be independently verified on the portal. Composite criterion of investment and turnover shall apply for classification of an enterprise as micro, small or medium. If an enterprise crosses the ceiling limits specified for its present category in either of the two criteria of investment or turnover, it will cease to exist in that category and be placed in the next higher category but no enterprise shall be placed in the lower category unless it goes below the ceiling limits specified for its present category in both the criteria of investment as well as turnover.

9.04 All units with Goods and Services Tax Identification Number (GSTIN) listed against the same Permanent Account Number (PAN) shall be collectively treated as one enterprise and the turnover and investment figures for all such entities shall be seen together and only the aggregate values will be considered for categorizing units into micro, small or medium enterprise.

9.05 The calculation of investment in plant and machinery or equipment and turnover will be linked to the Income Tax Return (ITR) and GST Returns of the previous years with certain conditions.

9.06 The Ministry of Micro, Small & Medium Enterprises vide Office Memorandum (OM) No 5/2(2)/2021-E/P & G/Policy dated July 2, 2021 has also included Retail and Wholesale Trade as MSMEs for the limited purpose of priority sector lending.

9.07 The RBI vide circular no. FIDD.MSME & NFS.BC.No.4/06.02.31/2020-21 dated August 21, 2020 clarified that the existing Entrepreneurs Memorandum (EM) Part II and Udyog Aadhaar Memorandum (UAMs) of the MSMEs obtained till June 30, 2020 shall remain valid till March 31, 2021. The RBI has subsequently vide its circular no. FIDD.MSME & NFS.BC.No.12/06.02.31/2021-22 dated June 25, 2021 extended the validity till December 31, 2021.

9.08 The RBI has issued circular no. RBI/2018-19/100 DBR.No.BP.BC.18/21.04.048/ 2018-19 dated January 1, 2019 on “Micro, Small and Medium Enterprises (MSME) sector – Restructuring of Advances”. One time relaxation is given for Restructuring of MSME Standard Accounts without downgrading, subject to compliance of the conditions mentioned therein.

9.09 The RBI has subsequently vide circular no. RBI/2019-20/160 DOR.No.BP.BC.34/21.04.048/2019-20 dated February 11, 2020 on “Micro, Small and Medium Enterprises (MSME) sector – Restructuring of Advances” extended

the period for the above One Time Restructuring (OTR) relief to the MSME borrowers subject to the following conditions upto 31.12.2020.

9.10 Banks have to create 5 percent additional provision in respect of accounts restructured in MSME OTR. Banks are required to put in place a Board approved policy on restructuring of such advances including viability assessment. Many times it is observed that in their eagerness to restructure an account bank may even restructure a non-viable unit. Hence special attention is to be paid to the application of Board approved policy while restructuring of accounts.

9.11 The requirement of additional provision can be withdrawn only on satisfactory performance during specified period, that is there should be no payment which remains overdue for a period of more than 30 days or in case of OCC/ OD account the outstanding in the account shall not be more than sanctioned limit/ DP whichever is lower for more than 30 days for a period of 1 year from the commencement of the first payment of interest/ principal whichever is later.

9.12 It should be ensured that the borrower meets the definition of MSME under Micro, Small and Medium Enterprises Development (MSMED) Act 2006 (as amended w.e.f.1<sup>st</sup> July, 2020) and may not be required to obtain MSME Certificate to qualify for the scheme. Additional disclosure is required to be made of the number and value of restructured accounts under this scheme.

9.13 Subsequently the RBI *vide* circular no. RBI/2020-21/17 DOR.No.BP.BC/4/21.04.048/2020-21 dated August 06, 2020 on Micro, Small and Medium Enterprises (MSME) sector – Restructuring of Advances extended the period for OTR relief to the MSME borrowers subject to the following conditions:

- a. Aggregate exposure (Fund based/Non Fund based) of all banks/ NBFC's should not have exceeded Rs. 25 Crores as on 01.03.2020.
- b. The borrower account should have been 'Standard' as on 01.03.2020 till the date of restructuring.
- c. Restructuring should have been implemented on or before 31.03.2021.
- d. The borrower should have been registered with GST. This condition is not applicable to those entities which are exempt from registration under GST.
- e. Asset classification of borrowers classified as standard may be retained as such, whereas the accounts which may have slipped into NPA category between March 2, 2020 and date of implementation may be upgraded as 'standard asset', as on the date of implementation of the restructuring plan.

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The asset classification benefit will be available only if the restructuring is done in terms of the provisions of this circular.

- f. Banks have to create 5 percent additional provision in respect of accounts restructured in MSME OTR.

9.14 Also refer circular no. 170/2020-21 dated June 24, 2020 issued by the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) regarding "Distressed Assets Fund - Subordinate Debt for Stressed MSMEs". As the credit facilities extended under the above scheme are backed by a guarantee from CGTMSE, as a special dispensation, the RBI *vide* its circular no. RBI/2020-21/09 DoR.BP.BC.No.01/21.04.048/2020-21 dated July 1, 2020 on Distressed Assets Fund - Subordinate Debt for Stressed MSMEs has decided to permit the banks to reckon the funds infused by the promoters in their MSME units through loans availed under the captioned scheme as equity/quasi equity from the promoters for debt-equity computation.

9.15 Subsequently, the RBI *vide* circular no. RBI/2021-22/32 DOR.STR.REC.12/21.04.048/2021-22 dated May 05, 2021 on "Resolution Framework 2.0 – Resolution of Covid-19 related stress of Micro, Small and Medium Enterprises (MSMEs)" has extended the period for OTR relief to the MSME borrowers subject to the following conditions:

- a. The borrower should be classified as a micro, small or medium enterprise as on March 31, 2021 in terms of the Gazette Notification S.O. 2119 (E) dated June 26, 2020.
- b. The borrowing entity is GST-registered on the date of implementation of the restructuring. However, this condition will not apply to MSMEs that are exempt from GST-registration. This shall be determined on the basis of exemption limit obtaining as on March 31, 2021.
- c. The aggregate exposure, including non-fund based facilities, of all lending institutions to the borrower does not exceed ₹25 crores as on March 31, 2021. This was, subsequently, enhanced to ₹50 crores by notification dated June 04, 2021.
- d. The borrower's account was a 'standard asset' as on March 31, 2021.
- e. The borrower's account was not restructured in terms of circular no. DOR.No.BP.BC/4/21.04.048/2020-21 dated August 6, 2020; circular no. DOR.No.BP.BC.34/ 21.04.048/2019-20 dated February 11, 2020; and circular no. DBR.No.BP.BC.18/ 21.04.048/ 2018-19 dated January 1, 2019.
- f. The restructuring of the borrower account is invoked by September 30, 2021. For this purpose, the restructuring shall be treated as invoked when

the bank and the borrower agree to proceed with the efforts towards finalising a restructuring plan to be implemented in respect of such borrower. The decisions on applications received by the bank from their customers for invoking restructuring under this facility shall be communicated in writing to the applicant by the bank within 30 days of receipt of such applications. The decision to invoke the restructuring under this facility shall be taken by each lending institution having exposure to a borrower independent of invocation decisions taken by other lending institutions, if any, having exposure to the same borrower.

- g. The restructuring of the borrower account is implemented within 90 days from the date of invocation.
- h. If the borrower is not registered in the Udyam Registration portal, such registration shall be required to be completed before the date of implementation of the restructuring plan for the plan to be treated as implemented.
- i. Upon implementation of the restructuring plan, the bank shall keep provision of 10 percent of the residual debt of the borrower.

9.16 In respect of restructuring plans implemented as above, asset classification of borrowers classified as standard may be retained as such, whereas the accounts which may have slipped into NPA category between April 1, 2021 and date of implementation may be upgraded as 'standard asset', as on the date of implementation of the restructuring plan.

9.17 In respect of accounts of borrowers which were restructured in terms of the MSME restructuring circulars, lending institutions are permitted, as a one-time measure, to review the working capital sanctioned limits and / or drawing power based on a reassessment of the working capital cycle, reduction of margins, etc. without the same being treated as restructuring. The decision with regard to above was to be taken by lending institutions by September 30, 2021. The reassessed sanctioned limit / drawing power shall be subject to review by the lending institution at least on a half yearly basis and the renewal / reassessment at least on an annual basis. The annual renewal/reassessment shall be expected to suitably modulate the limits as per the then-prevailing business conditions.

### **Preparation / Planning**

9.18 Obtain the revised, updated MSME policy of the bank. Discuss the process of collecting information from MSME customers and record the same in Account Master of CBS. Also find how this process was internally validated.

### **Conduct / Execution**

9.19 Verify whether the process for identification of MSME and restructuring of MSME advances has been followed at branches / Controlling offices / CBS:

- Check the internal controls for recognition of MSME accounts and eligible MSME accounts for OTR.
- Check the controls for ensuring that once OTR is extended under any one circular i.e., 1<sup>st</sup> January, 2019 or 11<sup>th</sup> February, 2020 or August 06, 2020 circular, the same account is not eligible for OTR relief under 05<sup>th</sup> May, 2021 circular of the RBI.
- Check 2 per cent interest subvention to all GST registered MSME Accounts.
- Check for restructured MSME accounts additional provision as prescribed in various circulars of the RBI (over and above provisions already held) is made at reporting date.
- Verify that all the conditions required as per extant RBI circulars, for an account to be continued to standard status are fully complied with and the implementation of restructuring is completed within stipulated timelines. In case of non-compliance of such conditions or delay in implementation, the IRAC status of the account needs to be suitably revised and required provisions shall be insisted.
- Check for restructured MSME accounts disclosure required in financial statements for the number of accounts restructured and the amount.
- What is the process for arriving at deviations and correction of the same, if any.

### **Reporting / Conclusion**

9.20 Based on audit issue appropriate certificate, report on compliance for MSME Advances in the Long Form Audit Report. Check whether appropriate disclosures are being made in the notes to accounts in the financial statements.

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## Rural and Agricultural Business Department

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### Introduction

10.01 The Rural & Agricultural Business Department (R&AB) focuses on lending under agriculture. This department's function revolves around Supervision, Policy & Strategy formulation for lending under priority sector with a focus on agriculture and other Government schemes relating to farmers and weaker sections.

10.02 The R&AB department is generally responsible for allocation, monitoring and compliances relating to priority or agricultural business across various sectors/ subsectors.

10.03 This department is also responsible to keep abreast of RBI regulations with regard to Rural and Agricultural advances and to frame guidelines within the frame work of RBI regulations and to issue internal circulars to the branches, ROs/ZOs/Circle offices of the bank and also monitor implementation of the same.

10.04 This department also interacts and liaises with other agencies like NABARD, SLBCs, and local Government authorities in the implementation of the schemes and reliefs.

10.05 This department also maintains Day Books for incurring administrative expenses relating to the functions of the department.

10.06 The RBI issued the Priority Sector Lending Master Direction No. RBI/FIDD/2020-21/72 no. FIDD.CO.Plan. BC.5/04.09.01/ 2020-21 dated 4<sup>th</sup> September 2020 (Updated as of 20<sup>th</sup> October 2022).

10.07 The Priority Sector Lending (PSL) guidelines issued by the RBI were last reviewed for Commercial Banks in April 2015 and for UCBs in May 2018 respectively. The current review of the Master Directions took into account the recommendations made by the 'Internal Working Group to Review Agriculture Credit' (Chairman: Shri M. K. Jain) apart from discussions with all stakeholders. Further, these Master Directions encompass the revised guidelines on PSL for all Commercial Banks, RRBs, SFBs, UCBs and LABs and, accordingly, supersede the earlier Master Directions on PSL issued separately for Scheduled Commercial Banks, RRBs, SFBs and guidelines issued for UCBs, respectively.

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**Changes in Targets / Sub-targets Classification for Priority Sector**

10.08 The targets and sub-targets set under priority sector lending is computed on the percentage basis of Adjusted Net Bank Credit (ANBC) / Credit Equivalent of Off-Balance Sheet Exposures (CEOBE). The Master Directions, had increased the total priority sector lending target for Urban Co-Operative Banks, which is to be achieved through milestones-based targets in a phased manner. Further there has been increase in targets for advances to weaker sections and Small Farmer Margins (SMF) in the agriculture sector. The table below summarises the changes (compared to earlier Master Direction) along with timelines for complying with Targets/Sub-targets for PSL.

Categories	Domestic Commercial Banks	Small Finance Banks	RRB	Urban Co-Operative Bank#
Agriculture Target <sup>4</sup>	Small Marginal Farmers (SMF) target increased to 10% <sup>9</sup> of the 18% of ANBC or CEOBE, whichever is higher.	Small Marginal Farmers (SMF) target increased to 10% <sup>10</sup> of the 18% of ANBC or CEOBE, whichever is higher.	Small Marginal Farmers (SMF) target Increased to 10% <sup>10</sup> of 18% of ANBC or CEOBE, whichever is higher.	No Target
		[earlier it was 8 % of 18%]	[earlier it was 8% of 18%]	

<sup>9</sup> Phased manner for achieving Small Marginal Farmers and Weaker Section Targets as below:

Financial Year	Small Marginal Farmer
2020-2021	8%
2021-2022	9%
2022-2023	9.50%
2023-2024	10%

<sup>10</sup> Phased manner for achieving Small Marginal Farmers and Weaker Section Targets as below:

Financial Year	Weaker Sections Target
2020-2021	10%
2021-2022	11%
2022-2023	11.50%
2023-2024	12%

\* Not applicable to UCBs



### 10.09 Inclusions in Eligible Categories

Along with the inclusion of fresh categories eligible for finance under priority sector there has been some enhancement in the credit limit of the existing categories as well. Some of the changes are as follows:

<p><b>Agriculture Lending Including Farm Credit (Allied Activities), lending for Agriculture Infrastructure and Ancillary Activities.</b></p>	<ul style="list-style-type: none"> <li>• Inclusion of loans to farmers for installation of stand-alone Solar Agriculture Pumps and for solarisation of grid connected Agriculture Pumps.</li> <li>• Inclusion of loans to farmers for installation of solar power plants on barren/fallow land or in stilt fashion on agriculture land owned by farmer.</li> <li>• Inclusion of loans up to ₹50 crores to start-ups, as per definition of Ministry of Commerce and Industry, Govt. of India that are engaged in agriculture and allied services.</li> <li>• Inclusion of loans up to ₹2 lakhs to individuals solely engaged in allied activities without any accompanying land holding criteria.</li> <li>• Inclusion of loans for construction of oil extraction/processing units for production of bio-fuels, their storage and distribution infrastructure along with loans to entrepreneurs for setting up Compressed Bio Gas (CBG) plants.</li> <li>• Laying of Indicative list (Annexure III of Master Direction) conveying permissible activities under Food Processing Sector as recommended by Ministry of Food Processing Industries.</li> <li>• A credit limit of ₹5 crores per borrowing entity has been specified for Farmers Producers Organisations (FPOs)/Farmers Producers Companies (FPCs) undertaking farming with assured marketing of their produce at a pre-determined price.</li> <li>• Loans against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months subject to a limit up to ₹75 lakhs against NWRs/eNWRs and up to ₹50 lakhs</li> </ul>
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	<p>against warehouse receipts other than NWRs/eNWRs.</p> <ul style="list-style-type: none"><li>• Loans for agriculture infrastructure will be subject to an aggregate sanctioned limit of ₹100 crores per borrower from the banking system. List of activities is furnished in Annex II of RBI Master Direction RBI/FIDD/2020-21/72 Master Directions FIDD.CO.Plan.BC.5/04.09.01/2020-21.</li><li>• Loans for Food and Agro-processing up to an aggregate sanctioned limit of ₹100 crores per borrower from the banking system.</li></ul>
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#### **Inclusion of Weights in PSL Achievement**

10.10 Based on the UK Sinha Committee's recommendations, Adjusted Priority Sector Lending mechanism has been implemented under the new regime, in order to address regional disparities in flow of credit to district levels and incentivise flow of credit to underserved districts. There is no change in the underlying sectors eligible for PSL, however an additional weightage has been given to lending to the more underserved districts. From financial year 2021-2022 onwards weights would be assigned to incremental priority sector credit as follows:

- Higher weight (125 per cent) would be assigned to the Districts where credit flow is comparatively lower, that is per capita PSL less than ₹ 6,000.
- Lower weight (90 per cent) would be assigned to the Districts where credit flow is comparatively higher, that is per capita PSL is greater than ₹ 25,000.

The list of both categories of Districts is given in Annex IA & IB of the Master Direction. This list will be valid for the period up to FY 2023-24 and will be reviewed thereafter. The Districts other than those mentioned in Annex IA and IB will continue to have existing weightage of 100 per cent.

RRBS, Urban Co-operative Banks, Local Area Banks and Foreign Banks have been kept out for the purpose of calculation of PSL weights, due to their limited presence.

10.11 Modified Interest Subvention Scheme for Short Term Loans for Agriculture and Allied Activities availed through Kisan Credit Card (KCC) during the financial years 2022-23 and 2023-24 was notified *vide* RBI circular no.

RBI/2022-23/139 FIDD.CO.FSD.BC.No.13/ 05.02.001/ 2022-23 dated 23<sup>th</sup> November 2022. Salient features of the scheme are explained in the following paragraph.

- (i) In order to provide short term crop loans and short term loans for allied activities including animal husbandry, dairy, fisheries, bee keeping etc. upto an overall limit of ₹3 lakhs to farmers through KCC at concessional interest rate during the years 2022-23 and 2023-24, it has been decided to provide interest subvention to lending institutions viz. Public Sector Banks (PSBs) and Private Sector Banks (in respect of loans given by their rural and semi-urban branches only), Small Finance Banks (SFBs) and computerized Primary Agriculture Cooperative Societies (PACS) which have been ceded with Scheduled Commercial Banks (SCBs), on use of their own resources. This interest subvention will be calculated on the loan amount from the date of disbursement/drawal up to the date of actual repayment of the loan by the farmer or up to the due date of the loan fixed by the banks, whichever is earlier, subject to a maximum period of one year. The applicable lending rate to farmers and the rate of interest subvention for the financial years 2022-23 and 2023-24 will be as follows:

<b>Financial Year</b>	<b>Lending rate to farmers</b>	<b>Rate of Interest Subvention to Lending Institutions</b>
2022-23	7%	1.50%
2023-24	7%	1.50%

- (ii) An additional interest subvention of 3 per cent per annum will be provided to such of those farmers repaying in time, i.e., from the date of disbursement of the loan/s upto the actual date of repayment or upto the due date fixed by the banks for repayment of such loan/s, whichever is earlier, subject to a maximum period of one year from the date of disbursement. This also implies that the farmers repaying promptly as above would get short term crop loans and/or short term loans for allied activities including animal husbandry, dairy, fisheries, bee keeping etc. at 4 per cent per annum during the financial years 2022-23 and 2023-24. This benefit would not accrue to those farmers who repay their agricultural loans after one year of availing such loans.
- (iii) Interest subvention and prompt repayment incentive benefits on short term crop loans and short term loans for allied activities will be available on an overall limit of ₹3 lakhs per annum subject to a maximum sub-limit of ₹2 lakhs per farmer in respect of those farmers involved only in activities related to animal husbandry, dairy, fisheries, bee keeping etc. The limit for

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crop loan component will take priority for interest subvention and prompt repayment incentive benefits and the residual amount will be considered towards allied activities including animal husbandry, dairy, fisheries, bee keeping etc. subject to the cap as mentioned above.

### 10.12 Lending to minority communities

RBI *vide* Master Circular No. RBI/2022-23/99 FIDD.GSSD.BC.No.11/09.10.001/2022-23 dated 2<sup>nd</sup> August, 2022 has provided further guidance on requirements of banks to fulfil the sub target of 11.5 per cent to minority sector under the overall PSL target. The circular also includes the list of notified communities, list of minority concentration Districts, requirements on creation of separate cell and roles and responsibilities of lead bank in addition to other guidelines.

### **Audit Approach**

1	Comparative Statement	I) Prepare a comparative chart of expenses as per Profit and Loss Account of current year & previous year and wherever variance is much higher than last year. Variance needs to be addressed. II) Verify that all records are upto date.
2	Expenses & Provisions Verification	Verification of Expenses and Provisions made thereof.
3	Scrutiny of Office Accounts	Verification of Office Accounts - scrutinizing long outstanding entries in Office Accounts.
4	Closure of Previous Auditor's Report	Ensure that previous Audit observations have been appropriately addressed and MOC effects have been given.
5	Verification of Interest Subvention process	Verification of Interest Subvention process - Submission to the RBI, accounting in books of accounts, Receipts from RBI and distribution to branches. Verify and advice reversal of non- recoverable amount.
6	Interest Subvention Certificate	Verification of accuracy and completeness of Interest Subvention Certificate.

7	Non-achievement of priority sector targets	<p>Scheduled Commercial Banks having any shortfall in lending to priority sector shall be allocated amounts for contribution to the Rural Infrastructure Development Fund (RIDF) established with NABARD and other Funds with NABARD/NHB/SIDBI/ MUDRA Ltd. as decided by the RBI from time to time. The achievement will be arrived at the end of the financial year based on the average of priority sector target /sub-target achievement as at the end of each quarter.</p> <p>While computing priority sector target achievement, shortfall / excess lending for each quarter will be monitored separately. A simple average of all quarters will be arrived at and considered for computation of overall shortfall / excess at the end of the year. The same method will be followed for calculating the achievement of priority sector sub-targets. An Illustrative example is given in Annex IV to the RBI Master Direction No. RBI/FIDD/2020-21/72 FIDD.CO. Plan. BC.5/04.09.01/ 2020-21 dated September 04, 2020 (Updated as on October 20, 2022) "Priority Sector lending – Target and Classification".</p> <p>The interest rates on banks' contribution to RIDF or any other Fund, tenure of deposits, etc. shall be fixed by the RBI from time to time. The misclassifications reported by the Department of Banking Supervision of RBI would be adjusted/ reduced from the achievement of that year, to which the amount of declassification/ misclassification pertains, for allocation to various funds in subsequent years. Non-achievement of priority sector targets and sub-targets will be taken into account while granting regulatory clearances/approvals for various purposes.</p> <p>The verification effectiveness of data purification process as well as process of capturing of</p>
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		correct data, related to classification of advances into priority and non-priority through system, should be carried out to ensure effectiveness of system-based control over PSL related data.
8	Directions from Regulatory Authorities charged with Governance	To check various RBI and Government guidelines and actions taken by bank upon the same. Relevant Board notes also to be checked.
9	Review Concurrent Audit Report	<ol style="list-style-type: none"><li>1. Review of Concurrent Audit Report for the changed targets, changed timelines for achieving the target lending.</li><li>2. Ensure that the Concurrent Audit covers observation on calculation of shortfall in lending and contribution to the Rural Infrastructure Development Fund (RIDF) established with NABARD and other Funds with NABARD/NHB/SIDBI/ MUDRA Ltd. as decided by the RBI from time to time.</li><li>3. Review the Concurrent Audit reports in view of other changes brought in by the current Master Direction.</li></ol>
10	Verification of various certificates	Various certificates issued by branch auditors to be verified and collated. Further some broad checks are to be applied to ensure correctness of certificates.

## Law Department

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11.01 The responsibility of the Law Department is ensuring and safeguarding the interest of the bank in all legal aspects during business and proactively identify, interpret and analyses existing as well as new legislations that impact the bank and implement action plans and issue guidelines accordingly.

11.02 Majority of the activities in the Law Department, though, do not directly pertain to the financial reporting, all the activities have indirect impact on the entire bank operations. Therefore, the audit of this Department should be seen from the functional understanding and interpretation of the decisions that may lead to financial reporting and not merely the financial figures of expenses generated through the department.

11.03 The key document w.r.t. the audit of Law Department is the legal policy of the bank. It contains a detailed write-up on the roles, responsibilities and also the manner of execution / implementation. It contains or refers to various documentation to be obtained / executed for various funded and non-funded facilities sanctioned by the bank and the custody, storage of the same as well as the stamping requirements which could vary from State to State. Important documents are scanned and movements of original loan papers need to be tracked.

11.04 The legal policy should be subject to periodic review. The legal Department headed by the Chief Legal Officer is the original compiler and custodian of this policy. The legal team is assisted by various staff centrally as well as at decentralized zonal/Circle, regional or cluster levels. Banks have to ensure that the legal team is adequately staffed and vacancies if any, are promptly filled in by inducting competent resources.

11.05 One of the key functions of the legal team is to have a legal audit conducted for advances over a particular threshold. The threshold varies from bank to bank. This audit is done either pre-sanction or pre-disbursement of the loan amount.

11.06 Further, the bank may establish support legal teams responsible for supporting the legal division of the bank at zone in order to ensure the mitigation and elimination of legal risks while enforcing adherence to all laws and regulations while preserving the Bank's interest.

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11.07 The legal department conducts the title search of the mortgaged premises and ensures that the original title deeds are in order on record. The work is also outsourced to panel advocates. The empanelment of advocates for conducting outsourced work, the detailed due diligence to be done prior to empanelment is all conducted by the legal team. The legal team is also responsible for framing and monitoring the legal outsourcing policy.

11.08 Banks have cases of credit defaults and at various occasions, legal action needs to be initiated against the borrowers for recovery. All legal cases of the bank are handled and co-ordinated by the bank's legal team either internally or through support of the panel advocates.

11.09 The legal team maintains a tracker of all legal cases court wise – date wise which is constantly updated post each case hearing. These updates have to be done timely. As best practice some banks have an online legal tracker updated close to real time. Timelines are also prescribed for updating the case status post the case date.

11.10 While the tracker for time barred debts is monitored at individual branches and also at cluster / regional / zonal/Circle level, in certain banks, the legal team as well monitors this tracker simultaneously.

11.11 The auditor needs to liaise with the legal team to get an updated status on all pending cases, filed by the bank or against the bank. This position has to be obtained with the amount in litigation and also whether the cases have been won or lost in earlier courts and appealed subsequently. Whether a lost case needs to be appealed further and whether the appeal timelines are met are also to be ensured by the legal team. The key discussion with the legal team is to quantify the amount of contingent liability and arrive at the provisioning requirement, if any, thereon. The provisioning of the fees payable to advocates will also have to be arrived at based on the agreements entered with the respective advocates and discussions with the legal team.

11.12 Banks also have a panel of valuers for conducting valuation of securities sanctioned / mortgaged to the bank. The responsibility of appointment of valuers, fixing their appointment terms and conditions is also co-ordinated by the bank's legal team.

11.13 The legal team is responsible for conducting a performance review of the efficiency and effectiveness of the empanelled advocates work. At times, the services of empanelled advocates are discontinued due to work quality and in all these decisions, the legal department is the key co-ordinator. The legal team is also subject to an internal audit review for efficiency and effectiveness.



11.14 The auditor should ensure the following:

- 1) The bank has an updated legal policy in place which is reviewed periodically preferably annually.
- 2) Due diligence for empanelment of panel advocates is done. This panel is reviewed periodically with appropriate evaluation metrics framed. Further, the bank may, at its discretion, take legal assistance of any other legal counsel with due prior approval for the same for matters which may be unusual and / or critical in nature.
- 3) Documentation requirements for each loan facility is established. Documentation is reviewed and amended in view of changing regulations and learnings from various ongoing litigations.
- 4) Tracker of legal cases is maintained court wise, amount wise, stage wise and updated immediately post the date of hearing. Delays, if any, are examined for root cause to ensure timely adherence in future.
- 5) Verify the classification of these legal cases between probable, possible and remote for the purpose of determining the contingent liability or provision as per AS-29, "Provisions, Contingent Liabilities and Contingent Assets (Revised 2016).
- 6) Arrival at the contingent liabilities for court cases, provisioning for legal liability and Debits to Profit and Loss for legal fees is correctly done after due evaluation of the case success probabilities.
- 7) Confirmation from independent lawyer engaged for various legal cases by the bank or against the bank.
- 8) Adverse issues noted in legal audit if any are properly addressed.
- 9) The RBI has directed the banks to undertake Legal Audit of title documents in respect of large value loan accounts (i.e., exposures above Rs. 5 crores) vide circular no. 2012-13/524-DBS.FrMC. BC.No.7/23.04.001/2012-13 dated June 07, 2013. Banks are required to devise the methodology for compliance of the said guidelines.
- 10) If any opinion / consultation is sought from an advocate (either on the panel of the bank or otherwise) the auditor should review / refer the same from the perspective of financial implications and / or compliance related aspects aligned thereto. The auditor may consider the legal opinions sought by the management as one obtained from "Management's Expert" as referred to in 'SA 620 – Using work of an Auditor's Expert' and consider the same appropriately as per the said SA. It would be pertinent to note that the legal opinion / views as referred to by the auditor would not dilute the auditor's sole responsibility for the audit opinion expressed.

## Credit Recovery Department

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### Introduction

12.01 The area of operation / function of the Credit Recovery Department is typically confined to the monitoring of ARBs (Asset Recovery Branches) with major thrust on the areas related to recovery of credit portfolio of the bank. The work scope of this Department may also include handling of recovery through various other mechanisms like NBAs (Non-Banking Assets, Selling of Assets to Asset Recovery Companies (ARCs) whereby upfront cash is realised or Security Receipts (SRs) may be received, Cases under Insolvency and Bankruptcy Code (IBC), One Time Settlement (OTS), upgradation of accounts, etc. The auditor needs to be penetrating in income recognition policies of the bank as regards the order of recovery and income recognition especially with respect to cases wherein the recovery is made in the form of Non-Banking Assets and sale of assets to ARCs.

### Preparation / Planning

12.02 The auditor should get acquainted with the Recovery Policy of the bank and the guidelines of the RBI as regards the accounting and income recognition thereto. The auditor needs to take into consideration the extent of automation of process related to accounting of recovery of credit portfolio of the bank while audit planning.

### Conduct / Execution

12.03 Following aspects need to be checked by the auditor:

- Verify the returns / data from Asset Recovery Branches (ARBs) under reporting of the departments.
- Verify the consistency in income recognition process as regards order of recovery and whether the same is in sync with the internal policy of the bank and is appropriately disclosed in notes on accounts.
- Verify whether income recognition is in compliance with extant RBI guidelines related to income recognition.
- Verify whether the non-performing accounts upgraded during the period under audit are upgraded in compliance with the extant RBI guidelines in this regard.

- Verify whether the income is recognised against recovery especially through NBAs and SRs only to the extent of cash realisation and not to the extent of fair market value of NBAs / SRs as the same is yet to be realised. The auditor should obtain an independent valuation report from the banks and review internal controls of the bank related with periodic valuation and assessment of the Non-Banking Assets<sup>11</sup>. In addition to substantive testing, the auditor should also identify and test management control on periodic valuation of assets held in satisfaction of debt.
- Review and verify as regards the possibility of the deterioration in the value of NBAs and / or requirement of provision for diminishing in the value of NBAs and the policy of the bank in this regard and the disclosure of the same in notes on accounts.
- Verify the accounts upgraded (from NPA to PA) during the period under audit with thrust on the source of funds and the compliance of upgradation norms as per the extant RBI guidelines, including RBI circular no. RBI/2020-21/37 Ref. No. DoS.CO.PPG./SEC.03/11.01.005/2020-21 dated September 14, 2020 on Automation of Income Recognition, Asset Classification and Provisioning processes in banks.
- Verify compliance with Insolvency and Bankruptcy Code w.r.t. the accounts under recovery under IBC mechanism.
- In case any aspect relating to credit recovery is subjected in internal or other audits, the auditor would have to peruse the reports of such audits to identify any audit issues already flagged off.
- In case bank has engaged recovery agents, whether bank has complied with applicable RBI regulations.

### **Reporting / Conclusion**

12.04 Check whether the appropriate disclosure of policy related to recovery especially in terms of order of recovery and NBAs / SRs is made in the 'notes on accounts'.

12.05 Based on adverse audit observations, appropriate reporting is to be ensured in LFAR and / or Audit Report.

Relevant RBI circulars:

1. Master Circular No. RBI/2015-16/100 DBR.No.CID.BC.22/20.16.003/ 2015-16 dated July 1, 2015 on "Wilful Defaulters".

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<sup>11</sup> Refer audit procedure as per SA 500 "Audit Evidence" on use of work of management expert.

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2. Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 dated April 1, 2022 on “Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances”.
3. Circular no. RBI/2020-21/37 Ref. No. DoS.CO.PPG./SEC.03/ 11.01.005/2020-21 dated September 14, 2020 on “Automation of Income Recognition, Asset Classification and Provisioning processes in banks”.
4. Master Direction No. RBI/DOR/2021-22/86 DOR.STR.REC.51/ 21.04.048/2021-22 dated September 24, 2021 on “Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021”.
5. Circular no. RBI/2007-2008/296 DBOD.No.Leg.BC.75 /09.07.005/2007-08 dated April 24, 2008 on “Recovery Agents engaged by banks”.
6. Circular no. RBI/2015-2016/187 DBR.BP.BC.No.41/21.04.048/2015-16 dated September 24, 2015 on “Prudential Norms on Change in Ownership of Borrowing Entities (Outside Strategic Debt Restructuring Scheme)”.
7. Circular no. RBI/2022-23/108 DOR.ORG.REC.65/21.04.158/2022-23 dated August 12, 2022 on “Outsourcing of Financial Services - Responsibilities of regulated entities employing Recovery Agents”.

## Risk Management Department

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13.01 Risk management is a key function in a bank. Banks face various risks in their conduct of business. Bank shall put in place suitable risk mitigation measures. Some of the major risks which the bank faces are:

- 1) Operational risk: Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.
- 2) Credit risk: Credit risk or default risk involves inability or unwillingness of a customer or counterparty to meet commitments in relation to lending, trading, hedging, settlement and other financial transactions.
- 3) Liquidity risk: Liquidity risk is the inability of a bank to meet such obligations as they become due, without adversely affecting the bank's financial condition.
- 4) Market risk: Market risk is defined as the risk of loss arising from movements in market prices or rates away from the rates or prices set out in a transaction or agreement.
- 5) Investment risk: Investment Risk is the uncertainty of losing the invested amount.
- 6) Interest rate risk: Interest Rate Risk is the risk where changes in market interest rates affect a bank's financial position.
- 7) Legal risk: Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.
- 8) Regulatory risk: Regulatory risk is the risk that a change in laws and regulations will materially impact a security, business, sector, or market.
- 9) Reputational risk: Reputational risk is a threat or danger to the good name or standing of a business or entity.
- 10) Financial risk: Financial risk is the possibility of losing money on an investment or business venture.
- 11) Money laundering risk: Money laundering is the illegal process of making large amounts of money generated by criminal activity, such as drug

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trafficking or terrorist funding, appear to have come from a legitimate source. The risk related to the same is Money laundering risk.

- 12) Technology risk: Any risk to information technology or data or applications that negatively impact business operations.
- 13) Product risk: Product risk is the set of things that could go wrong with the service, software or whatever is being produced by the project.
- 14) Concentration risk: A bank's exposures to its counterparties may result in concentration of its assets to a single counterparty or a group of connected counterparties.
- 15) Country risk: Country risk is a risk that denotes the probability of a foreign government (country) defaulting on its financial obligations as a result of economic slowdown or political unrest.
- 16) Social media risk: Banks using social media to market their products should be well equipped in handling social media risks and threats.
- 17) Basis risk: Basis risk is the risk that the interest rate of different assets, liabilities and off-balance sheet items may change in different magnitude.
- 18) Business risk: Business risk is the possibility a company will have lower than anticipated profits or experience a loss rather than taking a profit.
- 19) Strategic risk: Strategic risk is the probability that an event will interfere with a company's business model. A strategic risk undermines the value proposition which attracts customers and generates profits.
- 20) Compliance risk: Compliance risk is an organization's potential exposure to legal penalties, financial forfeiture and material loss, resulting from its failure to act in accordance with industry laws and regulations, internal policies or prescribed best practices. Compliance risk is also known as integrity risk.

13.02 Banks have a Risk Management Department which is responsible for framing a risk policy. The risk policy contains detailed risk guidance on the following:

- 1) Risk identification – Various risk scenarios, existing or emerging to which the bank could be exposed on an end-to-end activity, sub-activity basis. This could be done based both on in depth activity flow chart that captures all in house and outsourced employees or financial accounts opened and impacted.
- 2) Risk assessment – Classification of identified risks based on their probability or likelihood and significance or impact into high, medium or low.

The methodology for risk classification has to be objectively quantified. Alternate risks can also be classified into risk types.

- 3) Risk evaluation – (i) Mapping assessed risks based on current controls designed and in place to mitigate / remediate the risks. Evaluation of risk should also factor in the impact on account of pandemics, floods and other natural calamities and policy changes. (ii) Sector wise risk of the advances portfolio based on the last five years average especially on the agriculture / priority / educational loan.
- 4) Risk monitoring – Periodically reviewing the evaluated risks based on operating effectiveness of the controls to actually identify the status of residual risks or gaps. The auditor is expected to ensure that controls are automated and pro-active. Reactive and manual controls should be pointed out for upgradation or stringent maker-checker.
- 5) Risk response – Post risk evaluation, noting whether overall risks are within the risk appetite and transaction-wise within defined risk tolerances. If risks are beyond the risk appetite, ensuring that they are appropriately responded by strengthening controls to minimize impact to below risk tolerance / appetite acceptable levels. Alternatively, the bank could decide whether to avoid such transactions or get them insured or budget losses appropriately.
- 6) Risk communication – Banks have to ensure that activities have to be done right from the start. Hence, they need to sensitize their employees and make them risk aware and risk ready by proper training.

13.03 The risk policy of the bank will have to be comprehensively compiled and periodically updated. Banks have a risk department headed by a Chief Risk Officer (CRO) whose main responsibility is to ensure adherence to the risk policy in terms of identification, assessment, evaluation, response and communication. Banks have a risk review committee where key existing and emerging risks are discussed brainstormed from control perspective. The RBI vide circular no. RBI/2016-17/294 DBR.BP.BC.No.65/21.04.103/2016-17 dated April 27, 2017 on “Risk Management Systems – Role of the Chief Risk Officer (CRO)” has specified the role and working mechanism related thereto.

13.04 The Risk Management Department is generally centralized with various decentralized support functionaries located zone, region or cluster wise as the case may be. The key aspect is that risk is treated as close to the scene of origination especially operational, credit and money laundering risk.

13.05 The auditor has to primarily ensure that the bank has a formal risk structure in place with a formally approved comprehensive risk policy. The

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auditor should ensure that the bank is in adherence to the policy. Deviations to the policy should have been duly monitored and captured for action.

13.06 The RBI *vide* its circulars have mandated risk-based audit in banks. The auditor should focus on high-risk areas. Audit plan should be based on due risk classification and audit time spent should be commensurate with the risk involved. The auditor should ensure that there is a risk-based audit structure formally in place and review the Risk Based Audit Reports.

13.07 The Basel framework on capital adequacy ratio mandates banks to maintain minimum capital as per their risk weighted assets. Calculation of Capital to Risk-weighted Assets (CRAR) Ratio and continuously monitoring the same to ensure that it is within the minimum regulatory requirement, is also a vital function of Risk Management Department.

13.08 Important points in relation to CRAR that should be noted are:

- 1) Banks are required to maintain a minimum Capital to Risk-weighted Assets Ratio (CRAR) of 9 per cent on an on-going basis. In addition to this, outside the period of stress, banks are also required to maintain Capital Conversion Buffer (Comprised of Common Equity) at 2.50 per cent of RWAs.
- 2) Credit Risk, Market Risk and Operational Risk together determine the amount of minimum eligible capital to be maintained by the bank as per the regulatory requirements.

$$\text{Total Capital (CRAR) (\%)} = \frac{\text{Eligible Total Capital}}{\text{Credit Risk RWA} + \text{Market Risk RWA} + \text{Operational Risk RWA}}$$

- 3) Minimum Total Capital (MTC) of 9 per cent of Total Risk Weighted (RWAs) is further divided into different components.

<b>Sr. No.</b>	<b>Regulatory Capital</b>	<b>As % to RWAs</b>
(i)	Minimum Common Equity Tier 1 Ratio	5.50%
(ii)	Capital Conservation Buffer (comprised of Common Equity)	2.50%
(iii)	Minimum Common Equity Tier 1 Ratio plus Capital Conservation Buffer [(i)+(ii)]	8.00%
(iv)	Additional Tier 1 Capital	1.50%
(v)	Minimum Tier 1 Capital Ratio [(i) +(iv)]	7.00%



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(vi)	Tier 2 Capital	2.00%
(vii)	Minimum Total Capital Ratio (MTC) [(v)+(vi)]	9.00%
(viii)	Minimum Total Capital Ratio plus Capital Conservation Buffer [(vii)+(ii)]	11.50%

- 4) The auditor should ensure that calculation of RWAs for each type of risks i.e. credit, market and operational has been done as per the detailed methodologies contained in RBI Master Circular No. RBI/2022-23/12 DOR.CAP.REC.3/21.06.201/2022-23 dated 01<sup>st</sup> April, 2022 on Basel III Capital Regulations.
- 5) Further, for the calculation of RWAs for credit risk, the auditor should ensure that for all the entities with unhedged foreign currency exposures and having ratio of likely loss/EBID(percentage) in excess of 75 per cent, there is 25 per cent increase in the risk weight as a part of Incremental capital requirement.
- 6) For the calculation of RWAs for credit risk, the ratings assigned by the eligible external credit rating agencies (wherever available) are largely used while assigning risk weights for capital adequacy purposes. Accordingly, the auditor has to ensure that the latest external credit rating has been updated and used for this purpose.
- 7) For the calculation of Market Risk also external credit ratings are used to determine the risk weight (percentage). Along with this, applicable RW (percentage) varies based on the residual maturity of the investment. Thus, the auditor has to ensure that for each investment correct external rating and residual maturity has been taken.
- 8) Banks generally have investment in other banks' capital instruments such as bonds, equity shares etc. Risk weight (percentage) in these cases is based on the level of common equity Tier 1 capital (CET1) including applicable capital conservation buffer (CCB) (percentage) of the investee bank. In these cases, the auditor shall ensure that the level of CET1 & CCB has been taken as per the reported level in the latest quarterly results of the investee bank.
- 9) RBI vide circular no. RBI/2021-22/106 DOR.CAP.REC.No.56/21.06.201/2021-22 dated October 4, 2021 has provided clarification on amount capital funds that can be raised overseas.

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The “eligible amount” for the purpose of issue of PDIs in foreign currency as per para 1.16 (ii) of Annex 4 to the RBI Master Circular No. RBI/2022-23/12 DOR.CAP.REC.3/21.06.201/2022-23 dated 01<sup>st</sup> April, 2022 on Basel III Capital Regulations, would mean the higher of:

- (a) 1.5 per cent of Risk Weighted Assets (RWAs); and
- (b) Total Additional Tier 1 capital as on March 31 of the previous financial year.

Not more than 49 per cent of the “eligible amount” as above can be issued in foreign currency and/or in rupee denominated bonds overseas.

- 10) The RBI has issued revised guidelines vide RBI/2021-22/118 DOS.CO.PPG.SEC No.4/11.01.005/2021-22 dated November 02, 2021 on Prompt Corrective Action (PCA) framework. Leverage has been introduced as one of the parameters for invocation of PCA. Hence the indicators to be tracked are Capital, Asset Quality and Leverage RBI has also released three types of risk thresholds with mandatory and discretionary actions. Breach of any risk threshold below may result into invocation of PCA.

<b>PCA matrix – Parameters, indicators and risk thresholds</b>				
<b>Parameter</b>	<b>Indicator</b>	<b>Risk Threshold 1</b>	<b>Risk Threshold 2</b>	<b>Risk Threshold 3</b>
(1)	(2)	(3)	(4)	(5)
<b>Capital (Breach of either CRAR or CET 1 ratio)</b>	CRAR – Minimum Regulatory prescription for Capital to Risk Assets Ratio + applicable Capital Conservation Buffer(CCB)	Upto 250 bps below the Indicator prescribed at column (2)	More than 250 bps but not exceeding 400 bps below the Indicator prescribed at column (2)	In excess of 400 bps below the Indicator prescribed at column (2)
	<b>and/or</b>			
	Regulatory Pre-Specified Trigger of Common Equity Tier 1 Ratio (CET1)	Upto 162.50 bps below the Indicator prescribed at column (2)	More than 162.50 bps below but not Exceeding 312.50 bps	In excess of 312.50 bps below the Indicator prescribed at column

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	PST)+applicable Capital Conservation Buffer(CCB)		below the Indicator prescribed at column (2)	(2)
	<b>Breach of either CRAR or CET 1 ratio to trigger PCA</b>			
<b>Asset Quality</b>	Net Non-Performing Advances NNPA ratio	>=6.0%but <9.0%	>=9.0%but <12.0%	>=12.0%
<b>Leverage</b>	Regulatory minimum Tier1 Leverage Ratio	Upto 50 bps below the regulatory minimum	More than 50 bps but not exceeding 100 bps below the regulatory minimum.	More than 100 bps below the regulatory minimum

13.09 In addition to the above the auditor has to verify that:

- 1) The bank has a formally defined risk appetite and risk tolerance levels are fixed transaction wise.
- 2) Risk identification based on what can go wrong on an end to end activity wise basis is conducted considering the organization structure, functions and responsibilities. The bank should be maintaining a formal risk register for the same which has to be updated periodically.
- 3) Risk identification is an ongoing, periodic activity.
- 4) Risk assessment or classification of risks into risk types or high-medium-low or on a much detailed scale is comprehensively done.
- 5) Existing controls are mapped to risks.
- 6) Trainings on risk awareness is conducted amongst employees.
- 7) Gaps which are beyond risk appetite / risk tolerance are addressed. Timelines and the manner of addressing along with risk owner are identified. Open risk items should be duly tracked. Proper escalation mechanisms should be in place to highlight open items.

- 8) Risk policy is periodically updated and reviewed.
- 9) Minutes of Risk Committee Meetings are duly recorded in a timely manner.
- 10) Effectiveness of IT system/IT infrastructure including Management Information Systems is maintained.

13.10 Any risk deviations noted are to be appropriately discussed with the management or appropriate risk committee members and duly reported in the Long Form Audit Report as the case may be.

### **Frauds**

13.11 While the primary responsibility for identification, resolving/closing and preventing frauds lies with banks themselves, the RBI has been advising banks from time to time about the major fraud prone areas and the safeguards necessary for prevention of frauds. Banks are required to introduce necessary safeguards / preventive measures by way of appropriate procedures and internal checks so as to prevent/minimize occurrence of frauds and resultant financial loss to the banks.

13.12 The CEOs of the banks are supposed to provide singular focus on the "Fraud Prevention and Management Function" to enable, among others, effective investigation in fraud cases and prompt as well as accurate reporting of fraud cases to the appropriate regulatory and law enforcement authorities including the RBI. Banks are required to frame their internal policy for fraud risk management and fraud investigation function with the approval of their respective Boards. The auditor should refer SA 240, "The Auditor's Responsibilities relating to Fraud in an Audit of Financial Statements" in this regard.

### **Classification**

13.13 Frauds are classified, mainly on the basis of the provisions of Indian Penal Code (IPC), as under:

- a) Misappropriation and criminal breach of trust.
- b) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
- c) Unauthorized credit facilities extended for reward or for illegal gratification.
- d) Cash shortages.
- e) Cheating and forgery.

- f) Fraudulent transactions involving foreign exchange.
  - g) Any other type of fraud not coming under the specific heads as above.
- 13.14 As regards cases under (d) and (f) above cash shortages resulting from negligence and fraudulent forex transactions involving irregularities / violation of regulations have also to be reported as fraud if the intention to cheat/defraud is suspected or proved.
- 13.15 Cases will be deemed to be fraud and reported in the following circumstances:
- a) Cases of cash shortage of more than Rs. 10,000/-.
  - b) Cases of cash shortage of more than Rs. 5,000/- if detected by management / auditor/ inspecting officer and not reported on the day of occurrence by the persons handling cash.
- 13.16 Other points to be considered while reporting fraud are:
- a) Frauds involving forged instruments have to be reported only by the paying banker whereas collection of a genuine instrument fraudulently by a person who is not the true owner, the collecting bank, which is defrauded, will have to file fraud report with the RBI.
  - b) Collection of an instrument where the amount has been credited before realization and subsequently the instrument is found to be fake/ forged and returned by the paying bank, the collecting bank is required to report the transaction as fraud with the RBI as they are suffering a loss by parting with the amount.
  - c) Collection of an altered/fake cheque involving two or more branches of the same bank, the branch where the altered/fake cheque has been encashed is required to report the fraud to its H.O. for further reporting to the RBI by the H.O.
  - d) An altered/fake cheque having been paid/ encashed involving two or more branches of a bank under Core Banking Solution (CBS), the branch which released the payment is required to report the fraud to its H.O. for further reporting to the RBI.
  - e) Cases of theft, burglary, dacoity and robbery are not treated as fraud but are required to be reported separately to the RBI.

- f) Banks (other than foreign banks) having overseas branches/offices are required to report all frauds perpetrated at such branches/offices to the RBI.

## **Reporting**

### **Reporting of Frauds to RBI (FMR)**

#### **13.17 All Frauds Irrespective of the Amount**

- Fraud including in the subsidiaries and affiliates/joint ventures of the banks perpetrated through those in misrepresentation, breach of trust, manipulation of books of account, fraudulent encashment of instruments like cheques, drafts and bills of exchange, unauthorised handling of securities charged to the bank, misfeasance, embezzlement, misappropriation of funds, conversion of property, cheating, shortages, irregularities, etc.
  - Cases under criminal proceedings initiated by central investigating agencies *suo motu* and/or where the RBI has directed the bank to treat the acts as frauds.
  - In case of all frauds irrespective of the amount, banks are required to send soft copy of the reports (FMR/B) to be reported through FMR application in XBRL system supplied to them within three weeks from the date of detection of fraud.
  - A monthly certificate, in prescribed format to be submitted by bank to CFMC, Bengaluru with a copy to the respective SSM of the bank within 7 days from the end of the month.
  - Banks are also required to furnish a Flash Report(FR) for frauds involving amounts of Rs.50 million and above within a week of such fraud being noticed.
  - Any further developments in fraud cases are to be reported through FMR update application in XBRL system.
- a) Frauds Committed by Unscrupulous Borrowers.** Such frauds include:-
- Fraudulent discount of instruments or kite flying in clearing effects.
  - Fraudulent removal of pledged stocks/disposing of hypothecated stocks without the bank's knowledge/inflating the value of stocks in the stock statements and drawing excess bank finance.
  - Diversion of funds outside the borrowing units, lack of interest or criminal neglect on the part of borrowers, their partners, etc. leading to the unit becoming sick as also due to laxity in effective monitoring / supervision over

the operations in borrower accounts on the part of the bank functionaries rendering the advance difficult to recover.

- Banks are supposed to exercise due diligence while appraising the credit needs of all borrowers, borrower companies, partnership/ proprietorship concerns and their directors, partners and proprietors, etc. as also their associates who have defrauded the banks. Banks should ensure appraisal of credit proposal considering the genuine requirements of the working capital based upon the turnover achieved / turnover projected Besides the borrower fraudsters, other third parties such as builders, vehicle/tractor dealers, warehouse/cold storage owners, etc. and professionals are also to be held accountable if they have played a vital role in credit sanction/ disbursement or facilitated the perpetration of frauds. Banks are required to report to Indian Banks Association (IBA) the details of such third parties involved in frauds.

Most of the frauds in advances are perpetrated by the borrowers mainly due to the slackness in monitoring and control of borrower accounts.

**b) Frauds in Borrower Accounts having Multiple Banking Arrangements (MBA)**

- All banks under MBA arrangement are required to evolve a system of exchanging information on fraud committed by the borrower so as to take appropriate action including criminal action against the borrower.
- Banks are required to evolve an operating framework for tracking frauds and dealing with them.
- It is not necessary that the fraud may take place in all the banks which are the members of the consortium. However the information should be shared with the members of the consortium when the fraud takes place in one bank.
- The time taken to report the fraud also needs to be monitored.
- CRILC reported accounts can be checked regularly for its classification with other banks.

**Provisioning Pertaining to Fraud Accounts**

13.18 Banks are required to prescribe a uniform provisioning norm in respect of all cases of fraud, as under:

- (a) The entire amount due to the bank (irrespective of the quantum of security held against such assets), or for which the bank is liable (including in case of deposit accounts), is to be provided for 100 per cent or over a period not

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exceeding four quarters commencing with the quarter in which the fraud has been detected;

- (b) Where there has been delay, beyond the prescribed period, in reporting the fraud to the RBI, the entire provisioning is required to be made at once. In addition, the RBI may initiate appropriate supervisory action where there has been a delay by the bank in reporting a fraud, or provisioning against therein.

### ***Closure of Fraud Cases***

13.19 Banks shall report to CFMC, RBI and the SSM (Senior Supervisory Manager) of RBI, the details of fraud cases of ₹0.1 million and above closed along with reasons for the closure after completing the process as given below.

13.20 Banks should close only such cases where the actions as stated below are complete and prior approval is obtained from the SSM:

- a) Cases pending with CBI/Police/Court have been finally disposed off.
- b) Staff accountability has been examined/ completed.
- c) Amount involved in the fraud has been recovered or written off.
- d) Insurance claim wherever applicable has been settled.
- e) Bank has reviewed the systems and procedures and taken steps to avoid recurrence.
- f) Banks should also pursue vigorously with CBI for final disposal of pending fraud cases especially where the banks have completed staff side action, etc.

### **Reports to the Board**

#### ***Reporting of Frauds***

13.21 Banks need to ensure that all frauds of Rs. 1 lakh and above are reported to their Boards promptly on their detection. Such reports should, among others, contain the failure on the part of the concerned branch officials and controlling authorities and consider initiation of appropriate action against the officials responsible for the fraud.

Information relating to frauds for each quarter end are to be placed before the Audit Committee of the Board of Directors. Further report on individual cases of attempted fraud involving an amount of Rs. 10 million and above is to be placed before the Audit Committee of its Board.



### ***Quarterly Review of Frauds***

13.22 Information relating to frauds are to be placed before the Audit Committee of the Board of Directors on quarterly basis ending March, June and September with statistical analysis. The auditor is supposed to read the minutes of all such meetings and ensure the appropriate accounting and disclosure in the financial statements.

13.23 Banks are required to constitute a Special Committee consisting of CMD of public sector banks and MD in respect of SBI/its associates for monitoring and follow up of cases of frauds involving amounts of Rs. 1 crore and above exclusively. The main function of the Committee would be to monitor and review all the frauds of Rs. 1.00 crore and above and to put in place, among others, measures as may be considered to prevent recurrence of frauds such as strengthening of internal controls, etc.

### **Annual Review of Frauds**

13.24 Banks are required to conduct an annual review of the frauds and place a note before the Board of Directors/Local Advisory Board for information. The review would take into account, among others, whether the systems in the bank are adequate to detect frauds once they have taken place within the shortest possible time.

### **Early Warning Signals (EWS) and Red Flagged Accounts (RFA)**

13.25 A “Red Flagged Account” (RFA) is one where a suspicion of fraudulent activity is thrown up by the presence of one or more Early Warning Signals (EWS).

The threshold for EWS and RFA is an exposure of Rs. 50 crores or more at the level of a bank irrespective of the lending arrangement (whether solo banking, multiple banking or consortium). All accounts beyond Rs. 50 crores classified as RFA or ‘Frauds’ must also be reported on the CRILC data platform together with the dates on which the accounts were classified as such.

The FMG or any such designated committee shall classify the account as RFA and the details of RFA accounts shall be put up to the CMD/CEO every month.

In cases where the bank is the sole lender, the FMG will take a call on whether an account in which EWS are observed should be classified as RFA or not. This exercise should be completed as soon as possible and in any case within a month of the EWS being noticed. Further within a period of 6 months, banks should either lift the RFA status or classify the account as a fraud.

In case of multiple banking/consortium the overall time allowed for the entire exercise to be completed is six months from the date when the first member bank reported the account as RFA or Fraud on the CRILC platform.

The auditor should refer RBI circular no. RBI/2014-15/590 DBS.CO.CFMC. BC.No.007/ 23.04.001/ 2014-15 dated May 7, 2015 relating to the framework for dealing with loan frauds.

### **Guidelines for Reporting Frauds to Police/CBI**

13.26 While reporting the frauds, banks are required to ensure that, besides the necessity of recovering the amount expeditiously, the guilty persons do not go unpunished.

#### ***Private Sector Banks/Foreign Banks (Operating in India)***

13.27 All cases are required to be referred to State Police including:

- a) Cases of fraud involving an amount of Rs. 1 lakh and above committed by outsiders on their own and/or with the connivance of bank staff/officers.
- b) Cases of fraud involving amount exceeding Rs. 10,000 committed by bank employees.
- c) Fraud cases involving amounts of Rs. 1 crore and above should also be reported to the Serious Fraud Investigation Office (SFIO), GOI, in FMR-format.

#### **Public Sector Banks**

##### ***13.28 Cases to be referred to CBI***

- a) Cases of fraud involving amounts of Rs. 3 crores and above upto Rs. 25 crores:
  - Where staff involvement is prima facie evident - CBI (Anti Corruption Branch).
  - Where staff involvement is prima facie not evident- CBI (Economic Offences Wing).
- b) All cases involving amounts more than Rs. 25 crores but less than Rs. 50 crores - Banking Security and Fraud Cell (BSFC) of CBI.
- c) All cases involving amounts more than Rs. 50 crores - Joint Director (Policy) CBI, HQ, New Delhi.

**13.29 Cases to be referred to Local Police**

Fraud involving Rs. 1 Lakh and above but less than Rs. 3 Cores	Compliant to be filed with Regional Head of the bank to State CID/Economic Offences Wing of State concerned
Below Rs. 1Lakh but above Rs. 10,000/- (if committed by staff)	Local Police Station by the branch
Below Rs. 10,000 involving bank officials	Reported to Regional Head of the bank to decide on further course of action
Frauds involving forged instruments	By paying banker to Local Police
Fraudulent encashment of DD/TTs/Pay orders/ Cheques/ DWs, etc.	Local Police concerned
Collection of genuine instrument, but collected frequently by a person who is not the owner	Collecting Bank to Local Police concerned
Payment of uncleared instrument which is found to be fake/forged and returned by the paying bank	Collecting Bank to Local Police
Collection/payment of altered/fake cheque involving 2 or more branches of the same bank	Branch where the cheque was encashed to the Local Police

**Reporting of Cases of Theft, Burglary, Dacoity and Bank Robberies**

13.30 In respect of theft, burglary, bank robberies etc., the bank needs to do the following:

- Occurrence of any bank robberies, dacoities, thefts and burglaries are required to be reported immediately by Fax/e-mail to:
  - a) CFMC, Bengaluru.
  - b) The SSM of the bank.
  - c) RO of DBS under whose jurisdiction the affected bank branch is located to enable the Regional Office to take up the issues regarding security arrangements in affected branch/es during the State Level Security Meetings with the concerned authorities.

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- d) The Security Adviser, Central Security Cell, Reserve Bank of India, Central Office Building, Mumbai - 400 001.
- e) Ministry of Finance, Department of Financial Services Government of India, Jeevan Deep, Parliament Street, New Delhi-110 001.
- Banks are also required to submit a quarterly return to RBI electronically using the XBRL system within 15 days of the end of the quarter the incident relates to.

13.31 The auditor has to consider the above, assess the quantitative and qualitative factors and confirm whether the bank has complied with the above provisions. The auditor should also refer SA 240, "The Auditor's Responsibilities relating to Fraud in an Audit of Financial Statements" in this regard.

### **Audit Methodology**

13.32 The auditor has to verify:

- 1) That there is a policy on frauds in place which is reviewed and updated at periodic intervals. This policy has been circulated on the bank Intranet and employees are sensitized to the fraud policy.
- 2) Periodic anti-fraud training and awareness sessions are in place.
- 3) Whistleblower hotlines are in place and are functioning effectively. The auditor may go through the whistle blower complaints and on sample basis test how the management has dealt with the same, especially from fraud perspective.
- 4) Fraud risk scenarios are identified and current anti- fraud controls noted and mapped to fraud risks. Measures are put in place to prevent significant gaps.
- 5) The bank's zero tolerance policy for fraud or ethical violations are made known to all employees. FAQs to be in place to answer questions on conflict of interest or ethical violations.
- 6) Policy of swift dismissal / termination of employees found guilty of fraud is in place.
- 7) There are automated systems / surveillance systems to detect fraud and alerts.
- 8) Mechanism for early detection and reporting of incidents of frauds are in place.
- 9) Back ground screening checks for employee joining are in place.

- 10) There are periodic anti-fraud communications and care taken to prevent frauds / money laundering.
- 11) Auditor to examine the robustness of anti-fraud controls and staff accountability, especially from the relevance and its impact thereof on Financial Statements.
- 12) Mechanism for reporting to the RBI are effectively in place.
- 13) Fraud is clearly identified. Policies for reporting on fund diversions, siphoning off of funds and wilful defaults are in place.
- 14) Auditors should examine Action Taken Report (ATR) in respect of all red flagged accounts / fraud accounts.
- 15) If the auditor notes adverse issues, the same have to be discussed at appropriate levels of the management. Necessary reporting will have to be done in the long form audit report or the main audit reports as the case may be.
- 16) Auditors should refer to Chapter 6, 'Audit of Information Technology and Digital Banking Division' of Section A of the Guidance Note on Audit of Banks (2023 Edition) for paragraph on Fraud Risks involving Digital Banking.

## **Vigilance**

13.33 The Chief Vigilance Officers in the banks have been authorised to decide upon the existence of a vigilance angle in a particular case, at the time of registration of the complaint. Once a complaint has been registered as a vigilance case, it will have to be treated as such till its conclusion, irrespective of the outcome of the investigation. The investigation is to be headed by a senior resource person and adequately, competently staffed.

13.34 Key functions of the Vigilance Department include the following:

- Handling of complaints received from various quarters, examining the matter from vigilance angle and advising competent authority to take suitable disciplinary action.
- Determination/checking of existence of vigilance angle based on the findings/lapses indicated in investigation reports, inspection reports, Special Reports, fraud reports, accountability reports on advances which have slipped to NPA, etc., and communicating the same to disciplinary authorities, through HR Wing, for further action as per procedure.

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- Seeking the advice of Central Vigilance Commission (CVC) as per the norms in respect of vigilance cases involving officials who come under the jurisdiction of CVC and communicating the advice to disciplinary authorities for further action.
- Conducting intensive examination of works/purchase contracts as per norms and ensuring implementation of CVC guidelines on tender procedures in the bank.
- Finalising agreed list with CBI and preparation of list of Officers of Doubtful Integrity (ODI), and ensuring surveillance on such officials whose names appear in agreed list/ODI. Co-ordinating with CBI on all matters of vigilance investigations referred to them by the bank and providing assistance to CBI.
- Scrutiny of staff accountability reports in case of advances of large value.
- Ensuring implementation of guidelines of CVC, RBI and the Ministry in matters relating to Vigilance.
- Submitting Board notes/ review notes to the Board of Directors, Committee of Directors, Audit Committee and Chairman and Managing Director in respect of vigilance matters and also various returns to CVC, RBI, CBI and Ministry.

13.35 Generally, vigilance angle could be perceptible in cases characterized by:

- (i) commission of criminal offences like demand and acceptance of illegal gratification, possession of disproportionate assets, forgery, cheating, abuse of official position with a view to obtaining pecuniary advantage for self or for any other person; or
- (ii) irregularities reflecting adversely on the integrity of the public servant; or
- (iii) lapses involving any of the following:
  - (a) gross or willful negligence;
  - (b) recklessness;
  - (c) failure to report to competent authorities, exercise of discretion without or in excess of powers/jurisdiction;
  - (d) cause of undue loss or a concomitant gain to an individual or a set of individuals/a party or parties; and
  - (e) flagrant violation of systems and procedures.

13.36 In banking institutions risk-taking forms an integral part of business. Once a vigilance angle is evident, it becomes necessary to determine through an

impartial investigation as to what went wrong and who is accountable for the same.

13.37 Information about corruption, malpractices or misconduct on the part of public servants may come to the CVO's notice through various sources, such as:

- (i) Complaints received from the public, or through the administrative Ministry, CBI and the CVC;
- (ii) Departmental inspection reports and stock verification surveys;
- (iii) Scrutiny of property returns and the transactions reported by the concerned employee under the Conduct Rules;
- (iv) Audit reports;
- (v) Press reports; and
- (vi) Reports of Parliamentary Committees etc. Information received verbally should be reduced to writing and dealt with similarly.

13.38 The vigilance department acts upon all such complaints and conducts a detailed investigation. Periodic meetings are held with the respective committees and cases are discussed with the top Management of the bank. The SCA is expected to read the minutes of the meetings and understand the complaints and the actions taken upon them by the CVC/vigilance department. The details of the individual cases should be ascertained and the same can be discussed with the CVO and his department by the SCA. It is essential that the SCA arrives at a proper judgement over the cases and concludes its proper accounting/disclosure in the financial statements.

### **Risk Management Limits and Monitoring**

13.39 Risk is a function of probability and impact. Risk management is an important function in banks. Banks have a separate risk management department and a committee. The department is responsible for identifying key risks, assessing, evaluating, monitoring and responding to risks. The risk committee ensures that the risk oversight is adequate and effective. Design of automated Controls and its effective and efficient implementation and execution to pro-actively remediate and mitigate the risks is monitored in an ongoing manner.

13.40 One of the key aspects in risk monitoring is setting up of limits and ensuring that these are not breached. These are tolerance levels within which the activities have to be conducted. Limits ensure control. Any breach in the limits needs to be escalated, ratified and approved at appropriate levels. The limits are duly framed in respective policies and reviewed from time to time.

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Some limits are framed by the RBI itself while some limits are set up by banks internally.

13.41 Limits are also in place for reporting purposes as transactions over a particular threshold need to be reported to either RBI, FIU or the Income Tax authorities.

13.42 Banks have limits in place for various activities namely:

- 1) Advances – Single Borrower and Group Borrower exposure details – Priority Sector lending – Unsecured Advances – Minimum Provisioning – conduct of stock audits – obtaining end use and other certifications – obtaining second valuations.

Recovery of NPA advances is a major area for concentration and action. This requires constant follow up with legal and other support for expeditious settlement. Auction of the properties offered as security is to be attempted more vigorously.

- 2) Investments – Held to maturity securities / available for sale securities / non SLR securities – creation of investment fluctuation / depreciation reserve / investments made in Government securities / venture capital fund.
- 3) Borrowing limits.
- 4) Transfers to statutory and other mandatory reserves.
- 5) Cash reserve ratio – Statutory liquidity ratio limits.
- 6) Overseas foreign currency borrowing limits including overdrafts in Nostro accounts adjusted in 5 days.
- 7) Limits under various AP-DIR circulars - Reporting in XOS-BEF statements.
- 8) Treasury – Open limits, aggregate gap limits, individual gap limits, counterparty limits, settlement limits, and currency limits.
- 9) Country risk only in respect of country where a bank's net funded exposure is 1 per cent or more of its total assets, the bank is required to formulate the CRM policy for dealing with that country risk problem.
- 10) Obtaining PAN for cash transactions over a determined threshold.
- 11) Remittances under liberalized remittance scheme (LRS).
- 12) Legal audit and verification of title deeds for loans over Rs. 5 Crores – conducting due diligence reporting.
- 13) RTGS transactions – Minimum amount should be over Rs. 2 lakhs.



- 14) NEFT transactions have no limits. Earlier banks had certain time restrictions but now the RBI has instructed that these facilities be available 24 hours.
- 15) Parameters are in place for automated transaction monitoring and breach of these limits throws system alerts which are white washed or validated. Exceptions are reported in the Suspicious Transactions Report. Banks also have to report transactions in Cash transaction reports, Cross Border Wire Transfer Report, Counterfeit Currency reports and Non-Profit organization transaction reports.
- 16) Banks also have internal monitoring thresholds and any breach of these parameters is reported as exceptional transactions in Exception Reports which are generated and monitored daily.
- 17) Cash retention limits - Limits on amount of cash withdrawals at other than home branch with / without charges – Cash deposits other than home branches – ATM amount withdrawn per day.
- 18) Reporting under FATCA-CRS.
- 19) Limits for fraud reporting.
- 20) Annual information reporting.
- 21) Reporting to credit information companies as stipulated in the RBI.
- 22) Reporting to Central Repository of Information on Large Credits.

13.43 This list is not an exhaustive list and the auditor should look into various RBI – FEMA - CBDT circulars / bank's internal policies for the list of limits to be monitored and reported.

13.44 The auditor should primarily obtain a list of all limits which the bank is monitoring for internal control purposes or reporting purposes authority wise.

13.45 In the absence of such a list, the auditor will have to primarily report the non- existence of such a list as an issue.

13.46 The auditor should examine the process for compilation of this list and how these limits are monitored. An automated system should ideally be in place. Where the monitoring is done manually, stringent maker-checker process controls should be in place which should operate effectively and efficiently at all times.

13.47 Deviations or discrepancies noted should be reported appropriately in the Long Form Audit Report or duly qualified in the accounts, if necessary, as the case may be.

## Central Audit and Inspection Department

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### Introduction

14.01 The Central Audit and Inspection Department (CAID) in banks is a combination of various centralized functions with some level of decentralization at the Cluster, Regional or Zonal level. The structure may vary from bank to bank. Banks have their own Audit Manual, Audit Policy or Audit Charter. The CAID is generally headed by General Manager(s) / Chief General Manager(s) / Senior Executive(s). Designations may vary from bank to bank. The primary function of CAID is to ensure that the Audit/Inspection function is carried out smoothly, effectively and efficiently so as to curb any delays in timelines thereof.

14.02 The functions of CAID are as under, but are not limited to:

- 1) Scoping the audit – deciding who does what, how and when – maintaining an audit calendar and ensuring that it is communicated and adhered to, as scheduled.
- 2) Identification of branches to be subjected to concurrent/ revenue audit.
- 3) Appointment of concurrent auditors, deciding their scope, meeting the concurrent auditors, discussing their issues, conducting trainings if needed, and review their work. Ensuring that RBI guidelines on concurrent audit are well communicated between bank officials and adhered to.
- 4) Closely interacting with Credit Risk Management Department (CRMD), Chief Compliance Officer, etc., to monitor the effectiveness of their functioning.
- 5) Undertaking Risk-Based Internal Audit (RBIA) as per the framework as stipulated by the RBI.
- 6) Ensuring that the audit function follows a RBIA approach in accordance with RBI guidelines. Audit issues need to be approached from the angle of lack of control and supervision / fraud / potential weakness in the accounts / sector / system.
- 7) Closure of open audit issues within the stipulated timelines. Tracking long pending audit issues for timely closure.

- 8) Ensuring that statistical information and other inspection and audit related agenda of Audit Committee are properly framed. Minutes of the audit committee are read before Board and followed properly for the compliance.
- 9) Placing summary of internal / concurrent audit reports of branches / divisions / departments / verticals before the Audit Committee/ Management Committees, as the case may be. Ensuring actions suggested by the Audit Committee are duly followed and closed.
- 10) Conducting various audits internally like Branch audits, Functional audits like human resources, information technology, review of risks and compliance functions for effectiveness and efficiency, MIS reviews etc.
- 11) Conducting application audit of newly adopted software applications (either developed in house or vendor procured), updated versions of existing application software, modules, patches, programs before its release/implementation by using web-based Application Audit Package on specific requests from concerned functional groups and follow-up for closure of these audit reports.
- 12) Ensuring that the internal audit team is well equipped, trained and is kept abreast of circulars and regulatory directions issued by various regulators from time to time.
- 13) Co-ordinating with RBI inspectors or statutory auditors.
- 14) Ensuring that the audit function is automated and adopts the latest techniques and procedures.
- 15) Review risk rating of branches, whenever a fraud is reported in between two RBIA's.
- 16) Co-ordinating with the Department dealing with frauds for de-risking.
- 17) Laying down parameters for risk-based audit. Deciding risk classification in co-ordination with Risk / Business department.
- 18) Attend to processes relating to transfer, promotion, deputation and disciplinary matters of Inspecting Officers.
- 19) Laying internal metrics for evaluating efficiency and effectiveness of audit function and getting it validated externally and internally.
- 20) Close co-ordination with the Chairman of Audit Committee or similar functionary for ensuring effective audit oversight.

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- 21) Ensuring that other audits like stock audits, revenue audits, legal audits, information security audits, cyber security audits are duly planned, conducted and the process gaps noted therein are resolved timely.
- 22) Ensuring that the Audit Policy, Audit Manual or Audit Charter are duly reviewed annually.

14.03 The Internal Audit and Inspection function, over the years, has shifted from the traditional transaction verification to the process driven risk-based audit. The focus is on doing things right from the start. The key is ensuring that there are no gaps, and gaps, if any, are closed within acceptable time frames. The auditor should examine the system of concurrent / internal audit along with follow-up / compliance / remedial corrective action taken, with reference to the bank's internal policy related thereto.

### **Audit Approach**

14.04 The SCAs should review whether the CAID is effectively discharging its duties and functions enumerated above. SCA needs to co-ordinate with the CAID Head and validate the various audit processes. The validation could be done by a combination of transaction and system-process checks for ascertaining efficiency and effectiveness. Any shortcomings or gaps noted if material have to be escalated and reported appropriately in the LFAR. The SCAs should take the summary presented to the Board of Directors (Audit Committee/Management Committee) and review the compliances by the branch/Department. Follow up report by the CAID on the compliances should be reviewed. Cases of false compliances need to be escalated. All observations which change the risk rating of the SCAs need to be escalated to the joint auditors and a collective decision is to be arrived at. Appropriate documents also are required to be maintained.

14.05 The SCAs shall review the criteria set by the Department for selection of branches for the purpose of concurrent / internal / audit. The SCAs shall also review the selection of branches under audit and check that no branch that ought to have been covered (owing to its level of operation) under audit has been missed.

14.06 In addition to this, the SCAs shall verify that special function departments / divisions / verticals such as Forex Department, Treasury Department, Fixed Asset Department etc. are also covered under the scope of Internal Audit with adequate attention being given in terms of factoring in the eligibility and qualification of the person carrying internal audit of these specialised branches.

14.07 The scope of Concurrent / Internal Audit Reports is to be understood in detail to review whether there is any area that needs the attention of the auditor not already covered within the scope of the audit.

14.08 The SCAs shall also go through the reports of concurrent auditors of key branches/ functions on test check basis. SCAs shall review the system audit reports, revenue audit reports, stock audit reports, internal inspection reports, Unit Inspection Reports, Agency for Specialised Monitoring (ASM) reports and Credit Audit Reports. The scope, frequency and quality of such reports have to be looked into and commented appropriately. The SCA should review as to whether the short comings / adverse remarks within such reports have been duly and promptly attended to and corrective measures have been taken and monitored by bank. A summary of critical observations presented before the Board of Directors may be sought by the SCA and compliances thereof be reviewed along with follow-up action. A summary of serious irregularity pending for rectification may be included in the LFAR/communication to the ACB/TCWG in accordance with SA 260 (Revised), "Communication with Those Charged with Governance".

14.09 In some bank/s the concurrent audit function has been centralised at the Zonal/controlling office basis and multiple branches are audited by one concurrent auditor. The SCAs should review the functioning and efficiency of the concurrent audit in such case and include as a part of LFAR, comments if any on the scope and coverage of the concurrent audit system. The comments on the efficiency may also be communicated to ACB/TCWG.

14.10 The SCAs should go through RBI Inspection reports (Generally the management shares relevant portion of RBI Inspection report, only for reading, accordingly, the same should be mentioned in LFAR). These are sensitive, confidential reports for internal consumption and the SCAs should ensure that these findings are noted for adherence/ compliance. RBI inspection report provide various information on the control and management of the bank.

14.11 The focus is on systems, processes and a root cause analysis to find out what could go wrong, what went wrong and what preventive/ corrective actions can be taken-up by the management so as to minimize or eliminate the recurrence of the same.

14.12 The SCAs could attend Audit Committee meetings to better understand how the meetings are held, issues are discussed and resolved.

14.13 The SCAs should review the scope of work assigned in the reporting format for the concurrent audit of branches and other departments at HO and to ensure that there is adequate coverage of the working of the branch / related

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department, if not then may be reported in LFAR of the bank and may discuss with the respective department in the HO and / or major observation with the Audit Committee.

14.14 The SCAs should also go through the Minutes of the Board and Management Committee meetings to understand the functioning of the audit process and matters having impact on overall financial statement presentation and deal with such matters appropriately.

# 15

## Credit Monitoring and Restructuring Department

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### Introduction

15.01 The Credit Monitoring & Restructuring Department (CMRD), as the name suggests is a credit monitoring hub of the entire bank. Like many other departments at HO, CMRD too does not carry any financial activity. The sanctioning and operations of credit takes place at the respective branches and designated departments.

15.02 This Department is expected to keep a close watch over the health of the credit portfolio and to ensure that funds lent are safe and bring returns, and the lending is done as per internal policy guidelines and RBI guidelines.

15.03 In every bank, a monitoring policy is framed to equip the field functionaries with effective tools of monitoring so that various risks associated with the lending are identified and remedial measures initiated well in time so as to maintain quality asset.

15.04 The monitoring policy at the holistic level is an embodiment of the bank's approach at making the systems and controls more effective so that credit risks are managed in a systematic and effective manner.

15.05 The monitoring policy is reviewed every year keeping in view the inputs received from Branches/ROs/ZOs, experience gained, and to update the regulatory requirements.

15.06 The CMRD also monitors the special mention accounts (SMA 1 & 2) above a certain limit fixed internally by the bank. The overdue statements generated by the bank are closely monitored and necessarily followed up to the concerned department/ Branch or officer done through this Department.

15.07 Further in some banks, this department may be responsible for sanctioning of restructuring of advances. During the last few years in order to give relief to MSMEs, RBI has introduced restructuring schemes for stressed MSMEs without a downgrade in asset classification, and hence a large number of MSME accounts were given the benefit of these schemes and restructured. Further, this Department may also be responsible for calculation of the additional provision required for the restructured portfolio and sacrifice calculations.

## **Audit Approach**

15.08 It may be observed that all the activities of the CMRD are in the nature of controlling and compliance. This Department is also responsible for implementation of the bank's policies w.r.t monitoring and restructuring. It is necessary that the Statutory Central Auditor (SCA) familiarises with the functions of the CMRD and draws up the audit plan accordingly.

## **Credit Monitoring**

15.09 The CMRD is responsible for monitoring the credit portfolio independently and interact with the Zones/ Regions and Branches for the follow up. In particular, this department performs the following functions:

- Closely monitoring the overall overdues statement generated by the bank, particularly overdues above certain limits.
- Review of High risk rated accounts and providing periodic review notes to MD&CEO in respect of accounts under monitoring.
- Review of "Quick Mortality Accounts" and placing review notes before the Board of Directors/Audit Committee.
- Review of statement of expired credit limits and progress report on renewal of credit limits periodically and placing a note before the higher authorities as per extant guidelines.
- Ghosh Committee Recommendation – advances showing sticky tendencies above a certain limit to be monitored.
- Stock Audit report review in respect of accounts under monitoring as a part of monitoring exercise.
- Review of adhoc credit facility not regularized.
- To monitor effective implementation of Credit Audit System in the bank.

15.10 While undertaking supervision, monitoring and control over the credit portfolio, the SCA may be required to undertake certain tests with a different perspective and keeping in mind the overall materiality. Keeping in view their significance from the regulator's perspective following transactions may be selected for checking at the HO level:

1. Any account in the bank having exposure (funded and non-funded) which is more than Rs. 2000 crores across banking sectors.
2. Accounts against whom NCLT proceedings are initiated either by the bank, or any other financial creditors or the operational creditors.
3. List of SMA accounts having exposure of Rs. 50 crores and above.



4. Regarding “Red Flagged Accounts” the auditor may refer RBI circular no. DBS.CO.CFMC. BC. No.007/23.04.001/2014-15 dated May 7, 2015 on “Framework for dealing with loan frauds”.
5. Cases under vigilance or investigation for fraud: These are typically the ones not reported as fraud and hence not available with Fraud monitoring department.
6. List of upgraded accounts in the branch above Rs. 1 Crore.
7. Checking of Central Repository of Information on Large Credits (CRILC) reported accounts for classification with other banks.
8. Restructured project loans, by way of revision of DCCO beyond the time limits and retention of the ‘standard’ asset classification.
9. Large exposures on infrastructure and project funding where there is considerable time lag from the date of sanction / financial closures / implementation to the date of commercial operation; effective / periodic monitoring of such accounts with reference to the progress of work / project implementation / Government consents and approvals / capital required to be brought in by the promoter, etc.

It is necessary to keep the following developments in mind while conducting CMRD audit:

### **Market Mechanism for Large Borrowers**

15.11 Regarding the market mechanism for large borrowers the SCAs are required to bestow their attention on the following:

- Guidelines issued on August 25, 2016, effective from April 1, 2017.

15.12 Key aspects of this mechanism are discussed hereunder:

- **Aggregate Sanctioned Credit Limit (ASCL)** - It is aggregate of the fund based credit limits sanctioned or outstanding, whichever is higher, to a borrower by the banking system. ASCL would also include unlisted privately placed debt with the banking system.
- **Specified Borrower:** A borrower having an ASCL of Rs. 10,000 crores or more at any time from April 1, 2019.
- **Reference Date:** The date on which a borrower becomes a ‘specified borrower’.
- **Normally Permitted Lending Limit (NPLL):** Fifty per cent of the incremental funds raised by the specified borrower over and above its ASCL as on the reference date, in the financial years (FYs) succeeding the

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FY in which the reference date falls. For this purpose, any funds raised by way of equity shall be deemed to be part of the incremental funds raised by the specified borrower (from outside the banking system) in the given year.

- **Prudential Measures for NPLL:** Additional provisions of 3 percentage points over and above the applicable provision on the incremental exposure of the banking system in excess of NPLL, which shall be distributed in proportion to each bank's funded exposure to the specified borrower.
- Additional Risk weight of 75 percentage points over and above the applicable risk weight for the exposure to the specified borrower. The resultant additional risk weighted exposure, in terms of risk weighted assets (RWA), shall be distributed in proportion to each bank's funded exposure to the specified borrower.

### **Loan System for Delivery of Bank Credit**

15.13 The SCA should note the following:

- Guidelines made effective from April 1, 2019.
- Banks provide working capital finance by way of cash credit/overdraft, working capital demand loan, purchase/discount of bills, bank guarantee, letter of credit, factoring, etc. Cash credit (CC) is by far the most popular mode of working capital financing.
- While CC has its benefits, it also poses several regulatory challenges such as perpetual roll overs, transmission of liquidity management from the borrowers to banks/RBI, hampering of smooth transmission of monetary policy, etc.
- Refer RBI circular no RBI/2022-23/27 DOR.CRE.REC.23/21.08.008 /2022-23 dated April 19, 2022 on "Opening of Current Accounts and CC/OD Accounts by Banks".
- Refer RBI circular on RBI/2022-23/111 DOR.CRE.REC.66/21.07.001/2022-23 dated September 02, 2022 on "Digital Lending".
- Refer RBI Master Circular No- RBI/2022-2023/97 FIDD.CO.GSSD.BC.No.10/09.09.001/2022-23 dated August 01, 2022 on "Credit facilities to Scheduled Castes (SCs) & Scheduled Tribes (STs)".
- Refer RBI Master Circular No - RBI/2022-23/14 DOR.CRE.REC.No.07/21.04.172/2022-23 dated April 01, 2022 on "Bank Finance to Non-Banking Financial Companies (NBFCs)".
- Refer RBI Master Circular No - RBI/2022-23/16 DOR.CRE.REC.No.06/08.12.001/2022-23 dated April 01, 2022 on "Housing Finance".

- Refer RBI Master Circular No - RBI/2022-23/92 FIDD.GSSD.CO. BC.No.09/ 09.01.003/2022-23 dated July 20, 2022 on “Deendayal Antyodaya Yojana - National Rural Livelihoods Mission (DAY-NRLM)”.
- Refer RBI Master Direction No. RBI/DOR/2021-22/89 DoR.FIN.REC.95/ 03.10.038/2021-22 dated March 14, 2022 (Updated as on July 25, 2022) on “Reserve Bank of India (Regulatory Framework for Microfinance Loans) Directions, 2022”.

### **Restructuring of MSME Accounts**

15.14 In order to give relief to stressed MSMEs the RBI has introduced one-time restructuring of MSME Accounts subject to conditions as mentioned in circular no. DBR.No.BP.BC.18/21.04.048/2018-19 dated 01<sup>st</sup> January, 2019. This scheme was valid till 31<sup>st</sup> March 2020.

15.15 On 11<sup>th</sup> February, 2020, the RBI vide circular no. DOR.No.BP.BC.34/ 21.04.048/2019-20 decided to extend the validity of the above Scheme till 31<sup>st</sup> December, 2020.

15.16 Further, in view of the continued need to support the viable MSME entities on account of the fallout of Covid 19, the RBI vide circular no. DOR.No.BP.BC/4/ 21.04.048/2020-21 dated 6<sup>th</sup> August, 2020 on “Micro, Small and Medium Enterprises (MSME) sector – Restructuring of Advances” extended the restructuring scheme notified vide circular dated 11<sup>th</sup> February, 2020 till 31<sup>st</sup> March, 2021. Further, vide circular no. DOR.No.BP.BC/13/ 21.04.048/2020-21 dated 7<sup>th</sup> September, 2020, the RBI has stipulated certain key ratios while finalizing the resolution plans in respect of eligible borrowers.

15.17 Further, with uncertainties created by the resurgence of the Covid-19 pandemic in India, the above facility for restructuring existing loans without a downgrade in the asset classification was extended vide RBI circular no. RBI/2021-22/32 DOR.STR.REC.12/21.04.048/2021-22 dated May 5, 2021 on Resolution Framework 2.0 – Resolution of Covid-19 related stress of Micro, Small and Medium Enterprises (MSMEs) and revision in the threshold for aggregate exposure vide RBI circular no. RBI/2021-22/47 DOR.STR.REC.21/ 21.04.048/ 2021-22 dated 04<sup>th</sup> June, 2021 has been made subject to the following additional conditions:

- a. The borrower should be classified as a micro, small or medium enterprise as on 31<sup>st</sup> March, 2021 in terms of the Gazette Notification S.O. 2119 (E) dated 26<sup>th</sup> June, 2020, read along with RBI circular on “New Definition of Micro, Small and Medium Enterprises” dated 25<sup>th</sup> June, 2021 and the circular on “New Definition of Micro, Small and Medium Enterprises - Addition of Retail and Wholesale Trade” dated 07<sup>th</sup> July, 2021.

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- b. The borrowing entity is GST-registered on the date of implementation of the restructuring. However, this condition will not apply to MSMEs that are exempt from GST-registration. This shall be determined on the basis of exemption limit obtaining as on 31<sup>st</sup> March, 2021.
- c. The aggregate exposure, including non-fund based facilities, of all lending institutions to the borrower does not exceed ₹50 crores as on 31<sup>st</sup> March, 2021.

15.18 The RBI circulars clearly mentioned that accounts which have already been restructured in terms of the circulars dated August 6, 2020, February 11, 2020 and January 1, 2019 or circular no. DOR.No.BP.BC/3/21.04.048/2020-21 dated August 6, 2020 on “Resolution Framework for COVID-19-related Stress” shall be ineligible for restructuring under the circular dated 05<sup>th</sup> May, 2021.

15.19 The SCA should ensure that the accounts restructured as per the above-mentioned scheme satisfy all the conditions stipulated in the respective circulars issued by the RBI. In addition to that it should be verified that no MSME account is restructured more than once under this Scheme and also ensure the adequacy of provisions as per stipulated guidelines.

### **Restructuring of Accounts**

15.20 The following two aspects are integral parts of the department audit:

- Sacrifice calculations at the end of the period.
- Additional provisioning of the overall restructured portfolio.

These calculations are generally not being done by the CBS system of the bank at branches level.

### **Other Aspects**

15.21 The SCA should also obtain copies of inspection and other internal audit reports and latest Long Form Audit Report of this Department which covers the efficiency of various functional operations.

15.22 Any deviations or discrepancies noted should be appropriately reported in the Long Form Audit Report and major observations need to be discussed with the management / respective committees in the bank.

# 16

## Consolidation and Balance Sheet Preparation

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16.01 The preparation of the financial statements in case of a bank is significantly different as compared to the preparation of the financial statements of companies. The Third Schedule to the Banking Regulation Act, 1949 has prescribed Form A (Format of Balance Sheet) and Form B (Format of Profit and Loss Account). These two formats have been prescribed as per Section 29 of the Banking Regulation Act, 1949.

16.02 The RBI issued Master Direction No. RBI/DOR/2021-22/83 DOR.ACC.REC.No.45/ 21.04.018/2021-22 dated August 30, 2021 (Updated as on February 20, 2023) on Financial Statements – Presentation and Disclosures. This Master Direction (MD) supercedes the earlier directions on this subject. Members may refer Chapter VII of this Master Direction where the various circulars issued since inception, which stand repealed after issue of this MD have been listed in Annexure V. Besides the MD on disclosures, RBI regularly issues notifications and guidelines on other disclosures, from time to time and the same also need to be considered while preparing the FS of banks.

16.03 The process of verification of the financial statements by SCA is divided into following phases:

- A. Preparation of Standalone Financial Statements including consolidation of the branches, centralized departments and other accounting units, Role of SBA and SCA.
- B. Preparation of Consolidated Financial Statements (including subsidiary, associates, joint venture), Role of SCA.

### **A. Standalone Financial Statements including Branch Consolidation**

16.04 The preparation of the Standalone Financials of the bank is primarily the responsibility of the management and involves the consolidation of branch accounts and incorporation of various verticals/departments at the bank. The consolidation of branch accounts (audited and unaudited) is one of the important and sensitive aspects of the financial statements of a bank. Preparation of the

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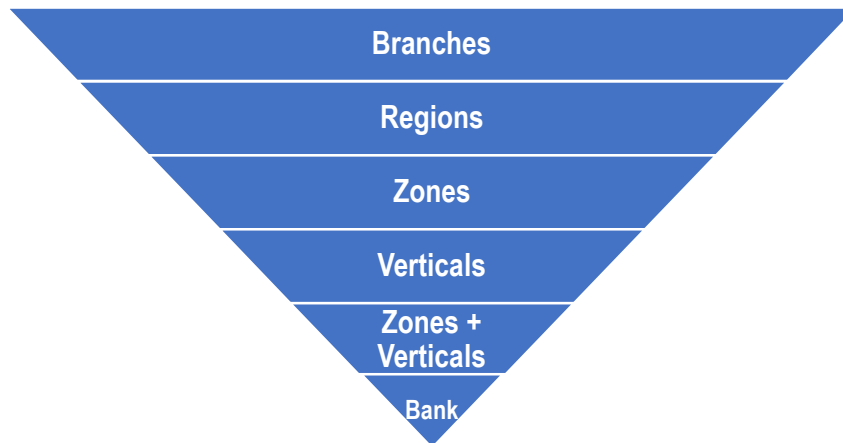
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consolidated financial statements of the bank (after consolidation of accounts of branches) is the responsibility of the bank's management.

16.05 The following documents audited by the SBA are consolidated at the bank level:

- Balance Sheet
- Profit and Loss Account
- Other statements, reports and returns on the classification of advances, provisioning, fixed assets, statements of contingent liabilities
- LFAR (Long Form Audit Report)
- Ghosh Committee compliance certification
- Jilani Committee compliance certification
- Tax audit report (in many banks this function is now centralized)
- Various other certificates like assets classification, fixed assets, bills payable, sundries, credit subventions, unhedged foreign currency exposure of borrowers etc.
- Memorandum of Changes (MOC)

### **Process of consolidation**



16.06 The consolidation process depends upon the structure of a bank and the level of centralization it has. Generally, this process always starts from branch level and the accounts of branches get consolidated at the respective

regional office and those of all regional offices get consolidated at the respective Zonal office and all zonal offices accounts get consolidated at Head Office along with those of various departments at the Head Office. In case of Private Banks, the consolidation process is centralized at the Head office since the systems and processes of accounting are all centralised and there is no concept of branch audit by branch auditors.

16.07 All banks are on CBS, which is a transaction recording application across the branch network. As output, it can only give a Trial Balance. All financial Statements and reports as required by SBI Act, Banking Regulation Act, BCA Act, RBI, SEBI Act and the Companies Act are prepared with the help of another application where the data flows from various sources including CBS. The data from the CBS flows without manual intervention, but that may not be true for .the financial statements of associates, subsidiaries and joint ventures. Different banks follow different applications/systems for preparing financial statements under the financial reporting framework. Also the level of automation of this consolidation process varies from bank to bank. Usually the CFSs are prepared by manual eliminations of inter group transactions.

16.08 Bank managements generally follow the under-mentioned process for the purpose of consolidation:

**Step 1**

**Data for the Financial Statements as on 31<sup>st</sup> March**

16.09 At the year-end i.e., 31<sup>st</sup> March, the bank provides the financial data to the statutory auditor in the form of various reports, returns, Branch Balance Sheet, Profit and Loss Account and department trial balance for the purpose of the audit.

**Step 2**

**Audit Adjustments through Memorandum of Changes (MOC)**

16.10 There are two types of financial statements, pre-MOC, i.e., the original data and post-MOC, i.e., after giving the effect of accounting entries suggested by the SCA (which is known as MOC). The effect of these MOCs are not fed in the live data but are recorded on a different software at appropriate consolidation level and are considered for the purpose of giving the financial impact in the closing financials. Usually pre-MOC data is provided immediately after the reporting date and the post-MOC data is usually provided after audit at branches and HO is done and after incorporating MOC impact. MOC could be of rectification in nature or could impact income/provision recognitions, amortization, classification and disclosure.

16.11 Banks have varied mechanisms of posting the effects of the MOC's in the financial statements. e.g. in few banks all MOCs suggested at branches get consolidated and recorded at Controlling Offices (Regional / Zonal / Circle offices) and MOCs of Controlling Offices gets consolidated at the Head Office.

16.12 In this way, MOCs get recorded in the parallel software e.g. ROSS, ADF at all levels of the bank. For making changes in the financial statements there must be a MOC approved by the SBA. Therefore, there will be a MOC for the difference between pre-MOC financial statements and post-MOC financial statements. All MOC should be approved either by SBA or SCA. It is also a good audit practice to reconcile both the pre and post-MOC data with the MOC.

***Accounting of Effect of MOCs in Live Data***

16.13 After the financial statements get approved and signed with all changes the MOCs get accounted in live data. For example, the financial statements for the financial year 2021-22 get approved and signed on 30<sup>th</sup> April, 2022, then on that day or on any other day with value date of 30<sup>th</sup> April, 2022, all MOCs will be accounted in the live data in CBS. Thus, if an account is marked as NPA by way of MOC during the audit, the same would be effected as NPA in the system from that day with date of NPA being the date as per the MOC suggested by the auditor.

**Step 3**

**Consolidation at Controlling Office (CO)-Regional Office/Zonal Office**

16.14 *The process involves the following:*

1. Branches can be either audited branches or unaudited branches depending on the limits prescribed and advance coverage decided by the management.
2. The branch financial statements are generated by the Information Technology department (ITD) or Central data Centre (CDC) and sent to the branches along with other returns and reports. These are used for audit by the SBA. These statements once signed by the concerned bank official (with or without MOC) are submitted to the regional office (RO) or Zonal office (ZO) for further processing and consolidation. Where there are MOCs the financial statements will be signed as given by the ITD but will carry the effect of MOC in parallel to be consolidated at ZO.
3. Similarly, the RO/ZO/CO standalone financial statement is prepared and consolidated like a branch. Regional, zonal and controlling offices are cost centres and SCA will be called upon to certify its financial statements.
4. Controlling Office accounts get consolidated and adjustments, if any, are made at regional level. The Controlling Office is a cost centre and the



auditor has to certify the financial statements of the Controlling Office in addition to the consolidation of the branches under the relevant Controlling Office.

***Audit Approach***

1. SCA for a Controlling Office should verify the completeness of the data uploaded by the branches into the system. However, this consolidation process is automated at most of the banks and the auditor should verify various controls adopted by the controlling office management to ensure the completeness. One way to ensure the completeness is to generate Regional Level/Zone Level/Bank level Trial Balance/GLB from the CBS and to map it with the consolidated GLB as generated by the Data Centre.
2. SCA should obtain reasonable assurance and sufficient appropriate audit evidence of the adjustments made if any at the controlling office level for the accounts which are audited by the SBA. The SCA may also communicate with SBAs in case they need any clarifications of issues raised during branch audit.
3. SCA should also reconcile and verify the effect of the branch MOC's which are consolidated and effected at the controlling office by comparing the pre and post MOC data with the recon of MOC passed.
4. SCA may communicate to the SBAs, the requirements regarding process of consolidation for the current year, about the significant observations from the previous year's audit, quarterly reviews and additional precautions, modifications in Audit Program required considering the recent RBI circulars. This communication can be circulated along with the closing instructions to SBAs.
5. SCA should ensure on sample basis if all the documents as required by the respective banks have been taken at each level of consolidation i.e. appropriate flow of data along with the required documents.
6. SCAs are also required to verify the consolidation of various certificates/returns which are audited by the SBAs; the SCA should clearly bring out his/her responsibility while issuing the report at the CO level.
7. The SCA should go through the audit reports of SBAs regarding the branches audited by them and also document, how they have dealt with the observation/modifications by the respective SBAs.

***Consolidation Process at Head Office***

16.15 *The consolidation process is as under:*

At Head Office level all the Controlling office data is consolidated (including HO

Departments) and further adjustments if any are made, ensuring the accuracy of the data uploaded at each stage of hierarchy. Further, the financial information from various other departments are also consolidated and incorporated in the Financial Statements e.g. Gratuity, Pension, Leave encashment, etc. are audited by the vertical auditor and are consolidated while preparing the financial statements.

Also various provisions such as provision on standard assets, restructured accounts, stress sector provision are computed and provided at the head office level.

The SCAs have to verify the full set of financial statements, including cash flow statement, other disclosures as per the applicable Accounting Standards, the Banking Regulation Act, Companies Act, SEBI and any other applicable regulations.

***Audit Approach to be followed by the Consolidating Auditor***

16.16 The consolidating auditor should do the following:

1. Understand the various processes and systems used by the bank for preparation and presentation of the financial statements.
2. Verify the various checks and controls placed by the bank to identify any unusual entries or any other difference.
3. Ensure the completeness as well as accuracy of the data at the whole bank level. However, the responsibility of the consolidating auditor is to verify the accuracy of the data consolidated from the various returns/financial information which are audited by the auditor of various departments/verticals.
4. Obtain reasonable assurance and sufficient appropriate audit evidence of the adjustments made, if any, at the bank level.
5. Since the SCA would have access to the complete financial statements, it is important that they apply analytical procedures including comparison and variance analysis with reasons.
6. Ensure that, if the data being consolidated is from a source other than the CBS in use, then the figures as per the trial balance from CBS matches with the detailed schedule prepared from the data of that different source including GL balances. For instance, if a different software is used for Fixed Assets accounting, the trial balance (CBS) and schedule of Fixed Assets figures (other software) should match.

16.17 The consolidating auditor should also examine the following key additional aspects:

- a. Check the effect of MOC from previous year/reporting period are properly accounted.
- b. Reversal of interest on inter-branch balances, internal transfer pricing entries and other similar items.
- c. Elimination of inter branch transactions like transfers of assets among branches etc.
- d. Review the observations made by the SBAs in audit report and LFAR; however, such review is done by the respective auditors of controlling office. Where the SBA has made comments which should normally be reported through a MOC, the SCA is well advised to insist on MOC rather than make the changes based on the report. The MOC must come signed from the SBA who reported the deviation.
- e. Effect of Memorandum of Changes (MOC) if any made at head office.
- f. Provision for tax, employee benefits, Standard Assets, Fraud Provision and Other Provisions.
- g. Review of MOCs to ascertain whether there are systemic issues or deficiencies which need to be addressed by the management.
- h. Review of Inter office accounts and other GL in the other assets and other liabilities.
- i. Review of other disclosures, including contingent liabilities and other off balance sheet items.

***IT Controls***

16.18 Significant and voluminous data is involved during this whole process of consolidation. Consolidation being an automated system driven process, the auditor should verify if the IT controls of the bank are present and operating effectively. The auditor should also review the system audit report available with the bank with respect to the system used for the purpose of preparation of the financial statement. Any exceptions and human interventions in the system of preparation of financial statements should be verified and dealt with appropriately by the SCA.

16.19 The application that is used for consolidation is mainly departmental and sometimes the ITD may not have full control over its functions. In many banks this process is automated but there could be an end user application like MS Excel or some simple addition software that is used. It, therefore, requires

higher level of vigilance on the part of SCA to ensure that the possibility of material misstatements are removed by testing vigorously.

***Consolidation of Overseas Branches***

16.20 While consolidating the overseas branches the auditor should examine the following aspects:

- a. Various reports of the overseas branches would be received in the local currencies of the reporting countries which need to be converted into 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 Rates.
- c. As per AS 11 (Revised), 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".
- d. It is advisable to receive an audited set of financial statements from the overseas branches converted into Indian Rupees and certified elimination transactions.
- e. Whenever specific difference in opinion arises among the auditors, the SCAs would take a final view. Continuing difference, if any, could be sorted out in prior consultations with RBI, if necessary.
- f. The auditor may also review the compliance with the applicable local laws and regulations of the concerned country by the overseas branches. The auditor should also review the report given by the overseas branch auditor to identify the areas of concerns.
- g. The auditor should also verify the process of translation from the foreign currency to the presentation currency and ensure that the consistent process have been followed by the bank over a period.
- h. The asset classification and provisioning on the loans are done as per the local rules of the respective branches or as per RBI IRAC norms whichever are stringent; The auditor should ensure that the stricter norms of the two (local or RBI mandated) have been followed by the bank at the time of consolidation.
- i. The auditor should have issued audit instructions to the overseas branch auditor for various compliances/control at the respective branches. The

response needs to be considered and further information, if necessary should be sought.

- j. Many jurisdictions require the branches to report their financial statements under local GAAP like IFRS etc. In such cases the SCA will require IGAAP financial statements certified by the auditor for the consolidation purposes.
- k. The Consolidating auditor should also take a confirmation from the overseas branch auditor that both the branch and HO have adopted common accounting policies. The SCA should also send out Group Reporting Instructions (GRI) to the overseas' auditor.

***Notes and Instructions for Compilation***

16.21 The RBI *vide* Master Direction No. RBI/DOR/2021-22/83 DOR.ACC.REC.No.45/ 21.04.018/2021-22 dated August 30, 2021 (Updated as on February 20, 2023) on Financial Statements – Presentation and Disclosures has given a guideline on notes and instructions on compilation of financial statements. The said guideline is compiled in Annexure II. Part A of the annexure contains general instructions for the compilation of Balance Sheet and Profit and Loss Account for Commercial Banks as also UCBs. Part B of Annexure II specifies guidance with respect to relevant issues in the application of certain Accounting Standards for Commercial Banks. It shall be applicable *mutatis mutandis* to UCBs, unless stated otherwise in the said Annexure.

***Disclosure in Standalone Financial Statements:***

16.22 The consolidating auditor is also required to verify various disclosures made in the financial statements as required by Master Direction No RBI/DOR/2021-22/83 DOR.ACC.REC.No.45/ 21.04.018/2021-22 dated August 30, 2021 (Updated as on February 20, 2023) on Financial Statements – Presentation and Disclosures:

- 1. Annexure III to the above said Master Direction is about disclosures in the financial statements. These disclosures are intended only to supplement and not to replace disclosure requirements under other laws, regulations, or accounting and financial reporting standards. More comprehensive disclosures than the minimum required under these Directions are encouraged, especially if such disclosures significantly aid in the understanding of the financial position and performance.
- 2. The Master Direction requires the bank to give various disclosures in Annual Accounts. Some of these disclosures are audited and certified by the auditor of various department/verticals. However, there are certain disclosures which are prepared and are to be verified by the consolidating

auditor e.g. Employee Benefits as per Accounting Standard 15, Segment Reporting as per Accounting Standard 17, and Earning Per Share as per Accounting Standard 20. The consolidating auditor should carefully review these disclosures and ensure their compliance as per the Master Directions.

**B. Consolidated Financial Statement (including Subsidiary, Associates and Joint venture)**

16.23 The PSB's and Private Sector Banks in India are listed on recognised stock exchanges and are required to comply with the SEBI Regulations including Listing Obligations and Disclosure Requirements (LODR) as issued and amended on time to time basis.

16.24 As per Regulation 33 of SEBI LODR Regulations, the listed entities are required to prepare the standalone financial results, and consolidated financial results shall be prepared as per generally accepted accounting principles in India. Further, a new sub-regulation was inserted under Regulation 33 of the SEBI LODR Regulations, which came into effect from April 01, 2019 requiring the entities to prepare consolidated financial results on quarterly basis.

16.25 The Master Direction on Consolidated Financial Statements (not applicable to LABs, RRBs and UCBs) provides as under:

1. The Master Direction gives the formats prescribed in Annexure IV in which CFS are to be prepared. The CFS shall also be submitted to the Department of Supervision (DOS), Reserve Bank of India within one month from the publication of the bank's annual accounts.
2. CFS shall be prepared in terms of the applicable accounting standards. For the purpose of financial reporting, the terms 'parent', 'subsidiary', 'associate', 'joint venture', 'control', and 'group' shall have the same meaning as prescribed in the applicable accounting standards. A parent presenting CFS shall consolidate all subsidiaries - domestic as well as foreign, except those specifically permitted to be excluded under the applicable accounting standards. However, the reasons for not consolidating a subsidiary shall be disclosed in the CFS. The responsibility of determining whether a particular entity shall be included or not for consolidation would be that of the Management of the parent entity. The statutory auditors shall mention in their audit report, if they are of the opinion that an entity which ought to have been consolidated has been omitted.
3. In cases where different entities in a group are governed by different accounting norms laid down by the concerned regulator/s, the balance

sheet size may be used to determine the dominant activity and accounting norms specified by its regulator may be used for the consolidation of similar transactions and events. Where banking is the dominant activity, accounting norms applicable to a bank shall be used for consolidation purposes in respect of like transactions and other events in similar circumstances. The SCA should verify the reclassification and disclosure of items of financial statements of entities within the group which are regulated by other regulators based on their nature.

4. An RRB shall be treated as an associate in the CFS of its sponsor bank.
5. Investments in Joint ventures and associates should be consolidated as per the applicable Accounting Standards. The valuation of investments in subsidiaries that are not consolidated and associates that are not included using the "Equity Method" shall be as per the relevant valuation norms issued by the RBI.
6. The Board of Directors of banks shall invariably record the intent of holding the investment for a temporary period or otherwise at the time of investment in the subsidiary, associate and joint venture. In the absence of a record of such intent by the Board at the time of such investment, the investee entity shall be consolidated into the CFS.
7. RBI directions regulate the holding of banks in other subsidiaries and provides guidance on accounting treatments and valuation. SCAs should verify the eliminations of inter group transactions.
8. The SCA should verify the audit reports of respective component auditors and document how they have dealt with the modifications/observations in their audit reports and whether any of them are material enough to also include in the audit report of the CFS.

### **Responsibility of a Bank**

16.26 The responsibility for the preparation and presentation of CFS is that of the bank's management. This responsibility, *inter alia*, includes:

1. Identifying components including financial information.
2. Identifying reportable segments.
3. Identifying related party transactions.

The responsibility of determining whether a particular entity shall be included or not for consolidation would be that of the Management of the parent entity.

## **Responsibility of the Statutory Central Auditor**

16.27 It is necessary for the auditor to take into consideration the Accounting Standards relevant for the purpose of CFS. They are AS 21, “Consolidated Financial Statements”, AS 23, “Accounting for Investments in Associates in Consolidated Financial Statements” and AS 27, “Financial Reporting of Interests in Joint Ventures”. Further, careful consideration should be given by the auditor of CFS to the Other Matters paragraph, Emphasis of Matter paragraph and Modified Opinion in the report issued by the component auditors. The auditor should also refer Guidance Note on Audit of Consolidated Financial Statements (Revised 2016) issued by ICAI for guidance in auditing the CFS.

16.28 When the parent bank’s auditor makes a reference to the auditor’s report of the other auditors in the auditor’s report on CFS, the latter should disclose clearly the magnitude of the portion of the financial statements audited by the other auditor(s) in the “Other Matter” paragraph. This may be done by stating the rupee amounts or percentages of total assets and total revenue of subsidiary(ies) included in CFS not audited by the parent’s auditor.

16.29 However, reference in the report of the auditor of CFS to the fact that part of the audit of the group was made by other auditor(s) is not to be construed as a modification of the opinion. With reference to SEBI circular no. CIR/CFD/CMD1/44/ 2019 dated March 29, 2019 the auditor should also consider the implications on reporting if some of the components are unaudited<sup>12</sup>.

16.30 Generally, while conducting audit of a bank, the SCA has a practice of issuing general instructions for the SBAs to facilitate easy consolidation of branch accounts. It would be appropriate to have a similar approach with respect to auditors of components, if the component auditors are different from the group auditor. This is especially important in case of “the other financial information” which is necessary for the purpose of consolidation and preparation of notes. It is advisable to make sufficient arrangements for co-ordination and efforts at the planning stage.

## **Audit of Consolidated Financial Statements**

16.31 The auditor should carefully review the following while auditing the consolidated financial statements:

- Accounting policy of the bank and its various components.

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<sup>12</sup>Attention in this regard is drawn to the Announcement on “Manner of Disclosure in the Auditor’s Report of the Fact of Inclusion of Unaudited Financial Statements/ Information of Component/s in the Financial Statements Audited by the Principal Auditor(s)” issued by ICAI in February, 2014.



- Any subsidiaries, associates and joint ventures of the bank not consolidated under CFS.
- Changes in the shareholding that might have taken place since the last audit.
- Any new additions/deletions of entities within the group during the reporting period and its impact to the CFS.
- The SCA should also carry out a regular impairment testing on investments in subsidiaries, Joint Ventures and Associates as per the requirements of Accounting Standard at every reporting date.

16.32 The SCAs should ensure that the CFS is prepared using uniform accounting policies for matters like transactions and other events in similar circumstances. If it is not practicable, the fact shall be disclosed together with the proportions of the items in the CFS to which the different accounting policies have been applied.

16.33 For preparing the CFS using uniform accounting policies, the banks shall rely on a Statement of Adjustments for non-uniform accounting policies, furnished by the statutory auditors of the subsidiaries.

16.34 The Standard on Auditing (SA) 580, "Written Representations" requires the auditor to obtain written representations from the management and where appropriate those charged with governance. Such representations would include:

- Completeness of components included in the CFS.
- Identification of reportable segments for segment reporting.
- Identification of related parties and related party transactions for reporting.
- Areas where the SCA has relied on the management's estimates and judgment.

Appropriateness and completeness of consolidation adjustments, including the elimination of intra-group transactions.

16.35 The valuation of investments in subsidiaries which are not consolidated and associates which are excluded under AS 23, 'Accounting for Investments in Associates in Consolidated Financial Statements', shall be as per the relevant valuation norms issued by the RBI. The valuation of investments in joint ventures shall be accounted for under the 'proportionate consolidation' method as per AS 27, 'Financial Reporting of Interests in Joint Ventures'. The banks may consider the provisions of the accounting standards relating to the exclusion of

subsidiaries, associates or joint ventures from consolidation under specific circumstances. This aspect shall be examined by the auditor.

16.36 In accordance with SA 600, 'Using the Work of Another Auditor', SCAs should communicate with the component auditors by requesting them to respond to the Group Reporting Instructions (GRI) covering independence, audit procedures adopted by the component auditors, observations and evidence gathered, limitation if any on the scope of component auditors and material observations. SCA should document the same and how they have dealt with the same in the report on Consolidated financial statements.

## **Other Aspects**

### **Head Office**

#### **16.37 Inter-Branch Account - Provisioning for Net Debit Balance**

1. Banks should segregate the credit entries outstanding for more than five years in the inter-branch account and transfer them to a separate 'Blocked Account' which should be shown under 'Other Liabilities and Provisions - Others' or in the case of UCBs, under 'Other Liabilities - Suspense'. Any adjustment from the Blocked Account should be permitted only with the authorisation of two officials, one of whom should be from the Controlling/Head Office if the amount exceeds Rupees <sup>13</sup>One lakh. The balance in Blocked Account shall be reckoned as a liability for the purpose of the maintenance of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR).

2. Banks shall maintain category-wise (head-wise) accounts for various types of transactions put through inter-branch accounts, so that the netting can be done category-wise. As on the balance sheet date, banks shall segregate the debit and credit entries remaining unreconciled for more than six months and arrive at the net position category-wise. The balance in the Blocked Account shall also be considered. Thereafter, the net debit under all the categories of inter-branch accounts shall be aggregated and a provision equivalent to 100 per cent of the aggregate net debit shall be made. While doing so, banks shall ensure that the net debit in one category is not set-off against net credit in another category.

3. SCA should be aware of RBI guidelines/restrictions on operations in inter office accounts and verify any potential misuse of such accounts. The

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<sup>13</sup> Vide Master Direction No. RBI/DOR/2021-22/83 DOR.ACC.REC.No.45/21.04.018/2021-22 August 30, 2021 (Updated as on February 20, 2023) on Financial Statements - Presentation and Disclosures.

SCA should verify the ageing of such entries and recommend appropriate entries if required.

**16.38 Reconciliation of Nostro Account and Treatment of Outstanding Entries**

1. Banks shall take steps to have a strong control over reconciliation and put in place a system of real-time reconciliation. Escalation of differences, if any, should be done immediately. There should be close monitoring of pending items in Nostro accounts by top management at short intervals. All unreconciled credit entries in Nostro accounts which are outstanding for more than three years shall be transferred to a Blocked Account and shown as outstanding liabilities. The balance in the Blocked Account will be reckoned for the purpose of CRR/SLR. Banks shall make 100 percent provision in respect of all unreconciled debit entries in the Nostro accounts, which are outstanding for more than two years.

2. In the past, Commercial Banks other than RRBs were permitted to transfer to Profit and Loss Account (followed by subsequent appropriation to general reserve) outstanding credit entries of individual value less than USD 2,500 or equivalent in Nostro accounts originated up to March 31, 2002, subject to certain conditions. Banks that availed this benefit shall ensure that any future claims in respect of these entries are honoured. Further the amount appropriated to the general reserve shall not be available for the declaration of dividend.

**16.39 Transfer to/ Appropriation from Reserve Funds**

1. In terms of Sections 17(1),11(2)(b)(ii) and 56 of the Banking Regulation Act, 1949 banks are required to transfer, out of the balance of profit as disclosed in the Profit and Loss Account, a sum equivalent to not less than 20 per cent of such profit to the Reserve Fund. This is a minimum statutory requirement. However, in order to augment capital, Commercial Banks (excluding LABs and RRBs) shall transfer not less than 25 per cent of the 'net profit' before appropriations to the Statutory Reserve.

2. Unless specifically allowed by extant regulations, banks shall take prior approval from the RBI before any appropriation is made from the Statutory Reserve or any other reserve. Banks are further required that:

- a. all expenses including provisions and write-offs recognized in a period, whether mandatory or prudential, shall 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/loss for the year);

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- b. draw down from reserves, with the prior approval of the RBI, shall be effected only 'below the line' (i.e. after arriving at the net profit / loss for the year); and
- c. suitable disclosures shall be made of such draw down in the 'Notes on Accounts' to the Balance Sheet.

3. Subject to compliance with applicable laws, banks, without prior approval of the RBI, can utilize the share premium account for meeting issue expenses of shares to the extent that such expenses are incremental costs directly attributable to the transaction that otherwise would have been avoided. The share premium account shall not be utilized for writing off the expenses relating to the issue of debt instruments.

4. In respect of provisioning for frauds, banks that have reported the fraud within the prescribed time shall have the option to make the provision for the same over a period, not exceeding four quarters, commencing from the quarter in which the fraud has been detected. Where such a bank chooses to provide for the fraud over two to four quarters and this results in the full provisioning being made in more than one financial year, subject to compliance with applicable laws, it may debit reserves other than the Statutory Reserve by the amount remaining un-provided at the end of the financial year by credit to provisions. However, subsequently, it should proportionately reverse the debits to the reserves and complete the provisioning by debiting Profit and Loss Account, in the successive quarters of the next financial year. Where there has been delay, beyond the prescribed period, in reporting the fraud to the RBI, the entire provisioning is required to be made at once.

#### **Unreconciled Balances**

16.40 Unreconciled credit balances in any transitory account representing unclaimed balances shall not be transferred to the Profit and Loss Account or to any reserves.

#### **Deferred tax liability (DTL) on Special Reserve created under Section 36(1) (viii) of the Income Tax Act, 1961**

16.41 Banks shall make provisions for DTL on the Special Reserve created under Section 36(1) (viii) of Income Tax Act, 1961.

#### **Office Accounts**

16.42 Apart from examination of consolidation of branch returns, verification of capital and reserves, and verification of investments and provisioning in respect thereof, the SCAs also usually deal with the following items:

- Review of Internal/ Office accounts.
- Depreciation on assets like, premises, etc. where the recording of the relevant fixed assets is centralised at the head office.
- Employee benefits and provisions for certain employee costs, such as, bonus/ex-gratia in lieu of bonus, gratuity, leave encashment, pension, ESOP cost 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.
- Any Provision required for contingent liability, reward points, specific account related provision, divergence, impairment etc.
- Statutory auditors of Public Sector Banks (PSBs) shall also check that, the conditions attached to capital infusion by the Government have been complied with by the respective PSBs. In case of any non-compliance, the same may be suitably highlighted by the statutory auditors of PSBs in their Audit Report.
- Dividends.

#### **Review of Internal/ Office Accounts**

16.43 The auditor is expected to check the CGL or BGL which relates to Suspense, Sundry Debits, Sundry receivables, Inter-branch accounts, HO accounts which are parking accounts. The normal clearance is T+1 day. The SOP/Policy and rules of the bank will prescribe the permissible entries, that would need evaluation and tracing if the entries are pending for more than 90 days. Any entry pending for more than 90 days requires 100 per cent provision.

The Reserve Bank of India has time and again emphasised the need for instituting proper control over the opening and operation of internal (office) accounts, in general, and of the sundry/ suspense accounts, in particular. Members may refer Annexure I to this Chapter for more details. The SCAs must therefore exercise adequate and appropriate audit procedures to verify the policies and SOP governing the opening, closing and operations in such office accounts along with monitoring of transactions with special emphasis on ageing of pending entries.

### **Provisioning for Non-Performing Assets**

16.44 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 No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 dated April 1, 2022 on “Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances”. 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 to 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. Further, the auditor needs to ensure that the bank complies with the PCR (Provision Coverage Ratio) as prescribed by the RBI.

### **Other Provisions at Central Office**

#### **Convergence of Foreign Subsidiaries/Branches Balance Sheet**

16.45 The Balance Sheets of the respective branches and subsidiaries are drawn in their respective currencies and hence for the purpose of the consolidation the same needs to be converted to the INR.

1. In compliance with AS 11 (Revised), The Balance sheet items are converted to INR at the Closing Rates published by FEDAI.
2. The Profit and Loss Account is converted on incremental basis for every quarter based on the average rate of the quarter published by FEDAI.

#### **Recognition of Certain Other Expenses**

16.46 Certain other 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
- (d) Corporate Social Responsibility (CSR)
- (e) GST, etc.

## **Audit Approach and Procedures**

### ***Directors' Fees, Allowances and Expenses***

16.47 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 local Committee members may also be included under this head. Under the Companies Act, 2013, 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.

16.48 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. 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 behalf.

### ***Insurance***

16.49 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.

16.50 Banks submit a Return on Total Insurable Deposits to the 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.

16.51 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***

16.52 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'.

### **Corporate Social Responsibility (CSR) expenses**

16.53 The Management needs to determine the quantum of CSR expenditure they need to incur based on the provision of the Companies Act, 2013 and based on average profits in the three preceding years. The management is also responsible for accounting of such expenses and disclosure as per the requirements of the Provisions of the Companies Act, ICAI publications and RBI guidelines. SCA needs to verify the amount of CSR spent by the Bank on project including ongoing projects and verify the utilization of CSR fund. SCA also needs to verify the disclosure made by the managements.

### **Accounting for GST**

16.54 As per the GST Law, banks are eligible for 50 per cent of the GST paid on the Purchase of input/capital goods and availment of services. Generally, accounting for GST Receivable is centralised. Entire GST paid for expenses / capital goods at the branch level is first debited to Profit and Loss Account and then at the HO level while preparing the consolidated balance sheet for the bank as a whole, 50 per cent of the eligible Input Tax Credit is recognised as asset (GST Receivable). The GST liability is determined at the HO on the eligible service provided by the bank and not on the interest income. However, the treatment for accounting GST can differ from bank to bank.

16.55 The auditor needs to pay proper attention to the calculation done for transferring eligible ITC from Expense head to GST Receivable Account. It is also to be noted that GST paid on Inter-state supplies of goods or services (or both) between two branches of the same 100 per cent GST is eligible. The RBI has authorized nominated Banks for import of Bullion subject to conditions stated in the Master Direction issued by the RBI from time to time. Banks authorized to import bullion on consignment basis disclose their Principal Accounting Policies on Bullion which is consistent with RBI directions. Accordingly, the income accruing from bullion operation are treated as service and grouped under Commission income. The auditor should examine whether income accruing from bullion operation is declared as service income under GST law in accordance with the disclosure of Accounting Policies in respect of bullion in the Annual Financial Statement.

### **Provision for Depreciation**

16.56 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 SCA should examine the same.



The procedures to be followed by the auditor in this respect would be similar to those discussed in Chapter 12 on “Fixed Assets and Other Assets” of Section B of the Guidance Note on Audit of Banks (2023 Edition) at the branch level, except that the SCA 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**

16.57 Provisions for certain employee costs such as bonus/ex-gratia in lieu of bonus, and gratuity, leave encashment, pension and other retirement benefits are usually made at the head office level.

16.58 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.

16.59 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 include 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 Life Insurance Companies, as appropriate under the facts and circumstances of the case.

16.60 The SCA should also verify that the accounting treatment and disclosure of ESOP cost made by the bank’s management is in accordance with the RBI guidelines and Master Directions.

### **Provision for Taxation**

16.61 Provision for taxation relates to income-tax, (including corporate dividend tax). The auditor should ensure compliance with AS 22 on “Accounting for Taxes on Income”.

#### ***Income-tax***

16.62 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.

16.63 The statutory auditor should consider the impact of Income Computation and Disclosure Standards (ICDS) issued by CBDT while calculating provision of tax. The notification requires income computation and disclosure standards to be followed by all assessees, following mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head "Profit and gains of business or profession" or "Income from other sources".

16.64 Some banks have foreign branches including in a GIFT City or any Special Economic Zones. In such cases, the CSA should verify whether the management has considered any tax exemptions/holiday available for such branches correctly.

***Provision for Bad and Doubtful Debts***

16.65 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 as deduction, subject to the following 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 in 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;
- (iii) any such debt or part of the 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 previous year not 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) of Section 36 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.

16.66 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.

16.67 A scheduled /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 the above paragraphs with respect to Section 36(1)(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'.

16.68 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**

16.69 Deduction in respect of a special reserve created and maintained by a banking company shall be as under:

- (a) Section 36(1)(viii) provides for a 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 per cent 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) '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.

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- (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.
- (e) The bank shall create deferred tax liability on special reserves created under Section 36(1)(viii) of the Income Tax Act, 1961 and the entire Special Reserves may be reckoned for the purpose computation of Tier-I Capital.

### ***Interest on Non-Performing Assets (NPAs)***

16.70 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***

16.71 The applicability of any Double Taxation Avoidance Agreement (DTAA) 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.

16.72 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.

16.73 In respect of any provision for bad and doubtful debts made by a foreign bank, an amount not exceeding 5 per cent of the total income (computed before making any deduction under Chapter VI-A of the Income tax Act, 1961) is allowable as deduction.

### ***Tax Refunds/Demands***

16.74 Where an assessment order relating to any previous assessment year is received during the year, the auditor should examine the same and if any interest is determined on the amount of refund, the same should be considered as income irrespective of whether the refund has been received or not. In case where the assessment results in fresh demand, the auditor should consider the need for additional provisioning based on the management's estimates and as per AS 29, Provisions, Contingent Liabilities and Contingent Assets. 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.

16.75 It is not prudent to recognise interest on possible refund which is not determined by any order from tax authorities.

***Pending Proceedings***

16.76 The auditor should review the appellate orders received during the year and consider the need for any additional provision/reversal as per AS 29, Provisions, Contingent Liabilities and Contingent Assets.

***Method of Accounting***

16.77 Some banks account for commission, exchange, brokerage, 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. Banks are required to follow the accrual basis of accounting. Further, accrual being a fundamental accounting assumption, the auditor would need to consider modification/ reference to/ in the Auditor's Report wherever cash basis of accounting is followed.

***Other Provisions***

16.78 It is possible that in the light of subsequent judicial pronouncements/ appellate orders the provisions of earlier years may turn out to be excessive.

16.79 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 probable 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. Usually, banks have policies in place to estimate the quantum of provision to be made based on probability or the possibility of occurrence of a contingent event and the liability crystalizing. SCA need to verify the adequacy of the provision based on the said policy.

16.80 Only in rare cases like for example, 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.

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16.81 On the above considerations, if there is no requirement to retain a provision, it can be reversed and the amount of liability included in the 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 the 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**

#### ***Other Assets/Other Liabilities and Provisions***

16.82 RBI circular no. RBI/2022-23/155 DOR.ACC.REC.No.91/ 21.04.018/ 2022-23 dated 13th December 2022 provides that as specified in Annexure II of Master Direction No RBI/DOR/2021-22/83 DOR.ACC.REC.No.45/ 21.04.018/ 2021-22 dated August 30, 2021 (Updated as on February 20, 2023) on "Financial Statements – Presentation and Disclosures", the banks should disclose the particulars of all such items in the notes to accounts wherever any item under the Schedule 5(IV)-Other Liabilities and Provisions- "Others (including provisions)" or Schedule 11(VI)-Other Assets-"Others" exceeds 1 per cent of the total assets.

#### ***Tax Implications of Valuation of Investments***

16.83 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. Various judicial decisions on the allowability of depreciation in valuation of investments, including implication of ICDS VIII(Securities held as stock-in-trade), should be considered while provisioning.

#### ***Notional Gain/Loss on Foreign Exchange Translations***

16.84 Banks are required to translate their foreign exchange balances / obligations in foreign currency as per FEDAI Guidelines. While recognising gains or loss for tax purposes the following decisions may be considered by the auditor along with FEDAI Guidelines:

- The Madras High Court in the case of *Indian Overseas Bank Vs. Commissioner of Income-tax (1990) 183 ITR 200* held that notional profits on conversion 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* held that notional loss on conversion of foreign exchange contracts is not tax deductible.

***Carry forward of Unabsorbed Business Loss and Depreciation on Amalgamation of a Banking Company with a Banking Institution***

16.85 Section 72AA of the Income Tax Act, 1961 deals with provisions relating to carry forward and set-off of accumulated loss and unabsorbed depreciation allowance in a Scheme of amalgamation of banking company in certain cases.

***FATCA /CRS***

16.86 Foreign Account Tax Compliance Act (known in short as FATCA) is a legislation to counter tax evasion in the United States of America (USA). FATCA was introduced by US Dept of Treasury (Treasury) and US Internal Revenue Service (IRS) to encourage better tax compliance by preventing US citizens from using banks and other financial organisations to avoid US taxation on their income and assets.

16.87 India and the USA have signed reciprocal version of model 1 IGA for FATCA on 9th July 2015. India signed the OECD's CRS (Common Reporting Standards) on 3<sup>rd</sup> June, 2015. The IGA has two models. India has signed Model 1 IGA wherein banks will have to report information to the prescribed authority who in turn will submit information to the IRS.

16.88 In Model 1 IGA, the Foreign Financial Institutions (FFI) have to report all FATCA related information to their Governmental agencies, which would then report the FATCA related information to the IRS. Some Model 1 IGAs are reciprocal, requiring the US to provide certain information about residents of the Model 1 country to the Model 1 country in exchange for the information that country provides to the USA. An FFI covered by a Model 1 IGA need not sign an FFI agreement but needs to register on the IRS's FATCA Registration Portal or file Form 8957.

16.89 Like FATCA, Common Reporting Standard (CRS) is a reciprocal exchange of information on financial accounts on an automatic basis with other countries/ non-sovereign territories so as to combat the menace of offshore tax evasion and avoidance and stashing of unaccounted money abroad.

16.90 India would be obligated to get its financial institutions to share financial account information of accountholders who are tax residents in any of these countries. Likewise, India would also get similar information through financial institutions of such treaty countries.

16.91 CBDT has notified Rule 114H for Due Diligence Requirement under FATCA; major requirements for the bank are as under:

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All the concerned financial institutions should register on the related e-filing portal of Income Tax Department as Reporting Financial Institution by submitting the requisite details. Thereafter, the reports can be submitted online by using the digital signature of the 'Designated Director' by either uploading the Form 61B or 'NIL' report.

16.92 As per RBI circular no. RBI/2015-16/165 DBR.AML.BC.No.36/14.01.001 /2015-16, dated August 28, 2015 on Reporting requirement under Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standards (CRS), for the new accounts opened after September 1, 2015, the due diligence procedures specified in Rule 114H (4) and 114H (6) would be applicable.

16.93 All the FIs were required to submit reports online using the digital signature of the designated director by either uploading Form 61B or 'Nil Report' by September 10, 2015. The first reporting was with respect to calendar year 2014 if an account has been identified as US reportable account consequent to completion of due- diligence procedures as laid down in Rule 114H. Therefore, the reasons for the 'Nil Report' should be captured as under:

a. *For pre-existing accounts*

Option 1: Due diligence procedure not completed.

Option 2: Due diligence procedure completed but no reportable US account identified.

b. *For new accounts*

Option 1: Alternative procedure invoked.

Option 2: Due diligence procedure as applicable to new accounts completed but no reportable US account identified.

16.94 All the regulated entities should take appropriate action for the implementation of due diligence and reporting requirements as laid down in the Rules and ensure compliance in a manner that lends itself to credible auditability including audit of the IT system which should be suitably upgraded not only to maintain the information required under the Rules but also to record and store the due diligence procedures. In due course, the detailed guidelines for carrying out audit of IT system for ascertaining the degree and level of compliance with due diligence procedures as laid down in the Rules will be issued.

16.95 The statutory auditor should verify whether the bank has put a process in place for complying with guidelines under FATCA/CRS and submitted reports as required by FATCA.



## Annexure I

### Un-authorized Operation of Internal / Office Accounts

(Refer Para 16.43)

Reserve Bank of India has time and again emphasised the need for instituting proper control over the opening and operation of internal (office) accounts, in general, and of the sundry / suspense accounts, in particular.

In order to curb frauds / malpractices, the opening of such internal accounts in the banks, as also their periodic reconciliation, should receive utmost attention of their Top Managements and be subjected to necessary checks in the form of concurrent audit, coverage under Long Form Audit, as also monitoring and review by the Audit Committee of the Board (ACB).

It has been noticed that post-migration to Core Banking Solutions, some banks have resorted to certain undesirable practices in opening and operating internal accounts unauthorisedly for affording credits to certain borrower accounts so as to prevent them from slipping into NPA. In almost all such cases, system based identification of NPAs was bypassed in this manner. The entries were effected by officials at the branches or controlling offices and in many cases have not been pointed out by the internal inspection / audit. Further, in some banks, these internal accounts/branch GLs have been used for disbursing loan amount, parking Govt. funds, disguising customer's cash transactions, booking expenses such as telephone charges, ATM charges, service charge and interest reversals, etc. Similarly, there are instances where advances to customers/staff members have also been debited to such accounts. An illustrative list of the modus operandi is as follows:

1. Many of the banks did not have any policy for opening, operating, reviewing, monitoring, reconciliation and provisioning of internal / office accounts. Further, no Standard Operating Procedure (SoP) or similar documents was available in the bank. As a practice, the data Centre (DC) opened office accounts on request of the Finance Department, which in turn received such requests from HO Departments/Zones/branches. Large number of office accounts did not have common mapping to link them with GL/PL heads. Multiple office accounts were opened under overdraft/deposits schemes inflating CASA.
2. The internal accounts were found to have been unauthorisedly opened in some banks with customer ID (UCIC) and operated at the branch level for parking funds and routing customer transactions including cash.

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3. In many banks, there was no mandatory requirement for keying-in reference number of the original entries at the time of reversals and, hence, CBS could not identify entries which remained unreconciled for more than six months and warranted provision. The HO relied on manual calculations/submissions made by branches for arriving at provision figures, which did not include many heads that may warrant provision.
4. Branches (authorised to conduct Government business) in some banks were found to be opening and operating adjustment/settlement accounts in the name of Government officers instead of routing the Government transactions through the designated accounts.
5. Several internal accounts mapped as liabilities in GL had debit balance which were netted against credit balances of other liabilities GLs while finalising accounts and consequently did not carry out age-wise reconciliation.
6. Many Profit and Loss Accounts having inherent nature of 'receipts' only neither had 'debit freeze' nor had any restriction of keying-in reference ID while being used for reversing charges. This led to revenue leakage and possible misutilization of these accounts.
7. In some cases, it is observed that large cash deposits into the customers' accounts are routed through internal / office accounts in order to disguise cash transactions in the customer's accounts and thus bypass the CTR/STR rules.

#### **Loan Accounts Manipulation Instances**

Different modus operandi have been used to bypass system-based identification of NPAs, upgrade accounts marked as NPA by some of the banks or use of internal accounts for routing unauthorised/unrelated entries. The modus operandi includes:

1. Changing the repayment schedule of loan accounts in the system without any sanction for restructuring of the account(s);
2. Using bank's internal account(s) for (a.) Debiting a General Ledger head, such as, 'Other liabilities' and crediting the loan account which has already been marked as NPA or SMA by the system; or (b.) Debiting the "Other liabilities" and crediting a "No lien" account (an internal account of the bank used for parking proceeds of compromise settlement cases). Thereafter, the "No lien" account is debited and the loan account is credited; or (c.) Debiting the "Other liabilities" and crediting the "Tax collections" account (an internal account of the bank). Thereafter, debiting

the "No lien" account and crediting the loan account. In all such cases, the IRAC status of the account is manually changed to "Standard". Entries in the "Other liabilities", "No lien account", "Tax collections" accounts are then reversed on the same/next day or after a few days.

3. Crediting a dummy entry of nil value to the borrower account and then debiting the same account. In between the two entries, the IRAC status is manually changed to "Standard".
4. Opening a new loan account for an existing borrower wherein a fresh disbursement is made to the account. The funds from the account are then transferred to an existing loan account.
5. Opening of a new account of the existing borrower with different or same facility. The existing account is closed and shown as compromise settlement/write-off by transferring funds from the new account through the "Other liabilities" account.
6. Passing the entries in a branch mode (one debit and credit to multiple accounts). Consequently, the respective account statement did not indicate the name of the contra account.
7. In some other cases, it was observed that the reversal entries were passed in "correction" mode. Consequently, one leg of the transaction appeared in the account statement but the entry passed in "correction mode" is not reflected in the statement. Further, the account balance remained unchanged.

## **Government Business Department**

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### **Introduction**

17.01 The basic scope of work relating to Government business carried on by banks is given in RBI Master Circular No. RBI/2021-22/07 DGBA.GBD.No. S-2/31.12.010/2021-22 dated April 1, 2021 on “Conduct of Government Business by Agency Banks – Payment of Agency Commission”. Master Circular No. RBI/2021-22/08 DGBA.GBD.No.S-1/31.02.007/2021-22 dated April 01, 2021 (Updated as on May 17, 2021) on “Disbursement of Government Pension by Agency Banks”, specifies the procedural aspects related to Disbursement of Government Pension by Agency Banks.

### **Government Transactions Eligible for Agency Commission**

17.02 Transactions relating to the following Government business undertaken by Agency Banks are eligible for agency commission paid by the RBI:

- a. Revenue receipts and payments on behalf of the Central/State Governments.
- b. Pension payments in respect of Central / State Governments.
- c. Any other item of work specifically advised by the RBI as eligible for agency commission.

17.03 Agency banks also undertake the work related to Small Savings Schemes (SSS) the commission for which is borne by Government of India. Though the settlement of commission on such SSS is processed by the RBI and settled at Central Accounts Section (CAS), Nagpur, the rates of agency commission related to SSS transactions are decided by Government of India. Agency commission claims on Special Deposit Scheme (SDS) related transactions (where mirror accounts are maintained in RBI) are also settled at CAS, Nagpur.

17.04 Short term/long term borrowings of State Governments raised directly from financial institutions and banks are not eligible for agency commission as these transactions are not considered to be in the nature of general banking business. The RBI pays the Agency Banks separate remuneration as agreed upon for acting as agents for management of public debt.

17.05 Whenever Agency Banks collect stamp duty through physical mode or e-mode (challan based), they are eligible for payment of agency commission, provided the Agency Banks do not collect any charges from the members of public or receive remuneration from the State Government for doing this work.

17.06 If the Agency Bank is engaged by the State Government as Franking Vendor and it collects stamp duty from the public for franking the documents, it will not be eligible for agency commission since the State Government is paying commission to it as Franking Vendor. However, the Agency Bank which collects the stamp duty paid by the Franking Vendor for credit to the Treasury through challan in physical or e-mode for purchase of the franking bar, would be eligible for agency commission since it is a regular payment of Stamp Duty as stated above.

#### **Government Transactions not Eligible for Agency Commission**

17.07 Agency Banks paying their own tax liabilities through their own branches or through authorised branches of any other Agency Bank including State Bank of India or offices of the RBI wherever they do not have their own authorised direct tax collection branch should indicate the same separately in the scroll. Such transactions will not be eligible for payment of agency commission. Banks should furnish a certificate to the effect that own tax liabilities (TDS, Corporation Tax, etc.) paid by them have been excluded while claiming agency commission.

17.08 The following activities, inter alia, do not come under the purview of Agency Bank business and are therefore not eligible for payment of agency commission.

- (a) Furnishing of bank guarantees/security deposits, etc. through Agency Banks by Government contractors/suppliers, which constitute banking transactions undertaken by banks for their customers.
- (b) The banking business of autonomous/statutory bodies/Municipalities/companies/Corporations/Local Bodies.
- (c) Payments which have been classified as capital in nature by Government to cover losses incurred by autonomous/statutory bodies/ Municipalities/ Corporations/Local Bodies, etc.
- (d) Prefunded schemes which may be implemented by a Central Government Ministry/Department (in consultation with CGA) or a State Government Department through any bank.
- (e) Transactions related to Gold Monetisation Scheme 2015.

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- (f) Transactions arising out of Letters of Credit / Bank Guarantee opened by banks on behalf of Ministries/Departments etc. do not qualify for agency commission as RBI only reimburses the paid amount to the banks based on the mandate received from the Governments.
- (g) Any other item of work specifically advised by the RBI or Central or State Government as ineligible for agency commission.

17.09 Agency Banks are advised to meticulously follow instructions issued by the RBI from time to time regarding transactions which are not eligible for agency commission and submit their claims for agency commission accordingly. All Agency Banks while claiming agency commission should certify that no claim of agency commission is made on ineligible transactions.

### **Reporting of Transactions by Agency Banks to RBI**

17.10 After the operationalisation of NEFT 24X7 and RTGS 24X7, Agency Banks authorised to collect GST shall upload their luggage files in RBI's QPX/E-Kuber on all days except the global holidays, which are January 26, August 15, October 2, all non-working Saturdays, all Sundays and any other day declared holiday by RBI for Government Transactions due to exigencies.

17.11 State Government transactions (in electronic as well as physical mode) of previous month reported after 8th of the succeeding month and those pertaining to earlier months should be reported to the RBI through a separate statement for accounting, after being confirmed by the competent authorities of concerned State Government.

17.12 For Central Government transactions (electronic as well as in physical mode) or any adjustments thereof, if reported after a gap of 90 days from the date of transaction, the Agency Banks have to obtain prior approval from concerned ministry/department and submit the same to RBI separately at the time of reporting such transactions for settlement.

### **Agency Commission Rates**

17.13 As per Agency Bank agreement, the RBI pays agency commission at rates determined by it. The rates applicable with effect from July 1, 2019 are as under:

Sr. No.	Type of Transaction	Unit	Revised Rate
a. (i)	Receipts - Physical mode	Per transaction	₹40/-
(ii)	Receipts - e-mode	Per transaction	₹9/-
b.	Pension Payments	Per transaction	₹75/-
c.	Payments other than Pension	Per ₹100 turnover	6.5 paise per ₹100

17.14 In this context, the 'Receipts-e-mode transactions' indicated against Sr. No. a.(ii) in the above table refer to those transactions involving remittance of funds from the remitter's bank account through internet banking as well as such transactions which do not involve physical receipt of cash /instruments at all. For example, challan generated electronically and submitted to Agency Bank along with cash/instrument should be treated as transaction under physical mode.

17.15 With reference to the implementation of Goods and Services Tax (GST) regime, it is advised that a single Common Portal Identification Number (CPIN), processed successfully leading to generation of a Challan Identification Number (CIN), under GST payment process, may be treated as a single transaction, even if multiple major head/sub major head/minor head of accounts are credited. This means that CGST, SGST, IGST and Cess etc. paid through a single challan would constitute a single transaction. Thus, all such records clubbed under a single challan i.e., CPIN have to be treated as a single transaction for the purpose of claiming agency commission effective July 1, 2017.

17.16 Similarly, in case of transactions not covered under GST, it is emphasised that a single challan (electronic or physical) should be treated as single transaction only and not multiple transactions, even if the challan contains multiple major head/sub major head/minor head of accounts that will get credited. Therefore, records clubbed under a single challan processed successfully have to be treated as a single transaction for the purpose of claiming agency commission.

17.17 Agency banks would be eligible to claim agency commission for pension transactions at the rate of ₹75 per transaction only when the entire work relating to disbursement of pension including pension calculation is attended to by them. If the work relating to pension calculations, etc., is attended to by the concerned Government Department / Treasury and the banks are required only to credit the amount of pension to the pensioners' accounts maintained with them by a single debit to Government Account, such transaction is to be categorised under 'other than pension payment' and would be eligible for payment of agency commission at the rate of 6.5 paise per ₹ 100 turnover w.e.f. July 1, 2019.

17.18 The number of transactions eligible for payment of agency commission should not exceed 14 per pensioner per year. This includes one monthly credit for payment of net pension and a maximum of two per year for payment of arrears on account of increase in dearness relief, if applicable. Cases involving payment of arrears on account of late start/restart of pension qualify as a single transaction for claiming of agency commission. In other words, any payment of arrears on account of late start/restart of pension should be treated as a single credit transaction and not as separate monthly credits.

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17.19 Agency commission is payable to an Agency Bank at the full rate provided the transactions are handled by the bank at all stages. Where, however, the work is shared between two banks, the agency commission is shared between the banks in the proportion of 75:25. Thus, broadly, the agency commission is payable to the Agency Banks as detailed below:

- a. Full rate, in cases where the transactions are handled by the bank at all stages, i.e., upto the stage of dispatch of scrolls and challans / cheques to the Pay and Accounts Offices, and treasuries/sub-treasuries.
- b. 75 per cent of the applicable rate, where the dealing branch is required to account for the transaction by passing on the scrolls and documents to the local/nearest branch of the RBI or by any Agency Bank conducting Government business.
- c. 25 per cent of the applicable rate, in the case of agency branch which received the scrolls and documents from dealing branches of other banks and is responsible for the accounting of these transactions and dispatching of the scrolls and documents to the Pay and Accounts Offices, Treasuries, etc.

17.20 All Agency Banks should settle their agency transactions for both funds and agency commission directly with the concerned Regional Office of the RBI instead of routing them through any other Agency Bank that acts as aggregator in certain cases. So also payments made by all Agency Banks on behalf of State Government/s get directly settled with the concerned Regional Office of RBI. Agency Transaction details/scrolls may be sent directly by individual Agency Bank to the concerned State Government/Treasury. This new arrangement for settlement of State Government funds on day to day basis (receipts and payments) directly with the RBI is with effect from January 1, 2018.

### **Claiming Agency Commission**

17.21 Agency Banks are required to submit their claims for agency commission in the prescribed format to CAS, RBI, Nagpur in respect of Central Government transactions and the respective Regional Office of the Reserve Bank of India for State Government transactions. However, agency commission claims with respect to GST receipt transactions will be settled at Mumbai Regional Office of the Reserve Bank of India only and accordingly all Agency Banks, authorized to collect GST, are advised to submit their agency commission claims pertaining to GST receipt transactions at Mumbai Regional Office only. The formats for claiming agency commission for all Agency Banks and separate and distinctive set of certificates to be signed by the branch officials and Chartered Accountants or Cost Accountants are given in Annex 2, Annex 2A and



Annex 2B of the above said Master Circular respectively. These certificates would be in addition to the usual Certificate from ED / CGM (in charge of Government business) to the effect that there are no pension arrears to be credited / delays in crediting regular pension / arrears thereof.

17.22 Where the external auditor is also the concurrent auditor / statutory auditor, claims can be certified by such concurrent auditor / statutory auditor. In addition to this, Agency Banks are required to ensure that the Agency Bank's internal inspectors / auditors verify the agency commission claims submitted by their branches and confirm their accuracy during the course of their inspection / audit.

17.23 Attention of the Members are also drawn to the instructions contained in the letter dated November 4, 2016 advising the process of claiming reimbursement of service tax (ST) on agency commission received for Central and State Government transactions, centrally from the Reserve Bank of India at Central Accounts Section, Nagpur. The same process is continued even after Service Tax got subsumed into the Goods and Service Tax (GST) framework. This process of centralised claims submission has been replaced with a system whereby applicable GST (18 per cent at present) shall be paid along with agency commission by the respective Regional Offices of RBI / CAS, Nagpur as the case may be.

17.24 For eligible Government transactions done with effect from July 01, 2019, Agency Banks shall submit the agency commission claims, including applicable GST amount, as per revised agency commission rates indicated above, to the RBI at respective Ros / CAS, Nagpur as per the extant instructions issued by the RBI in this regard. TDS on GST shall be deducted as applicable by RBI at the time of making agency commission payment in accordance with Government instructions in the matter.

17.25 However, for eligible Government transactions done by Agency Banks upto June 30, 2019, the Agency Banks shall continue to submit agency commission claims as well as the centralized claims for ST/GST reimbursement as hitherto.

17.26 Agency Banks are required to ensure that agency commission claims submitted to the Regional Offices of the Reserve Bank of India / Central Accounts Section, Nagpur as applicable in the prescribed format are accurate. Agency Banks may also alert their branches concerned to ensure that agency commission claims submitted to RBI Regional Offices are accurate. Erroneous claims, if certified by the internal / concurrent auditors, will defeat the very purpose of making such requirement an essential condition for making quarterly claims.

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17.27 Agency Banks are advised to furnish their claim on agency commission to the RBI within 60 calendar days from the end of the quarter in which the transactions have been conducted. If the banks fail to lodge the claims within the stipulated period mentioned above they may forward the same to the RBI only after giving reasons for the delay.

### **Penal interest for wrong claims**

17.28 As per the agreement that Agency Banks have with RBI, violation or non-compliance of instructions issued by Government or Reserve Bank of India shall attract imposition of penalty. Agency Banks will be liable to pay penal interest at Bank Rate as notified by the RBI plus 2 percent for any wrong claims of agency commission settled.

### **17.29 Other Relevant Circulars**

- a. Circular no. RBI/2021-2022/36 CO.DGBA.GBD.No.S77/42.01.033/2021-22 dated May 10, 2021 on Government Agency Business Arrangement – Appointment of Scheduled Private Sector Banks as Agency Banks of the RBI.
- b. Circular no. RBI/2021-2022/75 DGBA.GBD.No.S391/42.01.011/2021-22 dated August 02, 2021 on Maintenance of State Government Accounts – Recovery of Interest on Excess put through/ Double claim (State Government Transactions).

### **Preparation / Planning**

17.30 The auditor has to do the following:

- Obtain the bank's policy relating to Government business.
- Check whether the accounting policy is on accrual or cash basis and accordingly plan the work.
- Check if the checklist relating to Government business (pension related) for internal/concurrent audit as specified in Annexure 1 to RBI Master Circular No. RBI/2021-22/08 DGBA.GBD.No.S-1/31.02.007/2021-22 dated April 01, 2021 on "Disbursement of Government Pension by Agency Banks" (Updated as on May 17, 2021) is specified and factored in the scope of work of Internal / Concurrent Audit process of the bank.

17.31 Discuss the process of execution of Government business through authorised branches, recording of transactions in CBS system, reconciliation with

respective Government Departments for various schemes. Some examples are listed in the following Table:

Government Deposit Scheme	E-Kisan Vikas Patra Scheme, 2014 Sovereign Gold Bonds Public Provident Fund (PPF) Senior Citizen Savings Scheme 2004 Sukanya Samridhi Accounts 2014 RBI Bonds
Taxes	Collection of Direct taxes (CBDT) Goods and Services Tax Collection of State Taxes
Pension Payments to Government / Ministries / Departments / others	Central/Civil Freedom Fighters Pension Railway Telecom & Postal Defence
Other Schemes	Pension Payment to State Governments National Pension System (NPS) Treasury/Sub Treasury Business e-Stamping e-Biz Services to Civil/Non-Civil Ministries Atal Pension Yojana EPFO Collection ESIC Collection PFMS-Public Fund Management System NTRP (Non-Tax Receipt Portal) Gold Monetization Scheme, 2015

**Conduct / Execution**

17.32 The auditor is required to do the following:

- Verify whether Income from Government business is accounted properly.

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This can be done by taking the data dump of the Government transactions and analysing them to confirm that the GL/BGL contains the GB transactions, that the claim is arrived at automatically by the system – if not then the transactions in claim amount and the transactions in the GL/BGL match, that only those transactions which can be claimed have been selected, that the bank has a system to verify the amount of receipt with the amount of claim.

Any analytical tool will help in filtering the transactions on which agency commission can be received. For all transactions there will be a tag or flag which will determine whether there is any claim to be made.

- Income from Government business should be accounted for on accrual basis. This can be done by accounting the commission received, for the year under audit, in the subsequent year. Also on the basis of claims accepted for payment by the Govt. authorities/RBI.
- Check income reconciliation, follow up for recovery. Normally claims due and accepted should be accounted for. However, the outstanding dues should be followed up on a regular basis.
- Check Tax Collection and Payment to Government Treasury within the stipulated time schedules.
- Check the internal controls for receipt / payments.

### **Reporting / Conclusion**

17.33 Based on audit, issue appropriate certificate and report on compliance for Government business. Check whether appropriate disclosures are being made in the financial statements.

## **Consolidation of LFARs for the Bank**

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### **Introduction**

18.01 The financial statements of banks are, generally, signed within 45 days of the year end. However, the RBI has given time up to June 30 for the submission of Long Form Audit Report (LFAR). Hence, usually, formal consolidation process starts after the financial statements of the bank are signed and delivered.

18.02 The consolidation takes place based on LFARs submitted by the SBAs in respect of branches/offices and the information / explanations and other data provided by the management, for Audited/Unaudited branches and departments. Hence analyzing the data is required at the time of conducting annual financial audit at the zonal/ regional level and not just during LFAR consolidation process. It is often noted that branch LFARs may contain comments that may need attention in the main statutory audit report issued by the auditor during financial audit. If analysis of branch LFAR is deferred, there may be a probability of missing these comments.

18.03 The SCAs should identify gaps and vulnerable areas in the business operations, risk management, compliance and efficacy of internal audit and provide an independent opinion on the same to the Board of the bank alongwith their observations. It may also involve commenting on various risks to which banks are exposed like credit, market, operational and liquidity risk and risk management efficacy, assessment of appropriateness of procedures for timely preparations of supervisory returns, KYC /AML operations, cyber security, business performance, etc. It is the responsibility of the LFAR consolidating SCA to highlight the significant observations therein and summarize the issues after considering the information provided by the bank, wherever required. All statistical data needs to be incorporated as provided by the bank. Further the SCA is expected to consider the compliance report of the bank on LFAR for the previous year and RBI Inspection report. The SCA should analyze the compliance and comment if the mentioned compliance is incorporated. The SCA should verify the completeness of the data uploaded by the branch auditors in the system. The SCA should verify the various controls including IT general controls adopted by the bank to ensure the completeness of the data.

18.04 The SCA should ensure that the intent of the comments specified by SBAs in Branch LFAR is factored in while consolidating all LFARs and, accordingly, may consider keeping the same intact wherever need be. Further, the SCA should review the major observations by SBAs including those which are likely to have a systemic impact, though they have been reported at a few of the branches only. The SCA may opt to conduct testing of such instances as reported by SBAs, to identify the impact of the same on the consolidated LFAR of the bank and should be quantified to the extent possible.

18.05 At the start of the audit of the financial statements, the SCAs need to communicate with SBAs specifically to provide all the relevant data in a predefined structured format for the purpose of LFAR consolidation. The consolidated LFAR can give the illustrative observations from Branch LFARs under the various Annexures. The SCA may determine the materiality of the amounts to be reported in LFAR. However, the said data is required to be compiled bank-wide and submitted to the management.

### **Setting Reporting Materiality**

18.06 The overall objective is to design and carry out audit procedures in order to obtain reasonable assurance as to whether the financial statements are free from material misstatement, whether due to fraud or error.

18.07 Materiality set for the financial statements should represent the maximum cumulative numerical misstatement in an account balance, class of transactions or other disclosure that the auditor would regard as not influencing the decisions of users of those financial statements. The materiality for reporting may be categorised into the following two types:

#### **(i) Specific Transaction Materiality**

18.08 These transactions are suggested to be selected for reporting irrespective of the materiality due to their sensitive nature such as:

1. Any standard account in the branch having exposure (funded and non-funded) which is more than 50 or 100 crores rupees across the bank.
2. Accounts against whom NCLT proceedings are initiated either by the bank or by any other financial creditors/ operational creditors.
3. SMA accounts above 5 or 10 Crores rupees.
4. Red Flagged Accounts.
5. Quick mortality loan accounts.

6. Business with caution listed clients.
7. Imports/exports with FATF (Financial actions task force) list of high risk countries.
8. Borrowers in whose case some enquiry/investigation have been initiated by any Authorities post Balance Sheet date.

The above list is only an indicative one.

## **(ii) Overall Materiality Limits**

18.09 Having determined specific materiality, it is necessary to determine a level of overall materiality which will be used when assessing the risk of reporting. The use of overall materiality is intended to reduce the risk of inappropriate audit report.

18.10 Unlike financial statement materiality (which is dependent on the perceptions of users), this materiality is affected by the risk of misreporting.

18.11 Hence as a part of setting up of overall materiality limits, any uncorrected observations affecting the financial statement above certain amount, may be decided by the SCAs (all observations put together by individual auditor at unit level). The combined impact needs to be assessed and reported in consolidated LFAR.

## **Reporting**

18.12 The RBI has issued thoroughly revamped format of LFAR vide circular no. DOS.CO.PPG./SEC.01/11.01.005/2020-21 dated September 05, 2020. Though the mandate and scope of the audit will be as per the revised format, if the SCAs feels the need of any material additions, etc., the SCAs may have the same effected by giving specific justification and with the prior intimation to bank's Audit Committee of the Board (ACB). The auditor may report on the following aspects:

- i. Credit – If there are any loans given to directors/relatives of directors, maximum loan amount permissible under various loan schemes. Credit exposure norms- sector wise, adverse observations of stock auditors, process of pre and post sanction inspection of credit facility, SMA accounts, FITL, NCLT Accounts having significant haircut, NPA Movement, Data Security Policy, etc.
- ii. KYC/AML – CTR/STR, CCR, SFT, AML alerts, customer risk categorization, Re-KYC process, etc.

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- iii. Cash management – System of monitoring cash at branches, frequent exceedings in cash retention limits, security of cash vaults, soiled/mutilated notes and fake notes, insurance for cash held by bank and in transit, ATM reconciliation, system of cash movement within the branches, etc.
- iv. Internal controls – Internal financial controls, CBS, procedure of customer complaints' redressal, revenue leakage, System Audit Report, Risk Based Internal Audit Reports, etc.
- v. Liquidity and fund management – Investment portfolio, maturity pattern of investments, category wise investment held by banks, CRR & SLR, compliance with RBI guidelines and Master Circulars.

18.13 The compilation of the questions is done on the basis of information provided by the SBAs. However, as mentioned above, the specific information or the annexures that may be required by the consolidating auditor to ensure the adequacy of reporting, will have to be decided and called for during communication to the SBAs as required by SA 600 "Using the Work of Another Auditor". The illustrative list of Annexures that may be required could be as under:

- i. Instances of quick mortality cases.
- ii. Instances of disagreement of Asset Classification with bank, i.e., divergences observed at branch level.
- iii. Instances of an account wherein auto-marking through CBS is not done.
- iv. Instances of evergreening of Accounts.
- v. Accounts where excess over sanctioned limits are allowed.
- vi. Accounts where limits were disbursed without complying with the terms and conditions of sanction.
- vii. Accounts with deficiencies in documentation/inadequate insurance cover.
- viii. Accounts where periodic balance confirmation / acknowledgement of debt not obtained.
- ix. Accounts where review / renewal is pending.
- x. Accounts where stock / book debt statements and other periodical operational and financial statements not obtained.
- xi. Accounts where audited accounts not on record for advances to non-corporate with limit over Rs. 10 lakhs (or any other limit as decided by the bank internally).
- xii. Accounts where stock audit report is not obtained at prescribed interval.



- xiii. List of accounts (under multiple / consortium banking with exposure above Rs. 5 crores) wherein Diligence Report is not obtained.
- xiv. Short reviewed for period beyond six months.
- xv. Comments on major accounts (standard accounts having outstanding exceeding Rs. 10 crores).
- xvi. Quarterly/half yearly statements not obtained.
- xvii. Break up of outstanding entries in Nostro reconciliation as of 31.03.20YY.
- xviii. Rate of interest charged less than prescribed rate decided by the bank.
- xix. Deficiencies noticed in appraisal, monitoring and supervision.
- xx. Details of accounts where the relevant controlling authority of the bank has authorized legal action for recovery of advances.
- xxi. List of overdue / matured term deposits.
- xxii. Major / adverse comments / issues not addressed by the branch arising out of reports from previous auditors, concurrent auditors, stock or internal auditors or special audit or inspection report of the RBI.
- xxiii. Whether identification and classification of advances as standard/sub-standard/doubtful/ loss assets is as per RBI circular and instructions as per CO. If not, then details of accounts where there are deviations.
- xxiv. Guarantees involved / expired but not adjusted / reversed.
- xxv. Outstanding amount of letter of credit / buyers credit.
- xxvi. Cash holding/ cash held exceeds retention limit.
- xxvii. Details of cases where physical verification of securities not done as per laid down procedure.
- xxviii. Details of NPA accounts where valuation report is not obtained.
- xxix. Detail of items for more than three years in bills payable / sundry deposit etc.
- xxx. List of the accounts (with outstandings in excess of Rs. 10 crores), which have been downgraded regarding their classification as NPA or standard asset during the year.
- xxxi. List of the accounts (with outstandings in excess of Rs. 10 crores), which have been upgraded regarding their classification as NPA or standard asset during the year.
- xxxii. List of recoveries and their appropriation against interest and principal accounts settled/ written off/ closed during the year.

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- xxxiii. List of new borrower accounts transferred to the branch during the year.
- xxxiv. Borrower accounts where stock audits are planned but not conducted.
- xxxv. Loans to relatives of Higher Managerial authorities of the bank.
- xxxvi. Cash deposits in accounts in excess of justified by the profile of customer.
- xxxvii. List of accounts which are written off during the year.
- xxxviii. List of legal or fraud cases pending against/by the bank.
- xxxix. Income Leakage detected and whether the same is recovered during the year or not.
- xl. Cases where End Use of Funds are not monitored by the bank.
- xli. List of NCLT cases pending as on year end.
- xlii. List of Unusual Entries put through inter-branch/head office Accounts.
- xliii. List of Accounts where Fraud is detected during the year.

18.14 There are separate formats (part of LFAR) for following specific branches which need to be consolidated in respect of:

- Dealing in Foreign Exchange Transactions.
- Dealing in clearing house operations, normally referred to as service Branches.
- Dealing in NPAs such as Asset Recovery Management Branches.
- Annexure III (for Large/Irregular/Critical Advance Accounts), specified in the circular on Long Form Audit Report, to be obtained by the SBAs from branches dealing in large advances / asset recovery branches.

### Introduction

19.01 The SCAs have to issue various Special Purpose Reports and Certificates at the Head Office level. The appointment letter normally contains the exhaustive list of all such Reports and Certificates to be issued by the SCA's, as prescribed by the RBI. These are to be verified and certified by the SCAs to ensure their correctness and accuracy. The RBI regularly updates the lists of various certificates to be issued by SCAs. Many of these certificates require consolidating the certificates issued by SBAs for the respective branches/Regional offices/zonal offices/accounting units etc. and SCAs for respective HO departments allocated at the time of appointment.

### Regulatory Requirements

19.02 The RBI circulars issued from time to time specify the requirements of Certificates from SCAs in the case of banks.

19.03 While issuing certificates as auditors of bank, the SCAs should bear in mind the recommendations made in the Guidance Note on Reports or Certificates for Special Purposes (Revised 2016) issued by the Institute of Chartered Accountants of India (ICAI).

### Audit Approach

19.04 At the time of accepting the audit, issuing engagement letter, preparing the audit program, maintaining adequate working papers, the SCAs should ensure compliance with the requirements of Guidance Note on Reports or Certificates for Special Purposes (Revised 2016) issued by the ICAI. Readers may also refer the covering report for certificates as prescribed in Annexure A "Illustrative Format of Covering Report for various Certificates issued by SCAs" to this Chapter.

19.05 Before commencement of the year-end audit process, SCAs should ask the bank's management to prepare a complete list of all the certificates to be issued as part of the audit based on RBI directions from time to time.

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19.06 Based on the allocation of work/departments amongst joint auditors, various SCAs should be assigned the responsibility of verifying and issuing the certificate related to respective department. One of the SCAs should be assigned responsibility to collect all certificates and coordinate with bank for onward submission to the RBI in stipulated time.

19.07 Depending on the centralization of operations at the bank, the certificate to be issued at central office should be separated from the certificates to be issued based on consolidation process from various branches.

19.08 SCA should draft clear and adequate communication and instruction for SBAs (which would form part of the annual closing instructions from bank's management to SBAs). Instructions should cover the requirements of the certificate, areas and extent of verification, inclusions and exclusions if any and in some cases draft format in which the certificates have to be issued. This ensures compliance of SA 600, "Using the Work of Another Auditor".

19.09 The SCA should be careful while issuing certificates based on consolidation at branches/ROs/ZOs etc. The SCAs should understand and verify the process for consolidation of certificates received from various branches/ROs/ZO and head office departments with respect to the contents of consolidated certificates to be issued at HO level. In some cases such consolidations are carried out manually and not through the bank's CBS/IT system. All the returns/reports submitted by unaudited branches to various higher authorities should be cross verified judiciously.

19.10 SCAs should reconcile or tally the closing balance of the return/certificate with the General Ledger Heads in the Trial Balance or other relevant returns of the bank as at year end. This will be important for semi-automatic or manual returns. For entirely system generated returns, it should be ensured that they tally with the year-end figures, wherever applicable.

### **Responsibility of the Management**

19.11 The correctness in the preparation of various certificates is the responsibility of the management of the bank including designing, implementing and maintaining internal control relevant to the preparation and presentation of various certificates. The Management is also responsible for compliance with all the provisions of the RBI and other regulatory guidelines. The responsibility of the SCAs is to verify and report on the status of correctness of the same through necessary checks carried out during the audit.

The results of the verification carried out by the SCAs on test check basis and their comments thereon should be given in a separate report.

### **Audit Approach and Procedures**

19.12 The format of certificates required to be issued by the SBAs and SCAs are devised by the bank, RBI and other authorities who are the users of these certificates. The prescribed formats are required to be filled in by the banks for reporting on compliance.

19.13 The SCA shall obtain a confirmation from the management as to whether it has received the various reports/certificates from all the branches, RO/ZO, etc. and also whether it has prepared the status report as applicable at HO level. The SCA shall obtain a list of the branches, ROs/ZOs which have not submitted the prescribed report. Such a list would help the SCA to have a broad idea as to the extent of compliance.

19.14 The SCA should maintain proper documentation about the information sought and received, audit / verification procedures carried out, the extent of checking, observations and findings.

19.15 The SCA should obtain and review a copy of these reports/certificates so prepared/compiled and submitted to them by the bank. The review would help the auditors to identify areas which are susceptible to fraud/ malpractices. The results of such a review / checking may also require the auditor to re-consider the nature, timing and extent of the procedures adopted by them for carrying out the audit as well as their audit findings.

19.16 The SCA may also request the management to provide a list of branches which had been subject for a concurrent audit/ inspection by the in-house inspection department or the inspectors from the RBI. The SCA 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.

19.17 Some of the certificates to be issued by the SCAs are technical in nature and the SCA may have to rely on the work done by other experts (e.g. IT expert, etc.) or representation from the management. In such cases the SCA should clearly mention any scope limitations, whether he relied on the services of other expert(s), and give necessary disclaimer in the certificate. The SCA may also consider modifying the opinion paragraph (issue a negative

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assurance rather than a reasonable or absolute assurance on the work done by them).

19.18 The certificates should clearly state the records checked, to what extent they have been checked, and what has been checked.

19.19 The SCAs is also required to comply with the requirements of UDIN while issuing such certificates. Where a Certificate is jointly issued by multiple SCAs, the Certificate should clearly list out the particulars of all such SCAs and the compliance with the requirements of UDIN shall apply severally to each of them.

## ***Annexure A***

### **Illustrative Format of Covering Report for various Certificates issued by SCAs**

**Independent Auditor's Certificate for various certificates issued during the Statutory Audit of..... [Name of the Bank] for the Financial Year 20XX-XX**

1. This Certificate is issued in accordance with the terms of our agreement dated [date of Engagement Letter].
2. The accompanying Statement contains various certificates issued by us during the Statutory Audit of [Name of the Bank] for the financial year 20XX-XX, listed in Annexure [Name], which we have initialled for identification purposes only.

#### **Managements' Responsibility for the Statement**

3. The preparation of the accompanying Statement is the responsibility of the Management of the bank. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and presentation of the Statement, and applying an appropriate basis of preparation; and making estimates that are reasonable in the circumstances.
4. The Management is also responsible for ensuring that the bank complies with the requirements of the guidelines issued by regulators such as RBI, SEBI, etc.

#### **Auditor's Responsibility**

5. Pursuant to the requirements of the various RBI guidelines, our responsibility is to express reasonable assurance in the form of an opinion based on our audit and examination of books and records on test check basis, as to whether the [Name of the Bank] has undertaken only those activities that have been specifically permitted by the RBI and has complied with the specified terms and conditions.
6. We have audited the financial statements of [Name of the Bank] for the financial year 20XX-XX on which we issued an unmodified/ a modified audit opinion vide our reports dated [date of Audit Report]. Our audit of these financial statements was conducted in accordance with the Standards on Auditing and other applicable authoritative pronouncements issued by the Institute of Chartered Accountants of India. Those Standards require that we plan and perform audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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7. We conducted our examination of the Statements/Certificates given in Annexure [Name], in accordance with the Guidance Note on Reports or Certificates for Special Purposes (Revised 2016) issued by the Institute of Chartered Accountants of India . The Guidance Note requires that we comply with the ethical requirements of the Code of Ethics issued by the Institute of Chartered Accountants of India.

8. We have complied with the relevant applicable requirements of the Standard on Quality Control (SQC) 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

**Opinion**

9. Based on our examination, procedures performed, evidence obtained, and the information and explanations given to us, we report that the Statement in Annexure [Name] is in agreement with the books of account and other records of [Name of the Bank] for the Financial year 20XX-XX as produced to us for our examination, and the information thereof is prepared, in all material respects, in accordance with the applicable criteria.

**Restriction on Use**

10. This certificate has been prepared at the request of the [Name of the Bank] solely with reference to our appointment letter, for the purpose of onward compilation of various certificates and disclosure requirements for [Name of the Bank] as a whole. It should not be used by any other person or for any other purpose. Accordingly, we do not accept or assume any liability or any duty of care or for any other purpose or to any other party to whom it is shown or into whose hands it may come without our prior consent in writing.

For  
Chartered Accountants  
Firm's Registration Number:

Partner / Proprietor  
Membership Number  
UDIN

Place:  
Date:



**Section B**  
**Bank Branch Audit**



## Practical Guide for Statutory Branch Auditors performing Bank Branch Audit for the First Time

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1.01 The banking industry is the backbone of any economy as it is essential for the sustainable socio-economic growth and financial stability of the economy. There are different types of banking institutions operating in India. These are:

- (a) Commercial Banks
- (b) Regional Rural Banks
- (c) Co-operative Banks
- (d) Development Banks (more commonly known as 'Term-Lending Institutions')
- (e) Foreign Banks
- (f) Payment Banks
- (g) Small Finance Banks
- (h) EXIM Bank

1.02 All these banks have their unique features and perform various functions / activities in compliance with the guidelines issued by the Reserve Bank of India (RBI) from time to time. Section 6 of the Banking Regulation Act, 1949, specifies the forms of business which the banking companies may carry on. The text of Section 6 of the Banking Regulation Act, 1949 appears **Appendix I** of Section B of the Guidance Note on Audit of Banks (2023 Edition).

1.03 Of these banks, commercial banks are the most widely spread banking institutions in India. Commercial banks offer a number of products and services to the general public and other segments of the economy. Two of the main functions of commercial banks are (1) accepting deposits and (2) granting advances. Treasury operation is also one of the key functions of commercial banks which involves investment of surplus funds in various types of securities as also investment in specified securities as per RBI guidelines and carrying out forex operations. In addition to their main banking activities, commercial banks also undertake certain eligible para banking activities which are governed by the RBI Guidelines on Para Banking activities.

1.04 The functioning of banking industry in India is regulated by the RBI which is the Central Bank of our country. RBI is responsible for the development and supervision of the constituents of the Indian financial system (which comprises of banks and non-banking financial institutions) as well as for determining, in conjunction with the Central Government, the monetary and credit policies keeping pace with the need of the hour. Important functions of RBI 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 a licence from the RBI. The RBI also has the power to inspect any bank and carries out such inspections on regular basis.

1.05 The provisions regarding financial statements of banks are governed by the Banking Regulation Act, 1949. The Third Schedule to the said Act, prescribes the forms of balance sheet and profit and loss account in case of banks. Readers may refer **Appendix II** of Section B of the Guidance Note on Audit of Banks (2023 Edition) for the text of the Third Schedule to the Banking Regulation Act, 1949. Further, in case of banking companies, the requirements of the Companies Act, 2013, relating to the preparation of the balance sheet, profit and loss account and cash flow statement of a company, in so far as they are not inconsistent with the Banking Regulation Act, 1949, also apply to the financial statements, as the case may be, of a banking company. It may be noted that this provision does not apply to Nationalised Banks, State Bank of India, its Subsidiaries and Regional Rural Banks (RRBs). The provisions regarding audit of Nationalised Banks are governed by the Banking Regulation Act, 1949 and the RBI Guidelines. The audit of banking companies is governed by the provisions of the Banking Regulation Act, 1949, RBI Guidelines and the provisions of the Companies Act, 2013.

1.06 Annual Statutory Audit of banks is a very important exercise and considerable significance is given to the same by RBI. Given below are some of the guidelines for conducting statutory audit of bank branches.

### **Pre-commencement of Audit**

#### **Co-ordination with Branch Management**

1.07 Statutory Branch Auditors (SBAs) are given limited time within which they have to undertake the audit of branches allotted to them. Accordingly, the planning of the assignment and start of the work is really critical. Co-ordination between the auditor and the branch management is essential for an effective audit and timely completion with highest audit quality. A No Objection Certificate

(NOC) from the previous auditor should be obtained and kept on record by the SBA. 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 as required. Further, the SBA should also specify the books, records, and other information that he would require in the course of his audit. Such a communication would enable the branch management to keep the requisite documents, information, etc., ready.

1.08 The SBA needs to plan the work properly prior to commencement of the audit. The SBA needs to issue the audit engagement letter in accordance with Standard on Auditing (SA) 210, "Agreeing the Terms of Audit Engagements" and the requirement letter which will contain the details or information needed to conduct the audit. The SBA needs to obtain basic information about the size of the branch and nature of the activities carried out at the branch, to find out whether the branch is a normal branch or specialised branch such as forex / overseas or service branch. If the branch is a normal branch, then based on the size of the branch, the SBA should organise his audit team and prepare the audit plan. If it is specialised branch, members of the audit team should be thoroughly acquainted with the rules and regulations governing such specialised branch. The audit team needs to have a basic knowledge / understanding about RBI regulations and circulars governing the specialized branch as well as normal branch. It is advisable to complete the verification related to non-financial areas like documentation review, sanctioning terms, review of the supervision and monitoring terms, review of the concurrent/internal audit and inspection reports, etc. before the year-end itself.

### **Engagement and Quality Control Standards**

1.09 The auditor/audit 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 review / 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 individuals or firms to comply with SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements" will greatly depend on various factors such as the size, maturity, geographical location, type of work handled and other operating characteristics.

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1.10 The ICAI has issued various Standards on Auditing applicable to audit of financial statements which are mandatorily to be followed by all auditors. Understanding the concepts in these Standards on Auditing would help the SBAs in discharging their duties diligently.

1.11 In the present scenario of statutory bank branch audit, one of the most important aspects is proper planning and documentation of the auditing activity. The SBA should have sound and complete knowledge of the business of the bank.

1.12 The auditor needs to study the following:

1. **Appointment Letter** – It is necessary to read the Appointment Letter carefully and duly consider all the terms and conditions mentioned therein, that are required to be followed during the process of the audit. The letter of appointment sent by banks to SBAs 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 Statutory Central Auditors (SCAs).
  - Particulars of previous auditors.
  - Guidelines for conducting audit of branches, completion of audit, eligible audit fees, 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 undertakings by the firm/SBA, specimen signatures, etc.
  - Scope of work - Besides the statutory audit under the provisions of the Banking Regulation Act, 1949, the SBA is also required to verify certain other areas and issue various reports and certificates like LFAR, Tax Audit Report, certificates for cash verification on odd dates, Ghosh & Jilani Committee Reports etc.
2. **RBI Guidelines and Circulars** – SBA should read and study RBI circulars, master directions, notifications and the Banking Regulation Act, 1949. This is very crucial and shall help in proper understanding and execute the audit.
3. **Bank's Closing Circular** – Along with the appointment letter, banks also issue closing guidelines. These guidelines/circulars cover the process and

policies followed by the bank. Basic understanding of these circulars is necessary.

4. The SBA also needs to have a basic knowledge of allied applicable laws to carry out an effective audit. For example: Indian Contract Act 1872, Negotiable Instruments Act 1881, relevant Stamp Acts, etc.
5. **Internal Financial Controls over Financial Reporting (IFCoFR)** – The RBI has made reporting on IFCoFR for Public Sector Banks mandatory from Financial Year 2020-21. SCAs of Nationalised Banks report on the same on the basis of testing of various controls by them. However, some of the controls have to be tested at branch level also on sample basis which are decided and communicated to SBA by SCA in consultation with bank management. In case the branch allotted to SBA is selected for testing of IFCoFR, then the SBA would be required to report on IFCoFR of that branch. SBAs may refer the Technical Guide on “Audit of Internal Financial Controls in case of Public Sector Banks” in this regard.

### **Steps for Audit of Advances and NPA related matters**

1.13 The SBA should document the criteria for test check which he has chosen for verification of advances. SBA should prepare / suitably create check-list to verify advances which are selected for verification. Based on RBI guidelines, the auditor should see that sanctioning, disbursement, review / renewal and monitoring of advances are being done properly. If there are deviations, the auditor should report the same. The auditor should select appropriate sample from all categories of advances so that they truly represent the entire population and carry out appropriate test checks. The larger advances as required in any case would need to be audited.

1.14 The SBA should study the latest Income Recognition and Asset Classification (IRAC) Guidelines of RBI. The auditor should also check whether the bank has correctly classified the advances into performing and non-performing categories. Appropriate test checks should be carried out regarding classification of advances. The auditor should appropriately deal with the deviations in classification and accordingly, memorandum of changes should be issued if required. The SBA should report all deficiencies noted by him in the Long Form Audit Report. The RBI *vide* its notification dated September 14, 2020 has mandated that income recognition, asset classification and provisioning should be totally automated by the banks by June 30, 2021. This date has subsequently been extended upto December 31, 2021. This should be verified by SBAs.

1.15 The RBI is now insisting on checking of Central Repository of Information on Large Credits (CRILC) for advances over Rs. 5 Crores, which

maintains history of the borrowers from inception. Banks have to update this every time the borrower moves into or out of default. This history card will give a snap shot of the borrower's behaviour.

1.16 Similarly for advances less than Rs. 5 Crores, the RBI maintains the Central Fraud Registry (CFR) which holds all the data regarding frauds reported by banks in India. This allows the bank to decide whether the borrower is eligible before processing the sanction as well as for timely action against existing borrowers.

1.17 The SBAs should specifically check the review / renewal of advances, availability of drawing power, restructured cases, credit and debit summation in accounts, daily stamping of NPA, evergreening of loans, etc. carefully while conducting their audit, as such verification may not only indicate the lapses in the selected account but may also give an indication of control lapses at branch level in each of the above processes.

### **Steps for Audit related to Cash, Housekeeping, Deposits and Other Matters**

1.18 The SBA should check internal controls on custody of cash and check that the cash management policy of the bank is strictly followed. The SBA should physically check cash at the branch and at the ATM attached to the branch. The SBA should examine rotation of duties of key management at branch for effective operations. The SBA should examine the limit for cash holding and cash actually held by branch throughout the year.

1.19 The Deposits constitute the other major item of the financial statements. Interest accrued on these deposits at year end should be verified on sample basis. KYC, ReKYC and SFT reporting, etc. are being focussed and should be reviewed for their status and compliance.

1.20 The "Other Assets" and "Other Liabilities" heads in the financial statements should be reviewed for their correctness. Old balances in 'other assets' and the provisioning required against the same should be carefully examined.

### **Steps for Audit related to Financial Statements**

1.21 The SBA should apply basic audit principles and carry out checking of the financial statements. The SBA may apply analytical procedures such as ratio analysis and comparative analysis to find out key variances, if any in the financial statements and then to focus on such key variances for detailed audit. Based on the audit process carried out by the audit team and after examination of the final financial statements, the auditor should frame their audit opinion.



### Steps for Compiling the Main Report & LFAR etc.

1.22 The SBAs should also ensure that their audit report complies with the requirements of SA 700(Revised), “Forming an Opinion and Reporting on Financial Statements”, SA 705(Revised), “Modifications to the Opinion in the Independent Auditor’s Report” and SA 706 (Revised), “Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report”. Based on the audit process carried out, the auditor should report his findings in the Audit Reports. The illustrative formats of auditor’s report are given in **Appendices III and IV** of Section B of the Guidance Note on Audit of Banks (2023 Edition) as follows:

**Appendix III** - Illustrative Format of Report of the Branch Auditor of a Nationalised Bank

**Appendix IV** - Illustrative Format of Report of the Branch Auditor of a Banking Company

1.23 Besides the main audit report, the terms of appointment of auditors of public sector banks, private sector banks and foreign banks (as well as their branches), require the auditors to also furnish a Long Form Audit Report (LFAR) to the management. While planning the audit, the auditor should cover all aspects on which reporting is to be done in his main report and also in the LFAR. The matters to be dealt with by auditors in LFAR have been specified by the RBI. Latest revision to LFAR by RBI has been made in September 2020 and is to be applied accordingly. For matters which are reported in the main report and LFAR, the auditor should have necessary and appropriate audit documentation to evidence the findings made. If the auditor intends to issue modified opinion, reasons therefor need to be stated. SBAs may refer the “Technical Guide on Revised Formats of Long Form Audit Report” in this regard.

1.24 For the benefit of the members various illustrative formats have been given in Appendices V to XI of Section B of this Guidance Note as detailed hereunder:

**Appendix V** - Illustrative Format of Engagement Letter to be sent to the Appointing Authority of the Nationalised Bank by Branch Auditor.

**Appendix VI** - Illustrative Format of Engagement Letter to be sent to the Appointing Authority of the Nationalised Bank by Branch Auditor (Separate only for Audit of Internal Financial Controls Over Financial Reporting).

- Appendix VII** - Illustrative Format of Written Representation Letter to be obtained from the Branch Management.
- Appendix VIII** - Suggested Abbreviations used in the Banking Industry.
- Appendix IX** - Illustrative Bank Branch Audit Programme for the Year ended March 31, 2023.
- Appendix X** - Typical reasons observed for the divergence in asset classification and provisioning (large accounts) during Supervisory Cycle 2022-23 (FY 2021-22), during Capital Assessment Exercise
- Appendix XI** - Advisory for Statutory Bank Branch Auditors w.r.t. Specific Considerations while conducting Distance Audit / Remote Audit / Online Audit of Bank Branch under current Covid-19 situation issued on May 6, 2020.

## **Special Audit Considerations in Foreign Banks**

1.25 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.

1.26 Foreign banks generally operate in India through branches and do not have a separate legal entity/existence in India. Some are set up as Indian subsidiaries of the foreign banks. However, the RBI regulates their functioning in India, with regard to scale and nature of business they undertake in India.

1.27 Auditors of foreign banks will have to modify their audit procedures so as to take care of the operational structure and operations of these banks. Some of the important elements related to foreign banks which may have a bearing on the audit plan and procedure are:

- Management structure.
- More centralised operational functions.
- Core banking software used globally.
- Requirement for compliance with foreign legal and regulatory requirements.
- Cross border flow and processing of data.
- Complex treasury operations and cross border forex deals.
- Compliance with Basel III Regulatory Framework for Capital Adequacy.
- Operational processes.

## Bank Branch Audit Planning

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### Appointment of Auditors

2.01 The ICAI invites applications from CA firms to be empanelled for carrying out the Bank / Bank branch audit for nationalised banks. After due verification of details submitted by CA Firms, approved list of CA Firms is submitted to the RBI. The RBI circulates this list to banks for appointment of their auditors. Banks check with CA firms about their willingness and then confirm their appointments. Once the appointment of statutory auditors is done, the final list is submitted by all the nationalised banks for RBI's approval.

### Understanding the Business of Bank Branch

2.02 The auditor should understand the nature of activities carried out at the bank branch. The auditor should consider the requirements of SA 315 "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment". Besides the core business of banks of accepting deposits and sanctioning advances, newer banking products are being periodically introduced by the banking industry - e.g. Digital Loans. The auditor should have complete knowledge about the basics of the core business of banks and the products offered at the branches. The auditor should study the financial implication of all the products offered at the branches. The types of facilities provided to borrowers and the Standard Operating Procedures (SOP) or the product policies approved by the banks management should be studied. Before commencing the audit, the auditor should also have a basic understanding of the Core Banking Solution (CBS) used by the bank. Authority levels should be understood. Based on the features of the products, the auditor should draw up a suitable audit plan to verify the transactions of the activities being provided by the bank. Risk Assessment is to be carried out based on clear understanding of the business profile of the Bank Branch.

2.03 The auditor should find out the role and responsibilities of the branch officials and the internal controls in operation. Most of the banks have converted their branches as customer facing point of contact and sales and, almost all processing / decision making is centralised. Depending on the functions being carried out at the branch, the auditor should design his audit plan and the extent of verification. The auditor should assess the availability of the physical loan documents in cases where the processing of the loans are carried out from a centralised location.

2.04 The auditor should have a thorough understanding of RBI guidelines, prudential norms and master directions and be updated with the latest circulars and instructions issued by the RBI including relevant internal circulars issued by the bank.

### **Audit Planning**

2.05 The auditor should plan the audit keeping in mind the requirements of SA 300, "Planning an Audit of Financial Statements". The auditor should document the audit plan and conduct a preliminary enquiry to know the nature, size and category of bank branch to be audited. The auditor should work out an overall audit strategy for execution of the audit within the time limits.

2.06 The auditor needs to assess the risk involved in branch being audited. Depending on the nature of transactions executed at the branch, the audit plan should be designed. General branches will have one set of audit plan and specialised branches will have different audit plans based on the nature of transactions executed at the branch, such as treasury branches, forex branches, service / clearing branches. The category of the branch to be audited will also determine the overall audit plan and the various checks to be applied for audit e.g., large or mid corporate, retail branch, rural or agricultural branch, etc.

### **Internal Financial Controls over Financial Reporting (IFCoFR)**

2.07 The RBI has made reporting on IFCoFR for Nationalised Banks mandatory from Financial Year 2020-21. SCAs of Nationalised Banks report on the same on the basis of testing of various controls by them. However, some of the controls have to be tested at branch level also on sample basis which are decided by the SCA in consultation with the bank management. In case the branch allotted to SBA is selected for testing of IFCoFR then the SBA would be required to report on IFCoFR of that branch. SBAs may refer Technical Guide on Audit of Internal Financial Controls in case of Public Sector Banks in this regard. This aspect also needs to be considered at the planning stage by the SBA, in case the branch has been identified for reporting on IFCoFR under statutory audit. The auditor should include procedures to test the IFCoFR controls along with the regular branch audit procedure on selected areas.

2.08 The auditor should assess the resource requirements for audit to be completed within the stipulated timelines. Based on the volume and nature of transactions executed at the branch, staff will be deployed. Audit team needs to be updated with banking law and regulations and RBI guidelines.

2.09 Detailed requirement letter seeking information regarding branch should be sent by the auditor to branch management so that necessary information is received during the planning stage and accordingly proper audit plans can be made. On confirmation of the branch by the bank, the auditor should conduct a

preliminary meeting with the branch management to understand the structure and nature of the branch. The auditor should call for previous year's inspection/concurrent and other important reports so that beforehand the auditor may be aware of the past key issues. The auditor should also look at the previous year/period's reports of the previous statutory auditor and its compliance status. A study of the previous year's LFAR will also help in gaining an understanding of the issues at the branch.

2.10 All Public Sector Banks come out with closing instructions for bank's management and auditors at branches. The auditor should design the audit plan and audit procedures and the extent of checking keeping the bank's closing guideline/instructions. Many banks also have a practice of organising a meeting of the SCA and the branch auditors wherein insights are shared and areas of importance are highlighted. The overall audit plan should also consider the important aspect from this.

2.11 The auditor should document direction, supervision and review strategies in the Audit plan.

### **Audit Procedures /Understanding Forms and Content of Financial Statements/Reporting**

2.12 Before carrying out the audit at the branches, the auditor should carefully make a list of all the annual returns/financial statements and certificates to be verified and certified as part of the branch audit. Understanding the underlying requirements of the annual statements to be certified would help the auditor in designing the plan and audit procedures to be carried out.

2.13 The auditor should carry out analytical and substantive audit procedures to verify true and fair view of the financial statements. Due to stringent timelines set by the bank, along with appropriate test checks carried out, analytical procedures will be useful tool to detect material misstatement, if any, in the financial statements. The auditor should set materiality level in accordance with SA 320, "Materiality in Planning and Performing an Audit" and carry out substantive audit procedures for all material transactions.

2.14 Various closing forms and certificates are to be certified by the statutory auditors. Understanding the objective of such forms and certificates is very essential. The auditor should read relevant circulars and guidelines of the RBI before verifying the forms and certificates and should understand the process followed in making such forms / certificates.

2.15 Final audit report and Long form Audit Report are two documents that are issued by the statutory auditor to the bank management. In the final audit report, reporting on IFCoFR will also have to be done in case the branch is selected for verification of IFCoFR. During the course of audit, the auditor should

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note down the observations, which he had come across and which require attention of the management and various points need to be reported in the Long Form Audit Report. While carrying out audit of each area simultaneously the auditor should give replies for questions in Long Form Audit Report.

2.16 It is also important that the branch auditor complies with all the pre-audit formalities (like appointment letter, NOC from previous auditor, engagement letter etc.) immediately on receipt of confirmation from the bank and before the commencement of actual audit at the branch.

2.17 The branch auditor should develop a mechanism to list out the specific representations on certain matters/areas on which the auditor has relied upon during the course of audit for inclusion in the Management Representation letter. These representations should be discussed with the branch management before finalisation of the Final Audit Report and Long Form Audit Report.

# 3

## Audit Documentation in Bank Branch Audit

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3.01 SA 230, "Audit Documentation" requires the auditor to duly prepare and maintain audit documentation for an audit of financial statements. Bank Audit is no exception and the auditors need to collect all the documentary evidences while carrying out an audit. The nature and purpose of audit documentation have been explained in SA 230.

3.02 Various SAs also lay down the documentation that should be maintained by an auditor, which should be ensured. The auditor should ensure that the audit documentation meets the requirements of SA 230 and the specific documentation requirements of other relevant SAs and other regulatory requirements.

3.03 The auditor should prepare the audit plans and make a note of the checks that will be carried out during the audit process. The auditor should prepare a tracker to list down the queries raised, response received from the branch management, further queries and responses (if any), final conclusion of the auditor, documents received from the management for the same etc. Audit documentation should provide sufficient evidence of the auditor's basis for a conclusion about the true and fair view of the financial statements of the branches, certificates issued, and his observations mentioned in the LFAR. Audit documentation should also ensure satisfactory evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements. The branch should obtain and keep the documents which are final and executed by the branch management to avoid duplication and excessive paperwork.

3.04 The auditor should prepare audit documentation on a real time basis while conducting the audit. Audit documentation may be recorded on paper or on electronic or other media which can be easily retrieved as and when required. Audit documentation should be self-explanatory and should not require external help for interpretation. Examples of audit documentation include: Audit plan and programs (assigning responsibility of conduct, review and final authorization), final working papers and analysis, Issue-Memorandum, summaries of significant matters discussed with branch management, letters of confirmations and representations, checklists, correspondences (including e-mail) concerning significant matters with the branch or central office.

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3.05 An illustrative list of documents to be maintained in the bank branch audit file is given below:

- Appointment formalities, including appointment letter, NOC from previous auditor, engagement letter etc.
- Summary of latest RBI Master Directions / Circulars, other material for conducting the audit.
- Closing guidelines / circular issued by the bank.
- Summary of the relevant provisions of the RBI Master Directions, IRAC norms, closing circular used at the branch.
- Detailed branch audit plan and program as per SA 230.
- Obtaining Delegation of Power (DOP) booklet to understand the powers and responsibilities at various levels in the branch.
- Summary of the accounting policies, observations from previous audits, inspection reports, concurrent audits, etc. and how the auditor has verified their satisfactory compliances.
- Audit procedures adopted and determination of materiality levels. understanding of the internal controls, IT system controls.
- Audit working paper documenting the audit procedures carried out for testing IFCoFR controls;
- Audit working papers and issue trackers. How the issues raised during audit were concluded.
- Financial statements of the previous year and current year.
- Management certified trial balance for the year (if available from the system).
- Summary of various audit reports such as internal inspection report, concurrent audit reports, previous year statutory audit report.
- Statement of advances with classification along with various fields duly filled such as security, sanction limits, date of sanction / renewal, outstanding balance etc.
- Specific representation, notes and working papers received from the bank's management on sensitive or significant audit issues or accounts.
- List of latest and updated stock and security statements, valuation and inspection reports as on March 31.



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- List of documents verified and minutes of meeting with the bank's management.
- Copies of supporting documents that are verified and confirmations obtained during the audit.
- Break-up of other assets and liabilities and Inter-Branch Adjustments including the confirmation of deposits given by the branch.
- Proof of various securities, cash and other assets physically verified during the audit.
- ATM verification details.
- KYC verification, anti-money laundry verification, FEMA compliance at branches.
- Proof of verification of third party products if any.
- Details of off balance sheet items, claims against banks and contingent liabilities.
- Other Bank / RBI balance confirmation.
- List of customer complaints registered/responded by the branch- nature of complaint and its resolution.
- Management Representation Letter.
- Various other audit documents / evidence considered in the audit process.

# 4

## **Overview of Standards on Auditing**

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4.01 Effective implementation of Standards on Auditing (SAs) is essential to ensure quality in bank branch audit as in the case of any other audit engagement. While it is true that the degree of depth in application of SAs to various sizes of the branch will vary materially, it is necessary that the auditor should have on his/her records evidence that the auditor has carried the audit as per the applicable SAs.

4.02 In order to facilitate compliance of these SAs, every audit file should contain the list of these SAs and remarks of the signatory against each as to whether the Standard is applied. This will inculcate necessary discipline among the staff members and even the signatories of the audit statements.

4.03 Let us understand the overall structure of the Standards on Auditing. The entire structure of SAs is divided as under:

SAs are applicable to all audit engagements. SAs are categorised as under:

- |   |                  |
|---|------------------|
| 1. General principles & Responsibilities            | SA 200 to SA 299 |
| 2. Risk assessment & Response to the assessed risks | SA 300 to SA 499 |
| 3. Audit Evidence                                   | SA 500 to SA 599 |
| 4. Using the Work of Others                         | SA 600 to SA 699 |
| 5. Audit Conclusions & Reporting                    | SA 700 to SA 799 |
| 6. Specialised Areas                                | SA 800 to SA 899 |

4.04 It is necessary to keep checklists for SAs in the audit documentation file and ensure their compliance and completeness. The scope and objective of each SA is given in the following table which can be utilised as a reference for checklist for each audit/ assignment undertaken.

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SA - No.	Name of SA	Scope and Objective	Remark of Auditor
<b>SA-200</b>	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing	<p>This SA establishes the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with SAs. Specifically, it sets out the overall objectives of the independent auditor, and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority and structure of the SAs, and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the SAs.</p> <p>In conducting an audit of financial statements, the overall objectives of the auditor are:</p> <ul style="list-style-type: none"> <li>(a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and</li> <li>(b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.</li> </ul>	
<b>SA-210</b>	Agreeing the Terms of Audit Engagements	This SA deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged	

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		<p>with governance. This includes establishing that certain preconditions for an audit, responsibility for which rests with management and, where appropriate, those charged with governance, are present.</p> <p>The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:</p> <ul style="list-style-type: none"> <li>(a) Establishing whether the preconditions for an audit are present; and</li> <li>(b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.</li> </ul>	
<b>SA-220</b>	Quality Control for an Audit of Financial Statements	<p>This SA deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements. It also addresses, where applicable, the responsibilities of the engagement quality control reviewer.</p> <p>The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:</p> <ul style="list-style-type: none"> <li>(a) The audit complies with professional standards and regulatory and legal requirements; and</li> <li>(b) The auditor's report issued is appropriate in the circumstances.</li> </ul>	
<b>SA-230</b>	Audit Documentation	<p>This SA deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements. The specific documentation requirements of other SAs do not limit</p>	

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		<p>the application of this SA. Laws or regulations may establish additional documentation requirements</p> <p>The objective of the auditor is to prepare documentation that provides:</p> <ul style="list-style-type: none"> <li>(a) A sufficient and appropriate record of the basis for the auditor's report; and</li> <li>(b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.</li> </ul>	
<b>SA-240</b>	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements	<p>This SA deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Specifically, it expands on how SA 315 and SA 330 are to be applied in relation to risks of material misstatement due to fraud.</p> <p>The objectives of the auditor are:</p> <ul style="list-style-type: none"> <li>(a) To identify and assess the risks of material misstatement in the financial statements due to fraud;</li> <li>(b) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and</li> <li>(c) To respond appropriately to identified or suspected fraud.</li> </ul>	
<b>SA-250</b>	Consideration of Laws and Regulations in an Audit of Financial Statements	<p>This SA deals with the auditor's responsibility to consider laws and regulations when performing an audit of financial statements.</p> <p>The objectives of the auditor are:</p> <ul style="list-style-type: none"> <li>(a) To obtain sufficient appropriate audit evidence regarding</li> </ul>	

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		<p>compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements;</p> <p>(b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and</p> <p>(c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.</p>	
<b>SA-260 (Revised)</b>	Communication with Those Charged with Governance	<p>This SA deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements. Although this SA applies irrespective of an entity's governance structure or size, particular considerations apply where all of those charged with governance are involved in managing an entity, and for listed entities.</p> <p>The objectives of the auditor are:</p> <p>(a) To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;</p> <p>(b) To obtain from those charged with governance information relevant to the audit;</p>	

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		<p>(c) To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and</p> <p>(d) To promote effective two-way communication between the auditor and those charged with governance.</p>	
<b>SA-265</b>	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	<p>This SA deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements. This SA does not impose additional responsibilities on the auditor regarding obtaining an understanding of internal control and designing and performing tests of controls over and above the requirements of SA 315 and SA 330.</p> <p>The objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.</p>	
<b>SA-299 (Revised)</b>	Joint Audit of Financial Statements	<p>This SA lays down the principles for effective conduct of joint audit to achieve the overall objectives of the auditor as laid down in SA 200. This SA deals with the special considerations in carrying out audit by joint auditors. Accordingly, in addition to the requirements enunciated in this Standard, the joint auditors also</p>	

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		<p>need to comply with all the relevant requirements of other applicable SAs.</p> <p>The objectives of this Standard are:</p> <ul style="list-style-type: none"> <li>(a) To lay down broad principles for the joint auditors in conducting the joint audit.</li> <li>(b) To provide a uniform approach to the process of joint audit.</li> <li>(c) To identify the distinct areas of work and coverage thereof by each joint auditor.</li> <li>(d) To identify individual responsibility and joint responsibility of the joint auditors in relation to audit.</li> </ul>	
<b>SA-300</b>	Planning an Audit of Financial Statements	<p>This SA deals with the auditor's responsibility to plan an audit of financial statements. This SA is framed in the context of recurring audits. Additional considerations in initial audit engagements are separately identified.</p> <p>The objective of the auditor is to plan the audit so that it will be performed in an effective manner.</p>	
<b>SA-315</b>	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment	<p>This SA deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control.</p> <p>The objective of the auditor 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</p>	



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		<p>assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.</p>	
<b>SA-320</b>	<p>Materiality in Planning and Performing an Audit</p>	<p>This SA deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements.</p> <p>The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.</p>	
<b>SA-330</b>	<p>The Auditor's Responses to Assessed Risks</p>	<p>This SA 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 in a financial statement audit.</p> <p>The objective of the auditor is to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.</p>	
<b>SA-402</b>	<p>Audit Considerations Relating to an Entity Using a Service Organization</p>	<p>This SA deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations. Specifically, it expands on how the user auditor applies SA 315 and SA 330 in obtaining an understanding of the user entity, including internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.</p> <p>The objectives of the user auditor, when the user entity uses the services of a service organisation, are:</p>	

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		<p>a) To obtain an understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement; and</p> <p>b) To design and perform audit procedures responsive to those risks.</p>	
<b>SA-450</b>	Evaluation of Misstatements Identified during the Audit	<p>This SA deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.</p> <p>The objective of the auditor is to evaluate:</p> <p>(a) The effect of identified misstatements on the audit; and</p> <p>(b) The effect of uncorrected misstatements, if any, on the financial statements.</p>	
<b>SA-500</b>	Audit Evidence	<p>This SA explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.</p> <p>The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.</p>	
<b>SA-501</b>	Audit Evidence-Specific	This SA deals with specific considerations by the auditor in	

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	Considerations for Selected Items	<p>obtaining sufficient appropriate audit evidence in accordance with SA 330, SA 500 and other relevant SAs, w.r.t. certain aspects of inventory, litigation and claims involving the entity, and segment information in an audit of financial statements.</p> <p>The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the:</p> <ul style="list-style-type: none"> <li>(a) Existence and condition of inventory;</li> <li>(b) Completeness of litigation and claims involving the entity; and</li> <li>(c) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.</li> </ul>	
<b>SA-505</b>	External Confirmations	<p>This SA deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 330 and SA 500.</p> <p>The objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence.</p>	
<b>SA-510</b>	Initial Audit Engagements-Opening Balances	<p>This SA deals with the auditor's responsibilities relating to opening balances when conducting an initial audit engagement. In addition to financial statement amounts, opening balances include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.</p> <p>In conducting an initial audit engagement, the objective of the auditor</p>	

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		<p>with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:</p> <p>(a) Opening balances contain misstatements that materially affect the current period's financial statements; and</p> <p>(b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.</p>	
<b>SA-520</b>	Analytical Procedures	<p>This SA deals with the auditor's use of analytical procedures as substantive procedures, and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.</p> <p>The objectives of the auditor are:</p> <p>(a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and</p> <p>(b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.</p>	
<b>SA-530</b>	Audit Sampling	<p>This SA applies when the auditor has decided to use audit sampling in performing audit procedures. It deals with the auditor's use of statistical and non-statistical sampling when designing and selecting the audit sample,</p>	

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		<p>performing tests of controls and tests of details, and evaluating the results from the sample.</p> <p>The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.</p>	
<b>SA-540</b>	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	<p>This SA deals with the auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how SA 315, SA 330 and other relevant SAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.</p> <p>The objective of the auditor is to obtain sufficient appropriate audit evidence whether in the context of the applicable financial reporting framework:</p> <ul style="list-style-type: none"> <li>(a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable; and</li> <li>(b) related disclosures in the financial statements are adequate.</li> </ul>	
<b>SA-550</b>	Related Parties	<p>This SA deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements. Specifically, it expands on how SA 315, SA 330 and SA 240 are to be applied in relation to risks of material</p>	

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		<p>misstatement associated with related party relationships and transactions.</p> <p>The objectives of the auditor are:</p> <p>(a) Irrespective of whether the applicable financial reporting framework establishes related party requirements, to obtain an understanding of related party relationships and transactions sufficient to be able:</p> <p>(i) To recognise fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and</p> <p>(ii) To conclude whether the financial statements, insofar as they are affected by those relationships and transactions:</p> <p>a. Achieve a true and fair presentation (for fair presentation frameworks); or</p> <p>b. Are not misleading (for compliance frameworks); and</p> <p>(b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted</p>	
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		for and disclosed in the financial statements in accordance with the framework.	
<b>SA-560</b>	Subsequent Events	<p>This SA deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. It does not deal with matters relating to the auditor's responsibilities for other information obtained after the date of the auditor's report, which are addressed in SA 720(Revised). However, such other information may bring to light a subsequent event that is within the scope of this SA.</p> <p>The objectives of the auditor are to:</p> <ul style="list-style-type: none"> <li>(a) Obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements; and</li> <li>(b) Respond appropriately to facts that become known to the auditor after the date of the auditor's report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.</li> </ul>	
<b>SA-570 (Revised)</b>	Going Concern	<p>This SA deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report.</p> <p>The objectives of the auditor are:</p> <ul style="list-style-type: none"> <li>(a) To obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness</li> </ul>	

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		<p>of management's use of the going concern basis of accounting in the preparation of the financial statements;</p> <p>(b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and</p> <p>(c) To report in accordance with this SA.</p>	
<b>SA-580</b>	Written Representations	<p>This SA deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance.</p> <p>The objectives of the auditor are:</p> <p>(a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;</p> <p>(b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and</p> <p>(c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or,</p>	



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		where appropriate, those charged with governance do not provide the written representations requested by the auditor.	
<b>SA-600</b>	Using the Work of Another Auditor	This SA establishes standards to be applied in situations where the principal auditor, reporting on the financial information of an entity, uses the work of other auditor w.r.t. financial information of components included in the financial information of the entity. This Standard also discusses the principal auditor's responsibility in relation to his use of the work of the other auditor.	
<b>SA-610 (Revised)</b>	Using the Work of Internal Auditors	<p>This SA deals with the external auditor's responsibilities if using the work of internal auditors. This includes (a) using the work of the internal audit function in obtaining audit evidence and (b) using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor.</p> <p>The objectives of the external auditor, where the entity has an internal audit function and the external auditor expects to use the work of the function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor, or to use internal auditors to provide direct assistance, are:</p> <p>(a) To determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent;</p> <p>and having made that determination:</p> <p>(b) If using the work of the internal audit function, to determine whether that work is adequate for</p>	

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		<p>the purposes of the audit; and</p> <p>(c) If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.</p>	
<b>SA-620</b>	Using the Work of an Auditor's Expert	<p>This SA deals with the auditor's responsibilities regarding the use of an individual or organisation's work in a field of expertise other than accounting or auditing, when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence.</p> <p>The objectives of the auditor are:</p> <p>(a) To determine whether to use the work of an auditor's expert; and</p> <p>(b) If using the work of an auditor's expert, to determine whether that work is adequate for the auditor's purposes.</p>	
<b>SA-700 (Revised)</b>	Forming an Opinion and Reporting on Financial Statements	<p>This SA deals with the auditor's responsibility to form an opinion on the financial statements. It also deals with the form and content of the auditor's report issued as a result of an audit of financial statements.</p> <p>The objectives of the auditor are:</p> <p>(a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and</p> <p>(b) To express clearly that opinion through a written report.</p>	
<b>SA - 701</b>	Communicating Key Audit matters in the Independent Auditor's report	<p>This SA deals with the auditor's responsibility to communicate key audit matters in the auditor's report. It is intended to address both the auditor's judgment as to what to communicate in the auditor's report and the form and content of such communication.</p>	

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		The objectives of the auditor are to determine key audit matters and, having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report.	
<b>SA-705 (Revised)</b>	Modifications to the Opinion in the Independent Auditor's Report	<p>This SA deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700(Revised), the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary. This SA also deals with how the form and content of the auditor's report is affected when the auditor expresses a modified opinion.</p> <p>The objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that is necessary when:</p> <ul style="list-style-type: none"> <li>(a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or</li> <li>(b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.</li> </ul>	
<b>SA-706 (Revised)</b>	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent	<p>This SA deals with additional communication in the auditor's report when the auditor considers it necessary to:</p> <ul style="list-style-type: none"> <li>(a) Draw users' attention to a matter or matters presented or disclosed in the financial statements that are of such importance that they are</li> </ul>	

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	Auditor's Report	<p>fundamental to users' understanding of the financial statements; or</p> <p>(b) Draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.</p> <p>The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:</p> <p>(a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or</p> <p>(b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.</p>	
<b>SA-710</b>	Comparative Information- Corresponding Figures and Comparative Financial Statements	<p>This SA deals with the auditor's responsibilities regarding comparative information in an audit of financial statements. When the financial statements of the prior period have been audited by a predecessor auditor or were not audited, the requirements and guidance in SA 510 regarding opening balances also apply.</p> <p>The objectives of the auditor are:</p>	

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		<p>(a) To obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and</p> <p>(b) To report in accordance with the auditor's reporting responsibilities.</p>	
<p><b>SA-720 (Revised)</b></p>	<p>The Auditor's Responsibilities Relating to Other Information</p>	<p>This SA deals with the auditor's responsibilities relating to other information, whether financial or non-financial information (other than financial statements and the auditor's report thereon), included in an entity's annual report.</p> <p>The objectives of the auditor, having read the other information, are:</p> <p>(a) To consider whether there is a material inconsistency between the other information and the financial statements;</p> <p>(b) To consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit;</p> <p>(c) To respond appropriately when the auditor identifies that such material inconsistencies appear to exist, or when the auditor otherwise becomes aware that other information appears to be materially misstated; and</p> <p>(d) To report in accordance with this SA.</p>	

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<b>SA-800</b>	Special Considerations-Audit of Financial Statements Prepared in Accordance with Special Purpose Frameworks	<p>This SA deals with special considerations in the application of SAs in the 100-700 series to an audit of financial statements prepared in accordance with a special purpose framework.</p> <p>The objective of the auditor, when applying SAs in an audit of financial statements prepared in accordance with a special purpose framework, is to address appropriately the special considerations that are relevant to:</p> <ul style="list-style-type: none"> <li>(a) The acceptance of the engagement;</li> <li>(b) The planning and performance of that engagement; and</li> <li>(c) Forming an opinion and reporting on the financial statements but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.</li> </ul>	
<b>SA-805</b>	Special Considerations-Audit of Single Financial Statements and specific Elements, Accounts or Items of a Financial Statement	<p>This SA deals with special considerations in the application of SAs in the 100-700 series to an audit of a single financial statement or of a specific element, account or item of a financial statement. The single financial statement or the specific element, account or item of a financial statement may be prepared in accordance with a general or special purpose framework. If prepared in accordance with a special purpose framework, SA 800 also applies to the audit.</p> <p>The objective of the auditor, when applying SAs in an audit of a single financial statement or of a specific element, account or item of a financial statement, is to address appropriately the special considerations that are</p>	

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		<p>relevant to:</p> <ul style="list-style-type: none"> <li>(a) The acceptance of the engagement;</li> <li>(b) The planning and performance of that engagement; and</li> <li>(c) Forming an opinion and reporting on the single financial statement or on the specific element, account or item of a financial statement but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.</li> </ul>	
<b>SA-810</b>	Engagements to report on Summary Financial Statements	<p>This SA deals with the auditor's responsibilities when undertaking an engagement to report on summary financial statements derived from financial statements audited in accordance with SAs by that same auditor.</p> <p>The objectives of the auditor are to:</p> <ul style="list-style-type: none"> <li>(a) Determine whether it is appropriate to accept the engagement to report on summary financial statements;</li> <li>(b) Form an opinion on the summary financial statements based on an evaluation of the conclusions drawn from the evidence obtained; and</li> <li>(c) Express clearly that opinion through a written report that also describes the basis for that opinion.</li> </ul>	

Compliance with the SAs should be taken care of, while executing the audit as well as reporting.

# 5

## Special Considerations in a CBS Environment

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### Introduction

5.01 The face of banking industry is changing rapidly. What banking is today is quite different from what it was in the years gone by. Rapid strides in technological advancements, different payment systems, integration of Aadhaar for cardless transactions are changing the way of banking. However, in recent times there have been some instances of manipulating the banking system for unlawful gains and frauds.

### Responsibilities of Branch Auditors

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

- Accounting manual, entries, calculations and framework are built in computerised accounting systems.
- Critical IT and manual controls are centralised at HO level.
- Limited access to periodical MIS, exception reports, NPA related 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.
- Difficulty in audit sampling due to huge population of data.
- Hard copies relating to transactions.
- Independent IT Audit at branches.
- Staff ignorance about various aspects of the IT infrastructure at the branch.
- Independent verification of existence of business continuity plans and disaster recovery plans.

5.03 Overall review of IT environment and of the computerised accounting system has to be taken up at the 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 SCA to review whether the management is performing this role effectively. The roles and responsibilities of bank, and the branch auditors are enumerated in the following paragraphs.

***Role and Responsibilities of the Bank***

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

- Overall IT policy, structure and environment of the bank's IT system and changes/developments, if any, thereto. The bank is also required to put in place a cyber security framework as mandated by RBI vide circular no. RBI/2015-16/418 DBS.CO/CSITE/BC.11/33.01.001/2015-16, dated June 2, 2016 on "Cyber Security Framework in banks".
- Data processing and data interface between 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.
- Controls over key aspects, such as, account codes and mapping thereof, use of various account heads including other assets and other liabilities, asset classification, income recognition, expense booking, overdue identification, month-end and year-end procedures, valuation and re-valuation of various items of the financial statements, KYC, AML, etc.
- Controls and recording of various e-banking and internet banking products and channels.
- Manual processing of key transactions.
- Manual Interventions in the Information Systems, more particularly those with reference to the identification, classification and provisioning of Non-Performing Assets and compensating controls designed and implemented by the bank to mitigate the risks arising from the manual interventions.
- Access to the audit logs/ trails maintained for capturing events such as changes in master data/ parameters, activities carried out through administrative privileges and through backend access etc.

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- List containing exceptions granted to the system driven asset classification, along with the multi-level authorisation for the same, time stamps and reasons for such exceptions and audit trails captured for the same.
- 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 along with logic embedded in generation of such reports.
- 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 a bearing on the preparation and presentation of financial statements.
- Significant observations of internal auditors, concurrent auditors, system auditors, RBI inspection, 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 auditor conducting the System Audit should also be a Certified Information System Auditor (CISA) and registered with the ISACA. 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 is also required to comment on the deviations, if any, in the processes followed from the process flow submitted to RBI while seeking authorisation.<sup>14</sup>
- Compliance documentation with RBI, IT and security directives and guidelines.

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<sup>14</sup> Refer RBI circular no. DPSS.AD.No./1206/02.27.005/2009-2010 dated 7<sup>th</sup> December, 2009 on "System Audit of the Payment Systems operated under the PSS Act, 2007".

***Role and Responsibilities of Branch Auditors***

5.05 Based on the guidance and information received from the SCA / bank, the branch auditors need to ensure the following:

- Branch auditors' 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 are carried out at the branch level and, where considered necessary, the results are shared with the SCAs.
- Data review and analysis through CBS is carried out.
- Significant observations having bearing on the true and fair view of financial statements are reported to the SCAs.
- Any limitations on audit which are required to be reported to the SCAs are reported in a timely manner.
- Significant observations having bearing on report on Internal Financial Controls over Financial Reporting (IFCoFR), are reported to the SCAs.

**NPA Identification through System (RBI Guidelines)**

5.06 The RBI had come out with the following guidelines for NPA identification.

- Various instances have been observed wherein banks are still found to be resorting to manual identification of NPA and also over-riding the system generated asset classification by manual intervention. Several gaps have been observed in automated processes for NPA identification, income recognition, provisioning and generation of related returns.
- In order to ensure the completeness and integrity of the automated Asset Classification (classification of advances/investments as NPA/NPI and their upgradation), provisioning calculation and Income Recognition processes, the RBI vide circular no. RBI/2020-21/37 Ref. No. DoS.CO.PPG./SEC.03/11.01. 005/2020-21 dated September 14, 2020 on "Automation of Income Recognition, Asset Classification and Provisioning processes in banks", had advised banks to put in place / upgrade their systems to system based asset classification on an ongoing exercise for both down gradation and up-gradation of accounts.
- As per circular no. RBI/2020-21/37 Ref. No. DoS.CO.PPG./SEC.03/11.01. 005/2020-21 dated September 14, 2020, banks should ensure that the asset

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classification status is updated as part of day end process. Banks should also be able to generate classification status report at any given point of time with actual date of classification of assets as NPAs/NPIs.

- Banks shall not resort to manual intervention / over-ride in the system based asset classification process. In any exceptional circumstance where manual intervention is required to override the system classification, it must have at least two level authorisation. The branch auditor may obtain the exceptional report containing the log of instances where there were manual interventions in overriding the system classification and to ensure that the same are authorised at two levels.
- Day end process and manual interventions are generally at branch level operations; the branch auditor is to ensure compliance of circular no. RBI/2020-21/37 Ref. No. DoS.CO.PPG./SEC.03/11.01. 005/2020-21 dated September 14, 2020. Auditors should note that the above circular is applicable from June 2021.

### **Data Analytics on CBS MIS Reports**

5.07 In terms of Chapter VIII of Master Directions no. RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 dated July 1, 2016 (Updated as on July 03, 2017) on “Frauds – Classification and Reporting by commercial banks and select FIs”, banks should track Early Warning Signals (Annex-II of the above said Master Directions) by integrating with the credit monitoring process in the bank so that it becomes a continuous activity and also acts as a trigger for any possible credit impairment in the loan accounts, given the interplay between credit risks and fraud risks.

5.08 Among the 42 illustrative Early Warning Signals (EWS), the most prominent ones are, suspicious related party transactions and financial and stock statement manipulations and are exposed to high credit and fraud risks.

5.09 Further, the auditor should bring it to the notice of the top management and if necessary to the Audit Committee of the Board (ACB) for appropriate action such instances of EWS. Members may refer Chapter 21, “Fraud” of Section B of the Guidance Note on Audit of Banks (2023 Edition) to understand EWS in greater details.

### **I. Related Party Transactions**

These transactions pose a big threat to credit risks and fraud risks. As system preventive controls or manual maker and checker controls are weak in banking with respect to controlling borrowers suspicious related party transactions, auditors have to carry out substantive analytical procedures using tools like spreadsheet to rule out material misstatements due to fraud or error.

Data analytics can be used on the CBS MIS reports, borrowers financials and stock statements for assessing credit and or fraud risks.

Spreadsheet can be used as an audit documentation tool in support of compliance of various Auditing Standards like SA 230, SA 240, SA 315, SA 300, SA 520, etc. Also spreadsheet functions like sort, filter, sumif, vlookup, pivot can be used for audit analysis of transactions, identification of exceptions and documentation.

## **II. Financial Statement and Stock Statement Manipulations for enhanced loan eligibility**

Following are control weaknesses in the CBS:

- a. DP calculated on the basis of manual returns is entered in the CBS. Except for maximum sanctioned limit/DP, there is no other application control on quality of returns.
- b. There is lack of independent application systems to assess the quality of stock statements and periodical returns.
- c. Validation controls are weak with respect to DP limits.
- d. Controls around validation of borrowers' financial statement are weak.
- e. Audited financial statements content is entered into spreadsheet template as a part of CMA data for critical ratio analysis related to liquidity, profitability, and other ratios. Application controls for analysis of financial statements are weak.

## **III. Wrong IRAC Classifications by banks are significant audit risks.**

Following are control weaknesses in the CBS:

- a. The basis of IRAC classification is dependent on fields such as Loan Sanction Date, Period of Loan, Rate of interest, moratorium, nature of facility, priority sector, terms of re-schedulement, etc., which are at times updated manually at the branch and not through centralised / automated process.
- b. Periodic validation of IRAC classification, especially in case of doubtful or loss assets wherein at times it is observed that the same is not system driven but updated manually at the branch.
- c. Manual interventions/ subjective considerations in the process of restructuring of the advances and monitoring the Date of Commencement of Commercial Operations (DCCO) in respect of infrastructure and non-infrastructure project loans.
- d. In case of multiple loans sanctioned against a common security, there is a possibility of updation of common security at multiple loan account level as

independent security. This results in over statement of security amount and lower amount of provisioning. In case of consortium advance, the security value (attributable to the share of bank) should only be updated. If the entire security is updated, it results into over statement of the security.

## **Audit in a CIS Environment**

### **Assessment of Inherent and Control Risks**

5.10 The nature of banking operations is such that the auditors may not be able to reduce the audit risk to an acceptable low level by the performance of substantive procedures alone. It may be so on account of the following factors:

- Extensive use of IT and EFT systems, which mean that much of the audit evidence is available only in electronic form and is produced by the bank's own IT systems.
- High volume of transactions processed by banks, which makes reliance on substantive procedures alone impracticable.
- Geographic spread of banks' operations.
- Complex trading transactions (Highly inter connected and automated systems such as card, mobile banking and payment systems).
- Susceptibility of the financial statements to frauds and auditor's responses as per SA 240, 'The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements'.

5.11 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 obtain sufficient appropriate audit evidence to assess the level of inherent and control risks.

5.12 The auditor's procedures would need to be adapted as circumstances warrant and in respect of each account, different procedures may be necessary.

5.13 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 / misstatement. There are mainly four types of controls:

- A. **Deterrent controls** - Deterrent controls are designed to deter people, internal as well as external, from engaging in undesirable activities. For example, written policies including the punitive measures may deter people from doing undesired activities.

- B. **Preventive Controls** - Preventive controls are aimed to 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. Review processes in place at a branch are examples of detective controls.
- 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 the 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.

5.14 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 heads of the IT as well as the audit departments. 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**

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

- Ensuring that authorised, accurate and complete data is made available for processing.
- Ensuring that in case of interruption due to power, mechanical or processing failures, the system restarts without distorting the completion of the entries and records.
- Verifying 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.

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- Verifying that segregation of duties is ensured while granting system access to users and that the user activities are monitored by performing an activities log review.
- Verifying that changes made in the parameters or user levels are authenticated.
- Verifying that charges calculated manually for accounts when function is not regulated through parameters are properly accounted for and authorised.
- Verifying that exceptional transaction reports are being authorised and verified on a daily basis by the concerned officials. It is important for the auditor to understand the nature of exception and its impact on financials.
- Verifying that the account master and balance cannot be modified / amended / altered except by the authorised personnel.
- Verifying that all the general ledger accounts codes authorised by Head Office are in existence in the system.
- Verifying that balance in general ledger tallies with the balance in subsidiary book.
- Verifying that bank's IT Systems are equipped with necessary controls to prevent unauthorised operations in internal/ office accounts of the banks, including but not limited to the following:
  - Absence of a documented policy, standard operating procedures or authorisation mechanism for opening and operating office accounts.
  - Deficiencies in linking the office accounts with GL/PL and trial balance through mapping codes.
  - Gaps in reconciliation of office accounts including absence of key in reference numbers linking original entries with the reversal entries, non-adherence to the stipulated frequency of reconciliation, manual intervention in the reconciliation process etc.
  - Opening and operating office accounts for affording credits to borrower accounts to prevent them from being classified as NPAs.
  - Opening and operating office accounts for accounting of customer transactions including cash transactions, thus avoiding reporting under anti money laundering guidelines.
  - Accounting of debit balances in office accounts under liabilities to avoid provisioning.



- Booking of operating expenses for avoiding debit to the Profit and Loss Account.

### **Risks arising out of CBS Environment**

#### *Credit Risk*

5.16 Generally, the bank's credit risk does not increase by the mere fact that a loan has 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 the credit risk.

#### *Compliance/ Legal Risk*

5.17 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. Electronic 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.
- Retention of required compliance documentation for on-line advertising, applications, statements, disclosures, notices.

- Establishment of legally binding electronic agreements.

5.18 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 get 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*

5.19 The rise in sophisticated cyber-crime has become one of the fastest growing security and reputational risks to the 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. Banks have a significant role to play in identifying and addressing this risk thereby safeguarding its reputation and instilling the confidence in its customers.

**Audit through CBS**

5.20 With the adoption of CBS by banks, realignment in the conventional audit methodology has also become inevitable. Audit is required to be conducted through the system. In various aspects, the automated controls in the CBS system are also required to be reviewed and verified.

What is CBS?

5.21 The core banking system is the set of basic software components that manage the services provided by a bank to its customers through its branches (branch network). The bank's customers can execute their transactions from any branch, ATM, Service Outlets, Internet, Phone at their disposal. The CBS is based on Service Oriented Architecture (SOA). It helps banks to reduce the risk that can result from manual data entry and out of date information. It also helps banks to improve service delivery quality. The software is accessed from different branches of bank via communication lines like telephones, satellite, internet, etc.

5.22 Core Banking Solution (CBS) works on the concept of centralized database and processing. Transactions take place at various geographical locations which get recorded and processed at a centralized server. Updating of database is on real time basis. Due to centralization of transaction processing, the issue of "Out of Date Information" is eliminated. All the users connected to

CBS will be able to get up to date information. CBS also enhances the quality of reporting and strengthens access control.

5.23 Under CBS the data is stored in centralized servers at the data centre. This effectively means that all operations at the connected branches, back offices are carried out through servers at Data Centre including transactions through other delivery channels like ATMs, Internet Banking, Phone Banking.

5.24 Under CBS, back offices of the branches are considered as SOL (i.e. Service Outlets) where each SOL functions as a service window. The CBS is capable of processing any transaction from any branch location connected to CBS. It can be equated with single window operations at airline counters or railway reservation counters wherein all the services can be obtained at one place. Hence, under CBS the customer is now a customer of the bank and not merely a customer of a branch of the bank. This has facilitated “Any-where, Anytime Banking” convenience for customers.

5.25 From bank’s perspective, control over the application and processes has been entrusted at Data Center Level. In addition to it, CBS also makes available effective MIS on real-time basis. It enables generation of all periodical returns centrally.

5.26 Various CBSs developed by different software companies are now available in the market. Few widely used CBSs are (a) FINACLE, (b) BaNCS and (c) FlexCube. An Illustrative List of Special Purpose / Exception Reports that can be generated through CBS and through backend (i.e. from database) is given at the Annexure to this Chapter.

5.27 The branch auditor should call for reports, if any, of the CBS environment in use at the branch. Further, the auditor should also consider interaction of various other IT systems with the CBS and review whether the flow of data between various systems is seamless and without any manual intervention.

5.28 The branch auditor should scrutinise automated as well as manually compiled MIS reports on a sample basis to assess their quality (i.e. accuracy and adequacy for designated purpose) and report any shortcomings therein in the LFAR.

5.29 The master data/ parameters shall also be scrutinised on a sample basis to assess the accuracy and adequacy thereof. Any systemic deficiency in capturing correct information shall be appropriately factored in designing the substantive audit procedures and extent of coverage.

**Annexure**

**Illustrative List of Special Purpose / Exception Reports in CBS**

The following indicative list of reports will benefit SCAs and SBAs (if shared in advance) while undertaking the audit in a fully computerised environment:

**Advances**

Sr. No.	Report
i.	Advances snapshot covering all important parameters
ii.	Accounts with overdue in excess of 90 days and are classified as Standard Assets
iii.	List of LCs devolved during the period / year and current status of account, including list of forced debits pertaining to the devolvement, not debited to the operative accounts of the borrower i.e. parked separated either under advances or office accounts
iv.	List of BGs invoked during the period / year and current status of account, including list of forced debits pertaining to the invocation, not debited to the operative accounts of the borrower i.e. parked separately either under advances or office accounts
v.	Standalone Non Fund Based Limits granted to customers
vi.	List of accounts such as SMA / Watch list / Probable NPA / Weak account as on the last date of audit period
vii.	Backdated updation of stock and book debt statements (difference between date of updation in CBS and date of actual receipt of the stock statement)
viii.	List of accounts wherein the facility is not renewed / reviewed
ix.	List of accounts which are short reviewed (which may have impact in NPA identification)
x.	List of accounts which slipped to NPA during the current period
xi.	List of accounts wherein there is an amendment in date of NPA
xii.	List of accounts written off during the period / year
xiii.	List of accounts upgraded (along with date of upgrade and the overdues on the date of upgrade and the accounting treatment of recovery amount)

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Sr. No.	Report
xiv.	Quick mortality (NPA within 1 year of original sanction date)
xv.	List of NPA accounts with security valuation not carried out within the prescribed period
xvi.	List of accounts wherein re-phasing (change in EMI, tenor, moratorium period) is carried out in CBS (excluding re-phasing due to change in the reference rate)
xvii.	Loan / OD against FD with no linkage to FD (i.e. Security)
xviii.	Loan to minors (Excluding Non individual accounts and excluding Education, Loan/OD against deposit cases)
xix.	Loans below the benchmark rate (as applicable in each bank)
xx.	Loans above the maximum lending rate (as applicable in each bank)
xxi.	Loans where disbursement is made in cash (Threshold limit may be prescribed)
xxii.	Credit transactions in CC / OD / Loan Accounts with Value Date (Back Date) without Value Date (Back Date) at Debit Leg
xxiii.	Advance accounts where effective interest rate is Zero
xxiv.	CC accounts with primary security is "Nil"
xxv.	Multiple TODs / <i>Ad hoc</i> Sanctions for a customer
xxvi.	Non delinking of <i>Ad hoc</i> facility sanctioned on expiry
xxvii.	Multiple customer IDs having common PAN
xxviii.	Red flagged accounts since more than 6 months
xxix.	List of project loans (infra and non-infra) including fields such as Date of Financial Closure, Original DCCO, extended DCCO, Achieved DCCO, Time/ Cost Overruns
xxx.	List of advances, where significant erosion in security value is observed. (Accounts where erosion is more than 50 per cent)
xxxi.	Data submitted to CERSAI
xxxii.	SMA0, SMA1, SMA2 reports of all 12 months of the audit period

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**Profit & Loss**

<b>Sr. No.</b>	<b>Report</b>
i.	Manual debit to 'Interest Income' and 'Other Income' accounts
ii.	Manual credits to 'Interest Income' and 'Other Income' account
iii.	Manual debit to 'Interest Expense Account'
iv.	Interest pegging marked as "Y" for loans sanctioned at variable rate i.e. w.r.t. benchmark rates (pegging may freeze the interest rate at the respective time)

**Foreign Exchange, Internal Controls, Regulatory and Systems**

<b>Sr. No.</b>	<b>Report</b>
i.	Bills under LC devolved and not crystallized. / Bills under LC devolved wherein the crystallization account is office account / not of customer
ii.	Export bills discounted / purchased and outstanding beyond due dates
iii.	Packing Credits Accounts outstanding beyond due dates / Running Packing Credit accounts with age of un-utilized orders is more than 365 days
iv.	Resident customers having Non Resident Account (under same or multiple customer master)
v.	NRE Account Holder having resident savings account (under same or multiple customer master)
vi.	FDs / RDs with aggregate balance at customer master level in excess of Rs. 20,000 and closed one / all FDs / RDs in cash
vii.	Cash payments from Office Accounts in excess of Rs. 10,000
viii.	Non senior citizen customers (based on DOB) with senior citizen interest table code
ix.	Preferential interest rate applicable to staff applied to non staff deposit (Refer the policy of bank w.r.t. extending facility to ex-staff and relatives of staff / ex-staff)
x.	List of outstanding office accounts entries (pointing type accounts).
xi.	Accounts with invalid PAN (No. of digits, structure, constitution code mapping with 4 <sup>th</sup> digit)

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<b>Sr. No.</b>	<b>Report</b>
xii.	List of foreign exchange transactions with exchange rates beyond the card rate / maximum-minimum rate during the period

**Capital Adequacy**

<b>Sr. No.</b>	<b>Report</b>
i.	Accounts above the threshold limit wherein external credit rating is not obtained / updated
ii.	Bank guarantees and LC expired and not reversed
iii.	Accounts with mismatch in constitution code and BASEL mapping

The above list of reports is indicative only. There are various other reports that can be generated. However, the generation of reports requires in-depth review of bank's systems, processes and gaps. The reports can be made more effective through continuous review and update mechanism.

# 6

## Cash

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6.01 The primary check for cash is to carry out verification of the balance of cash on hand. Wherever feasible, 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 hours 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, at the time of audit and also reconcile with the cash register/balance in CBS.

6.02 The physical verification should be evidenced through working papers indicating the denominations and the number of currency notes. The auditor should ensure that the physical verification of cash includes physical verification of cash on hand, cash at ATM and cash at CDM (Cash Deposit Machines) and the reconciliation of the same with the GL balances of the respective GL heads if forming part of branch GL. In case of on-site ATMs at branch wherein the balance in ATM does not form part of branch GL and are part of centralised ATM monitoring department, the physical verification of Cash at such ATM need not be carried out by the SBA unless a specific instruction to verify the same is given to the SBA. The counting sheet should be counter signed by the Cashier and the Branch manager.

6.03 In some banks, the branches deposits a large portion of their cash balance with the RBI or the State Bank of India or any other bank on the closing day and in such cases, the auditor should request the branch to provide sufficient appropriate evidence for the same and also ensure that the same is reflected in the books of accounts and is not appearing as a bank reconciliation item.

6.04 Besides the physical verification, if there are instructions or certifications specific to the bank, the same need to be complied with. Following specific questions w.r.t. cash need to be addressed in LFAR:

- (a) Does the system ensure that cash maintained is in the effective joint custody of two or more officials, as per the instructions of the controlling authorities of the bank?



Branch Auditor needs to verify compliance of this as per the instructions of the controlling authorities and report accordingly.

- (b) Have the cash balances at the branch/ATMs been checked at periodic intervals as per the procedure prescribed by the controlling authorities of the bank?

Branch Auditor need to verify the compliance of procedure and also check cash balance while on audit and report accordingly.

- (c) (i) Does the branch generally maintain / carry cash balances, which vary significantly from the limits fixed by the controlling authorities of the bank?

- Controlling office communicates the cash retention limits to be maintained. Branch Auditor should check the report maintained by the branch manager on such limit exceeding events and reason for the same.

- It is important to note that the emphasis is on the word 'significantly'. Thus branch auditor need to report only if the cash held by the branch is in significant variance from the limits specified.

(ii) Does the figures of the balance in the branch books in respect of cash with its ATM(s) tally with the amounts of balances with the respective ATMs, based on the year end scrolls generated by the ATMs? If there is any difference, the same should be reported.

- (d) Whether the insurance cover available with the branch adequately meets the requirement to cover the cash-in hand and cash-in transit?

Bank usually takes insurance cover for cash-in-hand and cash-in-transit for entire bank with limit specified for each branch. Branch Auditor needs to verify that the branch has copy of insurance cover on its record and report accordingly.

# 7

## **Balances with Reserve Bank of India, State Bank of India and Other Banks (For Branches with Treasury Operations)**

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7.01 For branches wherein bank account(s) with RBI, SBI and/or any other banks have been maintained, the audit procedure to be followed should be as under:

- (i) Examine that no debit for charges or credit for interest is outstanding and all the items which ought to have been taken to books of accounts for the year, have been considered. This should be particularly observed when the bills collected are credited with net amount, transactions parked in office accounts and entries for commission, etc., are not made separately in the statement of account.
- (ii) Examine that no cheque sent or received in clearing is outstanding. As per the practice prevalent among banks, any cheque returned unpaid is accounted for on the same day on which it was sent for clearing or on the following day.
- (iii) Examine that all bills or outstanding cheques sent for collection and outstanding as on the closing date have been credited subsequently.
- (iv) 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.
- (v) 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. The auditor should also ensure that interest on such deposits has been recorded on time proportion basis and interest has been recorded till the closing day.
- (vi) The balances with banks outside India should also be verified in the manner described above. These balances should be converted into Indian currency at the exchange rates prevailing on the balance sheet date.

- (vii) 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.
- (viii) The auditor should review the bank reconciliation statement (whether automated or manual) and undertake age-wise and entry-wise analysis of the same and verify if any effect to un-responded entries is required to be given and / or provision related thereto is required.

7.02 Besides the requisite audit checks as specified above, in respect of branches where bank balances are maintained, following LFAR issues need to be addressed:

- a) Were balance confirmation certificates obtained in respect of outstanding balances as at the year-end and whether the aforesaid balances have been reconciled? The nature and extent of differences should be reported.
  - Balance confirmation certificates to be obtained in respect of outstanding balances as at the year end as well as at the end of the month.
  - Obtain bank reconciliation statement for the above referred period.
  - If the reconciliation is not carried out or carried out incorrectly, the same to be reported.
  - In case any difference is observed during reconciliation process, the amount, nature of difference and period since when the discrepancy is carried on in reconciliation statement should be reported.
- b) Observations on the reconciliation statements may be reported in the following manner:
  - (i) Cash transactions remaining un-responded (give details).
  - (ii) Revenue items requiring adjustments/write-off (give details).
  - (iii) Other credit and debit entries originated in the statements provided by RBI/other banks, remaining un-responded for more than 15 days.
  - (iv) Where the branch maintains an account with the RBI, the following additional matter may be reported and documented.

Entries originated prior to, but communicated / recorded after, the year end in relation to currency chest operations at the branch/other

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link branches, involving deposits into / withdrawals from the currency chest attached to such branches (Give details).

- c) In case, any matter deserves special attention of the management, the same may be reported and documented.
  - (i) Matters which are not reported under clause (a) and (b) above which the SBA wishes to report and / or bring to the attention of SCA and / or management of the bank should be reported under clause (c).

# 8

## **Money at Call and Short Notice**

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8.01 To manage the liquidity in business and to maintain CRR, SLR requirements the bank invests/lends and borrows funds for very short terms through call money market. These are lending and borrowing from one to fourteen days done through inter bank money market. There are norms/guidelines issued by the Reserve Bank of India and Head office of Banks in this regard for operation in money market.

8.02 The RBI prescriptions which are available to the treasury branch through online access, mentions the branch code against each of the entries and in turn the treasury department provides the same to the branch and asks the branch to respond for passing the appropriate accounting entry in the books of accounts. The auditor should check the communication between the branch and the treasury branch and ascertain that entries pertaining to the branch are appropriately identified and passed in the books of accounts.

8.03 If there are such types of transactions, the SBA should obtain instructions/ guidelines issued by the controlling authorities of the bank and examine the compliance thereof.

8.04 The auditor is required to report on following points for the said activity in Long Form Audit Report:

- a) Has the branch kept money-at-call and short notice during the year?
- b) Has the year-end balance been duly confirmed and reconciled?
- c) Has interest accrued up to the year-end been properly recorded?
- d) Whether instructions/guidelines, if any, laid down by the controlling authorities of the bank, have been complied with?

8.05 Generally, this activity is handled by the Treasury Department of the bank and consequently such types of transactions do not appear in the Branch Books. However, the auditor should confirm that no such transactions are appearing in the Branch Trial Balance.

8.06 If there are any such transactions at the branch then the auditor needs to reply to the above questions after due audit process.

# 9

## **Investments (For Branches Outside India)**

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9.01 In case of domestic branches, the investment portfolio is looked after by the Treasury Department of the bank. Hence, such types of transactions do not appear in the branch books. However, the auditor should confirm that no investments are appearing in the branch trial balance. However, in case of branches outside India, the investment activity is carried out at branch level as well.

9.02 If investments are appearing in the branch trial balance, verification of securities (physical or based on custodian report) and reconciliation with the books should be carried out and reported accordingly.

### **Reporting in Long Form Audit Report**

9.03 For branches outside India the SBA should check the following:

- 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?
- 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 evidence with regard to their physical verification been produced?
- 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?
- d) Whether there are any matured or overdue investments which have not been encashed and / or have not been serviced? If so, give details?

9.04 The questions on LFAR are self-explanatory and no specific guidance is provided here. However, the auditor may refer Chapter 5 “Treasury Operations” of Section A of the Guidance Note on Audit of Banks (2023 Edition).

**Introduction**

10.01 Agriculture has always been the backbone of the Indian economy despite sustained progress in industrial and service(s) sector. Many industries like handloom weaving, rice de-husking, cotton, sugar, textiles, etc. depend indirectly on agriculture.

10.02 Agricultural credit is considered as one of the most basic inputs for conducting all agricultural development programmes. In India there is growing need for proper agricultural credit as the economic condition of Indian farmers is generally precarious.

10.03 With a view to ensure wider reach of agricultural credit, the Government adopted the institutional credit approach through various agencies like co-operatives, commercial banks, regional rural banks etc. to provide adequate credit to farmers, at a cheaper rate of interest. The long term and short term credit needs of these institutions are also being met by National Bank for Agriculture and Rural Development (NABARD). NABARD has the objective of promoting the health and the strength of the credit institutions which are in the forefront of the delivery system namely, cooperatives, commercial banks and regional rural banks. It is, in brief, an institution for the purpose of refinance; with the complementary work of directing, inspecting and supervising the credit- flows for agricultural and rural development.

10.04 The evolution of institutional credit to agriculture could broadly be classified into four distinct phases –

- i. 1904-1969 (predominance of co-operatives and establishment of the RBI)
- ii. 1969-1975 [nationalization of commercial banks and setting up of Regional Rural Banks (RRBs)]
- iii. 1975 - 1990 (setting up of NABARD)
- iv. 1991 onwards (Financial Sector Reforms)

10.05 The Government has increasingly begun to tap institutional finance from banks and other term lending institutions for financing various developmental programmes in view of the need to supplement plan financing. Banks have also played a pivotal role in this regard. However, credit should be utilized in a

prudent manner to maximize returns and spread the benefit over wider sections of the population.

10.06 The State Level Bankers' Committee ('SLBC'), constituted by the RBI under the Lead Bank Scheme periodically takes up the review performance and monitors progress under special schemes. At the District level, the District Consultative Committee with the Chief Executive Officer of Zilla Panchayat as chairperson and representatives of financial institutions and Heads of Government departments at the District level as members' monitors the implementation of Government sponsored schemes and service area credit plans. At the block level, Block Level Bankers' Committee chaired by lead district manager with bank managers and departmental heads of Government at Block level as members periodically reviews the implementation of Government sponsored schemes and service area credit plans and sorts out problems encountered in the implementation of various programmes. In order to select and prioritise the works for loan assistance from NABARD under Rural Infrastructure Development Fund (RIDF) Scheme, launched in 1995-96, a Cabinet Sub-Committee on RIDF has been constituted under the chairmanship of the Minister for Public Works. There is also a High Power Committee chaired by the Additional Chief Secretary and Development Commissioner for reviewing the implementation of RIDF projects. These policy measures have resulted in an increase in the share of institutional credit to the rural households.

### **Priority Sector Lending (PSL)**

10.07 The RBI has classified lending to the agriculture and allied activities under Priority Sector Lending. Commercial banks are guided by priority sector lending policy of providing credit to various deserving sectors/sections including agriculture and allied activities.

10.08 With a view to regulate and encourage the flow of agricultural credit by all Scheduled Commercial Banks, the RBI from time to time, issues guidelines /instructions/directives to banks on Priority Sector Lending.

10.09 Priority Sector Lending programme has been an integral part of the banking policy in India. This scheme is intended to give loans to the important sectors of the economy (agriculture, small scale industries etc.) in such a way as to ensure maximum credit flow to the last man in the last village of the country through a strong banking network. Priority sector lending includes a sub-target for lending to the "weaker" sections of the society within the priority sector.

### **Meaning of Priority Sector & Priority Sector Advances**

10.10 Priority sector refers to those sectors of the economy which may not get timely and adequate credit in the absence of this special dispensation. Priority sector advances are small value loans to farmers for agriculture and allied



activities, micro and small enterprises, poor people for housing, students for education and other low income groups and weaker sections.

10.11 In terms of RBI Master Direction No. RBI/FIDD/2020-21/72 FIDD.CO.Plan.BC.5/04.09.01/2020-21 September 04, 2020 (Updated as on October 20, 2022) on “Priority Sector Lending (PSL) - Targets and Classification”, the categories under priority sector are as follows:

- (i) Agriculture
- (ii) Micro, small and medium enterprises
- (iii) Export credit
- (iv) Education
- (v) Housing
- (vi) Social infrastructure
- (vii) Renewable energy
- (viii) Others

10.12 The targets and sub-targets for agriculture set under priority sector lending for all scheduled commercial banks operating in India are furnished below for domestic scheduled commercial banks and foreign banks with 20 branches and above:

<b>Categories</b>	<b>Domestic commercial banks (excl. RRBs &amp; SFBs) &amp; foreign banks with 20 branches and above</b>
Total Priority Sector	40 per cent of ANBC as computed in Para 6 of RBI Master Direction No. RBI/FIDD/2020-21/72 FIDD.CO.Plan.BC.5/04.09.01/2020-21 September 04, 2020 (Updated as on October 20, 2022) on “Priority Sector Lending (PSL) - Targets and Classification or CEOBE whichever is higher
Agriculture	18 per cent of ANBC or CEOBE, whichever is higher; out of which a target of 10 per cent <sup>#</sup> is prescribed for Small and Marginal Farmers (SMFs)  Additionally, domestic banks are directed to ensure that the overall lending to non-corporate farmers does not fall below the system-wide average of the last three years achievement. The applicable target for lending to the non-corporate farmers for FY 2022-23 will be 13.78 per cent of ANBC or CEOBE whichever is higher. All efforts however should be made by banks to increase the Farm Credit (as per Para 8.1 of above

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	said Master Direction on Priority Sector Lending (PSL – Targets and Classification) higher than the NCF target <sup>15</sup> . Guidelines issued by RBI for Priority Sector lending by Small Finance Banks are different and these should be noted separately.
Micro Enterprises	7.5 per cent of ANBC or CEOBE, whichever is higher
Advances to Weaker Sections	12 per cent <sup>#</sup> of ANBC or CEOBE, whichever is higher
# Revised targets for SMFs and Weaker Section will be implemented in a phased manner as indicated in the following paragraph.	

The targets for lending to SMFs and for weaker sections shall be revised upwards from FY 2021-22 onwards as follows:

Financial Year	Small and Marginal Farmers target *	Weaker Sections target ^
2020-21	8%	10%
2021-22	9%	11%
2022-23	9.5%	11.5%
2023-24	10%	12%
* Not applicable to UCBs		
^ Weaker Sections target for RRBs will continue to be 15% of ANBC or CEOBE, whichever is higher.		

**Computation of Adjusted Net Bank Credit (ANBC)**

10.13 For the purpose of priority sector lending, ANBC denotes the outstanding bank credit in India [As prescribed in item No.VI of Form 'A' under Section 42 (2) of the RBI Act, 1934] and computed as follows:

<sup>15</sup> Para 5.3 of RBI Master Direction No. RBI/FIDD/2020-21/72 FIDD.CO.Plan.BC.5/04.09.01/2020-21 dated September 04, 2020 (Updated as on October 20, 2022) on Priority Sector Lending (PSL) – Targets and Classification.

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Bank credit in India [As prescribed in item No.VI of Form 'A' under Section 42 (2) of the RBI Act, 1934].	I
Bills rediscounted with RBI and other approved financial institutions.	II
Net Bank Credit (NBC)*.	III (I - II)
Outstanding deposits under RIDF and other eligible funds with NABARD, NHB, SIDBI and MUDRA Ltd. in lieu of non-achievement of priority sector lending targets/sub-targets + outstanding PSLCs.	IV
Eligible amount for exemptions on issuance of long-term bonds for infrastructure and affordable housing as per circular DBOD.BP.BC.No.25/08.12.014/2014-15, dated July 15, 2014 on "Issue of Long Term Bonds by Banks for Financing of Infrastructure and Affordable Housing".	V
Eligible advances extended in India against the incremental FCNR (B)/NRE deposits, qualifying for exemption from CRR/SLR requirements, as per guidelines.	VI
Investments made by public sector banks in the recapitalization bonds floated by Government of India.	VII
Other investments eligible to be treated as priority sector (e.g. investments in securitised notes).	VIII
Face value of securities acquired and kept under HTM category under the TLTRO 2.0 (Press Release 2019-2020/2237 dated April 17, 2020 read with Q.11 of FAQ and SLF-MF- Press Release 2019-2020/2276 dated April 27, 2020 and also Extended Regulatory Benefits under SLFMF Scheme vide Press Release 2019-2020/2294 dated April 30, 2020.	IX
Bonds/debentures in non-SLR categories under HTM category.	X
ANBC	III+IV- (V+VI+VII)+ VIII-IX+X
<p>* For the purpose of priority sector computation only. Banks should not deduct / net any amount like provisions, accrued interest, etc. from NBC.</p> <p>A. If a bank opts to subtract prudential write off at Corporate/Head Office level while reporting Bank Credit as above, bank credit to priority sector and all</p>	

other sub-sectors so written off should also be subtracted category wise from priority sector and sub-target achievement.

- B. All types of investments or any other items which are treated as eligible for classification under priority sector target/sub-target achievement should also form part of Adjusted Net Bank Credit.

## **Agriculture Credit**

10.14 Lending to agriculture sector includes the following:

- (i) Farm Credit - Individual farmers (which will include short-term crop loans and medium/long-term credit to farmers).
- (ii) Farm Credit - Corporate farmers, Farmer Producer Organisations (FPOs)/(FPC) Companies of Individual Farmers, Partnership firms and Co-operatives of farmers engaged in Agriculture and Allied Activities.
- (iii) Agriculture Infrastructure.
- (iv) Ancillary services.
- (v) Small and Marginal Farmers (SMFs).
- (vi) Lending by banks to NBFCs and MFIs for on-lending in agriculture.

10.15 A list of eligible activities under the above sub-categories is given hereunder:

### **(i) Farm Credit**

Loans to individual farmers [including Self Help Groups (SHGs) or Joint Liability Groups (JLGs), i.e. groups of individual farmers, provided banks maintain disaggregated data of such loans] and proprietorship firms of farmers, directly engaged in Agriculture and Allied Activities, viz., dairy, fishery, animal husbandry, poultry, bee-keeping and sericulture. This will include:

- a. Crop loans to farmers, which will include traditional/non-traditional plantations and horticulture, and, loans for allied activities.
- b. Medium and long-term loans to farmers for agriculture and allied activities (e.g. purchase of agricultural implements and machinery, and developmental loans for allied activities).
- c. Loans for pre and post-harvest activities, viz., spraying, harvesting, grading and transporting of their own farm produce.
- d. Loans to distressed farmers indebted to non-institutional lenders.
- e. Loans to farmers under the Kisan Credit Card Scheme.

- f. Loans to small and marginal farmers for purchase of land for agricultural purposes.
- g. Loans against pledge/hypothecation of agricultural produce (including warehouse receipt) for a period not exceeding 12 months subject to a limit up to Rs. 75 lakhs against Negotiable Warehouse Receipts (NWRs)/ electronic Negotiable Warehouse Receipts (eNWRs) and up to Rs. 50 lakhs against warehouse receipts other than NWRs/eNWRs.
- h. Loans to farmers for installation of stand-alone solar agriculture pumps and for solarisation of grid connected agriculture pumps.
- i. Loans to farmers for installation of solar power plants on barren/fallow land or in stilt fashion on agricultural land owned by farmer.

**(ii) Loans to corporate farmers, etc.**

The loans to corporate farmers, farmers' producer organizations/ companies of individual farmers, partnership firms and co-operatives of farmers directly engaged in agriculture and allied activities, up to an aggregate limit of Rs. 2 crores per borrower entity shall be for the following activities

- a. Crop loans to farmers which will include traditional/non-traditional plantations and horticulture, and loans for allied activities.
- b. Medium and long-term loans to farmers for agriculture and allied activities (e.g. purchase of agricultural implements and machinery, and developmental loans for allied activities).
- c. Loans for pre and post-harvest activities, viz., spraying, harvesting, grading and transporting of their own farm produce.
- d. Loans up to ₹75 lakhs against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months against NWRs/eNWRs and up to ₹50 lakhs against warehouse receipts other than NWRs/eNWRs.
- e. Loans up to Rs.5 crores per borrowing entity to FPOs/FPCs undertaking farming with assured marketing of their produce at a pre-determined price.
- f. It needs to be noted here that UCBs are not permitted to lend to co-operatives of farmers.

**(iii) Agriculture Infrastructure**

For the following loans, an aggregate sanctioned limit of Rs. 100 crores per borrower from the banking system, will apply.

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- a. Loans for construction of storage facilities (warehouses, market yards, godowns and silos) including cold storage units/ cold storage chains designed to store agriculture produce/products, irrespective of their location.
- b. Soil conservation and watershed development.
- c. Plant tissue culture and agri bio-technology, seed production, production of bio-pesticides, bio-fertilizer, and vermi composting.
- d. Loans for construction of oil extraction/ processing units for production of bio-fuels, their storage and distribution infrastructure along with loans to entrepreneurs for setting up Compressed Bio Gas (CBG) plants.

#### **(iv) Ancillary Services**

- a. Loans for setting up of Agri-clinics and Agri-business centres.
- b. Loans to Custom Service Units managed by individuals, institutions or organizations which maintain a fleet of tractors, bulldozers, well-boring equipment, threshers, combines, etc., and undertake farm work for farmers on contract basis.
- c. Bank loans to Primary Agricultural Credit Societies (PACS), Farmers' Service Societies (FSS) and Large-sized Adivasi Multi-Purpose Societies (LAMPS) for on-lending to agriculture.
- d. Loans sanctioned by banks to MFIs for on-lending to agriculture sector as per the conditions specified.
- e. Loans sanctioned by banks to registered NBFCs (other than MFIs) as per conditions specified.

#### **(v) Small and Marginal Farmers (SMFs)**

For the purpose of computation of achievement of the sub-target, small & marginal farmers will include the following:

- a. Farmers with landholding of up to 1 hectare (marginal farmers).
- b. Farmers with a landholding of more than 1 hectare and up to 2 hectares (small farmers).
- c. Landless agricultural labourers, tenant farmers, oral lessees and share-croppers, whose share of landholding is within the limits prescribed for small and marginal farmers.
- d. Loans to Self Help Groups (SHGs) or Joint Liability Groups (JLGs), i.e. groups of individuals small and marginal farmers directly engaged in agriculture and allied activities, provided the banks maintain disaggregated data of such loans.

- e. Loans up to Rs.2 lakhs to individuals solely engaged in allied activities without any accompanying land holding criteria.
- f. Loans to FPOs/FPC of individual farmers, and co-operatives of farmers directly engaged in agriculture and allied activities, where the land-holding share of SMFs is not less than 75 per cent, subject to the prescribed loan limits outlined above.

**(vi) Lending by Banks to NBFCs and MFIs for On-lending in Agriculture**

- (a) Bank credit extended to registered NBFC-MFIs and other MFIs (Societies, Trusts etc.) which are members of RBI recognised SRO for the sector, for on-lending to individuals and also to members of SHGs/ JLGs will be eligible for categorisation as priority sector advance under respective categories of agriculture subject to conditions specified.
- (b) Bank credit to registered NBFCs (other than MFIs) towards on-lending for 'Term lending' component under agriculture will be allowed up to Rs. 10 lakhs per borrower subject to conditions specified.

**Kisan Credit Card (KCC)**

10.16 The salient features of the kisan credit card scheme areas under:

- a. In terms of RBI circular no. RBI/2011-12/553 RPCD.FSD. BC.No. 77/05.05.09/2011-12 dated 11<sup>th</sup> May, 2012 on "Revised Kisan Credit Card (KCC) Scheme", the revised scheme for issue of Kisan Credit card was introduced by the RBI, which was subsequently modified vide various circulars. The latest circular issued by the RBI on the subject is Master Circular No. RBI/2018-19/10 FIDD.CO.FSD.BC. No. 6/05.05.010/2018-19 dated July 04, 2018 "Kisan Credit Card (KCC) Scheme". For KCC scheme for Animal Husbandry and Fisheries the RBI issued circular no. RBI/2018-19/112 FIDD.CO.FSD.BC.12/05.05.010/2018-19, dated February 04, 2019 on "Kisan Credit Card (KCC) Scheme: Working Capital for Animal Husbandry and Fisheries".
- b. The scheme aims at providing adequate and timely credit support under single window to the farmers for their cultivation and other needs as indicated below:
  - Short term credit limits:
    - i. To meet the short-term credit requirements for cultivation of crops.
    - ii. Post-harvest expenses.
    - iii. Produce marketing loan.

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- iv. Consumption requirement of farmer's household.
- v. Working capital for maintenance of farm assets and activities allied to agriculture.
- Long term credit limit:  
Investment credit requirement for agriculture and allied activities.
- c. It may be noted that KCC is not a type of loan, but is a channel for granting either short term or long term agricultural finance to:
  - i. Farmers, both individuals and joint borrowers who are owner cultivators;
  - ii. Tenant farmers, oral lessees and share croppers;
  - iii. Self Help Groups (SHGs) or Joint Liability Groups (JLGs) of farmers including tenant farmers, share croppers etc.
- d. Master Circular No. RBI/2018-19/10 FIDD.CO.FSD.BC.No.6/05.05.010/2018-19 dated July 04, 2018 on "Kisan Credit Card (KCC) Scheme", throws more light on the following macro aspects:
  - i. Eligibility for KCC.
  - ii. Fixation of credit limit / loan amount for:
    - All farmers other than marginal farmers.
    - For Marginal Farmers.
  - iii. How disbursement takes place.
  - iv. Issue of electronic kisan credit cards.
  - v. Validity/renewal.
  - vi. Rate of interest (ROI).
  - vii. Repayment period.
  - viii. Security and margin.

S.No.	KCC limit	Primary security	Collateral security	Margin
1.	Upto Rs.1.6 Lakhs <sup>16</sup>	Hypothecation of crops	Nil	Nil
2.	Upto Rs.3 Lakhs with tie-up for recovery	Hypothecation of crops	Nil	Banks to decide
3.	Above Rs.1.6 lakhs in case of non-tie up and Rs.3 lakhs in case of tie-up advances	Hypothecation of crops	Collateral required e.g. land.	Banks to decide

<sup>16</sup> Vide RBI/2018-19/118FIDD.CO.FSD.BC.No.13/05.05.010/2018-19 dated February 7, 2019.



- ix. Other features like simple documentation.
- x. Classification of account as NPA.

The extant prudential norms on income recognition, asset-classification and provisioning will apply for loans granted under the KCC Scheme.

- xi. Delivery channels - Technical features:
  - Issue of cards
  - Type of card
  - Delivery channels
  - Mobile banking / Other channels

**10.17 Interest Application**

- a. Unlike normal loans, the interest on agricultural advances is not charged at monthly rests but is charged as per the instructions contained in circular no. RPCD.No.CPFS.BC.60/PS.165-85 dated June 06, 1985 and circular no. RPCD.No. PLFS.BC.129/05.02.27/97-98 dated June 29, 1998.
- b. Interest on current dues i.e. crop loans and instalments not fallen due in respect of term loans in respect of direct agricultural advances should not be compounded.
- c. The RBI *vide* circular no. DBOD No. Dir. BC. 25/13.03.00/2002-03, dated September 19, 2002 on “Charging of Interest at monthly rests – Agricultural Advances” has informed the banks that instructions regarding charging of interest on monthly rests shall not be applicable to agricultural advances and banks shall continue to follow the existing practice of charging/compounding of interest on agricultural advances linked to crop seasons.

Examples of Interest application according to crop seasons and for other activities:

<b>Crop Season</b>	<b>Kharif</b>	<b>Rabi</b>
Disbursement Period	April 01 to September 30	October 01 to March 31
Interest Application Date	Due date fixed for repayment	Due date fixed for repayment
Compounding from date	After due date	After due date
Penal Interest	From the date the loan becomes overdue	From the date the loan becomes overdue

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	Allied Activities	
	Dairy, Poultry	Goat Rearing, Piggery
Repayment	Quarterly	Half Yearly / Yearly
Interest Application	Quarterly	Half Yearly / Yearly
Interest application date	Quarter end	Half Year end / Year end
Compounding Frequency	Quarterly	Half Yearly / Yearly
Compounding from date	After Quarter end	After Half Year end / Year end
Penal Interest	If overdue, after Quarter end	If overdue after half year /year end.

### Interest Subvention

10.18 Public / Private Sector Scheduled Commercial Banks (in respect of loans given by the rural and semi urban branches) are eligible under the interest subvention scheme. On a loan given at 7 per cent interest, subvention of 2 percent p.a. is allowed to banks on their own funds used for short term crop loans up to Rs.3.00 lakhs per farmer. Short term credit, thus made available at 7 percent p.a. to farmers, is considered for interest subvention. This is calculated on the crop loan amount from the date of its disbursement/ drawl up to the date of actual repayment of the crop loan by the farmer or up to the due date of the loan fixed by the banks, whichever is earlier, subject to a maximum period of one year. The process of passing on the interest subvention amount to the closed accounts should be reviewed.

10.19 From 2011-12, additional interest subvention of 3 per cent is available to those farmers, who repay their short term crop loans promptly and on or before the due date. Farmers, who promptly repay their crop loans as per the repayment schedule fixed by the banks, are offered loans at an effective interest rate of 4 per cent p.a. (7 percent minus 3 percent).

10.20 The RBI *vide* circular no. RBI/2022-23/139 FIDD.CO.FSD.BC.No. 13/05.02.001/2022-23 November 23, 2022 on "Modified Interest Subvention Scheme for Short Term Loans for Agriculture and Allied Activities availed through Kisan Credit Card (KCC) during the financial years 2022-23 and 2023-24" has specified continuation of the interest subvention scheme for the years 2022-23 and 2023-24 on the terms and conditions approved in the guidelines. Aadhaar linkage was also made mandatory for availing short-term crop loans in 2022- 23 and 2023-24.

10.21 The RBI *vide* circular no. RBI/2019-20/166 FIDD.CO.FSD.BC. No.1785/05.02.001/2019-20 dated February 26, 2020 on "Short Term Crop Loans eligible for Interest Subvention Scheme (ISS) and Prompt Repayment

Incentive (PRI) through KCC” has stated that all short term crop loans eligible for Interest Subvention (IS) and Prompt Repayment Incentive (PRI) benefit are extended only through KCC w.e.f. April 1, 2020. The existing Short Term Crop Loans which are not extended through KCC shall be converted to KCC loans by March 31, 2020.

10.22 The RBI vide circular no. RBI/2022-23/139 FIDD.CO.FSD.BC.No. 13/05.02.001/2022-23 November 23, 2022 on “Modified Interest Subvention Scheme for Short Term Loans for Agriculture and Allied Activities availed through Kisan Credit Card (KCC) during the financial years 2022-23 and 2023-24”, has decided that Interest subvention and prompt repayment incentive benefits on short term crop loans and short term loans for allied activities will be available on an overall limit of ₹3 lakh per annum subject to a maximum sub-limit of ₹2 lakh per farmer in respect of those farmers involved only in activities related to animal husbandry, dairy, fisheries, bee keeping etc. The limit for crop loan component will take priority for interest subvention and prompt repayment incentive benefits and the residual amount will be considered towards allied activities including animal husbandry, dairy, fisheries, bee keeping etc. subject to the cap as mentioned above.

10.23 Additional subvention is available in respect of short term crop loans also affected by natural calamity. Further, as notified by the Government of India (Subject to inclusion in the Interest Subvention Scheme on short term crop loans) from time to time, to provide relief to farmers availing short term crop loans and affected by a natural calamity, an interest subvention of 2 percent per annum shall be made available to banks for the first year on the restructured loan amount. Such restructured loans shall attract normal rate of interest from the second year onwards.

10.24 However in case of severe natural calamities under the ISS, 2 per cent subvention will be made available to banks for the first three years/entire period (subject to a maximum of 5 years).

### **Interest Subvention Scheme to Post Harvest Loans**

10.25 The interest subvention scheme has been extended to small and marginal farmers (having Kisan Credit Card) for a further period upto six months, post-harvest, against negotiable warehouse receipt for keeping their produce in warehouses. This is in order to discourage distress sale by farmers and to encourage them to store their produce in warehouses against warehouse receipts of warehouses accredited with Warehousing Development Regulatory Authority (WDRA).

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10.26 Auditors have to submit a certificate of interest subvention along with annual accounts of the branch audited by them.

10.27 Further, all short term crop loans processed during 2018-19 are required to be brought on ISS portal / DBT platform. Banks are advised to capture and submit category wise data of beneficiaries under the scheme and report the same on ISS portal individual farmer wise once it is launched to settle the claims arising from 2018-19 onwards.

#### **10.28 Audit Procedure**

1. For details of short term crop loans qualifying for subvention, obtain information in Format I, II, III and IV submitted by the branch to HO or submitted by bank to RBI (Refer Annexures 1, 2, 3, and 4 to this Chapter). Also refer the Guidance Note on Reports or Certificates for Special Purposes (Revised 2016) for suitably modifying the format of the certificate.
2. The auditor has to verify that the book credit entries are not passed for the purpose of availing the interest subvention.
3. Obtain list of eligible borrowers with interest rate charged to the account.
4. Obtain the working sheet of interest subvention and verify the same.
5. Obtain list of all advances appearing in these formats having necessary particulars, like date of sanction, due date, actual date of repayment, actual ROI and effective ROI etc.
6. Verify that the interest is first credited to the account and then a claim is made for reimbursement for 3 per cent prompt repayment subvention.
7. Check the following in respect of cases verified:
  - a) How the limit of 3 Lakhs per borrower is verified for claim purposes.
  - b) Only the cases where prompt repayment has been received are given the benefit of interest subvention of 3 per cent.
8. Inquire about any rejection made in earlier year's claims and reasons thereof and whether proper accounting done for the same in branch books.

10.29 As per RBI circular, the auditor needs to certify the correctness of the claim and hence substantive testing needs to be carried out for examinations.

10.30 As per the extant RBI 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 Banker's Committee in each State depending upon the duration of crops raised by an agriculturist.

## **State Level Banker's Committee (SLBC)**

10.31 Agriculture finance is supervised and monitored by the State Level Banker's Committee and its decisions are implemented by all banking sector having branches in the State. Every State has its own SLBC and guidelines have been issued to banks to develop agricultural finance.

10.32 The SLBC is an inter-institutional forum for co-ordination and joint implementation of development programmes and policies by all the financial institutions operating in a State. Although SLBC is envisaged as a bankers' forum, Government officials are also included. The lead bank is designated as the 'Convener Bank'. The SLBC meets once in a quarter.

10.33 The SLBC of the respective State decides the crop season for each crop, which effectively means the period up to harvesting of the crop raised and the banks of the respective State have to adhere to the crop season as decided by the SLBC of that State. Hence, practically it may occur that same crop may have different harvesting seasons in different States as decided by the SLBC of those States. In these cases, the auditor needs to verify whether the banks have the requisite mechanism to map the crop season(s) vis-à-vis the crop season(s) as defined by the SLBC of each State as any discrepancies may have a direct impact on identification of NPAs. The auditors are advised to refer to the guidelines issued by SLBC of the State wherein the branch under the audit is located. The guidelines issued by SLBC of respective States should be available at the branches. The branch auditor should refer to the same and ensure its adherence.

### ***RBI Clarification to the Maharashtra SLBC***

10.34 A loan may be treated as NPA immediately on completion of two crop seasons / one crop season (as the case may be, depending on the duration of the crops) after the repayment due date. Two crop seasons after the due date should refer to only those two consecutive crop seasons in which the farmer usually undertakes crop production.

10.35 The crop season for each crop, means the period up to harvesting of the crops raised. The asset classification norms assume that there is normal crop yield during the season for which credit is extended. Hence, immediately after consecutive two harvest seasons (as per the cultivation pattern followed by the farmer borrower) from repayment due date, the account is to be identified as NPA as per the revised guidelines. In case the yield is affected by natural calamities as declared by the State Government, the loan accounts should be restructured / rescheduled.

## Example of NPA Identification

### 10.36 NPA in Agricultural advances

- i. A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons.

A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

For the purpose of these guidelines, “long duration” crops would be crops with crop season longer than one year and crops, which are not “long duration” crops, would be treated as “short duration” crops.

The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the SLBA 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 only to farm credit extended to agricultural activities as listed at Annex 2 of the Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 April 1, 2022 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances. An extract of the list of these items is furnished in Annex - 2 of the above said Master Circular. In respect of agricultural loans, other than those specified in Annex - 2 of the above said Master Circular and term loans given to non-agriculturists, identification of NPAs would be done on the same basis as non-agricultural advances, which, at present, is the 90 days delinquency norm.

- ii. Where natural calamities impair the repaying capacity of agricultural borrowers for the purposes specified in Annex - 2 of the above said Master Circular, banks may decide on their own as a relief measure conversion of the short-term production loan into a term loan or re-scheduling of the repayment period; and the sanctioning of fresh short-term loan, subject to Master Direction on “Reserve Bank of India (Relief Measures by Banks in Areas affected by Natural Calamities) Directions 2018 – SCBs” dated October 17, 2018, as updated from time to time.
- iii. 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 and conditions and would be treated as NPA

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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.

- iv. As regards gold loans granted for agricultural purposes, interest is required to be charged as per Supreme Court's judgment at yearly intervals and payment should coincide with the harvesting of crops. Accordingly, such advances will be treated as NPA only if instalments of principal and / or interest become overdue after the due date.
- v. While fixing the repayment schedule in case of rural housing advances granted to agriculturists under Indira Awas Yojana and Golden Jubilee Rural Housing Finance Scheme, banks should ensure that the interest/instalment payable on such advances are linked to crop cycles.

10.37 Example of NPA identification for various types of crop loans are given as follows. It may be noted that different states SLBC may have different provisions applicable for that State. The example shared here is as applicable for the State of Maharashtra.

S.No.	Particulars	Short Term Crops		Long Term Crops	
		Kharif	Rabi	Sugarcane	Banana
1	Sanction date	1 <sup>st</sup> April 2020 to 30 <sup>th</sup> September, 2020	1 <sup>st</sup> October 2020 to 31 <sup>st</sup> March, 2021	1 <sup>st</sup> October, 2019	1 <sup>st</sup> July, 2019
2	Harvesting time	September, 2020	March, 2021	December, 2020	September, 2020
3	Repayment due date	31 <sup>st</sup> December, 2020	30 <sup>th</sup> June, 2021	31 <sup>st</sup> March, 2021	31 <sup>st</sup> December, 2020
4	Interest subvention @ 3%	Available upto the date of repayment subject to maximum repayment due date.(subject to 1 year)	Available upto the date of repayment subject to maximum repayment due date. (subject to 1 year)		
5	Date of irregularity	31 <sup>st</sup> December, 2020	30 <sup>th</sup> June, 2021	31 <sup>st</sup> March, 2021	31 <sup>st</sup> December, 2020

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<b>Multiple/ double cropping pattern</b>					
6	First crop season end date	30 <sup>th</sup> June, 2021	31 <sup>st</sup> December, 2021	NA	NA
7	Second crop season end date	31 <sup>st</sup> December, 2021	30 <sup>th</sup> June, 2022	NA	NA
8	Date of NPA	31 <sup>st</sup> December, 2021	30 <sup>th</sup> June, 2022	NA	NA
<b>Single/ mono cropping pattern</b>					
9	First crop season end date	31 <sup>st</sup> December, 2021	30 <sup>th</sup> June, 2021	31 <sup>st</sup> March 2023	31 <sup>st</sup> December 2022
10	Second crop season end date	31 <sup>st</sup> December 2022	30 <sup>th</sup> June, 2022	NA	NA
11	Date of NPA	31 <sup>st</sup> December 2022	30 <sup>th</sup> June, 2022	31 <sup>st</sup> March 2023	31 <sup>st</sup> December 2022

The above illustration is for guidance only and the facts may be verified with reference to each case in hand.

<b>Allied Activity (Instalment)</b>				
Type	Dairy	Goat Rearing	Piggery	Poultry
	(equated quarterly instalment with moratorium period, first instalment is due on Sept 30, 2020)	(equated half yearly / yearly instalment considering moratorium period of six months first instalment is due on June 30, 2021)	(equated half yearly / yearly instalment considering moratorium period of six months first instalment is due on June 30, 2021)	(equated quarterly instalment with moratorium period, first instalment is due on Sept 30, 2020)
<b>Loan Disbursed</b>	1-Jun-2022	1-Jul-2021	1-Jul-2021	1-Jun-2022
<b>Due Date</b>	30-Sep-2022	30-Jun-2022	30-Jun-2022	30-Sep-2022
<b>Overdue Date</b>	30-Sep-2022	30-Jun-2022	30-Jun-2022	30-Sep-2022
<b>Compounding</b>	30-Sep-2022	30-Jun-2022	30-Jun-2022	30-Sep-2022
<b>NPA turning date</b>	30-Dec-2022	29-Sep-2022	29-Sep-2022	30-Dec-2022
<b>Remarks</b>	NPA upon running day-end process on 90 days overdue	NPA upon running day-end process on 90 days overdue	NPA upon running day-end process on 90 days overdue	NPA upon running day-end process on 90 days overdue



<b>Investment Credit (Instalment)</b>	
Type	Investment Credit - Minor Irrigation system to a farmer cultivating cotton
Loan Disbursed	1-Jun-2020
Due Date	31-Mar-2021
Overdue Date	1-Apr-2021
Compounding	1-Apr-2021
NPA turning date	31-Mar-2022
Remarks	After two crop seasons. First crop season will end at March 2022 and the other will end at March 2023

### **Key Points in Auditing Agriculture Advances**

10.38 The audit approach for agriculture advances has to be on similar lines as in the case of other advances. The following is a summary of key aspects in the audit of agricultural advances:

- a. Sanctioned amount of agriculture loans should be as per the scale of finance applicable to the land under cultivation and the crop being cultivated. Further, appropriate security should be obtained as per the guidelines framed by the bank.
- b. Auditors should verify that the agricultural credit is extended only after obtaining 'No dues/ No objection certificates' from the existing credit agencies in the area of finance.
- c. Disbursement of agricultural finance is required to be carried out in various 'stages' based on the requirements of farming activity. This needs to be ensured strictly. In some cases, the expenditure is incurred by the farmer from his/her own sources or by raising loans from non-institutional lenders and subsequently banks are requested to reimburse the same. In such cases, the auditors have to carefully verify the facts from the documents/evidence available on record. Under all situations, the auditors should verify that the bank holds documents evidencing the utilisation of loans for agricultural activities.
- d. For crop loans, the primary security is normally the standing crops under cultivation; as such pre and post sanction visits by the officers of bank, who are experts in agriculture finance and adequate documentation of visit report is a key control.
- e. While verifying the security offered for agricultural loans, it is to be confirmed that the security is legally enforceable. Standing crops and agricultural

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machinery and implements are secured by a hypothecation charge, while the agricultural land is secured by a mortgage charge. Auditors have to ensure that amongst others, the following have been duly taken on record by the banks:

- Copy of the land revenue extracts, with bank charges recorded.
  - Land tax assessment and payment receipt.
  - Copy of record with sub registrar (wherever applicable).
  - Original copies of the title deeds.
  - Search of title deeds and Legal opinion from the advocate on the bank's approved panel.
  - Valuation of land from a valuer on the bank's approved panel.
- f. Loans granted to farmers against the security of NSC, KVP or fixed deposits of banks, which have been utilised for agricultural purposes, is allowed to be classified under the category of finance to agriculture under priority sector in Schedule 9. However, Auditors should carefully verify the loan documents and other supporting documents to ensure that non-agricultural loans are not classified as agricultural finance.
- g. Agricultural advances are required to be serviced through realisation of sale proceeds of crop. Auditors should be sceptical about the nature and timing of credits coming in to service the agricultural loans and ensure that they are from genuine sources.
- h. It needs to be specially identified that non agricultural advances are not tagged as agricultural advances to get benefit of classification of agricultural advances. The auditor should specifically check the same.

### **Agricultural Advances affected by Natural Calamities**

10.39 RBI Master Direction No. RBI/FIDD/2018-19/64 FIDD.CO.FSD.BC No.9/05.10.001/2018-19 dated October 17, 2018 on "Reserve Bank of India (Relief Measures by Banks in Areas Affected by Natural Calamities) Directions, 2018-SCBs" deal elaborately with 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 re-scheduling of the repayment period and the sanctioning of fresh short-term loan, subject to the guidelines contained in RBI Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 April 1, 2022 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances" and directions contained in RBI Master

Direction No. RBI/FIDD/2018-19/64 FIDD.CO.FSD.BC No.9/05.10.001/2018-19 dated October 17, 2018 on “Reserve Bank of India (Relief Measures by Banks in Areas Affected by Natural Calamities) Directions, 2018-SCBs”. In such cases the NPA classification would be governed by such rescheduled terms. Asset classification of remaining amount (if any), not restructured, continue to be governed by original terms and conditions.

10.40 Additional finance granted due to natural calamities treated as standard assets, will be governed by the terms and conditions of its sanction. Different dues from the borrower (e.g. current dues, dues which are not restructured etc.) will be classified under different asset classification norms. This is an accepted departure from the basic principle of IRAC norms, i.e. NPA should be borrower-wise and not facility-wise.

10.41 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 said benefit of restructuring of assets would not be available for short-term crop loans if the said loan was overdue at the time of occurrence of natural calamity and for long-term credits if the borrower has wilfully defaulted in repayment of loan in earlier years. The asset classification of these loans would thereafter be governed by the revised terms and conditions and would be treated as NPA if interest and/or instalment of principal remain 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.

10.42 In case of receipt of claim of crop insurance, the insurance proceeds shall ideally compensate the losses. Under the Prime Minister Fasal Bima Yojana (PMFBY), all Seasonal Agricultural Operations (SAO) loans for notified crops in notified areas are to be compulsorily provided insurance cover for all stages of the crop cycle including post-harvest risks in specified instances. There are further ancillary measures prescribed by RBI for providing relief in terms of relaxation on KYC norms, providing access to banking services, etc.

### **Collateral Free Agricultural Loans**

10.43 The RBI vide circular no. RPCD.PLFS.BC.No 85/05.04.02/2009-10 dated June 18, 2010 on “Credit Flow to Agriculture – Agricultural Loans – Waiver of Margin/Security Requirements” read with circular no FIDD.CO.FSD.BC.No.13/05.05.010/2018-19 dated February 7, 2019 on “Credit Flow to Agriculture - Collateral free Agricultural Loans”, has increased the collateral free limit for agricultural loans from Rs.1 Lac to Rs.1.60 Lac.

## **Agricultural Debt Relief / Waiver Schemes**

10.44 There are various State and Central Government debt waiver / relief schemes which are implemented for providing relief to the affected agriculture borrowers. The auditors should go through the schemes so declared and implemented by State / Central Government for providing agricultural debt relief / waiver as the case may be and consider the same in terms of eligible loans under the scheme, amount of relief / waiver provided, asset classification norms and accounting.

### **Audit Procedure**

10.45 The audit procedure involves the following steps:

1. Obtain copy of relevant schemes and bank's circular in this regard.
2. Obtain list of eligible borrowers with outstanding balance.
3. Check the claim amount statement submitted to RO/ZO for claiming the same.
4. Check the accounting entries passed for the credit of eligible amount in the account of the borrower.
5. Verify accounting of interest and other charges to be borne by the lending institution as per the scheme.
6. Ensure reporting requirement as per closing instructions of the bank.
7. Obtain written representation from the management about the scheme and its applicability including cut-off amount and period of loan disbursed.

10.46 Other important points are as under:

- i) The tagging of priority sector lending towards agricultural advances should be specially verified and checked to ensure that the same are as per RBI guidelines.
- ii) Land holding being the deciding criterion for an agricultural loan to an individual farmer, a company whose objects are farming etc., shall not qualify for agriculture loans in that category, if it is not a farm producer company and none of its directors hold any land.
- iii) Loans given for the purchase of vehicles shall come under commercial vehicle loan category. For purchase of tractors, loan can be given as agriculture term loan.
- iv) Loans to fishermen for purchase of trawlers/ boats etc. can be considered.

- v) SHG and JLGs where farmers are members of the Group, qualify for agricultural loans. Further loans are categorised according to the activities carried out by the Groups and purpose for which the loans are taken.
- vi) If term deposits are given by farmers to the Primary Agricultural Societies which are deposited in banks, the Societies qualify for loans against the deposits. The Primary Agricultural Society can, back to back, give loans to its member farmers.

**Annexure 1**

**Format I**

Claim for 1.5 per cent Interest Subvention on Short-term Crop Loans/ Post-harvest credit against negotiable warehouse receipts/ loans restructured due to NC/ loans restructured due to severe NC (separate claim to be submitted for each head) disbursed/drawn up to Rs. 3 lakh through Kisan Credit Card (KCC) for the year 2022-23/2023-24.

Name of the Bank: \_\_\_\_\_

Statement for the year ended on  
March 20\_\_ / Additional Claim

	<b>*Total short term production credit at 7% p.a</b>		<b>Amount of total subvention claimed (Rs. in actuals)</b>
	<b>No. of accounts (in thousands)</b>	<b>Amount Disbursed / drawn (Rs. lakh)</b>	
Loans up to Rs.3 lakh			

Category-wise claim for 1.5 per cent Interest Subvention for 2022-23/2023-24 for All India except North East region

	<b>*Total short term production credit at 7% p.a. for All India except North East region</b>								
	<b>General</b>			<b>SC</b>			<b>ST</b>		
	<b>No. of accounts (in thousands)</b>	<b>Amount Disbursed/ drawn (Rs. lakh)</b>	<b>Amount of subvention claimed (Rs. In actual)</b>	<b>No. of accounts (in thousands)</b>	<b>Amount Disbursed/ drawn (Rs. lakh)</b>	<b>Amount of subvention claimed (Rs. In actual)</b>	<b>No. of accounts (in thousands)</b>	<b>Amount Disbursed/ drawn (Rs. lakh)</b>	<b>Amount of subvention claimed (Rs. In actual)</b>
Loans up to Rs.3 lakh									

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Category-wise claim for 1.5 percent Interest Subvention for  
2018-19 / 2019-20 for North East region

	*Total short term production credit at 7% p.a. for North East region								
	General			SC			ST		
	No. of accounts (in thousand)	Amount Disbursed/drawn (Rs. lakh)	Amount of subvention claimed (Rs. in actuals)	No. of accounts (in thousand)	Amount Disbursed/drawn (Rs. lakh)	Amount of subvention claimed (Rs. in actuals)	No. of accounts (in thousand)	Amount Disbursed/drawn (Rs. lakh)	Amount of subvention claimed (Rs. in actuals)
Loans up to Rs.3 lakh									

i) We certify having disbursed the above loans at 7 percent p.a. up to Rs. 3 lakhs by way of short-term credit through KCC to the farmers during the year 2022-23/2023-24 and having calculated the interest subvention claim correctly and strictly in accordance with the RBI circular FIDD.CO.FSD.BC.No.13/05.02.001/2022-23 dated November 23, 2022. Further, we certify that Aadhar Number / Aadhar Enrolment Number (AEN) of all farmers for whom the interest subvention is being claimed for reimbursement has been captured and available with the bank and there is no case of claim for reimbursement where Aadhar No./AEN is not available (except for Assam, Meghalaya, and UTs of Jammu and Kashmir and Ladakh).

Sd/-

Authorised Signatory of the Bank

Name: \_\_\_\_\_

Date: \_\_\_\_\_ Designation: \_\_\_\_\_

We certify that the above claim for interest subvention of ₹ \_\_\_\_\_ calculated on eligible short term credit to farmers through KCC disbursed by the bank during the period from \_\_\_\_\_ to \_\_\_\_\_ has been found true and correct and strictly in accordance with the RBI circular FIDD.CO.FSD.BC.No.13/05.02.001/2022-23 dated November 23, 2022. Further, we certify that Aadhar Number / Aadhar Enrolment Number (AEN) of all farmers for whom the interest subvention is being claimed for reimbursement has been captured and available with the bank and there is no case of claim for reimbursement where Aadhar No./AEN is not

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available (except for Assam, Meghalaya, and UTs of Jammu and Kashmir and Ladakh).

ii) (Statutory auditor certifying the correctness of the subvention claim)

Seal and signature of Statutory Auditor/s

Name: \_\_\_\_\_

Firm Registration Number: \_\_\_\_\_

Date: \_\_\_\_\_ Membership Number: \_\_\_\_\_

UDIN: \_\_\_\_\_ (This claim format needs to be duly certified by the statutory auditors with the Firm Registration Number and Membership Number of all Signatories)

\* May be modified suitably for post-harvest credit against negotiable warehouse receipts/ loans restructured due to NC/ loans restructured due to severe NC.



**Annexure 2**

**Format II**

One - time Claim for Additional 3 percent Subvention for Prompt Repayment Incentive (PRI) of Short-term Crop Loans / Loans restructured due to Severe NC (separate claim to be submitted for each head), disbursed/drawn up to Rs.3 lakh through Kisan Credit Card (KCC) for the year 2022-23/2023-24

Name of the Bank: \_\_\_\_\_

	*Total short term production credit at 7% p.a		*Total short term production credit which were repaid in time		Amount of total subvention claimed (₹ in actuals)
	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	No. of accounts (in thousands)	Amount disbursed drawn (Rs. lakh)	
Loans up to Rs.3 lakh					

Category-wise one-time claim for additional 3 percent Prompt Repayment Incentive (PRI) for 2022-23/2023-24 for All India other than North East region

	*Total short term production credit which were repaid in time for All India except North East region								
	General			SC			ST		
	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. In actuals)	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. In actuals)	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. In actuals)
Loans up to Rs.3 lakh									

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Category-wise one-time claim for additional 3 percent Prompt Repayment Incentive (PRI) for 2022-23/2023-24 for North East region

	<b>*Total short term production credit which were repaid in time for North East region</b>								
	<b>General</b>			<b>SC</b>			<b>ST</b>		
	<b>No. of accounts (in thousands)</b>	<b>Amount Disbursed/drawn (Rs. lakh)</b>	<b>Amount of subvention claimed (Rs. in actuals)</b>	<b>No. of accounts (in thousands)</b>	<b>Amount Disbursed/drawn (Rs. lakh)</b>	<b>Amount of subvention claimed (Rs. in actuals)</b>	<b>No. of accounts (in thousands)</b>	<b>Amount Disbursed/drawn (Rs. lakh)</b>	<b>Amount of subvention claimed (Rs. in actuals)</b>
Loans up to Rs.3 lakh									

i) We certify that the above-mentioned short-term loans disbursed through KCC for which the claim is being made were repaid in time and the benefit of 3% prompt repayment incentive has already been passed on to the eligible loanee farmers, thereby bringing down the interest rate to 4% per annum for short term crop loan/loans restructured due to severe natural calamities, up to ₹3 lakh disbursed during 2022-23/2023-24 for these farmers. This claim for additional interest subvention has been calculated on eligible short term crop loan / loans restructured due to severe natural calamities strictly in accordance with the RBI circular FIDD.CO.FSD.BC.No.13/05.02.001/2022-23 dated November 23, 2022. Further, we certify that Aadhar Number / Aadhar Enrolment Number (AEN) of all farmers for whom the prompt repayment incentive is being claimed for reimbursement has been captured and available with the bank and there is no case of claim for reimbursement where Aadhar No./AEN is not available (except for Assam, Meghalaya, and UTs of Jammu and Kashmir and Ladakh).

Seal and signature of authorized signatory of bank

Name: \_\_\_\_\_

Date: \_\_\_\_\_ Designation: \_\_\_\_\_

We certify that the above claim for 3% prompt repayment incentive of ₹ \_\_\_\_\_ calculated on eligible short term crop loans / loans restructured due to severe natural calamities disbursed through KCC by the bank during the period from \_\_\_\_\_ to \_\_\_\_\_ has been found true and correct and strictly in accordance with

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the RBI circular FIDD.CO.FSD.BC.No.13/05.02.001/2022-23 dated November 23, 2022. Further, we certify that Aadhar Number/Aadhar Enrolment Number (AEN) of all farmers for whom the prompt repayment incentive is being claimed for reimbursement has been captured and available with the bank and there is no case of claim for reimbursement where Aadhar No./AEN is not available (except for Assam, Meghalaya, and UTs of Jammu and Kashmir and Ladakh).

Seal and signature of Statutory Auditor/s

Name: \_\_\_\_\_

Firm Registration Number: \_\_\_\_\_

Date: \_\_\_\_\_ Membership Number: \_\_\_\_\_

UDIN: \_\_\_\_\_

(This claim format needs to be duly certified by the statutory auditors with the Firm Registration Number and Membership Number of all signatories)

\* May be modified suitably for Loans restructured due to severe NC.

**Annexure III**

**Format III**

Claim for 1.50% Interest Subvention on Short-term Loans to farmers for Animal Husbandry (including Dairy)/Bee Keeping/ Fisheries/Loans restructured due to natural calamities /Loans restructured due to severe natural calamities (separate claim to be submitted for each head), disbursed/drawn up to ₹2 lakh through Kisan Credit Card(KCC) for the year 2022-23/2023- 24.

Name of the Bank: \_\_\_\_\_

Statement for the year ended on March 20\_\_ / Additional Claim

	Total short term credit at 7% p.a		Amount of total subvention claimed (₹ in actuals)
	No. of accounts (in thousands)	Amount Disbursed / drawn (₹ lakh)	
Loans up to ₹2 lakh			

Category-wise claim for 1.50% Interest Subvention for 2022-23/2023-24 for All India other than North East region

	Total short term credit at 7% p.a. for All India other than North East region								
	General			SC			ST		
	No. of accounts (in thousands)	Amount Disbursed/ drawn (₹ lakh)	Amount of subvention claimed (₹ in actuals)	No. of accounts (in thousands)	Amount Disbursed/ drawn (₹ lakh)	Amount of subvention claimed (₹ in actuals)	No. of accounts (in thousands)	Amount Disbursed/ drawn (₹ lakh)	Amount of subvention claimed (₹ in actuals)
Loans up to ₹2 lakh									

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Category-wise claim for 1.50% Interest Subvention for 2022-23/2023-24 for  
North East region

	Total short term credit at 7% p.a. for North East region								
	General			SC			ST		
	No. of accounts (in thousands)	Amount Disbursed/ drawn (₹ lakh)	Amount of subvention claimed (₹ in actuals)	No. of accounts (in thousands)	Amount Disbursed/ drawn (₹ lakh)	Amount of subvention claimed (₹ in actuals)	No. of accounts (in thousands)	Amount Disbursed/ drawn (₹ lakh)	Amount of subvention claimed (₹ in actuals)
Loans up to ₹2 lakh									

We certify having disbursed the above loans at 7% p.a. up to ₹ 2 lakh by way of short-term credit to farmers for animal husbandry (including dairy)/bee keeping/fisheries through KCC during the year 2022-23/2023-24 and having calculated the interest subvention claim correctly strictly in accordance with the RBI circular FIDD.CO.FSD.BC.No.13/ 05.02.001/2022-23 dated November 23, 2022. Further, we certify that Aadhar Number/Aadhar Enrolment Number (AEN) of all farmers for whom the interest subvention is being claimed for reimbursement has been captured and available with the bank and there is no case of claim for reimbursement where Aadhar No./AEN is not available (except for Assam, Meghalaya, and UTs of Jammu and Kashmir and Ladakh).

Seal and signature of authorized signatory of bank

Name: \_\_\_\_\_

Date: \_\_\_\_\_

Designation: \_\_\_\_\_

We certify that the above claim for interest subvention of ₹.... calculated on eligible short term credit to farmers for animal husbandry (including dairy)/bee keeping/fisheries disbursed through KCC by the bank during the period from.....to.....has been found true and correct and strictly in accordance with the RBI circular FIDD.CO.FSD.BC.No.13/05.02.001/2022-23 dated November 23, 2022. Further, we certify that Aadhar Number/Aadhar Enrolment Number (AEN) of all farmers for whom the interest subvention is being claimed for reimbursement has been captured and available with the bank and there is no

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case of claim for reimbursement where Aadhar No./AEN is not available (except for Assam, Meghalaya, and UTs of Jammu and Kashmir and Ladakh).

Date: \_\_\_\_\_

Seal and signature of Statutory Auditor/s

Name: \_\_\_\_\_

Firm Registration Number: \_\_\_\_\_

Membership Number: \_\_\_\_\_

UDIN: \_\_\_\_\_

**Annexure IV**

**Format IV**

One - time claim for 3% Prompt Repayment Incentive (PRI) for timely repayment of short-term loans to farmers for Animal Husbandry (including Dairy)/Bee keeping/Fisheries/Loans restructured due to severe natural calamities (separate claim to be submitted for each head), disbursed/drawn up to ₹2 lakh through Kisan Credit Card (KCC) for the year 2022-23/ 2023-24

Name of the Bank: \_\_\_\_\_

	Total short term credit at 7% p.a		Total short term credit which were repaid in time		Amount of total subvention claimed (₹ in actuals)
	No. of accounts (in thousands)	Amount Disbursed/ drawn (₹ lakh)	No. of accounts (in thousands)	Amount Disbursed/ drawn (₹ lakh)	
Loans up to ₹2 lakh					

Category-wise one-time claim for 3% PRI for 2022-23/2023-24 for All India other than North East region

	Total short term credit which were repaid in time for All India other than North East region								
	General			SC			ST		
	No. of accounts (in thousands)	Amount Disbursed/ drawn (₹ lakh)	Amount of subvention claimed (₹ in actuals)	No. of accounts (in thousands)	Amount Disbursed/ drawn (₹ lakh)	Amount of subvention claimed (₹ in actuals)	No. of accounts (in thousands)	Amount Disbursed/ drawn (₹ lakh)	Amount of subvention claimed (₹ in actuals)
Loans up to ₹2 lakh									

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Category-wise one-time claim for 3% PRI for 2022-23/2023-24 for North East region

	Total short term credit which were repaid in time for North East region								
	General			SC			ST		
	No. of accounts (in thousands)	Amount Disbursed/ drawn (₹ lakh)	Amount of subvention claimed (₹ in actuals)	No. of accounts (in thousands)	Amount Disbursed/ drawn (₹ lakh)	Amount of subvention claimed (₹ in actuals)	No. of accounts (in thousands)	Amount Disbursed/ drawn (₹ lakh)	Amount of subvention claimed (₹ in actuals)
Loans up to ₹2 lakh									

We certify that the above-mentioned short-term loans disbursed through KCC for which the claim is being made were repaid in time and the benefit of 3% prompt repayment incentive has already been passed on to the eligible loanee farmers, thereby bringing down the interest rate to 4% per annum for short term credit for Animal Husbandry (including Dairy)/Bee keeping/Fisheries, up to ₹2 lakh disbursed during 2022-23/2023-24 for these farmers. This claim for additional interest subvention has been calculated on eligible short term credit to farmers for animal husbandry/fisheries/bee keeping strictly in accordance with the RBI circular FIDD.CO.FSD.BC.No.13/05.02.001/2022-23 dated November 23, 2022. Further, we certify that Aadhar Number / Aadhar Enrolment Number (AEN) of all farmers for whom the prompt repayment incentive is being claimed for reimbursement has been captured and available with the bank and there is no case of claim for reimbursement where Aadhar No./AEN is not available (except for Assam, Meghalaya, and UTs of Jammu and Kashmir and Ladakh).

Seal and signature of authorized signatory of bank

Name: \_\_\_\_\_

Date: \_\_\_\_\_

Designation: \_\_\_\_\_

We certify that the above claim for 3% prompt repayment incentive of ₹ calculated on eligible short term credit to farmers for Animal husbandry / Bee keeping / Fisheries disbursed through KCC by the bank during the period from.....to.....has been found true and correct and strictly in accordance with



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the RBI circular FIDD.CO.FSD.BC.No.13/05.02.001/2022-23 dated November 23, 2022. Further, we certify that Aadhar Number/Aadhar Enrolment Number (AEN) of all farmers for whom the prompt repayment is being claimed for reimbursement has been captured and available with the bank and there is no case of claim for reimbursement where Aadhar No./AEN is not available (except for Assam, Meghalaya, and UTs of Jammu and Kashmir and Ladakh).

Date: \_\_\_\_\_

Seal and signature of Statutory Auditor/s

Name: \_\_\_\_\_

Firm Registration Number: \_\_\_\_\_

Membership Number: \_\_\_\_\_

UDIN: \_\_\_\_\_

## Reporting for Advances

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### Introduction

11.01 Lending constitutes a major activity of a bank besides the investment function. The core business of banks is accepting deposits for onward lending. Advances, generally, constitute the largest item on the assets side of the balance sheet of a bank and constitute the major source of its income.

11.02 Audit of advances is one of the most important areas covered by SBAs in bank audits. It is necessary that SBAs have adequate knowledge of the banking industry and its regulations. SBAs should be aware of various functional areas of the bank/branches, its processes, procedures, systems and prevailing internal controls with regard to advances.

11.03 Advances generally comprise of:

- a) Money lent by bank to its customers including interest accrued and due.
- b) Debit balances in depositor accounts.
- c) Inter-Bank Participation Certificates.

11.04 Every bank has its credit policy approved by its Board of Directors which is updated at regular intervals. The credit policy will be in line with applicable RBI guidelines, relevant laws and regulations. SBAs should acquaint themselves with the credit policy of the bank and the advances portfolio composition.

### Fund Based and Non-Fund Based Credit Facilities

11.05 In fund based credit facilities, there is an actual outflow of funds from the bank to the borrower, whereas non-fund based facilities, do not involve outflow of bank's funds. Typical fund based facilities are term loans, cash credits and overdrafts while non-fund based facilities are letters of credit, bank guarantees, letter of comfort/undertaking, etc. Non-fund based facility may turn into a fund based facility on due date, if not paid by the borrower, for e.g. devolvement of bills under LC, invocation of bank guarantee, etc. Different types of fund based facilities are explained in detail in **Appendix XII**, "Additional Guidance on Advances (Refer Chapter 11 "Reporting for Advances" of Section B of the Guidance Note on Audit of Banks (2023 Edition).

### **Audit Approach and Procedures**

11.06 The SBAs, in carrying out audit of advances are primarily concerned with obtaining evidence about the following:

- a) Amounts included in balance sheet in respect of advances which 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) Advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
- g) Appropriate provisions towards advances are made as per the RBI norms, Accounting Standards and Generally Accepted Accounting Practices (GAAP).

11.07 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 and it's vetting by the legal department;
- reviewing the operation of the accounts especially of accounts held and operated with other banks;
- examining the existence, enforceability and valuation of the security from time to time especially for loans given on a standalone basis;
- checking compliance with RBI norms including appropriate classification and provisioning;
- carrying out appropriate analytical procedures; and
- checking the procedure for loan balance confirmations.

11.08 In carrying out audit procedures for advances, the auditor should examine all large advances while other advances may be examined on sampling basis. The accounts identified to be problem accounts need to be examined in detail unless the amount involved is insignificant. The auditor should obtain a list of SMA 1 and SMA 2 borrowers from the bank and the same should also be considered for selection of problematic accounts. The extent of sample checking would depend on auditor's assessment of efficacy of internal controls. What

constitutes a 'large advance' needs to be determined in the context of volume of operations of the branch. As per revised LFAR guidelines, large advances are those in respect of which the outstanding amount is in excess of 10 percent of outstanding aggregate balance of fund based and non-fund based advances of the branch or Rs.10 crores, whichever is less. However, SBA should apply their professional judgement to decide advances accounts to be selected for verification.

11.09 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.

11.10 In nutshell, the SBA at branch may keep the following in mind to plan comprehensive coverage of advances and for selection of sample in addition to the mandatory selection of accounts as per revised LFAR guidelines:

1. **Obtain Top/ Large Exposure Accounts:** It may be advisable for a SBAs to visit the branch and ask for the list of large accounts/ exposures along with all the details such as status and security etc. before starting the audit. Number of accounts to be selected may differ from branch to branch based on the size and nature of advances sanctioned at the branch. Since LFAR requires comment on all large advances, the auditor needs to select all large advances.
2. **Obtain the List of Stressed Accounts:** Stressed accounts include accounts classified as SMA 1 or SMA 2 or projects where implementation is delayed. The banks monitor stressed accounts on daily basis. Accounts that generally have overdue beyond 60 days or likely to slip to NPA at the quarter end are termed as stressed account (some banks may use different terminology). It is advisable to obtain a list of stressed accounts at least 15 days ahead of the closing date i.e. say stressed account list as on 15<sup>th</sup> March. This will provide the SBA a ready list of such accounts. The SBA then can scrutinize (based on materiality) whether the account has slipped or if not whether has been kept standard by unusual transaction that cannot be termed as business transaction. The SBA should test the SMA list (used for analytics) for its completeness and accuracy. The SBA should perform month on month analytical procedure of SMA2 accounts to identify trend of slippages in quarter and month ends.

3. **Obtain List of Restructured Accounts:** Obtain a list of restructured accounts at the branch. Restructured account portfolio requires separate attention of the SBAs for compliance with applicable RBI directions.
4. **Obtain List of Unsecured Exposures above Rs. 1 Crore:** Unsecured exposure has significant impact on the bank, if it slips to NPA. Many times such accounts are reviewed in the traditional manner. These require close monitoring not only from the perspective of financial parameters of the prudential guidelines but also non-financial parameters that give signals of possible ill health. Banking industry (especially PSUs) has faced severe damages on account non-identification of such non-financial parameters.
5. **Quick Mortality Cases:** Any advance slippage to NPA within 12 months of its sanction is called “quick mortality” case. Quick mortality cases entail penalty on the sanctioning authorities. This will have to be checked to understand the reason for such happening to avoid such cases in future and also to find out whether there are any cases classified as performing on some untenable ground to push it beyond early mortality.
6. List of accounts upgraded during the year or previous years.
7. List of accounts rated adversely as per bank’s internal ratings.
8. List of accounts where adverse issues have been noted during previous audits.
9. Obtain the list of accounts identified in EWS (Early Warning Signals) reports at the branch: The list of accounts identified in EWS report should be sought by SBA along with the parameter(s) of EWS identified therein. The parameters of EWS may be looked into to analyse the possible indication of stress or otherwise and accordingly the SBA should factor-in the same appropriately for LFAR reporting purpose.

***Evaluation of Internal Controls over Advances***

11.11 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:

- 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 needs to be ensured that loans sanctioned are as per the

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loan policy of the bank and adhere to the regulatory (RBI) norms unless a specific exemption is taken in this regard.

- All necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should have been executed by the parties before advances are made.
- Compliance with the terms of sanction and end use of funds should be ensured.
- Sufficient margin specified in the sanction letter should be kept against securities taken to cover for any decline in the value thereof. Availability of sufficient margin needs to be ensured at regular intervals.
- Controls over custody and storage of documents and their removal for verification.
- If the securities taken are in the nature of shares, debentures, etc., the lien should be marked in the name of the bank and 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 accompanied by documents sufficient to give clear title to the bank.
- In the case of goods in possession of the bank, contents of the packages should be test checked at the time of receipt. The godown 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 physical possession of the bank.
- Drawing Power Register should be updated every month to record value of securities hypothecated. These entries should be separately checked by an independent officer.
- Accounts should be kept within the drawing power and the sanctioned limit.
- Policy related with valuation of primary and collateral securities including periodicity of the same.
- Policy related with internal and external rating of borrowers which includes frequency of such rating.
- Policy related to review of CIBIL rating of the borrower and its periodicity.
- All accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the controlling authority regularly.
- Operation of each advance account should be reviewed at least once a year, and at more frequent intervals in case of large advances.

***Consideration of Drawing Power/Limits in respect of Stocks Hypothecated***

11.12 In respect of credit facilities against hypothecation of stocks (inventories) being the primary security, bank's system of appraisal for determining the maximum permissible finance to borrowers and fixing of limits, *inter alia*, should take into consideration the level of sundry creditors. 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 declared stocks shall not cover the borrower's liability outstanding in the form of sundry creditors for goods or covered by LCs/ guarantees/ co-acceptances or Buyer's Credit availed for procurement of material. The bank should also insist on such information from the borrowers. In the case of consortium accounts, drawing power calculation and allocation made by the lead bank is binding on all member banks of the consortium.

11.13 The RBI has issued guidelines on treatment of unpaid stocks while arriving at the drawing power available in borrower accounts. The thrust of the guidelines is avoidance of double financing on unpaid stocks, if such stocks are taken as eligible for computation of drawing power.

11.14 The matter having been re-examined by RBI vide directive No. IECD.No.32/08.10.01/92-93 dated 28th April, 1993, banks were advised as regards the treatment of unpaid stocks while arriving at the drawing power available in the borrower accounts, wherein the thrust is avoidance of the double finance on the unpaid stock, if such stocks are taken as eligible for computation of drawing power. Thus, it would be unrealistic to assume that the composition of the stock items, the level of stock held and the portion of unpaid stock considered at the time of appraisal would be static and should be presumed to be at the same level for the subsequent period. For the said reason, the drawing power needs to be recomputed based on variations, not only in composition and level of stock but also in the unpaid portion of stocks before the stipulated margin is applied as per the sanction terms of working capital finance.

11.15 The auditor should review the bank's policy 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.

11.16 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 of:

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- Net value of stock as stated above.
- Net Value of Debtors (i.e., eligible Trade Debtors Less Bills Discounted with bank). The bank usually prescribes conditions as to what would comprise of “eligible trade debtors”, and stipulates the period for debts being considered as current and good on which the margin is computed.

11.17 For the purposes of classification of advances, computation of drawing power based on realistic value of hypothecated stocks (net of unpaid for stocks, whether covered by Buyer’s Credit, LCs/ Guarantees/ Co-acceptances or otherwise) and margin as stipulated, is vital, particularly in cases of default, and in border-line cases where health status of borrowers may be in question, to gauge slippages.

11.18 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 of drawing power limits; and
- consortium advances, where the bank, not being the leader, gets related figures of drawing power from the lead bank, without related evidence of computation or appropriateness of drawing power.

The auditor needs to look into this aspect to verify that there is no slippage of the account into NPA classification.

11.19 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***

11.20 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, the loan documents would include certificate of incorporation, memorandum and articles of association, certificate of commencement of business, resolution of board of directors, and special resolution of shareholders [in cases covered by Section 180 (1)(c) of the Companies Act, 2013, etc. Where the borrower is a partnership firm, the loan documents would include copy of the 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. Formats of many of the documents are also prescribed. The auditor should evaluate the adequacy of 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*

11.21 Of late, there is an increasing propensity in banks to process loans and advances, including appraisal, sanction, documentation, initial disbursements, etc., at the 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 borrowers' accounts are maintained/serviced. The branch places reliance only on the sanction letters, on the presumption that all required legal and documentation formalities are correct and complete at the centralized location.

11.22 In the absence of original documents (or even authenticated copies thereof) on an updated basis, the SBA should request the branch management for the files identified for examination by them. The SBA should 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 whether there are any cheques held by such centres that remain unbanked affecting the borrower's account balance. Reference should 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***

11.23 The SBA 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 exceeded; that the account is not becoming stagnant; that the customer is not drawing against deposits which are not free from lien; that the account is not window-dressed by running down overdrafts at the year end and again drawing further advances in the new year, etc. The audit procedure should be able to highlight disbursements from pre/freshly sanctioned limits made either to the same borrower or to group entities near the repayment dates of critical dues.

11.24 The SBA 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 item 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 regarding any major irregularities, if any, which may have a bearing on his report.

11.25 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 the 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 lakhs (or as approved by Board of Directors of respective banks) or above for working capital from the banking system.

11.26 The auditor should verify that interest is being charged on all performing accounts regularly on sample basis and should compare the rate of interest with the agreement, sanction letter and credit rating reports where rate of interest is linked to credit rating. In case the interest rate is revised based on changes in PLR/BPLR/Base Rate/External benchmark linked 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 the interest not serviced (received) in NPA is not recognised as income, as per RBI guidelines. It may be noted that interest accrued but not due on advances does not form part of advances.

11.27 Penal interest on 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. Compliance of the same should be checked in detail by the SBAs. If no penal interest / charges are levied, a letter of waiver, if any, from the respective authority should be referred to and verified.

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

11.29 In respect of consortium advances, the auditor should examine:

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

11.30 The SBA 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 is made.

***Verification of Security Against Advances***

11.31 An advance is treated as secured to the extent of the value of the security on the reporting date. If 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 and the remaining amount should be classified as unsecured.

11.32 Following points are relevant for classifying advances based on security:

- (a) Government guarantees include guarantees of Central/State Governments and advances guaranteed by Central/State Government owned corporations, financial institutions like IDBI, IFCI, ICICI, State Financial Corporations, State Industrial Development Corporations, ECGC, CGTS, etc.
- (b) Advances covered by bank guarantees include advances guaranteed against any negotiable instrument, 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 advances as secured, the primary security should be applied first and for residual balance, if any, 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'.

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- (e) There may be situations where more than one facility is granted to a single borrower and the 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 case of common collateral security for advances granted to more than one borrower, if there is a shortfall in the value of primary security in any one or more of the borrower accounts, the value of collateral security may be applied proportionately to the shortfall in each borrower account.
- (g) Advances covered by ECGC, CGTS guarantees should be treated as covered by guarantees to the extent of guarantee cover available. The amount already received from 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 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 and are endorsed in the name of the bank as on the balance sheet date should be classified as 'secured'.
- (j) Documentary bills under delivery-against-acceptance terms which remain unaccepted at close of 31st March (i.e., for which 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, rights, licenses, authorisations, etc., charged to banks as collateral in respect of projects (including infrastructure projects) financed by them, should not be reckoned as tangible security as per Master Direction No. RBI/DOR/2021-22/83 DOR.ACC.REC.No.45/21.04.018/2021-22 dated August 30, 2021 (Updated as on February 20, 2023) on "Financial Statements - Presentation and Disclosures".

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

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

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

- (a) Documents executed are complete and in force.
- (b) Where documents are not renewed, limitation period has not expired.
- (c) Evidence is available to the market value of the security.
- (d) Evidence is available to the effect that:
  - i. hypothecated/pledged goods are the property of the borrowers and are not old/obsolete or otherwise unsaleable;
  - ii. advances against book debts of borrowers are related to their current debts and not old/doubtful debts; and
  - iii. Stocks hypothecated/pledged are paid stocks owned by the borrower.
- (e) In 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 requisite information regarding value of security lodged with the bank.
- (g) In respect of 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.

*Stock Exchange Securities and Other Securities*

11.35 The SBA 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.

11.36 A quoted security may not have frequent transactions on the stock exchange and the value 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.

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

#### *Goods*

11.38 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. The auditor should also verify that the bank has a system of maintenance of proper register in this regard and a system of scrutiny of stock/book debt statement furnished by the borrower.

11.39 The SBA should also check the nature of goods hypothecated/pledged. If the goods are of perishable nature, it will not have a market value. In case of goods/book debts, movable assets hypothecated, the auditor should also examine whether the bank has a 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. It needs to be checked whether proper register is maintained in this regard and timely action is taken whenever there is an adverse remark in the inspection report. The 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.

11.40 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 valuation of 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 movement of goods inwards and/or outwards.

11.41 Sometimes, goods are in possession of third parties, such as clearing and forwarding agents, transporters, brokers, warehouse-keepers, etc. If these parties have given an undertaking to the bank that they will hand over the goods or sale proceeds thereof to the bank only, i.e., they have 'attorned' to the bank the advances made against such goods should be considered as secured. In

such cases, certificates should be obtained by the bank from such third parties regarding quantities on hand on balance sheet date. The valuation of such goods should be checked by the auditor. In case the borrower is a company, the auditor should examine the certificate of registration of 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*

11.42 The SBA may check the availability of sealed packets with the bank which tallies with the number of Gold Loans. He should also see the assayer's certificate regarding the net gold content of the ornaments and their valuation. Valuation should also be checked with reference to the current market price of gold. In the context of valuation, attention is also invited to the valuation norms as given in RBI circular no. DBOD.No.BP.BC.27/21.04.048/2014-15 dated July 22, 2014 on "Loans against Gold Ornaments and Jewellery for Non-Agricultural End-uses" read with Master Circular No. RBI/2015-16/95 DBR.No.Dir.BC.10/13.03.00/2015-16 dated July 01, 2015 on "Loans and Advances – Statutory and Other Restrictions", and RBI circular no. RBI/2021-2022/72 DOR.CRE.REC.No.33/13.03.00/2021-22 dated July 23, 2021 on "Loans and Advances – Regulatory Restrictions". The SBA should also check that services of multiple assayers are used instead of relying on few assayers.

11.43 As per Para 2.3.10 of RBI Master Circular No. RBI/2015-16/95 DBR.No.Dir.BC.10/13.03.00/2015-16 dated July 01, 2015 on "Loans and Advances – Statutory and Other Restrictions", the banks have been advised that while granting advance against the security of specially minted gold coins sold by them, banks should ensure that the weight of the coin(s) does not exceed 50 grams per customer and the amount of loan to any customer against gold ornaments, gold jewellery and gold coins (weighing up to 50 grams) should be within the Board approved limit. Such loans to be granted by the bank, may be covered under the policy framed by the bank's Board, in terms of circular no. 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. The SBA should inspect the sealed gold packets on test basis and verify the seals are intact. The weights mentioned on the bars may generally be accepted as correct.

*Life Insurance Policies*

11.44 The SBA should inspect the policies and see whether they are assigned to the bank and whether such assignment has been registered with the insurer. The SBA 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 SBA should particularly see that if

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such surrender value is subject to payment of certain *premia*, the amount of such *premia* has been deducted from the surrender value.

11.45 It should be verified whether policies are assignable in bank's favour. In certain types of policies where assignment to third party are restricted, due care has to be taken while considering it as a security.

#### *Bank's Own Deposit Certificates*

11.46 The SBA should inspect such certificates and examine whether they have been properly discharged and whether lien of the bank is noted on the face of the certificates, in the relevant register of the bank and in CBS master data.

#### *Hire-purchase Documents*

11.47 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*

11.48 These advances are classified as secured against the crop and/or the fixed assets (*viz.*, mortgage of land) of the plantation. The SBA 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.

11.49 The SBA should keep in mind that where moratorium is available for payment of interest in such plantation projects, the payment of interest becomes due only after the moratorium or gestation period is over. In such a case the account will become NPA in case interest is not recovered after the due date after the moratorium period, if specifically mentioned in the sanction letter.

#### *Immovable Property*

11.50 The SBA should inspect title deeds, empanelled solicitor's/advocate's opinion taken by the bank in respect thereof, and the mortgage deed. For valuation, he may rely on the report of the architect or valuer (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 this purpose<sup>17</sup>. He should also examine the insurance policies.

11.51 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 housing

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<sup>17</sup> Reference may be made in this regard to SA 620, "Using the Work of an Auditor's Expert".



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 housing society, 'no objection certificate' from the society/lessor (in the case of leasehold properties) for offering the property as security, etc.

11.52 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 the loan amount covered by such mortgage.

***Third Party Guarantees***

11.53 The auditor should examine guarantee bonds and demand promissory notes in order to verify the third party liability. The auditor should satisfy 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 the auditor has to see if the acknowledgement to debt from the borrower as well as guarantor is obtained by the bank.

***Reliance on / Review of Other Reports***

11.54 The auditor should take into account the adverse comments, if any, on advances appearing in the following:

- Previous years' Audit Reports.
- Latest internal inspection reports of bank officials.
- Latest inspection Report/Asset Quality Review/ Risk Based Supervision report of RBI.
- Concurrent /internal audit report.
- Report on verification of security.
- Any other internal reports specially related to particular accounts.
- Manager's charge-handing-over report when incumbent is changed.

***Verification of Bills Purchased and Discounted***

11.55 The auditor should familiarise with the guidelines issued by RBI and the policies framed by the bank regarding discounting and rediscounting of bills and the auditor should ascertain that the policy framed by the bank conforms to the RBI stipulations and requirements.

11.56 Bills purchased and discounted have to be shown separately in the balance sheet as 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.

11.57 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.

11.58 Bills purchased and discounted by the bank are generally drawn on outside 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 ensure that:

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

11.59 The SBA should examine whether registers of bills purchased and discounted are properly maintained and the transactions are recorded therein correctly. He should examine whether bills and 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 case of documentary bills, it should be examined whether 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 and the auditor should also examine the bills collected subsequent to the year-end to obtain assurance regarding completeness and validity of recorded bill amounts.

***Other Aspects***

11.60 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 status of the account has been determined 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.

11.61 The SBA should examine that advances made by a banking company otherwise than in the course of banking business, such as, prepaid expenses, advance for purchase of assets, etc., are not included under 'advances' but are included under 'other assets'.

11.62 The advances in India and those outside India are to be shown separately in the balance sheet. This classification will depend as to 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.

11.63 The SBA should examine whether any loan has been granted in violation of statutory limitations of Section 20 of the Banking Regulation Act, 1949. If any such loan is granted the report will have to be drafted with suitable qualification, as the transaction is ultra vires.

11.64 It may also be examined whether the bank has a system of ensuring end use of the funds granted compared with the purpose of sanction<sup>18</sup>.

***Drawing Power Consideration***

11.65 In "working capital borrower account", the drawing power calculated from stock statement older than 3 months has to be considered as "irregular"

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<sup>18</sup> Refer Para 2.4 and 4.2 of RBI Master Circular RBI/2015-16/100 DBR.No.CID.BC.22/20.16.003/2015-16 dated July 01, 2015 on 'Willful Defaulter' for Guidelines on Willful Defaulters w.r.t. End-use and Monitoring End-use of funds respectively.

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(overdue). If such “irregular” account continues for 90 days, it has to be classified as NPA, even though the account is otherwise operated regularly.

11.66 Stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinized in detail.

11.67 The audited Annual Report submitted by the borrower should be scrutinized properly. 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. Specific attention given to clause 47 of CARO 2020 (wherever applicable) which requires the auditor of corporate borrower to comment whether quarterly returns or statements filed with bank are in agreement with books of account of company. Similarly, attention should be given to the amended Schedule III which requires a company to furnish age-wise analysis of trade receivable, trade payable, capital WIP, etc. besides various financial ratios and year-on-year variance beyond 25 per cent thereon, charges not created on assets hypothecated / mortgaged to the bank.

11.68 It needs to be examined whether the drawing power is calculated as per the extant guidelines formulated by the bank, which should also be in line with RBI guidelines/directives. Special consideration should be given to proper reporting of sundry creditors for purposes of calculating drawing power.

11.69 Stock audit should be carried out by the bank for all accounts having funded exposure over Rs. 5 crores. The SBAs can recommend for conduct of stock audit in other cases if situation warrants the same. Branches should obtain stock audit reports from lead bank or any other member bank, as decided in consortium in cases where the bank is not the 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.

11.70 The drawing power needs to be verified carefully in case of working capital advances to entities engaged in construction business. Valuation of work in progress should be calculated properly and consistently. It should be examined whether mobilization advance being received by the contractors is reduced while calculating the drawing power. In respect of certain businesses such as diamond merchants and jewellers, the SBA should exercise due caution while verifying realisable value of precious metals, diamonds, jewellery etc. The SBA may also consider obtaining assistance of an expert in case circumstances so warrant.

11.71 In case of consortium accounts, the drawing power calculation and allocation is made by the Lead Bank and is binding on the member banks.

*Lending under Consortium Arrangement / Multiple Banking Arrangements*

11.72 In order to strengthen the information sharing system among banks in respect of borrowers enjoying credit facilities from multiple banks, banks are required to obtain regular certification by a professional, preferably a Company Secretary, Chartered Accountant or Cost Accountant regarding compliance of various statutory prescriptions that are in vogue, as per specimen given in Annexure III (Part I and II) to RBI circular no. DBOD.No. BP.BC.110/08.12.001/ 2008-09 dated February 10, 2009 on “Lending under Consortium Arrangement / Multiple Banking Arrangements”, read with Master Circular No. RBI/2015-16/95 DBR.No.Dir.BC.10/13.03.00/2015-16 dated July 01, 2015 on “Loan and Advances – Statutory and Other Restrictions”.

11.73 Accounts under consortium arrangements may, notwithstanding their classification as Standard, due to servicing thereof, may nonetheless be intrinsically weak or even be NPA in other participating bank(s), including on the basis of the certificate/report as aforesaid. The SBA 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.

11.74 The SBA should check compliance with RBI guidelines on unhedged foreign currency exposure. Self-declaration from the client or Independent Auditors’ certificate of foreign currency exposure should be obtained by the bank. Such declaration/certificate can be cross checked with computation of standard asset provisioning.

11.75 The bank should ensure that correct, sensitized and vetted data is duly and timely captured so that analytics could be run intelligently through the system to make data predictions to generate foresights on trends, patterns that show incipient sickness. Pro-active monitoring of the Early Warning Signals (EWS) as per Annex II of RBI Master Direction No. RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 dated July 01, 2016 (Updated as on July 03, 2017) on “Fraud – Classification and Reporting by commercial bank and select FIs” should be ensured. These (EWS) should be used as indicators for Red Flagged accounts (RFA). The SBAs should comment on the prevalence of the (EWS) - (RFA) system and its operational efficiency and effectiveness.

11.76 The SBAs should comment on the frequency and periodicity of trainings given to branch officials on knowledge and skill up-gradation especially on usage of technology and other advanced developments on appraisal, risk, controls and gap mitigation loan and cyber frauds.

Retail loans

11.77 Banks generally provide various retail advances namely:

- Home loans and loans against property
- Vehicle/automobile loans
- Education loans
- Personal loan
- Consumer durable loans
- Credit cards
- Micro finance loans
- Jewel loans or Gold Loan

**Audit Approach, Procedures including Regulatory Considerations**

**A. Preliminary Check**

11.78 SBA should review product note or circular or policy related to every loan product under the audit. Also, check if the product note/ policy/ circular is in line with RBI guidelines.

11.79 In retail advance, the volume of transactions are high; hence the auditor needs to apply effective sampling to ensure proper coverage. While selecting sample, the auditor may consider loan sanctioned/ disbursed near to reporting date, high/low in interest rate sanctions as compared to average rate, coverage of different branches and different type of loans. The auditor should review the compliance of Master Direction No. RBI/DBR/2015-16/20 DBR.Dir. No.85/13.03.00/2015-16 dated March 03, 2016 (Updated as on June 10, 2021) on "Reserve Bank of India (Interest Rate on Advances) Directions, 2016".

11.80 SBA should look into the following documents for checking the bank process for selected sample accounts:

- i. Prescribed application form.
- ii. CIBIL check of borrower and guarantor.
- iii. KYC compliance.
- iv. Income proof like salary slip, financial statement, Income tax returns, bank statement.
- v. Property Valuation Report.
- vi. Title clearance report in case where property like flat, plot, building is mortgaged.
- vii. Technical review in case of mortgage of machinery.

- viii. In case of vehicle loans, copy of original invoices, copy of RC and insurance policy of vehicle with bank clause should be obtained.
- ix. In case of education loans, document evidencing studies in affiliated universities/colleges, prospectus and fees details should be obtained.
- x. Whether the bank has complied with the particulars given in the documentation manual.
- xi. If the loan is taken over from another bank, satisfactory performance report from that bank needs to be collected.
- xii. If any additional limit is granted, ensure that security and eligibility is being considered.
- xiii. Whether the bank has obtained legal security report in addition to valuation report.
- xiv. Whether all registers required by the Bank/Branch are kept updated.
- xv. Confidential report and NOC from the existing bankers.
- xvi. Valuation report in case of Gold loan.
- xvii. Master creation of loan in Core Banking System/Operating system including classification of loans as priority sector loans.
- xviii. In respect of FDs pledge against the loans, the auditor should also verify the lien marking in the system.
- xix. Field verification in case of micro lending.
- xx. The Insolvency and Bankruptcy Board of India (IBBI) has registered National E-Governance Services Limited (NeSL). RBI has advised the banks to adhere to the relevant provisions of IBC, 2016 and IBBI (IUs) Regulations, 2017 and immediately put in place appropriate systems and procedures to ensure compliance with the provisions of the Code and Regulations (RBI vide circular No. RBI/2017-18/110 DBR.No.Leg.BC.98/09.08.019/2017-18 December 19, 2017).
- xxi. Legal Entity Identifier (LEI) for borrowers obtain specified limit borrower (RBI vide circular no RBI/2022-23/34 DOR.CRE.REC.28/21.04.048/2022-23 April 21, 2022).
- xxii. The SBA may also refer the Consolidated Circular on opening of current accounts and CC/OD accounts by banks (RBI circular no RBI/2022-23/27 DOR.CRE.REC.23/21.08.008/2022-23 April 19, 2022).
- xxiii. In case of term loans with floating rate of interest, the auditor should review

the existent system of the bank w.r.t. applying the change in the RoI and its impact on either EMI or tenor of loan as per the terms of sanction of the loan.

### **B. Disbursement**

11.81 The SBA should check whether the disbursements had been made only if all the terms and conditions of the sanction letter have been fulfilled and an acceptance letter for the same has been obtained.

Also check whether processing charges, inspection charges, mortgage charges and documentation charges have been collected by the bank. The practice may differ between banks; in few cases these charges are collected from the amount disbursed to the borrower.

### **C. Post Disbursement Inspection**

11.82 The bank should have a proper check on the active accounts. The important aspects that the SBA can check are as follows:

- i. There should be an acceptance letter duly acknowledged by the borrowers and guarantors, if any for all the loan accounts.
- ii. Execution of the loan documents should be as per the terms and conditions of the sanction letter.
- iii. All the original documents are held in the safe custody in fire resistance safe.
- iv. Valuation of securities.
- v. External and internal credit rating.
- vi. Due diligence certificate.
- vii. Verify if the payment schedule as per the sanction letter is implemented. Check the approval document for the same, if any.
- viii. Whether the interest and principal repayment are received in time in accordance with the repayment schedule as mentioned in the loan agreement/term sheet.
- ix. Whether the SMAs/EWS are reported to the management on regular intervals and what course of action has been taken to mitigate the same.
- x. Verify whether the group exposure and industry exposure are within the prescribed limits.
- xi. The SBA 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 monthly basis or quarterly basis.

- xii. The SBA should perform analytical procedures for computing the processing fee percentage for different ticket size loans.
- xiii. The SBA should check the master data of the borrower in the CBS to ensure correct feeding of data with regard to sectorial classification of advances, e.g. priority sector and non-priority sector in accordance with Master Direction No. RBI/FIDD/2020-21/72 FIDD.CO. Plan.BC.5/04.09.01/2020-21 dated September 4, 2020 (Updated October 20, 2022), amount of instalments with due dates of payment etc.
- xiv. The SBA should also carry out cut-off procedure for the purpose of ascertaining the completeness of loans and also should review the subsequent cancellation of loan after balance sheet period.

11.83 The SBA should check for any Non-Performing Asset (NPA). All accounts which are overdue or stops generating income for the banks continuously for 90 days, have to be treated as NPA and provision should be made as per extant guidelines of RBI.

## **Export Financing**

### **A. Pre-Shipment/Packing Credit to Exporters**

#### **11.84 Important Points:**

- Export packing credit can be in Indian Rupees and in Foreign Currency.
- To be issued on the basis of letter of credit or a confirmed and irremovable order for the export of goods/services, unless specifically waived.
- Period of packing credit will depend upon the circumstances of the individual case subject to maximum period for of 360 days.
- EPC / PCFC is disbursed against specific orders, in one lumpsum tranche or against the requirement as per export orders.
- To arrive at the eligible amount of drawl under EPC / PCFC facility, the amount of contract is first aligned to FOB basis, prescribed margin is deducted and thereafter the same is converted into rupees. The said eligible amount can be drawn in INR under Rupee Credit Facility and in foreign currency in case of PCFC facility.
- Each original contract or LC is endorsed for PC granted.
- In packing credit running account facility PC is adjusted on FIFO basis and not contact to contract.

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- Monthly stock statement for PC facility should be furnished wherein DP is available from paid goods only and book debts or unpaid goods are not permitted. Further, the stock considered for PC facility should be excluded from the drawing power calculation of regular CC account.
- Stock, RM, WIP & FG should remain fully insured and the policy endorsed in bank's favour.
- Rupee export packing credit can be shared between an Export Order Holder (EOH) and sub-supplier of raw materials, components etc., of the exported goods subject to:
  - Running account facility is not allowed.
  - Bankers to an EOH will open an inland LC specifying the goods to be supplied by the sub-supplier.
  - The above scheme is an additional window beside the existing system of sharing of packing credit. Further it has to be verified that the total quantum of advance or period cannot be extended.
- Liquidation of EPC / PCFC will be by way of export proceeds only. Liquidation by any other means than by way of exports will attract – commercial rate of interest as per bank's policy. However, the Master Directions on export of goods and services issued by RBI, prescribes that AD Category-I banks may permit exporters to repay packing credit advances whether availed in Rupee or in foreign currency from balances in their EEFC account and / or Rupee resources to the extent exports have actually taken place.

#### **Accounting Aspects**

- Banks open separate loan account in CBS for EPC / PCFC. It helps in monitoring the utilization and liquidation.
- The bank at the request of the borrower must convert the amount of pre-shipment credit into post-shipment credit by discounting / purchasing the export bills. When PC is granted no export bill should be sent on collection basis. In case any problem arises in the purchase of a bill say discrepant documents, the bill should be purchased and proceeds credited to PC account and PC account should be earmarked till it is accepted or paid by the foreign bank.

#### **Compliance Aspects**

- *End use of funds*

Banks should keep a close watch on the end-use of the funds and ensure that credit at concessional rates of interest is used for genuine requirements of exports only. The cheques/withdrawals from the PC account should be made to the suppliers of the raw materials purchased/ processed or for manufacturing expenses of the goods to be exported. Banks should also monitor the progress made by the exporters in timely fulfilment of export orders.

#### **Order Book Maintenance**

- Banks maintain order book / register to track export orders vis-a-vis export credit extended.
- PC should be supported by valid export orders on hand. If any export order or LC has expired the same should be extended or replaced.

#### **Submission of Export Documents**

- If pre-shipment advances are not liquidated from the proceeds of bills on purchase, discount, etc. on submission of export documents within 360 days from the date of advance, or from balance in EEFC account and / or Rupee resources to the extent exports have actually taken place, the advances will not be treated as export credit *ab initio*.
- If exports do not materialise at all, banks should charge on relative packing credit domestic lending rate plus penal rate of interest, if any, to be decided by the banks on the basis of a transparent policy approved by their Board.

#### **Auditing Aspects**

- Generate the list of EPC / PCFC accounts opened and maintained by the branch.
- Verify whether all details are correctly filled in the Masters.
- Whether the liquidation of EPC / PCFC is as per RBI guidelines? If not, whether interest rate as per bank's policy is charged or not.
- Documents evidencing end use of funds should be verified.
- Whether genuineness of export LC is confirmed before sanctioning EPC / PCFC?
- If remitting bank advises, the bill is required to be presented to the alternate drawee, then necessary approval and borrower's consent should be obtained.
- Similarly the advance should be covered under bank's WTPCG cover if stipulated. The premium should be recovered from the client if stipulated.

## **B. Post-Shipment Credit to Exporters**

### **Export Bills Discounted / Purchased**

11.85 Banks extend the following credits to exporters:

- Credits to exporters by way of
  - Export bills purchased / discounted / negotiated.
  - Advances against bills on collection basis.
  - Financing against duty drawback receivable from the Government.
- Facility of discounting / purchase of bill is available in both Indian Rupee and in Foreign Currency.

### **Revenue Aspects**

- Interest on Bill Discounting / Purchase is revenue for the bank. The auditor should review the accounting policy of the bank in this regard.
- Bank also charges fees for export bill lodgement and claims courier and other charges for submission of Export Documents.

### **Accounting Aspects**

- In case of discounting / purchase in foreign currency:
  - The rupee equivalent of the discounted value of the export bills will be payable to the exporter and the same should be utilised to liquidate the outstanding export packing credit.
  - As the discounting of bills/extension of foreign exchange loans (DP bills) will be in actual foreign exchange, Banks may apply appropriate spot rate for the transaction.
  - The rupee equivalent of discounted amounts/foreign exchange loan may be held in the bank's books distinct from the existing post-shipment credit accounts.
  - In case of overdue bills, banks may charge overdue interest as per the interest rate policy of bank from the due date to the date of crystallization.

### **Compliance Aspects**

- In case of overdue bills, IRAC norms for overdue bills will be applicable and the advance will be subject to asset classification.
- Export bills will be valid subject to maximum period of 365 days.

### **Auditing Aspects**

- Generate a report on export bills purchased/negotiated during the audit period.
- Verify whether details are correctly filled in Masters especially amount and discounting rate.
- Generate a report on outstanding / realized export bills during the audit period.
- In case of overdue bills, check whether interest has been charged as per bank's policy.
- Verify whether the period of sanction is within the limit prescribed by RBI in namely 360 days.
- Check to ensure that credit report on buyer is held from international agency.
- ECGC buyer wise cover should be obtained by the exporter client if stipulated.
- Similarly the advance should be covered under bank's WTPSG cover so stipulated.

### **Non Fund based Facilities**

11.86 Non-fund based facilities are letters of credit, bank guarantees, letter of comfort/undertaking, etc. Non-fund based facility may turn into a fund based facility on due date, if not paid by the borrower, for e.g. devolvement of bills under Letters of Credit, invocation of Bank Guarantee, etc. As on the date of a sanction and original booking they do not involve an outflow of funds.

Non fund based facilities are recorded in the books of accounts as a contra item appearing on both sides of the Trial Balance. In the balance sheet they appear under the prescribed Schedule.

11.87 The SBA should ensure the following:

- 1) As general rule bank guarantee should not have maturity of more than 10 years. However, this is not absolute and guarantee can be issued for periods longer than 10 years subject to the policy of the bank with prior approval of Board of Directors.<sup>19</sup>

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<sup>19</sup> Refer Para 2.1.3 of RBI Master Circular RBI/2022-23/10 DOR.STR.REC.8/13.07.010/2022-23 dated April 01, 2022 on Guarantees and Co-acceptances.

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- 2) There is a proper procedure for sanctioning non fund based facilities and these facilities are duly monitored and are within the sanctioned limits. Any outstanding beyond sanctioned amount is a deviation and should be promptly reported.  

Banks do not issue these facilities especially guarantees for walk-in customers even with 100 per cent cash margins. Necessary KYC checks and a due sanction should be in place for issuance of these facilities.
- 3) There is proper procedure for recording these amounts in the books of accounts through serial numbers or other appropriate methods.
- 4) Necessary margins as prescribed in the sanction letter have been duly collected. These margins are duly lien marked and not allowed to be withdrawn during pendency of the facility.
- 5) They have been issued in the prescribed standard format. Care should be taken to note the formats for issuance of Letters of Comfort / Undertaking.
- 6) They have been issued under proper authority. Banks have a schedule of powers for sanction of various facilities and it should be noted that these facilities are sanctioned under proper delegated authority levels.
- 7) They have been duly disclosed in the financials under appropriate prescribed heads in the prescribed manner. Some banks disclose these facilities as net of margins while some disclose this at gross. The auditor should ensure that whatever be the practice followed by banks, it is consistent as per their policy and is duly disclosed in the financial statements.
- 8) The bank has proper policies, procedures, manuals which could also be a part of their credit manual that describes in detail how these facilities are to be sanctioned, disbursed, documented, monitored, accounted and cancelled. The auditor should ensure due compliance with these policies, procedures and manuals.
- 9) If these facilities are devolved / invoked, then they would be funded advances. Appropriate removal from “non fund based advances” should be done to avoid duplicate disclosure as both funded and non funded advances.
- 10) The underlying documents should be kept under proper control and custody.
- 11) Where a number of guarantees / letters of credit issued have been invoked/ devolved, the auditor would have to consider the probability of invocation / devolvement of the guarantees / letters of credit on their due dates and consider making appropriate provisioning thereon as of current date.

- 12) On expiry of their term and if no letter of invocation has been received and if the original guarantee has been received back, there would be no liability due on these guarantees / letters of credit, these would have to be removed from the books of account.

Different banks have different practices in this regard especially for guarantees. In case of guarantees some banks wait for receipt of the original guarantee back from the issuer before cancelling the liability from the books. In such cases the auditor should also note whether there is a timely system of sending letters to the issuers asking for return of the original guarantees immediately post the expiry date.

11.88 For guarantees issued to Governments, specific rules apply and the auditor should ensure that these are followed.

- 1) The auditor should ensure proper classification of guarantees in to performance or financial as they carry separate risk weights.
- 2) The SBA should note that the RBI has issued Master Circular No. RBI/2022-23/10 DOR.STR.REC.8/13.07.010/2022-23 dated April 1, 2022 on "Guarantees and Co-acceptances". RBI also keeps on issuing guidelines/ circulars from time to time, which should be noted for compliance. RBI vide circular no. RBI/2017-18/139 A. P. (DIR Series) circular no. 20 dated March 13, 2018 on "Discontinuance of Letters of Undertaking (LoUs) and Letters of Comfort (LoCs) for Trade Credits" has also advised the AD Category-I banks to discontinue the practice of issuance of LoUs / LoCs for trade credits for imports into India with immediate effect.
- 3) Non fund based advances are prone to frauds and due care needs to be taken while verifying these facilities.
- 4) These facilities are duly reviewed and renewed as per procedures prescribed in the same manner and alongside funded advances.
- 5) Care should be taken to ensure that the bank does not issue letters on behalf of their customers to third parties which are in the form of a comfort / undertaking and may need classification as a non-fund based liability. Necessary procedures framed by the bank in this regard should be verified including the awareness, training and sensitization thereof.
- 6) The internal controls designed and in operation over the process from start to end from the sanction to the cancellation should be verified in depth on a standalone basis. Any gaps noted in the control process should be promptly reported.

Since these are specialized operational areas, staff with necessary, relevant experience with training are only posted to handle guarantee /

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Letters of Credit transactions. Controls over job rotations and mandatory leaves to these staff should be verified and reported.

- 7) The LFAR contains specific questions needing reporting on non fund based facilities. The auditor should note the requirements of the LFAR while planning and conducting the audit.
- 8) Non fund based facilities should be duly considered for all reporting and calculation purposes as prescribed in appropriate guidelines.
- 9) These facilities earn a fee based income for banks. Banks have different methods for booking fee based income especially in case of guarantees. Some do it up-front either monthly or quarterly. The auditor should ensure that there is consistency in the methodology followed for booking of income in accordance with prescribed policy at prescribed rates.

Banks should also ensure to collect processing fees on sanction, review and renewal of these facilities at prescribed rates.

- 10) There may be cases where the main non funded limit may be sanctioned at one branch and sub limits may be sanctioned at another branch. In such cases, appropriate monitoring should be done in the same manner as is done for sanctioned advances in similar situations.

For consortium accounts, monitoring and follow-up including obtaining of relevant information would be the same as would be done in the case of a funded facility.

- 11) In some banks especially foreign banks, non fund based facilities constitute a significant portion of their book size and at times even exceed their funded facilities.
- 12) Forward Contracts, Swaps – Currency or Interest Rate are also non fund based facilities which are also duly sanctioned, monitored, disclosed and transacted as per policies and guidelines.

### **Selection of Accounts**

11.89 The SBA should obtain a list or breakup of all advance accounts as at the yearend. This should be obtained facility wise – security wise – sanction date and amount wise. In accordance with RBI guidelines contained in the LFAR, the auditor has to mandatorily comment on all advances in respect of which the outstanding amount is in excess of 10 per cent of outstanding aggregate balance of fund based and non-fund based advances of the branch or Rs.10 crores, whichever is less. Apart from these accounts mandatorily to be considered for reporting, the auditor should also select advance accounts for each type – each of Unsecured, Educational, Housing, Vehicle, Personal, loan against FD, Loan against Shares, Loan against property, Loans granted against other securities.



Besides loan accounts cash credit accounts, overdraft against property, bills discounting / purchase accounts should be selected for verification, a mix of both - new sanctions in the current year and sanctions of previous years. The sampling should be based on the Standards on Auditing (SA) 530, Audit Sampling issued by the ICAI and in accordance with the requirement of LFAR.

11.90 All the accounts falling within the threshold should be scrutinized in depth end to end keeping in mind the reporting requirements of the LFAR. The selection has to be done in a manner that each distinct and unique type of credit facility is verified and reported. Adverse issues noted on verification to be discussed with the Branch, Branch responses obtained and appropriate reporting to be made in the LFAR requirements. In this context the SBA should refer the Technical Guide on Revised Formats of Long Form Audit Report.

11.91 The format of reporting for advances below Rs.10 Crores is not specified. The auditor may report the same in the format he feels appropriate ensuring that adverse issues noted are brought out for corrective action. It should be noted that finding gaps in process is the key. The transactional errors noted is the outcome of a weakness in the process and the process will need strengthening to ensure that such transactional errors are minimized if not zeroed.

11.92 The LFAR specifies the format (given below) in which the auditor has to obtain data from the branch for large advances. The compilation has to be done by the branch. The auditor has to review on a test check basis whether the data keyed into the system is correct.

11.93 While giving his observations, the auditor has not only to go through all the points filled in by the branch but also through all the loan correspondence files of the borrower. The process of appraisal, sanction, disbursement, documentation, monitoring, review or renewal, follow-up, classification as SMA-NPA will have to be independently verified for such accounts. Audit comments should not be simply based on the data submitted by the branch. Independent verification and assessment is essential.

11.94 The LFAR for Large / Irregular / Critical Advance Accounts (To be obtained by the SBAs from branches dealing in large advances/asset recovery branches) is as under:

Sr. No.	Items / Particulars	Details
1.	Name of the Borrower	
2.	Address	

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3.	Nature of business/activity						
4.	Total exposure of the branch to the borrower						
	(a) Fund Based (Rs. in crore)						
	(b) Non-Fund Based (Rs. in crore)						
5.	Name of Proprietor / Partners / Directors(As Applicable)						
6.	Name of the Chief Executive, if any						
7.	Asset Classification by the branch						
	(a) as on the date of current audit						
	(b) as on the date of previous Balance Sheet						
8.	Asset Classification by the branch auditor						
	(a) as on the date of current audit						
	(b) as on the date of previous Balance Sheet						
9.	Are there any adverse features pointed out in relation to asset classification by RBI inspection or any other audit						
10.	Date on which the asset was first classified as NPA (where applicable)						
11.	Facilities sanctioned						
	<b>Date of Sanction</b>	<b>Nature of facilities</b>	<b>Limit (Rs. in crore)</b>	<b>Prime Security</b>	<b>Collateral Security</b>	<b>Margin %</b>	<b>Balance outstanding at the year-end</b>
							<b>Current Year</b> <b>Previous Year</b>
<b>Sr. No.</b>	<b>Items / Particulars</b>						<b>Details</b>
12.	Whether the facility is a consortium facility or a facility made on multiple bank basis						
13.	If Consortium-						

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	(a) names of participating banks with their respective shares	
	(b) name of the Lead Bank in Consortium	
14.	If on multiple banking basis, names of other banks	
15.	Has the branch classified the facility under the credit rating norms in accordance with the guidelines of the controlling authorities of the bank	
16.	(a) Details of verification of primary security and evidence thereof	
	(b) Details of valuation and evidence thereof	

<b>Date of Verification</b>	<b>Nature of Security</b>	<b>Value</b>	<b>Valuation done by</b>
Insured for Rs.		(expiring on____)	

<b>Sr. No.</b>	<b>Items / Particulars</b>	<b>Details</b>
17.	(a) Details of verification of collateral security and evidence thereof	
	(b) Details of valuation and evidence thereof	
18.	Give details of the Guarantee in respect of the facility	
	(a) Central Government Guarantee	
	(b) State Government Guarantee	
	(c) Bank Guarantee or Financial Institution Guarantee	
	(d) Corporate / Personal / Other Guarantee	
	Provide the date, validity and value of the above Guarantees.	

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19.	Compliance with the terms and conditions of the sanction	
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Terms and Conditions		Compliance
<b>(i)</b>	<b>Primary Security</b>	
	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	
<b>(ii)</b>	<b>Collateral Security</b>	
	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	
<b>(iii)</b>	Guarantees - Existence and execution of valid Guarantees.	
<b>(iv)</b>	Asset coverage to the branch based upon the arrangement (i.e., consortium or multiple-bank basis)	
<b>(v)</b>	<b>Others</b>	
	(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	

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	(d)	Any other area of non-compliance with the terms and conditions of sanction	
20.		Key financial indicators of the borrower for the last two years and projections for the current year	

<b>Indicators</b>	<b>Audited Year ended 31<sup>st</sup>March</b>	<b>Audited Year ended 31<sup>st</sup>March</b>	<b>Projections for Current Year</b>
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 companies, market value of Share?			

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(a) High (b) Low (c) Closing			
Earnings Per Share			
Whether the accounts were audited? If yes, up to what date; and are there any audit Qualifications			

21.	Observations on the operations in the account	
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Particulars	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 drawing were reported to the Controlling Authority and approved		
	Debit Summation (Rs. in crore)	Credit Summation (Rs. in crore)
2. Total summation in the account during the year Less : Interest Balance		

Sr. No.	Items / Particulars	Details
22.	Adverse observations in other audit reports / Inspection Reports / Concurrent Auditor's Report / Stock Audit Report / Special Audit Report or RBI inspection with regard to:	

	(a) Documentation	
	(b) Operations	
	(c) Security/Guarantee	
	(d) Others	
23.	Branch Manager's overview of the account and its operations.	
24.	(a) In case the borrower has been identified/ classified as NPA 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 NPA.	

The above Annex III to Long Form Audit Report (LFAR) for Large / Irregular / Critical Advance Accounts is required to be signed by Branch In-Charge and is not to be signed / attested by SBAs.

11.95 An Illustrative list for Basis of Selection of Advance Accounts in case of Bank Branch Audit is given as Annexure to this Chapter.

### **RBI Guidelines on Income Recognition, Asset Classification, Provisioning and Other Related Matters**

11.96 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 circular no. BP.BC.129/21.04.043-92 dated April 27, 1992, the RBI 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 RBI. The latest Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 April 01, 2022 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances'.

11.97 The salient points of the guidelines as presently in force are discussed in the following paragraphs.

### **Regulatory Guidelines vis-a-vis Audit Approach and Reporting**

**A. Has the branch identified and classified advances into standard/substandard/doubtful/loss assets through the computer system without manual intervention (in line with the norms prescribed by the Reserve Bank of India) (The auditor may refer the relevant H.O. instructions for identification of NPAs and classification of advances).**

***The auditor needs to review and comment as to whether such identification & classification was through the computer system, without manual intervention?***

#### **Relevant Provisions**

11.98 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 is not a non-performing asset and does not carry more than normal banking risk attached to the business.

As per Part B1 "Framework for Resolution of Stressed Assets" of RBI Master Circular No. RBI/2022-23/15 DOR.STR. REC.04/ 21.04.048/ 2022-23 dated April 1, 2022 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, the banks shall recognise incipient stress in loan accounts, immediately on default, by classifying such assets as special mention accounts (SMA) as per the following categories:

SMA Sub-categories	Basis of Classification
SMA-0	1-30 days
SMA-1	31-60 days
SMA-2	61-90 days



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In the case of revolving credit facilities like cash credit, the SMA sub-categories will be as follows:

SMA Sub-categories	Basis of Classification
SMA-1	31-60 days
SMA-2	61-90 days

Lenders shall report credit information, including classification of an account as SMA to Central Repository of Information on Large Credits (CRILC) on all borrowers having aggregate exposure of ₹5 Crores and above with them, which will comprise of four sections i.e. Section 1: Exposure to Large Borrowers (Global Operations), Section 2 - Reporting of Technically/Prudentially Written-off Accounts (Global Operations), Section 3 - Reporting of Balance in Current Account (Global Operations) and Section 4: Reporting of Non cooperative Borrowers (Global Operations).on all borrowers having aggregate exposure of Rs. 5 Crores and above with them on monthly basis. Further the lenders shall submit a weekly report on instances of defaults of all borrowers having aggregate exposure of Rs. 5 Crores and above on close of business on every Friday.

Such classification also serves to be useful for bank officers monitoring as well as audit perspective to check the transactions and methods of keeping these standards at the balance sheet date.

In the above context, borrower accounts shall be flagged as overdue by the lending institutions as part of their day-end processes for the due date, irrespective of the time of running such processes. Similarly, classification of borrower accounts as SMA as well as NPA shall be done as part of day-end process for the relevant date and the SMA or NPA classification date shall be the calendar date for which the day end process is run. In other words, the date of SMA/NPA shall reflect the asset classification status of an account at the day-end of that calendar date.

*Example: If due date of a loan account is March 31, 2022, and the entire dues are not received before the lending institution runs the day-end process for this date, the date of overdue shall be March 31, 2022. If it continues to remain overdue, then this account shall get tagged as SMA-1 upon running day-end process on April 30, 2022, i.e., upon completion of 31 days of being continuously*

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*overdue. Accordingly, the date of SMA-1 classification for that account shall be April 30, 2022.*

*Similarly, if the account continues to remain overdue, it shall get tagged as SMA-2 upon running day-end process on May 30, 2022, and if continues to remain overdue further, it shall get classified as NPA upon running day-end process on June 29, 2022.*

It is further clarified that the instructions on SMA classification of borrower accounts are applicable to all loans, including retail loans, irrespective of the size of exposure of the lending institution.

(b) Sub-standard assets:

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:

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 substandard 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 which has been identified as wholly irrecoverable either by:

- the bank; or
- the internal or external auditors; or
- the RBI inspectors.

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.

### **Classification Norms relating to NPAs**

#### ***Criteria for Classification of Various Types of Credit Facilities***

11.99 Cash credit/overdraft (CC/OD) account is classified as NPA if it is 'out of order'. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, the extant instructions, *inter alia*, stipulate that the account should be treated as 'out of order' if 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. In order to avoid any ambiguity regarding determination of 'out of order' status of CC/OD accounts on a continuous basis, it is clarified that an account shall be treated as 'out of order' if:

- i. the outstanding balance in the CC/OD account remains continuously in excess of the sanctioned limit/drawing power for 90 days, or
- ii. the outstanding balance in the CC/OD account is less than the sanctioned limit/drawing power but there are no credits continuously for 90 days, or the outstanding balance in the CC/OD account is less than the sanctioned limit/drawing power but credits are not enough to cover the interest debited during the previous 90 days period.

Accordingly, treatment of CC/OD accounts as 'out of order' on or after the date of this circular<sup>20</sup> shall be based on the above instructions.

11.100 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. Thus, in case of term loans wherein there is no amount overdue (i.e., the ledger balance is less than ideal drawing power), such accounts will not be marked as NPA as the criteria for marking a term loan account as NPA is not based on the concept of servicing of interest but is based on the overdue concept.
- (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 Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021.
- (e) **Agricultural Advances:** A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains

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<sup>20</sup> RBI Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 DATED April 1, 2022 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances.

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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:** 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 payment due date mentioned in the statement. Banks shall report a credit card account as 'past due' to credit information companies (CICs) or levy penal charges, viz. late payment charges, etc., if any, only when a credit card account remains 'past due' for more than three days. The number of 'days past due' and late payment charges shall, however, be computed from the payment due date mentioned in the credit card statement.

11.101 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.

11.102 The above norms should be made applicable only to farm credit extended to agricultural activities as listed at Annex – 2 to RBI circular no. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-2 April 01, 2022. In respect of agricultural loans, other than those specified in the Annex - 2, identification of NPAs would be done on the same basis as in the case of non-agricultural advances, which, at present, is the 90 days delinquency norm.

### ***Temporary Deficiencies***

11.103 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 (DP) is required to be arrived at based on current stock statement. Proper computation of

drawing power (as per bank's policy) is imperative as the advances are to be checked with reference thereto. The auditor should review the bank's policy for treatment of creditor's balances for computation of DP. The auditor should factor in other considerations in the drawing power calculations, such as (i) comparison of the level of stock and books debts assumed at the time of assessment if the reduction of trade creditors is limited to the extent of excess over the level of trade creditors assumed at the time of assessment; (ii) excess of other Sundry Creditors (i.e., other than trade creditors) over the level assumed at the time of assessment (as suggested in Annexure to IBA Circular No. C&I/Circular/2014-15/689 dated September 29, 2014. Thus, if the bank is having a policy of considering trade creditors to the extent of excess over the level of trade creditors assumed at the time of assessment, the auditor will reciprocally review and verify the level of stock and book debts assumed at the time of assessment. Further, the auditor will refer and review the methodology adopted by the bank in the calculation of MPBF (as regards netting off of trade creditors against stock and book debts) based on the level of stock, book debts and trade creditors. Further, the term 'paid stock' denotes value of stock as reduced by trade creditors at gross level. 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. In case of consortium accounts, the drawing power calculation and allocation is made by the lead bank and is binding on the member banks (Refer Circular No. C&I/Circular/2014-15/689 dated 29 September 2014 issued by the Indian Banks Association).

- (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 underway 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/ *ad hoc* credit limits have not been reviewed/ renewed within 180 days from the due date/ date of *ad hoc* sanction will be treated as NPA. It would be pertinent to note that the counting of 180 days would be required to be done from

the date of original due date for renewal and not from the date of expiry of short reviews / technical reviews. The RBI issued circular no. RBI/2020-21/27 DoS.CO.PPG.BC.1/11.01.005/2020-21 dated August 21, 2020 on “Ad-hoc/Short Review/Renewal of Credit Facilities”, advising banks to follow the instructions related thereto in letter and spirit.

***Regularisation Near About Balance Sheet date***

11.104 The asset classification of borrower accounts where a solitary or a few credits are recorded before the balance sheet date 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 an NPA. In other genuine cases, the banks must furnish satisfactory evidence to the satisfaction of the auditor about the manner of regularisation of the account to eliminate doubts on their performing status.

***Cheque Bounce***

11.105 In case the account is regularised by making payment through cheque, the auditor should review the actual realisation of cheques to assess the NPA classification. In case, the cheque gets bounced, the same should not be considered as credit in the advance account for assessing the NPA classification.

***Asset Classification to be Borrower-wise not Facility-wise***

11.106 All facilities granted to a borrower and investment made in securities issued by the borrower will have to be treated as NPA / Non-Performing Investments (NPI), once any or a part of the facility / investment has become irregular, except in case of preference shares wherein if the same are marked as NPI, the rest of the exposures are not required to be considered as non-performing.

11.107 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 provisions are given in the Master Circular in this regard:

- (i) The bills discounted under LC favouring a borrower may not be classified as a 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. Further, in case of bills discounted under LC, if the payment under the LC is not made on the due date by the LC issuing bank for any reason, unless the amount is immediately made good by the borrower, the auditor needs to review the availability of security in the light of the straight away classification norms specified.

- (ii) Overdue receivables representing positive mark-to-market value of a derivative contract will be treated as NPA, 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 NPA 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 have already crystallised or might crystallize 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 as 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) 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 (ii) 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.
- (iv) 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.
- (v) 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 account' should be reversed and held in a 'Suspense Account-Crystallised Receivables' in the same manner as done in the case of overdue advances.
- (vi) Further, in cases where the derivative contracts provide 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 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', and 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.

- (vii) 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 outlined, subsequent to the crystallised/settlement amount in respect of a particular derivative transaction being treated as NPA.
- (viii) 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.
- (ix) 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.

***Non-Financial Parameters***

11.108 Normally NPA assessment is done based on record of recovery of dues in advances account. However, there are many other non-financial parameters which also should be considered while assessing classification of NPA account such as:

- Inherent weakness of the account.
- Non-achievement of DCCO.
- Failure to comply with key restructuring conditions.
- Erosion in value of security.



***Advances to Primary Agricultural Credit Society (PACS), Farmers Service Society (FSS) ceded to Commercial Banks***

11.109 In respect of agricultural advances as well as advances for other purposes granted by banks to PACS/ FSS under the on-lending system, only that particular credit facility granted to PACS/ FSS 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 to a PACS/ FSS. The other direct loans and advances, if any, granted by the bank to the member borrower of a PACS/ FSS outside the on-lending arrangement will become NPA even if one of the credit facilities granted to the same borrower becomes NPA.

***Erosion in Value of Securities/ Frauds Committed by Borrowers***

11.110 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 consequences are:

- (i) Erosion in the value of securities by more than 50 percent of the value assessed by the bank or accepted by RBI inspection team at the time of last inspection, as the case may be, would be considered as “significant”, requiring the asset to be classified as doubtful straightaway and provided for adequately.
- (ii) In the case of secured loan, if the realisable value of security as assessed by bank/approved valuers/RBI is less than 10 percent of the outstanding in the borrower accounts, the existence of the security should be ignored and the asset should be classified as loss asset and accordingly fully provided for.
- (iii) Provisioning norms in respect of all cases of fraud will be as under:
  - a. The entire amount due to the bank (irrespective of the quantum of security held against such assets), or for which the bank is liable (including in case of deposit accounts), is to be provided for over a period not exceeding four quarters commencing with the quarter in which the fraud has been detected.
  - b. However, where there has been delay, beyond the prescribed period, in reporting the fraud to the RBI, the entire provisioning is required to be made at once. In addition, the RBI may also initiate appropriate supervisory action where there has been a delay by the bank in reporting a fraud, or provisioning there against.

- c. Where the bank chooses to provide for the fraud over two to four quarters and this results in the full provisioning being made in more than one financial year, banks should debit 'other reserves' [i.e., reserves other than the one created in terms of Section 17(2) of the Banking Regulation Act 1949] by the amount remaining un-provided at the end of the financial year by credit to provisions. However, banks should proportionately reverse the debits to 'other reserves' and complete the provisioning by debiting profit and loss account, in the subsequent quarters of the next financial year.

***Government Guaranteed Advances***

11.111 The credit facilities backed by guarantees of Central Government though overdue may be treated as NPA only when the Government repudiates its guarantee by invoking it. This exemption from classification of Central Government guaranteed advances as NPA is not for the purpose of recognition of income and thus, in such instances the income would be required to be recognized on cash basis. 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***

11.112 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.

11.113 Banks participating in the consortium, therefore, need 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, etc.***

11.114 Advances against term deposits, NSCs eligible for surrender, KVP 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 and should be classified as NPA as per the extant IRAC norms. Advances against term deposits, NSCs eligible for surrender, KVPs, gold ornaments, government and other securities and life insurance policies would attract provisioning requirements as applicable

to their asset classification status. However, in respect of jewel loans taken for agricultural purposes, the classification has to be continued in accordance with crop seasons only.

***Agricultural Advances Affected by Natural Calamities***

11.115 Master Direction No. FIDD.CO.FSD.BC No.9/05.10.001/2018-19 dated October 17, 2018 on "Reserve Bank of India (Relief Measures by Banks in Areas affected by Natural Calamities) Directions 2018 – SCBs" deals elaborately with the classification and income recognition issues due to impairment to repaying capacity of agricultural borrowers for specified purpose, 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 Master Circular. In such cases the NPA classification would be governed by such rescheduled terms. The auditors are advised to obtain the latest decisions of State Level Banking Committee (SLBC) and the minutes of the SLBC meeting will be accessible in website.

11.116 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 and conditions and would be treated as NPA if interest and/or instalment of principal remain 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.

11.117 While fixing the repayment schedule in case of rural housing advances granted to agriculturists under Indra Awas Yojana and Golden Jubilee Rural Housing Finance Scheme, banks should ensure that the interest/ instalment payable on such advances are linked to crop cycles.

***Post Shipment Supplier's Credit***

11.118 In respect of post-shipment credit extended by the banks covering export of goods to countries for which the ECGC 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.

11.119 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<sup>21</sup>***

11.120 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 pre-determined 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 takeover by the 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 provision 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***

11.121 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 by payment received to the credit of account of exporter maintained in such country. 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***

11.122 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, except to the extent provided in Para 4.2.9 of

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<sup>21</sup> Takeout financing transactions that involve prior commitments shall be governed by the circular no. DBOD.No.BP.BC.144/21.04.048-2000 dated February 29, 2000 on "Income Recognition, Asset Classification, Provisioning and other related matters and Capital Adequacy Standards – Takeout Finance".

Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-2 dated April 1, 2022 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances'. Likewise, the availability of security and/or guarantee is not relevant for determining whether an account is an NPA or not.

***Project Finance Under Moratorium Period***

11.123 In the case of bank finance for industrial projects or for agricultural plantations etc., where moratorium is available for payment of interest, 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***

11.124 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 first due date 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.

***Partial Credit Enhancement to Corporate Bonds<sup>22</sup>***

11.125 In a waterfall mechanism, credit enhancement (CE) gets drawn only in a contingent situation of cash flow shortfall for servicing a debt / bond etc., and not in the normal course of business. Hence, such an event is indicative of financial distress of the project. Keeping this aspect in view, a drawn tranche of the contingent PCE facility will be required to be repaid within 30 days from the date of its draw (due date). The facility will be treated as NPA if it remains outstanding for 90 days or more from the due date and provided for as per the usual asset classification and provisioning norms. In that event, the bank's other facilities to the borrower will also be classified as NPA as per extant guidelines.

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<sup>22</sup> RBI circular no. RBI/2015-16/183 DBR.BP.BC.No. 40/21.04.142/2015-16 dated September 24, 2015 on Partial Credit Enhancement to Corporate Bonds.

## **NPA Management**

11.126 The circular stresses the importance of effective mechanism and availability of 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.
- Banks' IT and MIS system should be robust and be 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.
- The RBI issued circular no. RBI/2020-21/37 DoS.CO.PPG./SEC.03/11.01.005/2020-21 dated September 14, 2020 on 'Automation of Income Recognition, Asset Classification and Provisioning processes in banks' with reference to earlier circular no. DBS.CO.PPD.No.1950/11.01.005/2011-12 dated August 04, 2011 and had advised the banks to put in place / upgrade their systems to ensure completeness and integrity of automated asset classification, provisioning calculation and income recognition process by June 30, 2021 in compliance with the extant guidelines issued vide the circular.

## ***Audit Procedures and Reporting***

- The auditor should verify and comment whether the identification and classification of advances into standard/ substandard/doubtful/loss assets have been done in compliance with the RBI Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 dated April 1, 2022 on

“Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances” in conjunction with H.O’s instructions for identification of NPAs and classification of advances.

- The auditor should verify as to whether the bank has a system of ongoing identification and classification of advances through CBS without manual intervention and its accuracy in crystallising date of NPA. In case of accounts identified as NPA by the auditor, the auditor needs to review the reasons of non-identification of such accounts through CBS as regards the effectiveness of the existing auto-identification and marking system in the CBS.
- The auditor should verify the deposit account having debit balances due to charging of service charges/interest time to time and pending for recovery since long. Verify whether, the “Prudential Norms on Income Recognition, Asset Classification and Provisioning” have been followed. If there is any deviation to RBI circular and HO instructions the same should be commented and MOC should be given if required.
- The auditor should also review the quality and correctness of master data of loans accounts updated in core banking software. Check parameters viz. instalment amount, tenure of loan, moratorium period, interest rate, interest flags, limits setup, due date of first instalment and instalment amount. In case of errors in master data configuration, various advances related reports, statement of overdue accounts will not be generated correctly software. Such reports, if relied upon, lead to incorrect identification of NPAs. In view of the same, the auditor should take utmost care while verifying the compliance of NPA norms.
- The auditors should review and compare the date of NPA of loans accounts mentioned in current year statements with that of previous year. Normally there should not be change of date of NPA unless it is suggested by previous auditor in MOC or by RBI Inspectors. Any change other than these, should be reviewed closely and reasons for such change should be ascertained.
- If an account is identified as NPA either by the bank or by the auditors, the crystallisation of date of NPA needs to be carefully reviewed / verified, which needs to be the date of NPA after completion of requisite number of days of default (e.g. 90<sup>th</sup> day end process in case of continuously overdrawn CC/OD Accounts). The said date of NPA need not be confined to the current financial year but can be an earlier date too. However, in such circumstances, the auditor should also verify the reasons for such accounts not having been marked as NPA earlier through the system.

### **Guidance Note on Audit of Banks (Revised 2023)**

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- Whenever an incorrect master data related to interest or EMI or tenure of advance, is rectified by the bank, the effects of the same should be given as per the original terms of sanction and not prospectively as the prospective effects of such rectifications in certain cases (wherein the amounts due for repayment had been incorrectly considered on lower side as compared to the terms of sanction) may amount to restructuring of an advance. Further, the auditor needs to review and consider the instances of non-charging of penal interest, bank charges, processing fees on the due dates and its effects of NPA classification.
- In the case of advances upgraded during the year<sup>23</sup>, the auditor needs to review such upgradation in the light of the criteria specified for upgradation of NPA accounts, considering the possibility of incorrect upgradation of account on the basis of partial recoveries made in the account wherein the overdue portion is not extinguished in entirety, recoveries made in the account subsequent to the cut-off date, (i.e., date of financial statements) and non-identification of NPAs on on-going basis resulting in an account being considered as standard though overdue portion of such unidentified NPAs is not recovered in entirety.
- The auditor needs to ensure that each customer of the bank is tagged under one single customer ID / Unique Customer Identification Code (UCIC) in respect of all its accounts, including those in which credit facilities are granted, irrespective of their location, to enable the bank, (subject to the relaxations/exceptions for the time being applicable to any account/facility), to accord the same NPA classification status to the customer/borrower, based on the most adverse classification determined for any of its account/facility. The NPA classification of a group entity as such does not automatically extend to other related / group entities, where the classification will have to be judged independently, i.e., at the entity level and not at a group level, unless there is a diversion of funds.
- The auditor should also comment if the banks' IT and MIS system are robust and able to identify and generate reliable and quality information with regard to their asset quality for effective decision making without any manual intervention. There should be no inconsistencies between information furnished under regulatory/statutory reporting and the banks' own MIS reporting.

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<sup>23</sup> RBI Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 dated April 1, 2022 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances.



## Other NPA Related Aspects

### Income Recognition

#### *On Advances Granted*

11.127 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.

11.128 If any advance including bills purchased and discounted, becomes NPA, the entire interest accrued and credited to the income account in the past periods should be reversed if the same is not realised. Interest for the current year if recognised till the date of identification but not realised should also be reversed. 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 accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit.

In cases of loans where moratorium has been granted for repayment of interest, income may be recognised on accrual basis for accounts which continue to be classified as 'standard'. This shall be evaluated against the definition of 'restructuring' provided in Paragraph 16 of RBI Master Circular RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 dated April 01, 2022 on "Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances".

- iii. If Government guaranteed advances become NPA (subject to what is stated hereunder in respect of Central Govt. guaranteed accounts), the interest on such advances should not be taken to income account unless the interest has been realised.

Credit facilities backed by guarantee of the Central Government, though overdue, may be treated as NPA only when the Government repudiates its guarantee when invoked. Thus, where the guarantee is not invoked/repudiated, the related account cannot be classified as NPA and by implication, the advance is to be treated as "Standard" for the purpose of provisioning. This exemption from classification of such Central

Government guaranteed advances as NPA is not for the purpose of recognition of income; income is to be recognized only based on realisation made.

***Reversal of Income***

11.129 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 or provided for if the same is not realised. This will apply to Government guaranteed accounts also. In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected. Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognised as income in the previous year(s).

***On Leased Assets***

11.130 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***

11.131 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 be recognised as income unless realised from the borrower/taking-over institution (if the arrangement so provides).

***On Partial Recoveries in NPAs (Appropriation of recoveries in NPAs)***

11.132 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, "Revenue Recognition", when certainty attaches to realisation and accordingly amount reversed/de-recognised or not recognised in the past, should be accounted.

11.133 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**

11.134 When an account turns 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.

**Treatment of Interest Suspense Account**

11.135 Amounts held in “interest suspense account should not be reckoned as part of the provisions. Amounts lying in this account should be deducted from the relative advances and thereafter, provisioning as per the norms, should be made on the balance after such deduction.

**Upgradation of Loan Accounts Classified as NPAs<sup>24</sup>**

- 11.136(i) 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 is allowed only if the account reaches “no over dues” status. This should not be misunderstood with “overdues brought within 90 days”. Upgradation of a restructured/ rescheduled/CDR accounts is governed by the restructuring / rescheduling /CDR norms. Further, in case of borrowers wherein the bank has multiple exposures, it would be pertinent to note that the ‘no overdue’ status needs to be achieved w.r.t. all exposures of the bank as on the date of upgradation of the account.
- (ii) The 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 over dues 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,

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<sup>24</sup> RBI Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 dated April 1, 2022 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances.

operations in account, etc., should be reviewed in detail and only if found satisfactory, the account should be upgraded.

- (iii) 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 overdues are adjusted.
- (iv) Upgradation within the NPA category is not permitted i.e. a 'doubtful account' cannot be made sub-standard even if the overdues are reduced to less than 12 months.

### **Provisioning for Loans and Advances**

11.137 RBI Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 April 1, 2022 on Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to advances contains the principles to be followed by the bank in calculating the provisions required for the NPAs in conformity with the prudential norms. The circular also requires the bank to take into consideration aspects such as time lag between an account becoming an NPA, its recognition as such, realisation of security and the erosion over time in the value of security charged to the bank, while calculating the required amount of provision. The specific requirements of the Master Circular in respect of provisioning are as follows:

**(a) Loss Assets**

The entire amount should be written off. If the assets are permitted to remain in the books for any reason, 100 per cent of the outstanding should be provided for.

**(b) Doubtful Assets**

11.138 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. The auditor should verify whether that security is considered based on the latest information available with the bank, and DICGC/ECGC cover is considered.
- (ii) In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 25 to 100 per cent 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 needs to 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.

<b><i>Period for which the advance has been considered as doubtful</i></b>	<b><i>Percentage of provision on secured portion</i></b>
Up to 1 year	25
More than 1 year and up to 3 years	40
More than three years	100

*Valuation of Security:* With a view to bringing down the divergence arising out of difference in assessment of the value of security, in cases of NPAs with balance of Rs. 5 Crores 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**

11.139 A general provision of 15 per cent 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 per cent (i.e., total 25 per cent 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 this benefit of lower provisioning, 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. 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 per cent, *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.

11.140 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,

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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) It is noticed that most of the infrastructure projects, especially road/highway projects are user-charge based, for which the Planning Commission has published Model Concession Agreements (MCAs). These have been adopted by various Ministries and State Governments for their respective Public-Private Partnership (PPP) projects and they provide adequate comfort to the lenders regarding security of their debt. In view of the above features, in case of PPP projects, the debts due to the lenders may be considered as secured to the extent assured by the project authority in terms of the Concession Agreement, subject to the following conditions:
  - i) User charges / toll / tariff payments are kept in an escrow account where senior lenders have priority over withdrawals by the concessionaire;
  - ii) There is sufficient risk mitigation, such as pre-determined increase in user charges or increase in concession period, in case project revenues are lower than anticipated;
  - iii) The lenders have a right of substitution in case of default by the concessionaire;
  - iv) The lenders have a right to trigger termination in case of default in debt service; and
  - v) Upon termination, the Project Authority has an obligation of (i) compulsory buy-out and (ii) repayment of debt due in a pre-determined manner.
  - vi) In all such cases, banks must satisfy themselves about the legal enforceability of the provisions of the tripartite agreement and factor in their past experience with such contracts.
- d) Banks should also disclose the total amount of advances for which intangible securities such as charge over the rights, licenses, authority,

etc., have 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.

11.141 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 Schedule 9, without any quantification of the advances covered by security of debtors. The amounts comprising of the intangibles as per RBI Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 April 1, 2022 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances" will have 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.

**Utilisation of Floating Provisions/Counter Cyclical Provisioning Buffer**

11.142 As per RBI circular no. RBI/2021-22/28 DOR.STR.REC.10/21.04.048/2021-22 dated May 5, 2021 on "Utilisation of Floating Provisions/Counter Cyclical Provisioning Buffer", in order to mitigate the adverse impact of COVID 19 related stress on banks, as a measure to enable capital conservation, banks are allowed to utilise 100 per cent of floating provisions/ countercyclical provisioning buffer held by them as on December 31, 2020 for making specific provisions for non-performing assets with prior approval of their Boards. Such utilisation is permitted with immediate effect and upto March 31, 2022.

**(d) Standard Assets**

11.143 The bank is required 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) Farm credit to agricultural activities, individual housing loans and Small and Micro Enterprises (SMEs) sectors - 0.25 per cent.
- b) Advances to Commercial Real Estate (CRE) sector – 1.00 per cent.
- c) Advances to Commercial Real Estate – Residential Housing Sector (CRE - RH) at 0.75 per cent.

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For this purpose, CRE-RH would consist of loans to builders/developers for residential housing projects (except for captive consumption) under CRE segment. Such projects should not ordinarily include non-residential commercial real estate. However, integrated housing projects comprising of some commercial space (e.g. shopping complex, school, etc.) can also be classified under CRE-RH, provided the commercial area in the residential housing project does not exceed 10 per cent of the total Floor Space Index (FSI) of the project. In case the FSI of the commercial area in the predominantly residential housing complex exceeds the ceiling of 10 per cent, the project loans should be classified as CRE and not CRE-RH.

- d) Housing loans extended at teaser rates– 2.00 per cent - 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.

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.

All other loans and advances not included in (a), (b), (c), (d) and (e) above - 0.40 per cent.

11.144 It is clarified that the medium enterprises will attract 0.40 per cent standard asset provisioning. The RBI issued circular no. RBI/2020-2021/10 FIDD.MSME & NFS.BC.No.3/06.02.31/2020-21 dated July 02, 2020 on "Credit flow to Micro, Small and Medium Enterprises Sector", specifying the criteria for classification of enterprises into micro, small and medium enterprise with reference Government of India's Gazette Notification S.O. 2119 (E) dated June 26, 2020, regarding new criteria for classifying the enterprises as Micro, Small and Medium enterprises w.e.f. July 01, 2020. Further, the RBI has issued clarifications on the new definitions of Micro Enterprises, Small Enterprises, and Medium Enterprises vide circular no. RBI/2020-2021/26 FIDD.MSME & NFS.BC.No.4/06.02.31/2020-21 dated August 21, 2020 on "New Definition of Micro, Small and Medium Enterprises – clarifications". Further extension was made available upto March 31, 2022 vide RBI circular RBI/2021-2022/161



FIDD.MSME & NFS.BC.No.16/06.02.31/2021-22 February 18, 2022 and extension upto June 30, 2022 vide circular RBI/2022-23/52 FIDD.MSME & NFS.BC.No.7/06.02.31/2022-23 dated May 19, 2022.

11.145 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. <sup>25</sup>Banks shall make additional provision of 2 per cent (in addition to country risk provision that is applicable to all overseas exposures) against standard assets representing all exposures to the step-down subsidiaries of Indian companies, to cover the additional risk arising from complexity in the structure, location of different intermediary entities in different jurisdictions exposing the Indian company, and hence the bank, to greater political and regulatory risk. All the step-down subsidiaries, including the intermediate ones, must be wholly owned subsidiaries of the immediate parent company or its entire shares shall be jointly held by the immediate parent company and the Indian parent company and / or its wholly owned subsidiary. The immediate parent company should, wholly or jointly with the Indian parent company and / or its wholly owned subsidiary, have control over the step-down subsidiary.

11.146 A high level of unhedged foreign currency exposures of the entities can increase the probability of default in times of high currency volatility. Hence, banks are required to estimate the risk of unhedged position of their borrowers as per the instructions contained in RBI circular no. RBI/2013-14/448 DBOD.No.BP.BC.85/21.06.200/2013-14 dated January 15, 2014 on "Capital and Provisioning Requirements for Exposures to entities with Unhedged Foreign Currency Exposure" and circular no. RBI/2013-14/620 DBOD.No.BP.BC.116/21.06.200/2013-14 dated June 3, 2014 on "Capital and Provisioning Requirements for Exposures to entities with Unhedged Foreign Currency Exposure-Clarifications" and make incremental provisions on their exposures to such entities:

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<sup>25</sup> RBI circular no. RBI/2015-16/279 DBR.IBD.BC.No.68/23.37.001/2015-16 dated December 31, 2015 on Extension of Credit Facilities to Overseas Step-down Subsidiaries of Indian Corporates.

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<b>Likely Loss / EBID<sup>26</sup> (%)</b>	<b>Incremental Provisioning Requirement on the total credit exposures over and above extant standard asset provisioning</b>
Up to 15 per cent	0
More than 15 per cent and up to 30 per cent	20 bps
More than 30 per cent and up to 50 per cent	40 bps
More than 50 per cent and up to 75 per cent	60 bps
More than 75 per cent	80 bps

***Unhedged Foreign Currency Exposure of Corporates<sup>27</sup>***

11.147 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.

11.148 Banks may also consider stipulating a limit on unhedged position of corporates on the basis of bank's Board approved policy. In this context, attention of the readers is also invited to RBI 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 and clarification DBOD.No.BP.BC.116/ 21.06.200/2013-14 dated June 3, 2014 on "Capital and Provisioning Requirements for Exposures to entities with Unhedged Foreign Currency Exposure-Clarifications" providing the requirements for exposures to entities with unhedged foreign currency exposure.

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<sup>26</sup> For this purpose, EBID, as defined for computation of DSCR = Profit After Tax + Depreciation + Interest on debt + Lease Rentals, if any.

<sup>27</sup> Para 2.2.1.2 of RBI/2015-16/70 DBR.No.Dir.BC.12/13.03.00/2015-16 dated July 1, 2015.

11.149 The auditor while carrying out the audit of the Unhedged Foreign Currency Exposure (UFCE) should ensure that the bank has:

- Obtained the UFCE information from all its branches (including foreign branches) in respect of large borrowers.
- Obtained a certificate in respect of UFCE from entities on a quarterly basis on self-certification basis, which has preferably been internally audited by the entity concerned. However, at least on an annual basis, the UFCE information should be audited and certified by the statutory auditors of the entity for its authenticity.
- Computed the “Capital and Provisioning Requirements for Exposures to entities with UFCE” at least on a quarterly basis, as per the applicable RBI guidelines.

***Provisioning requirements for Derivative Exposures***

11.150 Credit exposures computed as per the current marked to market value of the contract, arising on account of the interest rate and 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***

11.151 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 percent, i.e., a total of 25 percent.

ii) Doubtful assets

iii) Loss assets

Provisioning norms for aforesaid clause (ii) & (iii) are same as applicable to advances.

***Accounting and Provisioning Norms for Equipment Leasing Activity***

11.152 While the accounting and provisioning norms discussed above shall also apply in respect of equipment leasing activities the bank should follow AS 19, "Leases" issued by ICAI in accounting for lease transactions.

***Advances Guaranteed by ECGC***

11.153 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 Para 5.9.3 of Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/ 21.04.048/ 2022-23 dated April 1, 2022 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances).

***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)***

11.154 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 CGTSl guarantee, refer Paragraph 5.9.4 of Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/ 21.04.048/2022-23 April 1, 2022 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances".

***Divergences Reported by RBI***

11.155 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 the banks. Accordingly, the auditor would be well advised to consider these aspects while taking final view on classification /provisioning of such accounts.

***Reserve for Exchange Rate Fluctuations Account (RERFA)***

11.156 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 and 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 corresponding assets.

***Provisioning For Country Risk***

11.157 Banks are required to make provision, 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:

<b>Risk Category</b>	<b>ECGC Classification</b>	<b>Provisioning requirement (percent)</b>
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

11.158 Banks are required to make provision for country risk in respect of a country where its net funded exposure is one percent 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 percent 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 per cent of the requirement) in respect of short-term exposures (i.e., exposures with contractual maturity of less than 180 days).

### **Write-off of NPAs**

11.159 Banks without forgoing the right of recovery, may prudentially write off non-performing advances and claim tax benefits as applicable, by evolving appropriate methodology in consultation with their auditors / tax consultants. Subsequent recoveries in such accounts should be offered for tax 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 percent provision shall be made.

11.160 Members may refer Chapter 25 on “Recovery of Non-Performing Assets by Asset Recovery Branches” of Section B of the Guidance Note on Audit of Banks (2023 Edition) for guidelines on sale/purchase of NPAs.

### **Audited Financial Statements in case of Bank Borrowers**

11.161 The RBI vide circular no. DBOD.No. CAS(COD)BC.146/27-77 dated December 22, 1977 had prescribed that all borrowers having credit limit of Rs.10 lakhs and above from the banking system should get their annual accounts audited by Chartered Accountants. Further the RBI vide circular no. DBOD.No.BP.BC.33/21.04.018/2002-03 dated October 21, 2002 on “Certification of Borrower's Account by Chartered Accountants” 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 the borrower by Chartered Accountants would be mandatory.

### **Guidelines on Restructuring of Advances by Banks**

11.162 Part B2 of RBI Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 dated April 1, 2022 on “Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances” provides the following guidelines on restructuring:

#### **Definition of Restructuring**

11.163 Restructuring is an act in which a lender, for economic or legal reasons relating to the borrower's financial difficulty, grants concessions to the borrower. Restructuring may involve modification of terms of the advances /

securities, which would generally include, among others, alteration of payment period / payable amount / the amount of instalments / rate of interest; roll over of credit facilities; sanction of additional credit facility/ release of additional funds for an account in default to aid curing of default / enhancement of existing credit limits; compromise settlements where time for payment of settlement amount exceeds three months.

11.164 For this purpose, the Board-approved policies of lenders on resolution of stressed assets, required to be in place in terms of these guidelines, shall also have detailed policies on various signs of financial difficulty, providing quantitative as well as qualitative parameters, for determining financial difficulty as expected from a prudent bank. In order to enable lenders to frame respective policies for determination of financial difficulty, a non-exhaustive indicative list of signs of financial difficulty are provided hereunder:

- a) A default, as per the definition provided in the framework, shall be treated as an indicator for financial difficulty, irrespective of reasons for the default.
- b) A borrower not in default, but it is probable that the borrower will default on any of its exposures in the foreseeable future without the concession, for instance, when there has been a pattern of delinquency in payments on its exposures.
- c) A borrower's outstanding securities have been delisted or are in the process of being delisted, or are under threat of being delisted from an exchange due to noncompliance with the listing requirements or for financial reasons.
- d) On the basis of actual performance, estimates and projections that encompass the borrower's current level of operations, the borrower's cash flows are assessed to be insufficient to service all of its loans or debt securities (both interest and principal) in accordance with the contractual terms of the existing agreement for the foreseeable future.
- e) A borrower's credit facilities are in non performing status or would be categorised as nonperforming without the concessions.
- f) A borrower's existing exposures are categorised as exposures that have already evidenced difficulty in the borrower's ability to repay in accordance with the bank's internal credit rating system.

The above list provides examples of possible indicators of financial difficulty, but is not intended to constitute an exhaustive enumeration of financial difficulty indicators with respect to restructuring. Lenders shall have to complement the above with key financial ratios and operational parameters which may include quantitative and qualitative aspects. In particular, financial

difficulty can be identified even in the absence of arrears on an exposure. The robustness of the Board approved policy and the outcomes would be examined as part of the supervisory oversight of the RBI.

**Prudential Norms**

11.165 Asset Classification

In case of restructuring, the accounts classified as 'standard' shall be immediately downgraded as non-performing assets (NPAs), i.e., 'sub-standard' to begin with. The NPAs, upon restructuring, would continue to have the same asset classification as it was prior to restructuring. In both cases, the asset classification shall continue to be governed by the ageing criteria as laid out in Part A of the above said Master Circular.

11.166 Conditions for Upgrade

- A. For MSME accounts where aggregate exposure of the lenders is less than ₹25 Crores:

An account may be considered for upgradation to 'standard' only if it demonstrates satisfactory performance during the specified period. 'Specified Period' means a period of one year from the commencement of the first payment of interest or principal, whichever is later, on the credit facility with longest period of moratorium under the terms of restructuring package. 'Satisfactory Performance' means no payment (interest and/or principal) shall remain overdue for a period of more than 30 days. In case of cash credit / overdraft account, satisfactory performance means that the outstanding in the account shall not be more than the sanctioned limit or drawing power, whichever is lower, for a period of more than 30 days.

- B. For all other accounts not included in sub-paragraph above:

1. Standard accounts classified as NPA and NPA accounts retained in the same category on restructuring by the lenders may be upgraded only when all the outstanding loan / facilities in the account demonstrate 'satisfactory performance' during the period from the date of implementation of RP up to the date by which at least 10 percent of the sum of outstanding principal debt as per the RP and interest capitalisation sanctioned as part of the restructuring, if any, is repaid (monitoring period). "Satisfactory performance" means that the borrower entity is not in default at any point of time during the period concerned. Outstanding principal debt shall include all credit facilities, including debt/debt like instruments (viz., non-convertible debentures, optionally convertible debentures, optionally convertible preference shares, non-convertible preference shares etc.) that exist post implementation of the RP. Only



equity and instruments compulsorily convertible into equity (without any embedded optionality) shall be exempt from determining outstanding principal debt.

Provided that the account cannot be upgraded before one year from the commencement of the first payment of interest or principal (whichever is later) on the credit facility with longest period of moratorium under the terms of RP.

2. Additionally, for accounts where the aggregate exposure of lenders is ₹100 Crores and above at the time of implementation of RP, to qualify for an upgrade, in addition to demonstration of satisfactory performance, the credit facilities of the borrower shall also be rated as investment grade (BBB- or better), at the time of upgrade, by CRAs accredited by the RBI for the purpose of bank loan ratings. While accounts with aggregate exposure of ₹500 Crores and above shall require two ratings, those below ₹500 Crores shall require one rating. If the ratings are obtained from more than the required number of CRAs, all such ratings shall be investment grade for the account to qualify for an upgrade.
3. If the borrower fails to demonstrate satisfactory performance during the monitoring period, asset classification upgrade shall be subject to implementation of a fresh restructuring/ change in ownership under Parts B-1 and B-2 of RBI Master Circular RBI/2022-23/15 DOR.STR.REC.4/21.04.048 /2022-23 dated April 1, 2022 or under IBC. Lenders shall make an additional provision of 15 percent for such accounts at the end of the review period. This additional provision, along with other additional provisions, may be reversed as per the norms laid down at Paragraph 11.5 of the RBI Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/ 2022-23 dated April 1, 2022.
4. Provisions held on restructured assets may be reversed when the accounts are upgraded to standard category.
5. Any default by the borrower in any of the credit facilities with any of the lenders (including any lender where the borrower is not in “specified period”) subsequent to upgrade in asset classification as above but before the end of the specified period, will require a fresh RP to be implemented within the above timelines as any default would entail. However, lenders shall make an additional provision of 15 percent for such accounts at the end of the review period. This additional provision, along with other additional provisions, may be reversed as per the norms laid down at Paragraph 11.5 of RBI Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 dated April 1, 2022.

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“Specified period” means the period from the date of implementation of RP up to the date by which at least 20 percent of the sum of outstanding principal debt as per the RP and interest capitalisation sanctioned as part of the restructuring, if any, is repaid.

### 11.167 Provisioning Norms

1. Accounts restructured under the revised framework shall attract provisioning as per the asset classification category as laid out in Part A of the RBI Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 dated April 1, 2022.
2. In respect of accounts of debtors where a final RP, as approved by the Committee of Creditors, has been submitted by the Resolution Professional for approval of the Adjudicating Authority (in terms of Section 30(6) of the IBC), lenders may keep the provisions held as on the date of such submission of RP frozen for a period of six months from the date of submission of the plan or up to 90 days from the date of approval of the resolution plan by the Adjudicating Authority in terms of Section 31 (1) of the IBC, whichever is earlier.
3. The above facility of freezing the quantum of the provision shall be available only in cases where the provisioning held by the lenders as on the date of submission of the plan for approval of the Adjudicating Authority is more than the expected provisioning required to be held in the normal course upon implementation of the approved resolution plan, taking into account the contours of the resolution plan approved by Committee of Creditors/ Adjudicating Authority, as the case may be, and extant prudential norms. However, lenders shall not reverse the excess provisions held as on the date of submission of the resolution plan for approval of the Adjudicating Authority at this stage. In cases where the provisioning held is lower than the expected required provisioning, lenders shall make additional provisioning to the extent of the shortfall. Subsequent to the lapse of above mentioned period, provisioning shall be as per the norms laid out in Part A of the above said Master Circular. The facility of freezing of provisions shall also lapse immediately if the Adjudicating Authority rejects the resolution plan thus submitted. Asset classification in respect of such borrower shall continue be governed by the extant asset classification norms.
4. MSME accounts restructured under circular no. DBR.No.BP.BC.18/21.04.048/ 2018-19 dated January 1, 2019 and circular nos. DOR.No.BP.BC.34/21.04.048/2019-20 dated February 11, 2020 RBI/2021-22/32 DOR.STR.REC.12/21.04.048/2021-22 dated May 5, 2021 and RBI/2021-22/47 DOR.STR.REC.21/21.04.048/2021-22 dated June 4, 2021 shall attract the provisioning requirements prescribed therein.

11.168 Additional Finance

1. Any additional finance approved under the RP (including any resolution plan approved by the Adjudicating Authority under IBC) may be treated as 'standard asset' during the monitoring period under the approved RP, provided the account demonstrates satisfactory performance during the monitoring period. If the restructured asset fails to perform satisfactorily during the monitoring period or does not qualify for upgradation at the end of the monitoring period, the additional finance shall be placed in the same asset classification category as the restructured debt.
2. Similarly, any interim finance [as defined in Section 5 (15) of the IBC] extended by the lenders to debtors undergoing insolvency proceedings under IBC may be treated as 'standard asset' during the insolvency resolution process period as defined in the IBC. During this period, asset classification and provisioning for the interim finance shall be governed by the norms laid down in Part A of the RBI Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 dated April 1, 2022. Subsequently, upon approval of the resolution plan by the Adjudicating Authority, treatment of such interim finance shall be as per the norms applicable to additional finance, as per the above Paragraph.

11.169 Income recognition norms

1. Interest income in respect of restructured accounts classified as 'standard assets' may be recognized on accrual basis and that in respect of the restructured accounts classified as 'non-performing assets' shall be recognised on cash basis.
2. In the case of additional finance in accounts where the pre-restructuring facilities were classified as NPA, the interest income shall be recognised only on cash basis except when the restructuring is accompanied by a change in ownership.

11.170 Conversion of principal into debt / equity and unpaid interest into 'Funded Interest Term Loan' (FITL), Debt or Equity Instruments:

1. An act of restructuring might create new securities issued by the borrower which would be held by the lenders in lieu of a portion of the pre-restructured exposure. FITL / debt / equity instruments created by conversion of principal / unpaid interest, as the case may be, shall be placed in the same asset classification category in which the restructured advance has been classified.
2. The provisioning applicable to such instruments shall be the higher of:

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- a) The provisioning applicable to the asset classification category in which such instruments are held; or
  - b) The provisioning applicable based on the fair valuation of such instruments as provided in the following paragraphs.
3. Debt/quasi-debt/equity instruments acquired by the lenders as part of a RP shall be valued as under:
- a) Debentures/bonds shall be valued as per the instructions specified at Paragraph 10 of the RBI Master Direction No. RBI/DOR/2021-22/81 DOR. MRG.42/21.04.141/2021-22 dated August 25, 2021 (Updated as on December 8, 2022) on "Classification, Valuation and Operation of Investment Portfolio of Commercial Banks (Directions), 2021".
  - b) Conversion of debt into Zero Coupon Bonds (ZCBs)/low coupon bonds (LCBs) as part of RP shall be subject to the conditions contained at Paragraph 10 of RBI Master Direction No. RBI/DOR/2021-22/81 DOR.MRG.42/21.04.141/2021-22 dated August 25, 2021 (Updated as on December 8, 2022) on "Classification, Valuation and Operation of Investment Portfolio of Commercial Banks (Directions), 2021". Such ZCBs/LCBs shall be valued as per the instructions contained at Paragraph 10 of the above said Master Direction, subject to the following:
    - i. Where the borrower fails to build up the sinking fund as required under the above said Master Direction, ZCBs/LCBs of such borrower shall be collectively valued at Re.1.
    - ii. Instruments without a pre-specified terminal value would be collectively valued at Re.1.
  - c) Equity instruments, where classified as standard, shall be valued at market value, if quoted, or else, should be valued at the lowest value arrived at using the following valuation methodologies:
    - i. Book value (without considering 'revaluation reserves', if any) which is to be ascertained from the company's latest audited balance sheet. The date as on which the latest balance sheet is drawn up should not precede the date of valuation by more than 18 months. In case the latest audited balance sheet is not available the shares are to be collectively valued at Re.1 per company.
    - ii. Discounted cash flow method where the discount factor is the actual interest rate charged to the borrower on the residual debt post restructuring plus a risk premium to be determined as per the Board

approved policy considering the factors affecting the value of the equity. The risk premium will be subject to a floor of 3 per cent and the overall discount factor will be subject to a floor of 14 per cent. Further, cash flows (cash flow available from the current as well as immediately prospective (not more than six months) level of operations) occurring within 85 percent of the useful economic life of the project only shall be reckoned.

- d) Equity instruments, where classified as NPA shall be valued at market value, if quoted, or else, shall be collectively valued at Re.1.
- e) Preference shares shall be valued on discounted cash flow (DCF) basis as per the instructions contained at Paragraph 10 of the RBI Master Direction No. RBI/DOR/2021-22/81 DOR.MRG.42/21.04.141/2021-22 dated August 25, 2021 (Updated as on December 8, 2022) on "Classification, Valuation and Operation of Investment Portfolio of Commercial Banks (Directions), 2021", subject to the following modifications:
  - i. The discount rate shall be subject to a floor of weighted average actual interest rate charged to the borrower on the residual debt after restructuring plus a mark-up of 1.5 percent.
  - ii. Where preference dividends/coupons are in arrears, no credit should be taken for accrued dividends/coupons and the value determined as above on DCF basis should be discounted further by at least 15 percent if arrears are for one year, 25 percent if the arrears are for two years, so on and so forth (i.e., with 10 percent increments).
- 4. The overarching principle should be that valuation of instruments arising out of resolution of stressed assets shall be based on conservative assessment of cash flows and appropriate discount rates to reflect the stressed cash flows of the borrowers. Statutory auditors should also specifically examine as to whether the valuations of such instruments reflect the risk of loss associated with such instruments.
- 5. In case lenders have acquired unquoted instruments on conversion of debt as a part of a RP, and if the RP is not deemed as implemented, such unquoted instruments shall collectively be valued at Re. 1 at that point, and till the RP is treated as implemented.
- 6. 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)".

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7. The unrealised income represented by FITL / debt or equity instrument can only be recognised in the profit and loss account as under:
  - a) FITL/debt instruments: only on sale or redemption, as the case may be;
  - b) Unquoted equity/ quoted equity (where classified as NPA): only on sale;
  - c) Quoted equity (where classified as standard): market value of the equity as on the date of upgradation, not exceeding the amount of unrealised income converted to such equity. Subsequent changes to value of the equity will be dealt as per the extant prudential norms on investment portfolio of banks.

### 11.171 Change in Ownership

1. In case of change in ownership of the borrowing entities, credit facilities of the concerned borrowing entities may be continued/upgraded as 'standard' after the change in ownership is implemented, either under the IBC or under this framework. If the change in ownership is implemented under this framework, then the classification as 'standard' shall be subject to the following conditions:
  - a) Lenders shall conduct necessary due diligence in this regard and clearly establish that the acquirer is not a person disqualified in terms of Section 29A of the IBC. Additionally, the 'new promoter' should not be a person/entity/subsidiary/associate etc. (domestic as well as overseas), from the existing promoter/promoter group. Lenders should clearly establish that the acquirer does not belong to the existing promoter group as defined in the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018.
  - b) The new promoter shall have acquired at least 26 percent of the paid up equity capital as well as voting rights of the borrower entity and shall be the single largest shareholder of the borrower entity.
  - c) The new promoter shall be in 'control' of the borrower entity as per the definition of 'control' in the Companies Act, 2013 / regulations issued by the Securities and Exchange Board of India/any other applicable regulations / Accounting Standards as the case may be.
  - d) The conditions for implementation of RP as laid out in Part B1 of RBI Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/ 21.04.048/ 2022-23 April 1, 2022 are complied with.

2. Upon change in ownership, all the outstanding loans/credit facilities of the borrowing entity need to demonstrate satisfactory performance during the monitoring period. If the account fails to perform satisfactorily at any point of time during the monitoring period, it shall trigger a fresh review period, in terms of Paragraph 9.1 of RBI Master Circular RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 dated April 1, 2022.
3. The quantum of provision held (excluding additional provision) by the bank against the said account as on the date of change in ownership of the borrowing entities can be reversed only after the end of monitoring period subject to satisfactory performance during the same.

#### 11.172 Principles on classification of sale and lease back transactions as restructuring

A sale and leaseback transaction of the assets of a borrower or other transactions of similar nature will be treated as an event of restructuring for the purpose of asset classification and provisioning in the books of lenders with regard to the residual debt of the seller as well as the debt of the buyer if all the following conditions are met:

- a) The seller of the assets is in financial difficulty;
- b) Significant portion, i.e. more than 50 percent, of the revenues of the buyer from the specific asset is dependent upon the cash flows from the seller; and
- c) 25 per cent or more of the loans availed by the buyer for the purchase of the specific asset is funded by the lenders who already have a credit exposure to the seller.

#### 11.173 Prudential Norms relating to Refinancing of Exposures to Borrowers

If borrowings/export advances (denominated in any currency, wherever permitted) for the purpose of repayment/refinancing of loans denominated in same/another currency are obtained:

- a) From lenders who are part of Indian banking system (where permitted); or
- b) With the support (where permitted) from the Indian banking system in the form of Guarantees/Standby Letters of Credit/Letters of Comfort, etc., such events shall be treated as 'restructuring' if the borrower concerned is under financial difficulty.

#### 11.174 Takeout Finance

Takeout financing transactions that involve prior commitments shall be governed by circular no. DBOD.No.BP.BC.144/21.04.048-2000 dated February

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29, 2000 on “Income Recognition, Asset Classification, Provisioning and other related matters and Capital Adequacy Standards – Takeout Finance”.

### 11.175 Regulatory Exemptions

#### A. Exemptions from RBI Regulations

1. Acquisition of non-SLR securities by way of conversion of debt is exempted from the restrictions and the prudential limit on investment in unlisted non-SLR securities prescribed by the RBI.
2. Acquisition of shares due to conversion of debt to equity during a restructuring process will be exempted from regulatory ceilings/restrictions on capital market exposures, investment in para-banking activities and intra-group exposure. However, these will require reporting to RBI (reporting to DoS, CO every month along with the regular DSB Return on Asset Quality) and disclosure by banks in the ‘Notes to Accounts’ in Annual Financial Statements. Nonetheless, banks will have to comply with the provisions of Section 19(2) of the Banking Regulation Act, 1949.

#### B Exemptions from Regulations of Securities and Exchange Board of India (SEBI).

1. SEBI has provided exemptions, under certain conditions, from the requirements of Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018 for restructurings carried out as per the regulations issued by the RBI.
2. With reference to the requirements contained in Regulation 158 (6) (a) of ICDR Regulations, 2018, the issue price of the equity shall be the lower of (a) or (b) below:
  - a) The average of the weekly high and low of the volume weighted average price of the related equity shares quoted on the recognised Stock Exchange during the twenty six weeks preceding the ‘reference date’ or the average of the weekly high and low of the volume weighted average prices of the related equity shares quoted on a recognised stock exchange during the two weeks preceding the ‘reference date’, whichever is lower; and
  - b) Book value: Book value per share to be calculated from the latest audited balance sheet (without considering ‘revaluation reserves’, if any) adjusted for cash flows and financials post the earlier restructuring, if any. The date as on which the latest balance sheet is drawn up should not precede the date of restructuring by more



than 18 months. In case the latest audited balance sheet is not available the shares are to be collectively valued at Re.1 per company.

3. In the case of conversion of debt into equity, the 'reference date' shall be the date on which the bank approves the restructuring scheme. In the case of conversion of convertible securities into equity, the 'reference date' shall be the date on which the bank approves the conversion of the convertible securities into equities.

**11.176 Restructuring of frauds/willful defaulters**

Borrowers who have committed frauds/ malfeasance/ willful default will remain ineligible for restructuring. However, in cases where the existing promoters are replaced by new promoters, and the borrower company is totally delinked from such erstwhile promoters/management, lenders may take a view on restructuring such accounts based on their viability, without prejudice to the continuance of criminal action against the erstwhile promoters/management.

***Willful Defaulters and Non-Cooperative Borrowers***

11.177 In addition to the instructions contained in Para 28 of RBI Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 dated April 1, 2022, the following prudential measures are applicable with a view to ensuring better corporate governance structure in companies and ensuring accountability of independent/professional directors, promoters, auditors, etc.:

- a) The provisioning in respect of existing loans/exposures of banks to companies having director/s (other than nominee directors of Government/financial institutions brought on Board at the time of distress), whose name/s appear more than once in the list of willful defaulters, will be 5 per cent in cases of standard accounts; if such account is classified as NPA, it will attract accelerated provisioning as under:

Asset Classification	Period as NPA	Current provisioning (%)	Revised accelerated provisioning (%)
Sub- standard (secured)	Up to 6 months	15	No change
	6 months to 1 year	15	25
Sub-standard unsecured ab-initio	Up to 6 months	25 (other than infrastructure loans)	25
		20 (infrastructure loans)	

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	6 months to 1 year	25 (other than infrastructure loans) 20 (infrastructure loans)	40
Doubtful I	2nd year	25 (secured portion)	40 (secured portion)
		100 (unsecured portion)	100 (unsecured portion)
Doubtful II	3rd & 4th year	40 (secured portion)	100 for both secured and unsecured portions
		100 (unsecured portion)	
Doubtful III	5th year onwards	100	100

- b) This is a prudential measure since the expected losses on exposures to such borrowers are likely to be higher. It is reiterated that no additional facilities should be granted by any bank/FI to the listed wilful defaulters, in terms of Paragraph 2.5 (a) of Master Circular on Wilful Defaulters dated July 1, 2015.
- c) With a view to discouraging borrowers/defaulters from being unreasonable and non-cooperative with lenders in their bonafide resolution/recovery efforts, banks may classify such borrowers as non-cooperative borrowers, after giving them due notice if satisfactory clarifications are not furnished. Banks will be required to report classification of such borrowers to CRILC. Detailed instructions in this regard have been issued vide circular no. DBR.No.CID.BC.54/20.16.064/2014-15 dated December 22, 2014 on “Non-Cooperative Borrowers”.
- d) Further, if any particular entity is reported as non-cooperative, any fresh exposure to such a borrower will, by implication, entail greater risk necessitating higher provisioning. Banks/FIs will therefore be required to make higher provisioning as applicable to substandard assets in respect of new loans sanctioned to such borrowers as also new loans sanctioned to any other company that has on its Board of Directors any of the whole time directors/promoters of a non-cooperative borrowing company or any firm in which such a non-cooperative borrower is in charge of management of the affairs. However, for the purpose of asset classification and income recognition, the new loans would be treated as standard assets. This is a prudential measure since the expected losses on exposures on exposures to such non-cooperative borrowers are likely to be higher.

## **Relief for MSME Borrowers registered under GST**

11.178 The RBI has issued circulars granting one time relief to eligible MSME borrowers to restructure accounts without downgrading, subject to prescribed conditions. The auditors need to be vigilant as regards the applicability of the said circular and eligibility of the borrower.

11.179 RBI circular no. RBI/2017-18/129 DBR.No.BP.BC.100/ 21.04.048/2017-18 dated February 07, 2018 on “Relief for MSME Borrowers registered under Goods and Services Tax (GST)” applies only to borrowers who are classified as micro, small and medium enterprise under the MSMED Act, 2006. The exposure of banks to such borrowers would be classified as standard assets subject to conditions specified in the circular.

11.180 Further RBI issued circular no. RBI/2017-18/186 DBR.No.BP.BC.108/ 21.04.048/ 2017-18 dated June 06, 2018 for encouraging formalisation of MSME sector. This circular is in continuity with circular no. RBI/2017-18/129 DBR.No.BP.BC.100/21.0 4.048/2017-18 dated February 07, 2018 on Relief for MSME borrowers registered under the Goods and Services Tax (GST). This circular applies only to borrowers who are classified as micro, small and medium enterprise under the MSMED Act, 2006. The exposure of banks to such borrowers would be classified as standard subject to conditions specified therein.

11.181 Further, RBI issued circular no. RBI/2018-19/100 DBR.No.BP.BC.18/ 21.04.048/2018-19) dated January 01, 2019 on “Micro, Small and Medium Enterprises (MSME) sector – Restructuring of Advances”, permitting one-time restructuring of existing loans of MSMEs classified as ‘Standard’ without a downgrade in asset classification subject to certain conditions. The said circular is with reference to the earlier circulars related to MSME borrowers issued on February 07, 2018 and June 06, 2018. The one-time restructuring as stated above is subject to conditions specified in the circular.

11.182 Further, RBI issued circular no. RBI/2019-20/160 DOR.No.BP.BC.34/ 21.04.048/ 2019-20 dated February 11, 2020 in continuation of earlier circular no. RBI/2018 -19/100 DBR.No.BP.BC.18/ 21.04.048/2018-19 dated January 01, 2019 on “Micro, Small and Medium Enterprises (MSME) sector – Restructuring of Advances”, extending the one-time restructuring of MSME advances classified as ‘standard’ without a downgrade in the asset classification with certain amended conditions.

11.183 Further, RBI issued circular no. RBI/2020-21/17 DOR.No.BP.BC./4/ 21.04.048/2020-21 dated August 06, 2020 in continuation of earlier circular no. RBI/2019-20/160 DOR.No.BP.BC.34/21.04.048/2019-20 dated February 11,

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2020 on “Micro, Small and Medium Enterprises (MSME) sector – Restructuring of Advances”, extending the one-time restructuring of MSME advances classified as ‘standard’ without a downgrade in the asset classification and aligning the guidelines with the Resolution Framework for COVID 19 – related stress announced for other advances, with certain amended conditions.

11.184 The RBI vide circular no. RBI/2021-22/32 DOR.STR.REC.12 /21.04.048/2021-22 dated May 5, 2021 on Resolution Framework 2.0 – Resolution of Covid-19 related stress of Micro, Small and Medium Enterprises (MSMEs) provides the following:

1. In view of the uncertainties created by the resurgence of the Covid-19 pandemic in India in the recent weeks, it has been decided to extend the above facility for restructuring existing loans without a downgrade in the asset classification subject to the following conditions:
  - (i) The borrower should be classified as a micro, small or medium enterprise as on March 31, 2021 in terms of the Gazette Notification S.O. 2119 (E) dated June 26, 2020.
  - (ii) The borrowing entity is GST-registered on the date of implementation of the restructuring. However, this condition will not apply to MSMEs that are exempt from GST-registration. This shall be determined on the basis of exemption limit obtaining as on March 31, 2021.
  - (iii) The aggregate exposure, including non-fund based facilities, of all lending institutions to the borrower does not exceed Rs. 25 Crores as on March 31, 2021.
  - (iv) The borrower’s account was a ‘standard asset’ as on March 31, 2021.
  - (v) The borrower’s account was not restructured in terms of the circular no. DOR.No.BP.BC/4/21.04.048/2020-21 dated August 6, 2020; circular no. DOR.No. BP.BC.34/21.04.048/2019-20 dated February 11, 2020; and circular no. DBR.No.BP.BC.18/21.04.048/2018-19 dated January 1, 2019 (collectively referred to as MSME restructuring circulars).
  - (vi) The restructuring of the borrower account is invoked by September 30, 2021. For this purpose, the restructuring shall be treated as invoked when the lending institution and the borrower agree to proceed with the efforts towards finalising a restructuring plan to be implemented in respect of such borrower. The decisions on applications received by the lending institutions from their customers for invoking restructuring under this facility shall be communicated in writing to the applicant by the lending institutions within 30 days of the

- receipt of such applications. The decision to invoke the restructuring under this facility shall be taken by each lending institution having exposure to a borrower independent of invocation decisions taken by other lending institutions, if any, having exposure to the same borrower.
- (vii) The restructuring of the borrower's account is implemented within 90 days from the date of invocation.
  - (viii) If the borrower is not registered in the Udyam Registration portal, such registration shall be required to be completed before the date of implementation of the restructuring plan for the plan to be treated as implemented.
  - (ix) Upon implementation of the restructuring plan, the lending institutions shall keep provision of 10 per cent of the residual debt of the borrower.
  - (x) It is reiterated that lending institutions shall put in place a Board approved policy on restructuring of MSME advances under these instructions at the earliest, and in any case not later than a month from the date of this circular.
  - (xi) All other instructions specified in circular no. DOR.No.BP.BC/4/21.04.048/2020-21 dated August 6, 2020 shall remain applicable.
2. In respect of restructuring plans implemented as per Clause 2 of the above said circular dated May 5, 2021, asset classification of borrowers classified as standard may be retained as such, whereas the accounts which may have slipped into NPA category between April 1, 2021 and the date of implementation may be upgraded as 'standard asset', as on the date of implementation of the restructuring plan.
3. In respect of accounts of borrowers which were restructured in terms of the MSME restructuring circulars, lending institutions are permitted, as a one-time measure, to review the working capital sanctioned limits and / or drawing power based on a reassessment of the working capital cycle, reduction of margins, etc. without the same being treated as restructuring. The decision with regard to above shall be taken by lending institutions by September 30, 2021. The reassessed sanctioned limit / drawing power shall be subject to review by the lending institution at least on a half yearly basis and the renewal / reassessment at least on an annual basis. The annual renewal/reassessment shall be expected to suitably modulate the limits as per the then-prevailing business conditions.

4. The above measures shall be contingent on the lending institutions satisfying themselves that the same is necessitated on account of the economic fallout from Covid-19. Further, accounts which have been provided relief under these instructions shall be subject to subsequent supervisory review with regard to their justifiability on account of the economic fallout from Covid-19.

11.185 The RBI has further clarified that the accounts classified as NPA can be restructured, however, the extant asset classification norms governing restructuring of NPAs continues to apply. As a general rule, barring the above one-time exception, any MSME account, which is restructured must be downgraded to NPA upon restructuring and will slip into progressively lower asset classification and higher provisioning requirements as per extant IRAC norms. Such an account may be considered for upgradation to 'standard' only if it demonstrates satisfactory performance during the specified period.

**Revision in the threshold for Aggregate Exposure w.r.t. MSME**

11.186 As per RBI circular no. RBI/2021-22/47 DOR.STR.REC.21/21.04.048/2021-22 dated June 4, 2021 on Resolution Framework - 2.0: Resolution of Covid-19 related stress of Micro, Small and Medium Enterprises (MSMEs) – Revision in the threshold for aggregate exposure, the threshold of aggregate exposure for MSME account given in Clause 2 of circular no. DOR.STR.REC.12/21.04.048/2021-22 dated May 5, 2021 on “Resolution Framework 2.0 – Resolution of Covid-19 related stress of Micro, Small and Medium Enterprises (MSMEs)” has been extended from Rs. 25 Crores to Rs. 50 Crores as on March 31, 2021.

**Revision in the threshold for Aggregate Exposure w.r.t. Individuals and Small Businesses other than those classified as MSME**

11.187 As per RBI circular no. RBI/2021-22/46 DOR.STR.REC.20/21.04.048/2021-22 dated June 4, 2021 on Resolution Framework - 2.0: Resolution of Covid-19 related stress of Individuals and Small Businesses - Revision in the threshold for aggregate exposure, the threshold of aggregate exposure for Individuals and small businesses account other than those classified as MSME given in clause 5 of circular no. DOR.STR.REC.11/21.04.048/2021-22 dated May 5, 2021, has been extended from Rs. 25 crores to Rs. 50 crores as on March 31, 2021.

**COVID19 Regulatory Package**

**(i) Package dated March 27, 2020**

11.188 The RBI issued COVID19 Regulatory package vide circular no. RBI/2019-20/186 DOR.No.BP.BC.47/21.04.048/2019-20 dated March 27, 2020

granting relief to eligible borrowers subject to the terms and conditions related to eligibility and implementation of the said package.

**(ii) Asset Classification and Provisioning dated April 17, 2020**

11.189 The RBI circular no. RBI/2019-20/220 DOR.No.BP.BC. 63/21.04.048/2019-20 dated April 17, 2020 on “COVID 19 Regulatory Package on Asset Classification and Provisioning”, granted relief to eligible borrower accounts, subject to terms and conditions related to eligibility and implementation of the said package.

11.190 The RBI issued circular no. RBI/2019-20/244 DOR.No.BP.BC.71/21.04.048/2019-20 dated May 23, 2020 on “COVID 19 Regulatory Package thereby further extending the benefit provided earlier circular RBI/2019-20/220 DOR.No.BP.BC. 63/21.04.048/2019-20 dated April 17, 2020 on COVID 19 Regulatory Package - Asset Classification and Provisioning, granting relief w.r.t. Asset Classification and Provisioning” to eligible borrower accounts, subject to terms and conditions related to eligibility and implementation of the said package.

**(iii) Review of Resolution Timelines under the Prudential Framework on Resolution of Stressed Assets**

11.191 The RBI issued circular no. RBI/2019-20/219 DOR.No.BP.BC.62/21.04.048/2019-20 dated April 17, 2020 on “COVID 19 Regulatory Package - Review of Resolution Timelines under the Prudential Framework on Resolution of Stressed Assets” to eligible borrower accounts, subject to terms and conditions related to eligibility and implementation of the said package.

**Resolution Framework for COVID 19 related Stress**

11.192 The RBI vide circular no. RBI/2020-21/16 DOR.No.BP.BC/3/21.04.048/2020-21 dated August 6, 2020 on Resolution Framework for COVID-19-related Stress provided conditions for the Resolution Framework for COVID-19-related Stress to eligible borrower accounts, subject to terms and conditions related to eligibility and implementation of the said Framework.

11.193 The RBI published FAQs on Resolution Framework for Covid-19 related stress on October 13, 2020 (Updated as on August 19, 2022) clarifying certain aspects related thereto.

11.194 The RBI issued circular no. RBI/2021-22/17 DOR.STR.REC.4/21.04.048/ 2021-22 dated April 7, 2021 w.r.t. Asset Classification and Income Recognition following the expiry of Covid-19 regulatory package advising the banks in connection with the Supreme Court’s judgement in the matter of Small Scale Industrial Manufacturers Association vs UOI & Ors. and other connected

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matters on March 23, 2021 as follows:

1. Refund/adjustment of 'interest on interest'
  - i. All lending institutions shall immediately put in place a Board-approved policy to refund/adjust the 'interest on interest' charged to the borrowers during the moratorium period, i.e. March 1, 2020 to August 31, 2020 in conformity with the above judgement. In order to ensure that the above judgement is implemented uniformly in letter and spirit by all lending institutions, methodology for calculation of the amount to be refunded/adjusted for different facilities shall be finalised by the Indian Banks Association (IBA) in consultation with other industry participants/bodies, which shall be adopted by all lending institutions.
  - ii. The above reliefs shall be applicable to all borrowers, including those who had availed of working capital facilities during the moratorium period, irrespective of whether moratorium had been fully or partially availed, or not availed, in terms of the RBI circulars DOR.No.BP.BC.47/21.04.048/2019-20 dated March 27, 2020 and DOR.No.BP.BC.71/21.04.048/2019-20 dated May 23, 2020 on "Covid-19 Regulatory Package".
  - iii. Lending institutions shall disclose the aggregate amount to be refunded/adjusted in respect of their borrowers based on the above reliefs in their financial statements for the year ending March 31, 2021.

### 2. Asset Classification

Asset classification of borrower accounts by all lending institutions following the above judgment shall continue to be governed by the extant instructions as clarified below.

- (a) In respect of accounts which were not granted any moratorium in terms of the Covid19 Regulatory Package, asset classification shall be as per the criteria laid out in the Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated April 01, 2022 or other relevant instructions as applicable to the specific category of lending institutions (IRAC Norms).
- (b) In respect of accounts which were granted moratorium in terms of the Covid19 Regulatory Package, the asset classification for the period from March 1, 2020 to August 31, 2020 shall be governed in terms of the circular DOR.No.BP.BC.63/21.04.048/2019-20 dated April 17, 2020, read with circular DOR.No.BP.BC.71/21.04.048/2019-20 dated May 23, 2020. For the period commencing September 1, 2020, asset



classification for all such accounts shall be as per the applicable IRAC Norms.

11.195 The RBI vide circular no. RBI/2021-22/31 DOR.STR.REC.11/21.04.048/2021-22 dated May 5, 2021 regarding Resolution Framework – 2.0: Resolution of Covid-19 related stress of Individuals and Small Businesses, had provided a window to enable lenders to implement a resolution plan in respect of eligible corporate exposures without change in ownership, and personal loans, while classifying such exposures as Standard, subject to specified conditions.

**11.196 Projects under implementation**

1. 'Date of Commencement of Commercial Operations' (DCCO)

For all projects financed by the FIs/ banks, the DCCO of the project should be clearly spelt out at the time of financial closure of the project and the same should be formally documented. These should also be documented in the appraisal note by the bank during sanction of the loan.

2. Deferment of DCCO

(i) 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 / rescheduling of loans by banks. Accordingly, the following asset classification norms would apply to the project loans before commencement of commercial operations.

(ii) 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. Further, infrastructure sector is a sector included in the Harmonised Master List of Infrastructure sub-sectors issued by the Department of Economic Affairs, Ministry of Finance, Government of India, from time to time.

(iii) Deferment of DCCO and consequential shift in repayment schedule for equal or shorter duration (including the start date and end date of revised repayment schedule) will not be treated as restructuring provided that:

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- a) The revised DCCO falls within the period of two years and one year from the original DCCO stipulated at the time of financial closure for infrastructure projects and non-infrastructure projects (including commercial real estate projects) respectively; and
  - b) All other terms and conditions of the loan remain unchanged.  
As such project loans will be treated as standard assets in all respects, they will attract standard asset provision of 0.40 percent.
- (iv) Banks may restructure project loans, by way of revision of DCCO beyond the time limits quoted at Paragraph 11.196(2)(iii)(a) of this Chapter and retain the 'standard' asset classification, if the fresh DCCO is fixed within the following limits, and the account continues to be serviced as per the restructured terms:
- a) Infrastructure Projects involving court cases  
Up to another two years (beyond the two year period quoted at Paragraph 11.196(2)(iii)(a) of this Chapter, i.e., total extension of four years), in case the reason for extension of DCCO is arbitration proceedings or a court case.
  - b) Infrastructure projects delayed for other reasons beyond the control of promoters  
Up to another one year (beyond the two year period quoted at Paragraph 11.196(2)(iii)(a) of this Chapter, i.e., total extension of three years), in case the reason for extension of DCCO is beyond the control of promoters (other than court cases).
  - c) Project Loans for Non-Infrastructure Sector (Other than Commercial Real Estate Exposures)  
Up to another one year (beyond the one year period quoted at Paragraph 11.196(2)(iii)(a) of this Chapter, i.e., total extension of two years).
  - d) Project Loans for Commercial Real Estate Exposures delayed for reasons beyond the control of promoter(s)  
Up to another one year (beyond the one year period quoted at Paragraph 11.196(2)(iii)(a) of this Chapter, i.e., total extension of two years), provided that the revised repayment schedule is extended only by a period equal to or shorter than the extension in DCCO and all

provisions of the Real Estate (Regulation and Development) Act, 2016 are complied with.

- (v) It is reiterated that a loan for a project may be classified as NPA during any time before commencement of commercial operations as per record of recovery (90 days overdue). It is further re-iterated that the dispensation at Paragraph 11.196(2)(iv) of this Chapter is subject to the condition that the application for restructuring should be received before the expiry of the period mentioned at Paragraph 11.196(2)(iii)(a) of this Chapter and when the account is still standard as per record of recovery. 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 and one year from the original DCCO for infrastructure and non-infrastructure projects (including commercial real estate projects) respectively, considering the high risk involved in such restructured accounts.
  - b) Banks should maintain following provisions on such accounts as long as these are classified as standard assets:

Particulars	Provisioning Requirement
If the revised DCCO is within two years/one year from the original DCCO prescribed at the time of financial closure for infrastructure and non-infrastructure projects (including commercial real estate projects) respectively	0.40 per cent
If the DCCO is extended: i) Beyond two years and upto four years or three years from the original DCCO, as the case may be, for infrastructure projects depending upon the reasons for such delay; ii) Beyond one year and upto two years from the original DCCO, for non-infrastructure projects (including real estate projects)	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

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- (vi) In case of infrastructure projects, where the appointed date (as defined in the concession agreement) is shifted due to the inability of the Concession Authority to comply with the requisite conditions, change in date of commencement of commercial operations (DCCO) need not be treated as 'restructuring', subject to following conditions:
  - a) The project is an infrastructure project under public private partnership model awarded by a public authority;
  - b) The loan disbursement is yet to begin;
  - c) The revised date of commencement of commercial operations is documented by way of a supplementary agreement between the borrower and lender and;
  - d) Project viability has been reassessed and sanction from appropriate authority has been obtained at the time of supplementary agreement.
- 3. Projects under Implementation – Change in Ownership
  - (i) In order to facilitate revival of the projects stalled primarily due to inadequacies of the current promoters, if a change in ownership takes place any time during the periods quoted in Paragraph 11.196(2) of this Chapter or before the original DCCO, banks may permit extension of the DCCO of the project up to two years in addition to the periods quoted at Paragraph 11.196(2) of this Chapter, as the case may be, without any change in asset classification of the account subject to the conditions stipulated in the following paragraphs. Banks may also consequentially shift/extend repayment schedule, if required, by an equal or shorter duration.
  - (ii) In cases where change in ownership and extension of DCCO (as indicated in Paragraph 11.196(3)(i) of this Chapter) takes place before the original DCCO, and if the project fails to commence commercial operations by the extended DCCO, the project will be eligible for further extension of DCCO in terms of guidelines quoted at Paragraph 11.196(2) of this Chapter. Similarly, where change in ownership and extension of DCCO takes place during the period quoted in Paragraph 11.196(2)(iii)(a) of this Chapter, the account may still be restructured by extension of DCCO in terms of guidelines quoted at Paragraph 11.196(2)(iv) of this Chapter, without classifying the account as non-performing asset.
  - (iii) The provisions of Paragraphs 11.196(3)(i) and 11.196(3)(ii) of this Chapter are subject to the following conditions:
    - a) Banks should establish that implementation of the project is stalled/affected primarily due to inadequacies of the current

- promoters/management and with a change in ownership there is a very high probability of commencement of commercial operations by the project within the extended period;
- b) The project in consideration should be taken-over/acquired by a new promoter/promoter group with sufficient expertise in the field of operation. If the acquisition is being carried out by a special purpose vehicle (domestic or overseas), the bank should be able to clearly demonstrate that the acquiring entity is part of a new promoter group with sufficient expertise in the field of operation;
  - c) The new promoters should own at least 51 per cent of the paid up equity capital of stake in the acquired project. If the new promoter is a non-resident, and in sectors where the ceiling on foreign investment is less than 51 per cent, the new promoter should own atleast 26 per cent of the paid up equity capital or up to applicable foreign investment limit, whichever is higher, provided the banks are satisfied that with this equity stake the new non-resident promoter controls the management of the project;
  - d) Viability of the project should be established to the satisfaction of the banks;
  - e) Intra-group business restructuring/mergers/acquisitions and/or takeover/acquisition of the project by other entities/ subsidiaries/ associates etc. (domestic as well as overseas), belonging to the existing promoter/promoter group will not qualify for this facility. The banks should clearly establish that the acquirer does not belong to the existing promoter group;
  - f) Asset classification of the account as on the 'reference date' would continue during the extended period. For this purpose, the 'reference date' would be the date of execution of preliminary binding agreement between the parties to the transaction, provided that the acquisition/takeover of ownership as per the provisions of law/regulations governing such acquisition/takeover is completed within a period of 90 days from the date of execution of preliminary binding agreement. During the intervening period, the usual asset classification norms would continue to apply. If the change in ownership is not completed within 90 days from the preliminary binding agreement, the 'reference date' would be the effective date of acquisition/takeover as per the provisions of law/regulations governing such acquisition/takeover;

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- g) The new owners/promoters are expected to demonstrate their commitment by bringing in substantial portion of additional monies required to complete the project within the extended time period. As such, treatment of financing of cost overruns for the project shall be subject to the guidelines prescribed in Paragraph 11.196(5) of this Chapter. Financing of cost overrun beyond the ceiling prescribed in Paragraph 11.196(5) of this Chapter would be treated as an event of restructuring even if the extension of DCCO is within the limits prescribed above;
  - h) While considering the extension of DCCO (up to an additional period of 2 years) for the benefits envisaged hereinabove, banks shall make sure that the repayment schedule does not extend beyond 85 per cent of the economic life/concession period of the project; and
  - i) This facility would be available to a project only once before achievement of DCCO and will not be available during subsequent change in ownership, if any.
- (iv) Loans covered under this guideline would attract provisioning as per the extant provisioning norms depending upon their asset classification status.

**4. Deemed DCCO**

- (i) A project with multiple independent units may be deemed to have commenced commercial operations from the date when the independent units representing 50 per cent (or higher) of the originally envisaged capacity have commenced commercial production of the final output as originally envisaged, subject to the following conditions:
  - a. The units representing remaining 50 per cent (or lower) of the originally envisaged capacity shall commence commercial operations within a maximum period of one year from the deemed date of commencement of commercial operations;
  - b. Commercial viability of the project is reassessed beyond doubt; and
  - c. Capitalisation of interest obligation in respect of project debt component attributable to the units of the plant which have commenced commercial operations has to cease and the revenue expenditure is booked under revenue account.
- (ii) In such cases, banks may, at their discretion, also effect a consequential shift in repayment schedule of the debt attributable to units which have not commenced commercial operations for equal or shorter duration (including

the start date and end date of revised repayment schedule) i.e., one year, subject to no other changes being carried out.

- (iii) If the remaining units do not commence commercial operations within the stipulated time of one year at Paragraph 11.196(4)(i)(a) of this Chapter, the account shall be treated as non-performing asset and the provisions shall be made accordingly.

5. Financing of Cost Overruns for Projects under Implementation

- (i) Internationally, project finance lenders sanction a 'standby credit facility' to fund cost overruns if needed. Such 'standby credit facilities' are sanctioned at the time of initial financial closure; but disbursed only when there is a cost overrun. At the time of credit assessment of borrowers/project, such cost overruns are also taken into account while determining the project Debt Equity Ratio, Debt Service Coverage Ratio, Fixed Asset Coverage Ratio etc. Such 'standby credit facilities' rank pari passu with base project loans and their repayment schedule is also the same as that of the base project loans.
- (ii) Accordingly, in cases where banks have specifically sanctioned a 'standby facility' at the time of initial financial closure to fund cost overruns, they may fund cost overruns as per the agreed terms and conditions.
- (iii) Where the initial financial closure does not envisage such financing of cost overruns, banks are allowed to fund cost overruns, which may arise on account of extension of DCCO upto two years and one year from the original DCCO stipulated at the time of financial closure for infrastructure projects and non-infrastructure projects (including commercial real estate projects) respectively, without treating the loans as 'restructured asset', subject to the following conditions:
  - a. Banks may fund additional 'Interest During Construction', which may arise on account of delay in completion of a project;
  - b. Other cost overruns (excluding Interest During Construction) up to a maximum of 10 per cent of the original project cost;
  - c. The debt equity ratio as agreed at the time of initial financial closure should remain unchanged subsequent to funding cost overruns or improve in favour of the lenders and the revised Debt Service Coverage Ratio should be acceptable to the lenders;
  - d. Disbursement of funds for cost overruns should start only after the sponsors/promoters bring in their share of funding of the cost overruns; and

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- e. All other terms and conditions of the loan should remain unchanged or enhanced in favour of the lenders.
  - (iv) The ceiling of 10 per cent of the original project cost prescribed in Paragraph 11.196(5)(iii)(b) of this Chapter is applicable to financing of all other cost overruns (excluding interest during construction), including cost overruns on account of fluctuations in the value of Indian Rupee against other currencies, arising out of extension of date of commencement of commercial operations.
6. Other Issues
- (i) All other aspects of restructuring of project loans before commencement of commercial operations would be governed by the provisions of Parts B-1 and B-2 of the Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated April 01, 2022. 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 per cent 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 DCCO.
    - d. On re-rating, (if already rated) the new rating is not below the previous rating by more than one notch.
  - (iii) Multiple revisions of the DCCO and consequential shift in repayment schedule for equal or shorter duration (including the start date and end date of revised repayment schedule) will be treated as a single event of restructuring provided that the revised DCCO is fixed within the respective time limits stipulated at Paragraph 11.196(2)(iv) of this Chapter, and all other terms and conditions of the loan remained unchanged.
  - (iv) Banks, if deemed fit, may extend DCCO beyond the respective time limits stipulated at Paragraph 11.196(2)(iv) of this Chapter; however, in that case, banks will not be able to retain the 'standard' asset classification status of such loan accounts.



- (v) In all the above cases of restructuring where regulatory forbearance has been extended, the Boards of banks should satisfy themselves about the viability of the project and the restructuring plan.
- 7. Asset classification and Income recognition for projects under implementation relating to deferment of DCCO and cost overruns:
  - (i) In cases where DCCO is extended within the periods stipulated in Paragraph 11.196(2) of this Chapter and funding of cost overruns complies with the thresholds/conditions stipulated in Paragraph 11.196(5) of this Chapter, such loans shall be treated as 'standard' in all respects.
  - (ii) In cases where DCCO is extended within the periods stipulated in Paragraph 11.196(2), but funding of cost overruns does not comply with the thresholds/conditions stipulated in Paragraph 11.196(5), such loans shall be treated as 'restructured standard' and attract a provision of 5 per cent from the date of such restructuring till the commencement of commercial operations or 2 years from the date of restructuring, whichever is later. These loans may be upgraded to 'standard' category once the entire project commences commercial operations.
  - (iii) In cases where DCCO is extended beyond the periods stipulated in Paragraph 11.196(2)(iii) but upto periods stipulated in Paragraph 11.196(2)(iv) and funding of cost overruns complies with the thresholds/conditions stipulated in Paragraph 11.196(5), such loans shall be treated as 'restructured standard' and attract a provision of 5 per cent from the date of such restructuring till the commencement of commercial operations or 2 years from the date of restructuring, whichever is later. These loans may be upgraded to 'standard' category once the entire project commences commercial operations.
  - (iv) In cases where DCCO is extended beyond the periods stipulated in paragraph 11.196(2)(iii) but upto periods stipulated in Paragraph 11.196(2)(iv) and funding of cost overruns does not comply with the thresholds/conditions stipulated in Paragraph 11.196(5), such loans will be treated as 'non-performing asset'. These loans may be upgraded to 'standard' category only after the account performs satisfactorily during the 'monitoring period' post DCCO;
  - (v) Any change to the major terms and conditions of the original project loans (i.e. promoters equity contribution, interest rate, etc.) of a borrower with financial difficulties, except what is specifically allowed such as changes in the DCCO, consequential parallel shift in repayment schedule and funding of cost overruns, as permitted within the thresholds, shall be treated as an

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event of 'restructuring' requiring the accounts to be classified as 'non-performing asset' and provided for accordingly. These loans may be upgraded to 'standard' category only after the account performs satisfactorily during the 'monitoring period' post DCCO.

- (vi) Banks may treat need based working capital sanctioned to projects after commencement of commercial operations as 'standard' irrespective of the asset classification category of the project loans, subject to satisfactory performance of such working capital accounts. Banks shall ensure that assessment of working capital loans are strictly need based and banks shall desist from over-financing. If the project loans classified as 'non-performing asset' do not perform satisfactorily during the 'monitoring period' and therefore fail to get upgraded to 'standard' category, then the working capital loans also shall be placed in the same asset classification category as that of project loans on completion of 'monitoring period'.

### ***Risk-Weights***

11.197 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 percent 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 No. RBI/2022-23/12 DOR.CAP.REC.3/21.06.201/2022-23 April 1, 2022 on 'Basel III Capital Regulations' may be referred.

### **Enhancement**

11.198 At the time of renewal of working capital facilities, the borrower may ask for increase in the existing facilities, which is called enhancement. All the other processes are similar to that of renewal of working capital facilities, except the exposure is higher than the earlier sanction.

### ***Restructuring***

11.199 RBI has given guidelines for treatment of restructured accounts in part B-1 and B-2 of Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 April 1, 2022 on "Prudential Norms on Income Recognition, Assets

Classification and Provisioning pertaining to Advances". RBI issued circular no. DBR.No.BP.BC.101/21.04.048/2017-18 dated February 12, 2018 regarding "Resolution of Stressed Assets – Revised Framework", and subsequently issued circular no. DBR.No.BP.BC.45/ 21.04.048/2018-19 dated June 7, 2019 regarding "Prudential Framework for Resolution of Stressed Assets", whereby the extant instructions on resolution of stressed assets such as Framework for Revitalising Distressed Assets, Corporate Debt Restructuring Scheme, Flexible Structuring of Existing Long Term Project Loans, Strategic Debt Restructuring Scheme (SDR), Change in Ownership outside SDR, and Scheme for Sustainable Structuring of Stressed Assets (S4A) stand withdrawn with immediate effect. Accordingly, the Joint Lenders' Forum (JLF) as mandatory institutional mechanism for resolution of stressed accounts also stands discontinued.

11.200 Once the bank receives an application/proposal in respect of an account for restructuring, it implies that the account is intrinsically weak. 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 the restructuring.

#### **Sale of Stressed Assets**

11.201 The RBI has issued Master Direction No. DOR.STR.REC.51/21.04.048/2021-22 dated September 24, 2021 (Updated as on December 05, 2022) on "Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021" superseding all previous guidelines in respect of sale of NPA.

#### **11.202 Important conditions applicable for all loan transfers**

1. The lenders must put in place a comprehensive Board approved policy for transfer and acquisition of loan exposures under these guidelines. These guidelines must, inter alia, lay down the minimum quantitative and qualitative standards relating to due diligence, valuation, requisite IT systems for capture, storage and management of data, risk management, periodic Board level oversight, etc. Further, the policy must ensure independence of functioning and reporting responsibilities of the units and personnel involved in transfer / acquisition of loans from that of personnel involved in originating the loans. All transactions must meet the requirements as detailed in the policy.
2. Loan transfers should result in transfer of economic interest without being accompanied by any change in underlying terms and conditions of the loan contract usually. In all cases, if there are any modifications to terms and conditions of the loan contract during and after transfer (eg. take-out financing), the same shall be evaluated against the definition of

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'restructuring' provided in Paragraph 1 of the Annex to the Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions 2019, dated June 7, 2019.

3. In loan participation transactions, by design, the legal ownership completely remains with the transferor even after economic interest has been transferred to transferee(s). In such cases, the roles and responsibilities of the transferor and transferee(s) shall be clearly delineated contractually.
4. Lenders referred to in Clause 3 of the above said Master Direction, regardless of whether they are transferors or otherwise, should not offer credit enhancements or liquidity facilities in any form in the case of loan transfers.
5. A transferor cannot re-acquire a loan exposure, either fully or partially, that had been transferred by the entity previously, except as a part of a resolution plan under the Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019 or as part of a Resolution Plan approved under the Insolvency and Bankruptcy Code, 2016.
6. A loan transfer should result in immediate separation of the transferor from the risks and rewards associated with loans to the extent that the economic interest has been transferred. In case of any retained economic interest in the exposure by the transferor, the loan transfer agreement should clearly specify the distribution of the principal and interest income from the transferred loan between the transferor and the transferee(s).
7. The transferor shall ensure that subsequent to transfer of the stressed loans, they do not assume any operational, legal or any other type of risks relating to the transferred loans including additional funding or commitments to the borrower / transferee(s) with reference to the loan transferred. Subsequently, fresh exposure may be taken on the borrower after the cooling period laid down in the respective Board approved policy of the transferor, which in any case, shall not be less than 12 months from the date of such transfer.
8. The transferor(s) shall ensure that no transfer of a stressed loan is made at a contingent price whereby in the event of shortfall in the realization of the agreed price, the transferor(s) would have to bear a part of the shortfall.

### **11.203 Transfer of loans to Asset Reconstruction Companies**

1. Subject to the provisions of circular no. DNBR.PD (ARC) CC.No.07/26.03.001/2018-19 dated June 28, 2019 and circular no. DOR.NBFC(ARC) CC. No. 8/26.03.001/2019-20 dated December 6, 2019,

stressed loans which are in default for more than 60 days or classified as NPA are permitted to be transferred to ARCs. This shall include loan exposures classified as fraud as on the date of transfer provided that the responsibilities of the transferor with respect to continuous reporting, monitoring, filing of complaints with law enforcement agencies and proceedings related to such complaints shall also be transferred to the ARC. The transfer of such loan exposures to an ARC, however, does not absolve the transferor from fixing the staff accountability as required under the extant instructions on frauds.

2. In case of specific stressed loans, where it is considered necessary, the transferor(s) shall be free to enter into agreement with the ARC to share, in an agreed proportion, any surplus realised by the ARC from the concerned stressed loan. In such cases, the terms of transfer should provide for a report from the ARC to the transferor(s) on the value realised from the loan. The transferor(s) shall not account for the profit until it has materialised.
3. When the stressed loan is transferred to ARC at a price below the NBV at the time of transfer, lenders shall debit the shortfall to the profit and loss account for the year in which the transfer has taken place. Banks are permitted to use countercyclical or floating provisions for meeting any shortfall on transfer of stressed loan when the transfer is at a price below the NBV.
4. On the other hand, when the stressed loan is transferred to an ARC for a value higher than the NBV at the time of transfer, lenders shall reverse the excess provision on transfer to the profit and loss account in the year the amounts are received and only when the sum of cash received by way of initial consideration and / or redemption or transfer of Security Receipts (SR) / Pass Through Certificates (PTCs)/ other securities issued by ARCs is higher than the NBV of the loan at the time of transfer. Further, such reversal shall be limited to the extent to which cash received exceeds the NBV of the loan at the time of transfer.
5. Investments by lenders in SRs / PTCs / other securities issued by ARCs shall be valued periodically by reckoning the Net Asset Value (NAV) declared by the ARC based on the recovery ratings received for such instruments. Provided that when transferors invest in the SRs/PTCs issued by ARCs in respect of the stressed loans transferred by them to the ARC, the transferors shall carry the investment in their books on an ongoing basis, until its transfer or realization, at lower of the redemption value of SRs arrived based on the NAV as above, and the NBV of the transferred stressed loan at the time of transfer. Provided further that when the investment by a transferor in SRs backed by stressed loans transferred by

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it, is more than 10 per cent of all SRs backed by its transferred loans and issued under that securitisation, the valuation of such SRs by the transferor will be additionally subject to a floor of face value of the SRs reduced by the provisioning rate as applicable to the underlying loans, had the loans continued in the books of the transferor.

Thus, if exposure to a SR is more than 10 per cent of the total of book value of all SRs held by the bank, the provision as required above would be required to be made w.r.t. such SRs. (e.g. If a bank holds 5 SRs with a total book value of Rs. 100 crores with individual book values at Rs. 5, 7, 8, 10, 20 and 50 crores, the above provisioning requirement will apply to SRs with book values more than 10 per cent of Rs. 100 crores, i.e., more than Rs. 10 crores, which are Rs. 20 and 50 crores)

6. SRs/PTCs which are not redeemed as at the end of the resolution period (i.e., five years or eight years as the case may be) shall be treated as loss assets in books of the lenders and fully provided for.
7. The valuation, classification and other norms applicable to investment in non-SLR instruments prescribed by RBI from time to time shall be applicable to lenders' investment in debentures/ bonds/ SRs /PTCs issued by ARC. However, if any of the above instruments issued by ARC is limited to the actual realisation of the financial assets assigned to the instruments in the concerned scheme, the lender shall reckon the NAV obtained from ARC from time to time, for valuation of such investments.

11.204 The Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021 issued vide Master Direction No. RBI/DOR/2021-22/85 DOR.STR.REC.53/ 21.04.177/2021-22 dated September 24, 2021 (Updated as on December 05, 2022) supersedes all guidelines issued earlier for sale of standard assets. The major aspects are outlined in the following paragraphs:

### **A. Assets eligible for securitisation**

Lenders, including overseas branches of Indian banks, shall not undertake the securitisation activities or assume securitisation exposures as mentioned below:

- a. Re-securitisation exposures;
- b. Structures in which short term instruments such as commercial paper, which are periodically rolled over, are issued against long term assets held by a SPE;
- c. Synthetic securitisation; and
- d. Securitisation with the following assets as underlying:

- i. revolving credit facilities as underlying – These involve underlying exposures where the borrower is permitted to vary the drawn amount and repayments within an agreed limit under a line of credit (e.g. credit card receivables and cash credit facilities);
- ii. restructured loans and advances which are in the specified period;
- iii. exposures to other lending institutions;
- iv. refinance exposures of AIFIs;
- v. loans with bullet payments of both principal and interest as underlying; and
- vi. loans with residual maturity less than 365 days.

**B. Minimum Retention Requirement (MRR)**

The MRR is primarily designed to ensure that the originators have a continuing stake in the performance of securitised assets so as to ensure that they carry out proper due diligence of loans to be securitised. The originators should adhere to the MRR as detailed below while securitising loans leading to issuance of securitisation notes other than residential mortgage backed securities:

- a. For underlying loans with original maturity of 24 months or less, the MRR shall be 5 per cent of the book value of the loans being securitised.
- b. For underlying loans with original maturity of more than 24 months as well as loans with bullet repayments, as mentioned in proviso to Clause 6 of above said Master Direction, the MRR shall be 10 per cent of the book value of the loans being securitised.

**C. Accounting Provisions**

1. Originators shall sell assets to SPE only on cash basis and the sale consideration should be received not later than the time of transfer of the asset to the SPE. Further, there should not be a gap of more than 30 days between the transfer of the assets and the issuance of securitisation notes.
2. NBFCs which are required to comply with Indian Accounting Standards (Ind AS) shall continue to be guided by the Standards and the ICAI Advisories with respect to accounting for securitisation exposures and transactions.
3. In case of other lenders, any loss, profit or premium realised at the time of the sale should be accounted accordingly and reflected in the profit and loss account for the accounting period during which the sale is completed.
4. For such lenders specified at Clause 35 of above said Master Direction, the following treatment shall be applicable in the case of unrealised gains

arising out of sale of underlying assets to the SPE such as that associated with expected future margin income (represented by interest-only strips or otherwise):

- a. The unrealised gains should not be recognised in profit and loss account; instead the lenders shall hold the unrealised profit under an accounting head styled as “Unrealised Gain on Loan Transfer Transactions”.
- b. The profit may be recognised in profit and loss account only when such unrealised gains associated with expected future margin income is redeemed in cash. However, if the unrealised gains associated with expected future margin income is credit enhancing (for example, in the form of credit enhancing interest-only strip), the balance in this account may be treated as a provision against potential losses incurred.
- c. In case of amortising credit-enhancing interest-only strip, a lender would periodically receive in cash, only the amount which is left after absorbing losses, if any, supported by the credit-enhancing interest-only strip. On receipt, this amount may be credited to the profit and loss account and the amount equivalent to the amortisation due may be written-off against the “Unrealised Gain on Loan Transfer Transactions” account bringing down the book value of the credit-enhancing interest-only strip in the lender’s books.
- d. In the case of a non-amortising credit-enhancing interest-only strip, as and when the lender receives intimation of charging-off of losses by the SPE against the credit-enhancing interest-only strip, it may write-off equivalent amount against “Unrealised Gain on Loan Transfer Transactions” account and bring down the book value of the credit-enhancing interest-only strip in the lender’s books. The amount received as final redemption value of the credit-enhancing interest-only strip in cash may be taken to the profit and loss account.

## **Recovery Mechanisms**

11.205 This topic has been prepared with the sole intention of helping the auditors who are doing the audit of Asset Reconstruction Management Branches (ARMB) or any other branch which have one or more of the non-performing assets (NPA) of a bank or an Institution, to understand the usual legal recovery options available in a broad manner. This note is not intended to provide a detailed insight to such options but only to provide a quick and an overall perspective in a simple and brief manner. In this context, the term “Bank” also includes financial institutions.



11.206 An account declared as NPA by a bank warrants that the bank takes steps for recovery of the outstanding dues. Such steps can involve rescheduling, re-phasing or restructuring of the outstanding loans. However, with the spurt in the NPA levels across the banking sector, the RBI, has been issuing revised guidelines from time to time which usually make it mandatory for banks to declare an account as NPA irrespective of the fact that the account could have been/ or is restructured.

11.207 This topic provides an insight to the following measures that a bank initiates once an account has been classified as NPA:

1. Recovery using the provisions of the SARFAESI Act, 2002.
2. Recovery using the provisions of the Recovery of Debt due to Banks and Financial Institutions Act, 1993.
3. Recovery using the Lok Adalats.
4. Recovery using the provisions of the Insolvency and Bankruptcy Code (IBC).

### **1. Recovery using the Provisions of the SARFAESI Act, 2002**

11.208 The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI) empowers banks / financial institutions to recover their Non-Performing Assets (NPA) without the intervention of the Court.

11.209 The provisions of this Act are applicable only for NPA loans in the following circumstances:

- Contractual dues are above Rs. One Lakh (Rs. 1.00 lakh).
- The default must have occurred i.e. account should have become NPA as per RBI norms.
- Securities are available in the loan account by way of hypothecation or mortgage or assignment.
- The security charges to the bank must be specific, clear and available to the bank. It must be duly and effectively charged to the bank and therefore, enforceable if the borrower fails to pay in response to notice.
- The securities available are enforceable in nature – agricultural land, aircrafts and vessels are not covered under the Act.
- Amount due is more than 20 per cent of the principal amount and interest thereon.
- There is a single lender for an account or a secured asset or 60 per cent of the lenders in consortium structured consent for action.

11.210 The Act provides three alternative methods for recovery of non-performing assets, namely:

- a. Securitisation
- b. Asset reconstruction
- c. Enforcement of security without the intervention of the Court

**a. Securitisation**

It refers to the process of drawing and converting loans and other financial assets into marketable securities worth selling to the investors. In other words, it involves repackaging of less liquid assets into saleable securities. The securitization company takes over the mortgaged assets of the borrower and is entitled to adopt the following steps:

- Getting hold of financial assets from the bank.
- Creating funds from eligible institutional buyers by dint of issuing security receipts to acquire the financial assets.
- Fund raising in any legal way.
- Financial asset acquisition along with taking over the mortgaged assets (such as building, land etc.).

Asset Reconstruction Companies (ARC) – which can carry out the above activities have been created as a result of this Act.

**b. Asset Reconstruction**

It refers to conversion of non-performing assets into performing assets. There are multiple steps to reconstruct an asset. The point to be noted in this context is that the reconstruction must be done in accordance with the SARFAESI Act and RBI regulations.

**c. Enforcement of Security without the intervention of the Court**

The Act empowers the Bank/ ARC:

- To issue demand notice under Section 13 (2) to the defaulting borrower and guarantor, calling upon them to discharge their dues in full within 60 days from the date of the notice.
- To give notice to any person who has acquired any of the secured assets from the borrower to surrender the same to the bank.
- To ask any debtor of the borrower to pay any sum due or becoming due to the borrower.

11.211 If on receipt of demand notice, the borrower makes any representation

or raises any objection, the Authorised Officer shall consider such representation or objection carefully and if he comes to the conclusion that such representation or objection is not acceptable or tenable, he shall communicate the reasons for non-acceptance within one week of receipt of such representation or objection.

11.212 A borrower / guarantor aggrieved by the action of the bank can file an appeal with DRT and then with DRAT, but not with any civil court. The borrower / guarantor has to deposit 50 per cent of the dues before an appeal is filed with DRAT.

11.213 If the borrower fails to comply with the notice, the bank may take recourse to one or more of the following measures:

- Take possession of the security.
- Sale or lease or assign the right over the security.
- Manage the same or appoint any person to manage the same.

### **Concluding Remarks**

11.214 Recovery action under this route is very popular as it does not entail a Court administered mechanism and therefore is much faster and often cost effective. Action under SARFAESI must adhere to the provisions of the Limitation Act though SARFAESI action itself is not considered to be an action tenable under Limitation Act and hence a separate suit must be filed in the Court to adhere to the provisions of the Limitation Act by the bank.

## **2. Recovery through the Recovery of Debt dues to Banks and Financial Institutions Act, 1993**

11.215 This Act was enacted in 1993 to facilitate speedy recovery of loans due to banks and financial institutions that were until then in the domain of Civil Courts. Debt Recovery Tribunals (DRTs) were created under this Act. The main objective and role of DRT is the recovery of duties from borrowers payable to banks and financial institutions. The Tribunal's power is limited to settle cases regarding the restoration of the unpaid amount from NPAs as declared by the banks under the RBI guidelines. The Tribunal has all the powers vested with the District Court. The Tribunal also has a Recovery officer who guides in executing the recovery Certificates as passed by the Presiding Officers.

### **Applicability of the Act**

11.216 The Act applies to the following cases:

- Where the amount of debt due is not less than Rs. 20,00,000/-.
- When the original application for recovery of debts is filed only by banks and Financial Institutions.

### **Composition of DRT**

11.217 DRT is controlled over by a Presiding Officer, who is qualified to be a District Judge and is appointed by notification by Central Government. The Central Government may also authorise another presiding officer of a DRT other than for discharging the function of a presiding officer of a DRT.

### **Documents Required**

11.218 Every application should be furnished by a paper book (called Original application or OA in short), by the affected bank containing details such as:

- A statement showing details of the debt due from a borrower and the circumstances under which such debt has become due.
- Any documents relied upon by the bank and those mentioned in the application by the bank.
- Details including crossed bank draft or Indian Postal Order representing the application fee.
- Index of the documents produced.

### **11.219 DRT Application contents**

- Particulars of debt.
- Particulars of security interest.
- Estimated value of security.
- If estimated value is less than the amount due then details of other assets owned by debtor.
- Application to DRT seeking an order to disclose the other properties owned by debtor.
- The application must be accompanied by true copies all documents relied upon to substantiate the claim.
- Documents include statement of account or entry duly certified.

### **Procedure for Filing the Case in DRT**

11.220 The following procedures are to be followed at the time of filing the case in the Debt Recovery Tribunal.

- The recovery application, in the prescribed format, should be submitted with the DRT within the specified time (as applicable under the Limitation Act).
- Recovery application should contain the description of all relevant documents and securities charged to the bank.

- Interim reliefs such as the injunction against properties, attachment before judgement, the appointment of Receiver, issue of recovery certificate for admitted dues should be appealed as a rule.
- Account extracts to be provided and certified as per the provisions of Bankers Books Evidence Act and be annexed to the Recovery Application.

#### **Procedure after Filing the Case in DRT**

11.221 The following procedures are to be followed after filing the case in Debt Recovery Tribunal.

- If the recovery application filed is found to be satisfactory in all respects, the DRT will issue a serial number and summons to borrowers or guarantors called defendants.
- Serving of warrant for quick disposal of the case and the branch/Advocate should see that summons are served within one month.
- If the summons is served on the defendants, proceedings commence with evidence by way of affidavits filed by the bank followed by cross-examination of bank's witnesses and vice versa followed by arguments ending up in Recovery Certificates in respect of the bank.
- Evidence by way of affidavits as preceding, clarifications or reports excepted by the DRT should be filed.

#### **Execution of Recovery Certificate**

11.222 The Presiding Officer finally grants recovery certificate and sends it to Recovery Officer (R.O.) for execution. On receipt of the recovery certificate, the RO can issue the notice to certificate debtors, giving 15 days for payment of the amount stated in the recovery certificate.

11.223 If the defendant neglects to pay the amount, the RO will proceed to recover the amount by any one or more of the methods, which are listed below:

- Attachment and sale of movable or immovable property of the defendant.
- Arrest and detention of the defaulter.
- Appointment of receiver.

After full recovery of bank dues, the application is closed by the RO.

#### **Appeal against Recovery Officer**

11.224 An appeal against an order of RO to DRT can be filed within 30 days from the date of order. The Tribunal has to resolve the claim within six months. An appeal against the judgment of DRT can be made within 45 days to DRAT (Debt Recovery Appellate Tribunal).

### **Concluding Remarks**

11.225 Banks resort to DRT as it is considered to be a legally tenable action and therefore satisfies the condition of the Limitation Act. It is common for banks to simultaneously initiate action under SARFAESI and this Act. Having said that, SARFAESI led resolution is usually faster than DRT led action. However, as mentioned earlier, SARFAESI action applies for eligible securities clearly charged to the bank. In cases, where recovery from secured assets is not enough to cover the dues of the bank, the bank needs to get additional assets charged to recover its balance amount. Such attachment happens through the DRT platform.

### **3. Recovery using the Lok Adalats**

11.226 Lok Adalat is a process of administering justice in a cost free and speedy manner without resorting to Courts' intervention. It is established under the Legal Services Authority Act, 1987. Under this Act, States have constituted Legal Services Authorities at High Court, District and at Taluka level. Under such Authorities, Courts are organising Lok Adalats in their respective areas.

11.227 Lok Adalat settles the dispute through assuagement and compromise. Lok Adalat acknowledges the cases pending in the civil courts within their purview which could be settled by conciliation.

11.228 There are several advantages in utilising the forum of Lok Adalats:

- No court fees payable when cases are referred to it.
- It can take cognizance of existing suits and look into fresh disputes as well.
- If no settlement is arrived, parties can continue their legal proceedings in civil courts.
- Every award by Lok Adalat shall be deemed to be a decree passed by Civil Court and is binding on the parties and execution proceeding can be filed accordingly.
- No appeal lies against the decree passed by Lok Adalats as the matter settles through negotiation and mutual consent.

#### **Types of Lok Adalat**

11.229 Various kinds of Lok Adalats are as under:

- *Continuous Lok Adalat*

This type of Lok Adalat is organized for a number of days continuously.

- *Daily Lok Adalat*  
As the name suggests, these are held every day.
- *Mobile Lok Adalat*  
These are the utility vans which are set up in different areas to resolve petty issues.
- *Mega Lok Adalat*  
This is held on a single day at State level, in all the courts of the State.
- *National level Lok Adalats*  
These are held at regular intervals throughout the country. The pending cases are disposed of in huge numbers.
- *Permanent Lok Adalats*  
The other type of Lok Adalat is the Permanent Lok Adalat, organized under Section 22-B of the Legal Services Authorities Act, 1987. Permanent Lok Adalats have been set up as permanent bodies with a Chairman and two members for providing compulsory pre-litigation mechanism.

### **Applicability**

11.230 If any of the party involved in a dispute, prior to approaching the court, files a grievance to the legal service authority of the State, the case is taken by the Lok Adalats. This is the pre-litigation stage.

11.231 Cases already pending before any court can also be referred to the Lok Adalats if both the parties consent to it.

### **Process Involved**

11.232 Briefly stated, the procedure followed by the Lok Adalats is as under:

- After referring the case, the Lok Adalat tries to communicate with the parties. They might invite the disputing parties for a meeting or communicate with them in writing or orally. In this stage, the factual information is discussed and if any one-party desires to keep the information confidential from another party, it can be done.
- Suggestions are invited from both the parties to settle the case.
- When the Lok Adalat believes that there are elements of settlement of the dispute and that the terms might be acceptable by the parties, it is informed

to the parties for observation and modifications and accordingly, the dispute is resolved.

- If the case is referred by a court then the award granted by Lok Adalat mentions a clause regarding refund of court fee to the parties.
- The members of Lok Adalat ensure that the issue is settled by mutual consent and that there is no element of coercion or force.

#### **Concluding Remarks**

11.233 Lok Adalats are low cost and speedy platform for recovery and banks do use this platform especially for settlement of cases where the amount involved is low and protracted legal battle is uneconomical and not viable in relation to the amount involved.

#### **4. Recovery through the Insolvency and Bankruptcy Code (IBC)**

11.234 The Insolvency and Bankruptcy Code was introduced in 2016 and subsequently amended in 2019. The Code provides a time-bound process for resolving insolvency in companies and among individuals. Insolvency is a situation where individuals or companies are unable to repay their outstanding debt.

##### **Applicability**

11.235 The IBC at present can only be triggered if there is a minimum default of Rs 1 Crore. This process can be triggered by way of filing an application before the National Company Law Tribunal (NCLT). The process can be initiated by two classes of creditors which would include financial creditors and operational creditors. For the application to be admitted, the creditor will have to show that a requisite default is ascertainable.

11.236 Another important aspect that has to be seen in respect of IBC is that at present only companies (both private and public limited) and Limited Liability Partnerships (LLP) can be considered as defaulting corporate debtors. This Code also contains provisions in respect of individual insolvency, but these provisions have not been notified yet. Therefore cases relating to unpaid debts against individuals and partnership firms would fall outside the purview of this Code at present.

11.237 As soon as the matter is admitted by the NCLT, it proceeds with the appointment of an Interim Resolution Professional (IRP) who takes over the



management of the defaulting debtor. The Resolution Professional may then be continued or removed, contingent on the wishes of the Committee of Creditors (COC). The role of the Resolution Professional primarily entails making on efforts to ensure that the defaulting debtor should as far as possible continue to operate as a going concern. All efforts will be made to ensure that maximum realization of debts can take place as a consequence of the Corporate Insolvency Resolution Process (CIRP) process.

### **Corporate Insolvency Resolution Process (CIRP)**

11.238 The CIRP may include necessary steps to revive the company such as raising fresh funds for operation and looking for new buyer to sell the company as going concern. The outstanding debts may be satisfied by way of another person submitting a Resolution plan to take over the company and pay off the remaining debts. In the event a resolution plan is not submitted or not approved by the COC, the CIRP process is deemed to have failed. In such a situation the liquidation proceedings would then commence subject to the order of the tribunal.

### **Timeline**

11.239 The Code states that the insolvency resolution process must be completed within 180 days, extendable by a period of up to 90 days. In the light of the recent amendment to the Code, for conducting the entire process a time period of 330 days has been specified.

### **Facilitating Institutions**

11.240 The Code creates various institutions to facilitate resolution of insolvency. These are as follows:

- *Insolvency Professionals:* A specialised cadre of licensed professionals have been created. These professionals will administer the resolution process, manage the assets of the debtor, and provide information for creditors to assist them in decision making.
- *Insolvency Professional Agencies:* The insolvency professionals will be registered with insolvency professional agencies. The agencies conduct examinations to certify the insolvency professionals and enforce a code of conduct for their performance.
- *Information Utilities:* Creditors will report financial information of the debt owed to them by the debtor. Such information will include records of debt, liabilities and defaults.

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- *Adjudicating authorities:* The resolution proceedings will be adjudicated by the National Company Law Tribunal (NCLT), for companies; and the Debt Recovery Tribunal (DRT), for individuals. The duties of the authorities will include approval to initiate the resolution process, appoint the insolvency professional, and approve the final decision of creditors.
- *Insolvency and Bankruptcy Board:* The Board will regulate insolvency professionals, insolvency professional agencies and information utilities set up under the Code. The Board will consist of representatives of the RBI, and the Ministries of Finance, Corporate Affairs and Law.

### **Procedure to Resolve Insolvency**

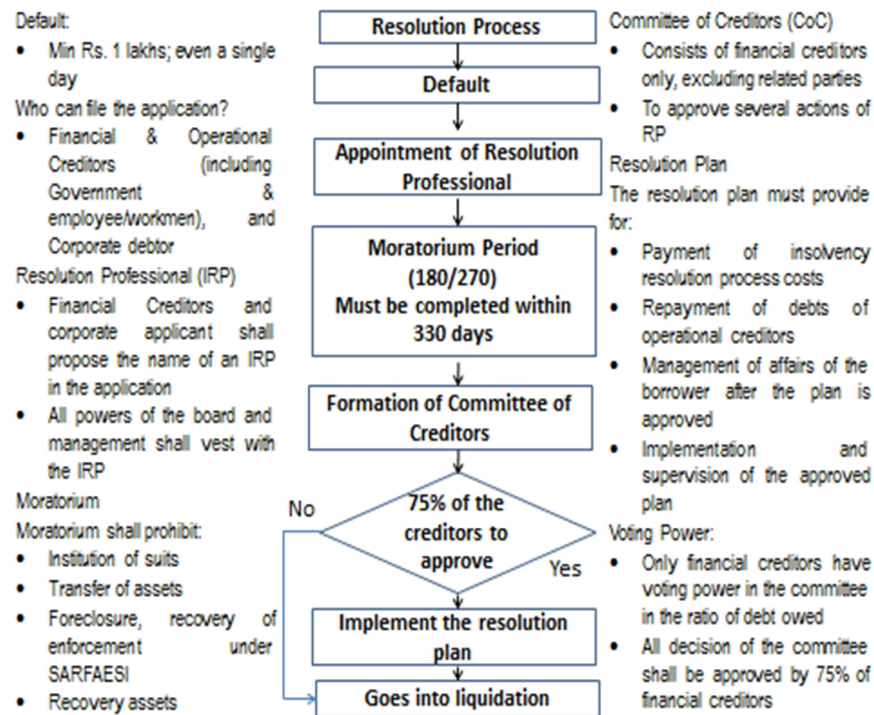
11.241 The Code contains the following steps to resolve insolvency:

- *Initiation:* When a default occurs, the resolution process may be initiated by the debtor or creditor. The insolvency professional administers the process. The insolvency professional provides financial information of the debtor from the information utilities to the creditor and manage the debtor's assets.
- *Decision to resolve insolvency:* A committee consisting of the financial creditors who lent money to the debtor will be formed by the insolvency professional. The creditors committee will take a decision regarding the future of the outstanding debt owed to them. They may choose to revive the debt owed to them by changing the repayment schedule, or sell (liquidate) the assets of the debtor to repay the debts owed to them.
- *Liquidation:* If the debtor goes into liquidation, an insolvency professional administers the liquidation process. Proceeds from the sale of the debtor's assets are distributed in the following order of precedence: (i) insolvency resolution costs, including the remuneration to the insolvency professional, (ii) secured creditors, whose loans are backed by collateral, dues to workers, other employees, (iii) unsecured creditors, (iv) dues to Government, (v) priority shareholders and (vi) equity shareholders.

### **Corporate Insolvency Process**

11.242 The following flowchart describes the insolvency process:

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### Concluding Remarks

11.243 The IBC platform is relatively new but certain provisions of the Code have been challenged on various grounds and courts have clarified these issues and as a result the Code has been made more robust. In the days to come, resolution through IBC mechanism is bound to pick up even more widely especially for the bigger ticket exposures of banks.

### Role of Statutory Auditor

11.244 The role of the statutory auditor is as under:

- The auditor should review the updated policies of the bank framed for handling recoveries through this mechanism.
- The rationale for transfer of cases to either of the aforesaid legal mediums should be documented.
- Listing of cases pending in each of the forums and the updated status should be obtained. Automated MIS trackers to be in place to ensure adherence to timelines is scrupulously maintained.
- Review of these processes by an internal audit team should be done.

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Issues raised by audit, if any should be followed up for understanding the gaps and initiating remedial action.

- Empanelment process for enrolment of Advocates or other professionals should be examined.
- A key factor is to adhere to timelines stipulated in the policy. Delays, if any, in adhering to the timelines needs to be reviewed and set right.

During the pandemic, courts have not been functioning and cancellations / extensions of court hearing procedures have happened delaying the judicial process. Auditors should review the operational procedures to ensure that necessary tracking and follow-up mechanism is in place and operating effectively.

**Annexure**

**Illustrative list for Basis of Selection of  
Advance Accounts in case of  
Bank Branch Audit**

*The list given for Bank Branch Auditors is only illustrative in nature. Members are expected to exercise their professional judgment while using this list depending upon facts and circumstances of each case.*

<b>Basis of selection of Advances accounts to be examined by Branch Auditor</b>	<b>No. of Accounts</b>
1. All Large accounts (excess of 10 per cent of outstanding aggregate balance of fund based and non-fund based advances of the branch or Rs.10 crores, whichever is less).	
2. Accounts wherein process under IBC is mandated but not initiated by branch.	
3. Borrowers wherein process of IBC initiated by any of the creditors including bank.	
4. NPA accounts upgraded to 'Standard' during the year.	
5. Advances where restructuring proposals/ requests are pending approval/disposal at year end.	
6. Accounts restructured in the earlier years to determine their year-end status, if in default or not classified as per RBI norms.	
7. Accounts restructured during the year to determine their year-end classification.	
8. Restructured advances with moratorium of Interest where interest is accrued contrary to RBI applicable norms.	
9. FITL cases arising out of restructuring where corresponding provisions are held in "Sundry Liabilities Account (Interest Capitalization)".	
10. Advances accounts where there is an initiation of proceedings involving investigation, vigilance, enquiry and those where fraud is reported.	

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11. Staff advances – where the persons have ceased to be employees of the bank; and accounts in default.	
12. SSI/SME cases under rehabilitation as at the year end.	
13. Standard advances in litigation.	
14. Central Government guaranteed cases which are classified as Standard which otherwise would have required to be marked as non-performing.	
15. 'Standard' accounts where there is Interest Suspense/ Unapplied Interest.	
16. Advances in the list of wilful defaulters of the RBI.	
17. Cases where one time settlement (OTS) has been sought; and those in which OTS was accepted but there is default in compliance.	
18. Advances subject to re-financing.	
19. Accounts which are not renewed regularly or adhoc not regularised for more than 180 days.	
20. Accounts which are classified as NPAs and also upgraded during the year.	
21. Accounts which are reported to CRILC during the year.	
22. Fresh NPAs identified by the Branch.	
23. NPA cases where the assessed realizable value of the securities has a significant shortfall – 50 percent or more.	
24. NPA cases where the realizable value of the security as assessed by the bank/approved valuers /RBI is less than 10 percent of the outstanding.	
25. Standard Accounts with temporary deficiencies as per Para 4.2.4 of Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 dated April 01, 2022.	
26. Quick Mortality Cases.	
27. Advances comprising frauds detected (Para 4.2.9.2 of the Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/ 21.04.048/2022-23 dated April 01, 2022).	

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28. Other accounts, not covered above, with adverse comments in the existing/latest Reports (as per Para 1 of Annexure I to the initial letter to Branch).	
29. Related party accounts of customers undergoing CIRP process.	
30. Accounts marginally escaped provisions of special review or monitoring etc.	
Comments on accounts as per latest RBI AFI Report.	

## **Fixed Assets and Other Assets**

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### **Fixed Assets**

#### **Introduction**

12.01 This Chapter deals with fixed assets and other assets. Fixed assets include movable and immovable property. Fixed assets comprise premises and other assets such as furniture and fixtures, motor vehicles, office equipment, computers, printers, UPS, generators, intangible assets such as application software and other computer software, etc.

#### **Purchase of Fixed Assets**

12.02 In most banks, fixed assets are generally purchased by the head office or regional or zonal offices. SBA has to ascertain the procedure followed by the bank and plan the audit accordingly. Also, the 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) and also the GST input tax credit wherever applicable and to the extent eligible. 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.

12.03 The auditor should verify whether the original invoices (or copy of original invoices) of the purchase including the purchases during the year are at the branch and required approval are in place as per approval matrix. The auditor should make specific inquiries and review open purchase orders, to ensure completeness of purchases recorded for the year. The auditor should verify whether an asset is already delivered to the branch but in the absence of invoice for same, accounting is not done. In case of sales /disposal of assets during the year, the relevant note and the compliance with process of the disposal including the accounting entries are to be verified by the auditor.

#### **Maintenance of Records**

12.04 In most of the banks maintenance of records is centralised at HO. In recent times, some of the banks have installed Fixed Asset Management Software and the information relating to purchase, sale of fixed assets and depreciation thereon (in some cases) is accounted for with the help of such



software. Such software helps the bank in identification of the assets that are available and put to actual use. SBA has to ascertain the procedures followed and audit accordingly.

### **Physical Verification of Fixed Assets**

12.05 The SBA should physically verify the assets at the branch particularly those acquired during the year and reconcile with the fixed asset management system (manual or electronic). The SBA is to ensure that assets provided to employees working in that branch are properly accounted for.

### **Balance Sheet Disclosure**

#### ***Disclosure of Assets***

12.06 The Third Schedule to the Banking Regulation Act, 1949 requires fixed assets to be classified into two categories in the balance sheet, viz., 'Premises' and 'Other Fixed Assets'. Though not specifically mentioned under the Banking Regulation Act, 1949, the assets taken on lease and intangible assets should be shown separately for proper classification and disclosure and also to comply with the requirements of the Accounting Standards (ASs) issued by the Institute of Chartered Accountants of India (ICAI).

12.07 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 equipment, computers and all other fixed assets except premises should be shown under the head 'Other Fixed Assets'. An immovable property acquired by the bank in satisfaction of debts due should be included under the head 'fixed assets' only, if it is held by the bank for its own use.

#### ***Depreciation on Fixed Assets***

12.08 Rates of depreciation on fixed assets have not 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. Depreciation on computers and software forming an integral part of computer hardware, in and outside India is provided on straight line method at the rate of 33.33 percent p.a., as per the guidelines of RBI. The SBA has to examine and ensure that the HO policy on depreciation is correctly followed. The auditor should be careful regarding the date of recording the fixed asset in the books of accounts and

commencement of depreciation which should be from the date, the asset available for use in line with AS 10 (Revised), "Property, Plant and Equipment".

## **Other Assets**

### **Disclosure of Other Assets**

12.09 The following items broadly are to be disclosed under the head 'Other Assets':

- Inter-office adjustments (net)
- Interest accrued
- Tax paid in advance/tax deducted at source
- Stationery and stamps
- Non-banking assets acquired in satisfaction of claims
- Others

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**

#### ***Audit of Fixed Assets***

12.10 While carrying out the audit of fixed assets, the auditor is concerned, primarily, with obtaining evidence about their ownership, identification, 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.
- Information controls for ensuring availability of reliable information about fixed assets (e.g.: process of tagging, verification and reconciliation of Fixed Assets).

#### ***Accounting of Fixed Assets***

12.11 The SBA 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.

12.12 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 SBA should examine whether acquisitions, disposals, etc. effected at the branch during the year have been properly communicated to the head office. The SBA should also bring this to the notice of SCA.

12.13 In cases where, for any reason acquisition of fixed asset is shown in suspense account then the branch cannot classify the asset in the balance sheet under this head unless the asset is put to use or ready for use, as the case may be, and all internal formalities are completed. A long-standing suspense entry of this type should be properly dealt with by the auditor and required provision as per the policy of the bank should be made by the branch. It may also need to be escalated to the SCAs if the amount involved is material.

**Premises**

12.14 *Verification of accounting for Premises:* The auditor should verify the opening balance of premises with reference to the 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 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 in the ledger and the final statements.

12.15 As per the AS-10 (Revised), "Property, Plant & Equipment", banks can adopt the policy to follow Cost Model or Revaluation Model for Premises or any other class of Property, Plant and Equipment (PPE). The auditor should inquire about the policy followed by the bank and verify the accounting treatment more specifically with reference to revaluation model. The auditor should also check the impairment, if any, by applying the principles laid down in Accounting Standard (AS) 28, "Impairment of Assets".

12.16 *Leasehold Premises:* 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. It would be appropriate to segregate the cost/value of the land from the building/superstructures to ensure that depreciation/amortisation is appropriately considered in case of leasehold premises.

12.17 *Capital Work-in-progress (CWIP)*: In case of property under construction, it should be seen that it is shown under a separate heading, e.g., 'premises under construction'. Advances to contractors may be shown as a separate item 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. The auditor should obtain ageing report of CWIP and inquire about old balances outstanding as CWIP.

12.18 *Holding of Immovable Property*: The auditor should specifically keep in mind the provisions of Section 9 of the Banking Regulation Act, 1949, which prohibits 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.

12.19 The auditor should specifically examine and be satisfied 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 SBA should also obtain a written representation to the above effect from the branch management.

#### **Other Fixed Assets**

12.20 *Other Fixed Assets*: The above procedures regarding premises also apply, to the extent relevant, to verification of other fixed assets. In respect of movable fixed assets, the auditor should pay particular attention to the system of recording the movements as well as other controls over such fixed assets. The policy regarding verification of fixed assets at premises, if any, should be noted.

12.21 For assets used by the branch officials at their residences; the auditor should verify the confirmations received by the branch from the respective staff member. In case of discrepancies, the SBA should ensure that the same has been properly dealt in the books of account and adequate provision in respect of any damaged assets has been made. The auditor should also ensure that transfer in/transfer out of the fixed assets are correctly recorded in the system.

12.22 *Operating Software*: Banks incur substantial expenditure on computer hardware and software. Computer hardware and operating software being an integral part of the hardware, qualifies the definition of plant and equipment as given in AS 10 (Revised), "Property, Plant and Equipment". Expenditure

incurred on acquisition and installation of hardware and operating software should be capitalised in accordance with the principles laid down in AS 10 (Revised) and depreciated over the remaining useful life of the hardware. Since these are susceptible to faster technical obsolescence; useful life of the asset should not be for a period of more than three years.

12.23 *Application Software:* 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". In estimating the useful life of application 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. The software can be acquired from outside or developed in-house. During the stage of development, the same needs to be accounted in accordance with AS 26 and while capitalising the same due consideration be given to Para 44 of the said Standard. The software should be capitalised on the date when the asset was put to use.

12.24 While conducting the audit of intangible assets, the auditor should also consider the guidelines issued by RBI vide Master Direction No. RBI/DOR/2021-22/83 DOR.ACC.REC.No.45/21.04.018/2021-22 dated August 30, 2021 (Updated as on February 20, 2023) on "Financial Statements - Presentation and Disclosures", wherein Part B of Annexure II provides guidance with respect to relevant issues in the application of certain Accounting Standards for Commercial Banks.

#### ***Transfer of Assets between Branches***

12.25 Fixed assets like furniture, office equipment, etc., may be 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 software is in use. The auditor has to examine the reasonableness of the internal controls with respect to recording such inter branch transfer of assets. The SBA may notice more of such transactions during this year due to mergers of banks.

#### ***Classification of Fixed Assets***

12.26 SBA should examine 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 equipment or the theft alarm system of the bank.

***Sale / Disposal / Scrapping of Fixed Assets:***

12.27 Usually, these decisions are taken at HO or Regional or Zonal offices, and the branch will not have authority to make these types of decisions. In case of any sale / disposal / scrapping of assets taken place during the year, the SBA has to examine whether there is adequate control system in place and also should verify the records, receipts and value of the transactions. In case of heavy values see whether proper authorisation is obtained from HO. Accounting for original cost, accumulated depreciation, sale value and profit/loss on sale of the asset should be verified. The SBA should ensure that proper taxes like GST are collected wherever applicable on sale or disposal of assets. Due consideration to be given to AS10 while accounting for the de-recognition of the fixed assets.

***Capitalisation of Subsequent Expenditure***

12.28 The auditor should examine whether any subsequent 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 (Revised), "Property, Plant & Equipment", 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.

***Use of Depreciated Assets***

12.29 At times, though depreciation has been fully provided on certain types of assets, they still continue to be in use. In such cases the auditor should verify whether the bank's policy in this regard has been followed.

***Leased Assets***

12.30 Master Circular No.RBI/2015-16/30 DBR.No.FSD.BC. 19/ 24.01.001/ 2015-16 dated July 01, 2015 on "Para- Banking Activities", consolidates all the instructions/guidelines issued to banks till June 30, 2015 on para-banking activities. The aforesaid circular also provides guidelines on equipment leasing in para no. 8 of the circular dealing with methodology, exposure, accounting, and prudential 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". Assets given on lease need to be shown separately in the same manner as "other assets".

***Impairment of Assets***

12.31 During the year if impairment of assets has taken place with respect to any of the assets at the branch, the SBA has to verify that the procedures as stated in AS 28 is duly followed by the branch. The auditor should also inquire

about assets which are not in use for long periods and whether any impairment provision to be done on same considering recoverable value of those assets.

**Verification of Fixed Assets**

12.32 The opening balances of the existing fixed assets should be verified from records such as the schedule of fixed assets, ledger or register balances.

12.33 Acquisition of new fixed assets and improvements in the existing ones should be verified with reference to supporting documents such as orders, invoices, receiving reports and title deeds.

12.34 Self-constructed fixed assets, improvements and capital work-in-progress should be verified with reference to the supporting documents such as contractors' bills, work-order records and independent confirmation of the work performed.

12.35 The auditor should scrutinize expense accounts like repairs and renewals) to ascertain that new capital assets and improvements have not been included therein.

12.36 Where fixed assets have been written-off or fully depreciated in the year of acquisition/ construction, the auditor should examine whether these were recorded in the fixed assets register before being written-off or depreciated.

12.37 In respect of fixed assets retired, i.e., destroyed, scrapped or sold, the auditor should examine

- (a) whether the retirements have been properly authorized and appropriate procedures for invitation of quotations have been followed wherever applicable;
- (b) whether the assets and depreciation accounts have been properly adjusted;
- (c) whether the sale proceeds, if any, have been fully accounted for; and
- (d) whether the resulting gains or losses, if material, have been properly adjusted and disclosed in the profit and loss account.

12.38 It is possible that certain assets which were destroyed, scrapped or sold during the year have not been recorded. The auditor may use the following procedures to ascertain such omissions:

- Review work orders/physical verification reports to trace any indicated retirements.

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- Examine major additions to ascertain whether they represent additional facilities or replacement of old assets, which may have been retired. Make enquiries of key management and supervisory personnel.
- Obtain a certificate from a senior official and/or departmental managers that all assets scrapped, destroyed or sold have been recorded in the books.

### **Other Assets**

12.39 Other assets include Inter-office adjustments, Interest Accrued, Tax Payments, Stationery and Stamps among other items. SBA may carry out the audit of various items appearing under the head 'Other Assets' in the following manner.

#### ***Inter-Office Adjustments***

12.40 Inter Office Adjustments/Inter Branch Account is dealt with separately in Chapter 20, "Inter Branch/Office Accounts" of Section B of the Guidance Note on Audit of Banks (2023 Edition). In the present CBS environment in most of the banks inter-office adjustments/ inter branch reconciliation are carried out by the system automatically on a real time basis.

#### ***Interest Accrued***

12.41 The main components of this item are interest accrued but not due on investments and advances and, interest due but not collected (i.e., interest accrued and due) on investments. As banks normally debit the borrower's account with interest due on the borrower's repayment cycle date, there would usually be an amount of interest accrued but not due on advances on balance sheet date, if the date of monthly interest debit is other than month-end. 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. Normally interest accrued on Investments is dealt with at the head office. In case of advances, the auditor should verify the accounting appropriateness of interest accrued but not due as on cut-off date.

12.42 The auditor should examine whether interest has accrued on the entire loans and advances portfolio of the bank. Special consideration should be given to the overdue bills purchased/ discounted. If interest accrued on such advances is manually computed by the branch and the auditors should check the workings thoroughly so as to avoid any income leakages and / or incorrect accounting of interest on time proportionate basis. As far as possible, the detailed breakup 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 re-computing 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 if possible, at the branch or else the auditor should obtain specific management representation in this regard.

### ***Stationery and Stamps***

12.43 Internal controls over stationery of security items (like term deposit receipts, drafts, pay orders, cheque books, traveller's cheques, gift cheques, tokens, 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 SBA should study and evaluate the existence, effectiveness and continuity of internal controls over these items in the normal course of his audit. Term deposit receipts which are blank are not considered as security item. However, the same is prone to frauds as a layman could be given a forged certificate using such blank stationery by any person who has access to such stationery.

12.44 *Valuation of Stationery and Stamps:* As per RBI instructions, 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. The valuation of such items is suggested to be at cost without any element of escalation/appreciation. 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.

12.45 *Physical Verification of Stationery and Stamps:* 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.

Auditor to ensure that there are no NON CTS stationery lying in the branch and

if any the same should be either disposed off with the permission of the higher authorities or to be returned at the head office with proper noting.

***Non-Banking Assets Acquired in Satisfaction of Claims***

12.46 This heading includes those immovable properties/tangible assets, which the bank has acquired in satisfaction of debts due or its other claims and is being held with the intention of being disposed of. As stated in Para 12.18 above, the banking company can't hold any immovable property for any period exceeding seven years. The RBI has the power to extend the aforesaid period in a particular case up to another five years. During this period, the bank may deal or trade in any such property for the purpose of facilitating the disposal thereof. The above provisions will not apply for those assets which the bank intends to use for its own purpose.

12.47 *Valuation and Verification:* At the date of acquisition, the assets should be recorded at the amount lower of the net book value of the advance or net realisable value of asset acquired. At each balance sheet date, net realisable value of such assets may be re-assessed and necessary adjustments may be made. The auditor should verify whether the bank has an appropriate system of obtaining insurance cover for NBAs and adherence thereto.

12.48 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 ensure that the ownership of the property is legally vested in the bank's name by verifying the Encumbrance Certificate(EC) of the property. 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".

12.49 If an immovable property is obtained in satisfaction of a claim then a suitable display at the premises of the immovable property is to be made by the bank stating that it is the property of the bank with a view to avoid trespass and illegal occupation of the premises by any other person/s. Also periodic physical verification of the same needs to be made to ensure that the same is unencumbered and free from any unauthorised possession / encroachment.

12.50 Since, most of these activities are centralised at banks, the branch will have limited role of facilitating the process.

**Others**

12.51 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, and prepaid expenses, Tax Deducted at source including that on GST. 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.

12.52 *Non-Interest-Bearing Staff Advances:* 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 rolls of the bank on the date of the preparation of financial statements.

12.53 *Festival and Other Advances:* Banks grant unsecured advances to staff like festival/drought relief/housing advances etc. due to the employer-employee relationship where normally lien is marked on the terminal benefits of the employee; but advances against FDRs and other securities etc. are also given. While a distinction needs to be made between advances given by the bank as an "employer" and as "banker", the RBI's latest applicable circular needs to be kept in view as regards disclosure requirement of advances in the latter category i.e. as banker.

12.54 *Security Deposits:* Security deposits with various authorities (e.g., on account of telephone, electricity, etc.) and with others (e.g., deposits in respect of premises taken on rent) should be examined with reference to documents containing relevant terms and conditions, and receipts obtained from the parties concerned. 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.

12.55 *Suspense Account:* 'Suspense' account is another item included under 'other assets'. Ideally, where accounts are maintained properly and on a timely basis, 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 representing losses on account of frauds awaiting adjustment.

12.56 Process of Creation of Suspense Accounts: The auditor should study the process of creation of suspense accounts, who is authorized to post and reverse entries in these accounts especially, the necessity of posting these entries, and controls over monitoring of ageing and reversal of entries therein. Auditors should also ensure that multiplicity of accounts and unnecessary accounts are not opened as suspense accounts. RBI has also suggested a quick audit of entries in Suspense Account and the status thereof to be reported in terms of RBI circular no. DBOD.BP.BC.4/ 21.04.018/2003-04 dated 19<sup>th</sup> July, 2003 on “Guidelines on netting off of old and small value entries - Clearing Differences” read with RBI circular no. DBOD No. BP.BC. 37 /21.04.018/2003-04dated October 20, 2003 on the same subject.

12.57 Unusual items in Suspense Accounts: 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 verify the process of the bank to ensure expeditious clearance of items debited to suspense account and whether the same is actually cleared. Also, verify the reasons for delay in adjusting the entries, if any. Where the outstanding balances comprised in suspense account require a provision/write-off, the auditor should examine whether necessary provision has been made/written off. All items of more than 90 days in suspense accounts need special attention of the auditor. The auditor has to certify all the suspense account entries through a separate certificate in the annual closing sets. If there are any intangible items, the same should be specifically reviewed for their recoverability. In case any of them is under investigation, the same should be reviewed in detail, status taken and accordingly be reported including if any provision needs to be made in this regard. The auditor should verify if there are any entries related to government business such as collection of taxes, etc. parked in the account and have remained unreconciled.

12.58 The auditor has also to verify whether any office account is used for allowing debits to accommodate temporary overdrafts without appropriate disclosures. This tantamount to a fraudulent practice and the bank has to put in place suitable internal controls to avoid opening and operating of such office account heads. Since, suspense account not monitored properly may lead to frauds, the SBA has to make proper verification and also report the same to the SCA.

12.59 The auditor should review the system at the bank for clearance of items debited to Suspense Account and the time taken for the same. Outstanding entries in excess of 90 days needs to be scrutinized in detail and the reasons for delay in adjusting the entries may be ascertained. Any old balances which are not expected to be recovered should be provided for.

12.60 *Prepaid Expenses:* The auditor should verify prepaid expenses in the same manner as in the case of other entities and 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. Timely apportionment of entries from prepaid accounts as per bank policy should be ensured.

12.61 *Miscellaneous Debit Balances on Government Account:* Miscellaneous debit balances on Government account in respect of pension, public provident funds, compulsory deposit scheme payments, etc., for which the branch obtains reimbursement from the Government through a designated branch, are also included under the head 'Others'. In many cases, the accounting for this is outside the core banking solution and needs the special attention of the auditor. The auditor should review the ageing statements pertaining to these items and 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 age-wise analysis of the same. Outstanding balances without any confirmation or proper justification should be provided for or written off as the case may, be in the accounts.

## **Borrowings and Deposits**

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### **Borrowings**

13.01 Borrowings is usually handled as a centralised activity. In exceptional cases, borrowing happens at few designated branches authorised in this behalf by the head office/ controlling authority either generally or specifically in respect of a particular borrowing. Mostly, borrowings are handled by the Treasury branches and form part of the Balance Sheet of the Treasury branch and hence, does not figure in the balance sheets of most branches of the bank.

13.02 RBI, Export-Import Bank of India (EXIM Bank), National Bank for Agriculture and Rural Development (NABARD) and Small Industries Development Bank of India (SIDBI) are the major agencies providing refinance to banks, generally for loans extended to specified sectors. Borrowings from RBI 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 are 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.

### **Deposits and Type of Deposits**

13.03 Deposits represent the most important source of funds for banks. Deposits are received from a large number of constituents, generally in small amounts.

13.04 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 subject to certain conditions, the deposits may be repaid prematurely at the request of the depositor.

#### ***Demand Deposits***

13.05 Current account and savings account are the most common forms of demand deposits.

#### ***Current Bank Deposits***

13.06 Current accounts can be opened in the names of individuals, association of persons, corporate bodies, trusts, societies, etc., i.e., for all

kinds of customers. The operations in 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 withdrawal or deposit of money or number of transactions by the account holder at any one time.
- Some guidelines are prescribed by the bank for maintaining a minimum balance, which differs from bank to bank. Bank also charges a penalty for non-maintenance of minimum balance, as per its internal policy.
- No interest is generally payable on this deposit except where it may be specifically permitted by the bank / RBI.
- As per RBI Master Directions No. RBI/DBR/2015-16/19 DBR. Dir. No.84/13.03.00/2015-16 dated March 03, 2016 (Updated on September 16, 2022), 'Balances lying in current account standing in the name of a deceased individual depositor or sole proprietorship concern shall attract interest from the date of death of the depositor till the date of repayment to the claimant/s at the rate of interest applicable to savings deposit as on the date of payment.'
- The consolidated Circular on "Opening of Current Accounts and CC/OD Accounts by Banks" issued by RBI vide RBI/2022-23/27 DOR.CRE.REC.23/21.08.008/2022-23 dated April 19, 2022, contains instructions and guidelines on opening of Current / CC / OD Accounts'.

### **Savings Bank Deposits**

13.07 Savings accounts are generally in the names of individuals– either singly or jointly and HUFs, and sometimes, in the names of institutions which are specifically approved by the RBI for maintaining savings bank accounts with banks (Trusts, Educational Institutions, etc). 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.

13.08 The salient features of this type of accounts are:

- Banks place restrictions on the maintenance of minimum balance (separate for accounts with cheque book facility and those without cheque book facility) and the amount of funds that can be withdrawn by the account holder at any point of time. Beyond this cut-off level, banks require the depositors to give notice of a specified period for withdrawal of the amount.

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- 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.
- Rate of interest has been largely de-regulated and is on the discretion of individual banks subject to uniformity for balance upto Rs.1 Lakh and differential rate for balance exceeding Rs. 1 Lakh. Banks pay interest at quarterly or shorter intervals on daily outstanding balances. Depending on the practice adopted by each bank provision for the balance period up to the year-end may be made at branches/Head Office.
- With effect from April 1, 2015, while levying charges for non-maintenance of minimum balance in savings bank accounts, banks shall adhere to the following additional guidelines:
  - (i) In the event of a default in maintenance of minimum balance / average minimum balance as agreed to between the bank and customer, the bank should notify the customer clearly by SMS / email / letter etc. that if the minimum balance is not being restored in the account within a month from the date of notice, penal charges will be applicable.
  - (ii) In case the minimum balance is not restored within a reasonable period, which shall not be less than one month from the date of notice of shortfall, penal charges may be recovered under intimation to the account holder.
  - (iii) The policy on penal charges to be so levied may be decided with the approval of Board of the bank.
  - (iv) The penal charges should be directly proportionate to the extent of shortfall observed. In other words, the charges should be a fixed percentage levied on the amount of difference between the actual balance maintained and the minimum balance as agreed upon at the time of opening of the account. A suitable slab structure for recovery of charges may be finalized.
  - (v) It should be ensured that the balance in the savings account does not turn into negative balance solely on account of levy of charges for non-maintenance of minimum balance.



13.09 As per RBI circular no. RBI/2008-09 /138 DBOD.No.Leg. BC. 34 /09.07.005/2008-09 dated August 22, 2008 on “Unclaimed Deposits / Inoperative Accounts in banks”, '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.' Such accounts identified as 'dormant' or 'inoperative' accounts may be transferred to a separate GL code. Further, transactions and even in some banks the viewing rights in these accounts are allowed only with the authority of the official designated by the bank for this purpose.

### ***Term Deposits***

13.10 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 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.

13.11 Recurring deposit account is 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 banks are offering fixed / flexible recurring deposit accounts in recent times where the customer chooses the amount of deposit each time based on his convenience.

13.12 Deposits maturing on non-business working day

According to “Reserve Bank of India (Interest Rate on Deposits) Directions, 2016” notified vide RBI Master Direction No. RBI/DBR/2015-16/19 DBR. Dir. No.84/13.03.00/2015-16 dated March 03, 2016 (Updated as on September 16, 2022), if a term deposit is maturing for payment on a non-business working day, Scheduled Commercial Banks shall pay interest at the originally contracted rate on the original principal deposit amount for the non-business working day, intervening between the date of the maturity of the specified term

of the deposit and the date of payment of the proceeds of the deposit on the succeeding working day.

13.13 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 Direction No. RBI/2021-22/78 FMRD.DIRD.01/14.01.001/2021-22 dated April 01, 2021 (Updated as on June 25, 2021) on Reserve Bank of India (Call, Notice and Term Money Markets) Directions, 2021. The RBI has also issued the Reserve Bank of India (Certificate of Deposit) Directions, 2021 vide Master Direction No. RBI/2021-22/79 FMRD.DIRD.03/14.01.003/2021-22 dated June 04, 2021.

13.14 CDs may be issued at a discount on the 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. CDs can be issued in Demat or in physical form, and in the latter case must be issued on security paper stationery, in denomination of Rs. 5 lakh (for a single subscriber) or in multiples of Rs. 5 lakh and without the benefits of repatriation if issued to NRI. Except for NRIs, CDs are transferrable by endorsement and delivery.

13.15 There is no grace period for repayment of CDs. If the 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.

13.16 In respect of term deposits, banks issue deposit receipts. These receipts are not negotiable, and therefore, these 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, premature buyback is not permitted and no loans can be taken against CDs. However, the RBI may relax these restrictions for temporary periods through a separate notification.

13.17 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 as per the rate applicable to the period for which the deposit had actually run which may be less than the rate contracted initially. Premature penalty may also be levied by the bank as per its policy in this regard.

### **Issues to be considered by the Auditor**

13.18 Following are the important issues in respect of different categories of accounts which an auditor should consider.

#### **(a) FCNR (B) Accounts**

Foreign Currency Non-Resident (FCNR) Accounts are the accounts, as the name suggests, opened by non-resident Indians / persons of Indian origin in the form of fixed deposit only.

The RBI, Master Direction No. RBI/DBR/2015-16/19 DBR. Dir. No.84/13.03.00/2015-16 dated March 03, 2016 (Updated as on September 16, 2022) on "Reserve Bank of India (Interest rate on Deposits) Direction, 2016", provides guidance on the interest rates on deposits held in FCNR(B) accounts. The Circular further provides:

- (i) Banks cannot accept or renew a deposit over five years and no recurring deposits shall be accepted under the FCNR (B) Scheme.
- (ii) Banks cannot 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, except for difference on account of tenor of deposits and size of deposits.

Further, the interest rates on floating rate deposits shall be within the ceiling of swap rates for the respective currency/maturity and interest reset period shall be six months. In case of fixed rate deposits, interest shall be paid within the ceiling of "Overnight Alternative Reference Rate" for the respective currency/ maturity.

The Overnight Alternative Reference Rate for the respective currency/ SWAP rates as on the last working day of the preceding month shall form the base for fixing ceiling rates for the interest rates offered effective in the following month.

The interest rate ceiling on FCNR(B) deposits shall be as under:

<b>Period of deposit</b>	<b>Ceiling rate</b>
1 year to less than 3 years	Overnight Alternative Reference Rate for the respective currency/ Swap plus 250 basis points
3 years and above upto and including 5 years	Overnight Alternative Reference Rate for the respective currency/ Swap plus 350 basis points

The Overnight Alternative Reference Rate for the respective currency/ Swap rates quoted/displayed by Financial Benchmarks India Pvt. Ltd (FBIL) shall be used as the reference for arriving at the interest rates on FCNR(B) deposits. RBI circular RBI/2022-23/82 DOR. SOG (SPE).REC.No 53/13.03.000/2022-23 dated July 06, 2022 specified that the interest rate ceiling applicable to FCNR (B) deposits is being temporarily withdrawn for incremental FCNR (B) deposits mobilized by banks for the period until October 31, 2022 and the restriction with respect to interest rates offered on incremental NRE deposits mobilized by banks shall be temporarily withdrawn with effect from July 07, 2022, for the period until October 31, 2022.

Interest shall be calculated on the basis of 360 days to a year and paid at intervals of 180 days each and thereafter for the remaining actual number of days. The depositor may also receive interest on maturity with compounding effect.

**(b) Resident Foreign Currency (RFC) Accounts**

The Returning Indians can have their foreign currency accounts or NRE accounts converted into RFC. There are two types of RFC Accounts namely (1) Resident Foreign Currency (Domestic) Account [RFC(D)] and (2) Resident Foreign Currency Account [RFC].

RFC(D) Accounts are opened as “Current Account” whereas RFC Accounts can be opened as “Current” or “Savings” or “Term Deposit”.

The utilization of funds in RFC(D) is permissible for any current / capital account transactions whereas for funds in RFC Accounts there is no restriction on utilization in / outside India.

**(c) Export Earners Foreign Currency (EEFC) Accounts**

- Exporters having good track record and a unit located in SEZ are entitled to open foreign currency account with banks with the following features.

- Non-interest bearing current account.
- No credit facilities against the security of the balances.
- Hundred per cent of export earnings can be credited to this account.
- Amount is credited in a calendar month is to be utilised for authorised purposes by the end of next calendar month except the amount set-aside for forward commitments. Any balance left unutilised needs to be converted into Indian Rupees for credit to rupee account of exporter.

**(d) Diamond Dollar Accounts (DDA)**

*DDA account can be opened subject to compliance with eligibility criteria stipulated in Foreign Trade Policy of Government of India. DDA would be opened as Current Account Type in the name of the exporter and will be maintained in USD only.*

Permissible credits in DDA are (1) Amount of Pre & Post shipment credit availed in USD (2) Realization of Export Proceeds from shipment of rough, cut, polished diamond studded jewellery, (3) Realization in USD from local sale of rough, cut and polished diamonds.

The balance in DDA can be used for (1) Payment for import / purchase of rough diamonds from overseas / local sources (2) Payment for purchase of cut and polished diamonds, coloured gemstones and plain gold jewellery from local sources (3) Payment for import / purchase of gold from overseas / nominated agencies and repayment of USD loans availed from banks (4) Transfer to rupee account of exporter.

**(e) Non-Resident (NRO and NRE) Bank Accounts**

NRE account may be opened by non-resident Indians (NRIs) and persons of Indian Origin (PIOs), whereas NRO account may be opened by all non-residents.

The accounts may be maintained in the form of savings, current, recurring or fixed deposit and are denominated in Indian Rupees.

The RBI, *vide* its Master Direction No. RBI/DBR/2015-16/19 DBR. Dir. No.84/13.03.00/2015-16 dated March 03, 2016 (Updated as on September 16, 2022) on Reserve Bank of India (Interest Rate on Deposits) Directions, 2016 provides guidance on the interest rates on rupee deposits held in Domestic, Ordinary Non-Resident (NRO) and Non-Resident (External) (NRE) Accounts.

**(f) Special Non-Resident Rupee Account (SNRR)**

Any non-resident having business interest in India may open SNRR account for the purpose of putting through bona fide transactions in rupee as specified under A.P.(DIR series) Circular No.09 dated Nov.22, 2019. The account shall not carry any interest and the maximum period shall not exceed seven years except in some specified cases.

**Unclaimed Deposits/ Inoperative Accounts**

13.19 As per RBI circular no. DBOD No. Leg.BC.34/ 09.07.005/2008-09 dated August 22, 2008 on “Unclaimed Deposits/inoperative accounts in Banks”, a bank is required to make an annual review of accounts in which there are no operations (i.e. no credit or debit other than crediting of periodic interest or debiting of service charges) for more than one year. A savings/current account should be treated as inoperative/ dormant if there are no transactions in the account for over a period of two years. 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. If the account holder 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 the proceeds are unpaid, the amount left unclaimed with the bank will attract savings bank rate of interest. Further no penal charges are to be levied for non-maintenance of minimum balances in any inoperative account w.e.f. May 06, 2014 (vide circular no. RBI/2013-14/580 DBOD.DIR.BC.No.109/13.03.00/2013-14 on “Levy of penal charges on non-maintenance of minimum balances in inoperative Accounts”).

13.20 In terms of Foreign Exchange Management (Crystallization of Inoperative Foreign Currency Deposits) Regulations, 2014 vide circular no. FEMA 10A/2014-RB dated March 21, 2014; and as per Clause 2.7 of the RBI Master Circular No. DBOD.No.Dir.BC.14/13.03.00/2014-15 dated July 01, 2014 on “Master Circular of Instructions Relating to Deposits held in FCNR(B) Accounts”, inoperative deposits having a fixed term and those with no fixed term maturity after the expiry of a three month notice, upon completion of three years, will get crystallized into Rupees.

**Depositor Education and Awareness Fund (DEAF) Scheme 2014**

13.21 The RBI vide its circular no. DBOD.No.DEAF Cell. BC.101/30.01.002/2013-14 dated March 21, 2014 issued “The Depositor Education and Awareness Fund Scheme, 2014 under Section 26A of the Banking Regulation Act, 1949” laying down certain guidelines with respect to the said

fund. Further, RBI issued updated circular no. RBI/2021-2022/37 DoR.DEA.REC.No.16/30.01.002/2021-22 dated May 11, 2021 on “Banking Regulation Act, 1949 – Section 26A Depositor Education and Awareness Fund Scheme, 2014 – Interest rates payable on unclaimed interest bearing deposit” specifying the rate of interest for calculation of payment of interest on unclaimed interest bearing deposits. Under the provisions of Section 26A of the Banking Regulation Act, 1949 the amount to the credit of any account including savings, term, recurring, current or any other deposit, cash credit account, loan accounts after due appropriation by the bank, outstanding TT, DD, sundry deposit accounts, clearing adjustments, unreconciled credit balance in ATM, undrawn balance in prepaid card etc., in India with any bank which has not been operated upon for a period of ten years or any deposit or any amount remaining unclaimed for more than ten years shall be credited to the Fund, within a period of three months from the expiry of the said period of ten years. The depositor would, however, be entitled to claim from the bank the deposit or any other unclaimed amount or operate the account after the expiry of ten years, even after such amount has been transferred to the Fund. The bank would be liable to pay the amount to the depositor/claimant and claim refund of such amount from the Fund.

13.22 Normally the list of the dormant accounts is generated by the system itself and the branch is required to follow up with the account holders. The system identifies dormant accounts at the branches and transfers the balances ageing more than 10 years to the DEAF usually through the RBI current account maintained at the Treasury Branch. The auditors should check all such balances which have been dormant more than 10 years and not transferred to the DEAF and make the necessary rectifications at the branches. Various returns are required to be submitted to RBI in this regard, which are also required to be verified by the auditors.

13.23 As per RBI/2013-14/614 DBOD.No.DEAF Cell.BC.114/30.01.002/2013-14 dated May 27, 2014 on “The Depositor Education and Awareness Fund Scheme, 2014 –Section 26A of Banking Regulation Act, 1949 - Operational Guidelines”, all such unclaimed liabilities (where amount due has been transferred to DEAF) may be reflected as “Contingent Liability – Others-items for which the bank is contingently liable” under Schedule 12 of the annual financial statements. Banks are also required to disclose the amounts transferred to DEAF under the “Notes to Accounts”.

### **Reserve Bank of India (Gold Monetization Scheme) Direction, 2015**

13.24 The RBI issued Master Direction No. DBR.IBD.No.45/23.67.003/2015-16 dated October 22, 2015 (Updated as on August 4, 2022) on “Gold Monetisation Scheme, 2015” to all Scheduled Commercial Banks that decide to

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implement the Scheme (*excluding Regional Rural Banks*), requiring such banks that decide to implement the Scheme (Designated Bank), to formulate a comprehensive policy with approval of their respective Boards.

13.25 The Gold Monetization Scheme, 2015 (GMS) which includes the Revamped Gold Deposit Scheme (R-GDS) and Revamped Gold Metal Loan Scheme (R-GML) was intended to mobilise gold held by households and institutions to facilitate its use for productive purposes and to reduce country's reliance on the import of gold.

13.26 Designated banks are authorised to accept deposits, the principal and interest of which, under the scheme, shall be denominated in gold and the interest will start accruing from the date of conversion of gold deposited into tradable gold bars after refinement or 30 days after receipt of gold, whichever is earlier. Such deposits can be accepted from eligible persons, *viz.*, resident Indians [Individuals, HUFs, Proprietorship & Partnership firms, Trusts including Mutual Funds/Exchange Traded Funds registered under SEBI (Mutual Fund) Regulations, companies, charitable institutions, Central Government, State Government or any other entity owned by Central Government or State Government]. Joint deposits of two or more eligible depositors can be made on the same basis as other joint deposit accounts and with nomination facility.

13.27 The minimum deposit at any one time shall be 10 grams of raw gold (bars, coins, jewellery excluding stones and other metals). There is no maximum limit with two types of gold deposit scheme i.e. Short term Bank deposit (STBD) and Medium and Long term Government Deposit (MLTGD). The broad features of the Gold Monetisation Scheme are summarised and given as Annexure to this Chapter.

### **Know Your Customer Requirements (KYC)**

13.28 The RBI *vide* Master Direction No. RBI/DBR/2015-16/18 DBR.AML.BC.No.81/14.01.001/2015-16 dated February 25, 2016 (Updated on May 10, 2021) on "Know Your Customer (KYC) Direction, 2016" 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 to manage their risks prudently.

13.29 These guidelines contain detailed requirements for banks in respect of customer acceptance policy, customer identification procedures, monitoring of transactions and risk management. The auditor should also keep in mind the reporting requirements under LFAR format while verifying the area.



### **Data Integrity and Modifications**

13.30 The auditor is required to verify the control processes to ensure that the customer accounts opened in the system are properly updated in the relevant module in CBS and errors, if any are identified and rectified. Further any subsequent changes in customer accounts, should be properly authorised and the control process should exist for their verification. The auditor may pick some cases on sample basis to verify the correctness of the above data updated in CBS system and any periodic changes in the same.

### **Audit Approach and Procedures**

#### **Borrowings**

13.31 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 would assist the auditor in obtaining audit evidence that the auditor requires to respond to significant risks of material misstatement. The auditor is required to comply with the requirements of Standard on Auditing (SA) 505, "External Confirmations" which contains guidance on designing and performing external confirmation procedures to obtain relevant and reliable audit evidence.

13.32 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.

13.33 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. 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**

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

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

***Current Accounts and Savings Bank Account***

13.35 The auditor should verify if any difference exists between the legacy system of control and subsidiary ledgers.

13.36 The auditor should examine whether the debit balances in current accounts are not netted out on the liabilities side but are appropriately included under the head 'Advances'.

13.37 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.

13.38 As per RBI/2020-21/20 DOR.No.BP.BC/7/21.04.048/2020-21 dated August 06, 2020 on "Opening of Current Accounts by Banks - Need for Discipline", banks have been instructed not to open current accounts for customers who have availed credit facilities in the form of CC/OD from the banking system. In other cases of credit facilities current account may be opened for facility less than Rs.5 crores and in other cases only lenders can open current account and other banks may open collection accounts, as per specified criteria.

The auditor has to verify whether the savings accounts are opened only for eligible entities for savings purposes and not for business purposes.

***Term Deposits***

13.39 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.

13.40 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.

13.41 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.

13.42 In case of bulk deposits (Rupees <sup>28</sup>two crore and above for Scheduled Commercial Banks and Rs.15 lakhs for RRBs) the interest rate would be obtained by the branch from the Treasury division. The auditor should check all such cases to verify the correctness of the rates offered.

13.43 In case of for closure of deposits, test check to be made whether the mandated foreclosure penalty has been deducted from the applicable Interest rate payable.

***Deposits Designated in Foreign Currencies***

13.44 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:

- i) For deposits up to one year, at the applicable rate without any compounding effect.
- ii) In respect of deposits for more than 1 year, the interest on FCNR (B) deposits should be calculated at intervals of 180 days each and thereafter for remaining actual number of days, till normal maturity.

13.45 Further, cases of conversion of FCNR (B) deposits into NRE deposits or vice versa before maturity should have been subjected to the provisions relating to premature withdrawal.

**Other Non-Resident Deposits**

13.46 Only eligible credits are made to the NRE account and only legitimate dues of the accountholder are credited to NRO accounts.

Debits to NRE and NRO accounts to be verified for any violation of applicable guidelines.

In the case of NRE deposits prematuring before 1 year, no interest is to be paid as per RBI guidelines.

It is also to be verified whether any customer is holding both non-resident and resident account at the same point of time, which may not be permissible.

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<sup>28</sup> Vide Master Direction No. RBI/DCBR/2015-16/23 Master Direction DCBR.Dir.No.1/13.01.000/2015-16 dated May 12, 2016 (Updated as on September 16, 2022).

Summary of NRE, FCNR(B) and NRO Accounts

Particulars	Non-Resident (External) Rupee Account Scheme [NRE Account]	Foreign Currency (Non-Resident) Account (Banks) Scheme [FCNR (B) Account]	Non-Resident Ordinary Rupee Account Scheme [NRO Account]
(1)	(2)	(3)	(4)
<p><b>Who can open an account</b></p>	<p>NRIs and PIOs Individual/entities of Pakistan and Bangladesh shall require prior approval of the RBI</p>		<p>Any person resident outside India for putting through bona fide transactions in rupees.</p> <p>Individuals/ entities of Pakistan nationality/ origin and entities of Bangladesh origin require prior approval of the RBI.</p> <p>A Citizen of Bangladesh/ Pakistan belonging to minority communities in those countries i.e. Hindus, Sikhs, Buddhists, Jains, Parsis and Christians residing in India and who have been granted LTV or whose application for LTV is under consideration, can open only one NRO account with an AD bank subject to the conditions mentioned in Notification No. FEMA 5(R)/2016-RB dated April 01, 2016, as updated from time to time.</p> <p>Post Offices in India may maintain savings bank accounts in the names of persons resident outside India and allow operations on these accounts subject to</p>

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<b>Particulars</b>	<b>Non-Resident (External) Rupee Account Scheme [NRE Account]</b>	<b>Foreign Currency (Non-Resident) Account (Banks) Scheme [FCNR (B) Account]</b>	<b>Non-Resident Ordinary Rupee Account Scheme [NRO Account]</b>
<b>(1)</b>	<b>(2)</b>	<b>(3)</b>	<b>(4)</b>
			the same terms and conditions as are applicable to NRO accounts maintained with an authorised dealer/ authorised bank.
<b>Joint account</b>	May be held jointly in the names of two or more NRIs/ PIOs. NRIs/ PIOs can hold jointly with a resident relative on 'former or survivor' basis (relative as defined in Companies Act, 2013). The resident relative can operate the account as a power of attorney holder during the life time of the NRI/ PIO account holder except closure and remittance back of funds to the depositor.		May be held jointly in the names of two or more NRIs/ PIOs. May be held jointly with residents on 'former or survivor' basis.
<b>Currency</b>	Indian Rupees	Any permitted currency i.e. a foreign currency which is freely convertible	Indian Rupees
<b>Type of Account</b>	Savings, Current, Recurring, Fixed Deposit	Term Deposit only	Savings, Current, Recurring, Fixed Deposit.
<b>Period for fixed deposits</b>	From one to three years, However, banks are allowed to accept NRE	For terms not less than 1 year and not more than 5 years	As applicable to resident accounts.

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Particulars	Non-Resident (External) Rupee Account Scheme [NRE Account]	Foreign Currency (Non-Resident) Account (Banks) Scheme [FCNR (B) Account]	Non-Resident Ordinary Rupee Account Scheme [NRO Account]
(1)	(2)	(3)	(4)
	deposits above three years from their Asset-Liability point of view		
<b>Permissible Credits</b>	Credits permitted to this account are inward remittance from outside India, interest accruing on the account, interest on investment, transfer from other NRE/ FCNR(B) accounts, maturity proceeds of investments (if such investments were made from this account or through inward remittance). Current income like rent, dividend, pension, interest etc. will be construed as a permissible credit to the <b>NRE account</b> . Care: Only those credits which have not lost repatriable character		Inward remittances from outside India, legitimate dues in India and transfers from other NRO accounts are permissible credits to NRO account.  Rupee gift/ loan made by a resident to a NRI/ PIO relative within the limits prescribed under the Liberalised Remittance Scheme may be credited to the latter's NRO account.
<b>Permissible Debits</b>	Permissible debits are local disbursements, remittance outside India, transfer to other NRE/ FCNR(B) accounts and investments in India.		The account can be debited for the purpose of local payments, transfers to other NRO accounts or remittance of current income abroad. Apart from these, balances in the NRO account cannot be repatriated abroad except by NRIs and PIOs up to USD 1 million, subject to conditions specified in Foreign Exchange

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<b>Particulars</b>	<b>Non-Resident (External) Rupee Account Scheme [NRE Account]</b>	<b>Foreign Currency (Non-Resident) Account (Banks) Scheme [FCNR (B) Account]</b>	<b>Non-Resident Ordinary Rupee Account Scheme [NRO Account]</b>
<b>(1)</b>	<b>(2)</b>	<b>(3)</b>	<b>(4)</b>
			Management (Remittance of Assets) Regulations, 2016. Funds can be transferred to NRE account within this USD 1 Million facility.
<b>Repatriability</b>	Repatriable		Not repatriable except for all current income. Balances in an NRO account of NRIs/ PIOs are remittable up to USD 1 (one) million per financial year (April-March) along with their other eligible assets subject to payment of due tax appropriately certified as per law.
<b>Taxability</b>	Income earned in the accounts is exempt from income tax and balances exempt from wealth tax		Taxable subject to withholding tax.
<b>Loans in India</b>	AD can sanction loans in India to the account holder/ third parties without any limit, subject to usual margin requirements. These loans cannot be repatriated outside India and can be used in India only for the purposes specified in the regulations. In case of loans sanctioned to a third party, there should be no direct or indirect foreign exchange consideration for the non-resident depositor agreeing to pledge his		Loans against the deposits can be granted in India to the account holder or third party subject to usual norms and margin requirement. The loan amount cannot be used for relending, carrying on agricultural/ plantation activities or investment in real estate. The term "loan" shall include all types of fund based/ non-fund based facilities.

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Particulars	Non-Resident (External) Rupee Account Scheme [NRE Account]	Foreign Currency (Non-Resident) Account (Banks) Scheme [FCNR (B) Account]	Non-Resident Ordinary Rupee Account Scheme [NRO Account]
(1)	(2)	(3)	(4)
	<p>deposits to enable the resident individual/ firm/ company to obtain such facilities.</p> <p>In case of the loan sanctioned to the account holder, it can be repaid either by adjusting the deposits or through inward remittances from outside India through banking channels or out of balances held in the NRO account of the account holder. <i>In case of a POA holder, confirmation from the original depositor must be obtained.</i></p> <p>The facility for premature withdrawal of deposits will not be available where loans against such deposits are availed of.</p> <p>The term "loan" shall include all types of fund based/ non-fund based facilities.</p>		
<b>Loans outside India</b>	<p>Authorised Dealers may allow their branches/ correspondents outside India to grant loans to or in favour of non-resident depositor or to third parties at the request of depositor for bona fide purpose against the security of funds held in the NRE/ FCNR (B) accounts in India, subject to usual margin requirements.</p> <p>The term "loan" shall include all types of fund based/ non-fund</p>		Not permitted



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<b>Particulars</b>	<b>Non-Resident (External) Rupee Account Scheme [NRE Account]</b>	<b>Foreign Currency (Non-Resident) Account (Banks) Scheme [FCNR (B) Account]</b>	<b>Non-Resident Ordinary Rupee Account Scheme [NRO Account]</b>
<b>(1)</b>	<b>(2)</b>	<b>(3)</b>	<b>(4)</b>
	based facilities		
<b>Rate of Interest</b>	As per guidelines issued by the regulating Department		
<b>Operations by Power of Attorney in favour of a resident</b>	Operations in the account in terms of Power of Attorney is restricted to withdrawals for permissible local payments or remittance to the account holder himself through normal banking channels, but he cannot close the account.		Operations in the account in terms of Power of Attorney are restricted to withdrawals for permissible local payments in rupees, remittance of current income to the account holder outside India or remittance to the account holder himself through normal banking channels. While making remittances, the limits and conditions of repatriability will apply.
<b>Change in residential status from Non-resident to resident</b>	NRE accounts should be designated as resident accounts or the funds held in these accounts may be transferred to the RFC accounts, at the option of the account holder, immediately upon the return	On change in residential status, FCNR (B) deposits may be allowed to continue till maturity at the contracted rate of interest, if so desired by the account holder. Authorised dealers should convert the FCNR(B)	NRO accounts may be designated as resident accounts on the return of the account holder to India for any purpose indicating his intention to stay in India for an uncertain period. Likewise, when a resident Indian becomes a person resident outside India, his existing resident account should be designated as NRO account.

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<b>Particulars</b>	<b>Non-Resident (External) Rupee Account Scheme [NRE Account]</b>	<b>Foreign Currency (Non-Resident) Account (Banks) Scheme [FCNR (B) Account]</b>	<b>Non-Resident Ordinary Rupee Account Scheme [NRO Account]</b>
<b>(1)</b>	<b>(2)</b>	<b>(3)</b>	<b>(4)</b>
	of the account holder to India for taking up employment or on change in the residential status.	deposits on maturity into resident rupee deposit accounts or RFC account (if the depositor is eligible to open RFC account), at the option of the account holder.	

**Summary of EEFC, RFC(D) and RFC Accounts**

<b>Particulars</b>	<b>Exchange Earners Foreign Currency (EEFC) Account</b>	<b>Resident Foreign Currency (Domestic) [RFC(D)] Account</b>	<b>Resident Foreign Currency (RFC) Account</b>
Who can open the account	Exchange Earners	Individuals	Individuals
Joint account	Jointly with eligible persons; or With resident relative(s) on former or survivor basis. Relative as defined under Companies Act, 2013 (viz. members of HUF, spouse, parents, step-parents, son, step-son, daughter-in-law,	Jointly with any person eligible to open the account	Same as EEFC

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<b>Particulars</b>	<b>Exchange Earners Foreign Currency (EEFC) Account</b>	<b>Resident Foreign Currency (Domestic) [RFC(D)] Account</b>	<b>Resident Foreign Currency (RFC) Account</b>
	daughter, son-in-law, brother/sister, step-brother/ step-sister) Relative joint account holder cannot operate the account during the life time of the account holder.		
Type of Account	Current only	Current only	Current/ savings/ term deposits.
Interest	Non-interest earning	Non-interest earning	De-regulated (As decided by the AD bank)
Permitted Credits	<ol style="list-style-type: none"> <li>1) 100 per cent of foreign exchange received on account of export transactions.</li> <li>2) Advance remittance received by an exporter towards export of goods or services</li> <li>3) Repayment of loans given to foreign importers</li> <li>4) Disinvestment proceeds on conversion of ADR/ GDR</li> <li>5) Professional earnings like director's/ consultancy/ lecture fees, honorarium</li> </ol>	<ol style="list-style-type: none"> <li>1) Foreign exchange received as payment/ service/ gift/ honorarium while on visit abroad or from a non-resident who is on a visit to India</li> <li>2) Unspent amount of foreign exchange acquired from AD for travel abroad</li> <li>3) Gift from close relative</li> <li>4) Earning through export of goods/ services, royalty</li> <li>5) Disinvestment proceed on</li> </ol>	<ol style="list-style-type: none"> <li>1) Foreign exchange received by him as super-annuation/ other monetary benefits from overseas employer</li> <li>2) Foreign exchange realised on conversion of the assets referred to in Section 6(4) of FEMA 1999</li> <li>3) Gift/ inheritance received from a person referred to in Section 6(4) of FEMA 1999</li> </ol>

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Particulars	Exchange Earners Foreign Currency (EEFC) Account	Resident Foreign Currency (Domestic) [RFC(D)] Account	Resident Foreign Currency (RFC) Account
	<p>and similar other earnings received by a professional by rendering services in his individual capacity</p> <p>6) Interest earned on the funds held in the account</p> <p>7) Re-credit of unutilised foreign currency earlier withdrawn from the account</p> <p>8) Payments received in foreign exchange by an Indian startup arising out of sales/ export made by the startup or its overseas subsidiaries</p>	<p>conversion of shares into ADR/ GDR</p> <p>6) Foreign exchange received as earnings of LIC claims/ maturity/ surrendered value settled in forex from an Indian insurance company</p>	<p>4) Foreign exchange acquired before July 8, 1947 or any income arising on it held outside India with RBI permission</p> <p>5) Foreign exchange received as earnings of LIC claims/ maturity/ surrendered value settled in forex from an Indian insurance company</p> <p>6) Balances in NRE/ FCNR (B) accounts on change in residential status</p>
Permitted Debits	<p>1) Any permissible current or capital account transaction</p> <p>2) Cost of goods purchased</p> <p>3) Customs duty</p> <p>4) Trade related loans and advances. The amount received in</p>	Can be used for any permissible current/ capital account transactions.	No restrictions on utilisation in/ outside India.

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<b>Particulars</b>	<b>Exchange Earners Foreign Currency (EEFC) Account</b>	<b>Resident Foreign Currency (Domestic) [RFC(D)] Account</b>	<b>Resident Foreign Currency (RFC) Account</b>
	one calendar month should be utilized before end of next calendar month except what is earmarked towards future liability due for payment in a near future.		

**Difference between SNRR Account and NRO Account**

<b>Feature</b>	<b>SNRR Account</b>	<b>NRO Account</b>
Who can open	Any person resident outside India, having a business interest in India for putting through bona fide transactions in rupees.  Opening of SNRR accounts by Pakistan and Bangladesh nationals and entities incorporated in Pakistan and Bangladesh requires prior approval of the RBI.	Any person resident outside India for putting through bonafide transactions in rupees.  Individuals/ entities of Pakistan nationality/ origin and entities of Bangladesh origin require the prior approval of the RBI.  However, a citizen of Bangladesh/Pakistan belonging to minority communities in those countries i.e. Hindus, Sikhs, Buddhists, Jains, Parsis and Christians residing in India and who has been granted LTV or whose application for LTV is under consideration, can open one NRO account with an AD bank subject to the conditions mentioned in Notification No. FEMA 5(R)/2016-RB dated April 01, 2016, as updated from time to time.
Type of	Non-interest bearing	Current, Savings, Recurring or

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Account		Fixed Deposit; Rate of interest – as per guidelines issued by Department of Banking Regulation.
Permissible Transactions	Debits and credits specific/incidental to the business proposed to be done by the account holder	Credits: Inward remittances, legitimate dues in India, transfers from other NRO accounts and any amount received in accordance with the Rules/ Regulations/ Directions under FEMA, 1999.  Debits: Local payments, transfer to other NRO accounts, remittance of current income, settlement of charges on International Credit Cards.
Tenure	Concurrent to the tenure of the contract / period of operation / the business of the account holder and in no case should exceed seven years, other than with approval of the RBI.  Restriction of seven years is not applicable to SNRR accounts opened for the purposes stated at sub. paragraphs (i) to (v) of paragraph 1 of Schedule 4 of FEMA 5(R).	No such restrictions on tenure.
Repatriability	Repatriable	Not repatriable except for current income; and remittances by NRIs/ PIOs up to USD 1 million per financial year in accordance with the provisions of FEMA 13(R).

***Interest Accrued But Not Due***

13.47 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'. The calculation of the same should be checked by the auditor by way of comparative analysis and substantive checking.

***Inoperative Accounts***

13.48 Internal controls over inoperative accounts, is imperative. A response to the letter addressed to the branch will assist the auditor to take a view on the system of dealing with inoperative accounts. Attention needs to be sharply focused on debits/withdrawals to ascertain whether these are unauthorised. In testing the debits, attention should be paid specially to large and repetitive debits out of otherwise dormant accounts.

Computer generated exception reports will also reveal the status of the inoperative accounts.

The activation of the account to be made only after the specific request from the customer and there should be operation in the account on the day of the activation.

The auditor may verify the existence of audit log for cheque returns due to account dormancy and subsequent activation. The auditor should also verify that the system should not allow the withdrawal in inoperative accounts through overrides.

The auditor may verify whether there is a practice in the bank to intimate the customers once the account has become dormant through letter/ SMS/ e-mails and suitable advice and also there is a follow up for the same.

***Window Dressing***

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

The auditor has to verify whether the unavailed portion of the credit facilities (overdraft, cash credit) are used to boost the loans and deposit at the end

quarter/ half year/annual and reversed on the next day which might tantamount to window dressing. If so the same needs to be suitably commented in the Audit Report/ LFAR.

The auditor has to verify whether cheques/ bills are purchased/discounted to boost the loan and deposits at the end quarter/ Half year/Annual and reversed on the next day which might tantamount to window dressing. If so the same needs to be suitably commented in the Audit Report/ LFAR.

The auditor has to verify whether the debits are made in suspense account/ sundries receivable account with an offset credit in current account at the end of the quarter and then reversed on the next day to validate the element of window dressing.

***LFAR Reporting***

13.50 Reporting on deposits shall be as under:

- a) Does the bank have a system of identification of dormant/ inoperative accounts and internal controls with regard to operations in such 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.
- Refer to the process of the bank for identification of dormant/inoperative accounts.
  - Refer the process for control over inactive/dormant accounts by restricting access and other control procedures.
  - Check the process of identifying DEAF accounts and transfer the same to RBI, as per process.
  - Sample check the control process is working and identify discrepancies. Properly report the same.
- b) 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 clarifications from the branch and give your comments thereon.
- Take the GL abstract on balance sheet date and date of audit and check for variations in the figures of deposits and loans.
  - Check the variations for any unusual movements, if any and identify the specific accounts resulting in this movement.
  - Obtain reasons and report accordingly after considering response of the management.



- c) Whether the scheme of automatic renewal of deposits applies to FCNR(B) deposits? Where such deposits have been renewed, report whether the branch has satisfied itself as to the 'non-resident status' of the depositor and whether the renewal is made as per the applicable regulatory guidelines and the original receipts / soft copy have been dispatched.
- Check for bank policy for renewal of FCNR(B) accounts and system parameters for automatic renewal marked in FCNR(B) accounts.
  - Check the process of obtaining documents at the time of renewal of FCNR(B) accounts including verification of the process of continuation of account holder in non-resident status.
  - Check the bank's policy of printing and dispatch of original receipts and control over them. Test check sample cases to form an opinion about the efficacy of the process.
- d) Is the branch complying with the regulations on minimum balance requirement and levy of charges on non-maintenance of minimum balance in individual savings accounts?
- Check the bank policy for minimum balance maintenance and intimation to customer for non-maintenance of the same.
  - Check in sample cases levy of charges with intimation given by the bank.
  - Check for any charges levied in inoperative/dormant accounts by the bank.

### **13.51 Implementation of KYC/AML Guidelines**

- Whether the branch has adequate systems and processes, as required, to ensure adherence to KYC/AML guidelines towards prevention of money laundering and terrorist financing.
- Whether the branch has been following the KYC/AML guidelines based on the test check carried out by the branch auditors.

### **Management Information System**

13.52 Whether the branch has the proper systems and procedures to ensure data integrity relating to all data inputs which are to be used for MIS at corporate office level and for supervisory reporting purposes. Have you come across any instances where data integrity was compromised?

**Annexure**

**Features of the Gold Monetization Scheme**

The Broad features of the Gold Monetization Scheme are summarised in the following Table:

<b>Acceptance of Deposits and Interest accretion</b>	<ol style="list-style-type: none"><li>1. Deposits under the scheme are to be made at the<ol style="list-style-type: none"><li>a. Collection and Purity Testing Centre (CPTC) -the collection and assaying centres certified by the Bureau of Indian Standards (BIS) and notified by the Central Government for the purpose of handling gold deposited and redeemed under the Scheme, or</li><li>b. GMS Mobilisation, Collection &amp; Testing Agent (GMCTA) – Jewellers/ Refiners certified as CPTCs by BIS and meeting additional eligibility conditions set by IBA will be recognised as GMCTA by designated Banks, or</li><li>c. Designated bank branches, where, at their discretion, banks may accept the deposit of gold.</li></ol></li><li>2. Minimum deposits -With no maximum limit for deposit, the minimum deposit at any one time shall be raw gold (bars, coins, jewellery, excluding stones and other metals) equivalent to 10 grams of gold (of 995 fineness only).</li><li>3. Assaying of Gold - All gold deposited under the scheme, whether tendered at the CPTC/GMCTA or designated bank branches, shall, (except standard good delivery gold accepted at the designated branches), be assayed at CPTC/GMCTA for fire as saying.</li><li>4. Interest on such deposits accrues from the date of conversion of gold deposited into tradable gold bars after refinement or 30 days after the receipt of gold at the CPTC/GMCTA or the bank’s designated branch, as the case may be, whichever is earlier.</li><li>5. Gold deposited to be treated as an item in safe custody - Between the date of acceptance of the gold and till commencement of the date of accretion of interest, the gold</li></ol>
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	deposited shall be treated as an item in safe custody held by the designated bank.
<b>Valuation</b>	<p>On the day the gold deposited starts earning interest, the designated banks shall translate the gold liabilities and assets into Indian Rupees*. The prevalent custom duty for import of gold will be added to the above value to arrive at the final value of gold. This methodology will also be followed for valuation of gold at any subsequent valuation date(s) and for the conversion of gold into Indian Rupees under the Scheme.</p> <p><i>(*by crossing the London AM fixing for Gold / USD rate with the Rupee-US Dollar reference rate announced by Financial Benchmarks India Private Limited (FBIL) on that day)</i></p>
<b>Reporting to RBI</b>	The designated banks will be required to submit a monthly report on GMS to the RBI in the prescribed format. Designated Banks shall furnish the statement giving details of redemption due in next three months, as per the prescribed Format. The information shall be furnished to Department of Banking Regulation, RBI by 7 <sup>th</sup> of the Month.
<p><b>Opening of Gold Deposit Account</b></p> <p><i>(Opened with a designated bank under the Scheme and denominated in grams of gold)</i></p>	<p>Customer identification criteria as applicable to any other deposit accounts (<i>KYC norms</i>), shall apply and non-customers can open a gold deposit account with zero balance at any time prior to tendering gold at the CPTC/GMCTA.</p> <p>Designated banks will credit the STBD or MLTGD, as the case may be (with the amount of 995 fineness gold as indicated in the advice received from CPTC), after 30 days of receipt of gold at the CPTC, <i>regardless of whether the depositor submits the receipt for issuance of the deposit certificate or not.</i></p> <p><b><u>Tendering of gold to CPTC/GMCTA</u></b></p> <p>Before tendering the raw gold to a CPTC, the depositor shall indicate the name of the designated bank with whom he would like to place the deposit.</p>

	<p>After assaying the gold, the CPTC will issue a receipt signed by authorised signatories of the centre showing the standard gold of 995 fineness on behalf of the designated bank indicated by the depositor. Simultaneously, the CPTC will also send an advice to the designated bank regarding the acceptance of deposit.</p> <p>As GMCTA will carry out functions of CPTC, the instructions applicable to CPTCs shall also be applicable to GMCTA.</p> <p><b><u>Fee to CPTC/GMCTA</u></b></p> <p>If in agreement with result of the fire assay test, the customer will exercise his option to deposit the gold with the bank and the fee charged by the centre will be borne by the bank. In case of any disagreement with the fire assay result, the customer will have the option to take back the melted gold after paying a nominal fee to the centre.</p> <p>The designated banks shall pay a maximum of 1.5% as incentive/handling charges to the gold handling/mobilizing functions performed by GMCTAs.</p> <p><b><u>Documentation</u></b></p> <p>Standard documentation (designed by IBA including application form for tendering raw gold to the assaying centres, the description of the physical appearance/ characteristics of gold, recording of the results of XRF by the assaying centre, customer's consent for melting the gold for fire-assaying and for making the final deposit, the final receipt to be issued to the depositor ), are to be made known and available to the CPTCs/GMCTAs and to the depositor upfront and should include all the terms and conditions of the Scheme including the schedule of charges. The documentation should be posted on IBA's website and should also be available in physical form at the CPCTs.</p> <p>-----</p> <p><i>(The 995 fineness equivalent amount of gold as determined by the CPTC will be final and any difference in quantity or quality found after issuance of the receipt by the CPTC</i></p>
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	<i>including at the level of the refinery due to refinement or any other reason shall be settled among the three parties viz., the CPTC, the refiner and the designated bank in accordance with the terms of the tripartite agreement to be entered into.)</i>
<b>Types of deposits</b>	<ol style="list-style-type: none"> <li>1. Short Term Bank Deposit (STBD).</li> <li>2. Medium and Long Term Government Deposit (MLTGD).</li> </ol>
<b>Short Term Bank Deposit (STBD)</b>	<p><b>Duration</b> - for a short term period of 1-3 years (<i>with a roll over in multiples of one year</i>), to be treated by banks as their on-balance sheet liability; the duration being subject to such minimum lock-in period and penalties, if any, as may be determined by the banks as per their laid down policy.</p> <p>Interest-banks are free to fix the interest rates; and the interest shall be credited in the deposit accounts on the respective due dates and will be withdrawable periodically or at maturity as per the terms of the deposit.</p> <p>With effect from April 5, 2021, interest in respect of STBD shall be denominated and paid in Indian Rupee only.</p> <p>Redemption of principal at maturity will, at the option of the depositor be either in Indian Rupee equivalent of the deposited gold based on the price of gold prevailing at the time of redemption, or in gold. The option in this regard shall be made in writing by the depositor at the time of making the deposit and shall be irrevocable:</p> <p>Premature redemption, if any, shall be in Indian Rupee equivalent or gold at the discretion of the designated bank. All STBDs made prior to the issue of Master Direction dated April 5, 2021 will continue to be governed by their existing terms and conditions.</p> <p><b>Imports permitted by designated banks for redemption</b></p> <p>The designated banks other than the nominated banks shall be eligible to import gold only for redemption of the gold deposits mobilised under the STBD.</p> <p><i>(Nominated bank – A Scheduled Commercial Bank authorized by RBI to import gold in terms of RBI circular</i></p>

	<p>A.P.(DIR Series) Circular No.79 dated February 18, 2015)</p> <p><b>CRR and SLR</b></p> <p>CRR and SLR requirements apply (as per instructions of RBI) from the date of credit of the amount to the deposit account. However, the stock of gold held by banks in their books will be an eligible asset for meeting the SLR requirement in terms of RBI Master Circular – Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) dated 1 July 2015. Further borrowing of gold by designated banks (from gold mobilised under STBD by other designated banks will be treated as Interbank liabilities and hence exempted from CRR and SLR.</p> <p><b><u>End use</u></b></p> <p>In respect of gold mobilised under the STBD, the designated banks may:</p> <ul style="list-style-type: none"><li>○ Sell the gold to MMTC for minting India Gold Coins (IGC), to jewellers and to other designated banks participating in GMS; or</li><li>○ Lend the gold under the GML scheme to MMTC for minting India Gold Coins (IGC) and to jewellers.</li><li>○ Lend the gold to other designated banks participating in the Scheme for granting GML subject to the following conditions:<ul style="list-style-type: none"><li>• Interest Rate: The interest rate to be charged on Interbank lending of gold mobilised from these deposits shall be decided by banks</li><li>• Repayment: The repayment shall be in INR or in locally sourced IGDS/ LGDS (LBMA's Good Delivery Standards) gold as agreed by the participating banks.</li><li>• Tenor: The tenor of interbank lending of gold shall be as per circular DBOD.No. IBD.BC.71/23.67.001/2006-07 dt. April 03, 2007, the Foreign Trade Policy and the Handbook of Procedures issued by DGFT.</li></ul></li></ul>
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<p><b>Medium and Long Term Government Deposit (MLTGD)</b></p>	<p>Deposits shall be accepted by the designated banks on behalf of the Central Government <i>and shall constitute the liability of Central Government; the receipts issued by the Collection and Purity Testing Centre (CPTC)/GMCTA -the collection and assaying centres certified by the Bureau of Indian Standards (BIS) and notified by the Central Government for the purpose of handling gold deposited and redeemed under the Scheme, and the deposit certificate issued by the designated banks shall clearly state this.</i></p> <p><i>Accordingly,</i> such deposits shall not be reflected in the balance sheet of the designated banks. The RBI will maintain the Gold Deposit Accounts denominated in gold in the name of the designated banks that will in turn hold sub-accounts of individual depositors.</p> <p>Control over the gold deposited - The designated banks will hold the gold deposited on behalf of Central Government until it is transferred to such person as may be determined by the Central Government.</p> <p>The gold received under MLTGD will be auctioned by the agencies notified by Government and the sale proceeds will be credited to Government's account held with RBI.</p> <p>The details of auctioning and the accounting procedure will be notified by Government of India.</p> <p>Duration - the deposit can be made for a medium term period of 5-7 years or a long term period of 12-15 years or for such period as may be decided from time to time by the Central Government (<i>The designated banks may allow whole or part premature withdrawal of the deposit subject to such minimum lock-in period and penalties, if any, as determined by the Central Government</i>).</p> <p>Redemption of the deposit including interest accrued - Redemption will be only in Indian Rupee equivalent of the value of the gold and accumulated interest as per the price of gold prevailing at the time of redemption.</p> <p>However, as per RBI Circular No. DGBA.GBD.No.1007/</p>
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	<p>15.04.001/2017-18 dated October 17, 2017 on Gold Monetisation Scheme, 2015.</p> <ul style="list-style-type: none"> <li>- Reimbursement of payments made by banks, relating to Medium and Long Term Government Deposit (MLTGD), will be made by Central Account Section (CAS), Nagpur, RBI.</li> <li>- Accordingly, banks are advised to pay immediately the interest amount already due to the depositors and to take note that, in future, payment of interest to the depositors is to be made on the due dates. After making payments, the banks may raise a claim to Government through RBI (CAS, Nagpur).</li> </ul> <p><b><u>End Use:</u></b></p> <p>Gold accepted under MLTGD will be auctioned by MMTC or any other agency authorized by the Central Government and the sale proceeds credited to the Central Government's account with RBI.</p> <p>The entities participating in the auction may include RBI, MMTC, banks and any other entities notified by the Central Government in this regard.</p> <p>Gold purchased by designated bank under the auction may be utilized by them and they may:</p> <ul style="list-style-type: none"> <li>○ sell the gold to MMTC for minting India Gold Coins (IGC), to jewellers and to other designated banks participating in GMS; or</li> <li>○ lend the gold under the Gold Metal Loan (GML) Scheme to MMTC for minting India Gold Coins (IGC) and to jewellers.</li> </ul>
<p><b>Tripartite agreement between the designated banks, refiners and</b></p>	<p>The designated bank shall enter into a legally binding tripartite agreement with the refiners and CPTCs with whom they tie up under the Scheme; the refiners being refineries accredited by the National Accreditation Board for Testing and Calibration Laboratories (NABL) and notified by the Central Government for the purpose of handling gold</p>



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<b>CPTCs</b>	<p>deposited and redeemed under GMS.</p> <p>The agreement shall cover the nature of services to be provided, standards of service, arrangements regarding movement of gold, payment of fees and rights and obligations of the parties.</p>
<b>Transfer of gold to the Refiners</b>	<p>The CPTCs will transfer the gold to the refiners as per the terms and conditions set out in the tripartite agreement.</p> <p>The refined gold may, at the option of the designated bank, be kept in the vaults maintained by the refiners or at the branch itself.</p> <p>For the services provided by the refiners, the designated banks will pay a fee as decided mutually.</p> <p>The refiners shall not collect any charge from the depositor.</p>
<b>Oversight over the CPTCs and Refineries</b>	<ol style="list-style-type: none"> <li>1. The Central Government: <ul style="list-style-type: none"> <li>• in consultation with BIS, NABL, RBI and IBA, may put in place appropriate supervisory mechanism over the CPTCs and the refiners so as to ensure observance of the standards set out for these centres by Government (BIS and NABL).</li> <li>• may take appropriate action including levy of penalties against the non-compliant CPTCs and refiners.</li> <li>• may put in place appropriate grievance redress mechanism regarding any depositor's complaints against the CPTCs.</li> </ul> </li> <li>2. Complaints against the designated banks regarding any discrepancy in issuance of receipts and deposit certificates, redemption of deposits, payment of interest will be handled first by the bank's grievance redress process and then by the Banking Ombudsman of RBI.</li> </ol>
<b>Risk Management</b>	<p>The designated banks should put in place suitable risk management mechanisms including appropriate limits to manage the risk arising from gold price movements in</p>

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	<p>respect of their net exposure to gold.</p> <p>The designated banks are allowed to access the International Exchanges, London Bullion Market Association or make use of Over-the-counter contracts to hedge exposures to bullion prices subject to the guidelines issued by RBI.</p>
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## **Other Liabilities and Provisions**

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14.01 This heading may include numerous accounts not included under other specific liability heading. Typically, a bank may maintain a number of individual accounts for control purposes and such accounts appear as “Other Liabilities” on the balance sheet. “Other Liabilities” and “Provisions” frequently include the following:

- Bills payable
- Inter-Office Adjustments (Net)
- Interest accrued
- Others (including provisions)

### **Bills Payable**

14.02 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.

14.03 The important aspect to look for in ‘bills payable’ is; whether there are material movements in the older balances. The reasonableness of such transactions should be verified.

### **Inter-office Adjustments**

14.04 The balance in inter-office adjustments account, if in credit, is to be shown under this head.

14.05 Inter-office transactions mostly take place at branches. The balances can be debit balance or credit balance in the balance sheet of the branches. Branches have a number of transactions amounting to large sums with the other branches and controlling office and hence it becomes very important to monitor the same. It is the responsibility of the bank to reconcile their transactions on a daily basis and keep a track on un-reconciled transactions.

14.06 The bank should first segregate the credit entries outstanding for more than 5 years in the inter-office account and transfer them to a separate Blocked Account which should be shown under ‘Other Liabilities & Provisions - Others’.

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14.07 While arriving at the net amount of inter-office transactions for inclusion here, the aggregate amount of Blocked Account should be excluded and only the amount representing the remaining credit entries should be netted against debit entries. Only net position of inter-office accounts, inland as well as foreign, should be shown here. For arriving at the net balance of inter-office adjustments all connected inter-office accounts should be aggregated and the net balance only will be shown, representing mostly items in transit and unadjusted items.

14.08 Following are the major transactions which occur between branches and Head office:

- a. Issue of remittance instruments like drafts/TTs/MTs on other branches.
- b. Payment of remittance instruments like drafts/TTs/MTs drawn by other branches.
- c. Payment to / receipts from other branches of the proceeds of instruments received/sent for collection /realization/clearing.
- d. Payments made under LCs of other branches.
- e. Cash sent to/received from other branches.
- f. Payment of instruments like gift cheques/ banker's cheques/ interest warrants/ dividend warrants/repurchase warrants/refund warrants / traveller's 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.
- g. Head office interest receivable and payable by the branches.
- h. Profit/loss transferred by the branch to head office.
- i. Government receipts and payments handled by the branch either as the nodal branch or as an agent of the nodal branch.
- j. Operations by the authorised branches on the bank's NOSTRO accounts.
- k. 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.
- l. Deposits into and withdrawal of money, by branches into currency chest maintained by another branch.
- m. Gold banking transactions at the branch on behalf of nodal branches.
- n. Transactions through NEFT, RTGS, NACH, UPI, etc.
- o. ATM transactions of the customer either at ATM linked with other branches or with merchant establishments.
- p. Internet based transactions other than inter-account transfers with the same branch.

- q. Credit card related transactions of the customers.
- r. Control accounts of Indian branches maintained with overseas branches of the bank.
- s. Capital funds with the overseas branches.
- t. Head Office balances with the overseas branches including subordinated debt lent to the overseas branches.
- u. GST transactions advise to nodal branches where GST remittance is made on behalf of other branches within their fold.

14.09 Following are the most common types of errors observed in inter branch transactions.

- Wrong identification of the nature of transaction.
- Recording of particulars in incorrect fields.
- Wrong accounting of bank charges, commission, etc.
- Errors in writing the amounts.
- Incorrect branch code numbers.
- Incorrect schedule numbers.
- Recording the same transaction twice.
- Difference between the closing and opening balances in successive daily statements.
- Squaring off the transaction by same amount without checking the transactions.
- Forced matched transactions.

14.10 Banks generally have a separate department to deal with the process of reconciliation of inter branch transactions. Hence reconciliation is not a responsibility at the branch level. As all the banks are on CBS and hence the inter branch entries are reconciled and adjusted by the system on a regular basis; but the auditor has to scrutinise the old credit entries and check the nature of such entries and confirm whether the same should remain in branch books or should be transferred to Head Office as per the policy of the bank. It is also observed that sometimes there are system generated entries posted under this head. The auditor in such cases should ascertain the details of such entries and find out if the necessary ticket has been raised by the branch with the IT department for an appropriate resolution.

### **Interest Accrued**

14.11 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'.

Further it includes provisioning of interest on matured term deposits.

Interest accruing on all deposits, whether payment is due or not, should be treated as a liability.

### **Rebate on Bills Discounted**

14.12 The bank collects interest in advance on usance bills discounted normally ranging over a period of 90 to 180 days. Interest collected by the branch is credited to 'Rebate on bills Discounted'. The system calculates the interest daily and debits the head. Sometimes the balance outstanding under this head is not matching with the balance of loan outstanding under 'Bills Negotiated under LC' or Bill purchased and discounting.

Where due to merger of the branches, the interest was not reversed on timely basis or period of bills was not correctly entered in the system, the auditor should review the outstanding balance of rebate on bills discounted account, balance of loan under bills discounting and unexpired period of bills outstanding. The branch can provide a report of outstanding interest on each bill.

### **Others (Including Provisions)**

14.13 At branch level, this includes only the expense provisions at the branch.

### **Audit Procedure**

14.14 The auditor should obtain bank's breakdown of accounts included under the above heading, and if it has relation to other areas then the person auditing this area must ensure that auditor in charge of those areas receive the necessary information.

14.15 The major emphasis in auditing this area should be the adequacy of the controls and procedures employed by the bank in promptly recording the proper amount of liability and evaluating the effectiveness and efficiency of the processes. The supervisory process adopted by the bank should be thoroughly reviewed as lack of attention can create an environment of misuse either intentionally or inadvertently. In a number of cases such accounts are used for

concealing shortages. For example, fraudulent entries in inter branch accounts are used to roll over every other date to avoid shortages of any amount and can be effectively concealed for indefinite period.

14.16 The auditors should note that unlike “Other Assets”, accounts under the head “Other Liabilities” with even small balances may be significant as review may disclose only a recoded liability but does not aid in determining whether such liabilities are accurate. Therefore, an depth review of source documents or other accounts from which the liability arose including a review of information flow relating to such accounts within the framework of approved policies, procedures, circulars would be very important, and might reveal a major understatement or concealment. The review should also determine that contractual liabilities are recorded in accordance with the agreed terms and conditions.

#### **LFAR REPORTING**

##### ***Bill Payable, Sundry Deposits, etc.***

14.17 The number of items and the aggregate amount of outstanding items pending for one year or more be obtained from the branch and reported under appropriate heads. Give details thereof as under:

<b>Year</b>	<b>No. of items</b>	<b>Amount (Rs.)</b>	<b>Remarks</b>

The auditor should obtain details of outstanding entries and match the same with GL balances and report in the prescribed format.

Does your test check indicate any unusual items or material withdrawals or debits in these accounts? If so, give details thereof.

As mentioned above, the balances under this head are susceptible to higher risks if movement in the old balances is seen. The auditor should check if the transactions are genuine.

On sample basis the auditor shall conduct scrutiny of such accounts to verify whether the transactions in accounts are for the purpose for which account is opened. Any outlier/ unusual transaction should be inquired and reported. If MoC is required, the same should be passed.

## Contingent Liabilities and Bills for Collection

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### Introduction

15.01 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 the 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 the 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 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, requires creation of a provision in the financial statements (*Members may refer to Accounting Standard (AS) 29, "Provisions, Contingent Liabilities and Contingent Assets"*).

15.02 The RBI has been issuing directions/guidelines from time to time to cover the key aspects relating to contingent liabilities in the banks; and reference may, in particular, be made to the following circulars /master directions issued by the RBI.

- (i) RBI/2021-22/121 DOR.STR.REC.66/13.07.010/2021-22 dated April 1, 2022 issued to all scheduled commercial banks (excluding Payment Banks and RRBs) Master Circular on "Guarantees and Co-acceptances".

This is a statutory directive issued by the RBI in exercise of the powers conferred by the Banking Regulation Act, 1949 and covers directions to the commercial banks in the matter of conduct of guarantee business, including prescriptions to be followed while issuing guarantees, restrictions placed on certain types of guarantees, precautions to be taken to avoid the risk of frauds etc.



- (ii) Master Direction No. RBI/FED/2018-19/67 FED No. 5/2018-19 dated March 26, 2019 (Updated as on September 30, 2022) on “External Commercial Borrowings, Trade Credits and Structured Obligations”, which contains certain guidelines and restrictions on guarantees being issued on certain types of borrowings, including ECBs and Trade Credits.
- (iii) Circular no. RBI/2017-18/139 A.P. (DIR Series) Circular No. 20 dated March 13, 2018 on Discontinuation of Letter of Undertaking (LOUs) and Letter of Comfort (LOCs) for Trade credit - issued to all Authorised Dealers Category-I Banks.
- (iv) Circular no. RBI/2013-14/614 DBOD.No.DEAF Cell.BC.114 /30.01 .002 /2013-14 dated May 27, 2014 on The Depositor Education and Awareness Fund Scheme, 2014 –Section 26A of Banking Regulation Act, 1949-Operational Guidelines.

### **Letters of Credit, Bank Guarantees and Letters of Comfort, Letters of Undertaking<sup>29</sup>**

15.03 Letters of credit, bank guarantees, letters of comfort, letter of undertaking are contingent liabilities, which need to be disclosed as “off Balance Sheet” items. The procedure for verification of these items is discussed under Chapter 11, “Reporting for Advances” of Section B of the Guidance Note on Audit of Banks (2023 Edition).

#### **Letters of Credit**

15.04 Letters of credit (LCs) are documents under which the bank agrees to meet the obligations of its customers (usually for purchases/imports).

15.05 Letters of credit are normally issued on certain terms, conditions and stipulations, against guarantees of the customers and may be with/without security/margin as permitted by the laid down policy of the bank. Generally the bank retains, as a percentage of the value of the LC, a cash margin or holds lien marked term deposit receipt(s) or marks a lien on the account of the customers, to enable it to appropriate the same in the event of a default by the customer in honouring its commitment to the bank. Upon honouring the commitment and making payment to the other bank/party, the amount is debited to the bank's customer and treated as an advance; and the related margin/security is released/adjusted depending upon the conditions of the LC.

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<sup>29</sup> The RBI has issued circular no. RBI/2017-18/139 A. P. (DIR Series) circular no. 20 dated March 13, 2018 on “Discontinuance of Letters of Undertaking (LoUs) and Letters of Comfort (LoCs) for Trade Credits”, to discontinue the practice of issuance of LoUs/ LoCs for Trade Credits for imports into India by AD Category –I banks with immediate effect.

15.06 Such Letters of credit may be:

- i. clean;
- ii. documentary - where bills drawn are accompanied by documents of title to goods;
- iii. revocable - entirely at the pleasure of the bank at any time prior to shipment of goods;
- iv. irrevocable or confirmed;
- v. for single transaction or bill-covering purchases/ imports;
- vi. "revolving" to cover a series of transactions within certain limits/value, sometimes restrictions being placed on the limit of each bill.

### **Guarantees**

15.07 Guarantees are issued on behalf of customers as part of the agency functions of the bank, and for which the bank charges commission. There is no outlay of the bank's funds till there is a default on the part of the bank's customer, giving rise to a claim from any claimant/beneficiary in whose favour guarantee is issued.

15.08 Guarantees issued may be specific to particular transactions or a series of transactions involving assumption of obligations upto certain monetary limits. Guarantees are issued for certain specified time limits and have a claim obligation within the currency/ tenure/ validity period of the guarantee and a specified time limit within which claims can be made by the claimant/beneficiary.

15.09 Such obligations are assumed by issuance of a guarantee document which is expected to be issued only on security paper stationery, kept under dual control, and normally signed on behalf of the bank, only by the authorised signatories; and the bank normally obtains as security, either a cash margin, generally based on a percentage of the obligation, or holds lien marked fixed deposits and in some cases, the bank marks a lien on the account of the customer, where the laid down policy so permits. It also obtains counter-guarantee of a third party, to be invoked in case the obligation devolves.

15.10 Entries are imperative in the guarantee register/records for each guarantee issued.

15.11 The entries are expected to be reversed upon expiry of the guarantee/claim period and when effectively the obligations of the bank cease. The management is duty bound to ensure that no contingent liability is carried in the books/records of the bank where the obligations under the guarantee have ceased, whether or not the original guarantee documents are formally returned to the bank for cancellation.

15.12 It is imperative for the auditor that internal control for recording of guarantees is looked into, to ensure that entries are made immediately upon assumption of guarantee obligations.

### **Letter of Comfort (LoC) / Letter of Undertaking (LoU)**

15.13 Banks agree to accept/ discharge the customers' contracted liability on due dates and assume obligations and give undertakings/assurance through execution of documents in the form of letters of comfort or letters of Undertaking. The distinction between these needs to be understood.

15.14 Letter of Comfort (LoC) in banking parlance is referred to a document which is provided by a person, typically an affiliate (such as the holding / parent company) of the borrower (LoC provider) assuring the financial soundness of the borrower to repay its debt(s) and applies generally to obligations between branches or subsidiaries of the bank. These require lower provisioning under the Basel III Norms.

15.15 Letter of undertaking, involves a contract to perform the stated promise, or to discharge the liability, of a third person in case of his default and is used in inter-bank obligations. Obligations comprising letters of undertaking, normally used for trade credits, are disclosed in the Notes in the manner required (by RBI), in foreign currency and Rupee equivalent, that should be at the year-end rates of exchange.

15.16 These attract higher provisioning under the Basel III Norms.

### **Liability on Partly Paid Investments**

15.17 The investments portfolio is generally handled at the Head Office and if the bank holds any partly paid Investments (shares, debentures, etc.), the auditor concerned to whom the related work is allocated, needs to examine the related books and records to verify the amount comprising the contingent liability by way of uncalled /unpaid amounts in respect of the investments that are not fully paid up; and ensure that the management has made appropriate disclosure thereof as at the year end, in the balance sheet of the bank.

### **Liability on Account of Outstanding Forward Exchange Contracts and Derivatives Contract**

15.18 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. The treasury of the bank enters into Over The Counter (OTC) derivatives

contracts like Interest Rate Swap, Cross currency Swaps, etc. Similarly, the bank may also be transacting in derivative contracts including forward exchange contracts on exchanges, which are known as exchange traded derivatives. The notional amount of these contracts should be disclosed either separately or under this head as separate sub head. The auditor should verify that notional value of that leg of the contract where the bank is under obligation to deliver is only considered as liability and therefore receivable leg of the contract should not be included in the liability.

15.19 The general principles to be observed for forward foreign exchange contracts are covered in detail in Master Direction No. RBI/FMRD/2016-17/31 FMRD No. 1/2016-17 dated July 5, 2016 (updated as on September 1, 2020) on "Risk Management and Inter-Bank Dealings".

### **Guarantees Given on Behalf of Constituents**

15.20 The amount of all guarantees outstanding on the balance sheet is to be shown under the above head after deducting therefrom cash margin, if any.

15.21 The guarantees may include those that have expired, where the claim period has expired and where the obligations have ceased. Where the bank's obligations have legally ceased, these cannot be included on the ground that the related guarantee documents have not been formally returned to the bank and that this verification needs to be done at the branch level by the auditor. The auditors need to be satisfied that appropriate instructions have been issued by management to the branches to ensure due care in compiling and disclosing this information.

### **Acceptances, Endorsements and Other Obligations**

15.22 This item includes the following balances:

- (a) Letters of credit opened by the bank on behalf of its customers.
- (b) Letters of comfort issued by the bank on behalf of its customers for availing buyers' credit facilities.
- (c) Bills drawn by the bank's customers and accepted or endorsed by the bank (to provide security to the payees) whether drawn under letters of credit or letters of comfort.

15.23 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 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***

15.24 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.

15.25 The auditor should verify whether the management has disclosed as a contingent liability, the total of all outstanding acceptances and endorsements at the end of the year, as reduced by the cash margin.

**Other Items for Which the Bank is Contingently Liable**

15.26 As per Annexure II to RBI Master Direction RBI/DOR/2021-22/83 DOR.ACC. REC.No.45/21.04.018/2021-22 dated August 30, 2021 (Updated as on February 20, 2023) on “Financial Statements - Presentation and Disclosures” 'Other items for which the bank is contingently liable' will include 'Arrears of cumulative dividends, bills rediscounted, commitments of underwriting contracts, estimated amount of contracts remaining to be executed on capital account and not provided for etc.

15.27 Underwriting involves an agreement by the bank to subscribe to the shares or debentures or issue of other similar securities which remain unsubscribed in a public issue, in consideration of underwriting commission. It also includes commitment made to participate in the venture capital fund or private equity fund or AIF or similar funds, which has not been called up till the balance sheet date.

15.28 Rediscounting is generally done with the RBI, 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. On the due date(s), the rediscounting entries are reversed, including in respect of the dishonour of the bills.

15.29 Tax demands, which have been disputed are in the nature of contingent liability should be disclosed, unless the same are considered as “remote” as per *Accounting Standard (AS) 29, “Provisions, Contingent Liabilities and Contingent Assets”*). 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 part 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".

15.30 The liability involved in cases lodged against the bank in various courts including consumer dispute redressal forums, Banking Ombudsman as per the RBI and any other Authority are in the nature of contingent liability and should be disclosed.

### **Depositor Education and Awareness Fund**

15.31 As per RBI Circular No. RBI/2013-14/ 614 DBOD.No.DEAF Cell.BC.114/ 30.01.002/ 2013-14 dated May 27, 2014 on "The Depositor Education and Awareness Fund Scheme, 2014 – Section 26A of Banking Regulation Act, 1949- Operational Guidelines", all such unclaimed liabilities (where the amount due has been transferred to DEAF) may be reflected as "Contingent Liability – Others, items for which the bank is contingently liable" under Schedule 12 of the annual financial statements.

15.32 Since the amounts could be claimed by the depositors together with interest to be compensated by the DEAF, it is appropriate to include the same as a contingent liability, by indicating that the claims, if any, are fully recoverable from the said Fund.

### **Bills for Collection**

15.33 Bills held by a bank for collection on behalf of its customers are to be shown by way of a footnote to the balance sheet.

15.34 These bills are generally *hundies* or bills of exchange accompanied by documents of title to goods. Frequently, bills of exchange are not 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.

15.35 Bills for collection do not involve an outlay of the bank's funds and bank has no financial liability in respect of such bills, the proceeds of which are to be credited to the customer's account if and when collected. The banks earn commission for rendering service relating to collection of bills for their customers. Bills not collected are normally returned to the customers, and only current outstanding bills as at the year end are to be shown as 'bills for collection' in the financial statements of the branches where such activity takes place. Thus, in the normal course, such bills are expected to collect on behalf of customers in a time

bound manner, and entries in respect thereof in the records cannot remain outstanding for long periods of time, beyond their normal dates of collection. Reasons for unwarranted retention of entries and their inclusion /disclosure in the Notes, need to be enquired into, to ensure that the aggregate amount of such bills is not overstated.

15.36 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.

15.37 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.

15.38 Bills received by the bank from its outstation branches and agents, etc. for collection is called Inward Bills for Collection.

15.39 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 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**

15.40 Through Master Circular No. RBI/2022-23/10 DOR.STR.REC.8/13.07.010/2022-23 dated April 01, 2022 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 the 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**

15.41 In respect of contingent liabilities, the auditor is primarily concerned with seeking reasonable assurance that all contingent liabilities are identified, accounted and properly valued. The audit procedures will generally be as under:

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- (a) The auditor should verify whether there exists a system whereby the non-fund-based facilities are extended only to their regular constituents, etc. in line with the bank's policy. There should be a documented policy that lays down the capturing of the liability based on a system generated number that can be tracked.
- (b) The auditor should 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 and appropriate checks and balances are in place.
- (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) The auditor should 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. There should also be controls to ensure these entries are not deleted or cancelled subsequently.
- (e) The auditor should perform 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) The auditor should 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) The auditor should review whether comfort letters issued by the bank have been considered for disclosure of contingent liabilities.
- (h) The auditor should ascertain the process followed to restate the contingent liabilities denominated in foreign currency into the reporting currency as at the balance sheet date. It is preferable to have automation in this regard to the extent possible.
- (i) While testing the adequacy of internal control procedure, the auditor should test whether there exists a proper system of numbering of such transactions for performing completeness test and whether there exists a proper system over recording of such transactions in straight through processing (STP). In case the STP has not been implemented or controls



over STP are not adequate, the auditor should perform such additional procedure as may be appropriate in the circumstances so that the risk of material misstatement is adequately addressed.

With banks using a variety of different programs for different needs, ensuring all the systems involved in the STP process work together and transfer information accurately and smoothly without delay is often the biggest challenge when implementing STP. Depending on the information being relayed, many different programmes may be required to help transfer the data and information correctly. Gaps in integrating all of those different programs to work together in one seamless structure can result in risk of misstatement and frauds.

In whichever branch SWIFT is installed, existence and adequacy of the internal control system and procedures need to be kept in view. It needs to be emphasised that for a fraud to be perpetrated in SWIFT messages/transactions, one would have to play the role of all four—maker, checker, verifier and the receiver of the transactional message from its origination to conclusion, which would be in breach of internal control system. Control systems would be robust where the outward messages, expected to be in pre-serially numbered and sequentially arranged forms on special stationery, are independently handled and authenticated at each stage before being transmitted under the signatures of the authorised officials. Similarly the laid down controls/procedure need to be strictly followed for the inward SWIFT messages. It needs to be ensured that the messages are linked to the CBS system; and at frequent short intervals, the related transactions and their closure need to be checked, particularly overdue entries outstanding in the accounts of the customers. The verification of such transactions and balances should also be extensively covered by internal inspection and concurrent audit.

### **SWIFT**

Founded in 1973 as a member-owned cooperative society, initially with 239 banks in 15 countries, and called Society for Worldwide Inter-bank Financial Telecommunications (SWIFT), it considerably expanded its spread and operations, to provide services not only to banks, but also to Brokerage Institutes and Trading Houses, Securities Dealers, Asset Management Companies, Clearing Houses, Depositories, Exchanges, Corporate Business Houses, Treasury Market Participants and Service Providers, Foreign Exchange and Money Brokers.

Recognised for its core business as a vast messaging network SWIFT is used by banks and other financial institutions, to quickly, accurately, and

securely send and receive information and instructions through a standardized system of codes, and has attained, and holds, a dominant position in the global processing of transactional messages for its members. In consideration of a one-time joining fee plus annual support charges, which vary by member classes, and for usage of services, SWIFT assigns to each such member, a unique code of 8, (going on to 11) characters (interchangeably called the Bank Identifier Code (BIC), SWIFT code, SWIFT ID, or ISO 9362 code). The characters represent the institution, country, location/city for the first 8 characters and the last three are used by the banks/institutions at their option to identify their branches etc.

- (j) 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)<sup>30</sup>. The period of guarantees is co-terminus with the period of credit reckoned from the date of shipment. The auditor also needs to examine as to whether contingent liability in respect of trade credits includes any amounts actually arranged and received by the bank from other banks in its NOSTRO Account(s) overseas, to discharge the financial commitment/obligation (of the bank's customer in India), in favour of such customer's overseas suppliers. The amounts so received are in the nature of funded obligations and intrinsically not of the nature of contingent obligations. On behalf of the bank's customer in India, guarantees provided to the customer's overseas supplier for imports into India, where no funds are transferred in discharge of the (customer's) liability, the same is in the nature of a contingent liability; and the contingent liability would cease on actual payment on the due date.
- (k) The auditor should verify whether the bank has extended any non-fund facility or additional/*ad hoc* credit facilities to persons other than its regular customers. In such cases, the auditor should examine the existence of concurrence of existing bankers of such borrowers and enquire regarding financial position of those customers. The auditor should also verify whether the required margin as per the sanction letter is invariably kept by the branch.
- (l) If the bank is using separate application for communicating, transacting, executing any co-acceptance / guarantees, the auditor should verify the

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<sup>30</sup> In terms of the Master Direction No. RBI/FED/2018-19/67 FED Master Direction No.5/2018-19 dated March 26, 2019 (Updated as on September 30, 2022) on External Commercial Borrowings, Trade Credits and Structured Obligations, any trade credit extended for a period of three years and above comes under the category of external commercial borrowings.

interface controls in respect of these applications and CBS. If the system-based interface is not available and manual intervention is involved then the auditor should verify the controls put in place by the bank for confirming completeness and correctness of transactions.

- (m) The auditor may also perform analytical procedure by analysing the commission/fee earned from these transactions *vis a vis* aggregate transactions during the period.
- (n) The auditor should obtain representation from the management to the effect that:
  - (i) all 'off-balance sheet' transactions have been accounted in the books of accounts as and when such transaction has taken place;
  - (ii) all 'off balance sheet' transactions have been entered into after following due procedure laid down;
  - (iii) all 'off balance sheet' transactions are supported by the underlying documents;
  - (iv) all year end contingent liabilities have been disclosed;
  - (v) the disclosed contingent liabilities do not include any crystallised liabilities which are of the nature of loss/ expense and which, therefore, require creation of a provision/adjustment in the financial statements; In case of such crystallized liabilities check whether they have been debited to the operative account of the borrower and not to a separate account. Further if one or few letters of credit have devolved or guarantees are invoked, whether a provision needs to be made for the balance outstanding letters of credit or guarantees if the financial conditions indicate that the balance would also crystallize on the respective due dates.
  - (vi) the estimated amounts of financial effect of the contingent liabilities are based on the best estimates in terms of Accounting Standard 29, including consideration of the possibility of any reimbursement;
  - (vii) in case of guarantees issued on behalf of the bank's Directors, the bank has taken appropriate steps to ensure that adequate and effective arrangements have been made so that the commitments would be met out of the party's own resources and that the bank will not be called upon to grant any loan or advances to meet the liability consequent upon the invocation of the said guarantee(s) and that no violation of Section 20 of the Banking Regulation Act, 1949 has arisen on account of such guarantee; and

- (viii) 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.

15.42 The specific procedures to be employed by the auditor to verify various items of contingent liabilities are discussed in the following paragraphs.

***Claims against the Bank Not Acknowledged as Debts***

15.43 Information relating to claims against the bank is recorded at each branch as also at the Head Office. Such information would include claims made by staff (particularly those under suspension/dismissal), constituents (e.g. for dishonour of cheques, frauds in customers' accounts due to negligence etc.), and any other matter in litigation which are contested by the bank but not acknowledged as a liability. Such claims may arise from Govt. bodies/authorities/others either under a statute or through litigation/arbitration etc. At the Head Office, the Legal Department would have a record of such claims, both originating at the Branches as well as at the Head Office.

15.44 The auditor concerned should seek information from the management as to the year end status of claims outstanding against the branch/ bank that are not acknowledged as debts. To begin with, an enquiry needs to be made as to the reasons for deletion during the year, of any such outstanding claims which were disclosed as at the previous year end, to ensure that the deletion thereof was justified based on facts and evidence. At the Head Office, reference needs to be made to the minutes of the Board/Committees, the records maintained by the Legal Department, relating to matters in litigation/arbitration, particularly those relating to notices served on the bank by the Central/State Government and local authorities/bodies. A review of subsequent events would also provide evidence about the completeness and valuation of claims. Based on the circumstances of each case and available evidence, the auditor should verify whether the item is likely to remain a claim against the bank not acknowledged as debt or it is likely to be a liability requiring provisioning. The auditor may ask the bank for an opinion from legal experts in respect of crystallisation of claim against the bank. Appropriate discussions with the legal team / experts should be held for high value amounts and opinions should not be accepted per se. The credentials of the expert giving the opinion should also be duly factored in while accepting the opinion. The auditor should use professional judgement to determine as to as to whether a claim needs to be provided or can be regarded as a contingent liability.

***Liability on Account of Outstanding Forward Exchange Contracts and Derivatives Contracts***

15.45 *Forward Exchange Contract:* The auditor may verify the outstanding forward exchange contracts with the statement of outstanding forward exchange contracts generated from the bank's computerised accounting system or manual register maintained by the branch. The auditor may physically verify the underlying documents including confirmations from merchants to test the existence of such outstanding contracts.

15.46 *Derivatives Contract:* The auditor may verify outstanding derivatives contracts (options, cross currency swaps, interest rate swaps, etc.) with report generated from treasury application. The audit procedure mentioned below may be used for verification of derivative contracts:

- The auditor may also verify the outstanding margin *vis a vis* the outstanding forward foreign exchange contracts/derivative contracts with reference to margin, if any, stipulated in terms of sanction.
- The auditor should verify the compliance related to margin collected in terms of RBI circular no. 10 issued vide RBI/2020-21/98 A. P. (DIR Series) dated February 15, 2021 on Margin for Derivative Contract.
- The auditor may also perform analytical procedure by analysing the commission/fee earned from these transactions *vis a vis* aggregate transactions during the period.

***Guarantees Given on Behalf of Constituents***

15.47 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.

15.48 The auditor should ascertain whether there are adequate controls over custody of unused guarantee forms, if the bank has a process of issue of guarantees in pre-printed forms, whether these are kept under the custody of a responsible official, whether a proper record is kept of forms issued, whether stock of forms is periodically verified and reconciled with the book records, etc.

15.49 The auditor should examine the guarantee register/statements generated from the computerised system to seek evidence whether the prescribed procedure of marking off the expired guarantees is being followed or not.

15.50 The auditor should check the relevant guarantee registers/statements generated from the computerised system 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 where claim period is also over are not included in this head. The treatment of a guarantee as expired should be strictly in sync with the bank policy in this regard. 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. The auditor should examine as to whether adjustments/provisions as required have been made in respect of contingent obligations that have ceased.

15.51 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 up to the balance sheet date which are yet to be recorded and that there are no obligations that have intrinsically ceased, which are included as contingent liabilities as on the balance sheet date.

15.52 In case of counter guarantees issued in favour of foreign banks for guaranteeing the obligation of bank's constituents in India, generally these guarantees are termed as "stand by letter of credit" or "letter of credit". These guarantees, standby letters of credit, letters of credit are transmitted through SWIFT messages, which has standard formats of different types of transactions. The auditor may verify the SWIFT messages to test such transactions.

15.53 The auditor should verify whether proper guidelines have been laid down for classification of guarantees as performance or financial and whether such guidelines have been scrupulously followed, considering that commission and margin and the risk weights are different for performance and financial guarantees.

***Acceptances, Endorsements and Other Obligations***

15.54 The auditor should evaluate the adequacy of internal controls over issuance of letters of credit and over custody of unused LC forms, if the bank has a process of issue of LCs in pre-printed forms, in the same manner as in the case of guarantees.

15.55 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 the extinguishment of obligations based on utilisation by the customer.

*Other Acceptances and Endorsements*

15.56 The auditor should study the arrangements made by the bank with its customers. He should verify the amounts of the bills with the register maintained/statements generated from computerised system 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.

15.57 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. The audit procedure applicable for auditing bank guarantees as mentioned above, mutatis mutandis, applies to the audit of the acceptances, endorsements and other obligations.

*Common Procedures*

15.58 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 balance sheet date, which are yet to be recorded.

15.59 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, the auditor should assess whether a provision is required to be made in the accounts for the bank's obligation, which should be determined after taking into account the probable recovery from the customer.

15.60 Various tests need to be carried out to ensure that IT applications have resulted in consistent and reliable system for inputting, processing and generation of output of data as required under Jilani Committee's recommendations at the branch level.

15.61 Verification is to be done for existence of the internal control as to whether bank guarantees/LCs are issued in security forms serially numbered, under two officers' signatures of the bank -above certain cut off point in triplicate, binding on beneficiary to seek confirmation of Controlling Office (incorporation of suitable condition in the document) etc., and unused security stationery are to be kept under joint custody as required under Ghosh Committee's recommendations (Relating to frauds and malpractices in banks to be implemented at the Branch level).

15.62 Verification is to be done whether all bank guarantees renewed/

extended after the original due dates - including extension of due date of letter of credits are duly reflected in CBS, as this is one fraud prone area and possibility of heavy leakage of income exists in the absence of proper validation in the system.

***Other Items for Which the Bank is Contingently Liable***

15.63 The auditor should examine whether commitments under all outstanding underwriting contracts have been disclosed as contingent liabilities. Similarly, the auditor should also examine whether commitment made to participate in the venture capital fund or private equity fund or AIF or similar funds, which has not been called up or unpaid till the balance sheet date have been disclosed as contingent liabilities. For this purpose, the auditor should examine the terms and conditions of the relevant contracts.

15.64 Rediscounting is generally done with the RBI or other financial institutions or, in the case of foreign bills, with foreign banks. If the drawer dishonours the bill, the rediscounting bank has a right to proceed against the bank as an endorser of the bill. The auditor may check this item from the register of bills rediscounted maintained by the branch. He should satisfy himself that all the bills are properly marked off on payment at the time of maturity.

15.65 The auditor should check whether any liability is involved in cases lodged against the bank.

15.66 The auditor may verify other items under this head in the same manner as in case of other entities.

**Bills for Collection**

15.67 The auditor should examine whether the bills drawn on other branches of the bank are not included in bills for collection.

15.68 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.

15.69 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.

15.70 Regarding 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. Necessary conversions should be done in case of bills sent for collection in foreign currency.

15.71 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. In case the bill is returned unpaid the auditor should also examine whether the prescribed charges have accrued in the accounts for recovery from the customer on whose behalf the bill was to be collected.

#### ***Co-acceptance of Bills***

15.72 The auditor should examine whether the bank has instituted adequate internal control system to comply with the safeguards as set out by the RBI vide Master Circular No. RBI/2021-22/121 DOR.STR.REC.66/13.07.010/ 2021-22 dated November 9, 2021 on "Guarantees and Co-acceptances" and ascertain whether such system, *inter alia*, captures all such items, appropriately records the same and also determines all the material items forming contingent liabilities, whether any item needs a provision in the books.

### **Disclosures**

#### **Balance Sheet Disclosure<sup>31</sup>**

15.73 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

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<sup>31</sup> Refer Master Direction No. RBI/DOR/2021-22/83 DOR.ACC.REC.No.45/21.04.018/2021-22 dated August 30, 2021 (Updated as on February 20, 2023) on "Financial Statements - Presentation and Disclosures".

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- (a) In India
- (b) Outside India

V. Acceptances, endorsements and other obligations<sup>32</sup>

VI. Other items for which the bank is contingently liable<sup>33</sup>

(b) *Bills for Collection*

15.74 The auditor should report in the LFAR the list of major items of the contingent liabilities (other than constituent's liabilities such as guarantees, letter of credit, acceptances, endorsements, etc.) not acknowledged by the branch.

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<sup>32</sup>This item will include letters of credit and bills accepted by the bank on behalf of its customers.

<sup>33</sup>This item will include – (1) Arrears of cumulative dividends, bills rediscounted, commitments of underwriting contracts, estimated amount of contracts remaining to be executed on capital account and not provided for etc. are to be included here.

(2) All unclaimed liabilities (where amount due has been transferred to the Depositors Education and Awareness Fund established under the Depositor Education and Awareness Fund Scheme 2014) shall be shown here.

(3) The undrawn partial credit enhancement facilities shall be shown here.

(4) When Issued ('WI') securities should be recorded in books as an off-balance-sheet item till issue of the security. The off-balance-sheet net position in the 'WI' market should be marked to market scrip-wise on daily basis at the day's closing price of the 'WI' security. In case the price of the 'WI' security is not available, the value of the underlying security determined as per extant regulations may be used instead. Depreciation, if any, should be provided for and appreciation, if any, should be ignored. On delivery, the underlying security may be classified in any of the three categories, viz; 'Held to Maturity', 'Available for Sale' or 'Held for Trading', depending upon the intent of holding, at the contracted price.

## Profit and Loss Account

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16.01 Section 29(1) of the Banking Regulation Act, 1949, requires the preparation of profit and loss account in Form B of the Third Schedule to the Act or as near thereto as the circumstances admit. This Section is applicable to Banking Companies, Nationalised Banks, State Bank of India and its subsidiaries, and Regional Rural Banks.

16.02 The RBI Master Direction No. RBI/DOR/2021-22/83 DOR.ACC.REC.No.45/ 21.04.018/2021-22 August 30, 2021 (Updated as on February 20, 2023) on “Reserve Bank of India (Financial Statements - Presentation and Disclosures) Directions 2021” requires the presentation and disclosures of profit and loss account in Form B of Annexure I (Given as Annexure I to this Chapter).

### Notes and Instructions for Compilation of Profit and Loss Account

16.03 The general instructions for the compilation of balance sheet, and profit and loss account for Commercial Banks are specified in Part A of Annexure II of the above said Master Direction. Commercial Banks shall ensure strict compliance with the Accounting Standards notified under the Companies (Accounting Standards) Rules, 2021, as amended from time to time, subject to Directions/Guidelines issued by the RBI. Part B of Annexure II of the above said Master Direction provides guidance with respect to relevant issues in the application of certain Accounting Standards for Commercial Banks. These shall be applicable *mutatis mutandis* to UCBs, unless stated otherwise in the said Annexure. Annexure II of this Chapter specifies general instructions for the compilation of profit and loss account for Commercial Banks.

### Disclosure in Financial Statements – Notes to Accounts

16.04 Banks shall disclose information as specified in Annexure III of the above said Master Directions, in the notes to accounts of the financial statements including profit and loss account. These disclosures are intended only to supplement and not to replace disclosure requirements under other laws, regulations, or accounting and financial reporting standards. More comprehensive disclosures than the minimum required under these Directions are encouraged, especially if such disclosures significantly aid in the understanding of the financial position and performance.

## Disclosures

16.05 The profit and loss account as set out in Form B, has four broad heads (Refer Annexure I to this Chapter)

- Income
- Expenditure
- Profit/ Loss
- Appropriations

The information to be provided under each of the above heads have also been specified in the Schedule. It would be pertinent to note that knowledge of the bank's accounting policies is of utmost importance before verifying the items within the profit and loss account. The auditor should make enquiries with the management to ascertain whether there have been any changes in the accounting policies and also review the closing circulars issued by the controlling authorities of the bank.

The reporting requirement in LFAR regarding income is as under:

***“Has the test checking of interest/discount/ commission/ fees etc. revealed excess/short credit of a material amount? If so, give details thereof.”***

## Background & Audit Approach

### Interest Earned

16.06 The following items are included under this head:

- 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 and penal 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. In modern day banking, the entries for interest income on advances are automatically generated through a batch process in the CBS system.
- Interest Income on Investments:* This will be generally dealt by treasury at the Head Office level so branch will not have any income under such head.
- Interest on Balances with RBI and Other Inter-bank Funds:* This will be generally dealt by treasury at the Head Office level so branch will not have any income under such head.

- (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**

16.07 Interest and dividend on investments are usually accounted for at the Treasury Branch of the bank or at the Head Office. Thus, a branch will not have any income under such head.

### **Other Income**

16.08 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.
  - (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 lockers.<sup>34</sup>
  - (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.

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<sup>34</sup> As per the Notes and Instructions for compilation of the profit and loss account, issued by the RBI, 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.

- (n) Income from rendering other services like custodian, demat, investment advisory, cash management and other fee based services.
- (ii) *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.
- (iii) *Profit on exchange transactions:* This includes revaluation gains/losses on forward exchange contracts and other derivative contracts, premium income/expenses on options, etc.
- (iv) Income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India.
- (v) Miscellaneous income.

***Profit/Loss on Revaluation of Property, Plant & Equipment (PPE)***

16.09 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 (Revised), *Property, Plant & Equipment*, relating to revaluation of fixed assets assume significance. According to the AS 10 (Revised), when a PPE 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.

16.10 From the above, it can be seen that as per AS 10 (Revised), 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***

16.11 This item includes profit (net of loss) on dealings in foreign exchange and will be applicable at treasury or selected foreign designated branches.

***Income Earned by Way of Dividends, etc. from Subsidiaries and Joint Ventures abroad/in India***

16.12 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***

16.13 This head generally includes the following items of income:

- (a) Recovery in written off accounts.
- (b) Rental income from bank's properties.
- (c) Security charges.
- (d) Insurance charges recoverable from customers.
- (e) Other income from carrying out other services like selling of gold coins etc.

16.14 The "Notes and Instructions for compilation of profit and loss account", issued by the RBI, require that in case any item under this head exceeds one percent of the total income, particulars thereof may be given in the notes.

**Audit Procedures**

**Income**

16.15 Refer Part B of Annexure II to RBI Master Direction No. RBI/DOR/2021-22/83 DOR.ACC.REC.No. 45/21.04.018/2021-22 dated August 30, 2021 (Updated as on February 20, 2023) on "Financial Statements – Presentation and Disclosures for Guidance on specific issues with respect to certain Accounting Standards".

16.16 Since the entire accounting in banks is done on the CBS, the auditor should plan the audit procedures based on controls testing. If the auditor is not satisfied with the controls in place for accounting and recording of items of income and expenses correctly, the auditor should resort to more of substantive checking of documents and records.

16.17 In case the auditor decides to adopt the control reliance strategy, the auditor should perform test of controls which mitigate the risk of what could go wrong.

16.18 As per Auditing Standards revenue is always considered as presumed risk of material mis-statements. The auditor therefore should plan the audit and test the controls considering mainly following assertions/attributes:

1. Occurrence – Whether recorded revenue is valid and accounting of revenue is not as per the terms of contract.

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2. Completeness – All revenue transactions are accounted for the period covered under audit.
3. Accuracy – The auditor needs to satisfy this assertion on the basis of system controls and risk assessment and substantive audits of samples derived.
4. Cut-off – Revenue is correctly accounted in case of period based contract.
5. Classification – Gross revenue and Net Revenue bifurcation have been correctly adhered to.
6. Disclosures – Verify the various disclosures requirements as per Banking Regulation Act, Accounting Standards and RBI directives.

#### **Interest Income**

16.19 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/ Interest Not Collected Account (INCA)/ Unrealised interest of previous year (UIPY) ' 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 report the following in LFAR:

***Has the branch compiled with the Income Recognition norms prescribed by RBI (The Auditor may refer to the instructions of the controlling authorities of the bank regarding charging of interest on non-performing assets).***

16.20 The auditor should check whether, in terms of the income recognition guidelines issued by the RBI, the bank has reversed interest accrued and credited to income account, in respect of an advance (including bills purchased and discounted) that becomes NPA during the year. Income in case of NPA account should be recognised only on cash basis as per circular no. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 dated April 1, 2022 on “Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances”. These norms are also applicable to Government guaranteed advances.

16.21 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.

16.22 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 monitors their business, analyse its credit portfolio and the interest income thereon.

16.23 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. This 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.

16.24 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 basis or quarterly basis.

16.25 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 analyze monthly/quarterly yields and document the reasons for the variances as per the expectation set. The auditor may 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.

16.26 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 about the following:

- (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.

The rate of interest is normally linked with marginal cost of funds based lending rate (MCLR)/ base rate of bank. But in case of consortium advances, the rate is normally linked with the MCLR/ base rate of lead bank or highest rate of member's bank. The rate of interest is reset from time to time. Normally the bank disables the field of fixed rate and links with its own MCLR/base rate. Whenever there is change in the MCLR base rate of the bank, the rate of interest is changed in such accounts also.

The auditor should check the sanction letter and find whether the rate of interest is reset as per sanction letter during the year. Special care should be given when there is change in MCLR of the bank.

- (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) Any interest subsidy received (or receivable) from RBI in respect of advances made at concessional rates of interest is correctly computed.
- (e) The moratorium period entered also affects the date of application of interest in the account and should therefore be verified on sample basis.

16.27 The auditor should also understand the process of accrual of interest income on credit card portfolio. Credit card account will be treated as an NPA if the minimum amount due as stated in statement is not fully paid within 90 days from the date of next statement.

16.28 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.

16.29 Identification of NPA on CIF level should also to be applied in cases of Credit Card NPA. The auditor should verify the same for the purpose of revenue recognition as well. The auditor should also satisfy that interest on non-performing assets has not been recognised unless realised.

**Interest recognition of book purchase from securitization**

16.30 In recent years, bank are commonly purchasing the retail loan pools of NBFCs for home loans, auto loans or other retails loans. In these transactions, the risk of the portfolio is shared between assignor and bank on the agreed percentage and the assignor will liable to pay interest to bank of the agreed ROI irrespective of the lending rate of assignor for the underlying advances. The auditor should review the sanction terms of these transactions and accordingly verify the accounting of interest and recognition of NPA by bank.

16.31 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.

16.32 The auditor should test 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.

16.33 In the case of bill discounting, interest income is received in advance and 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. Also for the overdue bills, the auditor should confirm whether the interest for the overdue period has been accrued by the system or is calculated manually by the branch.

16.34 The auditor should also understand the process of increase or decrease in Marginal Cost of funds based Lending Rate (MCLR) and process of updating in the system. The auditor should ascertain compliance with RBI guideline in respect of increase in tenor of retail loan due to increase in MCLR and also verify on sample basis as to whether the increase/decrease in base rate is effected in the system on the effective date.

16.35 Interest income includes interest accrued but not due on assets. 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. The auditor should verify the same.

16.36 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 agree with to the general ledger.

16.37 The auditor should examine whether interest has 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.

16.38 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 and their compliance by the bank. 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**

16.39 The 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 comfort. 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.

16.40 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 loans to corporates, 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 or non-utilisation 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.

16.41 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 and accounted is as

per the rate matrix. Interchange fees is earned from service providers namely Visa, Master, Amex cards 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.

16.42 The auditor should understand how the management monitors non-funded business and use their analysis for analytical procedures. The auditor should understand the relation of fee income with the business. For example, checking of 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 per the expectation set. Similarly the 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* interchange transactions etc.

16.43 The auditor may also compare the average fee income with the corresponding figures for the previous years and analyse any material differences.

16.44 The auditor should also check whether any fees or commission earned by the banks as a result of renegotiations or rescheduling of outstanding debts has, in terms of the income recognition guidelines issued by the RBI, have been recognised on accrual basis over the period covered by the renegotiated or rescheduled extension of credit.

16.45 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.

16.46 Fee on insurance referral is fast emerging as a major source of income for banks. In terms of RBI Master Circular No. DBR.No.FSD.BC 19/24.01.001/2015-16 dated July 1, 2015 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 said 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.

### **Income on Account of Commitment Charges**

16.47 Many times, it is noticed that the loan sanction letter contains a clause to the effect that if the borrower is not availing the full sanctioned limit in case of cash credit accounts, the bank is supposed to levy commitment charges on the unavailed portion of the loan which is usually recognised as income of the period in which the same is realised by the bank. The auditor has to ensure that the same is accounted for on accrual basis so that the income on this account is not understated.

### **Expenses**

16.48 Expenditure is to be shown under three broad heads: “Interest Expended”, “Operating Expenses”, and “Provisions & Contingencies”.

The auditor should report the following in LFAR:

***Has the test check of interest on deposits revealed any excess/short debit of material amount? If so, give details thereof.***

### **Interest Expended**

16.49 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. Usually, the rates of term deposits of banks are amended from time to time by the ALCO or the Board. The auditor has to ensure correct feeding of rates at correct dates and no unauthorized amendments to these rates. The process of verification by bank officials and concurrent auditors / internal inspections in this regard should also be noted.
- (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/ refinance from financial institutions. All other payments like interest on participation certificates, penal interest paid, etc. may also be included here.

16.50 RBI Master Direction No. RBI/DBR/2015-16/19 DBR.Dir.No.84/13.03.00/2015-16 dated March 03, 2016 (Updated as on September 16, 2022) on "Reserve Bank of India (Interest Rate on Deposits) Directions, 2016", contains the 'Interest Rate Framework'. The RBI has deregulated the savings bank deposit interest rate. In other words, the banks are 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) has been obtained by the bank while fixing interest rates on such deposits.

16.51 The auditor should review the circulars or guidelines issued by the controlling authorities of the Bank to identify the changes in the interest rates during the year.

16.52 The RBI has also deregulated the interest rates on Non Resident (External) Rupee Deposit Accounts 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 that offered 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 the 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.

16.53 The RBI has consolidated instructions pertaining to FCNR(B) deposits by banks. Specific consideration should be given to the ceiling on interest rates, 360 days to a year basis for interest payment, rounding off of interest etc. Recurring deposits should not be accepted under the FCNR (B) scheme.

Interest on FCNR (B) deposits should be calculated and paid at intervals of 180 days each and thereafter for the remaining actual number of days. However, the depositor will have the option to receive the compounded interest on maturity.

***Interest on Deposits***

16.54 The auditor may assess the overall reasonableness of the amount of interest expense in accordance with Master Direction No. DBR.Dir. No.84/13.03.00/2015-16 dated March 03, 2016 (Updated as on September 16, 2022) on “Reserve Bank of India (Interest Rate on Deposits) Directions, 2016” by analysing the 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.

16.55 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, the RBI directives, and agreements with the respective depositors.
- (c) In case of fixed deposits it should be examined whether the interest rate (as applicable) in the accounting system are in accordance with the interest rates mentioned in the fixed deposit receipt/certificate.
- (d) Interest on savings accounts should be test checked 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 authorized.
- (g) Interest on inter-branch balances has been provided at the rates prescribed by the head office.
- (h) Interest on overdue/ matured term deposits has been estimated and provided for.

16.56 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 breakup of 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.

**Few other Questions to be Answered by the Auditor in LFAR:**

***1. Does the bank have a system of estimating and providing interest accrued on overdue/matured/ unpaid/ unclaimed term deposits including in respect of deceased depositors?***

16.57 In most of the banks, now a days, term deposits are auto renewed. If the bank is not following the practice of auto renewal or customer has not given consent for auto renewal, then the bank should provide for interest on overdue term deposit. The auditor should check whether the branch has the practice of generating overdue deposits report and making provision for interest as per the bank's policy. If the same is carried out centrally then the auditor can check whether all overdue deposits are considered by central team by obtaining a report from them.

***2. Are there any divergent trends in major items of income and expenditure, in comparison with corresponding previous year, which are not satisfactorily explained by the branch? If so, the same may be reported.***

16.58 As explained earlier the auditor should carry out variance analysis of all

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expenses head and seek clarification from the branch for major variances, if any. Also based on variances, the auditor shall modify samples in respect of specific expenses.

16.59 The "Other Expenses" head and audit procedure thereof is as under:

- (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 Courts/Tribunals. The payroll process is generally centralized in all banks. The auditor should ascertain the control available at the branch level and test check sample working. Revisions in salaries as a result of employee wage agreements should be duly factored or if pending should be appropriately disclosed.
- (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. The auditor should specifically review cases where rental increases are in dispute and unpaid. Necessary provisions / disclosures should be appropriately made. It may be noted that income-tax and interest on 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.
- (iii) *Printing and Stationery:* This item includes books, 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 (security paper like draft forms, cheque books) would have been received by the branch from the head office. The auditor should specifically note the bank policy in this regard whether the same is expensed out on purchase or on usage. In any case any unusable or outdated stationery should be expensed out. If any stationery is shown as an asset, necessary physical verification should be done.
- (iv) *Advertisement and Publicity:* This item includes expenditure incurred by the bank for advertisement and publicity, including printing charges of publicity material. The auditor should specifically review such agreements to find out commitments made for such expenses in future periods.

- (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 operated manually at branches and other offices. The auditor should specifically review the residual value and useful life at the year end and provide for additional depreciation in case there is any downward revision in the useful life or change in residual value. The auditor should ensure that fixed assets are accounted from the date the asset is put to use. Necessary accounting of the asset needs to be done and depreciation calculated from this date. Generally, banks account for fixed assets on the date of final payment irrespective of the fact that the asset has been put to use much earlier.

The auditor should note the process for verifying assets booked by branch but allotted to employees and located at bank's residential premises allotted to these employees. The auditors should verify the calculation of depreciation by exporting the relevant report from software.

The auditor should also ensure that the movement of asset on account of transfer of employees are reconciled and confirmed by the Transferee branch to ensure appropriate depreciation charge on those assets.

Impairments or cases of accelerated depreciation due to increased wear and tear owing to asset usage or reduction in useful life should be duly recognized in the profit and loss account.

- (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. The auditor should specifically review the legal agreements to note future

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commitments for payables. Expenses paid to advocates recovered from borrowers by direct debit to that account should be specifically noted for consistency in accounting. The auditor should also co-relate legal expenses with the contingent liability appearing in financial statement or with the specific annexure/report to be certified by the branch auditors'. Some banks also have a separate vertical for handling legal issues and the auditor may rely on confirmations / reconciliation of number of pending cases to ensure adequacy of the data considered for accounting of legal expenses.

- (ix) *Postage, Telegrams, Telephones, etc.:* This item includes all postal charges like stamps, telegrams, telephones, tele-printers, etc. The telegrams facility has been discontinued since 15<sup>th</sup> July 2013 and this head is now just for academic purposes.
- (x) *Repairs and Maintenance:* This item includes repairs to bank's property, their maintenance charges, etc. Amortization of such expenses should be specifically noted.
- (xi) *Insurance:* This item is usually dealt with at the head office level and may not therefore be relevant at the branch level. This includes premium paid to DICGC, Insurance of Cash on Hand, in ATM & in transit and also Insurance of fixed assets, employee fidelity insurance, fraud covers, coverage for cyber risks. The auditor should specifically ensure that all risks are insured adequately. Decision not to insure specific risks / assets should be approved at appropriate management level and the auditor should obtain the relevant documents for record.
- (xii) *Direct Marketing Expenses:* These are certain expenses incurred mainly for sourcing of retail loans/credit cards and collection of retail overdue loans. RBI circular no. RBI/2006/167/DBOD.NO.BP.40/21.04.158/2006-07 dated 3<sup>rd</sup> November, 2006 on Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by banks, clearly states that activities of internal audit, compliance function and decision making functions like compliance with KYC norms for opening deposit accounts, according sanction for loans (including retail loans) and management cannot be outsourced.
- (xiii) *Other Expenditure:* This item includes all expenses other than those

included in any of the other heads, like, license fees, donations<sup>35</sup>, subscriptions to papers, periodicals, entertainment expenses, travel expenses, etc. The Notes and Instructions for compilation of profit and loss account, issued by the RBI, 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. The auditor should check such large value items reported under this head and identify the nature of items and if appropriate account head is available it should be classified in that head.

16.60 Some banks follow the policy of providing for the promotional points earned by the customers on the use of Debit/Credit cards on actuarial basis. These provisions could be shown under this head.

16.61 Expenses should be accounted on accrual basis and not on cash basis. The auditor may review payment vouchers of April to ascertain the correctness of provision made for expenses.

#### ***Operating Expenses***

16.62 Generally the audit procedures followed by auditors in any entity are to be followed.

#### ***Payments to and Provisions for Employees***

16.63 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. The auditor should understand the compensation structure and process of payment of salary,

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<sup>35</sup>The RBI, from time to time, prescribes the limits up to which banks can make donations. As per RBI circular no. DBOD. No. Dir. BC. 50/ 13.01.01/ 2005-06 dated December 21, 2005 on "Donations by banks", 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 in fields related to banking. 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.

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. Where payment is made on production of evidence or incurrence by employee, the auditor should ascertain whether provision for the same has been made in the books.

16.64 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. The auditor should also check the calculation of salaries and 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.

16.65 The 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. Further, the auditor should verify whether the bank has made adequate provisions for employee benefits and has complied with the recognition, measurement and disclosure requirements of AS 15, "Employee Benefits".

*Rent, Taxes and Lighting*

16.66 The auditor may test check the following:

- Rent paid - 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 paid to employees.
- Check whether municipal rates/ taxes are duly paid/ adjusted for the year under audit.
- Enquire whether any disputed liability exists on this account up to 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 done in accordance with AS-19, "Leases" unless the terms and conditions of the lease indicate otherwise.
- In addition, the auditor should perform month on month rent analysis and verify major variance in the average rent per month per branch. The auditor

should also verify the provision made for the expired lease rent agreements.

*Printing and Stationery*

16.67 The auditor should verify this item with reference to documents evidencing purchase/debit note received.

*Advertisement and Publicity*

16.68 Expenditure incurred by the bank for advertisement and publicity, including printing charges of publicity material is verified with the documents.

*Repair and Maintenance Expenses*

16.69 The auditor should verify the Annual Maintenance Contract (AMC) at the branch and should verify the provisioning and prepaid accounting of these contracts.

*Depreciation on Bank's Property*

16.70 The auditor should ascertain the procedure followed by the bank while verifying this item which 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 either be centralised at the head office level or decentralised.

16.71 The auditor should check head office instructions as regards adjustments of depreciation on the fixed assets of the branch. The auditor should also check whether depreciation on fixed assets has been adjusted at the rates and in the manner required by head office.

16.72 The auditor may also report unadjusted depreciation on assets acquired but not capitalised. The auditor should re-compute the depreciation for the period, perform depreciation rationalisation and agree the amount with the general ledger. The auditor may also verify and obtain explanation for the unadjusted depreciation on assets acquired but not capitalised.

**Provisions and Contingencies**

16.73 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.

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16.74 Provisioning norms for NPA are given in Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 dated April 1, 2022 on “Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances”. Interest reversal in case of advances which have become NPA needs to be specifically checked. 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**

16.75 RBI *vide* Circular No. DBOD.No.BP.BC.77/21.04.018/2013-14 dated December 20, 2013 on “Deferred Tax Liability on Special Reserve created under Section 36(1)(viii) of the Income Tax Act, 1961” has advised banks, that as a matter of prudence, DTL should be created on special reserve.

16.76 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.

16.77 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**

16.78 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.



16.79 The appropriation 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 SCA 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. According to RBI circular no. RBI/2006-07/132 DBOD.BP.BC No. 31 / 21.04.018/ 2006-07 dated 20<sup>th</sup> September, 2006 on “Section 17 (2) of Banking Regulation Act, 1949 – Appropriation from Reserve Fund” all expenses including provisions and write-offs recognized 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).

### **Expenditure**

#### **Provisions and Contingencies**

16.80 The auditor should ascertain compliance with the various regulatory requirements for provisioning as contained in the various circulars.

16.81 The auditor should obtain an understanding as to how the bank computes the 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 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.

16.82 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 and as per Income Computation and Disclosure Standards (ICDS). 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.

**Annexure I**

**Form B**

**Form of Profit and Loss Account  
for the year ended on 31<sup>st</sup> March (Year)**

(000, omitted)

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Particulars	Schedule	Year ended on 31-3-____ (Current year)	Year Ended on 31-3-____ (Previous year)
I. Income			
Interest earned	13		
Other income	14		
Total			
II. Expenditure			
Interest expended	15		
Operating expenses	16		
Provisions and Contingencies			
Total			
III. Profit/Loss			
Net profit/loss(-) for the year			
Profit/loss(-) brought forward			
Total			
IV. Appropriations			
a. Transfer to statutory reserves			
b. Transfer to other reserves			
c. Transfer to Government/proposed dividend			
d. Balance carried over to balance sheet			

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**Schedule 13 - Interest Earned**

	Year ended on 31-3-__	Year ended on 31-3-__
	(Current year)	(Previous year)
I. Interest/discount on advances/bills		
II. Income on investments		
III. Interest on balances with Reserve Bank of India and other inter-bank funds		
IV. Others		
Total		

**Schedule 14 - Other Income**

	Year ended on 31.3.__	Year ended on 31-3-__
	(Current Year)	(Previous year)
I. Commission, exchange and brokerage		
II. Profit on sale of investments		
<i>Less:</i> Loss on sale of investments		
III. Profit on revaluation of investments		
<i>Less:</i> Loss on revaluation of investments		
IV. Profit on sale of land, buildings and other assets		
<i>Less:</i> Loss on sale of land, buildings and other assets		
V. Profit on exchange transactions		
<i>Less:</i> Loss on exchange transactions		

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- VI. Income earned by way of dividends,  
etc. from subsidiaries/companies and/  
or joint ventures abroad/in India
- VII. Miscellaneous Income

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Total

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Note: Under items II to V loss figures shall be shown in brackets

**Schedule 15 - Interest Expended**

	Year ended on 31-3-__	Year ended on 31-3-__
	(Current year)	(Previous year)
I. Interest on deposits		
II. Interest on Reserve Bank of India/ Inter-bank Borrowings		
III. Others		
Total		

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**Schedule 16 - Operating Expenses**

	Year ended on 31-3-__	Year ended on 31-3-__
	(Current year)	(Previous year)
I. Payments to and provisions for Employees		
II. Rent, taxes and lighting		
III. Printing and stationery		
IV. Advertisement and publicity		
V. Depreciation on bank's property		
VI. Director's fees, allowances and Expenses		

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- VII. Auditors' fees and expenses  
(including branch auditors)
- VIII. Law charges
- IX. Postages, Telegrams, Telephones,  
etc.
- X. Repairs and maintenance
- XI. Insurance
- XII. Other expenditure

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Total

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**Annexure II**

**Profit and Loss Account**

**Notes and Instructions**

Item	Sch.		Coverage	Notes and Instructions for compilation
Interest earned	13	(I)	Interest/ discount on advances / bills	Includes interest and discount on all types of loans and advances like cash credit, demand loans, overdrafts, export loans, term loans, domestic and foreign bills purchased and discounted (including those rediscounted), overdue interest and interest subsidy, if any, relating to such advances/bills.
		(II)	Income on investments	Includes all income derived from the investment portfolio by way of interest and dividend. The amount of premium amortised in respect of HTM Securities shall be shown here as a deduction. The deduction need not be disclosed separately. The book value of the security shall continue to be reduced to the extent of the amount amortised during the relevant accounting period.
		(III)	Interest on balances with RBI and other Inter-bank funds	Includes interest on balances with Reserve Bank of India and other banks, call loans, money market placements, etc.
		(IV)	Others	Includes any other interest/ discount income not included in the above heads.

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				<p><i>Notes: General</i></p> <p>The balances in Reverse Repo Interest Income Account shall be classified under Schedule 13 (under item III or IV as appropriate).</p>
Other Income	14	(I)	Commission, Exchange and Brokerage	Includes all remuneration on services such as commission on collections, commission/ exchange on remittances and transfers, commission on letters of credit and bank guarantees, letting out of lockers, commission on Government business, commission on other permitted agency business including consultancy and other services, brokerage, etc. on securities. It does not include foreign exchange income.
		(II)	Profit on sale of investments Less: Loss on sale of investments	Includes profit/loss on sale of securities, furniture, land and building, motor vehicles, gold, silver, etc. Only the net position shall be shown. If the net position is a loss, the amount shall be shown as a deduction. The net profit/ loss on revaluation of assets as well as provision for depreciation (or reversal of excess depreciation) shall also be shown under this item. Provision for non- performing investments (NPI) shall not be shown here and instead reflected under Provisions and Contingencies.
		(III)	Profit on revaluation of investments Less: Loss on revaluation of investments	
		(IV)	Profit on sale of land, buildings and other assets Less: Loss on sale of land, buildings and other assets	

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		(V)	Profit on exchange transactions Less: Loss on exchange transactions	Includes profit/loss on dealing in foreign exchange, all income earned by way of foreign exchange, commission and charges on foreign exchange transactions excluding interest which will be shown under interest head. Only the net position shall be shown. If the net position is a loss, it is to be shown as a deduction.
		(VI)	Income earned by way of dividend etc. from subsidiaries, companies, joint ventures abroad/ in India	
		(VII)	Miscellaneous income	Includes recoveries from constituents for godown rents, income from bank's properties, security charges, insurance etc. and any other miscellaneous income. In case any item under this head exceeds one percent of the total income, particulars shall be given in the notes. The fee received from the sale of Priority Sector Lending Certificates (PSLCs) shall be shown here.
Interest expended	15	(I)	Interest on deposits	Includes interest paid on all types of deposits including deposits from banks and other institutions.
		(II)	Interest on RBI/inter-bank borrowings	Includes discount/interest on all borrowings and refinance from Reserve Bank of India and other banks.



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		(III)	Others	Includes discount/interest on all borrowings/ refinance from financial institutions. All other payments like interest on participation certificates, penal interest paid, etc. shall also be included here.
				Notes :General 1. The balances in Repo Interest Expenditure Account shall be classified under Schedule 15 (under item II or III as appropriate). 2. While acquiring Government and other approved securities, banks should not capitalize the broken period interest paid to seller as part of cost of the investment, but instead book it as an expense.
Operating Expenses	16	(I)	Payments to and provisions for employees	Includes staff salaries/wages, allowances, bonus, other staff benefits like provident fund, pension, gratuity, liveries to staff, leave fare concessions, staff welfare, medical allowance to staff, etc.
		(II)	Rent, taxes and lighting	Includes rent paid by the banks on buildings, municipal and other taxes paid (excluding income tax and interest tax), electricity and other similar charges and levies. House rent allowance and other similar payments to staff shall appear under the head 'Payments to and provisions for employees'.
		(III)	Printing and stationery	Includes books and forms and stationery items used by the bank and other printing charges which are not incurred by way of publicity expenditure.
		(IV)	Advertisement and publicity	Includes expenditure incurred by the bank for advertisement and publicity purposes including printing charges of publicity material.

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		(V)	Depreciation on bank's property	Includes depreciation on bank's own property, cars and other vehicles, furniture, electric fittings, vaults, lifts, lease hold properties, non-banking assets, etc.
		(VI)	Directors' fees, allowances and expenses	Includes sitting fees, allowances and all other expenses incurred on behalf of directors. The daily allowance, hotel charges, conveyance charges, etc. which though in the nature of reimbursement of expenses incurred shall be included under this head. Similar expenses of Local Board members, committees of the Board, etc. shall also be included under this head.
		(VII)	Auditors' fees and expenses (including branch auditors' fees)	Includes the fees paid to the statutory auditors and branch 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 should not be included under this head but shall be shown under 'Other Expenditure'.
		(VIII)	Law charges	All legal expenses and reimbursement of expenses incurred in connection with legal services shall be included here.
		(IX)	Postage, Telegrams, Telephones, etc.	Includes all postal charges like stamps, telephones, etc.
		(X)	Repairs and maintenance	Includes repairs to bank's property, their maintenance charges, etc.
		(XI)	Insurance	Includes insurance charges on bank's property, insurance premia paid to DICGC, etc. to the extent they are not recovered from the concerned parties.

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		(XII)	Other expenditure	All expenses other than those not included in any of the other heads like licence fees, donations, subscriptions to papers, periodicals, entertainment expenses, travel expenses, etc. shall be included under this head. In case any particular item under this head exceeds one percent of the total income, particulars shall be given in the notes. The fees paid for the purchase of PSLCs shall be shown here.
Provisions and Contingencies				Includes all provisions made for bad and doubtful debts, provisions for taxation, provisions for non-performing investments, transfers to contingencies and other similar items.

## Part B

### Guidance on Specific Issues with respect to certain Accounting Standards

#### 1. Accounting Standard 5 - Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

The objective of this Standard is to prescribe the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepare and present such a statement on a uniform basis. Accordingly, this Standard requires the classification and disclosure of extraordinary and prior period items, and the disclosure of certain items within profit or loss from ordinary activities. It also specifies the accounting treatment for changes in accounting estimates and the disclosures to be made in the financial statements regarding changes in accounting policies. Paragraph 4.3 of Preface to the Statements on Accounting Standards issued by the ICAI states that Accounting Standards are intended to apply only to items which are material. Since materiality is not objectively defined, it has been decided that all banks should ensure compliance with the provisions of the Accounting Standard in respect of any item of prior period income or prior period expenditure which exceeds one percent of the total income/total expenditure of the bank if the income/expenditure is reckoned on a gross basis or one percent of the net profit before taxes or net losses as the case may be, if the income is reckoned net of costs. 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.

#### 2. Accounting Standard 9 – Revenue Recognition

Non-recognition of income by the banks in case of non-performing advances and non-performing investments, in compliance with the regulatory prescriptions of the Reserve Bank of India, shall not attract qualification by the statutory auditors as this would be in conformity with provisions of the Standard, as it recognizes postponement of recognition of revenue where collectability of the revenue is significantly uncertain.

#### 3. Accounting Standard 11 - The Effects of Changes in Foreign Exchange Rates

AS 11 is applied in the context of accounting for transactions in foreign currencies and in translating the financial statements of foreign operations. The

issues that arise in this context have been identified and banks shall be guided by the following while complying with the provisions of the Standard:

**(I) Classification of Integral and Non-integral Foreign Operations**

Paragraph 17 of AS 11 states that 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". The issue that arises here pertains to the classification of representative offices set up in foreign countries, foreign branches and off-shore banking units set up in India as "integral foreign operation" or "non-integral foreign operation".

Taking into consideration the operation of the foreign branches of Indian banks and the indicators listed in Paragraph 20 of the Standard, it is clarified that foreign branches of Indian banks, IFSC Banking Units (IBUs) and Offshore Banking Units (OBUs) set up in India by banks shall be classified as "non-integral foreign operations". Taking into consideration the operation of the representative offices of banks set up abroad and the explanation in paragraph 18 of the Standard, representative offices shall be classified as "integral foreign operations". These classifications are for the limited purpose of compliance with the Standard.

**(II) Exchange rate for recording foreign currency transactions and translation of financial statements of non-integral foreign operation.**

As per Paragraphs 9 and 21 of the Standard, a foreign currency transaction shall be recorded by Indian branches and integral foreign operations, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction. Further, Paragraph 24(b) of the Standard states that income and expense items of non-integral foreign operations shall be translated at exchange rates at the dates of the transactions. Indian branches and integral foreign operations of banks may face difficulty in applying the exchange rate prevailing at the date of the transaction in respect of the items which are not being recorded in Indian Rupees or are currently being recorded using a notional exchange rate, due to their extensive branch network and volume of transactions. Banks may also face difficulty in translating income and expense items of a non-integral foreign operation by applying the exchange rates at the dates of the transactions.

Banks, which are in a position to apply the exchange rate prevailing on the date of the transaction for recording the foreign currency transactions at their

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Indian branches and integral foreign operations and for translating the income and expense items of non-integral foreign operations as required under AS 11 shall comply with the requirements. Banks, which have an extensive branch network, have a high volume of foreign currency transactions and are not fully equipped on the technology front shall be guided by the following:

- a) Paragraph 10 of the Standard allows, for practical reasons, the use of a rate that approximates the actual rate at the date of the transaction. The Standard also states that if exchange rates fluctuate significantly, the use of average rate for a period is unreliable. Since the enterprises are required to record the transactions at the date of the occurrence thereof, the weekly average closing rate of the preceding week can be used for recording the transactions occurring in the relevant week, if the same approximates the actual rate at the date of the transaction. In view of the practical difficulties which banks may have in applying the exchange rates at the dates of the transactions and since the Standard allows the use of a rate that approximates the actual rate at the date of the transaction, banks may use average rates as detailed below:
- b) FEDAI publishes a weekly average closing rate at the end of each week and a quarterly average closing rate at the end of each quarter for various currencies.
- c) In respect of Indian branches and integral foreign operations, those foreign currency transactions, which are currently not being recorded in Indian Rupees at the date of the transaction or are being recorded using a notional exchange rate shall now be recorded at the date of the transaction by using the weekly average closing rate of the preceding week, published by FEDAI, if the same approximates the actual rate at the date of the transaction.
- d) Generally, Indian banks prepare consolidated accounts for their domestic and foreign branches at quarterly or longer intervals. Hence, banks may use the quarterly average closing rate, published by FEDAI at the end of each quarter, for translating the income and expense items of non-integral foreign operations during the quarter.
- e) If the weekly average closing rate of the preceding week does not approximate the actual rate at the date of the transaction, the closing

rate at the date of the transaction shall be used. For this purpose, the weekly average closing rate of the preceding week would not be considered approximating the actual rate at the date of the transaction if the difference between (A) the weekly average closing rate of the preceding week and (B) the exchange rate prevailing at the date of the transaction, is more than three and a half percent of (B). In respect of non-integral foreign operations, if there are significant exchange fluctuations during the quarter, the income and expense items of non-integral foreign operations shall be translated by using the exchange rate at the date of the transaction instead of the quarterly average closing rate. For this purpose, the exchange rate fluctuation would be considered as significant, if the difference between the two rates is more than seven percent of the exchange rate prevailing at the date of the transaction.

- f) Banks are encouraged to equip themselves to record the foreign currency transactions of Indian branches as well as integral foreign operations and translate the income as well as expense items of non-integral foreign operations at the exchange rate prevailing on the date of the transaction.

**(III) Closing rate**

Paragraph 7 of the Standard defines 'Closing rate' as the exchange rate at the balance sheet date. In order to ensure uniformity among banks, closing rate to be applied for the purposes of AS 11 (Revised 2003) for the relevant accounting period would be the last closing spot rate of exchange announced by FEDAI for that accounting period.

**(IV) Foreign Currency Translation Reserve (FCTR)**

In the context of recognition of gains in profit and loss account from FCTR on repatriation of accumulated profits/retained earnings from overseas branch(es), it is clarified that the repatriation of accumulated profits shall not be considered as disposal or partial disposal of interest in non-integral foreign operations as per AS 11. Accordingly, banks shall not recognise in the profit and loss account the proportionate exchange gains or losses held in the foreign currency translation reserve on repatriation of profits from overseas operations.

**4. Accounting Standard 17 – Segment Reporting**

The indicative formats for disclosure under 'AS 17 – Segment Reporting' are as below:-

## Format

### Part A: Business segments

(Amount in ₹ crore)

Business Segments	Treasury		Corporate / Wholesale Banking		Retail Banking		Other Banking Business		Total	
	Current Year	Previous Year	Current Year	Previous Year	Current Year	Previous Year	Current Year	Previous Year	Current Year	Previous Year
Revenue										
Result										
Unallocated expenses										
Operating profit										
Income taxes										
Extraordinary profit / loss										
Net profit										
Other information:										
Segment assets										
Unallocated assets										
Total assets										
Segment liabilities										
Unallocated liabilities										
Total liabilities										

Note: No disclosure need be made in the shaded portion



## Part B: Geographic segments

(Amount in ₹ crore)

	Domestic		International		Total	
	CurrentYear	Previous Year	CurrentYear	Previous Year	CurrentYear	PreviousYear
(a) Revenue						
(b) Assets						

Note:

- a) *The business segment shall ordinarily be considered as the primary reporting format and geographical segment would be the secondary reporting format.*
- b) *The business segments will be 'Treasury', 'Corporate / Wholesale Banking', 'Retail Banking' and 'Other banking operations'.*
- c) *'Domestic' and 'International' segments will be the geographic segments for disclosure.*
- d) *Banks shall adopt their own methods, on a reasonable and consistent basis, for allocation of expenditure among the segments.*
- e) *'Treasury' shall include the entire investment portfolio.*
- f) *Retail Banking shall include exposures which fulfil the four criteria of orientation, product, granularity, and low value of individual exposures for retail exposures laid down in Master Directions on Basel III: Capital Regulations (modified from time to time). Individual housing loans will also form part of Retail Banking segment for the purpose of reporting under AS-17.*
- g) *Corporate / Wholesale Banking includes all advances to trusts, partnership firms, companies, and statutory bodies, which are not included under 'Retail Banking'.*
- h) *Other Banking Business includes all other banking operations not covered under 'Treasury, 'Wholesale Banking' and 'Retail Banking' segments. It shall also include all other residual operations such as para banking transactions/activities.*
- i) *Besides the above-mentioned segments, banks shall report additional segments within "Other Banking Business" which meet the quantitative criterion prescribed in the AS 17 for identifying reportable segments.*

### 5. Accounting Standard 18 – Related Party Disclosures

The manner of disclosures required by Paragraphs 23 to 26 of AS 18 is illustrated as below. It may be noted that the format given below is merely illustrative in nature and is not exhaustive.

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(Amount in ₹ crore)

Items/Related Party	Parent(as per ownership or control)	Subsidiaries	Associates/ Joint ventures	Key Management Personnel@	Relatives of Key Management Personnel	Total
Borrowings#						
Deposits#						
Placement of deposits#						
Advances#						
Investments#						
Non-funded commitments#						
Leasing/HP arrangements availed#						
Leasing/HP arrangements provided#						
Purchase of fixed assets						
Sale of fixed assets						
Interest paid						
Interest received						
Rendering of services*						
Receiving of services*						
Management contracts*						

@ Whole time directors of the Board and CEOs of the branches of foreign banks in India.

# The outstanding at the year end and the maximum during the year are to be disclosed.

\* Contract services etc. and not services like remittance facilities, locker facilities etc.

**Note:**

- i) Related parties for a bank are its parent, subsidiary(ies), associates/ joint ventures, Key Management Personnel (KMP) and relatives of KMP. KMP are the whole-time directors for an Indian bank and the Chief Executive Officer (CEO) for a foreign bank having branches in India.

Relatives of KMP would be on the lines indicated in Section 45 S of the RBI Act, 1934.

- ii) *The name and nature of related party relationship shall be disclosed, irrespective of whether there have been transactions, where control exists within the meaning of the Standard. Control would normally exist in case of parent-subsidiary relationship. The disclosures may be limited to aggregate for each of the above related party categories and would pertain to the year-end position as also the maximum position during the year.*
- iii) *The Accounting Standards is applicable to all nationalised banks. The accounting standard exempts state-controlled enterprises i.e., nationalised banks from making any disclosures pertaining to their transactions with other related parties which are also state controlled enterprises. Thus, nationalised banks need not disclose their transactions with the subsidiaries as well as the RRBs sponsored by them. However, they will be required to disclose their transactions with other related parties.*
- iv) *Secrecy provisions: If in any of the above category of related parties there is only one related party entity, any disclosure would tantamount to infringement of customer confidentiality. In terms of AS18, the disclosure requirements do not apply in circumstances when providing such disclosures would conflict with the reporting enterprise's duties of confidentiality as specifically required in terms of statute, by regulator or similar competent authority. Further, in case a statute or regulator governing an enterprise prohibits the enterprise from disclosing certain information, which is required to be disclosed, non-disclosure of such information would not be deemed as non-compliance with the Accounting Standards. On account of the judicially recognized common law duty of the banks to maintain the confidentiality of the customer details, they need not make such disclosures. In view of the above, where the disclosures under the Accounting Standards are not aggregated disclosures in respect of any category of related party i.e., 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.*

## **6. Accounting Standard 23 – Accounting for Investments in Associates in CFS**

This Accounting Standard sets out the principles and procedures for recognizing, in the CFS, the effects of the investments in associates on the financial position and operating results of a group. The Standard requires that an investment in an associate shall be accounted for in CFS under the equity method subject to certain exceptions. The term associate is defined as an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor. Significant influence is the power to participate in the financial and/ or operating policy decisions of the investee but not control over those policies. Such an influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investor holds, directly or indirectly through subsidiaries 20 percent or more of the voting power of the investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly through subsidiaries less than 20 percent of the voting power of the

investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

The issue is whether conversion of debt into equity in an enterprise by a bank by virtue of which the bank holds more than 20 percent will result in an investor-associate relationship for the purpose of AS 23. From the above it is clear that though a bank may acquire more than 20 percent of voting power in the borrower entity in satisfaction of its advances 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 this Accounting Standard. Hence the test shall not be merely the proportion of investment but the intention to acquire the power to exercise significant influence.

#### **7. Accounting Standard 24 - Discontinuing operations**

This Standard establishes principles for reporting information about discontinuing operations. 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 this Accounting Standard 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 shall be required under the Standard only when: (i) discontinuing of the operation has resulted in shedding of liability and realisation 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.

#### **8. Accounting Standard 25 – Interim Financial Reporting**

This Standard prescribes the minimum content of an interim financial report and the principles for recognition and measurement in a complete or condensed financial statements for an interim period. The disclosures required to be made by listed banks in terms of the listing agreements would not tantamount to interim reporting as envisaged under AS 25 and as such AS 25 is not mandatory for the quarterly reporting prescribed for listed banks. The recognition and measurement principles laid down under AS 25 shall however, be complied with in respect of such quarterly reports. Half yearly review of accounts shall be applicable for all commercial banks<sup>36</sup> irrespective of whether such banks are listed or not. Banks shall follow the format prescribed by the Department of Supervision, Reserve

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<sup>36</sup> Half yearly review of accounts by auditors has only been prescribed for commercial banks.

Bank of India (or National Bank for Agriculture and Rural Development for RRBs) for the purpose.

### **9. Accounting Standard 26 – Intangible Asset**

This Standard prescribes the accounting treatment for intangible assets that are not dealt with specifically in another accounting standard. With respect to computer software which has been customized for the bank's use and is expected to be in use for some time, the detailed recognition and amortization principle in respect of computer software prescribed in the Standard adequately addresses these issues and may be followed by banks. It may be noted that intangible assets recognized and carried in the balance sheet of banks in compliance with AS 26 shall attract provisions of Section 15(1) of the Banking Regulation Act 1949, in terms of which banks are prohibited from declaring any dividend until any expenditure not represented by tangible assets is carried in the balance sheet. Banks desirous of paying dividend while carrying any intangible assets in its books must seek exemption from Section 15(1) of the Banking Regulation Act, 1949 from the Central Government.

### **10. Accounting Standard 27 - Financial Reporting of Interests in Joint Ventures**

This Standard is applied in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of ventures and investors, regardless of the structures or forms under which the joint venture activities take place. This Standard identifies three broad types of joint ventures, namely, jointly controlled operations, jointly controlled assets and jointly controlled entities. In case of jointly controlled entities, where banks are required to present CFS, the investment in joint ventures shall be accounted for as per provisions of this Standard. In respect of joint ventures in the form of jointly controlled operations and jointly controlled assets, this Accounting Standard is applicable for both solo financial statements as well as CFS. It is clarified that though Paragraph 26 of the Accounting Standard prescribes that for the purpose of solo financial statements, investment in jointly controlled entities is to be accounted as per Accounting Standard 13, such investment is to be reflected in the solo financial statements of banks as per guidelines prescribed by Reserve Bank of India since Accounting Standard 13 does not apply to banks. RRBs sponsored by banks shall be treated as associates and AS 27 shall not apply for investment in RRBs. The investment in RRBs shall however, be accounted in the consolidated financial statements as per the provisions of Accounting Standard 23.

**11. Accounting Standard 28 – Impairment of Assets**

This Standard prescribes the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount. It is clarified that the Standard shall not apply to inventories, investments and other financial assets such as loans and advances and shall generally be applicable to banks in so far as it relates to fixed assets. The Standard shall generally 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.

## **Audit Reports and Certificates**

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### **Objectives of Audit and Need for an Audit Report**

17.01 The Objective of the auditor are:

- (a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and
- (b) To express clearly that opinion through a written report.

Thus, for the purpose of any audit the final result will be the audit report which will clearly demonstrate the findings of the auditor and will clearly provide to the stakeholders information and the assurance they were looking for when the process was first initiated.

17.02 Bank audit, is guided by statutory provisions and RBI pronouncements as to the minimum coverage and further need to comply with Standards of Auditing, to the extent applicable to a branch audit. Following are the SAs relevant to bank audit:

- SA 700 to 799 cover Audit Conclusions and Reporting
- SA 700 (Revised), Forming an Opinion and Reporting on Financial Statements
- SA 701, Communicating Key Audit Matters in the Independent Auditor's Report
- SA 705 (Revised), Modifications to the Opinion in the Independent Auditor's Report
- SA 706 (Revised), Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
- SA 710, Comparative Information—Corresponding Figures and Comparative Financial Statements
- SA 720 (Revised), The Auditor's Responsibilities Relating to Other Information

17.03 The auditor should decide on the basis of audit evidence and after discussion with the management, based upon audit conclusion that whether an unqualified opinion, qualified opinion or a negative report is required.

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17.04 In case the auditor has been unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement the auditor shall modify the opinion in the auditors report.

### **Qualified Opinion**

17.05 The auditor shall express a qualified opinion in the following circumstances:

- (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

### **Adverse Opinion**

17.06 The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

### **Disclaimer of Opinion**

17.07 The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

17.08 The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements

### **Memorandum of Changes (MOC)**

7.09 During audit of books of a bank branch, the auditor might come across various mistakes, deficiencies, and other issues, necessitating correction in the books of the branch. Such audit issues need to be discussed with the branch management and after discussion if it is clear to the auditor that the changes are required the primary responsibility to prepare the MOC is on the branch management, which should then be verified by the auditor before authentication.



It may be noted that the actual rectification entries are not to be passed at branch and is generally taken care at a centralised level. While drafting MOC, the auditor should verify the necessity of the same based upon criteria of materiality, which is generally defined in the closing instructions sent by the bank management. Also, reasons/audit issue noticed, which prompted the MOCs must be stated in MOC itself or as part of an enclosed Annexure so that the reason for the same are communicated to the management and the SCA.

17.10 Various instances where the changes required may be divided into various categories are as follows:

- A. Changes affecting two or more items of balance sheet.  
Wrong classification of credit balance in CC/OD under Advances in place of demand liabilities.
- B. Changes affecting two or more items of profit & loss account.
- C. Wrong classification of expenses/income under wrong head.
- D. Changes affecting one item of Balance Sheet and other item of profit and loss account.
- E. Interest de-recognised on declaring an account as a NPA.
- F. Changes affecting asset classification  
Loan accounts modified in terms of either sector-wise/security-wise/performance wise(NPA) classification.
- G. Changes affecting provisions  
Modification is account from Standard to NPA or within NPA categories, or in value of security requiring increase/decrease in provisions.
- H. Changes affecting capital adequacy provisions
  - i) Modifications in buckets requiring changes in BASEL chart
  - ii) Modifications in credit rating requiring changes in BASEL chart

### **Internal financial control over financial reporting (IFCoFR)**

17.11 RBI in terms of the reporting obligation by SCAs has advised them to include in their Independent Audit Report whether the bank has adequate internal financial control systems in place and operating effectiveness of such control. The branch auditors must check the process of verification of IFCoFR and their role in the process, so as to effectively discharge their duties.

## **BASEL Capital Adequacy Norms**

17.12 Basel III Norms relate to the capital adequacy requirement compliance which the bank has to achieve as contained in the BASEL III accord. The conclusive working or the calculation of capital adequacy is undertaken at the Head Office of the bank. The information related to capital is available at the Head Office which is verified by the SCAs of the bank along with verification of working and calculation of capital adequacy for bank as a whole. However, the calculation of risk weighted asset (RWA) value is generally undertaken at the branch level w.r.t. the assets at the respective branches and the same is required to be verified and certified by the SBAs. The calculation of RWAs as certified by SBAs (as well as departmental auditors) is consolidated at the head office.

Thus, the SBA needs to understand the fundamental concept of methodology of calculation capital adequacy as per Basel III norms to ensure that the preliminary level calculations of RWAs at branch level are duly verified.

### **Introduction**

17.13 Basel capital adequacy norms are meant for the protection of depositors and shareholders by prescriptive rules for measuring capital adequacy, thereby evolving methods of determining regulatory capital and ensuring efficient use of capital.

17.14 Basel III Accord strengthens the regulation, supervision and risk management of the banking sector. It is global regulatory standard on capital adequacy of banks, stress testing as well as market liquidity risk.

17.15 The Basel III Accord, aims at the following:

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

17.16 Basel II was fully implemented in all commercial banks (except RRBs and LABs) in India by March 31, 2009. In this regard, the RBI had issued a Master Circular No. DBR.No.BP.BC.4/21.06.001/2015-16 dated July 1, 2015 on "Prudential Guidelines on Capital Adequacy and Market Discipline - New Capital Adequacy Framework (NCAF)". RBI also issued Master Circular No. RBI/2022-23/12 DOR.CAP.REC.3/21.06.201/2022-23 dated April 01, 2022 on "Basel III Capital Regulations".

17.17 The major changes made in Basel III over Basel II are as under:

- (a) **Quality of Capital:** One of the key elements of Basel III is the introduction of much stricter definition of capital, which means the higher loss-absorption capacity, which in turn would lead to banks becoming stronger with enhanced capacity to withstand periods of stress.
- (b) **Capital Conservation Buffer:** Beginning 31<sup>st</sup> March, 2016, banks were required to hold capital conservation buffer of 0.625 percent, which was to be gradually increased to 2.5 percent by 31<sup>st</sup> March, 2019. As per the minimum capital conservation ratios in para 15.2.2 of Part D 'Capital Conservation Buffer Framework' of Master Circular No. RBI/2022-23/12 DOR.CAP.REC.3/21.06.201/2022-23 dated April 01, 2022 on 'Basel III Capital Regulations', shall continue to apply till the CCB attains the level of 2.5 per cent on October 01, 2021. This is to ensure that banks maintain a cushion of capital that can be used to absorb losses during periods of financial and economic stress, without affecting the core capital adequacy of 9 per cent.
- (c) **Counter Cyclical Buffer:** The counter cyclical buffer is designed to achieve broader macro-prudential goal of protecting banking sector from periods of excess aggregate credit growth (wherein excessive credit growth results in system-wide (national level) build-up of risk). The counter cyclical buffer is implemented on need-based basis.
- (d) **Minimum Common Equity and Tier 1 Capital Requirement:** The minimum requirement for common equity, the highest form of loss-absorbing capital, has been increased to 5.50 percent of RWA. The minimum tier 1 capital has been increased to 7 percent, which means that Additional Tier I (AT 1) capital can be a maximum of 1.50 percent of RWA and excess of Tier I capital can be used for Tier II capital. Though, the minimum total capital (Tier I plus Tier II) requirement remains at 9 percent, which means that the Tier 2 capital can be admitted maximum of 2 percent of RWA. With the requirement of gradually maintaining 2.5 percent of RWA as capital conservation buffer in the form of CET 1, the minimum overall capital requirement increases to 11.50 percent of RWA by October 01, 2021. The readers may refer Press Release 2022-2023/1481 dated January 02, 2023 for Domestic Systemically Important Banks (D-SIBs) for additional CET-1 requirement in addition to the Capital Conservation Buffer.
- (e) **Leverage Ratio:** An analysis of the 2008 financial crisis indicates that value of assets went down much more than what was perceived based on their risk rating, which led to the stipulation of Leverage Ratio. Therefore, under

Basel III, a simple, transparent, non-risk-based leverage ratio has been introduced. A leverage ratio is the relative amount of capital to total assets (not risk-weighted). It has been decided that the minimum leverage ratio shall be 4 per cent for Domestic Systemically Important Banks (DSIBs) and 3.5 per cent for other banks. These guidelines shall be effective from the quarter commencing October 1, 2019<sup>37</sup>.

- (f) **Liquidity Ratios:** Under Basel III, a framework for liquidity risk management has been set up. Liquidity Coverage Ratio (LCR) has become operational since 1<sup>st</sup> January, 2015 and banks are required to maintain 100 per cent LCR from April 01, 2021 onwards<sup>38</sup>.

17.18 Basel III capital regulation were implemented in India with effect from April 1, 2013 and have been fully implemented as on October 1, 2021. . Banks have to comply with the regulatory limits and minima as prescribed under Basel III capital regulations, on an ongoing basis. .

### **Guidelines on BASEL III Capital Regulations**

17.19 The RBI had issued circular no. DBOD.No.BP.BC.98 /21.06.201/2011-12 dated May 2, 2012 on “Guidelines on Implementation of Basel III Capital Regulations in India”. Through this circular, the RBI has prescribed the final guidelines on Basel III capital regulations. Again the RBI issued Master Circular No. RBI/2015-16/58 DBR.No.BP.BC.1/21.06.201/ 2015-16 dated July 1, 2015 on Basel III Capital Regulations. Following are the main features of these guidelines:

- These guidelines became effective from April 1, 2013 in a phased manner. The Basel III capital ratios were planned to be fully implemented by March 31, 2019, but have since been postponed.

As per RBI circular no. RBI/2020-21/93 DOR.CAP.BC.No.34/ 21.06.201/ 2020-21 dated February 05, 2021 on “Basel III Capital Regulations- Review of transitional arrangements”, in view of the continuing stress on account of COVID-19, RBI has decided to defer the implementation of the last tranche of 0.625 percent of the Capital Conservation Buffer (CCB) to October 01, 2021. Further, the pre-specified trigger for loss absorption through conversion / write-down of additional Tier 1 instruments (PNCPS and PDI) shall remain at 5.5 per cent of RWAs and will rise to 6.125 per cent of RWAs from October 01, 2021.

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<sup>37</sup> RBI Circular RBI/2018-19/225 DBR.BP.BC.No.49/21.06.201/2018-19 dated June 28, 2019 on Basel III Capital Regulations- Implementation of Leverage Ratio.

<sup>38</sup> RBI Circular RBI/2019-20/217 DOR.BP.BC.No.65/21.04.098/2019-20 dated April 17, 2020 on Basel III Framework on Liquidity Standards – Liquidity Coverage Ratio (LCR).

- The RBI issued circular no. DoR.BP.BC.No.76/21.06.201/2019-20 dated June 21, 2020 w.r.t. 'Assignment of Risk Weights on Credit Facilities (Guaranteed Emergency Credit Line) under the Emergency Credit Line Guarantee Scheme' specifying that where credit facilities extended under the scheme guaranteed by NCGTC are backed by an unconditional and irrevocable guarantee provided by Government of India, the member Lending Institutions shall assign zero per cent risk weight on the credit facilities extended under this scheme to the extent of guarantee coverage.
- 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 any capital planning exercise, banks should keep this in view.
- Banks were required to maintain 100 per cent LCR with effect from January 1, 2019. In order to accommodate the burden on banks' cash flows on account of the Covid19 pandemic, the RBI vide its circular no. RBI/2019-20/217 DOR.BP.BC.No.65/21.04.098/2019-20 dated 17<sup>th</sup> April, 2020 on "Basel III Framework on Liquidity Standards – Liquidity Coverage Ratio (LCR)" has permitted the banks to maintain LCR as under:
  - (i) From the date of circular to September 30, 2020 - 80 per cent
  - (ii) October 1, 2020 to March 31, 2021 - 90 percent
  - (iii) April 1, 2021 onwards - 100 percent
- Banks are required to prepare LCR restoration plans if there is a breach of the aforesaid prescribed LCR requirement.
- RBI vide circular no. RBI/2017-18/178 DBR.BP.BC.No.106/21.04.098/2017-18 dated May 17, 2018 on 'Basel III Framework on Liquidity Standards – Net Stable Funding Ratio (NSFR) – Final Guidelines', stipulating NSFR guidelines to ensure reduction in funding risk over a longer time horizon by requiring banks to fund their activities with sufficiently stable sources of funding in order to mitigate the risk of future funding stress. The implementation of NSFR guidelines was subsequently postponed. As per the related RBI circular no. RBI/2020-21/95 DOR.No.LRG.BC.40/21.04.098/2020-21 dated February 05, 2021 on Basel III Framework on Liquidity Standards – Net Stable Funding Ratio (NSFR), the implementation of NSFR guidelines was further deferred and are effective from October 01, 2021.
- The RBI issued circular no. RBI/2021-22/151 DOR.No.PRD.LRG.79/21.04.098/2021-22 dated January 06, 2022 on "Basel III Framework on Liquidity Standards – Liquidity Coverage Ratio (LCR), Liquidity Risk Monitoring Tools and LCR Disclosure Standards and Net Stable Funding ratio – Small Business Customers", with a view to align its guidelines with

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the BCBS standard and enable banks to manage liquidity risk more effectively, and increased the threshold limit for deposits and other extensions of funds made by non-financial small business customers from ₹ 5 crores to ₹ 7.5 crores for the purpose of maintenance of Liquidity Coverage Ratio (LCR). This modification is also applicable to deposits and other extensions of funds received from small business customers referred to in the RBI circular DBR.BP.BC.No.106/21.04.098/2017-18 dated May 17, 2018 on “Basel III Framework on Liquidity Standards – Net Stable Funding Ratio (NSFR) – Final Guidelines”.

- Banks have been required to disclose capital ratios under Basel III from the quarter ending June 30, 2013.
- Subsequently, RBI Master Circular RBI/2022-23/12 DOR.CAP.REC.3/21.06. 201/2022-23 dated April 01, 2022 on Basel III Capital Regulations, was issued, consolidating the instructions on prudential guidelines on Basel III capital adequacy, issued as on date.

### Components of Capital

17.20 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 per cent 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
(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

**Capital – What Constitutes Tier 1 and Tier 2 – A Representative Sample**

17.21 The RBI Master Circular RBI/2022-23/12 DOR.CAP.REC.3/21.06.201/2022-23 dated April 01, 2022 on 'Basel III Capital Regulations' 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:

	<b>Indian Banks</b>	<b>Foreign Banks Operating in India</b>
<b>Tier I Capital Common Equity Tier I (CET 1)</b>	Paid up equity capital (ordinary shares) <sup>39</sup>	Interest free funds from Head Office <sup>40</sup>
	Share premium on issue of common shares	
	Statutory reserves	Statutory reserves kept in Indian books
	Capital reserves representing surplus arising out of sale proceeds of assets	Capital reserves representing surplus arising out of sale of assets in India held in a separate account and which is not eligible for repatriation so long as the bank functions in India
	Other disclosed free reserves, if any	Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India
	Revaluation reserves with discount of 55 percent (with effect from 1 <sup>st</sup> March, 2015), subject to meeting conditions prescribed in RBI circular dated 1 <sup>st</sup> March 2016	Revaluation reserves with discount of 55 percent (till 29 <sup>th</sup> February, 2016), subject to meeting conditions prescribed in RBI circular dated 1 <sup>st</sup> March, 2016
	Foreign currency translation reserve arising due to translation of financial statements of their foreign operations in terms of Accounting Standard (AS) 11	Foreign currency translation reserve arising due to translation of financial statements of their foreign operations in terms of Accounting Standard (AS) 11 at a discount of 25 percent, subject to

<sup>39</sup>Refer Annexure 1 to Master Circular on Basel III Capital Regulations for criteria.

<sup>40</sup>Refer Annexure 2 to Master Circular on Basel III Capital Regulations for criteria.

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	<b>Indian Banks</b>	<b>Foreign Banks Operating in India</b>
	at a discount of 25 percent, subject to meeting conditions prescribed in RBI circular dated 1 <sup>st</sup> March, 2016	meeting conditions prescribed in RBI circular dated 1 <sup>st</sup> March, 2016
	Balance in profit and loss account at the end of the previous financial year	
	Profits of current financial year on a quarterly basis provided the incremental provisions made for NPA at the end of any of the four quarters of the previous financial year have not deviated more than 25 percent from the average of the four quarters with certain adjustments given in the Master Circular.	
		Interest free funds remitted from abroad for the purpose of acquisition of property and held in a separate account in Indian books provided they are non-repatriable and have the ability to absorb losses regardless of their source
	Less: Regulatory adjustments / deductions applied in the calculation of Common Equity Tier 1 capital	Less: Regulatory adjustments / deductions applied in the calculation of Common Equity Tier 1 capital
<b>Additional Tier I (AT 1)</b>	Perpetual non-cumulative preference shares <sup>41</sup>	Head office borrowings in foreign currency by foreign banks operating in India as per criteria <sup>42</sup>

<sup>41</sup>Refer Annexure 3 to Master Circular on Basel III Capital Regulations for criteria.

<sup>42</sup>Refer Annexure 4 to Master Circular on Basel III Capital Regulations for criteria.



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	<b>Indian Banks</b>	<b>Foreign Banks Operating in India</b>
	Share premium on instruments included in AT 1 capital	
	Debt Capital instruments including Perpetual Debt instruments <sup>43</sup>	
	Any other instrument notified by RBI from time to time	Any other instrument notified by RBI from time to time
	Less: Regulatory adjustments / deductions applied in the calculation of Additional Tier 1 capital	Less: Regulatory adjustments / deductions applied in the calculation of Additional Tier 1 capital
<b>Tier II Capital</b>	Revaluation reserves with discount of 55 percent (till 29 <sup>th</sup> February, 2016)	Revaluation reserves with discount of 55 percent (till 29 <sup>th</sup> February, 2016)
	General provisions against future but presently unidentified losses and loss reserves	General provisions against future but presently unidentified losses and loss reserves
	Debt Capital instruments <sup>44</sup>	Head Office (HO) borrowings in foreign currency received as part of Tier 2 debt capital
	Perpetual Cumulative Preference Shares(PCPS) / Redeemable Non-Cumulative Preference Shares (RNCPS) / Redeemable cumulative preference shares (RCPS) <sup>45</sup>	Perpetual Cumulative Preference Shares(PCPS) / Redeemable Non- Cumulative Preference Shares (RNCPS) / Redeemable cumulative preference shares (RCPS) <sup>46</sup>
	Premium on instruments included in Tier 2	
	Less: Regulatory	Less: Regulatory adjustments /

<sup>43</sup>Refer Annexure 4 to Master Circular on Basel III Capital Regulations for criteria.

<sup>44</sup>Refer Annexure 5 to Master Circular on Basel III Capital Regulations for criteria.

<sup>45</sup>Refer Annexure 6 to Master Circular on Basel III Capital Regulations for criteria.

<sup>46</sup>Refer Annexure 6 to Master Circular on Basel III Capital Regulations for criteria.

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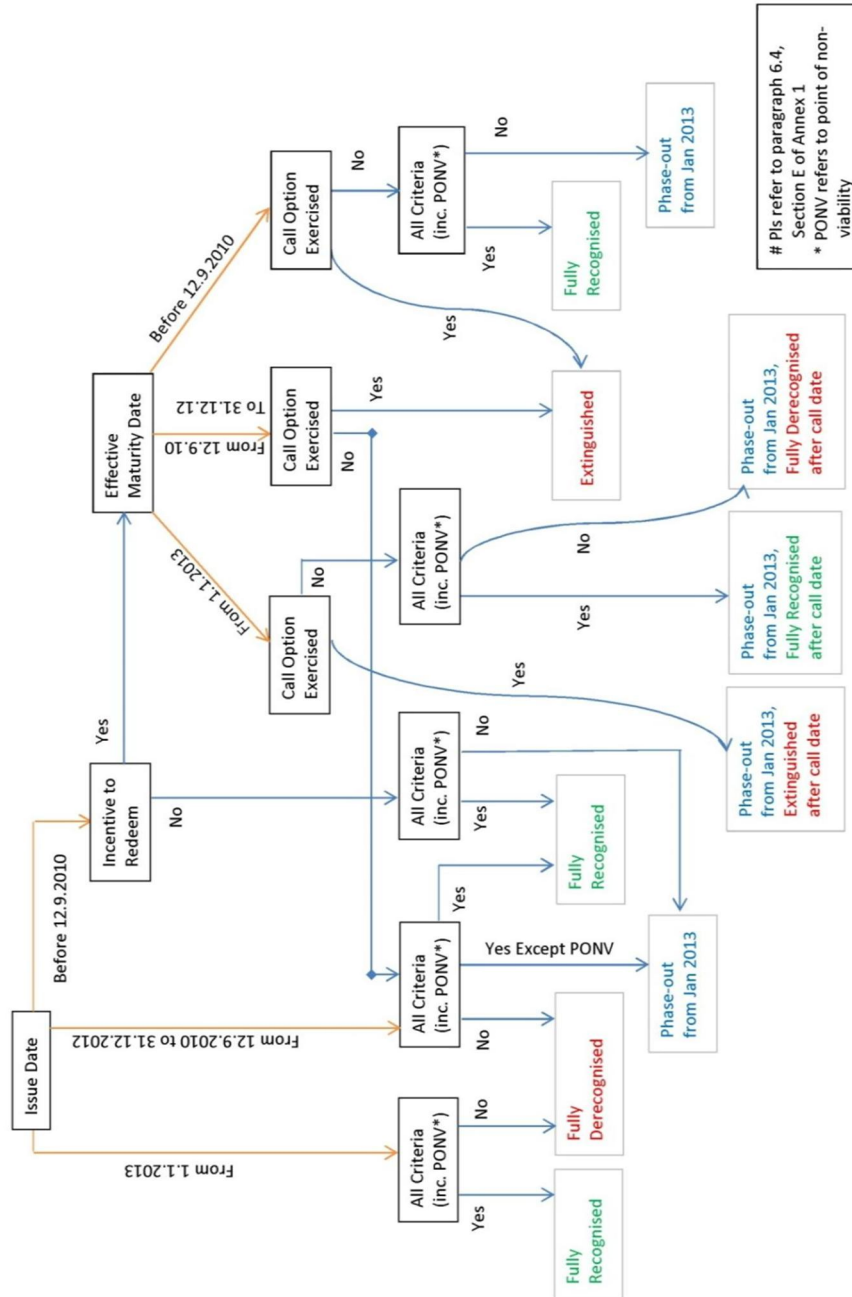
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	<b>Indian Banks</b>	<b>Foreign Banks Operating in India</b>
	adjustments / deductions applied in the calculation of Tier 2 capital	deductions applied in the calculation of Tier 2 capital

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

17.23 Capital instruments which no longer qualify as AT 1 capital or Tier 2 capital (e.g. IPDI and Tier 2 debt instruments with step-ups) will be phased out beginning January 1, 2013. Fixing the base at the nominal amount of such instruments outstanding on January 1, 2013, their recognition will be capped at 90 percent from January 1, 2013, with the cap reducing by 10 percent in each subsequent year. This cap will be applied to additional Tier 1 and Tier 2 capital instruments separately and refers to the total amount of instruments outstanding which no longer meet the relevant entry criteria. The following chart graphically depicts the provisions relating to such instruments:

## TRANSITIONAL ARRANGEMENTS FOR NON-EQUITY REGULATORY CAPITAL INSTRUMENTS



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**Deductions from CETI, AT I and Tier II**

17.24 The deductions from CET I, AT I and Tier II are tabulated below:

Item	Extent of Deduction (in %)		
	CET I	AT 1	Tier II
Intangible assets including goodwill	100	---	
Losses in the current period	100	---	
Losses brought forward from previous periods	100	---	
Deferred tax asset associated with accumulated losses	100	----	
Cash flow hedge reserve	100	---	
Shortfall of provisions to expected losses	100	---	
Gains on sale related to securitization transactions	100	---	
Cumulative gains and losses due to changes in own credit risk on fair valued liabilities	100	---	
Defined benefit pension fund liabilities and un-amortised employees' benefits	100	-	
Investments in own shares (if not already netted off paid-up capital on reported balance sheet) including indirect investments	100	---	
DTAs which relate to timing differences (other than those related to accumulated losses)	Excess of 10% of CET-1	----	
DTAs on timing difference along with limited recognition of significant investments in the common shares of unconsolidated financial (i.e. banking, financial and insurance) entities taken together	Excess of 15% of CET-1		
Equity investments in insurance subsidiaries	100		
Investments in equity instruments of other subsidiaries and capital of other banks,	100		

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Item	Extent of Deduction (in %)		
	CET I	AT 1	Tier II
insurance companies etc. which is more than 10 per cent of bank's CET1			
Equity investments in non-financial subsidiaries	100		
Intra group transactions beyond permissible limits	100		
Reciprocal cross investments in capital of other banks in the same component of capital	Full	Full	Full
Securitization exposure	50	50	
Investment in financial subsidiaries and associates which is above 30 percent 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 percent of investing bank's capital funds: <ul style="list-style-type: none"> <li>• Equity shares;</li> <li>• Perpetual Non- Cumulative Preference Shares;</li> <li>• Innovative Perpetual Debt Instruments;</li> <li>• Upper Tier II Bonds;</li> <li>• Upper Tier II Preference Shares;</li> <li>• Subordinated debt instruments; and</li> <li>• Any other instrument approved as in the nature of capital.</li> </ul>	50	50	
Investments made by a banking subsidiary/associate in the equity or non-equity regulatory-capital instruments issued by its parent bank	50	50	

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Item	Extent of Deduction (in %)		
	CET I	AT 1	Tier II
If net overseas placements with Head Office/other overseas branches/other group entities exceed 10 percent of the bank's minimum CRAR requirement, the amount in excess of this limit would be deducted from Tier I capital	100	---	

### Capital to Risk-weighted Assets Ratio (CRAR)

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

17.26 The CRAR is computed as follows:

$$\frac{\text{Eligible Total Capital funds} \times 100}{\text{Credit Risk RWA} + \text{Market Risk RWA} + \text{Operational Risk RWA}}$$

17.27 The minimum CRAR is required to be maintained at consolidated level also as per Basel III Guidelines. The requirements mentioned above relate to standalone banks only. For the requirement for the consolidated capital, members may refer RBI Master Circular RBI/2022-23/12 DOR.CAP.REC.3/21.06.201/2022-23 dated April 01, 2022 on "Basel III Capital Regulations".

### Board Oversight

17.28 The Board of Directors and senior management of each subsidiary/overseas branch should be responsible for conducting their own assessment of the subsidiary's/overseas branch's operational risks and controls and ensuring that the subsidiary/overseas branch is adequately capitalised in respect of those risks.

### Disclosure (Pillar 3)

17.29 Pillar 3 aims primarily at disclosure of a bank's risk profile and capital adequacy. It is recognised that Pillar 3 disclosure framework does not conflict with the requirements under Accounting Standards, which are broader in scope.

The banks in India have to follow Pillar 3 disclosure over and above RBI Master Direction No. RBI/DOR/2021-22/83 DOR.ACC.REC.No.45/21.04.018/2021-22 August 30, 2021 (Updated as on February 20, 2023) on “Financial Statements – Presentation and Disclosures”. 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 disclosures 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 Statutory Branch Auditors (SBAs)**

17.30 In case of credit risk management, the underlying computation for Basel III is based on credit ratings, which may be driven centrally and passed on to branches such that branches follow head office instructions in its entirety. This way the bank SBAs check only the computation process and test check the source rather than getting into the credit rating process. The SBAs 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 a pyramid approach whereby data from branches get consolidated at head office. The SCAs may choose to test check certain source data and also verify the basis considered at the head office. The SBAs are advised to refer RBI Master Circular RBI/2022-23/12 DOR.CAP.REC.3/21.06.201/2022-23 dated April 01, 2022 on “Basel III Capital Regulations” and any subsequent circular issued thereafter related thereto.

17.31 It will not be practical to expect the branch to comprehensively understand the Basel III requirements in its entirety. Thus, the SBAs should assess the sufficiency of the instructions provided to the branch by the head office and its adherence at the branch level. Any error at bank branch level can have a cascading effect at the head office level, especially when a large number of branches are involved.

17.32 At the Branch Level, the auditors will have to verify whether proper bucketing of assets has been done correctly or not. The SBA may obtain the system-generated report consisting of mapping of accounts to various buckets. The risk weights are allocated to each bucket and therefore it has to be ensured by the SBAs that the respective advances have been reflected in the correct bucket so the risk weights are correctly calculated for the advances held at the branch. While verifying the bucketing of corporate and institutional advances the auditors should call for the latest credit ratings of the borrowers which should not be more than one year old. The auditors should further confirm whether separate ratings are obtained for short term as well as long term advances. Although the reports shall be generated from the system, it is

important to verify whether the figures match with the general ledger balances (or limits whichever is higher) where ever required and the aggregate advances match with the return. The auditors are also required to verify the bucketing for non-fund based advances like bank guarantees and letter of credit which are also allotted risk weights.

17.33 Proper classification of all advances in SME sector, Commercial and Institutional sectors (with appropriate external credit rating), Restructured Advances, Non-Performing Assets, Unrated Institutional advances, etc. should be ensured.

17.34 Appropriate classification of guarantees into performance and financial along with the cash margins held there against should also be verified. An Illustrative Audit Checklist for Capital Adequacy is given as **Annexure A** to this Chapter.

## **Other Certificates**

### **Introduction**

17.35 The SBAs have to issue various special purpose reports and certificates at branch level. SBAs should ensure the correctness of financial / non-financial information given in these certificates.

17.36 The appointment letter normally contains an exhaustive list of all such reports and certificates which are required to be certified by the SBAs. These are to be verified and certified by the SBAs to ensure their correctness and accuracy. Since the SBAs have a direct access to the supporting branch documents and the relevant information, users of these certificates, such as Bank Management, SCAs, State Government/Central Government as well as RBI rely upon the reports and certificates issued by the SBAs and actually use them to release the various grants and subvention amounts to banks.

17.37 The purpose of these Reports/Certificates may be for:

- a) Disclosure requirements - SLR/CRR, provisions of NPAs, movement of NPA provisions, Gross/Net NPA, Asset Liability Management related returns, Exposure to Sensitive Sectors, Unhedged foreign currency exposures, etc.
- b) Related to provision to be made (other than advances) like fraud, suspense account, etc.
- c) Certificates related to Compliance of Internal Control Systems and Prevention of Frauds (Ghosh /Jilani Reports/Certificates).
- d) Certification relating to various subsidies, interest subvention, loan waivers,



etc. to be issued to RBI which is acting as an agency on behalf of Central and State Governments for administration of various public welfare schemes. Normally the advances to priority sectors like agriculture, SME sector, Educational Loans, Public Housing loans, etc. are covered under this head.

- e) Certification from SBAs relating to correctness of provisions and compliance of IRAC norms in respect of advances.
- f) Memorandum of Changes (MOCs) for the changes recommended by the SBAs to be considered by the bank and SCAs in respect of increase/decrease in assets/liabilities balances, changes in classification of assets and provisioning thereon and/or increase/decrease in profit/loss at the branch, changes related to capital adequacy calculations.
- g) Certificates in respect of Physical custody of Branch in respect of Investment scrips e.g. local municipal bonds, gold coins, etc. held by the branch on behalf of head office.
- h) Certificate in respect of contingent liabilities.
- i) Some additional certifications needed could be as under:
  - (i) Compliance with SLR requirements on 12 odd dates spread over the entire year (not being Fridays) and the accuracy in the computation of net DTL.
  - (ii) Verification of fortnightly CRR/SLR returns on a sample basis on at least 12 occasions during the year, including the last fortnightly returns, pertaining to every reporting quarter.
  - (iii) Adherence to income recognition, asset classification and provisions (IRAC Norms).
  - (iv) Implementation of gold card scheme for exporters as per extant instructions.
  - (v) Accuracy of computation of assessable deposits and premium (DICGC) classified under priority sector.
  - (vi) Correctness of the interest subvention claims under Interest Subvention Scheme for short term crop loans and Kisan credit card.
  - (vii) In cases of frauds the, process of reporting to central fraud registry, classification and monitoring of red flagged accounts.
  - (viii) Reporting of serious irregularities, if any.
  - (ix) Compliance with exposure norms under large exposure framework.
  - (x) Automation of income recognition, asset classification and provisioning processes in banks.

While issuing a special purpose report or certificate, the auditors should bear in mind the recommendations made in the Guidance Note on Reports or Certificates for Special Purposes (Revised 2016) issued by the Institute of Chartered Accountants of India (ICAI).

### **Audit Approach**

17.38 At the time of accepting the audit assignment, issuing engagement letter, preparing audit program, maintaining adequate working papers, the SBAs should appropriately comply with the requirements of the Guidance Note on Reports or Certificates for Special Purposes (Revised 2016) issued by the ICAI. They may also refer covering report for certificates as prescribed in **Annexure B** of this Chapter on “Illustrative Format of Covering Report for various Certificates issued by SBAs”.

17.39 The SBAs may verify the contents of certificates to be issued at branch level. All the returns submitted by branch to various higher authorities of the respective bank and also to various authorities of the regulators as per Master Directions No: DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 dated July 01, 2016 (Updated as on July 03, 2017) on ‘Frauds – Classification and Reporting by commercial banks and select FIs’ should be verified. In case of frauds, branch auditors should ensure the correctness of financial implication caused due to such frauds and confirm that adequate provision for the same has been made or are required to be done at HO level.

17.40 Considering various types of certificates and reports to be issued by the SBAs, it is important for the auditors to verify their correctness and accuracy from the available branch records and documents, as the bank, SCAs, RBI and other Governmental agencies use this data for consolidation, disclosure and also releasing various subsidies and waivers. Mostly the data certified by SBAs is consolidated, further certified and endorsed by the SCAs at the head office.

17.41 Wherever possible SBAs should reconcile or tally the closing balance of the return with the General Ledger Heads in the Trial Balance of the Branch as at the year end. This will be especially important for semi-automatic or manual returns. For system generated returns without manual intervention, it should still be ensured that they tally with the year-end figures, though detailed verification may not be warranted.

17.42 UDIN needs to be generated for reports and certificates issued by SBAs, as per the FAQs on UDIN issued by ICAI “Since UDIN has to be generated per assignment per signatory on a given date, one UDIN will suffice for the bank audit report including LFAR and certificates. However, separate UDIN will be required for tax audit report being separate assignment.” Further while generating UDIN, the details of multiple reports and certificates can be entered by “Add more” button.

## Certificates and Reports

17.43 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.
- Certificate as to 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 the 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 of cash and bank balances.
- Certificate relating to MOC entries of the previous year being accounted for.

As the MOC's are prepared and passed after the accounting year is over during the course of the statutory audit itself, the actual accounting entries in the records of the branch are passed during the next year. Therefore SBA's need to verify whether the previous year's MOCs have been effected at the branch and accordingly they have to issue the necessary certificate. Thus, for the audit in respect of financial year 2022-23, SBAs would verify the MOCs accounting effects recommended by previous year's SBAs i.e. for the year 2021-22.

- Certificate relating to credit/ deposit ratio.
- 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 for IRAC status of credit exposure in respect of non-performing investments.
- Certificates for IRAC Status of credit exposure in respect of borrowers having exposure with foreign offices.
- Certificate of contingent liabilities
- Certificate for agricultural interest subvention claim at the rate of 2 percent

for residual period of repayment of the loans disbursed during Financial year.

- Certificate for agricultural interest subvention claim at the rate of 2 percent for disbursements made during the financial year.
- Certificate for additional interest subvention (Incentive at the rate of 3 percent) for prompt repayment for short term production loans disbursed during financial year and other certificates as may be prescribed by the concerned bank in their respective closing instructions or appointment letters.
- Certificate of interest subvention for eligible housing loans.
- Certificate of interest subvention for eligible education loans.
- Certificate on unhedged foreign currency exposure in case of borrowal having exposure of 1 crore or more.
- Certificate on exposure to sensitive sectors, i.e., exposure to capital market, infrastructure and real estate sector.
- Certificate in respect of ECGC claims filed at the branch and its status.
- Certain other additional certificates as may be prescribed by the concerned bank in their respective closing instructions or appointment letters.

## **Implementation of Ghosh & Jilani Committee Recommendations**

### **Introduction**

17.44 The RBI had set up a High Level Committee on Frauds and Malpractices in banks under the Chairmanship of Shri A. Ghosh, the then Deputy Governor, RBI to enquire into various aspects of frauds and malpractices in banks with a view to make recommendations 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.

17.45 Later, 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.

## Regulatory Requirements

### Ghosh Committee Recommendations

17.46 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 44<sup>th</sup> report of the Committee on Government Assurances – Ghosh and Jilani Committees' Recommendations.

17.47 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 as:

- (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.

### Jilani Committee Recommendations

17.48 The 44<sup>th</sup> 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 not have been implemented. Accordingly, RBI laid down the following procedure to ensure the implementation of the 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.

17.49 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 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**

17.50 In terms of the letters issued to the banks regarding appointment of the SCAs 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.

17.51 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/her comments thereon are to be given in a separate report.

17.52 RBI through Master Circular No. RBI/2022-23/10 DOR.STR.REC.8/13.07.010/2022-23 dated April 1, 2022 on “Guarantees and Co-acceptances” has required that banks should implement the following recommendations of 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) While forwarding guarantees, banks should caution the beneficiaries that they should, in their own interest, verify the genuineness of the guarantee with the issuing bank.

17.53 The RBI through Master Circular No. RBI/2015-16/95 DBR.No. Dir. BC.10/13.03.00/2015-16 dated July 1, 2015 on “Loans and Advances – Statutory and Other Restrictions”. Directed the banks to 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 the areas of issuance of bank guarantees in favour of Financial Institutions, credit facilities extending to bank against the guarantees issued by other banks/FIs and advancement of Gold (Metal) Loans.

17.54 In this regard, it may be noted that the RBI has also issued Master Directions No. RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 dated July 1, 2016 (updated July 03, 2017) on “Frauds – Classification and Reporting by commercial banks and select FIs”. These directions deal with

Classification of Frauds, Reporting of Frauds to RBI, Quarterly Returns, Reports to the Board, Fraud Monitoring Returns, etc. and the auditor should verify the compliance of the same.

17.55 The RBI issued Master Circular No. RBI/2015-16/100 DBR.No.CID.BC.22/20.16.003/2015-16 dated July 01, 2015 on “Wilful Defaulters”, which also specifies the role of auditors including recommendations about the action to be taken against negligent / deficient auditors wherein falsification of accounts on the part of borrower is observed. Further, it specifies that to monitor 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 give a separate mandate to the auditors for the purpose. In addition to this, banks are advised that with a view to ensuring proper end-use of funds and preventing diversion/siphoning of funds by the borrowers, lenders could consider engaging their own auditors for such specific certification purpose without relying on certification given by borrower’s auditors. However, this cannot substitute bank’s basic minimum own diligence.

17.56 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 wilful defaulters, are wrongfully denied credit facilities on such grounds, banks/FIs have been advised to include the Director Identification Number (DIN) as one of the fields in the data submitted by them to RBI/CIC.

17.57 In terms of Para 2.9 of Master Circular on ‘Wilful Defaulters’ dated July 01, 2015 as stated above, banks / FIs have already been advised to submit the list of suit-filed accounts and non-suit filed accounts of wilful defaulters of Rs. 25 lakhs and above on a monthly or more frequent basis to all the four credit information companies. This would enable such information to be available to the banks / FIs on a near real time basis.

17.58 Further, in terms of RBI circular no. RBI / 2016-17 / 284 Ref. DBS.CO.PPD.BC.No.9/11.01.005/2016-17 dated April 20, 2017 on “Compliance with Ghosh Committee Recommendations”, compliance of the Ghosh Committee recommendation also need not be reported to the Audit Committee of the Board of Directors (ACB). However, banks are advised to ensure that:

- i) the compliance to these recommendations is complete and sustained; and
- ii) these recommendations are appropriately factored in the internal inspection/audit processes of banks and duly documented in their manual/ instructions, etc.

## **Audit Approach and Procedures**

17.59 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 SCAs for certifying the compliance/ implementation status of the Ghosh and Jilani Committees recommendations:

- In case of bank branch, the SBA 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 head office, the SCA shall 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 and the divisions at Head Office. 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 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 SBA 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 subjected to a concurrent audit/ inspection by the in-house inspection department or the inspectors from the RBI. SCA 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 SCA/SBA should request the concerned management to give a written representation as to why the particular recommendation(s) has/have not been implemented.
- The SBA/SCA may also consider it necessary to carry out test checks to ensure whether the recommendations said to have been implemented in the status report have indeed been implemented by the management.

17.60 In case, SBA/SCA 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, would 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, have to re-consider the nature, timing and extent of other audit procedures as also the truth and accuracy of any other management re-presentations obtained by the auditor.

### **Certificate / Report**

17.61 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.

17.62 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:

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- 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, of the 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.

17.63 **Annexure C** to this Chapter provides an illustrative format of the auditor's certificate w.r.t. compliance with/ implementation of the recommendations of the Ghosh and Jilani Committees.

## **Tax audit**

### **Introduction**

17.64 Normally tax audit at the branch has a limited scope. Further, in some cases, the tax audit work is fully centralized at Head Office Level and is not required to be done at branch level. Many times, the scope of work is defined by the head office in its letter of appointment. As most of the information is available at the head office, the scope is limited to the verification process limited to the branch data and supporting documents available there. Some of the banks allot the work to SCAs or to external audit firms other than SCAs/SBAs.

17.65 In the following paragraphs, we shall cover only the important matters relevant at the branch level. Although, it is expected that the branch makes full and correct disclosures in Form 3CD, the branch auditors are expected to exercise their professional scepticism to confirm whether the disclosures made by the branch are correct and exhaustive and accordingly give their report in Form 3 CA for the branch under audit.

### ***Fixed Assets and Depreciation – Clause No. 18 of Form 3CD***

17.66 Branch auditors should verify the fixed assets register maintained at the branch and more specifically the new assets purchased during the year and its tax invoices. The amount capitalized in the books of the branch, GST input credit (if any) and proper asset classification in the block of assets also needs to be verified. From the last year's audited return, the opening balances of current year's return should be verified block wise. The calculation of depreciation should

be verified in the light of the latest circular or as per closing instructions circular issued by the Head Office.

***General Scrutiny of Expenses/Charges – Clause No. 21 (a) of Form 3CD***

17.67 General scrutiny of charges or the profit and loss expense heads should be done to identify any nature of expenses which would be of personal nature (not related to the business of the bank and other than contractual nature), capital or revenue nature. It should also be ensured that if the branch has paid any penalty or fine which requires disclosure under the relevant clause of the Form 3CD, whether it has been done or not.

***Disallowance under Section 40A(3) read with Rule 6 DD – Clause No. 21(d) of Form 3CD***

17.68 General scrutiny of expenses or charges may also reveal disallowance under Section 40A(3) (read with rule 6 DD) of the Income Tax Act, 1961 if payment of more than Rs. 10,000/- is made otherwise than by way of account payee cheque or account payee draft. Auditors are expected to make an appropriate disclosure about the non-availability of evidence under this clause, apart from any specific case of non-compliance.

***Payment of Interest to any MSME Supplier – Clause no. 22 of Form 3CD***

17.69 Auditors should obtain an appropriate representation from the branch management whether it has paid any interest to any of its vendors or suppliers registered under MSME for delayed payment. Under Section 23 of the Micro, Small and Medium Enterprises Development Act, 2006, such interest is required to be disclosed under this clause and to be claimed/ disallowed in the computation of income for the bank.

***GST Compliance with respect to ITC – Clause 27 (a)***

17.70 Normally the bank has got a global GST number and files one consolidated return at the head office level. For the purpose of claiming the Input tax credit, it obtains the monthly return about the input tax credit along with other details from all its branches and submits a consolidated claim in the return filed at the head office. Then in such cases branch auditor can give a suitable disclosure.

***Prior Period Income/Expenses – Clause 27 (b)***

17.71 Branch auditor while doing a general scrutiny of charges should also identify any prior period expenditure debited to Branch Profit and Loss account and report the same.

***Repayment of Loan or Deposit exceeding the limit specified in Section 269T – Clause 31 (c) and (d)***

17.72 Considering the high volume of transactions at the branch, the auditor should obtain suitable management representation from the Branch Management and make appropriate disclosure in the relevant clause of the tax audit report.

***TDS Compliance – Clause No. 34 (a) to (c).***

17.73 This is the most important reporting clause in the branch tax audit report. This clause requires the auditors to verify and report Section wise details about the total expenditure incurred at the branch covered under various provisions of the Income-tax Act, 1961:

- Section 194 A- Interest
- Section 194 I – Rent
- Section 194 J – Fees for Professional and Technical Services
- Section 194 C – Payment made to contractors
- Section 195 - Payment to non-residents

17.74 The branch expenditure heads are required to be further classified into the above sections, especially the payments made to contractors spread in various expenditure heads at the branch are required to be considered wherever applicable. Similar is the case of fees for professional and technical services. While reporting the amounts in column no. 3 these have to be matched with the PL heads year-end figures wherever necessary.

17.75 Further, from the total amount from each head above the amount on which TDS is not applicable due to various reasons are to be excluded to determine the amount on which the TDS is required to be deducted. From the balance amount in column 4 where the TDS is required to be deducted again needs to be classified under following categories:

- a) Amounts on which TDS at regular rates is to be made on the above.
- b) Amounts on which TDS to be made at concessional rate (based on the certificates obtained from Income Tax authority) and TDS on above.
- c) Amounts on which tax is not deducted (to be matched with disclosure at Clause No.21 (b) of Form 3CD.
- d) Tax deducted but not paid.

17.76 The accuracy in reporting under this clause is important because, this is the most voluminous consolidation statement for reporting on the consolidated tax audit report for the bank as a whole and if there are any discrepancies in this

particular clause, then regional/zonal/HO consolidation is hampered and delayed.

17.77 General scrutiny of expenses should also be made keeping in mind the relevant TDS provisions covered under various sections and sub sections of Sections 194 and 195 of the Income tax Act, 1961. Payments made to non-residents (including interest payments made to NRE Account holders) interest paid to contractors, professionals, property owners, etc. should be verified keeping in mind the TDS provisions. It should be confirmed whether appropriate tax has been deducted and paid on various payments made to certain persons. Tax on fixed deposit interest shall be deducted at source by the system automatically, which also needs to be checked on a test check basis.

Likewise, compliance with the provisions of Tax collected at Source (TCS) is also to be ensured by the SBA. Any case of non-compliance with both TDS and TCS provisions should be reported under the appropriate sub-clause of Form 3CD.

17.78 Clause No. 34 (b) and (c) are applicable if the branch has obtained a TAN and it is doing its compliance at the branch level. In such a case the branch auditor is also required to verify the position, accuracy and timeliness of filing of quarterly ETDS returns filed by the branch and confirm the appropriate disclosure about the dates of filing, Interest payment and delayed filing fees paid by the branch. It is better to obtain CONSO files from TRACES and do an independent consolidation of four quarters and verify the data furnished by the branch to avoid the delay in verification of voluminous data.

17.79 As most of the points in Form 3CD are required to be verified only at the head office level, the branch auditors should make appropriate disclosure about the limitation of its scope in Form 3CA submitted along with Form 3CD.

**Annexure A**

**Illustrative Audit Checklist for Capital Adequacy**

*The checklist is only illustrative in nature. Members are expected to exercise their professional judgment while using the check list depending upon facts and circumstances of each case.*

<b>Audit Procedures</b>	
<b>CET 1, AT 1 and Tier II</b>	
1. Tally the balances in the various elements of capital from the trial balance/ groupings/ draft financial statements.	
2. Check whether various instruments comply with the guidelines as laid down in Master Circular by referring to the Terms of Offer and whether the same are approved by the Board or other appropriate committee.	
3. Check whether appropriate discounting has been applied in the case of instruments issued.	
4. 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.	
5. Examine whether various limits upto which individual elements are to be included in CET1, AT1 and Tier II capital as laid down in the Master Circular are adhered to.	
6. Verify 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.	
7. Verify the correctness of progressive discount based on the remaining maturity of instruments eligible for AT1 and Tier II.	

<b>Capital Charge on Credit Risk</b>	
<p>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"> <li>• On balance sheet items.</li> <li>• Off balance sheet items.</li> <li>• Failed transactions.</li> <li>• NPAs.</li> <li>• Securitisation transactions.</li> </ul> <p>duly adjusted for haircuts based on the nature of the collateral.</p>	
<b>Risk Weights – On Balance Sheet Items</b>	
<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"> <li>• Schedule 6 – Cash and balances with Reserve Bank of India.</li> <li>• Schedule 7- Balances with Banks and Money at Call and Short Notice.</li> <li>• Schedule 9- Advances.</li> <li>• Schedule 11(vi) – Other Assets – Others.</li> </ul>	
<p>2. Review and document the process of compilation and mapping of the various items on balance sheet based on the categories and their risk weights together with the appropriate ratings and / or other conditions, as applicable.</p>	
<p>3. 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>	

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<p>4. 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>5. Verify the validity of guarantees issued by Central or State Government. Verify whether the bank has properly classified claims on State Government and claims guaranteed by State Government due to difference risk weight.</p>	
<p>6. Verify the correctness of claims on CGTSI and ECGC.</p>	
<p>7. Verify the classification of loans – restructured loans/ NPAs/ NBFC/ CRE/ CRE-RH etc.</p>	
<p>8. Verify LTV ratio on a test check basis in respect of housing loans.</p>	
<p><b><i>Risk Weights – Off Balance Sheet Items</i></b></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"> <li>• The notional amount is converted into a credit equivalent amount by multiplying the amount by the specified credit conversion factor (for non market transactions) or by applying the current exposure method (for market related transactions).</li> <li>• 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.</li> </ul> <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</p>	



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sheet exposures which are considered for calculation with the financial statements, especially the schedule of contingent liabilities.	
2. Review and document the process of compilation and mapping of the various off balance sheet item based on the nature of the instruments.	
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.	
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.	
5. Verify the classification of financial and performance guarantee by perusing the sample guarantee issued by the branches.	
6. Verify whether bills accepted under letter of credit is assigned 100 percent risk weight as CCF.	
7. Verify whether the bank has proper control for accounting buyer's credit/ letter of comfort.	
8. Verify the correctness of undrawn exposures.	
<b>Capital Charge – Failed Transactions</b>	
1. Review and document the procedures for tracking and monitoring the credit risk exposure arising from unsettled transactions, both on Delivery Versus Payment (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.	

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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.	
<b><i>Risk Weights – NPAs</i></b>	
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 S.No. 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.	
5. Verify whether bucketing in difference risk weight in respect of NPAs based on NPA provision is carried out by the system and verify the correctness of classification on a test check basis.	
<b><i>Capital Charge – Securitisation Transactions</i></b>	
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	

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and extension of liquidity facility or credit enhancement.	
Examine whether the securitisation transactions fulfil the requirements as prescribed in Master Circular on "Prudential Guidelines on Capital Adequacy and Market Discipline - New Capital Adequacy Framework" (extract of the 'Revision to the Guidelines on Securitisation Transactions', issued vide circular no. DBOD.No.BP.BC.103/ 21.04.177/ 2011-12 dated May 07, 2012 on 'Revision to the Guidelines on Securitisation Transactions') 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 CET 1, AT I and Tier 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.	
<b>Collateral Risk Management and Credit Risk Mitigation</b>	
The objective of collateral risk 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 haircuts 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"> <li>• Ageing reports.</li> <li>• Confirmation procedures.</li> <li>• Control of documents.</li> <li>• Compliance with covenants.</li> <li>• Audit of collateral by independent agencies.</li> </ul>	

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<p>2. Examine whether the bank has complete legal rights to enforce the security including specific lien and is subject to haircuts for residual tenor mismatch and currency mismatch. Check the necessary documentation in respect thereof.</p>	
<p><b>Capital Charge for Market Risk</b></p>	
<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"> <li>• Securities under the HFT and AFS category.</li> <li>• Open gold and FX position limits.</li> <li>• Trading position in derivatives.</li> <li>• Derivatives entered into for hedging trading book exposures.</li> </ul>	
<p><b>Interest Rate – General Market Risk</b></p>	
<p>The capital requirement for general market risk is the sum of the following four components:</p> <ol style="list-style-type: none"> <li>(i) Net short (only derivatives) or long position in the trading book.</li> <li>(ii) Small proportion of matched position for each time band (vertical disallowance).</li> <li>(iii) A larger proportion of the matched positions across different time bands (horizontal disallowance).</li> <li>(iv) Net change for positions in options where applicable.</li> </ol>	
<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</p>	

<p>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>	
<p><b><i>Interest Rate – Specific Risk</i></b></p>	
<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"> <li>• Central, State and foreign government bonds under HFT and AFS category.</li> <li>• Banks bonds under HFT and AFS category.</li> <li>• Corporate bonds and securitised debt under HFT and AFS category.</li> </ul>	
<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>	

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<ul style="list-style-type: none"> <li>• Level of capital adequacy.</li> <li>• Nature of the bank (scheduled or non-scheduled).</li> <li>• Residual maturity.</li> </ul>	
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"> <li>• Rating assigned.</li> <li>• Nature of the investment.</li> <li>• Residual maturity.</li> </ul>	
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.	
<b>Equity – General and Specific Market Risk</b>	
A uniform percentage of 9 percent is currently attracted for the gross equity position for both specific and general risks.	
<b>Foreign Exchange and Gold</b>	
These currently attract a risk weight of 100 percent which is in addition to the capital charge for credit risk for on and off balance sheet items.	
1. Check the computation of the net open position in each currency as a summation of the following: <ul style="list-style-type: none"> <li>• Net spot position.</li> </ul>	

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<ul style="list-style-type: none"> <li>• Net forward position.</li> <li>• Guarantees and similar instruments.</li> <li>• Net future expenses / incomes not yet accrued but fully hedged.</li> </ul>				
<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><i>Interest rate risk</i></p> <p>a) General market risk</p> <ul style="list-style-type: none"> <li>• Net position</li> <li>• Horizontal disallowance</li> <li>• Vertical disallowance</li> </ul> <p>b) Specific market risk</p> <p><i>Specific and general market equity risk Foreign Exchange and gold.</i></p>				
<p><b>Capital Charge for Exposure to Entities with Unhedged Foreign Exchange Exposures (UFCE)<sup>47</sup></b></p>				
<p>1. Ascertain the amount of the UFCE: UFCE may exclude items which are effective hedge against each other viz. financial hedge and natural hedge (On sample basis, the UFCE considered by the bank can be verified with the certificates issued by the statutory auditor of the borrower entities, which is usually taken by the bank from them on a quarterly/ half yearly basis).</p> <p>2. Estimate the extent of likely loss.</p> <p>3. Estimate the riskiness of the unhedged position and provide appropriately:</p> <table border="1" data-bbox="412 1461 945 1640"> <tr> <td data-bbox="412 1461 578 1640">Likely Loss/EBID (%)</td> <td data-bbox="578 1461 781 1640">Incremental Provisioning Requirement on the total credit exposures over</td> <td data-bbox="781 1461 945 1640">Incremental Capital Requirement</td> </tr> </table>	Likely Loss/EBID (%)	Incremental Provisioning Requirement on the total credit exposures over	Incremental Capital Requirement	
Likely Loss/EBID (%)	Incremental Provisioning Requirement on the total credit exposures over	Incremental Capital Requirement		

<sup>47</sup> RBI/2013-14/448 DBOD.No.BP.BC. 85 /21.06.200/2013-14 dated January 15, 2014 on "Capital and Provisioning Requirements for Exposures to entities with Unhedged Foreign Currency Exposure".

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	<b>and above extant standard asset provisioning</b>	
Upto 15 percent	0	0
More than 15 percent and upto 30 percent	20bps	0
More than 30 per cent and upto 50 percent	40bps	0
More than 50 percent and upto 75 percent	60bps	0
More than 75 percent	80 bps	

Banks should calculate the incremental provisioning and capital requirements at least on a quarterly basis. However, during the periods of high USD-INR volatility, the calculations may be done on a monthly basis.

**Capital Charge for Operational Risk**

Currently banks are required to maintain capital charge for operational risk at 15 per cent of the average gross income for the last three financial years.

1. Obtain the computation of the 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.

- 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.



## **Annexure B**

### **Illustrative Format of Covering Report for various Certificates issued by SBAs**

**Independent Auditor's Certificate for various certificates issued during the Statutory Audit of .....[Name of the Branch]..... [Branch Code] of .....[Name of the Bank] for the Financial year 2021– 2022.**

1. This Certificate is issued in accordance with the terms of our agreement dated .....[date of Engagement Letter].
2. The accompanying Statement contains various certificates issued by us during the Statutory Audit of..... [Name of the Branch]..... [Branch Code]..... of [Name of the Bank] for the Financial year 2021 – 2022, listed in Annexure [Name], which we have initialled for identification purposes only/digitally signed.

#### **Managements' Responsibility for the Statement**

3. The preparation of the accompanying Statement is the responsibility of the Management of the Bank. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and presentation of the Statement, and applying an appropriate basis of preparation; and making estimates that are reasonable in the circumstances.
4. The Management is also responsible for ensuring that the..... (Name of the Branch)..... (Branch Code of Bank)..... (Name of the Bank) complies with the requirements of the equity listing agreement and for providing all relevant information to the Securities and Exchange Board of India.

#### **Auditor's Responsibility**

5. Pursuant to the requirements of the various RBI guidelines, our responsibility is to express reasonable assurance in the form of an opinion based on our audit and examination of books and records on test check basis, as to whether the .....[Name of the Branch] .....[Branch Code] of .....[Name of the Bank] has undertaken only those activities that have been specifically permitted by the RBI and has complied with the specified terms and conditions.
6. We audited the financial statements of ..... [Name of the Branch]..... [Branch Code] of .....[Name of the Bank] for the Financial year 2022 – 2023, on which we issued an unmodified/modified audit opinion vide our reports dated .....[date of Audit Report]. Our audit of these financial statements was conducted in accordance with the Standards on Auditing and other applicable authoritative pronouncements issued by the Institute of Chartered Accountants of India. Those Standards require that we plan and perform the

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audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

7. We conducted our examination of the Statements/Certificates given in Annexure..... [Name], in accordance with the Guidance Note on Reports or Certificates for Special Purposes issued by the Institute of Chartered Accountants of India. The Guidance Note requires that we comply with the ethical requirements of the Code of Ethics issued by the Institute of Chartered Accountants of India.

8. We have complied with the relevant applicable requirements of the Standard on Quality Control (SQC) 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

### **Opinion**

9. Based on our examination as above, and the information and explanations given to us, we report that the Statement in Annexure.....[Name] is in agreement with the books of account and other records of..... [Name of the Branch]..... [Branch Code] of .....[Name of the Bank] for the financial year 2022 – 2023 as produced to us for our examination, and the information thereof is prepared, in all material respects, in accordance with the applicable criteria.

### **Restriction on Use**

10. This certificate has been prepared at the request of ..... [Name of the Branch].....[Branch Code] of.....[Name of the Bank] solely with reference to our appointment letter, for the purpose of onward compilation of various certificates and disclosure requirements for .....[Name of the Bank] as a whole. It should not be used by any other person or for any other purpose. Accordingly, we do not accept or assume any liability or any duty of care or for any other purpose or to any other party to whom it is shown or into whose hands it may come without our prior consent in writing.

For  
Chartered Accountants  
Firm's Registration Number:

Partner / Proprietor  
Membership Number:  
UDIN

Place:  
Date:

**Annexure C**

**Illustrative Format of Certificate w.r.t. Compliance/  
Implementation Status of the Recommendations of the  
Ghosh and Jilani Committees**

We have examined the attached format of compliance/ implementation by \_\_\_\_\_ (*name of bank/ bank branch/Department/Zonal Office*) with the recommendations of the Ghosh Committee relating to Frauds and Malpractices in Banks and Format of Progress in Implementation of Jilani Committee recommendations, as prepared by the management. The responsibility for compliance with/ implementation of the recommendations of the Ghosh and the Jilani Committees is that of the management of the \_\_\_\_\_ (*name of the bank/ bank branch/Department/Zonal Office*). Our responsibility is to examine the report on the status of compliance therewith as contained in the attached formats, as prepared by the management, thus far and no further.

We have not carried out an investigation into the status of compliance by/ implementation of the management with the recommendations of the Ghosh and Jilani Committees. Our examination is limited to inquiries and obtaining confirmations from the management and other appropriate persons and test checks of the attached status of recommendations.

Based on our above examination, subject to the matter highlighted below, we certify that to the best of our knowledge and belief and according to the information and explanation given to us and as shown by the records examined by us, the attached formats of compliance with the recommendations of the Ghosh and Jilani Committees, as prepared by the management is correct except to the extent stated in annexure A attached herewith.

1. ....
2. ....

Date:

Place:

For and on behalf of  
Chartered Accountants  
(Firm Registration No.)

.....  
(Name and Designation)  
(Membership Number)  
UDIN

## Gold / Bullion / Security Items

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18.01 The RBI has discontinued the gold/ bullion sale at bank branches<sup>48</sup> and now RBI designates certain banks every year for the purpose of importing gold and selling it onward to customers. Besides some banks sell retail gold coins of a specific purity in specific denominations to their customers<sup>49</sup>.

18.02 In such cases, the auditor should ensure that:

- 1) Gold coins are stored properly in fire proof safe custody.
- 2) Insurance cover is obtained.
- 3) Stock records are properly maintained showing receipts, sales and closing stock.
- 4) Activity of verification and balancing of stocks is carried out on daily basis.
- 5) Sales / transfers within branches are made at prices determined by a systematic central driven process.
- 6) Proper entries are made in the books.
- 7) Tax payments if any including billing of invoices is done properly.

18.03 The auditor should duly verify the process and report discrepancies, if any. Escalations could be made depending on the gravity of the issue. Appropriate reporting could be made in the LFAR as follows:

- a) Does the system ensure that gold/bullion are in the effective joint custody of two or more officials, as per the instructions of the controlling authorities of the bank?

The auditor needs to take the details of the name and designation of the people who have joint custody of the same. The same needs to be verified as per the system laid down and the exceptions if any should be reported.

- b) Does the branch maintain adequate records for receipt, issues and balances of gold/bullion and updated these regularly? Does the periodic verification reveal any excess/shortage of stocks as compared to book records and the

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<sup>48</sup> RBI Master Direction No. RBI/2015-16/211 No.DBR.IBD.No.45/23.67.003/2015-16 dated October 22, 2015 (Updated as on August 04, 2022) on Gold Monetization Scheme, 2015.

<sup>49</sup> RBI circular no. RBI/2015-16/298 DBR.IBD.BC.75/23.67.001/2015-16 dated January 21, 2016 on Sale of India Gold Coin (IGC).

discrepancies observed have been promptly reported to the controlling authorities of the bank?

The records maintained in this regard should be verified by the auditors. The details of discrepancies noticed and the reporting to the controlling authorities should be taken and delays if any should be reported.

- c) Does the system of the bank ensure adequate internal control over issue and custody of 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? Have you come across cases of missing/lost items?

For the purpose of review of compliance for this audit area the auditor may consider the following points.

- Head Office instructions should be reviewed for existence of internal control.
- Carry out the physical verification of security items including stamps.
- Review whether lost security items have been promptly reported to the Controlling Authority.
- Review the accounting treatment of stationery items in financials. Different banks follow different policies w.r.t. valuation and accounting of stationery and stamps.
- Comment on the usage of security items during the year and the stock of such items *vis a vis* usage.
- Report lacunas observed in the system at the branch as this is a fraud prone area.

# 19

## Books and Records

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19.01 The SBA should rely on the following books and records to maintain audit working papers as per SA-230 w.r.t. review and reporting on maintenance of books and records by the branch:

- A. Computerised books of account / digital records
- B. Manual books of accounts, if any
- C. Other books of accounts and records like GST and TDS related records, Insurance registers, Fixed asset register, Cash registers / Scroll Book, Stock statements, Exception register, etc. (Other than A & B above)
- D. Non-financial records like complaints register, fraud related records, counterfeit currency related records, etc.

19.02 SBAs are required to report on the following points in the Long Form Audit Report.

- a) Whether there are any software / systems (manual or otherwise) used at the branch which are not integrated with the CBS? If yes, give details thereof:
  - At present, all the banks have implemented the core banking system. The auditor should report the system implemented at bank.
  - The Auditor should evaluate as to whether the books of accounts are maintained as per Accounting Standards and in accordance with fundamental accounting assumptions, i.e., Going Concern, Accrual and consistency and may refer to the accounting policies of the bank in this regards.
  - The auditor should also compile and review the details of other software deployed by the bank.
  - The reporting requirement in LFAR expects the auditor to report the software which are not integrated with CBS. There can be numerous software implemented by the banks. However, the auditor should review the software which have an impact on the financial transactions, reporting or any core activity which have not been integrated and report accordingly.

- The accounting and reconciliation required, if any, w.r.t. the ATM attached to the bank including cut-off procedures and its impacts on accounting be verified by the SBA.
  - For instance, whether the SWIFT system, Structured Financial Messaging System (SMFS), system for lockers etc. have been integrated with CBS and if so, what is the degree / percentage of integration of such system with CBS is required to be reviewed and commented upon.
  - The requirement of reporting of software / systems not integrated with CBS require in-depth review of all systems in place. Moreover, the auditor should also review the activities carried out manually at branch viz. compilation of details for various reporting, etc.
- b) (i) In case the branch has been subjected to IS audit whether there are any adverse features reported and have a direct or indirect bearing on the branch accounts and are pending compliance? If yes give details.
- The branch auditor should seek a confirmation from Branch Management for IS audit carried out at branch. If any IS Audit is carried out at branch, the branch auditor should seek the copy of the report.
  - The issues reported by IS Auditor should be reviewed from two important aspects viz. i) Impact of issue identified on branch books and ii) Compliance status of the issue. All the pending items with status thereof should be reported.
  - Necessary explanations (wherever required) should be obtained on issues reported by IS Auditor.
- (ii) Whether branch is generating, and verifying exception reports at the periodicity as prescribed by the bank.
- Each bank has a system of generation of various exception reports at the prescribed intervals. The branch auditor should obtain the list of exception reports prescribed by bank along with its periodicity for review
  - The auditor, on sample basis, should verify whether the branch has followed the instructions issued by bank w.r.t. generation and verification of exception reports.
  - The exception reports contain various types of transactions. Review of such transactions on sample basis will help the auditor in ascertaining

the nature of the transactions and risk involved.

iii) Whether the system of bank warrants expeditious compliance of daily exception reports and whether there are any major observations pending such compliance at the year end and reporting requirement and response system of such items to HO and review the system of closure of exception reports.

- The branch auditor should review whether exception reports which are required to be generated, reviewed and commented upon on daily basis have been complied with.
- Are there any issues which have not been complied / marked as pending compliance? If so, the status of the same should be obtained. All the critical items should be reported with status thereof.

iv) Whether the bank has laid down procedures for manual intervention to system generated data and proper authentication of the related transactions arising therefrom along with proper audit trail of manual intervention has been obtained.

- a. The branch auditor should obtain instructions issued by the bank for process to be followed when system generated data is manually altered.
- b. In case such instructions have not been issued, the same should be commented upon.
- c. Moreover, the auditor should also review the cases wherein the system data, report, reporting, etc. have been manually altered. However, identification of such case is a complex process. The branch auditor should identify the reporting requirement and should review the system on sample basis to ascertain the authenticity of data.
- d. There have been instances of manual updation of interest rate / refund of excess interest by debiting revenue / expenditure account. Such transaction should also be reviewed from manual intervention perspective.
- e. The auditor should enquire about availability of audit trail / logs related to such manual interventions and review the same which may be Manual or Digital.
- f. The auditor should refer to the instructions, if any, issued by the RBI,



- wherein manual intervention is prohibited (e.g. RBI circular no. RBI/2020-21/37 DoS.CO.PPG./SEC.03/ 11.01.005/ 2020-21 dated September 14, 2020 on Automation of Income Recognition, Asset Classification and Provisioning processes in banks) vis-à-vis observations related thereto during audit process.
- g. The auditor should enquire and obtain for manual intervention carried out by the branch though prohibited, through the audit trail provided and report the same in LFAR as per point (e) above.
- h. The auditor should obtain the manual records with respect to stock statements obtained from customers and verify the date and time of such entries posted correctly or not, observe the delay in posting in the system, or these entries are not posted at all in the system of Manual entries to be reported to HO promptly, since stock statements becomes the part of books o account, since DP (Drawing power) is fixed basing on the same.
- v) Furnish your comments on data integrity (including data entry, checking correctness / integrity of data, no back ended strategies etc.) which is used for MIS at HO / CO level.
- Data integrity aspect is generally handled at Data Administration level i.e. at Head Office / Corporate Office. Branches do not have any role to play in this aspect. However, the data entry being done at branch level which is used for MIS at HO / CO level needs to be reviewed at branch level. The auditor should carry out test check to verify that the data being entered at branch level is done properly and there is proper maker checker principle for verification of the same.
  - The auditor needs to find out whether there is any data masking and data breaches compromising data integrity.

## Inter Branch/Office Accounts

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### A. Introduction and Bank Process

20.01 Office accounts are mostly used for internal business transactions of banks or transactions to facilitate movement of funds in a flow of transaction. Banks have large number of transactions involving substantial sums with other banks, branches and controlling office or other business establishments and hence such transactions are carried out through office accounts. Therefore, it becomes important to monitor the same. It is the responsibility of the bank to reconcile their transactions on a daily basis and keep a track on un-reconciled transactions.

20.02 Following are the major transactions which occur between branches and the head office through inter-office accounts:

- 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 /realization/clearing.
- Cash sent to/received from other branches.
- Payment of instruments like gift cheques/ banker's cheques/ interest warrants/ dividend warrants/repurchase warrants/refund warrants / traveller's cheques, etc.
- Profit/loss transferred by the branch to head office.
- Government receipts and payments handled by the banks.
- Operations by the authorised branches on the bank's NOSTRO accounts through the treasury/ International Banking Division.
- 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.
- Deposits into and withdrawal of money, by branches into currency chest maintained by another branch.

- Transactions through NEFT, RTGS, NACH, UPI, etc.
- ATM transactions of the customer either at ATMs linked with other banks or branches or with merchant establishments.
- Internet based transactions.
- Credit card related transactions of the customers.
- Control 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.
- GST transactions of bank branches within a zone and Zonal or Head office.
- TDS of the branches is deposited by the central office.
- Parking of subsidies received from Government under various schemes.
- Head Office, 'Bad debts written off' account.
- Foreign portfolio Investment for purpose of investment in Portfolio Investment Scheme (PIS) transactions.
- Prepaid Payment Instruments (PPIs) transactions.
- Clearing Corporation of India Limited Transactions.
- Transactions related to Bharat Bill Payment System transactions.
- Trade Receivable Discounting system transactions.
- ATM transactions of the customer either at ATMs linked with other banks or branches or with merchant establishments.
- Payment Aggregators or Gateway Transactions.
- Transactions in Trust, Nominee or Fiduciary Account.
- Cross Border Wire Transfer.
- Point of Sale (POS) Terminals / online transactions using credit/debit/prepaid cards issued by Card Payment Networks Transactions

20.03 In respect of CBS, office accounts are bifurcated between accounts which mandatorily require the bank to enter a reference number while passing entry (pointing) and accounts which do not have such mandate (non-pointing). In respect of pointing accounts, reconciliation is easier as the entries can be

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knocked off based on reference number and each outstanding entry constituting outstanding balance at reporting date can be identified. In case of non-pointing, reconciliation requires manual intervention and tracking due to non-availability of unique reference number.

20.04 The branch writes off the loan balance due to OTS or otherwise and credit the balance of loan account and debit to Head Office bad debts written off account. The same is transferred to head office after due approval of the competent authority.

20.05 The auditors should verify the balance in this head and should seek explanation as to why the balance is not transferred to head office.

20.06 GST is normally centralised in banks but the entry of input is generated by the branch. The auditor should verify the expense voucher to ensure that no blocked credit is claimed by the branches and all eligible credit is claimed. The entry of reverse charge may also be examined.

20.07 In CBS most of the above mentioned transactions are automatically executed by the system. Hence where there is manual intervention or reversals are not through pointing accounts, these are to be monitored meticulously.

20.08 Following are the most common types of errors observed in the office accounts:

- Recording of particulars in incorrect fields.
- Posting of transactions in incorrect office accounts.
- Errors in mentioning the amounts.
- Recording the same transaction twice.
- Squaring off the transaction by same amount without checking the transactions.
- Merging of two branches into one and data is migrated to another branch but in the absence of reference of original entry, the transaction is not matched by the system.

#### **Unauthorised/ Objectionable practices in the Inter Office Accounts**

20.09 The RBI has issued a letter to all banks regarding certain objectionable practises observed by RBI in respect of office accounts. RBI has also instructed the banks to conduct a comprehensive audit of office accounts and place the same before the Audit Committee. Illustrative instances of such practices are as follows:

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- Not having documented the policy and standard operating procedures (SOPs) for opening and operating the inter office accounts. Not linking the office accounts/ deficiencies in linking the office accounts to the trial balance and general ledger.
- Disguising cash transaction of customer to avoid AML reporting and bypassing CTR/STR reporting of the same.
- Disbursal of loan or repayment of loan through office account general ledger resulting in misuse of funds and window dressing.
- No mandatory requirement of keying in reference number in case of pointing accounts.
- Lack of automation for identifying and reporting of the outstanding entries in the office accounts and aging thereof and resultant shortfall in provisions.
- Opening of saving and current account and funds movement thereon misused and routed through office accounts.
- Crediting a dummy entry by debiting the office account to the credit of borrowers account and then debiting so as to maintain the “standard” status of borrower or to prevent from becoming NPA.
- Netting off liability related GLs with debit balances with credit balances in other GLs resulting in disclosing net outstanding in Financials of the bank.
- Many income accounts do not have debit freeze or reference id for reversing charges.
- Passing entries from office accounts to customer accounts in a batch mode (one debit/credit with corresponding credit/debit to multiple accounts), which results into customer account statements not reflecting/ incorrectly reflecting the contra accounts.
- Unauthorised opening of Internal Accounts with customer ID and operated at the branch level to parking funds and routing customer transactions including cash.
- Government business authorised branches opened and operated adjustment settlement account in the name of Government officers instead of routing government transactions through designated accounts.
- Passing entries in internal accounts by debiting a general head and crediting loan account which is already marked as NPA or SMA.
- Passing entries by debiting other liabilities and crediting No Lien account or “Tax collection” Account (an internal account), which the bank has

maintained to park proceeds of compromised settlements or tax collection purpose and further debiting No lien or Tax collection Account to change IRAC status.

## **B. Audit Approach**

20.10 Office accounts have been a rather sensitive area and can prove to be problematic or prone to errors and frauds. The auditor should review the system of operation for such sensitive accounts. Many times it has been observed that there are old entries in such accounts due to migration issues. The auditor should check thoroughly the details of such entries with their ageing and also the improvement in settlement of the entries on a periodic basis by the bank including its reporting to the appropriate higher authorities at regular intervals.

- Every bank has its own procedures and methodology for office accounts transactions and hence it is important for the auditor to understand the procedure followed by the bank for recording the same.
- Every office account is opened for specific purpose and hence the auditor on sample basis should review the transactions in office accounts to verify whether the transactions in accounts are matching with the purpose of account.
- Normally as part of MIS reporting, branches report only ageing analysis of the outstanding balances of office accounts; however the auditor should verify whether there are any entries near to reporting date where second effect is to either office accounts or borrower account especially overdue account. In former scenario, the branch is avoiding long pending entry in office account by transferring to other office account and in later, the branch is trying to avoid classifying an account as NPA.
- The RBI has directed banks to carry out comprehensive audit to ensure that internal accounts are not allowed to be used unauthorized and proper checks are exercised before opening any such account, including adherence to the delegated power.
- As per Para 14 of Master Direction RBI/DOR/2021-22/83 DOR.ACC.REC.No.45/21.04.018/2021-22 dated August 30, 2021 (Updated as on February 20, 2023) on Financial Statements - Presentation and Disclosures, banks shall maintain category-wise (head-wise) accounts for various types of transactions put through inter-branch accounts, so that the netting can be done category-wise. As on the balance sheet date, banks shall segregate the debit and credit entries remaining unreconciled for more than six months and arrive at the net position category-wise. The balance in the blocked account shall

also be considered. Thereafter, the net debit under all the categories of inter-branch accounts shall be aggregated and a provision equivalent to 100 per cent of the aggregate net debit shall be made. While doing so, banks shall ensure that the net debit in one category is not set-off against net credit in another category.

- As per Para 15 of Master Direction RBI/DOR/2021-22/83 DOR.ACC.REC.No.45/21.04.018/2021-22 dated August 30, 2021 (Updated as on February 20, 2023) on Financial Statements - Presentation and Disclosures, banks shall take steps to have a strong control over reconciliation and put in place a system of real-time reconciliation. Escalation of differences, if any, should be done immediately. There should be close monitoring of pending items in Nostro accounts by top management at short intervals. All unreconciled credit entries in Nostro accounts which are outstanding for more than three years shall be transferred to a blocked account and shown as outstanding liabilities. The balance in the blocked account will be reckoned for the purpose of CRR/SLR. Banks shall make 100 per cent provision in respect of all unreconciled debit entries in the Nostro accounts, which are outstanding for more than two years.
- As per Para 13 of Master Direction RBI/DOR/2021-22/83 DOR.ACC.REC.No.45/21.04.018/2021-22 dated August 30, 2021 (Updated as on February 20, 2023) on Financial Statements - Presentation and Disclosures, banks should segregate the credit entries outstanding for more than five years in the inter-branch account and transfer them to a separate 'Blocked Account' which should be shown under 'Other Liabilities and Provisions - Others' or in the case of UCBs, under 'Other Liabilities-Suspense'. Any adjustment from the blocked account should be permitted only with the authorisation of two officials, one of whom should be from the Controlling/Head Office if the amount exceeds Rupees One lakh. The balance in blocked account shall be reckoned as a liability for the purpose of the maintenance of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR).
- There are some transactions like dividend warrant, interest warrant, refund order etc. which required special attention because in the recent past number of transactions have been reported by the banks in these groups. In these transactions the funds are deposited at one branch and payments take place at other branches. Hence to prevent fraud outstanding balances of these accounts should be checked with professional skepticism.
- The auditor should review all material transactions accounted in office

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accounts just before the year end and where required, request the bank management to rectify the same by accounting in the correct account head.

- The auditor should cautiously review all material transactions outstanding in office accounts even if it is outstanding for more than 6 months for which 100 per cent provision is made.
- The auditor should check all adjustments in the office accounts and ensure that the adjustments are done properly and supported by adequate documentary evidence as to its validity. The auditor should also verify that the reversal entries are made under proper authority and after due explanation and evidence.
- The auditor should report on the year end status of office accounts indicating the dates upto which all or any segments of accounts have been reconciled. The auditor should also indicate the number of outstanding entries and the amount involved 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 audit reports.
- Nostro Accounts at branch - Branches should also prepare reconciliation statement (REC) relating to those accounts for each of the foreign offices or foreign correspondents, as the case may be for examination by SBAs.
- In respect to subsidy cases, the auditor may verify that the credit to loan account is not treated as recovery of interest and principal and NPA accounts are not correctly identified. The banks may be advised in case of back end subsidy accounts, instead of opening subsidy term loan, teaser rate of interest may be fixed in the term loan account of the borrower and subsidy may be credited after the expiry of lock in period.
- Also, the auditor may review jottings/listing of current / savings bank account to check whether any account is opened with generic name/ Branch Address/ Bank Address/ Bank PAN, etc. If such account is identified then the auditor should verify the purpose of opening the account and thoroughly review the transactions in the account. Also report about existence of such account and transactions in the same in LFAR.
- The auditor should also review the periodicity of the parking of entries in the inter office accounts. It should not be the regular frequency and only the specific items to be parked here. It should not be the regular practice of the branch to park and reverse the entries here.
- As per Para 21 of Master Direction RBI/DOR/2021-22/83 DOR.ACC.REC.No.45/21.04.018/2021-22 dated August 30, 2021 (Updated



as on February 20, 2023) on Financial Statements - Presentation and Disclosures, unreconciled credit balances in any transitory account representing unclaimed balances shall not be transferred to the profit and loss account or to any reserves.

- As per Para 23 of Master Direction RBI/DOR/2021-22/83 DOR.ACC.REC.No.45/21.04.018/2021-22 dated August 30, 2021 (Updated as on February 20, 2023) on Financial Statements - Presentation and Disclosures, banks shall ensure that the balance sheet and profit and loss account reflect true and fair picture of its financial position. Instances of window dressing of financials are short provisioning, misclassification of NPAs, under-reporting/ incorrect computation of exposure/risk weight, incorrect capitalization of expenses, capitalization of interest on NPAs, deliberate inflation of asset and liabilities at the end of the financial year and subsequent reversal immediately in next financial year.
- The auditor should ensure controls over IT system and processes and should check control over passing automated entries and system generated entries in Inter office and Inter Branch account including process of reconciliation and daily settlement of these automated or system generated entries, with special emphasis on the possibility of forced matching of entries during reconciliation and possibility of manual intervention related to reconciliation process.

20.11 In CBS environment, in case of inter branch transactions the inter branch account is automatically debited or credited by the system. An example of the same is as under:

A having savings bank account in X branch withdraws cash from Y branch. In such a scenario, the following entries are passed:

In the Books of Branch 'Y'	In the Books of Branch 'X'
Inter Sol/ Branch A/c (Branch 'Y').... Dr To Cash	'A' savings bank A/c           Dr To Inter Sol/ Branch (Branch 'X') A/c

At day end the balance in Inter Sol / Branch A/c for the bank as a whole should be Nil. The SCA should verify the same.

### **C. Reporting**

20.12 The auditor needs to verify the following:

- Whether the bank has an effective system of office accounts w.r.t. each type of entries?

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- Whether the bank has requisite audit trail w.r.t. reconciled entries?
- Age-wise analysis of unreconciled entries for each type covered under office accounts, as on balance sheet date along with subsequent clearance, thereof if any.
- Whether the bank has a defined procedure for auto and forced matching of entries?
- Whether there are any unusual entries observed in the reconciliation process?
- Whether the bank has made adequate provision w.r.t. unreconciled entries as per the RBI guidelines and to the satisfaction of the auditor?
- Suggest measures for improvement in existing system related to inter-branch reconciliation.
- Verify that Inter-office transactions are not shown as borrowings.
- Verify compliance with Chapter VI of Master Direction RBI/DOR/2021-22/83 DOR.ACC.REC.No.45/21.04.018/2021-22 dated August 30, 2021 (Updated as on February 20, 2023) on “Financial Statements - Presentation and Disclosures” to the extent applicable.

#### **For LFAR purposes the Auditor needs to Comment on Inter-Branch Accounts**

*20.13 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 beyond 7 days? If so, give details?*

The auditor should also refer the previous year auditors report for quantification of any items under this clause and if the same is reversed in the current year or continued. The auditor should review the closure of entry and satisfy itself as to whether any open entry is closed arbitrarily.

The auditor should review the details of reconciliation of inter-office accounts to the extent available at the branch and comment appropriately.

# 21

## Fraud

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### Introduction

#### Definitions of Fraud

21.01 The term 'fraud' has been defined in several statutes:

- **Indian Contract Act, 1872:** As per Section 17, "Fraud" means and includes any of the following acts committed by a party to a contract, or with his connivance, or by his agents, with intent to deceive another party thereto or his agent, or to induce him to enter into the contract:-
  - (1) the suggestion, as a fact, of that which is not true, by one who does not believe it to be true;
  - (2) the active concealment of a fact by one having knowledge or belief of the fact;
  - (3) a promise made without any intention of performing it;
  - (4) any other act fitted to deceive;
  - (5) any such act or omission as the law specially declares to be fraudulent.

*Explanation.*—Mere silence as to facts likely to affect the willingness of a person to enter into a contract is not fraud, unless the circumstances of the case are such that, regard being had to them, it is the duty of the person keeping silence to speak, or unless his silence is, in itself, equivalent to speech.

- **Companies Act, 2013:** As per Section 447, "Fraud" in relation to the affairs of a company or any body corporate, includes any act, omission, concealment of any fact, or, abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its Creditors or any other person, whether or not there is any wrongful gain, or any wrongful loss.
- **The Reserve Bank of India** has defined the term "fraud" in its guidelines on frauds as under.

"A deliberate act of omission or commission by any person, carried out in

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the course of a banking transaction or in the books of accounts maintained manually or under computer system in banks, resulting into wrongful gain to any person for a temporary period or otherwise, with or without any monetary loss to the bank”.

- **Standard on Auditing (SA) 240 issued by ICAI** defines fraud thus: – “An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.”

### **Classification of Frauds**

21.02 In order to have uniformity in reporting, frauds have been classified as under, based mainly on the provisions of the Indian Penal Code:

- a. Misappropriation and criminal breach of trust.
- b. Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
- c. Unauthorised credit facilities extended for reward or for illegal gratification.
- d. Cash shortages.
- e. Cheating and forgery.
- f. Fraudulent transactions involving foreign exchange.
- g. Any other type of fraud not coming under the specific heads as above.

As regards cases falling under (d) and (f) above cash shortages resulting from negligence and fraudulent forex transactions involving irregularities / violation of regulations have also to be reported as fraud if the intention to cheat/defraud is suspected or proved. Notwithstanding the above, the following cases shall be treated as fraud and reported accordingly:

- a. on the day of occurrence by the persons handling cash cases of cash shortage of more than Rs. 10,000/-, (including at ATMs); and
- b. cases of cash shortage of more than Rs. 5,000/- if detected by management / auditor/ inspecting officer and not reported.

### **Types of Fraud in Banking System**

21.03 There are numerous ways in which banking frauds are committed. The frauds committed in banking system can be classified under different types, based on the historical data available. Some examples of banking frauds are as under:

- **Account Opening Fraud:** This involves an account being opened with either fake or original KYC documents with an intent to depositing and cashing of fraudulent cheques/ instruments.
- **Cheque Kiting:** It is the method where by a depositor utilizes the time required for cheques (which is issued from an account having insufficient funds) to clear, to obtain an unauthorized loan with or without any interest charge.
- **Cheque Fraud:** It is the most common method where frauds are committed through stolen cheques and forged signatures.
- **Counterfeit Securities:** In this type of fraud, forged, duplicated or tampered documents, securities, bonds and certificates are presented as security for availing loan.
- **Digital Fraud:** Under this type of fraud, the fraudster resorts to hacking, tampering to gain unauthorised access to siphon off or misappropriate funds.
- **Loan Fraud:** This type of fraud is committed by lending funds to a non-borrowing customer or allowing a borrowing customer to exceed his credit limit, without adequate sanction / authority.
- **Money Laundering Fraud:** This type of fraud is committed by concealing the existence, source or use of illegally obtained money, by converting the cash into untraceable transactions in banks.
- **Letters of Credit:** This type of fraud is most common in international trade but has also been observed in domestic trade. In respect of international trade, these instruments used in cross borders transactions with underlying trade documents which are forged, altered, adjusted and take longer to identify ultimate destiny of merchandise. In respect of domestic trade these instruments are used to convert non funded facility into cash in purported trade transactions. Cash generated through such transactions is diverted or misappropriated out of system.
- **Advanced Fees Fraud:** This is popularly known as “419 scam”. Advanced fees fraud may involve agent with an offer of a lucrative business proposition / promise to make substantial funds available against advance fee or series of advance fees.

### **Early Warning Signals**

21.04 Early Warning Signals (EWS) are those, which when noticed in any loan account, should alert the bank officials about some wrong doings in the loan

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accounts which may turn out to be fraudulent. An illustrative list of some EWS as per Master Directions No. RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 dated July 1, 2016 (Updated as on July 3, 2017) on Frauds – Classification and Reporting by commercial banks and select FIs are as follows:

1. a) Default in undisputed payment to the statutory bodies as declared in the Annual Report.  
b) Bouncing of high value cheques.
2. Frequent change in the scope of the project to be undertaken by the borrower.
3. Foreign bills remaining outstanding with the bank for a long time and tendency for bills to remain overdue.
4. Delay observed in payment of outstanding dues.
5. Frequent invocation of BGs and devolvement of LCs.
6. Under insured or over insured inventory.
7. Invoices devoid of GSTN and other details.
8. Dispute on title of collateral securities.
9. Funds coming from other banks to liquidate the outstanding loan amount unless in normal course.
10. In merchanting trade, import leg not revealed to the bank.
11. Request received from the borrower to postpone the inspection of the godown for flimsy reasons.
12. Funding of the interest by sanctioning additional facilities.
13. Exclusive collateral charged to a number of lenders without NOC of existing charge holders.
14. Concealment of certain vital documents like master agreement, insurance coverage.
15. Floating front / associate companies by investing borrowed money.
16. Critical issues highlighted in the stock audit report.
17. Liabilities appearing in ROC search report, not reported by the borrower in its annual report.
18. Frequent request for general purpose loans.
19. Frequent *ad hoc* sanctions.

20. Not routing of sales proceeds through consortium/ member bank/ lenders to the company.
21. LCs issued for local trade/ related party transactions without underlying trade transaction.
22. High value RTGS payment to unrelated parties.
23. Heavy cash withdrawal in loan accounts.
24. Non production of original bills for verification upon request.
25. Significant movements in inventory, disproportionately differing vis-a-vis change in the turnover.
26. Significant movements in receivables, disproportionately differing vis-à-vis change in the turnover and/or increase in ageing of the receivables.
27. Disproportionate change in other current assets.
28. Significant increase in working capital borrowing as percentage of turnover.
29. Increase in fixed assets, without corresponding increase in long term sources (when project is implemented).
30. Increase in borrowings, despite huge cash and cash equivalents in the borrower's balance sheet.
31. Frequent change in accounting period and/or accounting policies.
32. Costing of the project which is in wide variance with standard cost of installation of the project.
33. Claims not acknowledged as high debt.
34. Substantial increase in unbilled revenue year after year.
35. Large number of transactions with inter-connected companies and large outstandings from such companies.
36. Substantial related party transactions.
37. Material discrepancies in the annual report.
38. Significant inconsistencies within the annual report (between various sections).
39. Poor disclosure of materially adverse information and no qualification by the statutory auditors.
40. Raid by Income tax /GST/ sales tax/ central excise duty officials.

41. Significant reduction in the stake of promoter /director or increase in the encumbered shares of promoter/director.
42. Resignation of the key personnel and frequent changes in the management.

Banks may choose to adopt or adapt the relevant signals from this list and also include other alerts/signals based on their experience, client profile and business models.

#### Agencies For Specialised Monitoring (ASM)

21.05 RBI released a report dated December 31, 2018 on Financial Sector: Regulation and Developments. One of the recommendations in the said report was to establish additional surveillance measures to monitor advances above ₹ 250 crores. Following the above recommendation, the Indian Banks Association (IBA) established a panel of Agencies for Specialised Monitoring. Specialised monitoring is a preventive measure to regularly review borrower's operations on ongoing basis.

### **Expectations of the Regulator**

21.06 The Central Fraud Monitoring Cell (CFMC) of the RBI has analysed statistics of reported frauds in the banking system during the FYs 2014 to 2018. Based on the said analysis some of the points worth noting are as under:

- There has been an increasing trend in terms of number of frauds reported on both counts namely volume and value.
- About 90 percent of the frauds in terms of value involved have happened in credit portfolio.
- Out of the frauds reported in FY 2018, frauds involving amounts above Rs. 50 crores accounted for 80 per cent of the total frauds reported.

21.07 The identified factors facilitating fraud are as under:

- Opening current account with banks outside consortium without the No Objection Certificate from lenders.
- Deficient and fraudulent services/certificates by Third Party Entities (TPEs).
- Diversion of funds by the borrowers through various means including through associated / shell / front-end companies.
- Lapses in credit underwriting standards.
- Failure to identify the Early Warning Signals (EWS) of incipient frauds.

21.08 It is expected that while conducting bank branch audit the auditor



should plan and perform the audit to obtain reasonable assurance with respect to existence and effectiveness of fraud identification and reporting framework laid down by Master Direction No. RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/ 2016-17 dated July 1, 2016 (Updated as on July 03, 2017) on “Frauds – Classification and Reporting by commercial banks and select FIs” and Master Circular RBI/2015-16/100 DBR.No.CID.BC.22/ 20.16.003/2015-16 dated July 1, 2015 on ‘Wilful Defaulters’.

## **Role and Responsibility of the Auditor**

21.09 Branch auditor’s primary objective is to opine on the true and fair view of branch financial statements. The audit process needs to confirm compliance with Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI). Specific to the area concerning fraud, as laid down in SA 240, the auditor has responsibility to plan and perform the audit to obtain reasonable assurance as to whether the financial statements taken as a whole are free of material misstatement, whether caused by error or fraud. SA 240 requires the auditor to perform procedures with the following objectives:

- identify and assess the risks of material misstatement in the financial statements due to fraud;
- obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
- respond appropriately to identified or suspected fraud.

21.10 While reporting on fraud in LFAR, the SBA has to provide appropriate responses to identified or suspected fraud.

21.11 Further, RBI circular no. DBS.FGV(F) No.BC.15/23.08.001/2002-2003 dated January 21, 2003 w.r.t. “Terms and conditions of appointment of statutory/ concurrent/ internal auditors - Implementation of the recommendations of the Committee on Legal Aspects of Bank Frauds and the recommendations of the High Level Group set up by the Central Vigilance Commission (CVC)”, mandated that all statutory, internal and concurrent auditors appointed by the bank have “to specifically report, simultaneously, to the Chief Executive Officer of the bank and Central Office of the Department of Banking Supervision, RBI, Mumbai, any matter susceptible to be fraud or fraudulent activity or any foul play in any transactions.” These instructions were partially modified vide RBI circular no. DBS.FGV(F) No. BC.15/23.08.001/2002-2003 dated May 14, 2003, to the effect that only instances of fraud or fraudulent activity where the amount involved is Rs. 100 lakhs or above should be reported to the RBI, Department of Banking Supervision, Central Office, Mumbai and all other instances should be reported

to Regional office of the RBI, Department of Banking Supervision under whose jurisdiction the Head Office of the bank falls.

## **Audit Approach and Procedures**

21.12 The suggested audit approach and procedures to be performed are as follows:

- Based on a review of advances consider whether the branch is having an effective credit monitoring for its advances portfolio.
- Obtain internal circulars of the bank pertaining to fraud identification and reporting.
- Obtain history of fraud in the branch/business area of the branch.
- Examine whether the branch has an adequate and effective system in place to identify Early Warning Signals (EWS) of incipient sickness / fraudulent activities in respect of loans within shortest possible time.
- Obtain and review reports issued by ASMs in respect of advances above ₹250 crores to assess existence of any of the early warning signals (EWS)<sup>50</sup>.
- If there are advances which are required to be brought under ASM mechanism but no ASM has been appointed, conduct specific enquiries with the branch and obtain explanations. The branch auditor may communicate to the SCA facts of the cases where unreasonable delays have been observed.
- Obtain and review reports of internal auditor, concurrent auditor, internal inspector, revenue audit, system audit and vigilance functions and assess existence of any of the early warning signals (EWS).
- Enquire whether forensic/transaction audit was conducted in the process of Corporate Insolvency Resolution Process (CIRP). Obtain and review transaction/forensic audit reports, if any.
- Verify whether Form FMR 01 has been filed with RBI within 3 weeks, Flash report to RBI above rupees 5 crores and above within a week of such frauds coming to the notice of the bank's head office as per RBI Master Circular No. RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 dated July 01, 2016 (Updated as on July 03, 2017).
- If any of the aforesaid reports are pointing out existence of early warning signals in any of the accounts, conduct further enquiries with the branch to

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<sup>50</sup>Chapter III: Financial Sector: Regulation and Developments of RBI Report dated December 31, 2018.

assess whether branch has taken appropriate action and current status thereof.

- Enquire about any fraud reported to Controlling Authority/vigilance department, Head Office during the financial year and current status thereof.
- Whether frauds are examined from staff angle and, wherever necessary, the cases are reported to the Vigilance Cell for further action.
- Whether preventive/punitive steps have been taken by the bank during the year to reduce/minimise the incidence of frauds.
- Whether frauds have taken place because of laxity in following the systems and procedures and, if so, whether effective action has been taken to ensure that the systems and procedures are scrupulously followed by the staff concerned.
- Whether frauds are reported to local Police or CBI, as the case may be, for investigation, as per the guidelines issued in this regard to public sector banks by the Government of India.
- Review the analysis of frauds according to different categories detailed in Paragraph 2.2.1 of Master Direction on Frauds dated July 01, 2016 (Updated as on July 03, 2017) and also the different business areas.
- Review and analyse modus operandi of major frauds reported during the year along with their present position.
- Whether adequate provision for fraud has been made.
- Based on the audit procedures carried out, provide your suggestions.

## **Reporting**

21.13 Though the objective of the statutory auditor is not to find out fraud / fraudulent activity or its possibility, it would be advisable for the statutory auditor to assess the existence and effectiveness of fraud risk mitigating and avoidance framework and controls implemented by the auditee bank.

### **Main Report**

21.14 The branch auditor needs to consider the impact of his observations made in respect of fraud on overall presentation of financial statements of the bank while opining on these financial statements.

### **LFAR**

21.15 The branch auditor needs to report the particulars of frauds discovered during the year under audit. The auditor is also required to provide his suggestions based on his audit to minimise the possibilities of their occurrence.

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The auditor has to furnish particulars of: :

- (i) Frauds detected/classified but confirmation of reporting to RBI not available on record at branch.
- (ii) Whether any suspected or likely fraud cases are reported by branch to higher office during the year? If yes, provide the details thereof related to status of investigation. :
- (iii) In respect of fraud, based on your overall observation, please provide your comments on the potential risk areas which might lead to perpetuation of fraud (e.g. falsification of accounts/false representation by the borrower; misappropriation of funds especially through related party/ shell company transactions; forgery and fabrication of financial documents like invoices, debtor lists, stock statements, trade credit documents, shipping bills, work orders and encumbrance certificates and avail credit; use of current accounts outside consortium where Trust and Retention Account (TRA) is maintained, to divert funds; list of debtors/ creditors were being fabricated and receivables were not followed up/ write off of debt of related parties; fake export/shipping bill, etc.; over statement of invoice amount, stock statements, shipping bills, turnover; fly by night operations - including the cases where vendors, related/ associate parties, manufacturing units etc. aren't available on the registered addresses; round tripping of funds, etc.) :
- (iv) Whether the system of Early Warning Framework is working effectively and, as required, the early warning signals form the basis for classifying an account as RFA.

21.16 In the course of the audit, the auditors may come across instances where the transactions in the account or the documents point to the possibility of

fraudulent transactions in the account. In such a situation, the auditor should immediately bring it to the notice of the higher management and if necessary to the Audit Committee of the Board (ACB) for appropriate action.

### **Relevant Circulars**

1. RBI Master Circular No. RBI/2015-16/100 DBR.No.CID.BC.22/20.16.003/2015-16 dated July 01, 2015 on “Wilful Defaulters”.
2. RBI Master Direction No. RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 dated July 01, 2016 (Updated as on July 03, 2017) on Fraud – Classification and Reporting by commercial banks and selected FIs.

22.01 The Long Form Audit Report (LFAR) mentions a separate clause titled "Miscellaneous" wherein the auditors are required to provide their specific comments on the relevant questions. The LFAR is a detailed questionnaire on several of the key aspects which the Branch auditor has to reply for the perusal of the bank management. Miscellaneous includes a residuary clause wherein the branch auditor can specify his observations on any of the areas of the branch, which he feels necessary to be highlighted for the specific attention of the management and SCA. The relevant questions are detailed below:

- (a) In framing your audit report/ LFAR, have you considered the major adverse comments arising out of the latest reports such as:
  - i) Previous year's Branch Audit Report/ LFAR.
  - ii) Internal audit/Snap Audit/Concurrent Audit Report(s).
  - iii) Credit Audit Report.
  - iv) Stock audit Report.
  - v) RBI Inspection Report, if such inspection took place.
  - vi) Income and Expenditure (Revenue) Audit.
  - vii) IS/IT/Computer/Systems Audit.
  - viii) Any special inspection/investigation report.

As part of audit planning, the branch auditor should review various audit reports carried out by internal audit department or other departments of the bank and any other external authorities. The adverse comments in these reports should be considered while conducting branch audit. Also, the auditor should verify the status of the open observations in these reports and report the same in LFAR in respective paras as open observations from other audit reports. The auditor shall comment how he/she has considered the observations / adverse comment while conducting audit in this Para. Also special mention should be made by the auditor of any persisting irregularities pointed out by the auditors which the branch has not complied with.

- (b) Are there any other matter, which you, as branch auditor, would like to bring to the notice of the management or the Statutory Central Auditors?

The auditor can make the observations under this clause which have not been reported elsewhere in the report. The auditor should use this clause to highlight any matter which he feels is of importance for the attention of the SCA and the management. Some of the observations can be – the software licences being used at the branch are not genuine, pen drive is used on the desktop PCs at the branch, secrecy of the login passwords, placement of the branch server, router etc., general housekeeping of the branch, old assets physically lying at the branch pending disposal, expiry of the fire extinguishers, overall monitoring of the accounts etc.

## **Audit of Foreign Exchange Business**

23.01 Bank branches deal in different types of foreign currency transactions like (i) transactions related to import and export of goods and services; (ii) credit facilities availed by borrowers in foreign currency; (iii) trade and non trade related outward remittances and inward remittances (i.e. receipt or payment of funds) in foreign currency; (iv) compliance and approval (FEMA) related services. Similarly, at the branch level, the exposure of the branch can broadly be divided into two parts namely deposits and advances (funded as well as non-funded).

### 23.02 – Reporting Requirements under Long Form Audit Report

Long Form Audit Report (LFAR) for bank branches requires the auditors to review and comment on the following aspects w.r.t. branches dealing in foreign exchange business.

1. Are there any material adverse features pointed out in the reports of concurrent auditors, internal auditors and/ or RBI's inspection report which continue to persist in relation to NRE/ NRO/ FCNR-B/ EEFC/ RFC and other similar deposits accounts. If so, furnish the particulars of such adverse features.
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

### 3. **NOSTRO Accounts**

Obtain from the branch management, a list of all NOSTRO Accounts maintained/ operated by the branch.

- (a) Whether the bank has a system of periodic confirmation/ reconciliation of the balances in NOSTRO accounts maintained with each overseas



- bank/ correspondent? Has such confirmation been received and account reconciled at year end in each case. If not, give details.
- (b) Whether the system of the bank ensures that all entries originated by overseas banks/correspondents, have been duly responded promptly in the respective NOSTRO accounts maintained by the bank?
  - (c) Are there any dormant/closed NOSTRO accounts in respect of which balances continue to exist in the books of the branch, at year end?
  - (d) Have the NOSTRO balances been converted at year end at the rates of exchange as prescribed by controlling authorities?
  - (e) In case, any matter deserves special attention of the management, the same may be reported.
4. Does the branch follow the prescribed procedures in relation to maintenance of Vostro Accounts?

23.03 This Chapter is divided into following parts.

Part – 1: Review of Audit and Inspection Reports for Foreign Exchange Transactions

Part – 2: Adherence to instructions and guidelines of controlling authorities in relations to foreign exchange business

Part – 3: NOSTRO& VOSTRO Accounts related

**Part 1: Review of Audit and Inspection Reports for Foreign Exchange Transactions**

The auditor should seek various audit / inspection reports relating to foreign exchange transactions viz. concurrent audit report, internal audit report, forex audit (if carried out), IT audit report (containing part of foreign exchange transactions), RBI audit report (if applicable).

The issues identified and included in the said audit report should be reviewed and material discrepancies observed should be included in LFAR.

**Part 2: Adherence to Instructions and Guidelines of Controlling Authorities in relation to Foreign Exchange Business**

23.04 The LFAR deals with review of adherence to instructions and guidelines issued by RBI by the branch w.r.t. foreign exchange business in the field of:

- a. Deposits
- b. Advances

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- c. Export Bills
- d. Bills for Collection
- e. Dealing Room operations
- f. Any other area

23.05 The auditor should ensure compliances with internal policies of the bank and with various master directions as stated hereunder:

For the purpose of review of the said aspects the auditor should refer to various Rules, Regulations, master directions, master circulars and other directives issued by RBI and other relevant authorities in this respect. Some of the relevant guidelines issued are:

1. RBI Master Direction No. RBI/FED/2018-19/67 FED No.5/2018-19 dated March 26, 2019 (Updated as on September 30, 2022) on "External Commercial Borrowings, Trade Credits and Structured Obligations".
2. RBI Master Direction No. RBI/FED/2015-16/6 FED No.10/2015-16 dated January 01, 2016 (Updated as on May 18, 2021) on Establishment of Branch Office (BO)/ Liaison Office (LO)/ Project Office (PO) or any other place of business in India by foreign entities.
3. Borrowing and lending transactions in Indian Rupee between persons resident in India and non-resident Indians/ persons of Indian origin vide Master Direction No. RBI/FED/2015-16/2 FED Master Direction No. 6/2015-16 dated January 1, 2016.
4. Liberalised Remittance Scheme (LRS) vide Master Direction No. RBI/FED/2017-18/3 FED Master Direction No. 7/2015-16 dated January 1, 2016 (Updated as on August 24, 2022).
5. Other Remittance Facilities vide Master Direction No. RBI/FED/2015-16/4 FED Master Direction No. 8/2015-16 dated January 1, 2016 (Updated as on November 6, 2018).
6. Remittance of Assets vide Master Direction No. RBI/FED/2015-16/8 FED Master Direction No. 13/2015-16 dated January 1, 2016 (Updated as on April 28, 2016).
7. Deposits and Accounts vide Master Direction No. RBI/FED/2015-16/9 FED Master Direction No. 14/2015-16 dated January 1, 2016 (Updated as on January 9, 2020).
8. Import of Goods and Services vide Master Direction No. RBI/FED/2016-17/12 FED Master Direction No. 17/2016-17 dated January 1, 2016

(Updated as on November 21, 2022).

9. Reporting under Foreign Exchange Management Act, 1999 vide Master Direction No. RBI/FED/ 2015-16/13 FED Master Direction No.18/2015-16 dated January 1, 2016 (Updated as on September 30, 2022).
10. Miscellaneous vide Master Direction No. RBI/FED/2017-18/14 FED Master Direction No. 19/2015-16 dated January 1, 2016 (Updated November 12, 2018).
11. Opening and Maintenance of Rupee/Foreign Currency Vostro Accounts of Non-resident Exchange Houses vide Master Direction No. RBI/FED/2015-16/16 FED Master Direction No.2/2015-16 dated January 1, 2016 (Updated as on December 22, 2022).
12. Export of Goods and Services vide Master Direction No. RBI/FED/2015-16/11 FED Master Direction No. 16/2015-16 dated January 1, 2016 (Updated as on November 22, 2022).
13. Money Transfer Service Scheme (MTSS) vide Master Circular No. RBI/FED/2016-17/52 FED Master Direction No.1/2016-17 dated February 22, 2017.
14. Insurance vide Master Direction No. RBI/FED/2015-16/5 FED Master Direction No.9/2015-16 dated January 1, 2016 (Updated as on December 07, 2021).
15. Compounding of Contraventions under FEMA,1999 vide Master Direction No. RBI/FED/2015-16/1 FED Master Direction No.4/2015-16 dated January 1, 2016) (Updated as on May 24, 2022).
16. Guarantees and Co-Acceptances vide Master Circular No. RBI/2022-23/10 DOR.STR.REC.8/13.07.010/2022-23 dated April 1, 2022.
17. Foreign Exchange Management (Overseas Investment) Directions, 2022 vide circular no. RBI/2022-2023/110 A.P. (DIR Series) Circular No.12 dated August 22, 2022.
18. Foreign Exchange Management (Overseas Investment) Regulations, 2022 vide circular no. No. FEMA 400/2022-RB dated August 22, 2022.
19. Unhedged Foreign Currency Exposure, Directions, 2022 vide circular no. RBI/2022-23/131DOR.MRG.REC.76/00-00-007/2022-23 Dated October 11, 2022.
20. Acquisition or transfer of Immovable property under Foreign Exchange Management Act, 1999 vide Master Direction No. RBI/FED/2015-16/7 FED Master Direction No.12/2015-16 dated January 1, 2016 (Updated as on September 01, 2022).

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21. Master Direction No. RBI/FED/2017-18/60 FED No.11/2017-18 dated January 04, 2018 (Updated upto March 17, 2022) on Foreign Investment in India.

### **Part 2(a) – Deposits**

23.06 Detailed guidance for deposit accounts (viz. Type of Deposit accounts for Non Residents) is provided in Chapter 13, “Borrowings and Deposits” of Section B of the Guidance Note on Audit of Banks (2023 Edition).

### **Part 2 (b) – Advances**

23.07 Detailed guidance for advances (Letter of Credit, Bank Guarantee, Pre Shipment Credit in Rupee & Foreign Currency, Post shipment credit in Rupee & Foreign Currency, Export Bill Purchase / Negotiated / Discounted, Trade Credits viz. Buyer’s Credit, Suppliers’ Credit) has been provided in Chapter 11, “Reporting for Advances” of Section B of the Guidance Note on Audit of Banks (2023 Edition). Few important aspects of letter of credit are as under.

A letter of credit is in the nature of a guarantee issued in favour of the beneficiary (say overseas supplier) to assure payment on the due date irrespective of whether they receive the payment from the applicant or not for the complied documents received by the LC Issuing Bank under their credit. Important aspects for audit of letter of credit are as follows.

#### ***Revenue aspects of LC Transactions***

- Bank charges fees / commission for opening of letter of credit.
- The commission amount is collected upfront at the time of opening of LC.
- The commission so collected is for the entire tenure / duration of the letter of credit.
- Income for unrealized period will be shown under Other Liability, as per the accounting policy of the bank

#### ***Accounting aspects of LC Transaction***

- Letter of credit is a non-Fund based facility extended by the banks. Hence, there are no accounting entries for Letter of Credits which will have impact on balance sheet.
- However, a contra transaction will be initiated which will update the contingent liability / assets accounts for off-balance Sheet items reporting.
- Moreover, banks will enter LC transactions in LC Register / LC Module in CBS.

- Bills under LC will be tracked and status will be updated under specific LC Ref. No.
- Outstanding liability under particular LC will also be updated (either in Register / LC Module in CBS)
- In case of devolvement of bills under LC, the transaction will be recorded as advance to customer transaction and thus will be brought into the balance sheet.

***Compliance aspects of LC Transaction***

- In the event of devolvement of bills under LC, the said facility will be converted to fund based facility.
- From the said date, IRAC Guidelines issued by RBI will be applicable in determining the asset classification.

***Auditing aspects of LC Transaction***

- Verify the cases of outstanding LCs as on 31st of March.
- Are there any LCs outstanding as per CBS beyond the expiry date? If so what are the reasons for the same?
- Whether balance of letter of credits under contingent liability agrees with the outstanding letter of credit liability? (Under BASEL Guidelines computation of Capital Adequacy Ratio [CAR] takes cognizance of contingent liabilities. Any excess amount appearing under contingent liability will impact the bank's CAR.)
- Whether the activity of collection of charges is system driven or manual? Select appropriate sample based on the review of process.
- Whether Charges so collected are inclusive of GST? If so, verify whether the GST liability. is determined and accounted correctly.

**Part 2 (c) - Export Bills**

23.08 There are different types of export bills in foreign exchange transactions viz. export bills on collection, export bills discounted / purchased, advance against export bills etc.

Important aspects of export bills negotiated / discounted / purchase have been included in Chapter 11, "Reporting for Advances" of Section B of the Guidance Note on Audit of Banks (2023 Edition).

Various important aspects of export bills of collection are as under.

***Revenue aspects of Export Bills on Collection***

23.09 Export bills on collection involve the following revenue aspects:

- Bank charges fees / commission for handling bills on collection.
- Generally, it is observed that in case of Forex transactions handled through CBS, the charges are collected by CBS. However, the auditor should carry out walkthrough process of collection of charges. Sanction for waiver/concession in charges should be verified.

***Accounting aspects of Export Bills on Collection***

23.10 The accounting aspects on collection of export bills are the following:

- The bills are lodged in CBS / recorded in export bills on collection register
- In case of CBS, the payment of bill made through bill module in CBS. The CBS will update the outstanding Bill Liability on realization event.
- Only contra transaction for Contingent Liability is created for export bills on collection.

***Compliance aspects of Export Bills on Collection***

23.11 The compliance aspects on collection of export bills are the following:

- Export bills under collection must form part of contingent liability.
- Lodgement, realization and closure of bill should be carried out through bill module under CBS.

***Auditing aspects of Export Bills on Collection***

23.12 The auditing aspects on collection of export bills are the following:

- Generate bill balancing report for export bills on collection transaction preferably for 31<sup>st</sup>March.
- Carry out physical verification of all outstanding bills appearing under Bill Balancing Reports. Special attention should be given to bills under "Lodgement" status and verify for availability of original documents not yet dispatched.
- Verify on sample basis the proof of export in EDMPS (Export Data Processing and Monitoring System).
- Verify whether total of outstanding export bills on collection as per bill balancing report tallies with bills for collection under contingent liability?

- Whether the activity of collection of charges is system driven or manual? Select appropriate sample based on the review of process.
- It is generally observed that the activity of collection of charges for discrepancy memo is manual. If so, verify whether the charges have been properly collected or not.
- Overdue bills report should be obtained and follow up done with the bank may be verified.
- GST compliance on the charges so collected and accounting thereof.

For detailed additional guidelines, the auditor should refer Master Direction No. RBI/FED/2015-16/11 FED No. 16/2015-16 issued on January 1, 2016 (Updated as on November 22, 2022) on “Export of Goods and Services” and circular no. RBI/2019-20/206 A.P.(DIR Series) Circular No.27 dated April 01, 2020 on “Export of Goods and Services- Realisation and Repatriation of Export Proceeds-Relaxation”.

#### **Part 2(d) – Import Bills for Collection**

23.13 Under import bills for collection the foreign seller sends goods through shipping channel and documents to its banker with an instruction to send the same to the importer’s banker. The document so sent contains instructions on handling of the said documents. The importer’s bank will follow the instructions mentioned in the bill schedule and deliver the documents to the buyer.

In this type of transaction the importer’s banker is dealing only as a mediator i.e. in case the importer does not pay the bill amount the importer’s bank will notify the exporter’s bank and will act as per exporter’s bank instruction.

#### ***Revenue aspects of Import Bills on Collection***

23.14 Import bills on collection involve the following revenue aspects:

- Bank charges fees / commission for handling bills on collection.
- Generally, it is observed that in case of Forex transactions handled through CBS, the charges are collected by CBS. However, the auditor should carry out walkthrough process of collection of charges. Sanction for waiver/concession in charges should be verified.

#### ***Accounting aspects of Import Bills on Collection***

23.15 The accounting aspects on collection of import bills are the following:

- Bills are lodged in CBS / recorded in Import Bills on Collection register

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- In case of CBS, the payment of bill is made through bill module in CBS. The CBS will update the outstanding Bill Liability on realization event.
- Only contra transaction for contingent liability is created for import bills on Collection.

#### ***Compliance aspects of Import Bills on Collection***

23.16 The compliance aspects on collection of import bills are the following:

- Import bills under collection must form part of contingent liability.
- Lodgement, realization and closure of bills should be carried out through bill module under CBS.

#### ***Auditing aspects of Import Bills on Collection***

23.17 The auditing aspects on collection of import bills are the following:

- Generate bill balancing report for import bills on collection transaction preferably for 31st March.
- Carry out physical verification of all outstanding bills appearing under Bill Balancing Reports. Special attention should be given to bills under “Lodgement” status for availability of original documents (In normal course, transport documents alongwith other documents are handed over only after payment in case of sight bill or only after acceptance of bill of exchange in case of usance bill).
- Verify whether total of outstanding import bills on collection as per bill balancing report tallies with bills for collection under contingent liability?
- Whether the activity of collection of charges is system driven or manual? Select appropriate sample based on the review of process.
- It is generally observed that the activity of collection of charges for discrepancy memo is manual. If so, verify whether the charges have been properly collected or not.
- Overdue bills report should be obtained and follow up done with the bank may be verified.
- GST compliances on the charges so collected and accounting thereof.

For detailed additional guidelines, the auditor should refer the Master Direction on “Import of Goods and Services” (RBI/FED/2016-17/12 FED No. 17/2016-17 dated January 1, 2016 (Updated as on November 21, 2022).



### **Part 2(e) – Dealing Room Operations**

23.18 The core areas of treasury operations in a bank can be functionally divided into the following broad compartments:

- Front Office Operations (Dealing room operations);
- Middle Office Operations (Market Risk Department / Product Control Group);
- Back Office Operations (Deal Confirmation and Settlement).

23.19 Some of the main functions of Front Office, Mid-Office and Back-office operations are detailed below:

#### **Front Office (Dealing Room)**

- Money and fixed income dealings
- Forex and derivatives
- Treasury sales
- Equities
- Primary dealers
- Debt sales
- Credit default swaps

#### **Middle Office (Risk)**

- Identification, measurement and monitoring of risk
- Monitoring counter party, product and dealer limits

#### **Back Office**

- Settlement and follow up
- Reconciliations
- Accounting
- Valuation

23.20 Increasing regulation and compliance requirements and the need for risk management have made 'treasury front and back office efficiency' as one of the most critical factors in ensuring the well-being of any bank today. This is especially important as the operations of treasury become more onerous while financial products become increasingly complex, despite streamlining of processing systems. Staff of Front Office, Middle Office and Back Office should be segregated and all the work should not be handled by one officer.

### **Front Office Operations**

23.21 The front office operations consist of dealing room operations wherein the dealers transact deals with the various approved counterparties. Deals are transacted by dealers on various anonymous order matching platforms such as NDS-OM, CROMS, NDS-CALL, FX-CLEAR, FX-SWAP, E-Kuber and international information platform such as Reuters', Bloomberg, telephonic conversation with counter party or through empanelled brokers.

23.22 The dealers are primarily responsible to check counterparty exposure limits, eligibility, and other requirements of the bank before initiating any deal with the counter-party. Dealers must ensure that all risk/credit limits are available before transacting a deal. Also, the deal must not contravene the current regulations regarding dealing in INR with overseas banks/counterparties. All counterparties are required to execute the International Swaps and Derivatives Association ('ISDA') agreement as well as pass a board resolution allowing it to enter into derivative contract. As soon as the deal is struck with counterparty, the deal details are noted in a dealers' deal pad and thereafter captured in front office system of the Bank which gets queued in for authorization by back office.

23.23 Quoting of rates to clients should be based on ongoing market and specific policy should be framed for loading of margins based on size of the transactions.

### **Middle Office Operations**

23.24 Middle office is responsible for online risk measurement, monitoring and management reporting. The other functions of the middle office are:

- Limit setting and monitoring exposures in relation to limits.
- Assessing likely impact of market movements based on internal assessments and external /Internal research.
- Evolving hedging strategies for assets and liabilities.
- Interacting with the bank's Risk Management Department on liquidity and market risk.
- Monitoring open currency positions.
- Calculating and reporting VAR.
- Stress testing and back testing of investment and trading portfolios.
- Risk-return analysis.
- Marking open positions to market to assess unrealized gain and losses.

## **Back Office Operations**

23.25 The mainstream role of the back office is in direct support of the dealing room or front office. Traditionally, this included the input of deal details in the settlement system, checking of deal input details, verification by confirmation from counterparty, settlement, checking existence of a valid and enforceable International Swap Dealers Association ('ISDA') agreement and reconciliation of positions and NOSTRO accounts. However, with the advent of online front office systems and, more importantly, online trading platforms, the input of deals has progressively moved to the dealing room as mentioned above.

23.26 An important development in the back office has been the advent of straight-through processing (STP), also called 'hands-off' processing. This has been made possible through enhancement of computer system to real time online input in the trading platform, which in turn has meant that the back office can authorise/confirm deals pending for authorisation in the trading platform. In practice this is done automatically by matching incoming data from counterparties thereby focusing on investigating exceptions. With the introduction of online trading systems, the deal is 'confirmed' as it is done, allowing the back office to concentrate principally on handling exceptions, settlement and monitoring and risk control.

23.27 One of the basic tenets for a treasury area in a bank is the strict segregation and allocation of duties between the front, middle and back office, the latter controlling confirmations, settlement and accounting of transactions. These 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.

## **Functions of Back Office**

### ***Input and Completion***

23.28 The first core function of the back office is to extract the details of the deal either through the input system or by accessing the online platform and authorise/confirm the same after verifying the deal details with the external evidence i.e. incoming data from counterparty, Reuters'/ Bloomberg's conversation, broker notes. Deals input through front-end data capture or agreed on one of the proprietary trading systems are subjected to numerous system checks to ensure that the transaction details are 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 per the agreement. This could also be true for derivative 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. The bank normally releases its own confirmation to the counterparty, particularly for over the counter ('OTC') deals.

### **Counterparty Confirmation**

23.29 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 conversation or trading systems, or a broker's confirmation if the deal has been done through a broker. Telephone confirmations are also sought for immediate authorisation. Further, the banks have entered into bilateral agreement with counterparty banks who are members of CCIL; whereby exchange of confirmations for Forex Interbank deals (matched on CCIL) have been discontinued.

23.30 Deals done with non-bank customers will normally be confirmed by e-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**

23.31 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.

Brokerage is paid on settlement basis in the case of forex transactions.

### **Reconciliation**

23.32 Operations areas are typically involved in a number of reconciliation processes, including the reconciliation of dealers' overnight positions, Nostro accounts and brokerage payments. This can also mean reconciling the positions for margin calls in futures trading or reconciling 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 correspondent 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 represent those that have not been responded to in either the books of the bank or its correspondent and should, therefore be, investigated.

**Others**

23.33 Card rates should be decided in the beginning of the day and should be prominently displayed uniformly in all exchange dealing branches.

**Net Overnight Open Position Limit (NOOPL)**

23.34 NOOPL may be fixed by the Boards of the respective banks and communicated to the Reserve Bank immediately. However, such limits should not exceed 25 per cent of the total capital (Tier I and Tier II capital) of the bank. The net open position may be calculated as per the method given below:

**Calculation of the Net Open Position in a Single Currency**

23.35 The open position must first be measured separately for each foreign currency. The open position in a currency is the sum of (a) the net spot position, (b) the net forward position and (c) the net options position.

**a) Net Spot Position**

The net spot position is the difference between foreign currency assets and the liabilities in the balance sheet. This should include all accrued income/expenses.

**b) Net Forward Position**

This represents the net of all amounts to be received less all amounts to be paid in the future as a result of foreign exchange transactions, which have been concluded. These transactions, which are recorded as off-balance sheet items in the bank's books, would include:

- i. Spot transactions which are not yet settled.
- ii. Forward transactions.
- iii. Guarantees and similar commitments denominated in foreign currencies which are certain to be called.
- iv. Net future income/expenses not yet accrued but already fully hedged (at the discretion of the reporting bank).
- v. Net of amounts to be received/paid in respect of currency futures, and the principal on currency futures/swaps.

**c) Net Options Position**

The net options position is the "delta-equivalent" spot currency position as reflected in the authorized dealer's options risk management system, and

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includes any delta hedges in place which have not already been included under (a) or (b) (i) and (ii) above.

23.36 Calculation of the overall net open position involves measurement of risks inherent in a bank's mix of long and short position in different currencies. It has been decided to adopt the "shorthand method" which is accepted internationally for arriving at the overall net open position. Banks may, therefore, calculate the overall net open position as follows:

- i. Calculate the net open position in each currency.
- ii. Calculate the net open position in gold.
- iii. Convert the net position in various currencies and gold into Rupees in terms of existing RBI / FEDAI Guidelines. All derivative transactions including forward exchange contracts should be reported on the basis of Present Value (PV) adjustment.
- iv. Arrive at the sum of all the net short positions.
- v. Arrive at the sum of all the net long positions.

Overall net foreign exchange position is the higher of (iv) or (v). The overall net foreign exchange position arrived at as above must be kept within the limit approved by the bank's Board.

23.37 Authorised Dealer banks should report all derivative transactions including forward exchange contracts on the basis of PV adjustment for the purpose of calculation of the net open position. Authorised Dealer banks may select their own yield curve for the purpose of PV adjustments. Banks however should have an internal policy approved by its ALCO regarding the yield curve/(s) to be used and apply it on a consistent basis.

### **Audit Approach and Procedures**

23.38 Examination of compliance with statutory and regulatory requirements is also an important objective in audit of dealing rooms. The Auditors should keep this in view while designing their audit procedures relating to dealing rooms.

### **Process Review, Walk through and Control Testing**

23.39 Banks normally have documented standard operating procedures (SOPs) and hence the auditor can peruse SOPs for understanding and documenting significant processes. During the process understanding, the 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 identified controls. Identified controls need 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 as per the methodology.

23.40 In today's scenario, most of the dealing room 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.

23.41 Some of the typical audit procedures would include:

- Perusing reports on concurrent audit of treasury transactions, system audit report, if any 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.
- Verification of voice recording mechanism and to ensure user IDs of dealers left / transferred/ on leave is deactivated / suspended on timely basis.

**Part 1 (f) –Other Areas**

23.42 Apart from the transactions referred to above in detailed, bank branches carry out various other transactions as well. The Auditor should review the nature of transactions carried out by branch, the role of bank branch in transaction in terms of FEMA guidelines and should review applicable Master Directions / Circulars.

23.43 The Auditors should also review linkages between CBS system and SWIFT system. The RBI has suggested banks to centralize / ensure effective control over access and sending messages through SWIFT system by bank branches. In case the SWIFT message system is centralized the Auditor should review system / process of generation of SWIFT messages. Auditors may, on test check basis get the SWIFT messages generated from the said system and compare the same with CBS information. Any deviation observed should be reported under LFAR.

23.44 The following are various types of transactions processed and reporting to be done by bank branches. The auditor should ascertain the applicability of

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the same in audit unit and review the applicable guidelines issued by RBI (as mentioned in Part – B above)

- a. Advance payment against import and direct import bills.
- b. Merchanting Trade (MT) transactions.
- c. Reporting by banks under FEMA.
- d. Delivery order issuance.
- e. Foreign inward remittance certificate issuance.
- f. Follow up with customers for submission of various documents/reports.
- g. Other Approval and compliances related matters.

The auditor may consider review of the following through reports and information.

1. Open (unsettled) merchanting trade transactions.
2. Outstanding (unsettled) import transactions (wherein advance is already made).
3. Outstanding (unsettled) export transactions (wherein remittance is not received) / document submission (where advance is received).
4. Reports generated through CBS
  - a. Long outstanding import bills on collection - Check availability of original documents.
  - b. Outstanding import bills under LC - Check availability of original documents.
  - c. LCs outstanding beyond expiry date with outstanding liability.
  - d. BGs outstanding beyond claim expiry date with outstanding liability.
  - e. Export bills discounted / purchased / negotiated and outstanding beyond due dates.
  - f. List of import bills under LC devolved during the audit period.
5. Control around SWIFT and SFMS Systems
  - a. Access control related.
  - b. Review of defined process.
  - c. Integration of systems with reference to the circular issued on CBS.
6. Control around various other secured stationery including for BG, FIRC, etc.



### Part – 3: NOSTRO & VOSTRO Accounts Related

23.45 As per the need of LFAR for NOSTRO and VOSTRO Accounts:

Obtain from the Branch Management, a list of all NOSTRO Accounts Maintained/ Operated by the Branch (Answers to these questions require the auditor to ensure adherence to the master directions/circulars mentioned in Para 23.05 above)

23.46 A NOSTRO account refers to an account that a bank holds in a foreign currency in another bank. As explained earlier in case of receipts in foreign currency by the bank from other countries, the counter party/ foreign bank will remit funds in NOSTRO account of the bank. Then based on the transaction type and obtention of necessary documents, the bank will transfer the amount in NOSTRO account to customer Rupee account post conversion or EEFC accounts.

23.47 The starting phase of this audit should be, to obtain a list of all the NOSTRO accounts maintained / operated by the branch. Also, the Branch will have mirror account of each NOSTRO account in its trial balance. The list shall contain all the relevant details in this regard including the account number, country, currency, etc. Ideally the list of NOSTRO accounts provided by the branch and details of mirror accounts should match.

- a) Whether the bank has a system of periodic confirmation/ reconciliation of the balances in NOSTRO accounts maintained with each overseas bank/ correspondent? Has such confirmation been received and account reconciled at year end in each case. If not, give details.

One of the important elements of the audit of NOSTRO accounts is to check the transactions entered through these accounts. It is important that these accounts are duly confirmed and reconciled between the two branches. The auditor should check the confirmations received by the bank branch from their overseas bank and also the reconciliation of the same. The auditor should not only verify the same relating to year end but also verify if the branch had process of periodic reconciliation and confirmation of the same. With respect to year end, the auditor may also consider to obtain an independent confirmation from the overseas branch in case of material balances / transactions. The reconciliation also needs to be tallied with the subsequent transactions after year end.

- b) Whether the system of the Bank ensures that all entries originated by overseas banks/correspondents, have been duly responded promptly in the respective NOSTRO accounts maintained by the Bank?

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The overseas bank / correspondent intimates to the respective branch for each transaction entered by them relating to them. It is imperative on the part of the branch to respond to the same at the earliest. Timely response results in proper entries and reconciliation of the same on timely basis.

The auditor should study the process and system of the bank in this regard and also whether the branch is acting as per the system defined. Delays in the same if any should be properly highlighted and the impact of the same at year end needs to be looked into and wherever required, appropriate entries should be passed or given in MOC.

- c) Are there any dormant/closed Nostro accounts in respect of which balances continue to exist in the books of the branch, at year end?

The auditor needs to examine the transactions entered in the respective Nostro accounts. There could be some accounts where there are no transactions but still the balances are lying outstanding. The reasons for the same needs to be ascertained, verified and reported accordingly.

- d) Have the Nostro balances been converted at year end at the rates of exchange as prescribed by controlling authorities?

The Nostro accounts are in foreign currency. For the purposes of the accounting as per norms, these would need to be converted into Indian Rupees at each period end. Accordingly, it is imperative that the rate of conversion used for the same is proper. Generally, the rate of conversion is put in the system of the bank and the same rate is used for conversion of all the such balances at the whole bank. The Auditor needs to check that the rates fed into the system are the ones which are as prescribed by the controlling authorities. It also needs to be verified that the rates prescribed by the controlling authorities are appropriate.

RBI Master Direction No. RBI/DOR/2021-22/80 DOR.No.RET. REC.32/12.01.001/2021-22 dated July 20, 2021 (Updated as on April 06, 2022) on Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)] Directions – 2021, Reference rate for INR/USD and exchange rate of other major currencies” provides that for conversion of foreign currency assets/ liabilities reference rate from FBIL should be taken. If reference rate is not available from FBIL, banks may continue to use New York closing pertaining to the day end of the reporting Friday for conversion of such currency into USD.

- e) In case, any matter deserves special attention of the management, the same may be reported.

The auditor needs to use his professional scepticism to check if there are

any unusual transactions or any unusual trend or significant transactions reflected in the NOSTRO accounts. If any such transaction is noted, the same needs to be further verified with respect to documents and purpose and in case the auditor is not satisfied, the same should be referred in LFAR.

The reconciliation of NOSTRO accounts (with NOSTRO Mirror Accounts) needs to be scrutinized carefully to analyse and ascertain if any inwards remittances are received on behalf of the customers / constituents of the bank and have remained unaccounted and / or any other debit (inward) entries have remained unaccounted and are pertaining to any liabilities for the bank. These need to be properly reported.

Borrowings from abroad by banks in India need to be considered as 'liabilities to other' and thus, need to be considered at gross level unlike 'liabilities towards banking system in India', which are permitted to be netted off against 'assets towards banking system in India'. Thus, the adverse balances in NOSTRO Mirror Account needs to be considered as 'Liabilities to other'.

- (f) Does the branch follow the prescribed procedures in relation to maintenance of VOSTRO Accounts?

The procedure and process reported for NOSTRO needs to be carried out for VOSTRO accounts as well.

## Clearing House Operations by Service Branches

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### Introduction/ Bank's Process

24.01 The Service Branch/ Clearing House primarily acts as an intermediary between branches and banks to ensure processing of negotiable instruments. Considering the functions of this branch, the primary objective of the Auditor is to ensure that there are no long old outstanding open entries as well as unreconciled entries.

24.02 The Service Branch ensures that the duly balanced outward clearing batches are received from the various branches within the prescribed time schedule. The outward clearing presentation for the bank as a whole, duly balanced and with the necessary control documents, should be forwarded to the Cheque Processing Centre as per the time schedule stipulated by it.

24.03 Under the Cheque Truncation System (CTS) implemented by RBI, an electronic image of the cheque is transmitted to the paying branch through the clearing house, along with relevant information like data on the MICR band, date of presentation, presenting bank, etc. This effectively eliminates the associated cost of movement of the physical cheques, reduces the time required for their collection. Under this approach the entire cheque volume in the country which was earlier cleared through 66 MICR cheque processing locations is consolidated into the three grids in New Delhi, Chennai and Mumbai. The illustrative jurisdiction of the three grids are indicated below:

- **New Delhi Grid:** National Capital Region of New Delhi, Haryana, Punjab, Uttar Pradesh, Uttarakhand, Bihar, Jharkhand, Rajasthan and the Union Territory of Chandigarh.
- **Mumbai Grid:** Maharashtra, Goa, Gujarat, Madhya Pradesh and Chattisgarh.
- **Chennai Grid:** Andhra Pradesh, Telangana, Karnataka, Kerala, Tamilnadu, Odisha, West Bengal, Assam and the Union Territory of Puducherry.

24.04 Under grid-based Cheque Truncation System clearing, all cheques drawn on bank branches falling within the grid jurisdiction are treated and cleared

as local cheques. As per FAQs issued by RBI on Cheque Truncation System dated October 31, 2022, no outstation cheque collection charges are to be levied if the collecting bank and the paying bank are located within the jurisdiction of the same CTS grid even though they are located in different cities.

24.05 RBI vide circular no. DPSS.CO.RPPD.NO.SUO 21102/04.07.005/ 2020-21 dated March 15, 2021 had advised the banks to ensure that all their branches participate in image based CTS under respective grid by September 30, 2021.

24.06 In CTS, the presenting bank (or its branch) captures the data (on the MICR band) and the images of a cheque using their capture system (comprising of a scanner, core banking or other application) which is internal to them, and have to meet the specifications and standards prescribed for data and images.

24.07 To ensure security, safety and non-repudiation of data / images, end-to-end Public Key Infrastructure (PKI) has been implemented in CTS. As part of the requirement, the collecting bank (presenting bank) sends the data and captured images duly signed digitally and encrypted to the central processing location (Clearing House) for onward transmission to the paying bank (destination or drawee bank). For the purpose of participation, the presenting and paying banks are provided with an interface / gateway called the Clearing House Interface (CHI) that enables them to connect and transmit data and images in a secure and safe manner to the Clearing House (CH).

24.08 Only CTS 2010 compliant instruments can be presented for clearing through CTS. The separate non-CTS clearing sessions in CTS grid centres had been discontinued with effect from December 31, 2018. As on September 2020, all ECCS centres have migrated to CTS. Positive pay system for cheque truncation has been implemented from January 1, 2021. The RBI via circular no. RBI/2020-21/41 DPSS.CO.RPPD.No.309/04.07.005/2020-21 dated September 25, 2020 has provided that positive pay involves a process of reconfirming key details of large value cheques. Under this process, the issuer of the cheque submits electronically, through channels like SMS, mobile app, internet banking, ATM, etc., certain minimum details of that cheque (like date, name of the beneficiary / payee, amount, etc.) to the drawee bank, details of which are cross checked with the presented cheque by CTS. Any discrepancy is flagged by CTS to the drawee bank and presenting bank, who would take redressal measures.

24.09 Cheques are scanned and retained at the presenting bank and do not move physically to the paying bank. To meet the legal requirements, the presenting banks have to preserve the physical instruments in their custody securely for a period of 10 years.

24.10 The grid clearing allows banks to present / receive cheques to/ from multiple cities to a single clearing house through their service branches in the grid location. If there is any delay in credit, beyond the period specified above, the customer is entitled to receive compensation at the rate specified in the Cheque Collection Policy (CCP) of the concerned collecting bank. In case, no rate is specified in the CCP for delay in realisation of local cheques, compensation at savings bank interest rate has to be paid for the corresponding period of delay.

24.11 <sup>51</sup>For outstation cheques, maximum timeframe for collection of cheques drawn on State capitals / major cities / other locations are 7/10/14 days respectively. If there is any delay in collection beyond this period, customer is entitled to receive compensation at the rate specified in the CCP of the concerned bank. In case the rate is not specified in the CCP, interest rate on fixed deposits for the corresponding maturity to be paid. Banks' cheque collection policy also indicates the limit up to which outstation cheques are given immediate / instant credit.

#### **Income Recognition and Verification by Auditors**

24.12 The auditor should get the SOP for income accrual at these branches. The auditor needs to understand the basis of income booking. Generally, the amount accrued is based on number of instruments processed and charges / fees for processing is booked in service / clearing branch and it is debited to the branch for which instruments are processed / decoded. Income recognized needs to be checked by the auditor with respective instruments processed.

24.13 The auditor should also examine the correspondence with RBI Clearing house and ensure that branches directly dealing with RBI clearing house are following applicable rules and regulations. The auditor should check that RBI account, if any, is reconciled as at the year-end. The auditor should also check that penalty / charges / late fees if any charged by RBI are accounted for by the branch. RBI levies penalty for omissions and errors. Such penalties should be accounted for only after obtaining approval from competent authority who is vested with discretionary powers for such expenditure.

24.14 The auditor should examine that the compensation for delay in realisation of local cheques is adequately accounted for. Either it should be credited to the customer or required provision should be maintained in the books of account

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<sup>51</sup> FAQs on Collection of Instruments dated October 31, 2022.

24.15 The Service branch is required to install devices/machines to detect the frauds. The auditor should verify whether such machines are being used extensively and whether they are in working condition etc. Also, the auditor needs to enquire the alerts generated and corrective actions taken by the branch.

#### **24.16 Inward Clearing**

- The auditor is to check whether signature of the drawer of the cheque is being verified by the staff religiously or not as else there will be liability of the paying bank under all circumstances.
- If the encoded amount is more than the cheque amount and the cheque is passed through oversight, it will create contingent liability for the bank. The auditor is required to verify if any claims for refund of the amount excess debited are received from the customer, such claims to be verified and if necessary provision for that to be made.

#### **Outward Clearing**

24.17 For outward clearing the following need to be done:

- Branch is required to verify if the cheque paper quality invariably.
- Branch is also required to verify if the signature of the drawer of the cheque is chemically altered.
- If the encoded amount is more than the cheque amount and the cheque is sent for collection and passed through oversight by the paying bank, it will create contingent liability for the bank. The auditor is to verify if any claims for refund of the amount excess credited are received from the other banks, such claims to be verified and if necessary provision for that to be made.

#### **Fraud Monitoring**

24.18 After centralising the clearing transactions work, both inward and outward, at the service branch, perpetration of fraud in this area has increased. The service branch should initiate steps on ongoing basis to prevent frauds. All the staff at service branch to be involved in awareness programmes and training programmes to minimise frauds. They should be made aware about the frauds that took place in recent past in other banks to guard against its occurrence in the bank.

24.19 The auditor should check that the cheque collection charges including speed clearing charges are not levied by banks if the collecting bank and the paying bank are located within the jurisdiction of the same CTS grid even though

they are located in different cities.

**24.20 Reporting under LFAR**

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?
  - To obtain note or review existing SOP followed by the branch / bank.
  - The old entries in clearing suspense account, which are unreconciled need to be reviewed and reasons for pendency should be understood.
  - Any MIS/ exceptional report generated from system.
  - System for reporting of long outstanding entries to Head Office.
  - To ensure that daily printout of inward and outward clearing scroll are generated by the service branch and corrections if any are done by the authorised official in the system itself.
  - To verify that no high value transactions are routed through personal accounts.
  - To examine the report on failure to lodge clearing cheques.
  - Whether any amount is lying in suspense for clearing difference for an unusual long period- normally any entry should not remain outstanding for more than 3 working days of lodgement.
  - To examine whether any instrument stolen or fraudulently obtained by a fraudster is red flagged in the system on the basis of communication from the concerned bank.
  - The auditor should check all relevant documents maintained by the branch and comments on level of compliance by the branch. In case the branch has not followed the defined process/ system like non-reporting of long outstanding entries etc., the auditor should report the same.
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:
  - To obtain clearing adjustment account and review old entries.
  - To obtain ageing of old entries along with nature of such entries.



- On sample basis, check old entries from the system, to ensure correctness of ageing given by the branch.
- On sample basis, check origination of old outstanding entries.
- Check action taken to reconcile the unreconciled entries.

Year-wise break up should be given of outstanding clearing in number and value.

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.
  - Considering the unique nature of operations of the clearing branch, the controlling authority (head office) normally issues guidelines with respect to operations of clearing transactions. The auditor should obtain those guidelines from the branch / controlling office and ensure that the branch is complying with it.
  - The auditor should carry out walk-through of some sample transactions and check reporting done by the branch to head office to understand the process followed by the branch.

## Recovery of Non-Performing Assets by Asset Recovery Branches

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### Introduction and Bank's Process

25.01 Banks have designated branches/ departments for recovery of Non-Performing Assets (NPA). The accounts which are already marked as NPA are transferred from other branches to this branch for centralized monitoring. The responsibility of this branch is to ensure the best resolution/ recovery from these NPA accounts either by recovery or restructuring or realization from liquidation of security. The details of primary and collateral security available with bank with respect to these NPA accounts are also maintained at this branch.

### Audit Approach, Procedures including Regulatory Considerations

25.02 Members may refer Chapter 11 "Reporting for Advances" of Section B of the Guidance Note on Audit of Banks (2023 Edition) for guidance on audit of NPAs, Provisioning and Restructuring.

25.03 Other critical aspects to be considered by the auditor in case of Asset Recovery Branches are as follows:

- Asset Recovery Branches deal with NPA accounts. Most of them are old and with large outstanding amounts. The auditor should obtain a list of all NPA accounts at the start of the financial year, movement during the year and closing NPA Accounts. To ensure that opening and closing balances are matching with respective trial balance.
- The accounts get classified as NPA either due to record of recovery or non-financial indicators like inherent weakness in account, Non-achievement of DCCO, Failure to comply with key restructuring conditions, erosion in value of security etc. It is important to understand the reason of NPA for each account.
- The auditor for this purpose also needs to consider the policy of transferring NPA accounts to these branches, especially with reference to system aspect. Also it needs to see the policy of transferring back to respective branches when the account gets upgraded.
- To analyse the reason for movement during the year. Key reasons for movement will be as follows:

- Accounts transferred from other branches to asset recovery branches during the year or vice-versa.
- Accounts upgraded during the year – special attention is required for audit of these accounts.
- Recovery effected during the year.
- Movement in provision due to change in classification of NPA or change in value of security.
- To check that interest income on NPA is recognized only on actual receipt, Interest accrued earlier and not received should be reversed.
- To verify adherence to policy related to expenses incurred by the banks after accounts become NPA.
- As regards recovery - The following aspects need to be checked:
  - 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, "Revenue Recognition" when certainty is attached to realisation and accordingly the amount reversed/derecognised or not recognised in the past should be accounted. Interest partly/fully realised from 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.
  - In case of long-term loans, the valuation report of the security pledged (the date of valuation and the values) to be seen. A valuation report normally contains three values (Fair value, market value and distress value). The policy adopted by the bank for consideration of value needs to be seen. Banks may consider Fair value to reduce the burden of provision in absence of specific direction from RBI. Such matters need to be judged based on the facts of the cases and short fall, if any, is to be provided as per RBI norms.
  - Valuation reports should not be older than three years.
  - In case of advance the values of the security (i.e. primary as well as collateral) as entered in the CBS should be cross checked with the terms in the sanction letter.
  - Consider any orders issued by any of the authorities like DRT, SARFAESI etc.

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- Verify the CGTMSE amount as recorded in the books for facilities availed under MSME schemes since provision and classification are made after deducting the claimed amount. In most of the cases the amounts are recorded as per the claims lodged by the bank with the authorities. In some banks, the branches forward the application to the respective regional offices which in turn upload the details in the Government portal. Subsequent changes, if any, in the portal are not incorporated in the individual borrower level, for e.g. any rejection or modification of the claim lodged with the authorities.
- In order to reflect the actual receivable amounts, proper classification and provision, this exercise should be done periodically for the bank as a whole which will include both NPA and standard accounts.

The auditor is required to ensure compliance with the requirements of RBI Master Circular No. RBI/2022-23/15 DOR.STR.REC.4/21.04.048/2022-23 April 1, 2022 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances w.r.t. the framework for resolution of stressed assets, RBI Master Direction No. RBI/DOR/2021-22/86 DOR.STR.REC.51/21.04.048/2021-22 dated September 24, 2021 (Updated as on December 05, 2022) on “Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021” and also the requirements of the Insolvency and Bankruptcy Code, 2016, in cases where the borrower has been referred to IBC.

### **Guidelines on Sale/Purchase of NPAs**

25.04 The Board of Directors of banks should lay down policy in respect of the 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.

25.05 The 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.

25.06 Banks while selling NPAs should, 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 not generally be lower than the net present value so arrived.

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

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

25.09 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. 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.

25.10 A non-performing financial asset should be held by the purchasing bank in its books at least for a period of 12 months before it is sold to other banks. Banks should not sell such assets back to the bank, which had sold the NPA.

25.11 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.

25.12 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.

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

25.14 As per Para 41 of RBI Master Direction No. RBI/DOR/2021-22/86 DOR.STR.REC.51/21.04.048/2021-22 dated September 24, 2021 (Updated as on December 05, 2022) on Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021, in case of transfer of loans which are not in default any loss or profit arising because of transfer of loans, which is realised, should be accounted

for accordingly and reflected in the profit and loss account of the transferor for the accounting period during which the transfer is completed. However, unrealised profits, if any, arising out of such transfers, shall be deducted from CET 1 capital or net owned funds for meeting regulatory capital adequacy requirements till the maturity of such loans.

### **Asset Classification Norms for Sale/Purchase of NPA**

25.15 As per RBI Master Direction No. RBI/DOR/2021-22/86 DOR.STR.REC.51/ 21.04.048/2021-22 dated September 24, 2021 (Updated as on December 05, 2022) on “Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021”, the asset classification norms for sale/purchase of NPAs are as follows:

- (i) If the transferee(s), except ARCs, have no existing exposure to the borrower whose stressed loan account is acquired, the acquired stressed loan shall be classified as “Standard” by the transferee(s). Thereafter, the asset classification status of the loan acquired, shall be determined by the record of recovery in the books of the transferee(s) with reference to cash flows estimated at the time of transfer of the loan.
- (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/rephasing 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***

25.16 The provisioning norms for books of the selling bank are as under:

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

- (iii) If the sale is for a value higher than the NBV, the excess provisions may be reversed<sup>52</sup>.

**Books of Purchasing Bank**

25.17 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**

25.18 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**

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

**Exposure Norms**

25.20 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**

25.21 Banks acquiring loans other banks / ARCs shall be required to make the disclosures in the Notes on Accounts in their balance sheets as per the format specified in Chapter V of RBI Master Direction No. RBI/DOR/2021-22/86 DOR.STR.REC.51/21.04.048/2021-22 dated September 24, 2021 (Updated as on December 05, 2022) on Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021 as follows:

Details of loans acquired during the year		
(Amounts in Rs. Crore)	From lenders listed in Clause 3	From ARCs
Aggregate principal outstanding of loans		

<sup>52</sup>Para 62 of RBI Master Direction No. RBI/DOR/2021-22/86 DOR.STR.REC.51/21.04.048/2021-22 dated September 24, 2021 (Updated as on December 05, 2022) on Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021.

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acquired		
Aggregate consideration paid		
Weighted average residual tenor of loans acquired		

25.22 Banks shall be required to disclose the details of stressed loans transferred during the year separately for NPAs and SMAs as per the format of disclosure as specified in Chapter V to RBI Master Direction No. RBI/DOR/2021-22/86 DOR.STR.REC.51/21.04.048/2021-22 dated September 24, 2021 (Updated as on December 05, 2022) on Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021.

25.23 The purchasing bank shall furnish all relevant reports as per RBI circular no. RBI/2020-2021/106 DoR.FIN.REC.46/20.16.056/2020-21 dated March 12, 2021 on “Data Format for Furnishing of Credit Information to Credit Information Companies and other Regulatory Measures” 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 non-performing financial assets purchased by it.

**Sale/ Purchase of NPAs**

25.24 In case of a sale/ purchase of NPAs by the bank, the auditor should examine the policy<sup>53</sup> laid down by the Board of Directors relating to procedures, valuation and delegation of powers.

25.25 The transferor shall transfer the stressed loans to transferee(s) other than ARCs only on cash basis. The entire transfer consideration should be received not later than at the time of transfer of loans, and the loan can be taken out of the books of the transferor only on receipt of the entire transfer consideration.

25.26 The lender acquiring stressed loans shall make provisions for such loans as per the asset classification status in its books upon acquisition. Regardless of the asset classification, if the net present value of the cash flows estimated while acquiring the loan is less than the consideration paid for acquiring the loan, provisions shall be maintained to the extent of the difference. For this purpose, the discount factor shall be the actual interest rate charged to the borrower as per the original loan contract plus a risk premium to be determined as per the transferee’s Board approved policy considering the asset

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<sup>53</sup>Para 51 of RBI Master Direction No. RBI/DOR/2021-22/86 DOR.STR.REC.51/21.04.048/2021-22 dated September 24, 2021 (Updated as on December 05, 2022) on Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021.



classification of the loan on the books of the transferor. The risk premium will be subject to a floor of 3 percent.

25.27 When the stressed loan is transferred to ARC at a price below the NBV at the time of transfer, lenders shall debit the shortfall to the profit and loss account for the year in which the transfer has taken place. Banks are permitted to use countercyclical or floating provisions for meeting any shortfall on transfer of stressed loan when the transfer is at a price below the NBV.

25.28 When the stressed loan is transferred to an ARC for a value higher than the NBV at the time of transfer, lenders shall reverse the excess provision on transfer to the profit and loss account in the year the amounts are received and only when the sum of cash received by way of initial consideration and / or redemption or transfer of Security Receipts (SR) / Pass Through Certificates (PTCs)/ other securities issued by ARCs is higher than the NBV of the loan at the time of transfer. Further, such reversal shall be limited to the extent to which cash received exceeds the NBV of the loan at the time of transfer.

25.29 Investments by lenders in SRs / PTCs / other securities issued by ARCs shall be valued periodically by reckoning the Net Asset Value (NAV) declared by the ARC based on the recovery ratings received for such instruments.

Provided that when transferors invest in the SRs/PTCs issued by ARCs in respect of the stressed loans transferred by them to the ARC, the transferors shall carry the investment in their books on an ongoing basis, until its transfer or realization, at lower of the redemption value of SRs arrived based on the NAV as above, and the NBV of the transferred stressed loan at the time of transfer.

Provided further when transferors invest in the SRs/PTCs issued by ARCs in respect of the stressed loans transferred by them to the ARC, the transferors shall carry the investment in their books on an ongoing basis, until its transfer or realization, at lower of the redemption value of SRs arrived based on the NAV as above, and the NBV of the transferred stressed loan at the time of transfer. However, when the investment by a transferor in SRs backed by stressed loans transferred by it, is more than 10 percent of all SRs backed by its transferred loans and issued under that securitisation, the valuation of such SRs by the transferor will additionally be subject to a floor of face value of the SRs reduced by the provisioning rate as applicable to the underlying loans, had the loans continued in the books of the transferor.

### **25.30 Reporting under LFAR**

1. In respect of borrowers with outstanding of Rs. 10 Crores and above and other sample accounts selected by the auditor, the information should be obtained from the Branch Management. Comments of the branch auditor

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on advances with significant adverse features and which might need the attention of the Management / SCAs should be appended to the Long Form Audit Report. (Refer RBI circular no. DOS.CO.PPG./SEC.01/ 11.01.005/ 2020-21 dated September 5, 2020 on Long Form Audit Report (LFAR)).

- To obtain a list and information of borrowers having outstanding of Rs.10 Crores and above.
- To review movement during the year in those accounts.
- The branch auditors should review each account and give comments on adverse features, if any in accounts.
- The comments of branch auditors will be either account specific or observations on system which may have impact on bank as whole. The auditor should highlight the nature of each comment for proper action to be taken by the Management / SCAs.
- The reporting in LFAR is not substitute for qualification or modification in audit report. Hence if the observation of auditors warrants qualification in audit report, the auditor should make reporting of same in main report.
- If the observation of the auditor is having impact on financial numbers like short provisioning, error in valuation of securities etc., the auditor should get the same rectified by suggesting appropriate MOC for the same.

2. List the accounts with outstandings in excess of Rs. 10.00 Crores, which have been upgraded from 'non-performing' to 'Standard' during the year and the reasons thereof.

Sr. No.	Name of the Unit / Account	Outstanding [Rs. In Crore]	IRAC Status as on 31st March [Last Year]	IRAC Status as on 31st March [Current Year]	Reasons
1					
2					
3					
4					
5					

- To obtain a list of all upgraded accounts during the year. In some cases, once the accounts are upgraded same are being transferred to

- other branches hence may not appear in closing balances of this branch.
- To analyse the reason for upgrade and link the same with reason for classifying an account as NPA.
  - To check entries for recovery in core banking system to ensure that there is full recovery of all dues before upgrade of account.
3. Whether the Branch has a system of updating periodically, the information relating to the valuation of security charged to the bank?
- To obtain details of security charged to the bank against all NPA accounts.
  - To understand and review the process of updating value of security in the system.
  - 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.
  - If the branch has not timely updated the value of security in the books then the auditor shall update it by issuing of MOC.
  - The Branch auditor shall check that the minimum realisable value of securities from two or more different valuation report of securities for advance above Rs 10 Crores to be updated in the books and that valuation report shall not be older than three years.
  - The branch auditor should check and ensure that the value of other securities like stock, book debt, etc. are realisable in nature and it is not older than the specified time limit.
4. Age-wise analysis of the recovery suits filed and pending, for the last 3 years may be furnished along with latest status thereof.
- | Year            | No. of Accounts | Amount [Rs. In Crore] |
|-----------------|-----------------|-----------------------|
| Upto March 2019 |                 |                       |
| 2019-20         |                 |                       |
| 2020-21         |                 |                       |
| 2021-22         |                 |                       |
- To obtain the list of all recovery suits filed and pending as at the reporting date.

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- To give details of age-wise details of recovery suits.
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 thereof. Give age-wise analysis of decrees obtained and not executed.
- 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 as per the bank's policy. Give particulars of recoveries which are pending for appropriation as on year-end with reasons thereof.
- 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 off or closed, if any, will also have to be attached. The auditor should satisfy himself that 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?
- 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, details 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.

# 26

## Bank Branch Audit and GST Compliance

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### Background

26.01 GST, a paradigm shift from origin based to destination-based tax in indirect tax regime was implemented in India from 1<sup>st</sup> July 2017.

Article 366(12A) of the Constitution of India provides that, **Goods and Services Tax** means any tax on supply of goods, or services or both except taxes on the supply of the alcoholic liquor for human consumption.

India adopted dual GST model in view of the Federal structure of the country. Here, Centre and States simultaneously levy GST on taxable supply of goods or services or both which, takes place within a State or Union Territory. The Centre also has the power to tax intra-State sales and States are also empowered to tax services.

### Extent of GST

26.02 GST in India comprises of the following:

- (A) **Central Goods and Services Tax Act, 2017** (“CGST Act”) which extends to the whole of India.

In terms of Section 2(56) of the CGST Act:

*“India” means the territory of India as referred to in Article 1 of the Constitution, its territorial waters, seabed and sub-soil underlying such waters, continental shelf, exclusive economic zone or any other maritime zone as referred to in the Territorial Waters, Continental Shelf, Exclusive Economic Zone and other Maritime Zones Act, 1976, and the air space above its territory and territorial waters.*

Central Goods and Service Tax (CGST) is levied on all intra-State supplies of taxable goods and/or services and collected by the Central Government.

- (B) **State Goods and Services Tax Act, 2017** (“SGST Act”) is levied and collected by the State Government/ Union Territory with State Legislatures. The SGST Act of the respective State/Union Territory with State Legislature [Delhi and Pondicherry]\*\* extends to the whole of the respective

State/Union Territory.

*\*\*State: includes a Union Territory with Legislature [Section 2(103) of CGST Act].*

- (C) **Union Territory Goods and Services Tax Act, 2017** (“**UTGST Act**”) extends to the Union territories of the Andaman and Nicobar Islands, Lakshadweep, Dadra and Nagar Haveli, Daman and Diu, Chandigarh and other territories, i.e. the Union Territories without State Legislature [Section 1 of the UTGST Act]. UGST is levied and collected by Central Government through appointed administrator.
- (D) **Integrated Goods and Services Tax Act, 2017** (“**IGST Act**”) extends to the whole of India. IGST is levied on all inter-State supplies of goods or services or both (except alcoholic liquor for human consumption) at a rate recommended by the GST Council (not exceeding 40 per cent). It is collected by the Central Government.

Apart from the above Acts there is one more Act under GST namely “The Goods and Services (Compensation to States) Act 2017”. This Act was introduced to provide for compensation to the States for the loss of VAT revenue, if any arising on account of implementation of GST. This tax is levied on a few supplies at present. It is provided that such levy will be collected for five years but this period can be extended on the recommendation of the GST Council.

NOTE: It is pertinent to mention here that, GST extends to the whole of India including the State of Jammu and Kashmir. Though, GST was implemented in the State of Jammu and Kashmir from 8<sup>th</sup> July, 2017 *vide* the Central Goods and Services Tax (Extension to Jammu and Kashmir) Ordinance, 2017 and the Integrated Goods and Services Tax (Extension to Jammu and Kashmir) Ordinance, 2017 the domain of Central GST Act and the Integrated GST Act has been extended to the State of Jammu and Kashmir.

26.03 Now with the advent of Jammu and Kashmir Reorganisation Act, 2019, from 31<sup>st</sup> October, 2019, the State of Jammu and Kashmir has been re-constituted into two union territories:

Jammu and Kashmir (Union territory of Jammu and Kashmir with Legislature);

Ladakh (Union territory of Ladakh without Legislature) *vide* Jammu and Kashmir Reorganisation Act 2019.

26.04 In this regard, the Ministry of Home Affairs (Department of Jammu and Kashmir Affairs) issued Jammu and Kashmir Reorganisation (Removal of

Difficulties) Order, 2019 which *inter alia* stipulates that-

The Jammu and Kashmir Goods and Services Tax Act, 2017 shall be applicable to the Union Territory of J&K; and

The Union Territory Goods and Services Tax Act, 2017 shall be applicable to the Union Territory of Ladakh.

### **Applicability to Banking Sector**

26.05 As evident from the above, GST is applicable to banking services as far as it qualifies the taxable event i.e. supply of services. However, following supplies made without consideration as specified in Schedule I of the CGST Act, 2017 are subject to GST:

- Permanent transfer or disposal of business assets where input tax credit has been availed on such assets.
- Inter Unit Supply: Supply of goods/ services or both between related persons or between distinct persons as specified in Section 25, when made in the course or furtherance of business.
- As per Section 22(1) of CGST Act, every supplier shall be liable to be registered under this Act in the State or Union Territory, other than special category States, from where he makes a taxable supply of goods or services or both, if his aggregate turnover in a financial year exceeds twenty lakhs rupees registration under GST has to be taken.
- *Further as per Section 25(2) A person seeking registration under this Act shall be granted a single registration in a State or Union Territory.*

*Provided that a person having multiple places of business in a State or Union territory may be granted a separate registration for each such place of business, subject to such conditions as may be prescribed.*

Hence banks have to take separate registrations for branches in each State or voluntarily banks can take separate registrations for each branch/office. Such separate registrations shall make each registrant bank a distinct person under the Act.

Therefore, any supply of goods or services or both between branches/offices/head Office of the banks having separate registrations, without consideration, shall be considered as supply under GST for payment of tax.

- Any activity amounting to supply provided by the employer to the employee without consideration will be taxable under GST, except

where the value of such supply does not exceed Rs. 50,000 in a financial year.

- Import of services by a person from a related person or from any of his other establishments outside India, in the course or furtherance of business

Although no consideration is involved here, payment of tax needs to be made on the value determined in terms of Section 15 of the CGST Act read with Rule 28 of the CGST Rules.

Such transactions are generally not captured in the books of accounts, and therefore the auditor should apply substantive audit procedure to check compliances.

### **Exemptions relating to Banking Sector**

26.06 GST is applicable on all services provided by the banks except the followings:

- Services by way of—
  - (i) extending deposits, loans or advances in so far as the consideration is represented by way of interest or discount (other than interest involved in credit card services);
  - (ii) *inter se* sale or purchase of foreign currency amongst banks or authorised dealers of foreign exchange or amongst banks and such dealers.

*Where-*

*(zk) "interest" means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) but does not include any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized;*

- Services provided by a banking company to Basic Saving Bank Deposit (BSBD) account holders under Pradhan Mantri Jan Dhan Yojana (PMJDY). [*inserted w.e.f. 01-01-2019 vide Notification No. 28/2018-Central Tax (Rate), dated 31-12-2018 in CGST and vide Notification No. 29/2018-Integrated Tax (Rate), dated 31-12-2018 in IGST.*]
- Services by an acquiring bank, to any person in relation to settlement of an amounts up to Rs. 2,000 in a single transaction transacted through credit card, debit card, charge card or other payment card service.



Explanation. — For the purposes of this entry, “*acquiring bank*” means any banking company, financial institution including non-banking financial company or any other person, who makes the payment to any person who accepts such card.

- Services supplied by Central Government, State Government, Union territory to their undertakings or Public Sector Undertakings (PSUs) by way of guaranteeing the loans taken by such undertakings or PSUs from the banking companies and financial institutions. [*Initially this exemption was inserted w.e.f. 27-07-2018 vide Notification No. 14/2018-Central Tax (Rate), dated 26-07-2018 in CGST and vide Notification No. 15/2018-Integrated Tax (Rate), dated 26-07-2018 in IGST. Later, the words "banking companies and" were inserted w.e.f. 01-01-2019 vide Notification No. 28/2018-Central Tax (Rate), dated 31-12-2018 in CGST and vide Notification No. 29/2018-Integrated Tax (Rate), dt.31-12-2018.*]
- Services by way of collection of contribution under the Atal Pension Yojana.
- Services by way of collection of contribution under any pension scheme of the State Governments.
- Services by the following persons in respective capacities:
  - (a) business facilitator or a business correspondent to a banking company with respect to accounts in its rural area branch;
  - (b) any person as an intermediary to a business facilitator or a business correspondent with respect to services mentioned in Entry (a); or
  - (c) business facilitator or a business correspondent to an insurance company in a rural area.
- Services by an intermediary of financial services located in a multi services Special Economic Zone (SEZ) with International Financial Services Centre (IFSC) status to a customer located outside India for international financial services in currencies other than Indian rupees (INR).

Where-

The intermediary of financial services in IFSC is a person,-

- (i) who is permitted or recognised as such by the Government of India or any Regulator appointed for regulation of IFSC; or
- (ii) who is treated as a person resident outside India under the Foreign

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Exchange Management (International Financial Services Centre) Regulations, 2015; or

- (iii) who is registered under the Insurance Regulatory and Development Authority of India (International Financial Service Centre) Guidelines, 2015 as IFSC Insurance Office; or
- (iv) who is permitted as such by Securities and Exchange Board of India (SEBI) under the Securities and Exchange Board of India (International Financial Services Centres) Guidelines, 2015.

*[inserted w.e.f. 25-01-2018 vide Notification No. 2/2018-Central Tax (Rate), dated 25-01-2018 in CGST and vide Notification No. 2/2018-Integrated Tax (Rate), dated 25-01-2018 in IGST]*

- Services provided to the Central Government, State Government, Union Territory under any insurance scheme for which total premium is paid by the Central Government, State Government and Union territory.

Intra/ inter-State supply of the above services has been specifically exempted vide Notification No. 12/2017- Central Tax (Rate) dated 28<sup>th</sup> June, 2017[“Notification No. 12/2017”] and Notification No. 09/2017-Integrated Tax (Rate) dated 28-6-2017 [“Notification No. 9/2017-ITR”] as amended from time to time.

26.07 Additional exemptions under the IGST are:

- Services received by RBI from outside India in relation to management of foreign reserves. [*Notification No. 9/2017-ITR*]
- Services imported by a unit or a developer in the Special Economic Zone for authorised operations. [*Notification No. 18/2017-Integrated Tax (Rate) dated 5-7-2017*]

26.08 Services provided by Asian Development Bank (ADB) and International Finance Corporation (IFC) are exempt from GST as clarified by CBIC vide circular no. 83/02/2019-GST, dated 1-1-2019 read with C.B.I. & C. Circular No. 211/1/2019-S.T., dated 15-1-2019.

26.09 The ADB Act, 1966 provides that notwithstanding anything to the contrary contained in any other law, the bank, its assets, properties, income and its operations and transactions shall be exempt from all the taxation and from all customs duties. The bank shall also be exempt from any obligation for payment, withholding or collection of any tax or duty [Section 5 (1) of the ADB Act, 1966 read with Article 56 (1) of the Schedule thereto]. *Vide letter*

No. 1/28/2002-ADB dated 22-01-2004 to ADB, it was conveyed that services provided by ADB are exempt from service tax.

26.10 Similarly, the IFC Act, 1958 also provides that notwithstanding anything to the contrary contained in any other law, the Corporation, its assets, properties, income and its operations and transactions authorised by the agreement, shall be immune from all taxation and from all customs duties. The Corporation shall also be immune from liability for the collection or payment of any tax or duty [Section 3 (1) of IFC Act, 1958 read with Article VI, Section 9 (a) of the Schedule thereto].

26.11 CESTAT Mumbai *vide its* order dated 17-10-2016 in the case of *M/s Coastal Gujarat Power Ltd.* has held that when the enactments that honour international agreements specifically immunize the operations of the service provider from taxability, a law contrary to that in the form of Section 66A of Finance Act, 1994 will not prevail. With the provider being not only immune from taxation but also absolved of any obligation to collect and deposit any tax, there is no scope for subjecting the recipient to tax. There is no need for a separate exemption and existing laws enacted by the sovereign legislature of the Union suffice for the purpose of giving effect to agreements.

26.12 Accordingly, it is clarified that the services provided by IFC and ADB are exempt from GST in terms of the provisions of IFC Act, 1958 and ADB Act, 1966. The exemption will be available only to the services provided by ADB and IFC and not to any entity appointed by or working on behalf of ADB or IFC.

### **Taxability of the Income Earned by Banks**

26.13 Albeit interest income forms the major part of the income of bank but due to globalisation banking sector has involved themselves into numerous activities resulting into variety of incomes. Let us analyse the applicability of GST on various incomes so earned by banks:

- 1) **Interest Income:** The income earned by way of grant of loans, deposits etc., is a taxable supply. However, by virtue of Entry 27(a) of Notification No. 12/2017 and Entry 28(a) of Notification No. 12/2017-ITR, no GST is payable on income earned by way of interest except interest income earned through credit card. The relevant extract of the said Entry is as under:

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<b>Sl No.</b>	<b>Chapter, Section, Heading, Group or Service Code (Tariff)</b>	<b>Description of services</b>	<b>Rate (%)</b>	<b>Condition</b>
27	Heading 9971	(a) Services by way of— (a) extending deposits, loans or advances in so far as the consideration is represented by way of interest or discount (other than interest involved in credit card services);	NIL	NIL

*Para 2 clause (zk) of Notification No. 12/2017 clarifies that interest does not include any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilised.*

Therefore, audit from the perspective of GST may be restricted to the fundamental question as to whether the income is rightly characterized as 'interest' to enjoy the exemption under GST Act and especially the income earned from credit card services as it is taxable under GST.

- 2) **Commission Income:** This is classified as income from a supply of service transaction and accordingly would be classified in terms of Chapter heading as specified in the relevant notifications issued under GST.

Commission earned (on accrual) is liable to GST.

Example A Ltd. wants to invest in fixed securities / bonds which can be routed only through XYZ bank as they have exclusive rights for subscribing to the same. XYZ bank gets 2 percent commission on the amounts so subscribed. For the period 2022-23, the bank earns Rs. 250 crores by way of commission from such subscription which is recorded as 'Other Income'. The auditor has to check

- Whether GST is appropriately charged on the said amount.
- Whether payments are made by complying with the due date for payment of GST.

If the tax is not discharged, then appropriate disclosure would be required.

- Verify that the returns filed reveal the correct amount of liability. Discrepancy in the returns filed (after any revision) and liability as determined may be disclosed.
- Interest being mandatory, may suitably be included in the disclosure.
- Suitable disclosure as to whether any contingency exists in respect of applicable penalty may also be provided.

Further, review of agreements where commission is earned should be carried out thoroughly and if any milestone incentives, performance bonus, time bonus etc., is offered then appropriate tax treatment should be suggested.

**3) Brokerage Income:** This income is classified as arising from a supply of service transaction and accordingly would be classified in terms of Chapter Heading as specified in the relevant notifications issued under GST.

**4) Agency Charges:** Generally, such income is earned on account of being appointed as an agency either by RBI, State Governments, Central Governments or by some corporates. Under such arrangements, banks act as a facilitator/collection centre and in lieu of provision of such services such banks collect certain fees as “agency charges”. Such charges are liable for payment of GST. Very often, the underlying arrangement will be of agency, but it may be described in a contemporary terminology like ‘enablement charge’ or ‘facilitation fee’ or simple ‘management fee’ which may appear misleading.

The auditor needs to analyse the relevant agreements entered and has to study the flow of consideration and its nature and thereafter decide the taxability and the amount on which GST is applicable. The same has to be communicated to the management if no GST is being paid till date.

**5) Portfolio Management Service:** Generally, the said services are being provided by different entities within the banking sector. Due to stiff competition and one-stop window for priority customer’s (i.e. customers who are depositing amounts beyond a certain limits) only one person provides all such services and thereafter relevant commission is split between entities or costs are shared. In fact, inter-branch sharing of portfolio management services in lieu of the skill set available in selected

branches between different States is taxable and a fair value has to be assigned to such transactions and applicable GST is payable on such transactions. Further, appropriate classification has to be made for such supply of services under relevant chapter heading as per the notifications issued under GST.

- 6) Account Maintenance Charges:** It is a common practice that in most of the banks certain charges are recovered towards maintenance. The said charges are nominal but the same is liable for payment of GST. Accordingly, the concerned concurrent /internal /statutory auditor would have to check on this aspect of taxability and ensure compliance.

Even locker charges are being recovered from the customers on an annual basis which is liable for payment of GST. There can be different modes of arrangement for availing such income, but such income is taxable under GST.

The provisions relating to place of supply will become imperative while determining the correct nature of the transaction and thereafter taxability has to be decided. Further, appropriate classification must be made for such supply of services under relevant chapter heading as per the notifications issued under GST.

- 7) Credit/Debit Card Charges:** Income earned by way of issuing and maintaining such transactions are liable for payment of GST. Therefore, the auditor should carefully examine such transactions and appropriate disclosures be made in case of non-compliance with relevant tax provisions. Following question in the FAQs released is relevant in this regard-

*Q. Whether GST will be levied on interchange fees on card settlement fees paid/shared by banks?*

*Ans. Fees charged for card settlement is a consideration which is part of a separate transaction between the banks which are parties to this transaction and shall be liable to GST. This is a B2B supply and credit of this transaction is available.*

In Short GST will be levied on interchange fees on card settlement fees paid/shared by banks.

- 8) Digital Payment Facilities-** Banks charge some convenience fees from persons who accept payment through debit card, credit card or through

some other card service. The charges earned by the bank are chargeable under GST. No GST will be payable in respect of services provided by bank, to any person in relation to settlement of an amount up to Rs. 2000 in a single transaction carried out through credit card, debit card or charge card or other payment card service.

- 9) Sale and Purchase of Foreign Currency:** Banking companies receiving consideration for providing services by way of securities and foreign exchange broking and purchase or sale of foreign currency, including money changing is chargeable to GST on special value calculated as per option availed in terms of Rule 32 of CGST Rules, 2017.

Hence at the time of conversion (purchase/sale) of foreign currency to Indian currency or vice a versa, GST is applicable in two stages - once on the charges separately levied by banks for such conversion and second on the value of sale/purchase as per Rule 32 of CGST Rules, 2017.

However, pursuant to Entry no. 27(b) of Notification No. 12/2017 and Entry no.28(b) of Notification no 9/2017-ITR, inter-bank transactions of sale or purchase of foreign currency or transactions with authorized dealers of money changing are exempt under GST regime.

**10) Other Income-**

- Income earned by banks by way of penalties, retention charges etc are liable for payment of GST.

Example:

- (a) IVY Bank charges Rs. 2500/- to all those customers who maintain an average quarterly balance below Rs. 25000/-. Accordingly, the total collection of income from such source is Rs. 5,00,00,000/- and therefore IVY Bank has to pay GST at appropriate rate.
- (b) IVY Bank collects a penalty of Rs. 500 from to all such customers whose cheques are bounced and the income collection for the period 2019-2020 is Rs. 50,00,000/-. IVY Bank has to discharge GST liability on the same at appropriate rate.
- Tax liability on realisation of payment by way of disposal of NPA to an asset reconstruction company [ARC] or to any other buyer is a debatable issue. There is a divergence in the views and the

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taxability will depend upon the structuring of the transaction. One view is that this transaction may be considered as actionable claim and GST will not apply as the definition of supply [Clause 6 Schedule III read with Section 7] under CGST Act excludes actionable claim. Another view is that, this transaction may be an outright sale. And when there is outright sale, Service Tax/GST applicability will depend on the nature of underlying asset sold and is to be paid by the borrower. For example, IVY bank sells one of its NPA as a going concern to ABC Co. The instant transaction is taxable under GST but the same is classified as a supply of service and accordingly the rate of tax payable is NIL in terms of Entry 2 classified under Chapter 99 as specified under Notification No. 12/2017.

26.14 The aforesaid discussion on the nature of services by bank and their taxability is summarised as under:

<b>SI No</b>	<b>Nature of Service</b>	<b>Remarks about Taxability</b>
1.	Assignment or Sale of Debts	Not Chargeable (Sale, transfer or assignment of debts falls within the purview of the actionable claims, which are neither good nor service as per Schedule III of the CGST Act. )
2.	Bank Guarantee Commission Charges	Taxable
3.	Bill Discounting	Exempt to the extent of interest component. However, commission, fees, brokerage or documentation charges will be taxable.
4.	Charges on Cheque Bouncing	As per Circular no. 10 of 2022 dated 3 <sup>rd</sup> August 2022, Charges on Cheque Bouncing is not Taxable (Ref. Point no. 7.3 of the said Circular)
5.	Interest and charges on delay/ non-payment of credit card bills	Taxable
6.	Charges for issuance of	Taxable



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	Demand Draft	
7.	Loan or other Documentation Charges	Taxable
8.	Forward Contract in Currencies	Where the settlement takes place by way of actual delivery of underlying currency, then such forward contracts would be treated as normal supply of goods and liable to GST (Commission portion). Where the settlement takes place by way of net settlement of differentials of the forward rate over the prevailing market rate on the settlement date, the same would be falling within the purview of 'securities' as securities are neither 'goods' nor 'services' as defined in the CGST Act, 2017, and therefore future contracts are not chargeable to GST.
9.	Future Contracts	Not Chargeable (Since it is financial derivative and falls within the definition of securities (which is neither goods nor service in GST) and hence they are not liable to GST. Commission and documentation charges will be liable for GST.
10.	Income from Commercial Paper or Certificate of Deposit	Exempt, due to nature of interest.
11.	Inspection Charges	Taxable
12.	Interest/ Discount on Loans / Deposits or Advances	Exempt
13.	Issuance of Bank Statement Charges	Taxable, except for Basic Saving Bank Deposit (BSBD) account holders under Pradhan Mantri Jan Dhan Yojana (PMJDY).
14.	Issuance of Letter of Credit	Exempt, as it is included in the definition of 'Money' under Section 2(75) of CGST Act and hence outside the definition of goods and services.

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15.	Ledger Folio Charges	Taxable
16.	Loan takeover transactions	Taxable (GST will be charged on the processing fees charged for the takeover of the loan).
17.	Processing Fees on Loans	Taxable
18.	Promissory Notes	Not Chargeable [As it is covered in the definition of "money" (which is neither good nor service in GST) and hence exempt. However, if any extra amount is charged in the name of commission, fees, brokerage etc. then it will be chargeable].
19.	Sale of Derivatives	Not Chargeable (Since derivatives falls within the definition of securities (which is neither good nor service in GST) and hence they are not liable to GST. However, if any extra amount is charged in the name of commission, fees, brokerage etc. than it will be chargeable.
20.	Security receipt as defined in clause (zg) of Section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act	Exempt, as covered under the definition of "securities", which is excluded from definition of "Goods" and "Services".
21.	Services provided to Reserve Bank of India	Interest charged on deposit kept with RBI is exempt. Other charges are taxable, as not exempt specifically.
22.	Standing Instruction Charges	Taxable, except for Basic Saving Bank Deposit (BSBD) account holders under Pradhan Mantri Jan Dhan Yojana (PMJDY).
23.	Stop Payment Charges	Taxable, except for Basic Saving Bank Deposit (BSBD) account holders under Pradhan Mantri Jan Dhan Yojana (PMJDY).
24.	Services supplied by a	Taxable under RCM

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	recovery agent to a bank.	
25.	Services supplied by individual Direct Selling Agents (DSAs) other than a body corporate, partnership or limited liability partnership firm to bank.	Taxable under RCM
26.	Services provided by BF/BC to a banking company in compliance with RBI's Circular No. DBOD.No.BL.BC.58/22.01. 001/2005-2006 dated 25.01.2006 and subsequent instructions on the issue.	Exempt vide Entry no. 39 [Heading no. 9971] of Notification 12/2017.
27.	Services provided by a banking company to Basic Saving Bank Deposit (BSBD) account holders under Pradhan Mantri Jan Dhan Yojana (PMJDY).	Exempt under Notification No. 28/2018 dated 31 <sup>st</sup> December, 2018.
28.	Business facilitator or a business correspondent to a banking company with respect to accounts in its rural area branch;	Exempt under Notification No. 12/2017
29.	Any person as an intermediary to a business facilitator or a business correspondent with respect to services mentioned in Entry 28	Exempt by Notification 12/2017
30.	Penal interest in case of delay payment of EMI	Exempt with reference to Circular No. 102/21/2019- GST dated 28 <sup>th</sup> June, 2019
31.	Foreclosure charges for foreclosure of loan to compensate for the loss in interest income	As per the clarification issued by Department vide Circular no. 10 of 2022 dated 3rd August 2022, GST is leviable on Foreclosure charges / Pre payment charges levied by bank. Details of text

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		is in Point no. 7.1.6 of said circular.
32.	Cheque dishonor fine / penalty	As per Circular No. 178/10/2022-GST, cheque dishonor fine or penalty is not a consideration for any service and not taxable
33.	Incentive paid by MeitY to acquiring banks under Incentive scheme for promotion of RuPay Debit Cards and low value BHIM-UPI transactions	As per Circular No .190/02/2023-GST dated 13 <sup>th</sup> January, 2023, Incentives paid for promotion of Rupay Debit cards and low value BHIM UPI transactions are in the nature of subsidy and thus not taxable.

Hence all income sources of the banks, have to be thoroughly scrutinized and thereafter the auditor has to comment on its taxability, classification and compliance with tax payment along with interest, applicable penalty and transparency in disclosure in the returns filed.

#### Rate of Tax under GST

26.15 Broadly the rates of tax in GST are – Nil; 0.25; 3; 5; 12; 18 and 28 per cent. Depending upon the classification of goods or types of services, different rates are applicable on different goods or services. These rates are uniform across India. In case IGST is levied, the rate is applied in consolidation, say 18 per cent IGST; and in case CGST and SGST are levied, the rate is applied in two equal parts say 9 per cent CGST and 9 per cent SGST.

The charging section of CGST Act and IGST Act provides an upper cap of rate as 20 per cent and 40 per cent respectively. However, currently the actual maximum tax prescribed on any commodity or services is 28 per cent plus cess, where applicable.

There is an increase in the tax rate from 15 per cent in service tax (erstwhile indirect tax) to 18 per cent under GST on the transaction charges levied on the financial services provided by the banks in relation to credit card, fund transfer, ATM transactions, processing fees on loans etc.

#### Classification of Goods and Services

26.16 When we say that different rates have been prescribed for different types of goods and services or when we say that tax is payable under reverse charge for specific types of goods and services, we recognise these

different types of goods and services by their classification under the GST Law. How the law has classified these goods and services is explained below.

- 1. Classification of Goods-** Classification of goods under the GST law is based on HSN Codes. '*Harmonised System of Nomenclature*' gives a unique code to each commodity by which it is recognized for the purpose of international trade. Each code is accompanied with the corresponding description of goods which are covered under that code.

In the GST law, the HSN Codes of the Customs Tariff Act have been recognised. In the Customs Tariff Act, 1985, there are 99 Chapters containing these codes. Each Chapter pertains to a broader class of commodities and contains sub-codes for sub-classes of such commodity.

- 2. Classification of Services -** In GST, a list of different classes of services has been given *vide Annexure to Notification No. 11/2017-Central Tax (Rate)*. This Annexure contains 4 to 6 digit numeral codes for every description of services. One has to identify the service code which matches with the description of service.

## **Invoice**

26.17 As inferred from the above, GST is chargeable at the time of supply. Invoice is an important indicator of the time of supply. Tax invoice is the primary document evidencing the supply by the supplier and vital for availing input tax credit by the recipient. Under the GST regime, an "invoice" or "tax invoice" means the tax invoice referred to in Section 31 of the CGST Act. This section mandates issuance of invoice or a bill of supply for every supply of goods or services or both.

26.18 The type of invoice to be issued depends upon the category of registered person making the supply. For instance, if a registered person is making supplies, then a tax invoice needs to be issued by such registered person. However, if a registered person is dealing only in exempted supplies or is availing composition scheme, then such registered person needs to issue a bill of supply in lieu of tax invoice. Further, where a registered person is supplying taxable as well as exempted goods or services or both to an unregistered person, a single-invoice-cum-bill of supply may be issued for all such supplies.

26.19 In terms of Rule 46 of the CGST Rules, 2017, subject to Rule 54 (*Tax invoice in special cases*), a tax invoice referred to in Section 31, shall

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be issued by the registered person containing the following:

- (a) name, address and GSTIN of the supplier;
- (b) a consecutive serial number, not exceeding sixteen characters, in one or multiple series, containing alphabets or numerals or special characters hyphen or dash and slash symbolised as “-” and “/” respectively, and any combination thereof, unique for a financial year;
- (c) date of its issue;
- (d) name, address and GSTIN or UIN, if registered, of the recipient;
- (e) name and address of the recipient and the address of delivery, along with the name of State and its code, if such recipient is un-registered and where the value of taxable supply is Rs. 50,000/- or more;
- (f) name and address of the recipient and the address of delivery, along with the name of the State and its code, if such recipient is un-registered and where the value of the taxable supply is less than Rs. 50,000/- and the recipient requests that such details be recorded in the tax invoice;
- (g) Harmonised System of Nomenclature code for goods or services; [Rule 46(g)]

[As regards the requirement to quote the HSN of the supplies, the annual turnover of the registered person for the previous year shall be referred. In case of suppliers having annual turnover in the previous year:

- i. Up to Rs.1.5 Crores – No HSN required.
- ii. Exceeding Rs. 1.5 Crores up to Rs. 5 Crores – HSN up to 2 digits required.
- iii. Exceeding Rs.5 Crores – HSN up to 4 digits required.  
The above limits were upto 31<sup>st</sup> March, 2021 and from 1<sup>st</sup> April, 2021 following limits are applicable as per Notification no. 2020/78 dated 15<sup>th</sup> October, 2020.
- iv. Up to Rs. 5 Crores – HSN up to 4 digits required.
- v. Exceeding Rs.5 Crores – HSN up to 6 digits required.

8 Digit HSN Code needs to be quoted in case of export turnover irrespective of the quantum of turnover.

The term ‘annual turnover’ has not been defined. Therefore, it may be

understood, to be the turnover in the State as defined in Section 2(112) of the Act, computed for the preceding financial year.

It is also relevant to note that no notification has been issued in respect of services, separately. However, considering that the term 'HSN' has been used commonly in respect of both goods and services, the aforesaid order can be applied even in respect of services, while quoting the code from the scheme of Classification of Services, as provided in *Notification No. 11/2017-Central Tax (Rate) dated.28-06-2017.*]

- (h) description of goods or services;
- (i) quantity in case of goods and unit or Unique Quantity Code thereof;
- (j) total value of supply of goods or services or both;
- (k) taxable value of supply of goods or services or both considering discount or abatement, if any;
- (l) rate of tax (central tax, State tax, integrated tax, Union territory tax or cess);
- (m) amount of tax charged in respect of taxable goods or services (central tax, State tax, integrated tax, Union Territory tax or cess);
- (n) place of supply along with the name of State, in case of a supply in the course of inter-State trade or commerce;
- (o) address of delivery where the same is different from the place of supply;
- (p) whether the tax is payable on reverse charge basis; and
- (q) signature or digital signature of the supplier or his authorized representative.

However, such signature or digital signature shall not be required in the case of issuance of an electronic invoice in accordance with the provisions of the Information Technology Act, 2000 (21 of 2000).

26.20 Further, the Government may, by notification, on the recommendations of the GST Council, and subject to such conditions and restrictions as mentioned therein, specify that the tax invoice shall have Quick Response (QR) code. In this regard, w.e.f.01/10/2020, Government has provided *vide* Notification No. 72/2019 of CGST Act dated 13<sup>th</sup> December 2019 that, an invoice issued by a registered person, whose aggregate turnover in a financial year exceeds Rs. 500 crores, to an unregistered

person (hereinafter referred to as B2C invoice), shall have Quick Response (QR) code. Where such registered person makes a Dynamic QR code available to the recipient through a digital display, such B2C invoice issued by such registered person containing cross-reference of the payment using a Dynamic QR code, shall be deemed to be having QR code.

26.21 Further Circular no. 21 of 2021 dated 17<sup>th</sup> November, 2021, clarified that it is not compulsory to have Dynamic QR code on invoice if issued to a recipient located outside India, for supply of services, for which the place of supply is in India, as per the provisions of IGST Act 2017, and the payment is received by the supplier, in *convertible foreign exchange or in Indian Rupees* wherever permitted by the RBI, such invoice may be issued without having a Dynamic QR Code, as such dynamic QR code cannot be used by the recipient located outside India for making payment to the supplier."

26.22 Further, Notification No 68/2019-Central Tax dated 13<sup>th</sup> December 2019, *inter alia* inserted Rule 48(4) of CGST Rules, 2017, which stipulates that the invoice shall be prepared by including particulars contained in Form GST INV-01 after obtaining an invoice reference number by uploading the information contained therein on the Common Goods and Services Tax Electronic Portal in such manner and subject to such conditions and restrictions as may be specified in the notification. In this regard, w.e.f. 1<sup>st</sup> October, 2022, vide Notification No. 17/2022 dated 1<sup>st</sup> August, 2022, the Government has notified registered persons, whose aggregate turnover in a financial year exceeds Rs. 10 crores (limit is Rs. 20 Crore for the period from 1<sup>st</sup> April, 2022 to 30<sup>th</sup> September, 2022), as a class of registered person who shall prepare invoice in terms of Rule 48(4) in respect of supply of goods or services or both to a registered person.

26.23 The Government has also notified the Common Goods and Services Tax Electronic Portal for the purpose of preparation of the invoice as per Rule 48(4).

26.24 As per Notification no. 2020/13 dated 21<sup>st</sup> March, 2020 E-Invoice for Insurance or Banking Company including NBFC needs to be issued as per Rule 54(2) which reads thus:

"Where the supplier of taxable service is an insurer or a banking company or a financial institution, including a non-banking financial company, the said supplier may issue a consolidated tax invoice or any other document in lieu thereof, by whatever name called for the supply of services made during a month at the end of the month, whether issued or made available, physically or electronically



whether or not serially numbered, and whether or not containing the address of the recipient of taxable service but containing other information as mentioned under rule 46”.

26.25 It is pertinent to mention that in case of export of goods or services, the invoice shall carry an endorsement as follows:

1. Where the supply is effected on payment of IGST: “*Supply meant for export/supply to SEZ unit or SEZ developer for authorised operations on payment of integrated tax*” or
2. Where the supply is effected without payment of IGST: “*Supply meant for export/supply to SEZ unit or SEZ developer for authorised operations under bond or letter of undertaking without payment of integrated tax*”. And details in lieu of those specified in Rule 46 (e) cited supra should contain the following:
  - (i) name and address of the recipient;
  - (ii) address of delivery; and
  - (iii) name of the country of destination.

#### **Time Limitation for Issuance of Invoice**

26.26 Section 31(2) read Rule 47 provides that a registered person supplying taxable services shall, before or after the provision of service but within 30 days (or 45 days in case of suppliers of services being an insurer / banking company / financial institution, including a NBFC) from the date of supply of the service, issue a tax invoice, showing the description, value, tax charged thereon and such other particulars as has been prescribed in the Invoice Rules.

26.27 Further, an insurer or a banking company or a financial institution, including a NBFC, or a telecom operator, or any other class of supplier of services as may be notified by the Government on the recommendations of the Council, making taxable supplies of services between distinct persons as specified in Section 25, may issue the invoice before or at the time such supplier records the same in his books of account or before the expiry of the quarter during which the supply was made.

26.28 Moreover, the Government may, on the recommendations of the Council, by notification and subject to such conditions as may be mentioned therein, specify the categories of services in respect of which:

- (a) Any other document issued in relation to the supply shall be deemed to be a tax invoice; or

(b) Tax invoice may not be issued.

26.29 Therefore, an insurer / banking company / financial institution, including a NBFC may issue an invoice or any other document in lieu thereof.

26.30 Rule 54 of the CGST Rules which contain provisions relating to tax invoices in cases of special services, *inter alia* stipulates that, an insurer or a banking company or a financial institution, including a non-banking financial company, may issue a consolidated tax invoice or any other document *in lieu* thereof, by whatever name called for the supply of services made during a month at the end of the month, whether issued or made available, physically or electronically whether or not serially numbered, and whether or not containing the address of the recipient of taxable service but containing other information as mentioned under rule 46.

26.31 The signature or digital signature of the supplier or his authorised representative shall not be required in the case of issuance of a consolidated tax invoice or any other document in lieu thereof as per the Information Technology Act, 2000.

26.32 Further, Section 31 (1)(b) read with the proviso to rule 46 provides that a registered person [other than the supplier engaged in making supply of services by way of admission to exhibition of cinematograph films in multiplex screens,] may not issue a tax invoice if the value of the goods or services or both supplied is less than Rs. 200/- subject to the following conditions, namely:

- (1) the recipient is not a registered person; and
- (2) the recipient does not require such invoice.

However, the supplier shall issue a consolidated tax invoice for such supplies at the close of each day in respect of all such supplies.

26.33 Therefore, banking companies have the option to issue a consolidated tax invoice or any other document in lieu of tax invoice for the supply of services made during a month, at the end of the month, either in physical form or electronically.

#### **Notes**

- A registered person on receipt of advance payment with respect to any supply shall issue receipt voucher.
- Further, where at the time of receipt of advance:

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- the rate of tax is not determinable the tax shall be paid at the rate of 18 percent.
- the nature of supply is not determinable, the same shall be treated as inter-State supply.
- Where, on receipt of advance payment with respect to any supply of goods or services or both the registered person issues a receipt voucher, but subsequently no supply is made and no tax invoice is issued in pursuance thereof, the said registered person may issue to the person who had made the payment, a refund voucher against such payment.
- A registered person who is liable to pay tax under Section 9(3) or 9(4) shall issue an invoice in respect of goods or services or both received by him from the supplier who is not registered on the date of receipt of goods or services or both. Here, a registered person may issue a consolidated invoice at the end of a month for supplies covered under Section 9(4), the aggregate value of such supplies exceeds Rs. 5,000/- in a day from any or all the suppliers.
- A registered person who is liable to pay tax under Section 9(3) or 9(4) shall issue a payment voucher at the time of making payment to the supplier.
- The GST law specifies the following particulars to be contained in documents evidencing supply:

<b>CGST Rule</b>	<b>Document Substantiating Supply</b>
Rule 46	Invoice
Rule 49	Bill of supply
Rule 50	Receipt voucher
Rule 51	Refund voucher
Rule 52	Payment voucher
Rule 53	Revised tax invoice and credit or debit notes

- In cases where tax invoice has been issued for supply of any goods or services or both and subsequently it is found that the value or tax charged in that invoice is more than what is actually payable/ chargeable or where the recipient has returned the goods, the supplier can issue a credit note to the recipient.

In cases where tax invoice has been issued for supply of any goods or services or both, and subsequently it is found that the value or tax

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charged in that invoice is less than what is actually payable/chargeable, the supplier can issue a debit note to the recipient.

The adjustment of GST already paid is allowed only by way of issuance of credit/debit note in terms of Section 34 of the CGST Act, 2017. The proviso to Section 34(2) of the CGST Act, 2017 provides that no reduction in liability would be allowed if the incidence of tax has been passed on to another person. If bad debts are on account of deficiency in supply of services, or tax charged being greater than actual tax liability, or goods returned, GST paid on the same is refundable subject to fulfilment of the prescribed conditions. Therefore, GST already paid on bad debts, as used in the trade parlance, cannot be adjusted.

- The tax invoice must be prepared in triplicate for goods, and in duplicate for services. Each copy of the tax invoice in case of service, is required to be marked as follows:

<b>Goods</b>	<b>Services</b>
1. ORIGINAL FOR RECIPIENT	1. ORIGINAL FOR RECIPIENT
2. DUPLICATE FOR TRNSPORTER	2. DUPLICATE FOR SUPPLIER
3. TRIPLICATE FOR SUPPLIER	–

### **Value of Taxable Supply Under GST**

26.34 Once it is determined that an activity or transaction is supply under GST, ascertaining the value of the same becomes significant.

26.35 Under Section 15(1) the value of a supply of goods or services or both shall be the transaction value, which is the price actually paid or payable for the said supply of goods or services or both where the supplier and the recipient of the supply are not related, and the price is the sole consideration for the supply.

26.36 Explanation to Section 15 of the CGST Act deems the following persons to be “related persons”:

- Officers / Directors of one another’s business.
- Partners in business.
- Employer – employee.
- A person directly / indirectly owns / controls / holds 25 per cent more of the outstanding voting stock or shares of both the persons.

- One directly / indirectly controls the other.
- Both are directly / indirectly controlled by a third person.
- Together, they directly / indirectly control a third person.
- Members of the same family.
- Sole agent / distributor / concessionaire of the other.

<b>Section 15(2) Transaction Value INCLUDES:</b>	<b>Transaction Value EXCLUDES Discount</b>
<ul style="list-style-type: none"> <li>(i) Amounts charged by the supplier to recipient in respect of any taxes, duties, cesses, fees and charges levied under any statute, other than taxes paid under GST regime;</li> <li>(ii) Amount incurred by recipient which is liable to be paid by the supplier and not included in price actually paid or payable;</li> <li>(iii) Charges by Supplier to Recipient being: Incidental expenses (e.g. packing, commission)</li> <li>(iv) Charges for anything done by the supplier at the time or before the supply, in respect thereof  Interest/ late fee/ penalty for delayed payment of consideration</li> <li>(v) Subsidies directly linked to price – for supplier receiving the subsidy (excluding Central and State Govt. subsidies; i.e., Government subsidies will not be included in transaction value)</li> </ul>	<ul style="list-style-type: none"> <li>(i) Before / at the time of supply Single condition: Such discount is duly recorded in the invoice                             <ul style="list-style-type: none"> <li>▪ After the supply: Cumulative conditions: Agreement establishing discount entered into before / at the time of supply Discount specifically linked to relevant invoices ITC reversed by the recipient to the extent attributable to the discount</li> </ul> </li> </ul>

26.37 To determine the value of certain specific transactions, specific rules have been incorporated in CGST Rules, 2017 (Rules 27-35). Rules pertaining to banking Sector are:

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Banking sector provides services of purchase and sale of foreign currency to its customers, the value of which can be ascertained in terms of Rule 32(2) of the CGST Rules as under:

OPTION –I [Section 32(2)(a)]	OPTION -II [Section -32(2)(b)]	
When exchanged from or/ to INR: (i) Difference of buying rate / selling rate and RBI reference rate X Total units of currency (If RBI reference rate is not available, value shall be 1 percent of gross amount of INR received or provided) (ii) If neither of the two currencies exchanged in INR, (iii) the value shall be equal to 1 per cent of the lesser of the two amounts (iv) the person changing the money would have received by converting any of the two currencies into INR (v) on that day at the reference rate provided by RBI.	<b>Where Amount of Currency Exchanged</b>	
	Up to Rs. 1 lakh	1 per cent of the gross amount of currency exchanged or Rs. 250/-, <i>whichever is higher</i>
	Rs. 1 lakh and up to Rs. 10 lakhs	Rs. 1,000/- plus 0.5 percent of the gross amount of currency exchanged above Rs. 100,000/-
	exceeding Rs. 10 lakhs	Rs. 5,500/- plus 0.10 percent of the gross amount of currency exchanged above Rs. 10 lakhs or Rs. 60,000/-, <i>whichever is lower</i>

Note - A person supplying the services may exercise the option to ascertain the value in terms of clause(b) for a financial year and such option shall not be withdrawn during the remaining part of that financial year.

26.38 Further, it is pertinent to mention here that Rule 34 of the CGST Rules provides the rate of exchange of currency, other than Indian rupees, for determination of value as under:

Transactions undertaken in foreign currency must be translated into Indian Rupees. The rate of exchange for the determination of the value of taxable goods shall be the applicable rate of exchange as notified by the Board under Section 14 of the Customs Act, 1962 and for the determination of the value of taxable services it shall be the applicable rate of exchange determined as per the generally accepted accounting principles for the date

of supply in respect of such supply in terms of Section 12 or, as the case may be, Section 13 of the Act.

### Valuation of Services between the Distinct and Related Persons (excluding Agents)

26.39 Generally, banks would have lots of common/ shared services being supported from Head Office such as call center, security software etc. Further, many times one branch would internally provide service to other branches for example: resolving issue of a customer having PAN India accounts, providing local information to other branches etc. The value will be determined in terms of Rule 28 of the CGST Rules, 2017 as under:

(a) The open market value of such supply	
<b>(b) If open market value is not available</b>	Value of supply of goods or services of like kind and quality
<b>(c) If value of supply is not determinable under clause (a) or (b)</b>	Value as determined by application of Rule 30 or Rule 31, in that order
<i>Provided that where goods are intended for further supply as such by the recipient, the value shall, at the option of the supplier, be an amount equivalent to 90% of the price charged for the supply of goods of like kind and quality by the recipient to his customer not being a related person</i>	
<i>Where the recipient is eligible for full input tax credit, the value declared in the invoice shall be deemed to be the open market value of goods or services</i>	

Value of supply based on cost i.e. cost of supply plus 10 per cent mark-up (Rule 30 of the CGST Rules 2017).

Value of supply determined by using reasonable means should be consistent with the principles and general provisions of GST law (Rule 31 of the CGST Rules 2017).

### Value of supply in case of Re-possessed Assets from Defaulting Borrowers

26.40 Rule 32(5) provides that where a taxable supply is provided by a person dealing in buying and selling of second hand goods i.e., used goods as such or after such minor processing which does not change the nature of the goods and where no input tax credit has been availed on the purchase of such goods, the value of supply shall be the difference between the selling

price and the purchase price and where the value of such supply is negative, it shall be ignored.

Provided that the purchase value of goods repossessed from a defaulting borrower, who is not registered, for the purpose of recovery of a loan or debt shall be deemed to be the purchase price of such goods by the defaulting borrower reduced by 5 per cent points for every quarter or part thereof, between the date of purchase and the date of disposal by the person making such repossession.

### **Rate of Exchange of Currency, other than Indian Rupees, for Determination of Value**

26.41 The rate of exchange for determination of value of taxable goods or services or both shall be the applicable RBI reference rate for that currency on the date of supply as determined in terms of Section 12 or Section 13 of the CGST Act.

### **Value of Supply inclusive of Integrated Tax, Central Tax, State Tax, Union Territory Tax**

26.42 Where the value of supply is inclusive of GST, the tax amount shall be determined in the following manner:

Tax amount = (Value inclusive of taxes x GST tax rate)/(100+ sum of GST tax rates).

For example - If the value inclusive of tax is Rs. 100/- and applicable GST tax rate is 18 per cent then

Tax amount =  $(100 \times 18) / (100 + 18) = 1800 / 118 = \text{Rs. } 15.25$ .

### **Nature of Supply and Place of Supply**

26.43 The term 'Place of Supply' is of vital importance in the GST. To know the nature of supply whether the supply is inter-State supply or intra-State supply, one should know the place of supply to determine the nature of supply.



## Inter-State Supplies



26.44 Section 7 of the IGST Act, provides as to when the supplies of goods and/or services shall be treated as supply in the course of inter-State trade/commerce.

Sections 7(1) and 7(2) of IGST Act, primarily cover two kinds of supplies – supply of *goods* within India and supply of *goods* imported into India respectively and Sections 7(3) and 7(4) of IGST Act, cover two kinds of supplies – supply of *services* within India and import of *services* into India respectively. Certain supplies of goods or services are treated as supplies in the course of inter-State trade or commerce as defined in Section 7(5) of the IGST Act.

26.45 Inter-State supplies: Section 8(1) of IGST Act, deals with supply of *goods* and Section 8(2) of IGST Act with supply of *services* treated as supplies in the course of intra-State trade or commerce.

Section 8(2) of IGST Act reads thus:

*“Subject to the provisions of Section 12, supply of services where the location of the supplier and the place of supply of services are in the same State or same Union territory, shall be treated as intra-State supply:*

*Provided that the intra-State supply of services shall not include supply of services to or by a Special Economic Zone developer or a Special*

*Economic Zone unit.*

*Explanation 1 —For the purposes of this Act, where a person has, —*

- (i) an establishment in India and any other establishment outside India;*
- (ii) an establishment in a State or Union territory and any other establishment outside that State or Union territory; or*
- (iii) an establishment in a State or Union territory and any other establishment registered within that State or Union territory;*

*then such establishments shall be treated as establishments of distinct persons.*

*Explanation 2 —A person carrying on a business through a branch or an agency or a representational office in any territory shall be treated as having an establishment in that territory.”*

With regard to supply of service, if the twin factors of “location of supplier of services’ and ‘place of supply of services’ are in the same State or UT, then such supply will be treated as intra-State supply. Location of the supplier of services has been defined in the Act to mean ‘place of business from where supply is made and duly registered for the purpose’. It also includes other places and reference may be had to the discussion in respect of inter-State supply of services for the implications of this definition.

For instance, consider audit services being provided by a Chartered Accountant located in Delhi to a company in Delhi. For the purpose of the audit, the Chartered Accountant visits the company’s factory located in Noida. Here, although the Chartered Accountant is physically moving to Noida, he is not supplying the audit services from Noida. The transaction will be an intra-State supply from Delhi to Delhi.

Therefore, it is relevant to understand the terms “location of supplier of services’ and “place of supply of services’ to determine the nature of supply.

26.46 Section 2 (15) of IGST Act states that, location of supplier of services means –

- (a) where a supply is made from a place of business for which the registration has been obtained, the location of such place of business;
- (b) where a supply is made from a place other than the place of business for which registration has been obtained (a fixed establishment elsewhere), the location of such fixed establishment;
- (c) where a supply is made from more than one establishment, whether the

place of business or fixed establishment, the location of the establishment most directly concerned with the provision of the supply; and

- (d) in the absence of such places, the location of the usual place of residence of the supplier.

26.47 Section 2(85) of CGST Act, 2017 provides an inclusive definition of 'place of business' and Section 2(50) of CGST Act, 2017 provides an exclusive definition of 'fixed establishment' as under:

- place of business includes:
  - (a) a place from where the business is ordinarily carried on, and includes a warehouse, a godown or any other place where a taxable person stores his goods, supplies or receives goods or services or both; or
  - (b) a place where a taxable person maintains his books of account; or
  - (c) a place where a taxable person is engaged in business through an agent, by whatever name called.
- fixed establishment means;
  - a place (other than the registered place of business)
  - which is characterised by –
    - a sufficient degree of permanence; and
    - suitable structure in terms of human and technical resources to supply services, or to receive and use services for its own needs.

It can be inferred from the above that, in case of services provided by bank to a customer from multiple locations, the location of supplier will be the home branch/ account branch. The other branches providing services to such customer actually provide services to the home branch/ account branch.

### **Place of Supply for Banking Sector**

26.48 In the case of banks and financial institutions the place of supply will have to be determined as under:

- Where the location of the banks or location of the recipient of service is in India, Section 12(12) of the IGST Act, 2017, provides for the place of supply of services -

*The place of supply of banking and other financial services, including stock broking services to any person shall be the location of the*

*recipient of services on the records of the supplier of services.*

*Provided that, if the location of recipient of services is not on the records of the supplier, the place of supply shall be the location of the supplier of services.*

Hence, the place of supply of banking and other financial services, to any person shall be the location of the recipient of services on the records of the supplier of services. The address available on the records of the bank or financial institution, which is ordinarily used for communication with the customer, may be considered as the place of supply. Where the address/ location of recipient of services is not on the records of the supplier, the place of supply shall be the location of the supplier of services.

Under section 10 of the CGST Act (composition taxable persons) and to UIN holders, as required to be declared in Table 3.2 of FORM GSTR-3B, under the notion that the taxable value of the same along with tax payable has already been reported in Table 3.1 of the said FORM. In certain cases, it has also been noticed that the address of unregistered person are captured incorrectly by the supplier, especially those belonging to banking, insurance, finance, stock broking, telecom, digital payment facilitators, OTT platform services providers and E-commerce operators, leading to wrong declaration of Place of Supply (PoS) in both the invoices issued under section 31 of the CGST Act, as well as in Table 3.2 of FORM GSTR-3B.

- In cases, where the location of the banks or location of the recipient of service is outside India, Section 13(8) of the IGST Act, 2017, provides as under:

*The place of supply of the following services shall be the location of the supplier of services, namely: —*

- (a) services supplied by a banking company, or a financial institution, or a non-banking financial company, to account holders;*
- (b) intermediary services;*
- (c) services consisting of hiring of means of transport, including yachts but excluding aircrafts and vessels, up to a period of one month.*

*Explanation - For the purposes of this sub-section, the expression, —*

- (a) “account” means an account bearing interest to the depositor, and includes a non-resident external account and a non-resident*

*ordinary account;*

- (b) *“banking company” shall have the same meaning as assigned to it 2 of 1934. under clause (a) of Section 45A of the Reserve Bank of India Act, 1934;*
- (c) *“financial institution” shall have the same meaning as assigned to it 2 of 1934. in clause (c) of Section 45-I of the Reserve Bank of India Act, 1934;*
- (d) *“non-banking financial company” means, —*
  - (i) *a financial institution which is a company;*
  - (ii) *a non-banking institution which is a company, and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner; or*
  - (iii) *such other non-banking institution or class of such institutions, as the Reserve Bank of India may, with the previous approval of the Central Government and by notification in the Official Gazette, specify.*

In terms of Section 13(8) of the IGST Act, 2017 the services provided by the bank to its account holder shall be deemed to be the service provided at the place where such bank is located. “Account” here means an account bearing interest to the depositor, and includes a non-resident external account and a non-resident ordinary account.

26.49 Further, in terms of Section 13 of the IGST Act, 2017, where the location of the supplier or location of the recipient is outside India, the place of supply will be the location of the recipient of the services. Where the location of the recipient of services is not available in the ordinary course of business, the place of supply shall be the location of the supplier of services. Therefore, the service provided by the bank to a person other than an account holder located outside India, shall be the location of the supplier of services. Accordingly the place of supply of service provided by the bank to its customer located outside India shall be the location of bank and Central tax and State tax or Union Territory tax, as the case may be, will be payable.

26.50 Further Section 2(13) of IGST Act defines the term ‘intermediary’ as under:

*“intermediary” means a broker, an agent or any other person, by whatever name called, who arranges or facilitates the supply of goods or*

*services or both, or securities, between two or more persons, but does not include a person who supplies such goods or services or both or securities on his own account;*

As inferred from Section 13(8)(b) of IGST Act, the place of supply in the case intermediary services provided by a banking company, or a financial institution, or a non-banking financial company, to account holders shall be the location of the supplier.

### **Registration**

26.51 One of the criteria to exemplify a transaction to be a supply under GST is that the supply should be made by a taxable person. Section 2 (107) of the CGST provides that taxable person means a person who is registered or liable to be registered under Section 22 or Section 24. Therefore, a thorough understanding of the provisions pertaining to registration under GST is important for the auditors.

26.52 During the pre-GST regime, the services provided by the banks were liable to service tax, which was a central tax only. Therefore, in spite of banks having their branches spread in multiple states, they had an option to have a centralised registration, payment and compliance. Accordingly, most of the banks opted for centralised registration and its compliance activities were managed at this centralised registration centre.

26.53 Unlike the concept of centralized registration available under erstwhile service tax, under GST every supplier effecting taxable supplies, subject to a threshold limit is liable for registration and hence the concept of centralized registration does not exist here.

26.54 In terms of Section 22 of the CGST Act, every supplier shall be liable to be registered under this Act in the State or Union Territory, other than special category States [as specified in sub-clause (g) of clause (4) of Article 279A of the Constitution], from where he makes a taxable supply of goods or services or both, if his aggregate turnover in a financial year exceeds Rs. 20 lakhs and in case of special category State wherein the registration limit is Rs. 10 lakhs. It is important to note that registration is required 'in' the State 'from which' taxable supplies are made. Registration is not required 'in' the State 'to' which taxable supplies are made, even though this is a destination-based tax.

26.55 The explanation to Section 22 defines 'Special Category States' as the States specified in sub-clause (g) of clause (4) of Article 279A of the

Constitution except Jammu & Kashmir.<sup>54</sup> Following is the list of States provided in Article 279A(4)(g) of the Constitution:

“Arunachal Pradesh, Assam, Jammu & Kashmir, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, Tripura, Himachal Pradesh, Uttarakhand”.

Further, *w.e.f.1-02-2019 vide CGST, (Amendment) Act, 2018 read with Notification No.2/2019 dated 29.01.2019*, the States of Arunachal Pradesh, Assam, Meghalaya, Sikkim, Himachal Pradesh, and Uttarakhand have been excluded from the definition of special category States for the purpose of Section 22 of GST Act, 2017.

Therefore, now for all States excepting the States of Manipur, Mizoram, Nagaland and Tripura, the threshold limit for registration is Rs. 20 lakhs.

Moreover, *w.e.f. 1-02-2019 vide the CGST, (Amendment) Act, 2018*, the Second Proviso to Section 22(1) has been inserted to provide that Government may, at the request of a special category State and on the recommendations of the Council, enhance the aggregate turnover referred to in the first proviso from Rs. 10 lakhs to such amount, not exceeding Rs. 20 lakhs and subject to such conditions and limitations, as may be so notified.

26.56 It needs to be noted that the proviso to Section 22(1) appearing in the CGST Act also appears in the SGST Act(s). As a result, for a taxable person in a non-Special Category State, who has a branch in Special Category State, the threshold becomes Rs. 10 lacs and not Rs. 20 lacs.

26.57 Besides the above, with effect from 1<sup>st</sup> April 2019, the Central Government vide Notification No. 10/2019-Central Tax dated 7<sup>th</sup> March, 2019 has granted exemption to persons engaged exclusively in the supply of goods and whose aggregate turnover in the financial year does not exceed Rs. 40 lakhs from obtaining registration except persons making intrastate supplies in the States of Arunachal Pradesh, Manipur, Meghalaya, Mizoram, Nagaland, Puducherry, Sikkim, Telangana, Tripura and Uttarakhand.

26.58 From above it is important to understand the term aggregate turnover which means the aggregate value of all taxable supplies, exempt supplies, export of goods or services or both and inter-State supplies of persons having the same PAN, to be computed on all India basis and excludes CGST/SGST, IGST, UTGST and cess.

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<sup>54</sup> Inserted vide CGST (Extension to Jammu and Kashmir) Act, 2017 w.e.f.8-07-2017.

26.59 Aggregate turnover does not include the value of inward supplies on which tax is payable on reverse charge basis.

26.60 For calculating the threshold limit, as per the Explanation to Section 22 of the CGST Act, the turnover shall include all supplies made by the taxable person, whether on his own account or made on behalf of all his principals. Further, supply of goods by a registered job worker, after completion of job work, shall be treated as the supply of goods by the “principal” referred to in Section 143 (i.e. Job work procedure) of this Act. The value of such goods shall not be included in the aggregate turnover of the registered job worker.

26.61 Now, it is important to mention that Section 23 provides relaxation from the requirement of obtaining registration to the following two categories of persons -

- Agriculturists.
- Persons engaged exclusively in the supply of exempted goods or services or both.

The Government on the recommendation of the Council, by notification may specify the category of persons who may be exempted from obtaining registration under this Act.

26.62 The term exclusive indicates engaging in only those supplies which are exempt. Therefore, if a supplier is supplying both exempt and non-exempt goods and/or services, then this provision is not applicable, and he is required to obtain registration under Section 22 and aggregate turnover will include both taxable as well as well exempted supplies.

26.63 A person whose ‘entire’ supply consists of ‘exempt supplies’, is excluded from obtaining registration in terms of Section 23 of the CGST Act.

### **Compulsory Registration Under GST**

26.64 Notwithstanding anything contained under Section 22 (1), Section 24 of the CGST Act provides the categories of persons who shall be required to be registered under this Act irrespective of the threshold. The following categories of persons are required to obtain registration compulsorily under this Act:

- (i) Persons making any inter-State taxable supply.

Exception: vide Notification 10/ 2017–Integrated Tax, dated 13.10.2017, persons making inter State supply of services and having turnover not exceeding Rs. 20 lakhs have been exempt under section 23 from



obtaining registration. Accordingly, only persons who make inter-State supply of goods have to compulsorily obtain registration and not eligible to claim the benefit of Notification no. 10/2017-Integrated Tax dated 13.10.2017.

However, the aggregate value of supply of services should not exceed Rs. 10 lakhs in respect of Special Category States except the States of Jammu and Kashmir, Arunachal Pradesh, Assam, Himachal Pradesh, Meghalaya, Sikkim and Uttarakhand.

- (ii) Casual taxable persons making taxable supply.
- (iii) Persons who are required to pay tax under reverse charge.
- (iv) Person who are required to pay tax under Section 9(5).
- (v) Non-resident taxable persons making taxable supply.
- (vi) Persons who are required to deduct tax under Section 51.
- (vii) Persons who make taxable supply goods or services or both on behalf of other taxable persons whether as an agent or otherwise.
- (viii) Input service distributor.
- (ix) Persons who supply goods or services or both, other than supplies specified under Section 9(5), through such electronic commerce operator who is required to collect tax at source under Section 52.
- (x) Every electronic commerce operator who is required to collect tax at source under Section 52.
- (xi) Every person supplying online information and database access or retrieval services from a place outside India to a person in India, other than a registered person.
- (xii) Such other person or class of persons as may be notified by the Government on the recommendations of the Council.

Note: Out of the twelve categories of persons who need to take registration compulsorily, two categories of persons are most relevant to the banking sector i.e., person who is required to pay tax under reverse charge [listed at (iii) above] and input service distributors [listed at (vii) above].

### **Effective date of Registration**

26.65 Where the application for registration has been submitted within thirty days from the date on which the person becomes liable to registration, the effective date of registration shall be date on which he become liable for registration.

26.66 Where an application for registration has been submitted by the applicant after thirty days from the date of his becoming liable to registration, the effective date of registration shall be the date of grant of registration.

26.67 In case of registration pursuant to any survey, enquiry, inspection, search or any other proceedings, the effective date shall be the date of order of registration.

26.68 Section 25 read with Rules 8 to 26 of the CGST Rules, 2017 relating to registration provides a detailed road map on the procedural aspects of the registration. The time limit for application is 30 days (for persons other than casual taxable person or a non-resident taxable person) and casual taxable person or a non-resident taxable person shall have to obtain the registration at least 5 days prior to the commencement.

### **GST applicability on Receipt of Services under RCM**

26.69 Generally, the obligation to discharge GST lies on the supplier. But there exist certain cases in which reverse charge is applicable and hence the duty to discharge tax is cast on the recipient of supply. Even various expenses incurred by the banks are eligible to tax under Reverse Charge Mechanism ("RCM"). No partial reverse charge will be applicable under GST. Hundred per cent tax will be paid by the recipient if reverse charge mechanism applies.

26.70 All taxpayers required to pay tax under reverse charge have to mandatorily obtain registration and the threshold exemption is not applicable on them. Payment of taxes under reverse charge cannot be made with utilisation of input tax credit and has to be made in cash.

26.71 Section 9(3) of CGST/ Section 5(3) of the IGST Act specify the categories of supply of goods or services or both as notified by Government on recommendations of the Council on which RCM is applicable. In this regard, the Govt. vide Notification No. 13/2017- Central Tax (Rate) dated 28.06.2017 ("Notification 13/2017") / Notification No. 10/2017- Integrated Tax (Rate) dated 28.06.2017 (Notification 10/2017-ITR) as amended from time to time specify the category of services on which RCM is applicable.

26.72 The list of such services mentioned in Notification 13/2017 are as under:

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Sl. No.	Category of Supply of Services	Supplier of service	Recipient of Service
(1)	(2)	(3)	(4)
1	<p>Supply of services by a goods transport agency (GTA), [who has not paid central tax at the rate of 6%,]<sup>55</sup> in respect of transportation of goods by road to-</p> <p>(a) any factory registered under or governed by the Factories Act, 1948(63 of 1948);or</p> <p>(b) any society registered under the Societies Registration Act, 1860 (21 of 1860) or under any other law for the time being in force in any part of India; or</p> <p>(c) any co-operative society established by or under any law; or</p> <p>(d) any person registered under the CGST Act or the IGST Act or the SGST Act or the UTGST Act; or</p> <p>(e) any body corporate established, by or under any law; or</p> <p>(f) any partnership firm whether registered or not under any law including association of persons; or</p> <p>(g) any casual taxable person.</p>	Goods Transport Agency (GTA)	<p>(a) Any factory registered under or governed by the Factories Act, 1948 (63 of 1948); or</p> <p>(b) any society registered under the Societies Registration Act, 1860 (21 of 1860) or under any other law for the time being in force in any part of India; or</p> <p>(c) any co-operative society established by or under any law; or</p> <p>(d) any person registered under the CGST Act or the IGST Act or the SGST Act or the UTGST Act; or</p> <p>(e) any body corporate established, by or under any law; or</p> <p>(f) any partnership firm whether registered or not under any law including association of</p>

<sup>55</sup> Inserted vide Notification No. 22/2017 – Central Tax (Rate) dated 22.08.2017.

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	<p>[Provided that nothing contained in this entry shall apply to services provided by a goods transport agency, by way of transport of goods in a goods carriage by road, to, -</p> <p>(a) a Department or establishment of the Central Government or State Government or Union territory; or</p> <p>(b) local authority; or</p> <p>(c) Governmental agencies, which has taken registration under the CGST Act, 2017 (12 of 2017) only for the purpose of deducting tax under Section 51 and not for making a taxable supply of goods or services.]<sup>56</sup></p>		<p>persons; or</p> <p>(g) any casual taxable person; located in the taxable territory.</p>
2	<p>[Services provided by an individual advocate including a senior advocate or firm of advocates by way of legal services, directly or indirectly.</p> <p><i>Explanation.-</i> “Legal service” means any service provided in relation to advice, consultancy or assistance in any branch of law, in any manner and includes representational</p>	<p>An individual advocate including a senior advocate firm</p>	<p>Any business entity located in the taxable territory.</p>

<sup>56</sup> Inserted vide Notification No. 29/2018 – Central Tax (Rate) dated 31.12.2018.

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	services before any court, tribunal or authority.] <sup>57</sup>		
3	Services supplied by an Arbitral Tribunal to a business entity.	An Arbitral Tribunal.	Any business entity located in the taxable territory.
4	Services provided by way of sponsorship to any body corporate or partnership firm.	Any person	Any body corporate or partnership firm located in the taxable territory.
5	Services supplied by the Central Government, State Government, Union territory or local authority to a business entity excluding, - (1) renting of immovable property, and (2) services specified below- (i) services in relation to an aircraft or a vessel, inside or outside the precincts of a port or an airport; (ii) transport of goods or passengers.	Central Government, State Government, Union territory or local authority	Any business entity located in the taxable territory.
5A	Services supplied by the Central Government, State Government, Union territory or local authority by way of renting of immovable property to a person	Central Government, State Government, Union territory or local	Any person registered under the Central Goods and Services Tax Act, 2017. <sup>58</sup>

<sup>57</sup> Substituted vide corrigendum to Notification No. 13/2017-Central Tax (Rate), dated 25.09.2017. Prior to substitution it read: "Services supplied by an individual advocate including a senior advocate by way of representational services before any court, tribunal or authority, directly or indirectly, to any business entity located in the taxable territory, including where contract for provision of such service has been entered through another advocate or a firm of advocates, or by a firm of advocates, by way of legal services, to a business entity."

<sup>58</sup> Inserted vide Notification No. 3/2018 – Central Tax (Rate) dated 25.01.2018.

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	registered under the Central Goods and Services Tax Act, 2017 (12 of 2017).	authority	
5B	Services supplied by any person by way of transfer of development rights or Floor Space Index (FSI) (including additional FSI) for construction of a project by a promoter.	Any person	Promoter <sup>59</sup>
5C	Long term lease of land (30 years or more) by any person against consideration in the form of upfront amount (called as premium, salami, cost, price, development charges or by any other name) and/or periodic rent for construction of a project by a promoter.	Any person	Promoter <sup>60</sup>
6	Services supplied by a director of a company or a body corporate to the said company or the body corporate.	A director of a company or a body corporate	The company or a body corporate located in the taxable territory.
7	Services supplied by an insurance agent to any person carrying on insurance business.	An insurance agent	Any person carrying on insurance business, located in the taxable territory.
8	Services supplied by a recovery agent to a banking company or a financial institution or a non-banking financial company.	A recovery agent	A banking company or a financial institution or a non-banking financial company, located in

<sup>59</sup> Inserted vide Notification No. 5/2019 – Central Tax (Rate) dated 29.03.2019.

<sup>60</sup> Inserted vide Notification No. 5/2019 – Central Tax (Rate) dated 29.03.2019.

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			the taxable territory.
<sup>619</sup>	Supply of services by a music composer, photographer, artist or the like by way of transfer or permitting the use or enjoyment of a copyright covered under clause (a) of sub-section (1) of Section 13 of the Copyright Act, 1957 relating to original dramatic, musical or artistic works to a music company, producer or the like.	Music composer, photographer, artist, or the like	Music company, producer or the like, located in the taxable territory.
<sup>629A</sup>	Supply of services by an author by way of transfer or permitting the use or enjoyment of a copyright covered under clause (a) of sub-section (1) of Section 13 of the Copyright Act, 1957 relating to original literary works to a publisher.	Author	Publisher located in the taxable territory: Provided that nothing contained in this entry shall apply where,- (i) the author has taken registration under the Central Goods and Services Tax Act, 2017 (12 of 2017), and filed a declaration, in the form at Annexure I, within the time limit prescribed therein, with the jurisdictional CGST or SGST Commissioner, as the case may be, that he exercises

<sup>61</sup> Substituted vide Notification No. 22/2019-Central Tax (Rate) dated 30.09.2019 effective from 1.10.2019.

<sup>62</sup> Inserted vide Notification No. 22/2019- Central Tax (Rate) dated 30.09.2019 effective from 1.10.2019.

		<p>the option to pay central tax on the service specified in column (2), under forward charge in accordance with Section 9 (1) of the Central Goods and Service Tax Act, 2017 under forward charge, and to comply with all the provisions of Central Goods and Service Tax Act, 2017 (12 of 2017) as they apply to a person liable for paying the tax in relation to the supply of any goods or services or both and that he shall not withdraw the said option within a period of 1 year from the date of exercising such option;</p> <p>(ii) the author makes a declaration, as prescribed in Annexure II on the invoice issued by him in <b>Form GST Inv-I</b> to the publisher.</p>
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10	Supply of services by the members of Overseeing Committee to Reserve Bank of India	Members of Overseeing Committee constituted by the Reserve Bank of India	Reserve Bank of India. <sup>63</sup>
11	Services supplied by individual Direct Selling Agents (DSAs) other than a body corporate, partnership or limited liability partnership firm to bank or non-banking financial company (NBFCs).	Individual Direct Selling Agents (DSAs) other than a body corporate, partnership or limited liability partnership firm.	A banking company or a non-banking financial company, located in the taxable territory. <sup>64</sup>
12	Services provided by business facilitator (BF) to a banking company	Business facilitator (BF)	A banking company, located in the taxable territory. <sup>65</sup>
13	Services provided by an agent of business correspondent (BC) to business correspondent (BC).	An agent of business correspondent (BC)	A business correspondent, located in the taxable territory. <sup>66</sup>
14	Security services (services provided by way of supply of security personnel) provided to a registered person:  Provided that nothing contained in this entry shall apply to, -  (i)(a) a Department or Establishment of the	Any person other than a body corporate	A registered person, located in the taxable territory. <sup>67</sup>

<sup>63</sup> Inserted vide Notification No. 33/2017 – Central Tax (Rate) dated 13.10.2017.

<sup>64</sup> Inserted vide Notification No. 15/2018 – Central Tax (Rate) dated 26.07.2018.

<sup>65</sup> Inserted vide notification No. 29/2018 – Central Tax (Rate) dated 31.12.2018.

<sup>66</sup> Inserted vide notification No. 29/2018 – Central Tax (Rate) dated 31.12.2018.

<sup>67</sup> Inserted vide notification No. 29/2018 – Central Tax (Rate) dated 31.12.2018.

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	<p>Central Government or State Government or Union territory; or</p> <p>(b) local authority; or</p> <p>(c) Governmental agencies; which has taken registration under the Central Goods and Services Tax Act, 2017 (12 of 2017) only for the purpose of deducting tax under Section 51 of the said Act and not for making a taxable supply of goods or services; or</p> <p>(ii) a registered person paying tax under Section 10 of the said Act.</p>		
<sup>68</sup> 15	<p>Services provided by way of renting of any motor vehicle designed to carry passengers where the cost of fuel is included in the consideration charged from the service recipient, provided to a body corporate</p>	<p>Any person, other than a body corporate who supplies the service to a body corporate and does not issue an invoice charging central tax at the rate of 6 per cent to the service recipient</p>	<p>Any body corporate located in the taxable territory.</p>

<sup>68</sup> Substituted vide Notification No. 29/2019- Central Tax (Rate) dated 31.12.2019. Prior to this substitution it was read as below which was inserted vide Notification No. 22/2019 - Central Tax (Rate) dated 30.09.2019 effective from 1.10.2019.

15.	<p>Services provided by way of renting of a motor vehicle provided to a body corporate</p>	<p>Any person other than a body corporate, paying central tax at the rate of 2.5% on renting of motor vehicles with input tax credit only of input service in the same line of business</p>	<p>Any body corporate located in the taxable territory</p>
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6916	Services of lending of securities under Securities Lending Scheme, 1997 (Scheme) of Securities and Exchange Board of India (SEBI), as amended.	Lender i.e. a person who deposits the securities registered in his name or in the name of any other person duly authorised on his behalf with an approved intermediary for the purpose of lending under the Scheme of SEBI	Borrower i.e. a person who borrows the securities under the Scheme through an approved intermediary of SEBI.
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In addition to the above list given under Central Tax- Rate, following additional category of supply of services is listed under Notification 10/2017- ITR on which GST shall be paid by the recipient on reverse charge basis:

Sl. No.	Category of Supply of Services	Supplier of service	Recipient of Service
(1)	(2)	(3)	(4)
1	Any service supplied by any person who is located in a non-taxable territory to any person other than non-taxable online recipient	Any person located in a non-taxable territory	Any person located in the taxable territory other than non-taxable online recipient.
2	Services supplied by a person located in non-taxable territory by way of transportation of goods by a vessel from a place outside India up to the customs station of clearance in India	A person located in non-taxable territory	Importer, as defined in clause (26) of Section 2 of the Customs Act, 1962(52 of 1962), located in the taxable territory.

<sup>69</sup> Inserted vide Notification No. 22/2019- Central Tax (Rate) dated 30.09.2019 effective from 1.10.2019.

**RCM as per Section 9(4) of the CGST Act or Section 5(4) of the IGST Act**

26.73 Pursuant to Section 9(4) of the CGST Act or Section 5(4) of the IGST Act, supply of taxable goods or services or both by an unregistered supplier to a registered person was liable to CGST/ IGST under RCM.

26.74 Thereafter, *vide* Notification No.8/2017-Central Tax (Rate) dated 28.06.2017, intra-State supply of taxable goods or services or both by an unregistered supplier to a registered person were exempt from CGST provided the aggregate value of such supplies of goods and/or services received by a registered person from any or all the unregistered suppliers did not exceed Rs. 5,000 in a day. However, no such parallel notification was issued under IGST for inter State supplies.

26.75 Subsequently, the aforesaid limit was withdrawn *vide* Notification no. 38/2017- Central Tax (Rate) dated 13.10.2017 and hence, intra-State supply of taxable goods or services or both by an unregistered supplier to a registered person was exempt till 31.03.2018.

26.76 Moreover, *vide* Notification No. 32/2017 – Integrated Tax (Rate) dated 13.10.2017, the Central Government exempted inter-State supply of goods or services or both received by a registered person from any unregistered supplier, from IGST leviable under Section 5(4) of IGST Act till 31.03.2018.

26.77 Later, this provision of reverse charge was deferred till 30.09.2019. Then, in view of the enforcement of the amendments (regarding RCM on supplies by unregistered persons) in the GST Acts, reverse charge exemption Notification No. 8/2017-Central Tax (Rate) dated 28.06.2017 and Notification No. 32/2017 – Integrated Tax (Rate) dated 13.10.2017 have been rescinded with effect from 1.02.2019 *vide* Notification No 01/2019-Central/ Integrated Tax (Rate), dated 29-01-2019.

26.78 Further, with effect from 1<sup>st</sup> February, 2019, the Central/Integrated Goods and Services Tax (Amendment) Act, 2018 has substituted Section 9(4) of the CGST Act/ 5(4) of the IGST Act, as under:

*“(4) The Government may, on the recommendations of the Council, by notification, specify a class of registered persons who shall, in respect of supply of specified categories of goods or services or both received from an unregistered supplier, pay the tax on reverse charge basis as the recipient of such supply of goods or services or both, and all the provisions of this Act shall apply to such recipient as if he is the person liable for paying the tax in relation to such supply of goods or services or both.”*

Hence, reverse charge on inward supply of goods and / or services effected

by a registered person from an unregistered supplier is applicable only in respect of (a) notified 'class of registered persons' and (b) notified 'categories of goods or services'.

26.79 Some of the services which are relevant with respect to the banking sector are explained in details in the following paragraphs:

- **Services provided by Recovery Agent** -Generally, lending is the areas wherein the banks earn major portion of their income. It is the most organized form of extending credit to customers and interest is earned as an income in respect of such credits extended. Majority of banks spend great time and effort in recovering credits so granted.

Further, many banks sell their loans to third parties or hire third party agents to initiate recovery on their behalf.

Loans sold to factoring agents are not liable for payment of GST. The auditor should examine to ensure that these transactions would be 'exempt supply' depending on whether these are with or without recourse.

Another type of transaction is where third parties are hired to initiate recovery on behalf of the banks which is purely a service transaction and liable to payment of GST. Further, RCM is applicable on such transactions and therefore the banks which hire such third-party agents are liable for payment of GST on the fees so paid to these recovery agents/third party agents. Banks also provide infrastructure, phone facilities and such other benefits to these third-party agents in order to perform their services. Even such value is required to be taken into consideration while determining the value of supply for the purpose of payment of GST.

An auditor should check the agreements between the bank and the recovery agent. Under GST regime, the bank should raise a self-invoice and thereafter appropriate GST @ 18 per cent should be paid on the same. The income so earned should be disclosed in the relevant Chapter Heading as classified under the GST regime.

- **Services provided by Insurance Agent**- If the banks are also engaged in the business of insurance, then the services provided by such insurance agents who sell insurance products of the banks is liable for payment of GST. Further, the amount on which tax is payable is commission so paid to the insurance agent. Such commission also includes reimbursement by any mode.

The insurance division of the banks so receiving the services from those

insurance agents are liable for payment of GST under RCM.

An auditor should check the agreements between the bank and the insurance agent. Under GST regime, the bank should raise a self-invoice and thereafter GST @ 18 per cent should be paid on the same. The income so earned should be disclosed in the relevant chapter heading as classified under the GST regime.

- **Services provided by Goods Transport Agency Service - W.e.f. July 1, 2017 vide Entry No.1 of Notification 13**, if any services in respect of transportation of goods by road are provided by a goods transport agency (GTA) to the following recipients located in the taxable territory, then the recipient of the service is liable to pay tax under reverse charge:
  - (a) any factory registered under or governed by the Factories Act, 1948 (63 of 1948); or
  - (b) any society registered under the Societies Registration Act, 1860 (21 of 1860) or under any other law for the time being in force in any part of India; or
  - (c) any co-operative society established by or under any law; or
  - (d) any person registered under the CGST Act or the IGST Act or the SGST Act or the UTGST Act; or
  - (e) any body corporate established, by or under any law; or
  - (f) any partnership firm whether registered or not under any law including association of persons; or
  - (g) any casual taxable person.

However, w.e.f. from 22<sup>nd</sup> August 22,2017 vide Notification No. 22/2017 dated 22.08.2017 which amended Notification 13/2017, the GTA was given an option to pay to GST @ 5 per cent (2.5 CGST+2.5 SGST/ 5 per cent IGST) if no input tax credit is availed subject to RCM. Further, if GTA has been availed ITC/ GST is to be paid by the GTA @12 per cent.

Further, w.e.f. 1<sup>st</sup> January, 2019 vide Notification No. 29/2018-Central Tax (Rate), dated 31-12-2018, it has been provided that nothing contained in this entry shall apply to services provided by a GTA, by way of transport of goods in a goods carriage by road, to, -

- (a) a Department or establishment of the Central Government or State Government or Union territory; or
- (b) local authority; or

(c) Governmental agencies;

which has taken registration under the CGST Act, 2017 (only for the purpose of deducting tax under Section 51 and not for making a taxable supply of goods or services.

Therefore, the auditor has to check that correct ITC is taken, and appropriate person has discharged the tax. Carriage of Goods by Road Act, 2007 mandates that no motor vehicle undertakes transport of goods by road except with a proper registration of such motor vehicle. Every consignment must be accompanied by a forward note or receiving note. Merely because goods are not of substantial value or not involving supply or involving inter-branch movement, it is not appropriate to avoid issuing such a 'note'. When such 'note' is issued, the transporter will be a GTA. Under the GST notification, GTA is one who issues a consignment note '*by whatever name called*'.

- **Services provided by Advocates:** W.e.f. 1<sup>st</sup> July , 2017 In terms of entry no. 2 of Notification 13/2017, RCM was made applicable on services supplied by an individual Advocate including a Senior Advocate by way of representational services before any court, tribunal or authority, directly or indirectly, to any business entity located in the taxable territory, including where contract for provision of such service has been entered through another advocate or a firm of advocates, or by a firm of advocates, by way of legal services, to a business entity.

Thereafter a Corrigendum to Notification No. 13/2017 was issued [M.F. (D.R.) Corrigendum F. No. 336/20/2017-TRU, dated 25-9-2017], and RCM was made applicable on services provided by an individual Advocate including a senior advocate or firm of advocates by way of legal services, directly or indirectly.

*“Legal service”* means any service provided in relation to advice, consultancy or assistance in any branch of law, in any manner and includes representational services before any court, tribunal or authority.

Very often, legal services are availed by banks 'on account of' their customers. Here, auditors should ensure that banks do not withhold themselves from payment of RCM on legal fee paid on the premise that these services are availed 'on account of' their customers, especially when the legal fee is debited to customer's account. It is more appropriate that banks discharge RCM as fee from Advocate will be issued to bank. Very often, it is observed that where expenses are

incurred but debited to customer's account, RCM liability thereon, is somehow omitted. Customer's being unaware of the various components of costs that are embedded in the amounts debited to the account, RCM liability cannot possibly be discharged by them. Hence, banks may be advised to suitably ensure RCM is complied with.

- **Service provided by way of Import of Services:** Many banks do spend a lot of funds on procuring services from abroad. Where the supply of goods or services or both are taxable in nature, GST is payable by the recipient bank. Some important areas are summarized as under:

1. **Bond Floating Expenditure:** Generally, bond floating expenditure is an expenditure which though appropriately recorded in the books of accounts, skips the attention and the applicable taxes are not discharged often in respect of the same. Therefore, the concerned auditor should thoroughly inspect the books of accounts and identify all payments in foreign currency for compliance with these provisions.

Example IVY Bank wants to issue bonds in NYSE and for the said purpose has appointed WYE Bank a leading bank of America for floating the said bonds and acting as a lead merchant banker. The fee for the same is generally a fixed percentage of the ticket size which is recorded appropriately in the books of accounts. The instant transaction is taxable in terms of Section 13 (2) of the IGST Act, 2017.

Under the GST regime, the same requires a thorough analysis of the transaction. These are generally taxable as per Section 13 of the IGST Act, 2017. However, the answer may vary depending upon the structuring of the transaction.

2. **Underwriting Charges:** If underwriting charges are paid in foreign currency to an underwriter who is located outside India, then GST is payable on such transactions. Appropriate ledgers, contracts etc., should be scrutinised in great detail and thereafter relevant disclosures should be made regarding taxability on the same.
3. **I.T Infrastructure Cost:** It is a common cost which the banks bear on all-India basis and execute one common contract for the same if the vendor is based outside India or the technicians are outside India and payment is being disbursed in foreign currency. Though, such cost requires careful apportionment in terms of appropriate



provisions including rules and depending upon the nature of the transaction appropriate GST (generally @ 18 per cent) is payable. Further, credit for GST so paid is available.

## **Input Tax Credit**

26.80 Under the GST regime, a banking company or a financial institution including a non-banking financial company engaged in supplying services by way of accepting deposits, extending loans or advances shall have the following two options to avail Input tax credit in terms of Section 17(4) of the CGST Act 2017. And the option once exercised, shall not be withdrawn during the remaining part of the financial year.

### **Option I**

Reverse the credit pertaining to exempted services as per the method stated in Section 17(2) of the CGST Act, 2017 read with the relevant State Act and Rules thereof.

### **Option II**

Avail 50 per cent of the eligible input tax credit on inputs, capital goods and input services in that month and the rest shall lapse. Accordingly the following procedure be adopted in accordance with Rule 38 of the CGST Rules, 2017:

1. Such banking company or financial institution shall not avail credit of:
  - the tax paid on inputs and input services that are used for non-business purposes; and
  - the credit attributable to the supplies specified in Section 17(5), in FORM GSTR-2.
2. Further, the condition of 50 per cent restriction would not be applicable in case of the tax paid on supplies made by one registered person to another registered person having the same PAN. Hence, a banking company or financial institution shall avail the credit of tax paid on inputs and input services in case of supplies made to its own branches i.e. inter branch i.e., by one registered person to another registered person having different GSTIN.

Avail full credit on inter-branch supply of services between distinct persons of the banking or NBFC company. In other words, if HO has restricted the credit to 50 per cent and those goods or services are

involved in inter-branch taxable supplies, the receiving branch is NOT required to further apply the 50 per cent restriction. This relief is provided in second proviso to Section 17(4).

3. Fifty per cent of the remaining amount of input tax shall be admissible and shall be furnished in FORM GSTR-2.
4. The amount referred to in points 2 and 3 above shall subject to the provisions of Sections 41, 42 and 43, be credited to the electronic credit ledger of the said banking company or financial institution.

NOTE- The non-applicability of 50 per cent reversal is only to the extent of inter-branch services between registered branches having the same PAN in India. Thus, tax paid on services received from a related person / distinct person located outside India would be liable to 50 per cent reversal.

### **Apportionment of credit**

26.81 Section 17 (2) of the CGST Act stipulates that, where the goods or services or both are used by the registered person partly for effecting taxable supplies including zero-rated supplies under this Act or under the IGST Act and partly for effecting exempt supplies under the said Acts, the amount of credit shall be restricted to so much of the input tax as is attributable to the said taxable supplies including zero-rated supplies.

26.82 Credit attributable to exempt supplies is not available to a registered person. "Exempt for this purpose" means all supplies other than taxable and zero-rated supplies and specifically include the following:

- Supplies liable to tax under reverse charge mechanism
- Transactions in securities
- Sale of land
- Sale of building subject to Para 5(b) of Schedule II.

26.83 Moreover, *vide CGST Amendment Act, 2018 w.e.f 1-02-2019*, the "value of exempt supply" shall not include the value of activities or transactions specified in Schedule III, except those specified in paragraph 5 of the said Schedule i.e., Sale of Land (S-III) / building (S-II).

26.84 Rule 42 of the CGST Rules, 2017: Manner of determination of ITC in respect of inputs or input services and reversal thereof *via* illustration:

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Sl. No	Particulars	Reference	CGST	SGST/UTGST	IGST
1	Total input tax on inputs and input services for the tax period May 2018	T	1,00,000	1,00,000	50,000
	Out of the total input tax (T):				
2	Input tax used exclusively for non-business purposes (Note 1)	T1	10,000	10,000	5,000
3	Input tax used exclusively for effecting exempt supplies (Note 1)	T2	10,000	10,000	5,000
4	Input tax ineligible under Section 17(5) (Note 1)	T3	5,000	5,000	2,500
	Total		25,000	25,000	12,500
	ITC credited to Electronic Credit Ledger (Note 1)	C1 = T - (T1 + T2 + T3)	75,000	75,000	37,500
	Input tax credit used exclusively for taxable supplies (including zero-rated supplies) [Note 4]	T4	50,000	50,000	25,000
	Common credit	C2 = C1 - T4	25,000	25,000	12,500
	Aggregate value of exempt supplies for the tax period May 2018 (Note 2 & 3)	E	25,00,000	25,00,000	25,00,000
	Total Turnover of the registered person for the tax period May	F	1,00,00,000	1,00,00,000	1,00,00,000

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	2018 (Note 2)				
	Credit attributable to exempt supplies (Note 5)	D1 = (E/F) * C2	6,250	6,250	3,125
	Credit attributable to non-business purposes	D2 = C2 * 5%	1,250	1,250	625
	Net eligible common credit [Note 6]	C3 = C2 - (D1 + D2)	17,500	17,500	8,750
	Total credit eligible (Exclusive + Common)	G = T4 + C3	67,500	67,500	33,750

Note 1: T1, T2, T3 and T4 shall be DETERMINED AS ABOVE and declared in Form GSTR-2 and at summary level in FORM GSTR-3B.

Note 2: If the registered person does not have any turnover for May 2018, then the value of E and F shall be considered for the last tax period for which such details are available.

Note 3: Aggregate value of exempt supplies and the total turnover shall exclude the amount of any duty or tax levied under Entries 84 and 92A of List I of the Seventh Schedule to the Constitution and Entries 51 and 54 of List II of the said Schedule.

*Remarks: Please note in case of supply of services covered by clause (b) of paragraph 5 of Schedule II of the Act (apartment construction project-promoter), the calculation of Note 4 and 5 will done differently. For detail refer Rule 42 of the CGST Rules.*

Note 6: Amount of 'C3', 'D1' and 'D2' shall be computed separately for ITC of CGST, SGST, UTGST and IGST declared in FORM GSTR-3B or through FORM GST DRC-03.

The amount equal to aggregate of 'D1' and 'D2' shall be reversed by registered person in FORM GSTR-3B or through FORM GST DRC-03.

Note 7: The registered person is expected to make such computation for each tax period and reverse the same in the periodic returns being filed by such registered person. However, on completion of the financial year, input tax credit shall be determined accurately based on actuals, in the same manner as provided in Rule 42. A reconciliation is required to be done on an

annual basis (between the amounts reversed for each tax period during the year and the amount determined at the end of the financial year) and any excess credit availed needs to be reversed with interest while short credit, if any, needs to be re-availed within 6 months from end of the financial year.

26.85 It is to be noted that the registered person would be required to remit excess ITC claimed (as determined in Note 7 above) with interest calculated at for the period starting from the first day of April of the succeeding financial year till the date of payment. However, no interest can be claimed if, at the end of the financial year, it is found that short credit was availed.

26.86 Therefore, an auditor can check whether the concerned branch is reversing ITC in compliance with the above Rule. If ITC is not reversed in compliance with the above Rules, it shall be treated as ITC wrongly taken and the same will be recovered along with the interest under Section 50 of the CGST Act, 2017.

26.87 Note the following pre-requisites for availing credit by registered person pursuant to Section 16(2) of the CGST Act:

- (a) The registered person (RP) is in possession of tax invoice or any other specified tax paying document.
- (b) The RP has received the goods or services. "Bill to ship to" scenarios also included.
- (c) Tax is actually paid by the supplier.
- (d) The RP has furnished the return.
- (e) If the inputs are received in lots, the RP will be eligible to avail the credit only when the last lot of the inputs is received.
- (f) The RP should pay the supplier the value of the goods or services along with the tax within 180 days from the date of issue of invoice, failing which the amount of credit availed by the recipient would be added to his output tax liability, with interest [rule 37(1) & (2) of CGST Rules, 2017]. However, once the amount is paid, the recipient will be entitled to avail the credit again. In case part payment has been made, proportionate credit would be allowed.

26.88 Beside the above, the value of supplies in respect of the following shall be deemed to have been paid and ITC shall not be reversed in such cases:

- Value of supplies made without consideration as per Schedule-I.
- Value of supplies on account of any amount added in accordance with Section 15(2) (b), i.e. any amount that the supplier is liable to pay in relation

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to such supply but which has been incurred by the recipient of the supply and not included in the price actually paid or payable for the goods or services or both (Notification No. 26/2018-Central Tax, dated 13.06.2018).

- Value representing discount for which financial credit notes have been issued by the supplier.
- Note- Provisions of Section 18(6) of the CGST Act, 2017 for reversal of input tax credit availed on capital goods would be applicable to banks only to the extent of the input tax credit availed by it.

### **Documents required for availing Credit (Section 36 of the CGST Act)**

(a) Invoice issued by a supplier of goods or services or both as per Section 31	(b) Invoice issued as per Section 31(3)(f) by recipient along with proof of payment of tax	(c) A debit note issued by supplier under Section 34
(d) Bill of entry or similar document prescribed under Customs Act, 1962	(e) Revised invoice	(f) Document issued by Input Service Distributor

### **Restriction/ When ITC not allowed to be availed**

- Beyond September of the following FY to which invoice pertains or date of filing of annual return, whichever is earlier. However, due date of taking ITC for FY 21-22 was extended till 30<sup>th</sup> November, 2022.
- In terms of Section 36(4), ITC to be availed by a registered person in respect of invoices or debit notes, the details of which have not been uploaded by the suppliers under Section 37(1), shall not exceed 5 percent<sup>70</sup> of the eligible credit available in respect of invoices or debit notes the details of which have been uploaded by the suppliers under Section 37(1) of the CGST Act.
- With effect from 1<sup>st</sup> January 2022, as per Notification No 39/2021 – Central tax dated 21<sup>st</sup> December, 2021 Section 16(2) has been amended by inserting clause (aa) which states that if the supplier has

<sup>70</sup> These figures and words were substituted for the figures and words “20 per cent”. By the central Goods and services Tax (Ninth Amendment) Rules 2019 as per Notification No.75/2019-Central tax, dated 26-12-2019 (w.e.f. 1-1-2020) and again these figures and words were substituted for the figures and words “10 per cent”. By the Central Goods and services Tax (Fourteenth Amendment) rules 2020 as per Notification No.94/2020- Central Tax, dated 22-12-2020 (w.e.f.1-1-2021).

furnished details of invoice / debit note in his GSTR 1 then only the recipient will be able to claim the ITC of the same. Hence ITC will be available only for invoices or debit notes, the details of which have been uploaded by the suppliers in their respective GST returns.

**No ITC can be availed in terms of Section 17(5) of CGST Act, 2017**

No ITC shall be available in respect of the following:

(a) motor vehicles for transportation of persons having approved seating capacity of not more than 13 persons (including the driver), except when they are used for making the following taxable supplies, namely: —

<b>(A)</b> further supply of such motor vehicles; or	<b>(B)</b> transportation of passengers; or	<b>(C)</b> imparting training on driving such motor vehicles;
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(aa) vessels and aircraft except when they are used—

(i) for making the following taxable supplies, namely	(ii) for transportation of goods
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A. further supply of such vessels or aircraft; or	B. transportation of passengers; or	C. imparting training on navigating such vessels; or	D. imparting training on flying such aircraft;
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(ab) services of general insurance, servicing, repair and maintenance in so far as they relate to motor vehicles, vessels or aircraft referred to in clause (a) or clause (aa):

<b>However, ITC is available in respect of such services</b>	
(i) where the motor vehicles, vessels or aircraft referred to in clause (a) or clause (aa) are used for the purposes specified therein;	(ii) where received by a taxable person engaged – (I) in the manufacture of such motor vehicles, vessels or aircraft; or (II) in the supply of general insurance services in respect of such motor vehicles, vessels or aircraft insured by him;

(b) the following supply of goods or services or both—

(i) food and beverages, outdoor catering, beauty treatment, health services, cosmetic and	(ii) membership of a club, health and fitness	(iii) travel benefits extended to employees on
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<p><i>plastic surgery, leasing, renting or hiring of motor vehicles, vessels or aircraft referred to in clause (a) or clause (aa) except when used for the purposes specified therein, life insurance and health insurance ###</i></p>	<p><i>centre; and</i></p>	<p><i>vacation such as leave or home travel concession</i></p>
<p><i>### Provided that the ITC shall be available where an inward supply of such goods or services or both is used by a registered person for making an outward taxable supply of the same category of goods or services or both or as an element of a taxable composite or mixed supply;</i></p>		

**Note-** The provisions have been amended so as to allow ITC in respect of goods or services or both specified above if it is made obligatory for an employer to provide such services under any law for the time being in force.

In all the above cases [Section 17(5)(b)], credit will be available if the goods or services are required to be provided by the employer through any obligation imposed under any law.

(c) *works contract services when supplied for construction of immovable property, (other than plant and machinery), except where it is an input service for further supply of works contract service;*

(d) *goods or services or both received by a taxable person for construction of an immovable property (other than plant and machinery) on his own account, including when such goods or services or both are used in the course or furtherance of business;*

*Explanation. - For the purpose of clause (c) and (d), the expression "construction" includes re-construction, renovation, additions or alterations or repairs, to the extent of capitalization, to the said immovable property.*

(e) *goods or services or both on which tax has been paid under Section 10;*

(f) *goods or services or both received by a non-resident taxable person except on goods imported by him;*

(g) *goods or services or both used for personal consumption;*

(h) *goods lost, stolen, destroyed, written off or disposed of by way of gift or free samples; and*

(i) *any tax paid in accordance with the provisions of Sections 74, 129 and 130. i.e., any tax paid due to short payment on account of fraud, suppression, mis-declaration, seizure, detention.*



### Credit utilization

26.89 In terms of Section 49 of the CGST Act, the amount of ITC available in the electronic credit ledger of the registered person on account of:

- IGST shall first be utilised towards payment of IGST and the amount remaining, if any, may be utilised towards the payment of CGST and SGST/UTGST, in that order.
- CGST shall first be utilised towards payment of CGST and the amount remaining, if any, may be utilised towards the payment of IGST.
- SGST/UTGST shall first be utilised towards payment of SGST/UTGST and amount remaining, if any, may be utilised towards payment of IGST. However, w.e.f. 1-02-2019 *vide* the CGST (Amendment) Act, 2018, ITC on account of SGST/UTGST shall be utilised towards payment of IGST only where the balance of ITC on account of CGST is not available for payment of IGST.
- CGST shall not be utilised towards payment of SGST/ UTGST and vice versa respectively [Section 49(5)(e) and (f)].

26.90 Subsequently, w.e.f. 1-02-2019, Sections 49A and 49B have been inserted *vide* the CGST (Amendment) Act 2018. Section 49A stipulates that notwithstanding anything contained in Section 49, ITC on account of CGST, SGST/UTGST shall be utilised towards payment of IGST, CGST, SGST or UTGST as the case may be, only after the ITC available on account of IGST has first been utilised fully towards such payment.

26.91 Further, Section 49B of the CGST Act, 2017 provides that notwithstanding anything contained in ITC Chapter V of the CGST Act and subject to Section 49(5)(e) and (f) of the CGST, the Government may, on the recommendations of the Council, prescribe the order and manner of utilisation of the ITC on account of IGST, CGST, SGST or UTGST, as the case may be, towards payment of any such tax.

26.92 In this regard, w.e.f. 29-03-2019 *vide Notification No. 16/2019 – Central Tax dated 29.03.2019*, Rule 88A has been inserted in the CGST Rules providing the order of utilization of ITC as under:

*“Input tax credit on account of integrated tax shall first be utilised towards payment of integrated tax, and the amount remaining, if any, may be utilised towards the payment of central tax **and** State tax or Union territory tax, as the case may be, in any order: The registered person shall not use the amount available in electronic credit ledger to discharge his liability towards output tax in excess of ninety-nine per cent. of such tax liability, in cases where the value of taxable supply other than exempt supply and*

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zero-rated supply, in a month exceeds fifty lakh rupees (with few exceptions).

Provided that the input tax credit on account of central tax, State tax or Union territory tax shall be utilised towards payment of integrated tax, central tax, State tax or Union territory tax, as the case may be, only after the input tax credit available on account of integrated tax has first been utilised fully.”

### Return Under GST – Banking Sector

26.93 To avoid Interest and penalties, timely filling GST Returns is of paramount importance. Every registered banking and/or financial institution including non-banking financial company is liable to file Forms GSTR-3B, GSTR-1, GSTR-6, GSTR 9 and GSTR-9C.

FORM	PARTICULARS	DUE DATE	APPLICABLE TO
GSTR-3B	Monthly summary return	20 <sup>th</sup> / 22 <sup>nd</sup> of the next month based on State.	All registered persons (other than Input Service Distributor (ISD), person liable to deduct TDS and personally liable to collect tax at source).
GSTR-1	Outward Supplies > 1.5 Crores Outward Supplies < 1.5 Crores	11 <sup>th</sup> of the next month Last date of month subsequent to the quarter	Normal / Regular Taxpayer
GSTR-6	Monthly return by input service distributors	13 <sup>th</sup> of the next month	Input Service Distributor
GSTR-9	Annual return	31 <sup>st</sup> December of the next Financial Year For FY 21-22 last date is 31 <sup>st</sup> December, 2022.	Normal tax payer Voluntary Filing of GSTR – 9 in case of Turnover not exceeds 2 Cr in the previous FY)
GSTR-9C	Annual return along with the copy of	31 <sup>st</sup> December of the next financial year	Normal tax payer having aggregate

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	audited annual accounts and a reconciliation statement duly certified by auditor s (71For FY 20-21, self-certified reconciliation statement to be submitted by dealer)	For FY 21-22 last date is 31 <sup>st</sup> December, 2022.	turnover of more than Rs. 5 crores
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**Obligation to furnish Information Return**

26.94 Any person, being a banking company within the meaning of Section 45A(a) of the Reserve Bank of India Act, 1934, who is responsible for maintaining record of registration or statement of accounts or any periodic return or document containing details of payment of tax and other details of transaction of goods or services or both or transactions related to a bank account or consumption of electricity or transaction of purchase, sale or exchange of goods or property or right or interest in a property under any law for the time being in force, shall furnish an information return of the same in respect of such periods, within such time, in such form and manner and to such authority or agency as may be prescribed.[Section150(1)(e) of the CGST Act]

26.95 Furthermore, if the Commissioner, or an officer authorised by him in this behalf, considers that the information furnished in the information return is defective, he may intimate the defect to the person who has furnished such information return and give him an opportunity of rectifying the defect within 30 days from the date of such communication of information or within such further period. If the defect in the return is not rectified within the time prescribed, the information return should be treated as not submitted and penalty of Rs.100/- for each day during which the failure continues, would be payable subject to a maximum of Rs. 5,000 in terms of Section 123 of the CGST Act.

26.96 Moreover, if no information return is filed, within the stipulated period, the authority may serve a notice requiring him to furnish of such return within a period not exceeding 90 days from the date of service of the notice and

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<sup>71</sup> The CBIC has notified changes to Sections 35(5) and 44 of the CGST Act. The requirement to get a GST audit and certification done by a CA/CMA now stands removed. Taxpayers with a turnover exceeding Rs.5 crores in the previous financial year are required to file Form GSTR-9C on a self-certification basis. This change is applicable from FY 20-21 onwards.

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such person shall furnish the information return.

**Note:**

In terms of Circular no.129/48/2019-GST dated 24<sup>th</sup> December 2019 the Department should follow the standard operating procedure in case the return is not filed on time as tabulated hereunder:

<b>Timeline</b>	<b>Action by Department</b>
3 Days prior to the due date i.e. on 17 <sup>th</sup> of any month	A system generated message would be sent to all the registered persons to remind them about filing of the return for the tax period by the due date.
After due date i.e. any day after 20 <sup>th</sup> of any month	A system generated mail / message would be sent to all the defaulters immediately after the due date to the effect that the said registered person has not furnished his return for the said tax period; such mail/message is to be sent to the authorized signatory as well as the proprietor/ partner/director/ kartha, etc.
Five days after due date i.e. 25 <sup>th</sup> of any month	A notice in FORM GSTR-3A (under Section 46 of the CGST Act read with rule 68 of the CGST Rules) shall be issued electronically to such registered person who fails to furnish return under Section 39, requiring him to furnish such return within fifteen days.
15 days from 25 <sup>th</sup> of any month	<ol style="list-style-type: none"><li>1. In case the said return is still not filed by the defaulter within 15 days of the said notice, the proper officer may proceed to assess the tax liability of the said person (under Section 62) of the CGST Act, to the best of his judgement taking into account all the relevant material which is available or which he has gathered and would issue order (under rule 100) of the CGST Rules in FORM GST ASMT-13.</li><li>2. The proper officer would then be required to upload the summary thereof in FORM GST DRC- 07.</li><li>3. For the purpose of assessment of tax liability under Section 62 of the CGST Act, the proper officer may take into account the details of</li></ol>

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	<p>outward supplies available in the statement furnished (under Section 37 (FORM GSTR-1)), details of supplies auto-populated in FORM GSTR-2A, information available from e-way bills, or any other information available from any other source, including from inspection (under Section 71).</p> <p>4. In deserving cases [Not specified] , based on the facts of the case, the Commissioner may resort to provisional attachment to protect the revenue (under Section 83 of the CGST Act) before issuance of FORM GST ASMT-13.</p>
30 days after service of assessment order	<p>In case the defaulter furnishes a valid return within 30 days of the service of assessment order in FORM GST ASMT13, the said assessment order shall be deemed to have been withdrawn (in terms of Section 62(2) of the CGST Act).</p> <p>However, if the said return remains unfurnished within the statutory period of 30 days from issuance of order in FORM ASMT-13, then the proper officer may initiate recovery proceedings (under Section 78) and recovery of Tax (under Section 79) of the CGST Act</p>
Any time after above 30 days	<p>The proper officer would initiate action for cancellation of registration(under Section 29(2) of the CGST Act) in cases where the return has not been furnished for the period specified in Section 29</p>

**Input Service Distributor**

26.97 Input Service Distributor (ISD) is an office of the supplier of goods or services or both where a document (like invoice) of services attributable to other locations are received (since they might be registered separately). Since the services relate to other locations the corresponding credit should be transferred to such locations (having separate registrations) as services are supplied from there. Note that ISD cannot be an office that does any supply of its own but must be one that merely collects invoice for services and issues prescribed documents for its distribution.

26.98 ISD cannot normally be used in a situation where there is a liability to pay GST. It can only receive input tax credits on invoices related to input services

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and distribute such credits in the manner discussed below. An ISD cannot discharge tax liability under reverse charge. This would require obtaining another registration as a regular registered person and discharge RCM liability.

26.99 Section 20 read with Rule 39 of the CGST Act deals with the manner and procedure of distribution of credit by ISD. ISD shall distribute the credit of CGST as CGST or IGST and IGST as IGST or CGST, by way of issue of a document containing, the amount of ITC credit being distributed in such manner as may be prescribed and subject to certain conditions. ISD may distribute the credit available for distribution in the same month in which it is availed. As per Rule 39(1)(e) and (f) of the said rules, ISD shall distribute:

- ITC on account of CGST and SGST or UTGST
  - in respect of recipient located in the same state shall be distributed as CGST and SGST or UTGST respectively.
  - in respect of a recipient located in a State or Union Territory other than that of the ISD, be distributed as IGST.
- the amount to be so distributed shall be equal to the aggregate of the amount of ITC of CGST and SGST or UTGST that qualifies for distribution to such recipient in accordance with Rule 39(1)(d).
- ITC on account of IGST shall be distributed as IGST.

26.100 The conditions to be adhered as prescribed in Section 20 are:

- the credit can be distributed to recipients against a document containing such details as may be prescribed.

Where the ISD is an office of a banking company or a financial institution, including a nonbanking financial company, a tax invoice shall include any document in lieu thereof, by whatever name called, whether or not serially numbered but containing the prescribed information.

Each type of tax must be distributed through a separate ISD invoice. However, there is no requirement to issue ISD invoices at an invoice-level (received from the supplier of the service). However, there is no requirement to issue ISD invoices at an invoice-level (received from the supplier of the service).

- the amount of ITC distributed shall not exceed the amount of credit available for distribution.
- the credit of tax paid on input services attributable to recipient of credit shall be distributed only to that recipient.
- the credit of tax paid on input services attributable to more than one recipient of credit shall be distributed amongst such recipient(s) to whom

the input service is attributable and such distribution shall be pro rata on the basis of the turnover in a State or turnover in a Union Territory of such recipient, during the relevant period, to the aggregate of the turnover of all such recipients to whom such input service is attributable and which are operational in the current year, during the said relevant period.

- the credit of tax paid on input services attributable to all recipients of credit shall be distributed amongst such recipients and such distribution shall be pro rata on the basis of the turnover in a State or turnover in a Union Territory of such recipient, during the relevant period, to the aggregate of the turnover of all recipients and which are operational in the current year, during the said relevant period.

### **Payment dates**

26.101 GST should be disbursed by following the due dates mentioned below: — 20<sup>th</sup> of the next month. FORM GST PMT-6 Challan for deposit of GST — valid for 15 days from the date of generation of challan.

26.102 Further, the interest under Section 50, to be paid in case of failure to pay tax or part thereof to the Government within the period prescribed is 18 percent from the due date of payment to the actual date of payment of tax And 24 per cent in case of excess claim of Input Tax Credit or excess reduction in output tax liability.

### **Accounts and Records**

26.103 Sections 35-36 of the CGST Act and Rule 56 to 58 of CGST Rules deal with provisions pertaining to accounts and records. Rule 56 of the CGST Rules provide for the documents with maintenance of accounts by registered persons. Rule 56(7) stipulates that every registered person shall keep the books of account at the principal place of business and books of account relating to additional place of business mentioned in his certificate of registration and such books of account shall include any electronic form of data stored on any electronic device.

26.104 Section 36 *inter alia* prescribes that, every assessee shall retain the books of accounts and other records until the expiry of 72 months (6 years) from the due date for filing of Annual Return for the year pertaining to such accounts and records. If the Annual Returns for the FY 2017-18 are filed on say 31.12.2018, even then, the books of account and other records are to be maintained till 31.12.2024. Even where the annual return is filed earlier, the start date for considering 72 months runs from the end of due date to file the annual return.

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26.105 In case an appeal or revision or any other proceeding is pending before any Appellate Authority or Provisional Authority or Appellate Tribunal or Court, or in case the assessee is under investigation for an offence under Chapter XIX, the assessee shall retain the books of account and other records pertaining to the subject matter of such appeal or revision or proceeding or investigation for a period of one year after final disposal of such appeal or revision or proceeding, or for the period specified records u/s 35(1), whichever is later.

26.106 Based on the above discussions, an exemplary Questionnaire for GST Audit of Banks is given hereunder:

**Name of the Branch:**

**GSTIN:**

**Particulars/information for the year**

<b>PART A: Basic Details of Assessee</b>	
1.	Name of the Supplier/ Recipient of Supply
2.	Full address of <b>(Note- In GST, there is no Concept of Centralised Registration. State wise registration prevails and each unit in the respective states should be added in the registration certificate classifying as a principal place of business in the State and others as additional place of business).</b>
	Address of the Branch under audit and address of the branches in the State:
3.	List of GST registration numbers in the State with date of registration and nature of registration as Supplier/ Recipient of Supply.
4.	Validity Period of Registration (in case of casual person and NRI)
5.	PAN of the assessee
6.	List the principal activities <b>(Note- In order to understand the taxability of various supplies provided by the concerned branch/head office, it is important to identify the various supplies provided by such branch or head office. For this purpose, the auditors may analyse the various income heads (Operating and Non-Operating).Hence in GST various lists of principal supplies need to be provided by the unit registered (assessee) i.e., branch)</b>
7.	Is there any change in the activities stated above during the year as compared to immediately preceding year? Whether the same is



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	included in registration ( <b>Note-</b> Check whether any new service is provided by the concerned branch or head office. If yes, being an auditor, we can check whether the same is updated in the GST Registration Certificate or not? However, GST portal allows addition of Top 5 supplies only. It becomes important because taxability of any activity depends upon its nature and any exemption or relief will be available accordingly).
8.	Whether the taxpayer has maintained accounts and records in terms of Section 35 -36 of the CGST Act, 2017 read with Rules 56 to 58 of the CGST Rules, 2017.
<b>PART B: EXEMPTION AVAILABLE UNDER CGST/SGST/IGST</b>	
9.	Broad description of nature of income
10.	(a) Erstwhile service tax law was not applicable in case of J&K but GST is applicable, so check no transaction is left. (b) Are services provided outside India? If Yes, please specify nature of Service and amount involved
11.	Broad description of exempted services provided, if any, along with Notification No. and amount Involved
12.	Whether GST is leviable on Transaction in Money under GST?
13.	Whether securities/ derivatives are eligible for GST?
14.	Whether any service charges or administrative charges or entry charges are recovered in addition to interest on a loan, advance or a deposit such as locker rent, folio charges, loan processing fee, late payment fee, lease management fee, rent, management fee etc. are eligible to GST?
15.	Whether the Bank is trading in Commercial paper /Certificates of deposits? If yes, whether any separate charges are collected, and GST being paid on the same and provide details thereon.
16.	Whether GST is levied on late fee charges collected from credit card holders? If yes, then whether GST is being paid on the same and give details thereof.
<b>PART C: COMPLIANCES UNDER GST ACTs AND RULES, 2017</b>	
17 (a)	Is Section 9(3) of the CGST Act read with Notification No.13/2017

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	as amended followed by the bank?
17 (b)	If the answer to (a) is No, specify the head of expenditure and corresponding details
17 (c)	<ul style="list-style-type: none"> <li>• Whether GST has been paid on RCM on services procured from supplier in terms of Section 9(3) of the CGST Act?</li> <li>• Whether GST has been paid on advances paid by the banks under section 9(3) of the CGST Act?</li> <li>• Whether all inward supplies (whether creditable or not) flow into the books of the bank through the GSTR-1 of any registered supplier? If not, have such supplies been reported in GSTR-2/ 3B under Section 9(3) of CGST Act / 5(4) of IGST Act, even if no tax is payable from 13<sup>th</sup> October, 2017?</li> <li>• Whether in respect of each inward supply where no tax has been paid, is there a clear disclosure made to the auditors as to the reasons for the tax position taken in each case? The auditor may examine, if the tax position taken requires to be reported in the audit report or other communication?</li> <li>• Whether the credit taken in respect of services covered under RCM is taken only after making payment of GST under RCM?</li> </ul>
18.	<p>(a) Whether payment and other ledger entries are made in terms of the CGST Act and payment rules given in CGST Rules, 2017? [Refer Annexure B (for discharge of liability)]</p> <p>(b) If tax is paid belatedly, specify interest paid on delayed payment under Section 50 of the CGST Act, 2017?</p> <p>(c) Whether RCM tax liability is not discharged by utilizing the accumulated ITC?</p>
19.	The banking sector provides services of purchase and sale of foreign currency to its customers, the value of which can be ascertained in terms of Rule 32(2) of the CGST Rules, hence liable to GST. However, (i) inter se sale or purchase of foreign currency amongst banks or authorised dealers of foreign exchange or amongst banks and such dealers is exempt vide Notification No.12/2017. [Note- The auditor has to check, the value of supply of services in relation to the purchase or sale of foreign currency, including money changing is determined in terms of Rule 32(2)] and also check the parties involved in the supply.

<b>PART D: COMPLIANCE OF ITC PROVISIONS GIVEN UNDER CGST ACT AND CGST RULES, 2017</b>	
20.	<p>(a) Whether ITC taken/ utilized is matching with books of accounts and GST returns (Annexure A)</p> <p>(b) If the answer of (a) above is negative, Report differences thereof.</p>
21.	Whether ITC credit taken, utilized and reversed on input services / inputs and Capital goods (Annexure C) is as per the CGST Act read with CGST Rules?
22.	<ul style="list-style-type: none"> <li>• Whether the head office has not availed depreciation under Section 32 of the Income Tax Act, 1961 on the amount of GST on the capital goods on which input tax credit has been availed?</li> <li>• Whether the bank has taken the Input Tax Credit in respect of input and capital goods / services on the basis of proper duty paying documents, containing all particulars as prescribed by CGST Rules read with Section 31 of the CGST Act, 2017?</li> </ul>
23.	<p>Where the taxpayer is registered as an ISD the Auditor should check the following points:</p> <p>(a) Ensure that every person being an ISD shall make a separate application for registration as such Input Service Distributor?</p> <p>(b) Whether an ISD invoice is issued to each recipient of credit on every distribution in terms of CGST Act read with CGST Rules?</p> <p>(c) Ensure, Credit distributed does not exceed the credit available for distribution?</p> <p>(d) Whether ISD is distributed to those taxable persons whose PAN no is same as that of ISD (Under GST)?</p> <p>(e) Whether credit attributable to a specific unit is distributed to that unit only?</p> <p>(f) Whether, Section 20 of the CGST Act is adhered to in reference to the manner of distribution of credit by ISD?</p> <p>(g) Whether, procedure for distribution of ITC by ISD is adhered?</p> <p>(h) Whether tax paid on input services used by a particular location (registered as supplier), is to be distributed only to that location?</p> <p>(i) Whether, credit of tax paid on input service used by more than one location who are operational is to be distributed to all of them based on the pro rata basis of turnover of each location in a State to aggregate turnover of all such locations who have</p>

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	<p><i>used such services?</i></p> <p>(j) <i>Ensure that, each type of tax must be distributed through a separate ISD invoice?</i></p> <p>(k) <i>Whether the credit of IGST is distributed as IGST, irrespective of the location of the ISD?</i></p> <p>(l) <i>Whether the CGST, SGST and UTGST), are aggregated as IGST, where the ISD is located in a State other than that of the recipient of credit?</i></p> <p>(m) <i>Whether the CGST and SGST (or UTGST) is distributed as the CGST and SGST (or UTGST), respectively, where the ISD is located in the same State as that of the recipient?</i></p> <p>(n) <i>Whether turnover for the distribution has been determined in accordance with the CGST Rules?</i></p> <p>(o) <i>Ensure every ISD shall, for every calendar month or part thereof, furnish a return in FORM GSTR-6 within 13 days after the end of such month?)</i></p>
24.	List of major Input services /inputs on which the company takes ITC: whether it complies with CGST Act read with CGST Rules.
25.	<p>Whether credit has been reversed for every month for an amount equal to 50 percent of the Input Tax Credit availed on inputs, input services and capital goods or input tax credit has been reversed in respect of exempted supplies on actual basis?</p> <p>Note- Such reversal is not required in case of cross charge made to other branches (refer Rule 42 )</p>
26.	<p>Whether ITC distributed is in compliance with Section 20 of the CGST Act 2017,</p> <p>If the answer to the above is in the negative, provide the discrepancy in the distribution and reasons thereof.</p>
27.	Amount of ITC received from ISD, if any together with address of the unit from which it is received.
28.	Whether any input tax credit has been claimed on invoice/ debit notes after the due date of furnishing of the return under Section 39 for the month of September of the subsequent financial year or furnishing of the relevant annual return?
<b>PART E: COMPLAINTS OF GST ACTS AND CGST RULES, 2017</b>	
29.	(i) Value of service provided to persons other than account holders where tax not charged on the ground that the place of supply is

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	<p>outside the taxable territory.</p> <p>(ii) Value of services exported.</p> <ul style="list-style-type: none"> <li>• With payment of IGST and claimed refund.</li> <li>• Without payment of IGST under the cover LUT or Bond and claimed refund.</li> </ul>
30.	Whether conditions for export of supply of service satisfied to avail benefit of export supply without payment of tax, as such benefit is subject to furnishing of LUT/Bond?
31.	Is the payment for services exported received by the service provider in convertible foreign currency within the time limit prescribed by RBI? If not, give details.
<b>PART F- OTHERS</b>	
32.	<ul style="list-style-type: none"> <li>• Whether GST had been properly charged by the head office, regional offices, zonal offices in case of inter unit / branch transactions?</li> <li>• Whether the registered person have filed the applicable returns on timely basis as notified by the Government?</li> <li>• Whether IGST has been paid on 'import of services'?</li> <li>• Whether ITC has been reversed with Interest, if recipient fails to pay the amount to the supplier within 180 days(Rule 37)?</li> <li>• Whether Tax wrongfully collected and paid to Central or State Government (interstate supply considered as intra state supply or vice versa)?</li> <li>• If Yes, state the details of transaction (quantum)</li> <li>• GST audit report for earlier year should be examined for comments by GST auditor. Also the concurrent audit reports need to be reviewed for any comment on GST.</li> </ul>

**NOTE:** Also refer the Frequently Asked Questions (FAQ) issued by CBIC on Banking, Insurance and Stock Brokers Sector updated as on 27.12.2018 which is relevant for GST Audits. The FAQs can be accessed through the following link:

[https://old.cbic.gov.in/resources//htdocs-cbec/gst/27122018-UPDATED\\_FAQs%20ON%20BANKING,%20INSURANCE%20AND%20STOCK%20BROKERS.pdf](https://old.cbic.gov.in/resources//htdocs-cbec/gst/27122018-UPDATED_FAQs%20ON%20BANKING,%20INSURANCE%20AND%20STOCK%20BROKERS.pdf)

**NAME OF THE ASSESSEE**

**ANNEXURE A**

**RECONCILIATION OF TURNOVER FOR THE YEAR.....**

<b>GSTR 1: RECON WITH BOOKS</b>		
	<b>Total Credits in statement of profit and loss</b>	<b>XXX</b>
<b>Less:</b>	Not Goods / Not Services - e.g. dividend income	(XXX)
<b>Less:</b>	Schedule III Item which is not a Supply e.g. Land & Building etc	(XXX)
<b>Less:</b>	April - June Supplies (only for FY 2017-18)	(XXX)
<b>Less:</b>	Receipts not in the course of business	(XXX)
<b>Add:</b>	Schedule I Supplies like Branch Transfer not in books, but supply as per GST Law	XXX
<b>Add:</b>	Receipts capitalised but taxable to GST	XXX
<b>Less:</b>	Profit on Sale of capital goods	(XXX)
<b>Add:</b>	Taxable Value of Supply of capital goods	XXX
<b>Add:</b>	Advance received during the current period	XXX
<b>Less:</b>	Advance of earlier period adjusted during the current period	(XXX)
<b>Less:</b>	Closing unbilled revenue recognised - but time of supply did not arise	(XXX)
<b>Add:</b>	Opening unbilled revenue (Billed during the period/Time of supply falls in the month)	XXX
	<b>Total Value in GSTR 1</b>	<b>XXX</b>
<b>Less:</b>	Exempted Supply	(XXX)
<b>Less:</b>	Non-Taxable Supplies like HSD, Motor Spirit Etc including Liquor	(XXX)
<b>Less:</b>	NIL Rated Supply	(XXX)
	<b>Taxable Value in GSTR 1</b>	<b>XXX</b>

**NAME OF THE ASSESSEE**

**ANNEXURE B**

**Details of Discharge of Liabilities**

A	Month	CGST				SGST				IGST				Cess			
		Liability	Credit utilised	Cash utilised	Ratio	Liability	Credit utilised	Cash utilised	Ratio	Liability	Credit utilised	Cash utilised	Ratio	Liability	Credit utilised	Cash utilised	Ratio
	Apr																
	May																
	Jun																
	Jul																
	Aug																
	Sep																
	Oct																
	Nov																
	Dec																
	Jan																
	Feb																
	Mar																
	Total																

B	Month	CGST				SGST				IGST				Cess			
		Liability for	Liability	Delay	Date of	Interest	Liability	Delay	Date of off-	Interest	Liability	Delay	Date of off-	Interest	Liability	Delay	Date
	Apr																

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May																				
Jun																				
Jul																				
Aug																				
Sep																				
Oct																				
Nov																				
Dec																				
Jan																				
Feb																				
Mar																				
Tot al																				



**ANNEXURE C**

**Details of Input Tax Credit**

A	Goods / services on which ITC is eligible (A)				Goods / services on which ITC is ineligible (B)				Total inward supplies	Out of (B), Value of capital goods on which credit is not availed on account of Sec. 16(3) of the CGST Act, 2017 (Depreciation claimed on Capital Goods on GST component under the IT Act, 1961)	
	Month	Value of Inputs	Value of Input services	Value of Capital goods	Total ineligible	Value of Inputs	Value of Input services	Value of Capital goods			Total eligible
	Apr										
	May										
	Jun										
	Jul										
	Aug										
	Sep										
	Oct										
	Nov										
	Dec										
	Jan										

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	Feb										
	Mar										
	Total										

**B. Out of total of (A), eligible credits on supplies received from related persons and distinct persons**

GSTIN of supplier	Nature of relationship	Value of supply		Tax		
		Goods	Services	CGST	SGST	IGST

**ITC Reversal**

A		Details of amount of tax credit paid as output tax liability u/s 16 r/w Rule 37, which was reclaimed during the year											
		<i>Amount of credit reclaimed upon payment of consideration</i>											
Month in which the credit was paid as output liability	Amount of ITC paid as output tax liability u/s 16(2) read with Rule 37	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar
PY -3													
PY -2													
PY -1													
Apr		-											
May		-	-										

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	Jun		-	-	-														
	Jul		-	-	-	-													
	Aug		-	-	-	-	-												
	Sep		-	-	-	-	-	-											
	Oct		-	-	-	-	-	-	-										
	Nov		-	-	-	-	-	-	-	-									
	Dec		-	-	-	-	-	-	-	-	-								
	Jan		-	-	-	-	-	-	-	-	-	-							
	Feb		-	-	-	-	-	-	-	-	-	-	-						
	Mar		-	-	-	-	-	-	-	-	-	-	-	-					
	Total																		

<b>B</b>	<b>Details of amount of tax credit paid as output tax liability u/s 16 r/w Rule 37, which was reclaimed during the year</b>														
			<i>Month in which the amount of credit should have been paid as output liability u/s 16(2) r/w rule 37</i>												
	<b>Month in which the credit was paid as output liability</b>	<b>Amount of ITC paid as output tax liability u/s 16(2) r/w Rule 37</b>	<b>Apr</b>	<b>May</b>	<b>Jun</b>	<b>Jul</b>	<b>Aug</b>	<b>Sep</b>	<b>Oct</b>	<b>Nov</b>	<b>Dec</b>	<b>Jan</b>	<b>Feb</b>	<b>Mar</b>	
	Apr														
	May														
	Jun														
	Jul														
	Aug														

