Western India Regional Council of
The Institute of Chartered Accountants of India

Bank Audits – Expert Guidance for Professionals

Compilation of Papers 2023

Western India Regional Council of
The Institute of Chartered Accountants of India

Bank Audits – Expert Guidance for Professionals

Compilation of Papers 2023

Published by
CA. Arpit Kabra, Chairman, Western India Regional Council of
The Institute of Chartered Accountants of India,
ICAI Tower, Plot No. C-40, G Block, Opp. MCA Ground,
Next to Standard Chartered Bank, Bandra-Kurla Complex,
Bandra (East), Mumbai-400 051
Tel.: 022-33671400 / 33671500 • E-mail: wirc@icai.in • Web.: www.wirc-icai.org

Printed by
Finesse Graphics & Prints Pvt. Ltd.
309, Parvati Industrial Premises, Sun Mill Compound,
Lower Parel (West), Mumbai-400 013
Tel.: 4036 4600

Foreword

India has one of the strongest banking and financial systems in the world. A dynamic and well-regulated industry, its rapid adaptation of digital technology coupled with increasingly complex transactions has led regulators to strive for greater transparency and credibility of financial statements.

Hence, the Reserve Bank of India's (RBI) regular issuance of updated circulars and notifications which have a direct bearing on financial statements of banks. More importantly, our fraternity is expected to be up-to-date with respect to all these notifications in order to execute the attest functions.

Globally, regulators and auditors are increasing their focus on the impact of technology. There are clear benefits that technology can bring from operational efficiency to financial inclusion and greater insights. However, as Banks use more technology they are increasingly taking on more risk, and their stakeholders will require a new suite of services to address these new risks. Thus, it is clear that with enhanced use of technology, our audits and approach have to be revisited, appropriately modified and be made robust.

Annual audits of voluminous and variety of transactions of many banks in a truncated time-frame is a very challenging task. However, it is one which our fraternity has been performing this function over the decades very successfully to the full satisfaction of all stakeholders and regulators, thus contributing greatly towards the success of the banking industry.

This publication provides Chartered Accountants an overview as well as expert insights into best practices in the area of Audit of Bank Branches and other aspects of auditing a Banking ecosystem. The knowledge presented here will help keep bank auditors, in any and every capacity up-to-date with latest concepts thereby ensuring trustworthiness of financial statements, sustaining public confidence, and most importantly, augmenting the reputation of the accountancy profession.

Here I am pleased to state that not only have we adopted a new title for this publication but for the first time, we have provided QR codes in the publication to ensure easy and seamless access to all important material, references, checklists (in word and excel), circulars and notifications in SOFT COPY. With one click all of these can be accessible by everyone and put to use without recreating it.

I congratulate CA. Ketan Saiya, Treasurer of WIRC, CA. Hitesh Pomal, Vice-Chairman of WIRC, CA. Rahul Parikh, Regional Council Member and the Professional Development Committee (which now includes the Banking, Financial services and Insurance committee) and the galaxy of contributors for their time and insights in publishing this scholarly compilation. Here I must mention the immense efforts put in by the contributors amidst tight deadlines to make this publication wider in scope and technologically current yet lucid and absorbing.

I am confident that this publication will be useful not only for Statutory Bank Branch Audits but all kinds of audits and engagements involving the Banking environment.

In this context, I am reminded of the incomparable Sam Walton who said, "You can't just keep doing what works one time, everything around you is changing. To succeed, stay out in front of change."

It is patently clear that in this digital age, mere acceptance is not enough but as finance professionals we have to be one step ahead in order to continue to provide excellence of services to all stakeholders. This audit season lets us proactively embrace technology, streamline our functions for increased efficiency, and adopt a dynamic filing and documentation process to deliver Excellence ! Happy auditing!

CA. Arpit Kabra
Chairman, WIRC of ICAI

Preface

The depth and spread of the Banking System in any country is a major indicator of the economic strength of that country. The development of a robust banking system contributes to the economic development of a country. Unlike recent failures, which have shaken up the financial sector aboard, in India, Banks are quite safe.

We have seen the banking system in the world undergoing substantial ups and downs, especially in the last decade and one has to appreciate the strength and the manner in which the banking system in India has withstood the pressures from within and outside the country.

Such a stable banking system is due to strict rules and regulations framed by the Reserve Bank of India and the strong auditing system of public sector banks in India and Bank Branch audits carried out by Chartered Accountants in public sector banks.

The credit for this strength also goes to all those who were controlling and managing the banking system during this turbulent period. Auditors of banks have played a major role in assisting the Regulators to supervise the entire banking system in the country even through these difficult times.

The audit profession could be looking at bank audits as an area of tremendous opportunities. However, Society at large looks upon the auditors to give them an assurance that "All Is Well" in the banking system. This requirement of assurance which is expected by Society from the auditors raises various issues for the audit profession and these require careful consideration.

The onus of ensuring compliances and controls has fallen squarely onto the shoulders of Chartered Accountants. As auditors, we are responsible for bringing integrity to banks and ensuring to the stakeholders at large the integrity and robustness of the bank being audited. We need to burn the midnight oil to carry out an effective audit using technology and tools. Our audit should be giving confidence to stakeholders at large that once the audit is carried out by a Chartered Accountant, the accounts are true and fair and have no gross irregularities, and Non-performing assets are identified correctly in a timely manner.

To that end, we need all the support that we can get and I am confident that this publication will go far in helping meet auditors' professional obligations in an effective manner.

This publication by WIRC provides an excellent overview of the best practices in the area of audit of Bank Branches to our members. The publication will help us review the various recent reforms and concepts thereby creating a more informed and transparent audit.

I take this opportunity to thank CA. Arpit Kabra, Chairman, WIRC; CA. Hitesh Pomal, Vice Chairman, WIRC, CA. Ankit Rathi- Chairman Professional Development Committee, CA. Rahul Parikh- Regional Council Member and all the expert contributors in compiling this publication. I am sure that our members will find this publication a practical and insightful guide to the intricacies of Bank Branch Audits.

CA. Ketan Damji Saiya
Treasurer, WIRC of ICAI

Western India Regional Council 2023-24

Chairman
CA. Arpit Jagdish Kabra

Vice Chairman
CA. Hitesh Pomal

Secretary
CA. Sourabh Ajmera

Treasurer
CA. Ketan Saiya

Members
CA. Ankit Agarwal
CA. Ruta Chitale
CA. Piyush Chandak
CA. Shweta Jain
CA. Vikash Jain
CA. Ishwarkumar Jivani
CA. Murtuza Kachwala
CA. Yashwant Kasar
CA. Pinki Kedia
CA. Abhijit Kelkar
CA. Gautam Lath
CA. Sanjay Nikam
CA. Hrudyesh Pankhania
CA. Rahul Parikh
CA. Chintan Patel
CA. Ankit Rathi
CA. Shilpa Shinagare

Ex-Officio Members
CA. Aniket Sunil Talati
President ICAI
CA. (Dr.) Rajkumar Adukia
CA. Piyush Chhajed
CA. Chandrashekhar Chitale
CA. Vishal Doshi
CA. Durgesh Kabra
CA. Dheeraj Khandelwal
CA. Purushottamlal Khandelwal
CA. Mangesh Kinare
CA. Priti Paras Savla
CA. Umesh Sharma

Professional Development Committee 2023-24

Chairman
CA. Ankit Rathi

Vice Chairman
CA. Murtuza Kachwala

Office Bearers
CA. Arpit Kabra
CA. Hitesh Pomal

Regional Council Member
CA. Piyush Chandak
CA. Yashwant Kasar
CA. Gautam Lath
CA. Pinki Kedia

CCM (Ex-officio)
CA. Mangesh Kinare

Bank Audits – Expert Guidance for Professionals

INDEX

Current Developments in Banking Industry

CA. Gautam Shah, CA. Vinit Jain

Overview

The Bank plays a very important role in functioning of organized financial sector of the economy. A well-organized and efficient banking system is a prerequisite for economic growth of the country. The banking system is developing not only geographically but also operationally. It is no more an institution, which used to collect deposits to lend money. Anti-money laundering measures guidelines, submission of different returns of information about excess cash withdrawal, obtaining PAN for certain high value transactions, TDS on interest on Bank deposits and submission of returns, etc. reveal that the Government is thinking of using banking system to streamline and strengthen the economy.

The banking sector plays a major role in the development of the economy, as it mobilizes deposits and provides credit to various sectors across India. The banking sector collects surplus funds from customers/ depositors in the form of deposits and channelizes them to borrowers in the form of loans.

The Reserve Bank or RBI is the central banking institution that regulates and operates the banking system in India. It supervises and administers exchange control and banking regulations and administers the government's monetary policy.

RBI encompasses commercial banks, co-operative banks and development banks that function according to the guidelines imposed by the RBI. These banks provide various banking services across India from urban and metropolitan areas to the remotest rural areas.

Indian banking industry has recently witnessed the roll out of innovative banking models like payments and small finance banks. RBI's new measures may go a long way in helping the restructuring of the domestic banking industry.

The digital payments system in India has evolved the most among 25 countries with India's Immediate Payment Service (IMPS) being the only system at level five in the Faster Payments Innovation Index (FPII).

Perspective

From the global financial crisis to the Eurozone sovereign debt crisis; from the taper tantrum to Brexit; from unprecedented quantitative easing to among the most accelerated monetary tightening in recent memory; from a pandemic which brought humankind to a standstill to a geopolitical crisis which threatens the world order as it exists today - it would not be an exaggeration to say that the world has moved from one storm to another in the years since the global financial crisis.

Against this backdrop, the journey of Indian financial markets has been driven by two key objectives – stability and development. Crisis management has been a key component of this journey. Nonetheless, the pursuit of developmental reforms, with the key objective of widening and deepening of financial markets was continued even amidst the worst storms.

The outbreak of the COVID-19 pandemic in March 2020 necessitated swift and focussed policy responses to address the emerging or potential market dislocations. As in the past, policy rates were reduced and systemic liquidity was expanded. But, this time, the policy corridor was asymmetrically widened and the fixed rate reverse repo became the effective anchor for the evolution of short and longer-term interest rates. To improve transmission of policy rates and ensure flow of credit to the affected sectors, unconventional measures were used viz., the Long-Term Repo Operations (LTROs), targeted LTROs and special refinance facilities to All India Financial Institutions. A special liquidity facility for mutual funds aimed at assuaging redemption pressures was also instituted. For the first time, the Reserve Bank pledged its balance sheet to revive the economy through a Government Securities Acquisition Programme (G-SAP) which provided an upfront commitment on the amounts to be purchased. Special open market operations involving simultaneous purchase and sale of securities (Operation Twist) were undertaken for orderly evolution of the yield curve and liquidity management. Forward guidance gained prominence with the emergence of time and state-contingent guidance, with assurances on the Reserve Bank's commitment to maintain congenial financial conditions. Communication became a significant part of our monetary policy toolkit.

The onset of the war in Ukraine again weakened risk sentiment, with commodity prices and inflation rising to multi-decade highs. As major central banks accelerated policy rate hikes and tightened liquidity to tackle inflationary pressures, financial market volatility spiralled, and the Rupee came under considerable pressure. The policy response this time eschewed administrative measures to contain outflows and instead focused on measures to enhance inflows through incentivising non-resident deposits, foreign investments in debt instruments and ECBs. To promote exports and support the increasing global interest in the Rupee, an additional arrangement for invoicing, payment and settlement of exports/ imports in Rupees was put in place.

Market Size

The Indian banking system consists of 12 Public sector banks (PSBs), 22 Private sector banks, 46 Foreign banks (FBs), 56 Regional Rural banks (RRBs), 12 Small Finance Banks (SFBs), 6 Payments Banks (PBs), 1,485 Urban Co-operative banks (UCBs) and 96,000 Rural Co-operative banks (RCBs) in addition to Co-operative credit institutions. As of March 31, 2022, the total number of ATMs & CRMs in India is 2,49,228. Out of these ATMs, 31, 499 are white label ATMs (WLAs). Out of these, 50.03 % of the ATMs are installed in the rural and semi- urban centres.

According to Reserve Bank of India (RBI), India's foreign exchange reserves stood US$ 524.52 billion) as on October 21, 2022. As of November 18, 2022, gross bank credit stood at 1,29,47,735 crores. As of November 4, 2022, credit to non-food industries stood at ₹ 128.87 lakh crore (US$ 1.58 trillion) In 2020-2022, bank assets across sectors increased. Total assets across the banking sector (including public and private sector banks) increased to US$ 2.67 trillion in 2022. In 2022, total assets in the public and private banking sectors were US$ 1,594.51 billion and US$ 925.05 billion, respectively. Indian banks are increasingly focusing on adopting integrated approach to risk management.

The Non-performing assets (NPAs) recovered by scheduled commercial banks (SCBs) improved to 18.4% of the amount involved in FY22 against 14% in FY21, according to RBI. SCBs recovered ₹89,661 crore via multiple channels — Lok Adalats, Debt Recovery Tribunals, Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, and Insolvency and Bankruptcy Code (IBC) — in FY22 against ₹4,87,062 crore involved. These banks had recovered ₹64,229 crore in FY21 against ₹4,56,274 crore involved, RBI said in its latest report on 'Trend and Progress of Banking in India 2021-22'.

To read scan QR Code

During FY2016-FY2022, bank credit increased at a CAGR of 0.62%. As of FY2022, total credit extended surged to US$ 1,532.31 billion. During FY2016-FY2022, deposits grew at a CAGR of 10.92% and reached US$ 2.12 trillion by FY2022. Bank deposits stood at ₹ 173.70 trillion (US$ 2.12 trillion) as of November 4, 2022.

Banking India:

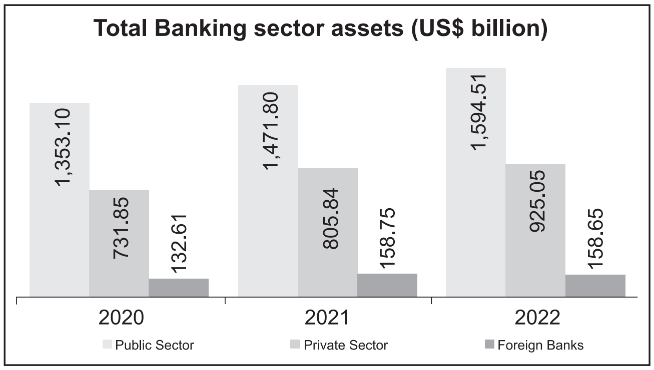
Developments:

Emerging from the Shadows of COVID-19:

In the wake of the pandemic-related lockdowns during 2020-21, supply chains froze, and demand declined on economic agents trying to conserve cash with a precautionary motive. This resulted in sharp decline in credit growth even as deposits increased. The fall in yields provided a silver lining, as banks booked profits on their trading accounts. Although construction of a counter factual is difficult, the benefit of hindsight indicates that the pandemic's impact on the economy =would have been much sharper, had the Government and the Reserve Bank not stepped in with timely initiatives.

Data available for 2021-22 so far indicate that banks' gross as well as net non-performing assets have moderated while provision coverage ratios (PCRs), capital buffers as well as profitability indicators have improved relative to pre-pandemic levels. A closer look at granular data, however, reveals a more nuanced picture. Credit growth is muted, indicative of pandemic scarring on aggregate demand as also risk aversion of banks. Banks' asset quality may get dented, going forward.

Most of the regulatory accommodations announced by the Reserve Bank, including deferment of implementation of net stable funding ratio (NSFR), restrictions on dividend payouts by banks, deferment of implementation of the last tranche of capital conservation buffer (CCB) have already expired. As the pandemic situation is dynamic, the regulatory response will be calibrated in response to the evolving situation.



I. Resolution of Stressed Assets

Through an amendment to the IBC Act, a pre-pack resolution window for MSMEs has been made available, which is a blend of formal and informal mechanisms having debtor-in-possession model as an option. Even before the corporate debtor's admission application is filed, debtor and creditors can negotiate and arrive at a potential resolution plan. This has considerably expedited and simplified the process up to admission in the National Company Law Tribunal (NCLT).

The setting up of the National Asset Reconstruction Company Limited (NARCL), to consolidate and take over the stressed debt from banks, is a step forward for resolution of large value legacy assets. International experience, however, suggests that for the experiment to succeed and to avoid perverse incentives, risks to banks' balance sheets are clearly identified; transparent transfer pricing for sale of assets are ensured; and management of the new entity is independent and professional.

II. Open Banking

Open banking frameworks allow authorised third parties to access customers' data, with the explicit consent of the latter. Benefits of the framework include convenient access to financial data and services to consumers and streamlining some costs for financial institutions. On the other hand, concerns about data privacy and security, customer grievance redressal, cyber security and operational risks, compliance and regulation risks need to be carefully addressed to develop a safe and secure ecosystem.

From the regulators' perspective, introduction of open banking has a wide range of ramifications. In many jurisdictions, including India, outsourcing arrangements by banks and other REs are covered under explicit regulations. Supervisors also have certain amount of oversight over third-party entities. If the relationships in the open banking extend beyond the existing supervisory and regulatory perimeters, the enforcement of standards and prudential policies may become difficult.

In contrast to the initiatives in some other countries, India has embraced an approach where both the regulator and the market collaborated towards development of the open banking space. In India, under the guidance of the Reserve Bank, the National Payments Corporation of India (NPCI) developed systems such as unified payments interface (UPI) and released its application programming interface (API) for banks and third-party app providers (TPAPs) to build upon. Market participants are also driving innovation and many banks are releasing their own APIs and joining forces with FinTech companies. Moreover, with the launch of its regulatory sandbox and the Reserve Bank Innovation Hub, the Reserve Bank has been guiding new vistas of development in financial intermediation.

At the same time, the importance of customer privacy and data protection cannot be overemphasised. Going forward, the challenge is to generate and sustain trust amongst customers about safety and security of the system while also nurturing innovation.

III. Digital Lending

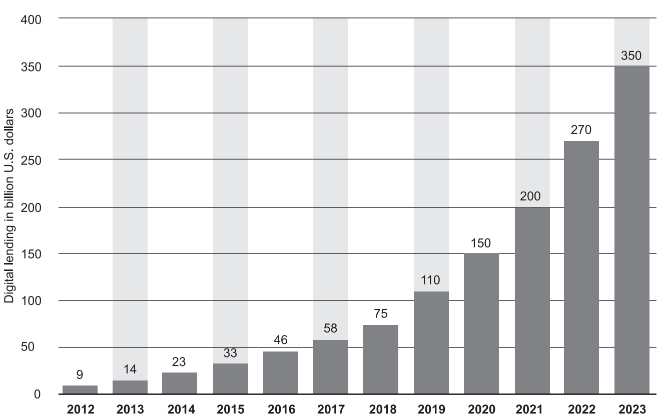
In the recent period, many digital platforms have emerged that offer hassle-free loans to retail individuals, small traders, and other borrowers. Banks and NBFCs too, have started lending directly through their own digital platforms or indirectly through an outsourced platform. Many large multi-national corporations whose primary business is technology (e-commerce, social media, payments enablers etc.), popularly known as BigTechs, have started lending either directly or in partnership with regulated financial entities.

Even enhancing the traditional entity-based regulatory approach with activity-based regulations may be inadequate to ensure stability, a level playing field, competition, and customer protection. While use of digital channels in financial services is a welcome move, the potential downside risks embedded in such endeavours need to be addressed.

Taking cognisance of the recent spurt in unfair digital lending practices, the Reserve Bank had constituted a Working Group on Digital Lending that has made recommendations to foster a safe digital lending ecosystem, such as establishing a verification process for digital lending apps by a nodal agency; setting up of a self-regulatory organisation (SRO); enactment of a separate legislation to prevent illegal digital lending activities; development of certain baseline technology standards and compliance with those standards as a pre-condition for offering digital lending solutions; and consent-based data collection with verifiable audit trails. Going forward, a balanced approach needs to be followed so that the regulatory framework supports innovation while ensuring data security, privacy, confidentiality, and consumer protection.

Digital lending value in India 2012-2023

Digital lending is one of the fastest growing fintech segments in India and grew exponentially from nine billion U.S. dollars in 2012 to nearly 150 billion dollars in 2020. It was expected that the digital lending market would reach a value of around 350 billion dollars by 2023. This business was mainly covered by fintech startups and non-banking financial companies (NBFC).



(Source: https://www.statista.com/statistics/1202533/india-digital-lending-volume/)

Digital lending companies in India

Digital lending companies provide comparatively small loans to their customers through apps or online platforms. In comparison to bank loans, digital lending does not require a specific bank account, requirements are lower, and the process is significantly quicker. Digital lending start-ups are increasingly becoming popular among customers and aim to meet the credit gap.

Funding the MSME sector

Besides providing loans for individuals, lending companies also served micro, small, and medium enterprises (MSME). An already high credit demand in this sector was fuelled by the coronavirus (COVID-19) pandemic. Many enterprises were not eligible for banking loans and had to look for alternative funding.

IV. Central Bank Digital Currency

In its basic form, a central bank digital currency (CBDC), provides a safe, robust, and convenient alternative to physical cash. Depending on various design choices, it can also assume the complex form of a financial instrument. In comparison with existing forms of money, it can offer benefits to users in terms of liquidity, scalability, acceptance, ease of transactions with anonymity and faster settlement. Central banks across the globe are now deliberating on how to implement CBDCs, moving ahead from their initial exploratory forays.

Certain crucial questions about design elements of CBDC need to be navigated before its introduction, e.g., whether the CBDC would be general purpose and available for retail use (CBDC-R), or would it be for wholesale use (CBDC-W). Furthermore, in a country like India, the decision about distribution architecture, i.e., whether CBDC would be issued directly by the central bank or through commercial banks, needs to be carefully weighed. Gauging magnitude of issuance/ distribution will also help in identifying the appropriate underlying technology best suited to handle such operations.

Given its dynamic impact on macroeconomic policy making, it is necessary to adopt basic models initially, and test comprehensively so that they have minimal impact on monetary policy and the banking system. India's progress in payment systems will provide a useful backbone to make a state-of-the-art CBDC available to its citizens and financial institutions.

RBI has been exploring the pros and cons of introduction of the CBDCs for some time. As there are multiple compelling motivations for the introduction of CBDCs, RBI is currently engaged in working towards a phased implementation strategy, going step by step through various stages of pilots followed by the final launch, and simultaneously examining use cases that could be implemented with minimal or no disruption. Depending on the different use cases, multiple technological options shall be tested and based on the outcomes, the final architecture shall be decided. As per recommendations of the internal Working Group (WG) set up by Reserve Bank in October 2020, RBI is exploring the option of implementation of account-based CBDC in Wholesale segment and token-based CBDC in Retail segment vide a graded approach.

This involves the following steps:

a) Build a prototype as per the recommendations of the WG. Specify technical requirements to technology partners.

b) Test the idea in an operationally controlled environment to examine its functionality, including the design, deployment plan and success criteria.

c) Perform test cases with both positive and negative scenarios to examine its durability and document the results.

d) Evaluate Test Results and finalise the design of the prototype.

This will help RBI understand the potential use of the CBDC in a diverse country like India. The results and learnings need to be carefully evaluated and must be incorporated into the final design of the CBDC.

V. NEW INDIA DIGITAL INDIA:

India will contribute 2.2% to the world's digital payments market by 2023, while the value of such transaction is expected to reach US$ 12.4 trillion globally by 2025.

Special Vostro Account for trade in Rupee:

Introduction:

A vostro account is an account that domestic banks hold for foreign banks in the former's domestic currency, in this case, the rupee.

The SRVA is an additional arrangement to the existing system that uses freely convertible currencies and works as a complimentary system.

Freely convertible currencies refer to currencies permitted by rules and regulations of the concerned country to be converted to major reserve currencies (like the U.S. dollar or pound sterling) and for which a fairly active market exists for dealings against major currencies.

The existing systems thus require maintaining balances and positions in such currencies.

Purpose of the SRV Account (SRVA):

a) **Reduce Forex demand:** The framework could largely reduce the "net demand for foreign exchange, the U.S. dollar in particular, for the settlement of current account related trade flows" as per the Economic Survey (2022-23).

b) **Reduce dependence on foreign currencies:** The framework would also reduce the need for holding foreign exchange reserves and dependence on foreign currencies, making the country less vulnerable to external shocks.

c) **Promote INR:** Indian exporters could get advance payments in INR from overseas clients and in the long term promote INR as an international currency once the rupee settlement mechanism gains traction.

To view Scan QR Code

NARCL

a) Asset Acquisition:

NARCL has been set up with a strategic initiative to clean up the legacy stressed assets with an exposure of Rs 500 crore and above in the Indian Banking system. NARCL will offer adaptable acquisition structures comprising of an optimal mix of Cash and Security Receipts (SRs) to the Selling Banks and Financial Institutions, across sectors and geographies. NARCL's acquisition processes will be administered by their Financial Asset Acquisition Policy framed under the extant guidelines for Asset Reconstruction Companies. NARCL's investment strategy focuses on aggregating the stressed assets under one roof to ensure efficient resolution of such assets. NARCL's offer shall have a notable feature where the SRs issued by NARCL for acquiring stressed loan assets will be backed by guarantee from the Government of India. The Guarantee shall provide NARCL a unique strategic advantage, thereby enabling easier aggregation, which is very important for value preservation and driving any resolution process.

b) Asset Resolution

NARCL shall have an exclusive arrangement with IDRCL, Wherein IDRCL shall provide end-to-end assistance to NARCL for the optimal resolution outcome for acquired assets. This shall include determination of appropriate resolution strategy as per the RBI framework, Corporate Insolvency Resolution Process proceedings under Insolvency and Bankruptcy Code, 2016, Enforcement of security / liquidation, sale of assets / slump sale, sale to Stressed Funds, Alternate Investment Funds, Strategic Investors, etc.

Digital Banking Units (DBUs):

On October 16, 2022, Prime Minister Narendra Modi launched 75 Digital Banking Units (DBUs) in 75 districts across the country to boost financial inclusion and simplify banking.

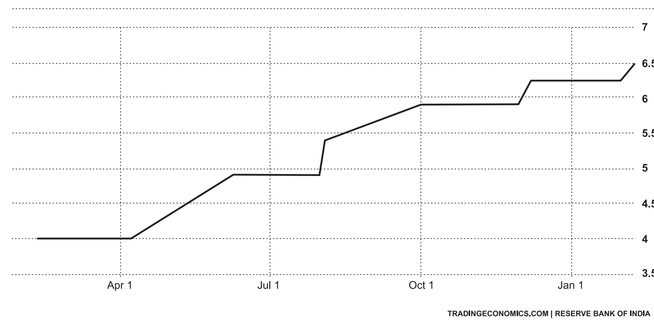
The DBUs will enable people who do not have a personal computer, who do not have a laptop, or do not have even a smartphone, to be able to access banking services. They can do it digitally in a paperless mode.

These units will be brick-and-mortar outlets. The services they will offer include opening of savings accounts, balance-check, printing passbooks, transfer of funds, investment in FD, loan applications, stop-payment instructions for cheques issued, applications for credit and debit cards, tax and bill payment and nominations.

As many as 11 banks in the public sector, 12 in the private sector and one Small Finance Bank are participating in setting them up.

Interest Rate movements in India:

The Reserve Bank of India (RBI) raised its key repo rate by the expected 25 bps to 6.5% during its February 2023 meeting, the sixth-rate hike in a row, amid easing inflation prompted by moderation in food prices. The annual inflation rate slowed to a 1-year low of 5.72% in December 2022 and stayed below the RBI target of 2-6% for the second straight month. The decision followed a 35bps hike in December last year. The central bank has lifted rates by an aggregate of 250bps starting from May 2022, bringing the rate to a level of January 2019. The board lowered its inflation forecast for FY 2023 to 6.5% from 6.7% and revised India's GDP growth to 7% from 6.8%. For the next FY, the board projected inflation to ease further to 5.3% with an economic growth rate of 6.4%. The RBI also raised both the standing deposit facility (SDF) rate and the marginal standing facility (MSF) rate by 25 bps to 6.25% and 6.75, respectively.



Related	Last	Previous	Unit	Reference
Interest Rate	6.50	6.25	percent	Feb 2023
Cash Reserve Ratio	4.50	4.50	percent	Mar 2023
Interbank Rate	7.24	7.24	percent	Mar 2023
Money Supply M1	55271.04	53563.88	INR Billion	Dec 2022
Money Supply M2	56383.57	55710.46	INR Billion	Jan 2023
Money Supply M3	219882.77	218942.48	INR Billion	Feb 2023
Foreign Exchange Reserves	561270.00	566950.00	USD Million	Feb 2023
Central Bank Balance Sheet	29184.82	29456.00	INR Billion	Jan 2023
Loan Growth	16.10	16.30	percent	Feb 2023
Reserve Repo Rate	3.35	3.35	percent	Dec 2022

Key Investments/ Developments and Government initiatives/achievements in Banking Industry:

To read scan QR Code

a) On June 2022, the number of bank accounts—opened under the government's flagship financial inclusion drive 'Pradhan Mantri Jan Dhan Yojana (PMJDY)'—reached 45.60 crore and deposits in the Jan Dhan bank accounts totaled ₹ 1.68 trillion (US$ 21.56 billion).

b) In April 2022, India's largest private bank HDFC Bank announced a transformational merger with HDFC Limited.

c) Unified Payments Interface (UPI) recorded 803 Cr transactions worth INR 12.98 Lakh Cr ($157.85 Bn) in January 2023.

d) National payments corporation India (NPCI) has plans to launch UPI lite this will provide offline UPI services for digital payments. UPI Lite lets users carry out "quick and seamless transactions" of up to Rs 200 at a time. Similar to Paytm Wallet payments, it does not ask for a pin whenever you make a payment. Users can also transfer their UPI balance back to the same bank account anytime without charges.

e) In the Union budget of 2022-23 India has announced plans for a central bank digital currency (CBDC) which will be possibly know as Digital Rupee.

f) The significant updates from Union Budget 2022-23 for the banking sector are - Improved Governance and Investor Protection, Central Data Processing Center, Financial Support for Digital Payments, Introduction To Mahila Samman Bachat Patra, Benefits For Senior Citizen, Data Embassy, Revamped Credit guarantee scheme for MSMEs.

UPI Payment Outside India:
To read scan QR Code

India's digital payment systems which is the Unified Payments Interface (UPI) is steadily becoming globally attractive to enable seamless cross-border transactions and lowers cost of fund transfers.

India has been making significant strides in expanding the network of its digital payment systems like RuPay, UPI (Unified Payments Interface), etc. globally. These global partnerships have come through as the NIPL (NPCI International Payments Limited) is forging partnerships with different countries to build a huge acceptance network for RuPay and UPI, which will allow Indian travellers to make payments via these channels in their destination country of travel. Countries that have embraced different forms of Indian payment systems include France, UAE, Saudi Arabia, Bahrain, Singapore, Maldives, Bhutan, Nepal, Europe, UK, Malaysia and Oman. This implies that Indians will now be able to make payments through UPI, RuPay etc. in these countries.

Non-resident Indians (NRIs) in selected international countries would also be allowed to conduct transactions on UPI platforms without requiring an Indian mobile number. UPI platforms will be able to onboard non-resident accountholders (NRE/NRO accounts) from 10 countries with international mobile numbers if they satisfy certain conditions. NRIs use NRE accounts to transfer foreign earnings to India, while NRO accounts helps them manage their income earned in India. Their banks must ensure the NRE/NRO accounts meet Foreign Exchange Management Act (FEMA) regulations and guidelines released from time to time by the Reserve Bank of India (RBI) besides guarding against money laundering or terror financing. This means that NRIs seeking to transact via UPI platforms in these stipulated countries would not require an Indian mobile number. It will help international students, family living abroad, and local businesses.

Road Ahead:

Enhanced spending on infrastructure, speedy implementation of projects and continuation of reforms are expected to provide further impetus to growth in the banking sector. All these factors suggest that India's banking sector is poised for robust growth as rapidly growing businesses will turn to banks for their credit needs. The advancement in technology has brought mobile and internet banking services to the fore. The banking sector is laying greater emphasis on providing improved services to their clients and upgrading their technology infrastructure to enhance customer's overall experience as well as give banks a competitive edge.

In recent years India has experienced a rise in fintech and microfinancing. India's digital lending stood at US$ 75 billion in FY18 and is estimated to reach US$ 1 trillion by FY23 driven by the five-fold increase in digital disbursements. The Indian fintech market has attracted $29 billion in funding over 2,084 deals so far (January 2017-July 2022), accounting for 14% of global funding and ranking second in terms of deal volume. By 2025, India's fintech market is expected to reach ₹ 6.2 trillion (US$ 83.48 billion).

Recent Updates:

i. Revised Guidelines for Appointment / Reappointment of Statutory Branch Auditors of Public Sector Banks (PSBs)

ii. Norms on Business Coverage

Eligibility Criteria:

- Eligible as per Section 141 of Companies Act;
- Not debarred by any Regulators like RBI, SEBI, CAG, NFRA and ICAI;
- No existing audit engagements with any other PSBs;

- Cooling Period of 4 years in case firm was earlier SBA and 6 years in case firm was earlier SCA;
- No Directorship with same PSB;
- Network firms are also covered.

Number of Branch: Maximum two (2)

Period: Four (4) consecutive Years

Business Coverage:

FY 2022-23: Minimum of 70% of all funded & non-funded credit exposures of the Bank

FY 2023-24: PSBs to determine business coverage under statutory branch audit as per Board Approved Policy

Expectation of Central Statutory Auditors and Banks from Branch Auditors

CA. Vipul Chocksi

I. EXPECTATION OF BANKS FROM BRNCH AUDITORS

Statutory Audit of Banks is a very important annual exercise and considerable importance is attached to it not only by bank's management but also by RBI. Finalisation of bank's financial statement is a time consuming and mammoth exercise due to large network of branches and the volume of business which is handled by each bank. Volume of business has increased manifold in majority of the nationalised banks because of merger of smaller nationalised banks in the bigger nationalised banks from 1st April 2020. Besides this, banks are also required to publish their results within stipulated timelines and therefore all the banks attach a lot of importance to statutory branch audit and has very high expectations from Branch Auditors. Its very important to note that banks expect value addition from auditors and bank management is generally receptive to worthwhile suggestions.

Given below are some of the key expectations by the banks from auditors

1. **CLOSING INSTRUCTIONS:** All the banks issue closing instructions to branches so that branch accounts are error free as far as possible. These closing instructions give detailed guidelines to branches which auditor need to refer and ensure its compliance.

2. **TIMELINESS:** Finalisation of audited financial statements typically of nationalised bank, is a three-tier system wherein after branch audit, financial statements of bank branches are consolidated by zone in which it falls and financials statements of all zones and other business verticals are consolidated into one financial statement of bank as a whole. In light of this three-tier system of consolidation, banks expect branch auditors to complete audit of branches allotted to them in a stipulated time frame which could be 12th to 18th April.

   Branch auditors would be expected to complete the audit in given time frame. However, branch auditors need to ensure that they complete audit after the due audit process without compromising on quality.

3. **KNOWLLEDGE OF BANKS' INFORMATION TECHNOLOGY (IT)SYSTEM/CORE BANKING SYSTEM (CBS):** Almost all the operations of banks are now IT driven and therefore banks would expect that auditors have reasonable knowledge of IT system especially CBS on which all the transactions of banks are recorded. It would, therefore, be imperative for auditors to have some of its team member to have reasonable knowledge of IT system/CBS. In absence of knowledge of IT, it would be difficult for auditor to comprehend as to how transactions are processed, how interest is calculated etc and that would delay the process of finalisation of audit. Also, knowledge of IT makes audit more effective.

4. **COMPLIANCE OF VARIOUS RBI /INTERNAL CIRCULARS:** RBI issues various circulars to banks from time to time on various aspects of bank operations. Banks in turn make its internal circular for branches and controlling offices. Though banks have their internal mechanism to verify its compliance through concurrent audits, internal inspection, MIS etc, bank management expect branch auditors also to verify its compliance. Needless to mention that audit program of branch auditor would cover this aspect as well.

   One important circular from branch auditors perspective, relevant for branch auditors for audit of bank for March 2022 is RBI circular dated September 14 2020 as per which banks are expected to fully automate its income recognition, asset classification and provisioning. Banks were granted extension by RBI, and they were expected to automate its IRAC process. Branch auditors may verify compliance of this circular.

5. CLASSIFICATION OF ASSETS AS PER IRAC NORMS:

As mentioned in the above para, banks are expected to fully automate asset classification as per IRAC norms of RBI. Bank would expect auditors to thoroughly verify asset classification as well as provisions thereon. Periodical valuation of assets which are hypothecated /mortgaged with banks is imperative to determine the correct provision on NPA.

6. MEMORANDUM OF CHANGE:

Errors noticed by auditors in respect of interest on loan, asset classification, provision on NPA, provision of expense etc are reported in MOC so that bank management can give effect of correction of these items at consolidation level. This is very important aspect of bank branch audit and bank management expects that auditors issue MOC only in respect of items which are material

Materiality is very important aspect of any audit. Branch auditors therefore should bear in mind materiality aspect of an item while issuing MOC. Needless to mention that in case of asset classification as per IRAC norms or provisioning in respect of NPA, a more conservative approach may be adopted by branch auditors.

Also bank management would expect branch auditor to issue MOC which is error free. For example, if there is under charging of interest in an advance then one effect of that will be in p& l item by increase in interest income and second effect would be in balance sheet item by way of increase in advance. At times branch auditors do not give proper effect in MOC which results in correction of the same by bank management at the time of consolidation. Branch auditors may refer closing circular of bank to have better understanding for preparation of MOC.

7. SOME IMPORTANT AREAS:

i. NOMINAL ACCOUNTS/SUSPENSE ACCOUNTS:

Banks are expected to make provision if debit balance in suspense accounts is outstanding beyond 180 days. Therefore, this becomes an important area of verification from bank's perspective and auditors are expected to scrutinise these accounts thoroughly as this is also a fraud prone area.

ii. FIXED ASSETS SCHEDULE:

Accounting not being the core area of a banker, at times fixed assets are not accounted properly. For example, there may be cases of advance against fixed asset, and it not being capitalised despite having received the asset and put to use. Similarly, items which are revenue in nature are at times capitalised. Also in banks, lot of inter branch transfer of fixed assets keep happening. Therefore, this area becomes an important area from accounting perspective.

iii. PROVISION FOR EXPENSES:

At times at branch level, branches do not follow proper cut off procedure due to which provision for expense is not properly made. So, this aspect also bank management would expect auditors to verify.

iv. FRAUDS:

RBI is very strict about reporting of fraud, red flagged accounts by banks. Branch auditors are therefore expected to verify this area quite critically.

v. EXPIRED BANK GUARANTEES:

It is commonly found that expired bank guarantees are not reversed by branches due to various reasons. For capital adequacy of banks, guarantees are assigned risk resulting in higher capital requirement even for expired guarantees.

8. CERTIFICATES:

Branch auditors are expected to give host of certificates to Bank. Some of the important ones being

i. subsidy to be claimed from the Government /RBI

ii. Ghosh and Jilani Committee recommendations

iii. Capital adequacy returns.

iv. Certification relating to various disclosures to be made in the financial statements of the Bank.

Branch Auditors are expected to verify these certificates quite critically as the data certified has various implications. Needless to mention above is just an illustrative list and branch auditor is expected to verify other certificates as well equally meticulously.

9. VERIFICATION OF INTERNAL FINANCIAL CONTROLS OVER FINANCIAL REPORTING:

Reserve Bank of India has made reporting on IFCoFR for Nationalised Banks mandatory from F.Y.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 SCA in consultation with bank management. In case branch allotted to branch auditor is selected for testing of IFCoFR then he would be required to report on IFCoFR of that Branch. ICAI has issued Technical Guide on Audit of Internal Financial Controls in case of Public Sector Banks which can be referred to by the branch auditor.

Bank management would expect branch auditor to cover this as part of audit assignment and he would be expected to complete branch audit in the given time frame covering this aspect also.

10. AUDIT RPEORTS:

i. **BRANCH STAUTORY AUDIT REPORT:**

This report is given as per The Banking Regulation Act, 1949. The format is given by bank to auditors wherein certain aspect like compliance of various accounting standards and may other items are dealt with at the Head Office. Branch Auditor would be expected to mention this in his audit report without qualifying the report.

Also at times some of the observations which are given in LFAR do not warrant qualification in main audit report which branch auditor need to be careful about.

Similarly, MOCs issued by Branch Auditors do not warrant qualification.

ii. **LFAR:**

RBI has revised the reporting requirement under LFAR substantially in 2020. On the basis of LFAR of branches, LFAR for the bank as a whole is prepared. Therefore this is one area where branch auditor is expected to give value addition by giving observation which would help bank in strengthening its functioning rather than giving observations which are general in nature.

Last but not the least is the expectation of bank from auditor to be perfectly professional, objective and judicious with the matchless decent behaviour.

Above are some of the important areas of expectation of Banks from Branch Auditors. However Branch Auditor should not confine their verification only to above aspects but should conduct audit covering all the aspects which are required to be covered in bank branch audit.

II. EXPECTATION OF STATUTORY CENTRAL AUDITORS FROM BRNCH AUDITORS

Statutory Central Auditors (SCAs) of Banks to a great extent rely on the work of the Branch Auditors. All SCAs, collectively audit only a few Branches of Bank and for other branches under audit, they rely on the work of Branch Auditors. Role of SCAs as consolidating auditor is to verify consolidated financial statements of all the audited and unaudited branches at Regional level or Zonal level or at LHO level (controlling office) depending on the organisational structure of Bank and also review Branch Audit Reports and form an opinion about controlling office on the basis of Branch Audit Reports. Therefore, the quality of audit which Branch Auditor does is very important. It is suggested that Branch Auditors should thoroughly study technical material necessary to conduct bank branch audit viz Guidance on Audit of Banks, 2023 Edition etc which would help them in doing Bank Branch Audit in a better way.

Besides the quality of audit which SCAs expect from Branch Auditors following are some of the important areas of expectation of SCAs from Branch Auditors

1. BRANCH CLOSING INSTRUCTIONS:

As per SA 600- "Using the Work of Another Auditor", there is a practice of giving referral instructions to the component auditors (in case of banks, branch auditors). Accordingly, in Branch closing instructions, requirement of SCAs from branch auditors is incorporated. Therefore, SCAs expect that branch closing instruction is strictly followed by branch auditors.

2. ANALYTICAL PROCEDURE:

Besides the normal audit , branch auditor may carry out analytical review process in some important areas for variance analysis so as to identify significant variance, if any, in some of the critical area at branch level.

3. ASSET CLASSIFICATION:

i. At times, during the course of audit, branch auditors come across accounts which they feel are NPA but bank management has a contrary view. In such cases, branch auditors make a mention of such accounts in LFAR/ main Audit Report, leaving judgments to SCAs. This should be avoided, and branch auditors should take their independent view and close the matter at branch level itself.

ii. Value of security is one important aspect in arriving at provision in NPA account. Branch auditor should verify this aspect more diligently as during the course of scrutiny while consolidating NPA statement, some deficiencies are observed in this area.

iii. Date of classification of NPA sometimes is not correctly carried forward. Branch auditors therefore may verify this aspect too.

4. MEMORANDUM OF CHANGES (MOC):

Branch auditor should keep materiality aspect in mind while issuing MOC.

5. CLASSIFICATION OF ADVANCES:

i. Classification of advances into various sectors such as priority, real estate etc is very important since this has implication on provisioning on Standard Assets (which is higher on real estate sector) and risk weight assigned to advance to arrive at the capital adequacy ratio of bank.

ii. Branch auditors have tendency of verifying classification of advance into secured and unsecured only in case of NPA. But it is equally important to verify the same for standard advances also for the correct disclosures in the financial statements as well as for capital adequacy ratios.

6. AUDIT REPORTS:

As mentioned earlier, SCAs rely on the work of branch auditor and therefore it is very important that Statutory Branch Audit Report and LFAR is issued by Branch Auditor in unambiguous manner :

i. Branch Statutory Report:

Generally, bank management provides standard audit report to branch auditor which is in accordance with the Banking

Regulation Act,1949. But branch auditor need to ensure that audit report is in accordance with SA 700, SA 705 or SA 706 as the case may be. Branch auditor need not qualify matter which is not material and also should not make LFAR observations as subject matter of qualification.

ii. LFAR :

a. Observations in LFAR should not be vague and it should be descriptive and unambiguous. As mentioned earlier, LFAR should not contain any observations where view about classification of NPA is left to the judgement of SCAs.

b. LFAR for the Bank as a whole is compiled on the basis of the observations of branch auditors. The view about the internal controls, deficiency in the system, procedure etc is formed on the basis of branch LFAR. Therefore, it is of paramount importance that branch auditor allots sufficient time for preparation of LFAR and doesn't issue report in a routine way.

Above are some of the important aspects with regard to expectation of SCAs from branch auditors which may be taken care of while doing bank branch audit.

■■■

Audit Planning with the Use of Technology

CA. Sonali Piyush Chandak

The Code of Ethics of ICAI outlines five fundamental principles: Integrity, Objectivity, Professional Competence & Due care, Confidentiality, and Professional Behaviour. Among these, Professional Competence & Due Care is the most important. By accepting the appointment, it is assumed that the auditor knows everything and cannot say "I didn't know that."

Most banks conduct internal audits using their own staff, which lasts for 1 to 2 months, daily from 10:00 to 06.00, and provides a detailed report. However, the same scope is expected to be covered within 3-4 days by Bank Branch Statutory Auditor. Therefore, it is necessary for auditors to be technically competent to plan the audit efficiently. Even if we do not know all the CBS commands, we need to know how to extract the required reports from the system.

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, conduct a preliminary inquiry to know the nature, size, and category of the bank branch to be audited, and work out an overall audit strategy for executing the audit within the time limits. The auditor should also have a thorough understanding of RBI guidelines, prudential norms, and master directions, and be updated with the various recent circulars and instructions issued by the RBI.

SA 300 link:

All public sector banks issue closing instructions for the 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 in mind. They 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 objective of such returns and certificates is very essential.

The auditor should first understand the nature of the activities carried out at the branch and consider the requirements of SA 315 "Identifying and Assessing the Risks of Material Misstatement through understanding the entity and its environment." To do this, they need to ask for various reports, which can be obtained from the report server in every banks.

SA 315 link:

The auditor should send a detailed requirement letter seeking information regarding the branch to the branch management so that necessary information is received during the planning stage, and proper audit plans can be made. The auditor should call for various types of audit reports conducted during the year and their compliance status.

1) Concurrent Audit reports
2) Risk Base Internal Audit (RBIA) Report
3) Stock Audit Reports
4) Revenue Audit Report
5) Internal Inspection Report
6) System Audit Report, If any
7) Previous Year Statutory Branch Audit Report
8) Previous Year LFAR & MOC

The auditor should carry out analytical and substantive audit procedures to verify the true and fair view of the financial statements. Due to time constraints, along with appropriate test checks carried out, analytical procedures will be useful tools to find material misstatements, if any, in the financial statements. The auditor should set a materiality level in accordance with SA 320, "Materiality in Planning and Performing an Audit," and carry out substantive audit procedures for all material transactions.

SA 320 link:

The auditor can obtain various reports for analysis, some of these reports are; the Loan Balance File, SMA Reports, Review Renewal Pending Reports, Instalments Overdue Report, Insurance Expiry Report, Irregular Overdrafts Report, Loan Sanction/ Disbursement Report, List of A/c Restructured during the year, Bank Guarantee Expired Report, O/s Bank Guarantee Report, GL PL Reports for supplementary Suspense, sundry Assets Liabilities, like all Parking or office A/c, and BGL Accounts age-wise break-up. These reports may be available in Text or Notepad format and can be easily converted into Excel for analysis purposes.

The Loan Balance File contains information such as

- Customer No. CIF
- Account No.
- Name of A/c Holder.
- Type of Facility scheme
- Sanction Date
- Sanction Amount.
- O/s Balance.
- Rate of Interest.
- Security Value
- Last Dr.
- Last Cr.
- Total Turnover.
- DP = Drawing Power
- Overdue Amount
- SMA status.

  Special Monitoring A/c

  00-30 Overdue SMA-0

  30-60 Overdue SMA-1

  60-90 Overdue SMA-2
- IRAC Status (NPA Status)

According to the revised format of LFAR (Long Form Audit Report) from FY-2020-21, large advances that require 100% verification are those with an outstanding amount exceeding 10% of the outstanding aggregate balance of fund-based and non-fund based advances of the branch, or ₹ 10 crores, whichever is less. Using the pivot table function in Excel, you can easily select accounts based on customer number (CIF) and outstanding loan balance.

It's also necessary to provide a list of accounts examined for the audit in the LFAR. Therefore, sample selection is crucial. You can use Excel functions like sort, filter, pivot, and V-lookup to select:

- Top borrower accounts sorted by outstanding balance
- Accounts from each type of scheme
- Irregular overdraft accounts
- SMA 2 accounts
- New loan accounts sanctioned/disbursed during the period

In addition, you can use the V-lookup command to create an Excel sheet that includes all advances reports for analysing SMA position month-wise, IRAC (Income Recognition and Asset Classification) status month-wise, and so on.

These are some of the Nomenclature used in various Banks for Loan Balance Files:

Sr. No.	Bank	CBS System	Nomenclature of report	Source/ From
1	Bank of Maharashtra	BaNCS	All PA & NPA File	ULC-MIS Report
2	Punjab National Bank	Finacle	RPT 3/7- Daily outstanding	MIS Report Server
3	Bank of India	Finacle	CCIS File	MIS Report Server OR you can ask from Regional/Zonal office
4	Canara Bank	Flexcube	BI - Report Server - 280004	MIS Report Server (Excel or PDF Customer wise also & Product wise also available)

Sr. No.	Bank	CBS System	Nomenclature of report	Source/ From
5	Union Bank of India	Finacle	A1 A4	MIS Report Server OR you can ask from Regional/Zonal office
6	UCO Bank	Finacle	BS-5 (Loan Balance File)	MIS Report Server
7	Bank of Baroda	Finacle	All Advance MIS Data (Excel)	MIS Report- Q Lik Sense OR you can ask from Regional/ Zonal office
8	Indian Bank	BaNCS	Loan Balance File- LAA RPT CC OD Bal file- CCOD RPT	MIS Report Server OR you can ask from Regional/Zonal office
9	Central Bank of India	BaNCS	Loan Balance File- LAA RPT CC OD Bal file- CCOD RPT	MIS Report Server OR you can ask from Regional/Zonal office
10	Indian Overseas Bank	Finacle	Loan outstanding as on date	Finacle Report Server
11	Punjab & Sind Bank	Finacle	Loan Balance File(Code 383 & 381)	PSBRPT-MIS Report Server
12	State Bank of India	BaNCS	All in One Loan File for PA NPA	Webcas Report Server OR you can ask from Regional/Zonal office

The audit program should cover the following:

1) The audit scope should be clearly defined.
2) The focus areas should be identified.
3) Materiality levels should be set for each area.
4) An overall time schedule should be established.
5) Audit staff should receive training, and special skills should be identified if needed.
6) Weak areas identified during the audit should receive extra attention.
7) Cash, other securities, and sensitive accounts should be physically verified.
8) Frauds, sundry assets, suspense accounts, inter-branch reconciliation, and contingent liabilities should be reviewed.

Plan **SMART: S**pecific, **M**easurable, **A**chievable, **R**elevant, **T**ime-bound

Suggested Bank Branch Audit Program / Illustrative Checklist Time & Manpower planning

Verification of Advances- Funded & Non-Funded

(Including Agricultural Advances)

CA. Pankaj Tiwari

A. Brief Background:

The Reserve Bank of India (RBI) released its 26th Financial Stability Report (FSR) on December 29, 2022, which inter alia stated that the gross non-performing asset (GNPA) ratio of scheduled commercial banks (SCBs) fell to a seven-year low of 5% and net non-performing assets (NNPA) have dropped to ten-year low of 1.3% in September 2022.

Further, the improvement in the GNPA ratio in respect of the industrial sector continued, although it remained higher for gems and jewellery and construction sub-sectors. The asset quality of the personal loans segment improved during H1:2022-23, especially for housing and vehicle loans. These factors indicat¬e significant improvement in the quality of assets across the banking industry. The Profit after Tax (PAT) across the banks have improved due to strong growth in net interest income (NII) and significant lowering of provisions.

The credit growth which had started picking up during H2:2021-22 has also shown significant upward movement specially in Personal Loans. In respect of Personal loan segment, the growth in credit card receivables and vehicle/ auto loans is significantly higher as compared to other products.

In spite of all the above positive indicators, audit of advances (both funds based & non-fund) is still critical because critical because of the following factors:

- Advances generally constitute the largest item of the assets in the Bank Balance Sheet;
- Close Monitoring of Lending Activity of the Bank by the Reserve Bank of India-Significant Divergence in earlier year
- Inherent Fraud Risk in loans granted by the bank;
- Misappropriation/diversions of funds by the borrower in absence of predefined end use restriction;
- Possible Evergreening of Loans by the bank/ borrowers;
- Interest income and Fee income on advances (Retail as well as Corporate Loans) is major income for banks
- Important area of reporting in Long Form Audit Report in Bank Audit etc.

Hence, inclusion of such chapter discussing important aspects in this publication is important from the perspective of the Bank Branch Auditor.

B. Scope of the paper:

The paper deals with providing guidance on basics of advances in banking, important circulars relevant from FY 2022-23, audit, practical aspects to be covered during audit & observations relating to different types of advances. The paper also covers some brief audit procedures which can be performed during verification of advances.

The paper excludes detailed discussion on IRAC norms relating to non-performing assets and reporting on matters required under LFAR.

C. Advances-Basics & regulatory guidance:

In India, generally the bank originates fund-based advances in one of the following manners:

- Self- Origination (including through DSA's)
- Securitisation /Assignments of loans from other banks/FI;
- Inter Bank Participation Certificates [IBPC];
- Priority Sector Lending Certificate (PSLC)[off-balance sheet item]

The advances originated through IBPC and PSLC are normally dealt at the head-office or corporate offices & therefore the same may not be covered by bank branch auditor.

At the commencement of the audit, the branch auditor should always first analyse portfolio mix of the branch in the following manner to assess the audit risk:

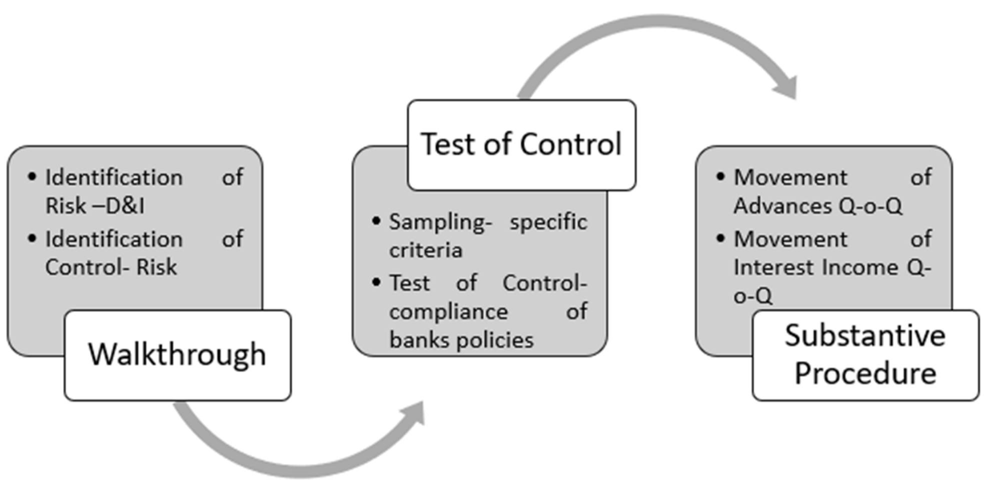
Risk parameter	Branch Status	Risk
Type of Advances	Major unsecured portfolio	High
Nature of Advances	Major advances to Industrial entities & less exposure to retail customer	High
Movement in Advances	Significant increase in advances over previous year	High
Fraud reporting	Major frauds reported during the quarter	High
Internal/External audit report	Significant lapses identified in the reports	High
Authorisation Matrix	90% of loans sanctioned by within the branch authority	High

The above risk matrix will help the auditor to be more vigilant and plan the assignment in effective manner.

Some of the important circular relating to advances (relevant for FY22-23) are as follows:

To view the Circulars Scan QR Code

E. Audit Approach for Advances:



The audit procedures may differ based on the type of branch, nature of advances and risk assessment done at the beginning.

The branch auditor should keep the following points in mind at the time of verification of the advances:

- Testing of the Internal Control System in the bank on sanction & disbursement of loans- different process owner (Credit + Operation)
- Identify the risk areas- Large Advances, Smaller Advances- coverage as per new RBI circular.
- Materiality - Sample Checking to be done- team to decide the criteria for sampling depending upon the exposure of the bank (retail vs. corporate)

- Full verification of certain advances- Reported in IA, RBI inspection reports, widely reported in press.
- Review SMA reporting by the bank on Monthly basis to identify account with continuous weakness- independent process understanding of SMA- implication on Provisioning

During the evaluation of internal control system, the branch auditor should inquire and verify the following:

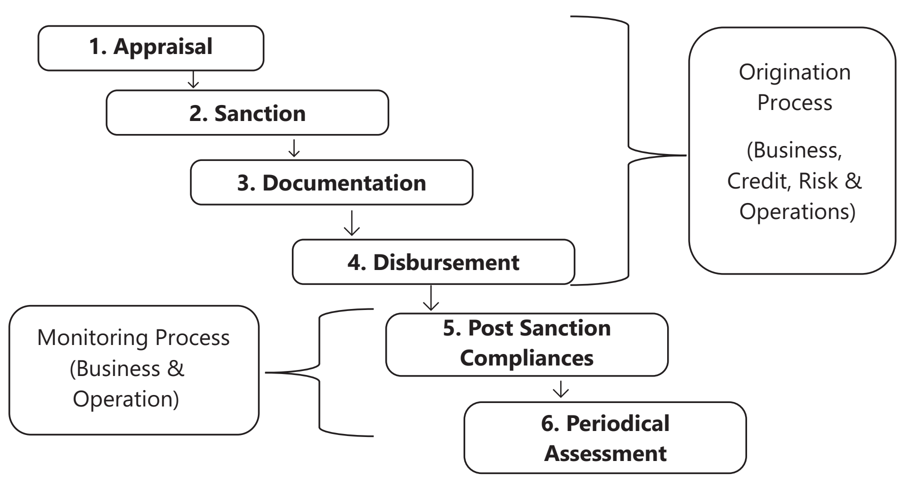
- Review of operating manuals/SOP related to various processes at the branch
- Level of implementation of the IC system at the bank
- Sanctioning process in the Bank
  - o Sanctioning Authority and Powers
  - o Extent of computerization & Documentation- Sanction note/CAM
  - o Internal Communication within departments (Credit, Risk & Operations)
  - o Quality and trained Staff at Credit & Operation department
- External Inspection/valuation done by expert- evaluation of onboarding process/allotment process.
- Existence of IT systems and its effectiveness
  - o Reports on Potential/Automatic NPAs and whether any parameters can be changed by manual intervention.

The branch auditor should consider following at the time of determining **extent of checking and materiality level:**

- Understand the various categories of portfolio at the bank- Corporate, SME & Retail
- New Sanctions during Financial Year- Top exposures- specifically moved to SMA in CY
- Advances with Adverse Remarks in:
  - o Concurrent Audit/IA Report
  - o PY LFAR & Audit report
  - o RBI Inspection report
  - o Internal Inspection/Credit Audit
- Major movements (upgrades & downgrades) in NPA / Restructured advances.
- Quick mortality accounts (QMR) from the perspective of probability of Fraud

The bank during the process of sanctioning loans obtains & prepares various documents to assess the credit risk & other risk relating to the exposure. As part of verification of loan documentation, the branch auditor may adopt checklist approach to verify these documents and focus on certain key documents such as Credit Appraisal Memo (CAM), Legal report, Valuer report, Inspection report, CIBIL reports etc.

F. Stages for verification of Advances:



The auditor should review following points during Credit Appraisal & Sanction stage of the loan cycle:

- Sanction by Appropriate authority as per authorisation Matrix (SMC, COE etc.)
- All parameters as per credit policy have been considered by the bank before making the appraisal (financial ratio, inspection of unit, sector exposure details etc.)
- Review of the information available in public domain relating to the borrower and promoters
- Security provided to the bank against the facility (primary and collateral)- charge created by the bank on the same- confirmation from consortium member on security creation
- Comments made by the credit team and responses from business team on the same- mainly on deviation as compared to normal policy.
- Adverse comment in key financial indicators- Sales, Profit, Current Assets Current Liabilities, Contingent Liabilities and Notes to Accounts
- Inherent risk in the new exposure either due to promoter group or industry performance (Airline, Gems & Jewelry)

The auditor should review following points during Disbursement process of the loan cycle:

- Review of the valuation reports and legal report
- Adequate documentation – as per sanction note/bank's policy- Corporate Guarantee resolutions etc.
- Creation of charge – ROC site and verification of records with MCA
- NOC from previous banker/lender in case of security creation on existing mortgage property
- Review of Internal Disbursement checklist (different format in banks) under Maker- Checker control
- Review of process of account opening (finacle, finone etc.) under Maker –checker control – verification of Master Creation in operating system is critical
- End-use of funds in case of disbursement to Current a/c of the borrower (normally in case of project loans, term loans etc.)- self certified or by Independent Auditor
- Physical Inspection of Security documents on sample basis /access to e-depository

The auditor should **review following points during Monitoring process of the loan cycle:**

- Review of operation in accounts – sample basis across all categories of advances
  - o Cash Credit- utilisation vs. Turnover in account vs. Turnover as per FS
  - o Term Loan/Project loans for Capex- % of completion vs. disbursement- any negative indicator
  - o SMA reporting process- identification of stress in particular exposure to group or exposure to sector
  - o Retail advances- mainly servicing of EMI/interest
  - o Intelligent Scrutiny of accounts- sign of weakness
  - o Transfer from/transfer to other Current accounts- window dressing
  - o Frequent cheque returns, excessive withdrawal- EWS (Early Warning Signal)
  - o Transfer of funds to group concern
- Review of Probable NPA report generated by the bank and identification of instances of ever greening- routing through other accounts
- Loan against shares- Periodic statement of valuation of shares pledged to ensure margin is maintained.
- Assessment of Impact of Change in Government Rules & Regulations

The auditor should review following points during Review/Renewal of Advances of the loan cycle:

To view Scan QR Code

G. Key Points on verification of Advances:

Areas of evaluation	Corporate portfolio	Retail Portfolio	Retail Agri/Priority Sector portfolio
Credit Evaluation	• Background of promoters • Business model evaluation – industry or sector performance	• Repayment capacity of Borrower • Income to Loan obligation ratio • Credit history with other banks/FI	• Eligibility criteria- agri or allied agri activities • Inspection/visits done by the Branch manager before disbursement- Jewel Loan experience
Security cover & Documentation	• Original security documents	• Original security documents	• Margin money details
	• Original security documents • Verification of Legal Report • Valuation Report • Adequacy of security available against loan O/s • Regular Inspection/ valuation • Charge Creation on ROC/ CERSAI	• Original security documents • Valuation Report- HL • Physical inspection by bank • Existence of security & Marketability • Compliance to LTV ratio of RBI • Charge creation- CERSAI for HL	• Margin money details • Land records/ documents for validating AG land • Availability of security for sale • End Use verification- diversion • High risk on unsecured advances

H. Verification of Non-Fund based advances:

While the general verification of funded and non-funded advances is done simultaneously, there are certain components of non-funded advances, which need to be looked into additionally. Reserve Bank of India has issued a Master Circular under the heading "Guarantees and Co-acceptances", which can act as a guiding parameter.

Non-funded advances are called "Off Balance Sheet" items, as their value is not reflected in the Balance Sheet. They form the "Contingent Liability" items of the bank. However, for the purpose of keeping a control over these items, banks have a system of passing contra entries in its books of accounts at the branch level and hence these items get reflected on the liability as well as asset side of the Trial Balance. However, while preparing the Balance Sheet of the bank as a whole, the value of these items are reflected in the "Notes to Accounts".

Guarantees - Guarantees are of two types –

Financial guarantee	Performance guarantee
wherein the guarantor (the bank) promises to pay the stated amount to the beneficiary, if the person for whom the guarantee is given, fails to pay the same (also referred to as invoking the guarantee	wherein the guarantor promises to pay the beneficiary a stated sum of amount, if the person for whom the guarantee is given, fails to perform, as expected, in a given period of time.
Financial guarantee carry the same credit risk as a direct extension of credit i.e. the risk of loss is directly linked to the creditworthiness of the counterparty against whom a potential claim is acquired.	The risk of loss depends on the event which need not necessarily be related to creditworthiness of the counterparty involved.

Letter of Credit:

Letter of Credit (LC) is a promise by a banker to honour the payments to be made by its customer (the buyer or importer) to the seller or exporter. This type of payment facility is generally used in international trade. In this type of facility, at the request of the buyer, his banker opens an LC, which is sent to the seller. Based on such LC, the seller dispatches the goods and then sends the bills and other documents through his banker to the buyer's banker, which has opened the LC, to make payment of the bill.

Area of Auditor's scepticism for non-Fund based advances-

- Verification of classification as performance and financial guarantee- incorrect classification impact the capital adequacy computation,
- All LCs/BGs which are either devolved/ invoked during the year are debited to the primary account (current/cc) of the borrower and not parked as separate facility.
- Inquiry in cases where the guarantees are issued on behalf of customer who is not having any fund based facility with the bank,
- Verification of margin in form of fixed deposits and lien on the same
- Verification of income & accrual in the books- more specifically in cases where the recovery is done at the end of tenure,
- Expired LCs/BGs wherein the claim period has expired & the same are continuing to be included in the outstanding list by the branch. The auditor should issue suitable MOC to reverse all such instruments.
- Overall level reconciliation between the income recorded vs. gross number and value of these instruments.

I. Verification of Agricultural advances:

Over the past few years, together with an increase in the aggregate of Agricultural advances the non-performing assets have also been growing considerably. These advances are treated differently both in their process of sanctioning & also in their asset classification based on due date of repayment.

The RBI has issued Master Directions – Priority Sector Lending (PSL) – Targets and Classification dated September 4, 2020 (as amended from time to time) which provide detailed guidelines on Agricultural advances.

The main classification of agricultural advances is following:

- Farm Credit - Individual farmers
- Farm Credit - Corporate farmers
- Agriculture Infrastructure
- Ancillary Services
- Small and Marginal Farmers (SMFs)
- Lending by banks to NBFCs and MFIs for on-lending in agriculture

The guidelines on classification of the above loans include various limits applicable as prescribed in the above circular. The branch auditor should refer the above guidelines for the purpose of verification of agricultural advances.

Some of the important concept in case of agricultural advances are as follows:

a. Crop Season:

The crop season refers to the time period from preparation to cultivation of a crop till its ultimate realisation. It is essential for auditors to understand concept of crop season, since the repayment of agricultural advances is linked with the season of each crop and the same would play an important role in determining default date and NPA classification norms.

IRACP norm uses term such as 'long duration crop' or 'short duration crop'. These are determined based on State Level Banker's Committee (SBLC) which reviews and decides the crop season and duration thereof for various crops cultivated in that state.

It is advisable that auditors use the crop season determined by SBLC of their state.

b. Interest demand & Application:

Unlike normal loans, the interest on agricultural advances is not charged at monthly rests but is charged normally at half yearly or annual rests viz directly linked with the cropping season.

c. ***State Level Bankers Committee (SLBC)***

An inter-institutional bankers' forum for co-ordination & joint implementation of development programmes and policies by all the financial institutions operating in a state. In terms of RBI directives, SLBC of respective state is required to determine "Crop Season" for each crop.

d. ***District Level Technical Committee (DLTC)***

The District Level Technical Committee (DLTC) shall be constituted by District Administration with District Central Cooperative Banks as its Convener and shall work in alignment with District Consultative Committee (DCC). The prime role of DLTC is fixation of the scale of finance (SOF) based on local cost worked out based on per acre/per unit/per animal/per bird etc. These rates are further submitted to State Level Technical Committee (SLTC) for final approval.

Recent changes/ amendments in RBI Guidelines relating to MFI loans:

To view Scan QR Code

Area of Auditor's scepticism for agricultural advances-

- Adherence to banks guidelines and SOP's in terms of authorisation matrix, computation of eligible income etc.
- Determination of sanctioned amount of agricultural loans based on the scale of finance as applicable to the land under cultivation and the crop being cultivated.
- Verification of documents/evidence available on record for the purpose of margin money (e.g. Tractor loans)
- Field verification reports conducted by the agricultural officers & other documents for end use verification.
- Classification of loan between priority and non-priority based on the purpose and utilisation of loans
- Verification of realisation of sale proceeds to crop- credits in the account are from genuine sources
- Verification of independent quotation obtained by the bank w.r.t. Tractor loans for determining the eligible amount
- Review of judgements and assumptions used by the branch officials at the time of sanctioning of loans (for e.g. considering certain income on estimated basis which are not part of ITR)

J. Reporting & Rectifications

The bank branch auditor should report discrepancies noted in the process and controls advances in - Statutory Audit Major/Critical discrepancies report & in Long Form Audit Report (LFAR) section related to advances. The auditor should maintain adequate documentation of issues reported in LFAR to avoid any dispute/ disagreement in future for e.g. RBI clarification/ observations.

The discrepancies having financial impact need to be rectified through Memorandum of Changes (MOC). The auditor should maintain adequate documentation for the discrepancies observed and rectified through MOC.

The chapter does not cover the NPA classification of advances including agricultural advances which has been covered separately in the publication.

K. Conclusion:

The verification of advances (fund and non-fund based) is one of most critical areas in the bank audit. The AQR reports issued by the RBI in past had highlighted various discrepancies in asset classification & provision of NPA. In recent time, such instances have reduced however this still remains as one of the focus areas of the regulators. The RBI has issued various circulars/notification/directions to capture certain loopholes/ambiguity enjoyed by the banks in past. As an auditor, this is high risk area and the auditor should not only carry out suitable audit procedures but should also document the same along with appropriate audit evidences.

Identification of Non-Performing Assets (NPA)

CA. Dhananjay J. Gokhale, *Mumbai*

The Audit of Advances can never be said to have concluded without verification of classification, income recognition, provisions w.r.t. Advances and identification of NPAs is one of the prime factors related thereto.

To read scan QR Code

The preamble of RBI Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, highlights the expectation of the regulator from banks such as 'the classification of assets of banks has to be done on the basis of objective criteria which would ensure a uniform and consistent application of the norms, which abrogates the myth about classification of advances being a subjective concept.

The RBI issued circular on 'Automation of Income Recognition, Asset Classification and Provisioning processes in banks' with reference to earlier circular DBS.CO.PPD. No.1950/11.01.005/2011-12 dated August 04, 2011 and have 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 in compliance with the extant guidelines issued. The System based asset classification is expected to be an ongoing exercise and is required to be made part of day end process, whereby classification status report can be generated through system at any given point of time with actual date of classification of assets as NPAs/NPIs.

As an auditor, one needs keep professional scepticism alive as regards such automations, instead of blind reliance on it, especially considering ample examples around us wherein at times automations may lack factoring artistry in human behaviour. Thus, one needs to be well versed with the regulatory guidelines related to Income Recognition, Asset Classification and Provisioning, besides being equally aware about the accounting aspects related thereto.

A Standard Asset can be defined as an asset which does not carry risk more than normal banking risk, whereas a Non-Performing Asset (NPA) is the one which either carries risk more than normal banking risk or ceases to generate income for the bank. The RBI has defined various objective criteria as regards classification of advances, which are as follows:

Firstly, one has to acquaint oneself about the definition of Overdue which states 'If an amount due to bank under any credit facility is not paid on the due date fixed by the bank, such amount would be called as Overdue.' Secondly, the classification of advances would be qua borrower unless otherwise stated. Thus, all facilities granted to a borrower shall be treated as NPA and not only that facility which has become irregular.

The RBI has defined various objective criteria as regards classification of advances, which are as follows:

1. **<u>Term Loan</u>:**

   Interest and/or installment of principal remains overdue for a period of more than 90 days.

   The vital character of the above criteria is the requirement of specified amount to be overdue, hence, one needs to refer to the definition of 'overdue'. RBI has mandated banks to ensure that exact due dates for repayment of a loan, frequency of repayment, breakup between principal and interest is clearly specified in the loan agreement and the borrower is apprised of the same at the time of loan sanction and also at the time of subsequent changes, if any, to the sanction terms/loan agreement till full repayment of the loan. Term Loans with moratorium period granted for interest as well as principal, the interest would be accrued and due only after the completion of the predefined moratorium period. The bank provides (ideal / expected) repayment schedule to the TL Borrowers based on which, one can draw an inference of expected (ideal) outstanding balance in TL account as on any date expected as per the repayment schedule.

An amount overdue for a term loan is nothing but shortfall of amount received from the borrower as against amount demanded by (due to) the bank (which is Interest / Principal / EMI plus any other amount as per the terms of sanction). In other words, overdue amount as on a particular date is an adverse difference between ideal drawing power (i.e., ideal balance in term loan account if the repayment is made exactly on the respective due dates) and ledger balance as on that date. In case of any Term Loan, there are few possible additional demands besides predefined repayments sums which are as follows:

1. Additional Interest for delayed repayment which arises due to delay in payment of the predefined repayment amount.
2. Penal Interest levied on the overdue amount as per terms of sanction,
3. Bank charges, insurance charges, etc. debited to the account.

Such additional amounts are immediately due as and when are debited in term loan account and are not due at the end of tenor of the loan, and as such are required to be paid by the borrower in addition to the predefined repayment amounts. If the said amounts remain unpaid by the borrower, the same would be qualified as 'overdue'. Thus, the simple yardstick of characterizing an amount as overdue is to verify if there is an adverse difference between ideal drawing power and ledger balance, (i.e., ledger balance being more than ideal drawing power as on a cut-off date). The ledger balance so considered includes interest as well as any other charges debited to the account and as such no amount is required to be distinguished from the ledger balance for the purpose of calculating 'overdue' component, since the concept of realization of interest / charges do not relate with the concept of 'Overdue'. Thus, an overdue TL Account can have unrealized interest / charges (e.g.: the borrower has paid partial portion of EMI which covers only interest debited to the account) and a TL Account without overdue component may have 'unrealized interest / charges' (e.g.: the borrower has paid EMIs in advance).

There are differential treatments followed in banking sector as regards advance repayment of loans, such as – (i) Advance EMIs received are not credited in Term Loan account but are parked as 'Other Liabilities' and amount of EMI is recovered therefrom on respective due dates, (ii) Advance EMIs received are credited to Term Loan account and borrower is asked to opt for either reducing remaining tenor of the loan and / or reduce the amount of subsequent EMIs, (iii) Such advance EMIs received are not considered as for change of tenor / EMI and are credited to Term Loan account , thereby the benefit of reduced interest for further period is passed on to the borrower due to reduced balance outstanding in Term Loan Account.

As an auditor, one should refer to the policy of the bank as well as the terms of sanction w.r.t. the treatment of the advance repayment of TL and verify the accounting treatment related thereto.

2. <u>Bills Purchased/Discounted</u>:

If such Bill remains overdue for period more than 90 days.

3. <u>Agricultural Advances</u>:

If Interest or installment remains overdue for two crop seasons for short duration crop, one crop season for long duration crop. A crop season is defined as 'period up to harvesting of crops raised' as determined by State Level Bankers' Committee (SLBC) and long duration crop means a Crop wherein crop season is more than 12 months. It is pertinent to note that Banks have discretion of rescheduling the agricultural advances in case of natural calamities, which impair repaying capacity (refer latest Master Direction dated October 17, 2018, by RBI on Relief Measures by banks in areas affected by Natural Calamities Directions 2018 - SCBs).

4. <u>Derivative Transaction</u>:

Overdue receivables representing a positive mark to market value of a derivative contract remaining unpaid for a period of 90 days from specified due date.

5. **Liquidity facility:**

If it remains outstanding for more than 90 days in respect of Securitization transaction.

6. **Credit card dues:**

If the minimum amount payable is not paid fully within 90 days from the next statement date.

7. **Cash Credit / Overdraft Account:**

The account is treated as NPA if the same is 'Out of Order'. The account is called as out of order if any one of the following conditions is fulfilled:

a. Outstanding Balance remains continuously in excess of sanctioned limit / drawing power (whichever is lower) for more than 90 days; or,

b. No credit continuously for 90 days; or credits in the account are not enough to cover interest debited during the previous 90 days.

One needs to take note of differential concept related to '90 days norms' w.r.t. Term Loan and CC / OD account, wherein a TL account is marked as NPA if amount is overdue more than 90 days whereas in case of a CC/OD account the concept is of 90 days and not more than 90 days as regards applying conditions related to 'out of order' status.

The classification of advances would be qua borrower unless otherwise stated. Thus, all facilities granted to a borrower shall be treated as NPA and not only that facility which has become irregular.

Apart from the financial parameters specified above, there are certain non-financial parameters based on which an account would be considered as NPA. The non-financial parameters along with certain exceptions to the NPA norms are defined by the Master Circular as follows:

1. Non-submission / non-availability of stock statement: outstanding Balance in account based on the drawing power calculated from stock statements older than 3 months would be deemed as irregular and if such irregular drawing is permitted for a period of more than 90 days, account needs to be classified as NPA. However, this relaxation is given 'considering the difficulties of large borrowers', thus, limiting its applicability to large borrowers only and thus should not be construed as applicable to every CC account.

2. Non-renewal/ Non-regularization of Regular / Adhoc limit: If the same is not done within 180 days from the due date, the account would be classified as NPA.

3. Advances against term deposits, NSCs, IVPs, KVPs and Life Insurance Policies need not be treated as NPAs, till security cover is sufficient to cover outstanding balance, provided Income is recognized subject to availability of margin.

4. Central Government guaranteed advance to be classified as NPA only if Government repudiates the guarantee when invoked. However, income from such accounts is required to be recognized on 'Cash' (realization) basis.

5. **LCBD Facilities:**

The Bill discounted against accepted LC would be treated as PA even though rest of the facilities of the borrower are treated as NPA (since the exposure of the bank in such cases would be on the LC issuing bank and not on the borrower), except in the instances wherein the LC issuing bank is itself. If bank's own LCs are discounted, the exposure is considered to be on the borrower.

6. In case of consortium / multiple banking arrangements, each member banks shall classify the accounts according to their own record of recovery.

7. **Potential threat of Recovery (Straightway Classification):**

Where realizable value of security is less than 50% of the value assessed (by bank or value accepted in last RBI Inspection), account to be straightaway classified as Doubtful Asset and where realizable value (as assessed by Bank / Valuator / RBI Inspector) of security is less than 10% of outstanding balance, account to be straightaway classified as Loss Asset.

8. **Fraud Accounts:**

In case of Fraud Accounts, 100% provision is to be made irrespective of security, spread over 4 quarters commencing from the quarter in which fraud has been detected wherein the same is reported to RBI and in cases wherein the fraud cases are not reported to RBI, 100% to be provided instantly.

9. <u>Solitary or few credit entries recorded before Balance Sheet to regularize the account</u>: In such cases, if the account is exhibiting signs of inherent weakness, such account is required to be marked as NPA and in other cases, the bank needs to evidence the auditors about manner of regularization of account or otherwise in absence of such evidence such accounts should be marked as NPA. A prolongation of this concept, any regularization of the account either at year-end or otherwise needs, to be out of genuine sources of funds, such as from income generating activities of the borrower and not by way of availing additional credit facilities / loans either from the bank or any other resources including to regularize existent credit facilities, wherein the asset classification needs to be considered as NPA. In the instances wherein an account is regularized by way of sale of fixed assets of the borrower, whether provided as security to the bank or not, the auditor needs to critically evaluate and test the possibility of inherent weakness as such realization are not part of income generation out of regular business activities of the borrower.

10. **<u>Mandatory Valuation of Securities</u>**:

    In case of NPAs, wherein the outstanding balance is more than ` 5 crores, it is mandatory to conduct stock audit by external agencies and as regards immovable properties taken as securities, the valuation is required to be carried out at least once in three years by an approved valuer. As regards other securities, one needs to verify the appropriateness in the valuation methodology thereof and consistency followed w.r.t. the same.

11. **Regularization of accounts** –

    Partial regularization and regularization after the balance sheet date: In case if an account is a NPA, irrespective of whether the account is marked by the bank as NPA or not, the upgradation of the account would be subject to the condition that the entire arrears of interest and principal are recovered (in case of Term Loan Accounts) or the working capital accounts are regularized out of genuine business credits. The regularization of the account subsequent to the Balance Sheet date does not affect the assets classification as the upgradation of the account would be effected only prospectively on the date of regularization. Such regularization of the account needs to be verified at borrower level (i.e., at cust-id level), and not at account level.

Project Loans

The change in repayment schedule is permitted without change in asset classification if the same is caused due to increase in project outlay on account of increase in scope and size of the project, subject conditions stipulated in Para 4.2.15.6.2 of the Master Circular.

The usual classification norms apply before the commencement of commercial operations. However, in case of accounts wherein the borrower fails to commence the commercial operations within two years and within one year from the date of commencement of commercial operations (DCCO) w.r.t. Infrastructure and non-infrastructure sectors respectively, the account needs to be classified as NPA, unless eligible to be restructured and classified as standard asset as specified in the master circular.

Income Recognition / Reversal of Income

The income on Standard Assets is recognised on Accrual basis and that on NPAs is recognised on Cash (realisation) basis. As per para 3.2 of RBI Master Circular - 'If any advance, including bills purchased and discounted, becomes NPA, the entire interest accrued and credited to income account in the past periods, should be reversed if the same is not realised. This will apply to Government guaranteed accounts also. Similarly, in respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed with respect to past periods, if uncollected.

The reversal of income is required once an account is marked as NPA to the extent of income and fees / commission, etc., which has remained unrealised, and as such the unrealised interest is not a criterion for classification of an account as NPA. e.g.: (a) one of the criteria for treating a CC/OD account as 'out of order' is whether credits are not enough to cover the interest debited during the previous 90 days period. The concept of 'cover' and 'realisation' are not identical and needs to be considered appropriately for respective purposes. (b) in case of a Term Loan, if an advance repayment received is credited to TL ledger account, the same results in reduction in ledger balance and accordingly effects the calculation of 'overdue amount', though cannot be considered as effective for considering realisation of interest which is debited in the account at subsequent dates, unless the accounting treatment related thereto is in sync thereof.

In usual circumstances, interest / fees / commission would be considered as realised only when there is a subsequent credit received in the account or, the ledger balance as on EoD of interest application is an adverse balance (credit balance). Thus, credits received (whether as advance payment of instalment or otherwise) prior to debiting of interest would not be helpful for considering interest as realised, unless the same are accounted for categorically as 'Advance income received (Liability)' instead of crediting against outstanding loan balance.

Following is an example to elaborate the point further:

CC / OD Account (with drawing power and limit of ₹ 1,00,000/-)

Date	Narration	Dr	Cr	Balance
01.Apr.2022	Disbursal	1,00,000.00		1,00,000.00
25.Apr.2022	Receipt		2,500.00	97,500.00
30.Apr.2022	Interest	1,000.00		98,500.00
31.May.2022	Interest	1,000.00		99,500.00
30.Jun.2022	Interest	1,000.00		1,00,500.00

In the instant case, the account will be marked as NPA on 30.Jun.2022 as the credits in 'previous 90 days' (of ₹ 2,500/-) are not enough to cover the interest debited during the same period (of ₹ 3,000/-). The amount of interest unrealised will be ₹ 3,000/- and not ₹ 500/-.

Similarly, in case of a Term Loan account, interest debited in the account cannot be said to be realised out of prior credits received in the account (whether as prepayment or otherwise).

Thus, to summarise, when an account is marked as NPA, the interest / fees / commission / bank charges debited to the account, which are not realised as on the date of NPA are required to derecognised and subsequently needs to be recognised on realisation basis.

While reviewing automation of NPA classification and income recognition, one needs to critically evaluate the software behaviour to ensure adherence to the concept of realisation.

Interest on additional finance in NPAs should be recognised on cash basis. If interest due is converted into unlisted equity / FITL, the same should be fully provided for and if the same is converted into a listed instrument, the interest should be recognised to the extent of market value of such security on the date of conversion.

In case of recoveries in NPAs, in the absence of clear agreement between the Bank and the Borrower, an appropriate policy to be followed in uniform and consistent manner as regards order of recovery of outstanding interest and principal amount.

Conclusion:

Though adoption of technology and heavy reliance of automation is a norm in banking industry, an auditor should ensure that reliance placed on such automation is after due testing of the software, its behaviour, keeping his / her professional scepticism alive.

Note: The topic related to classification / identification of NPAs is a vast subject, thus, only important aspects related thereto from audit perspective are covered in this article. It is therefore suggested that reader should refer various RBI Master Circulars related thereto and "Guidance Note on Audit of Banks" issued by the Institute of Chartered Accountants of India and.

■■■

Restructured Advances and Restructuring Packages

CA. Parag Hangekar

Restructuring of Advances is done by the Banks when they assess that the borrowers have not been able to make timely payments as per the agreed terms due to genuine stress in the business because of varied reasons and support from the banks would enable the borrowers to revive their businesses. Each of the banks have a detailed laid down policy of restructuring approved by their Board. It cannot be done arbitrarily by the bank staff. The entire restructuring exercise has to be carried out based on the processes and procedures laid down in the Restructuring policy and has to be as per the RBI regulations. The concept of restructuring of advances needs to be understood in line with the regulatory guidelines related thereto and the effects thereof needs to be considered in terms of provisioning as well as accounting treatments.

What is restructuring?

The RBI Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances defines 'Restructuring' as 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.

Thus, to put it in simple terms, 'restructuring' is an act where one of the following criteria are (tweaked favorably to the borrower in the form of concession, for reasons other than market competition) observed –

(i) moratorium in the repayment of principal and interest, both or either of them.,

(ii) ballooning of payment, (iii) concession in interest rate, (iv) granting of additional credit facilities in order to cure a default and / or nursing of ailing borrower account, (v) Roll-over of credit facilities.

It should be noted that restructuring of advances should be carried out only in genuine cases upon proper assessment of the borrowers and should not be done to avoid slippages of advances to NPA. The auditors should use their professional judgement to ascertain that the restructuring has been done in genuine and appropriate cases by the banks to support the borrowers to overcome their temporary financial difficulties and in no way should be used for any kind of window dressing or manipulation for avoiding slippages of advances to NPA.

Let us understand the different types of Restructuring as under:

- One Time Settlements (OTS)
- Insolvency and Bankruptcy Code, 2016 (New concept of PPIRP)
- Internal restructuring under the RBI framework – COVID relief
- MSME Restructuring
- Projects Under Implementation

One Time Settlement (OTS):

OTS is an effective tool for speedy recovery of Bank's dues. Through negotiated settlements Bank agrees to part with certain concessions in terms of sacrifice in total dues payable, rate of interest etc so that the recovery can take place immediately, without undergoing the legal process. NPA's have following effects on the Banks:

a) The NPAs do not generate any income even though they are part of assets portfolio.

b) Provision requirement on NPAs is a drain on profits of the Bank.

c) Additional expenses by way of legal charges, security charges etc., are required to be incurred till the actual recovery of the dues.

d) It requires additional capital to attain Capital Adequacy Ratio.

BENEFITS:

a) Bank can recycle the funds recovered through compromise settlement;

b) Bank can save on man power, time and expenses involved in the legal process;

c) The gross level of Non-Performing Assets of the bank is reduced through the recovery affected;

d) Provision held against the NPA will be released on recovery, which can be utilized to meet additional provision requirement in respect of fresh NPAs;

SELECTION OF CASES FOR ONE TIME SETTLEMENT OTS:

a) Accounts classified as NPAs and activities are closed or on the verge of closure.

b) Where activities are running in losses and there is inadequate security / deterioration in the quality of security;

c) The net worth of the borrowers/guarantors is meagre;

d) There is difficulty in disposal of security;

e) Chances of recovery through legal process are time consuming due to certain legal procedures and time involved in actual recovery through execution proceeding would be long.

f) The borrower has sincere desire to settle the dues.

g) The cases where field functionaries are satisfied that the OTS / settlement is a better option in the given circumstances.

AUDIT ISSUES:

1. Check the delegation of powers as per the recovery policy of Bank.
2. Cases of Wilful Default, Fraud and Malfeasance.
3. Ascertain the reasons for NPA and repayment Capacity of Borrower.
4. Usually the OTS amount should not be less than the NPV of the available security + net of cost realisation.
5. Ensure that Upfront amount and Deposit in No Lien Account has been taken.
6. Check the accounting of processing income
7. Withdrawal of counter claims by the borrowers against the Bank to be confirmed.
8. The time required to make payment under OTS should be such that it has linkage with the sources available e.g., sale of property, raising loans from other FIS/Banks or friends and relatives.
9. Total dues = **Ledger Balance as on NPA date + unapplied interest + other charges.** Non fund based exposures also to be considered.

Auditor to check

1. OTS should be : One Time Settlement as per the Banks and RBI's policy
2. Note on proposal for compromise settlement.
3. Acceptance of OTS by the Borrower
4. Justifications for waivers
5. SWOT analysis
6. Calculation of Minimum Expected Recovery (MER)
7. Delegation of powers
8. Latest valuation reports
9. Accounting of income – processing charges/ legal charges

10. Recoveries as per the agreed terms
11. Release of securities and issuance of NOC
12. In case of technically written off accounts (TWO) then entire recovery will be profit for Bank.

Pre - packaged Insolvency Resolution Process (PPIRP) for MSMEs

- IBC (Amendment) Ordinance, 2021 on 4th April 2021
- Mainly to help the MSMEs in stress due to COVID
- Quicker, cost effective and value maximizing outcomes for the stakeholders with least disruption to business and which preserves jobs.
- Built on trust and honors the honest MSME owners by enabling resolution when the Company remains with them.
- Defaults at least 1 crores for which CIRP available
- Also, for defaults at least ₹ 10 lakhs and for defaults that were between 25/3/2020 to 24/3/2021

  Eligibility:

  i. Committed default of at least ₹ 10 lakhs

  ii. Eligible to submit plan u/s 29A of the C ode

  iii. Not undergone under PPIRP in previous 3 years

  iv. Not completed CIRP in previous 3 years

  v. Is not undergoing CIRP

  vi. Not required to be liquidated u/s 33 of the code
- Copy of Udyam Regn Certificate to be attached/ proof of investment in Plant and machinery/ equipment for confirming MSME status.
- Corporate Dalton (CD) will initiate the process by conducting the meeting of the Unsecured Financial Creditors (UFC) and appointing the Resolution Professional (RP) based on Mutual understanding. From the total List of creditors consent of Unsecured Financial Creditors (UFC) 66% is required. Application to Adjudicating Authority (AA) for admission is made. Later the list of claims is updated. CD will then submit the Base Resolution Plan (BRP).
- If the Base Resolution Plan (BRP) impairs operational creditors, then Resolution Professional (RP) invites alternate RP and the Best alternate plan (BAP) is selected.
- Comitted of Creditors (COC) has to approve the best plan by comparing the BAP and BRP and approve it.
- Plan to be submitted to AA by 90 days.
- If AA approves the plan, then the PPIRP closes with resolution or else it closes without resolution

To put it succinctly, the PIRP mechanism is aimed to further the object with which IBC was promulgated. It allows, though with a rider, the Corporate Debtor to control the management of business and to also submit a base resolution plan; meaning thereby that the Corporate Debtor can make bonafide attempts to resuscitate its business and to also clear its defaults.

Asset Classification Norms

A bank can restructure any account except the accounts which are declared as 'fraud' and the restructuring is required to be implemented prospectively and not retrospectively. An account irrespective of its classification, nature is eligible for restructuring. When an advance account is restructured, the same needs to be downgraded with immediate effect unless the account satisfies differential treatment specified for certain instances of restructuring wherein the class of asset can be retained. Thus, a standard account which is restructured would be downgraded to 'Sub-Standard Asset' category. The NPAs, upon restructuring, would continue to have the same asset classification as prior to restructuring.

A restructured account is eligible for upgradation only if it demonstrates satisfactory performance during the specified period. The criteria for the same are as follows:

(a) MSME Account where lender's exposure is less than ₹ 25 crores:

'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 accounts which are not included in (a) above:

'Specified Period' here means 'Monitoring Period' which is the period from the date of implementation of RP up to the date by which at least 10 per cent of the sum of outstanding principal debt as per the RP and interest capitalisation sanctioned as part of the restructuring, if any, is repaid.

Satisfactory performance means that the borrower entity is not in default at any point of time during the period concerned.

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.

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. 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.

In the following instances, the RBI has permitted restructuring of borrower account with benefit of retention of class –

(i) Project Loans

Project loan means any term loan which has been extended for the purpose of setting up of an economic venture. The bank needs to clearly spell out 'Date of Commencement of Commercial Operations' (DCCO) 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. There are two types of Project Loan, viz., (a) Infrastructure Sector; and

(b) Non-Infrastructure Sector Project Loans

In case of project loans, an account will be required to be marked as NPA if it fails to achieve DCCO (Date of Commencement of Commercial Operations), i.e., if it fails to commence the commercial operations by DCCO as documented in sanction note. However, there are certain leverages provided for deferment of DCCO without downgrading which are as follows:

(a) The DCCO can be deferred without downgrading of the asset to the extent of period as specified in the following chart, wherein such deferral would not be construed as 'restructuring':

Particulars	Infrastructure	Non-Infrastructure
Revised DCCO is within	Two years from original DCCO	One years from original DCCO
Revision of DCCO due to Court Case	Additional two years from original DCCO	Additional one year from original DCCO
Revision of DCCO due to any other reason(s) which are beyond the control of the promoters	Additional one year from original DCCO	

The banks are permitted to defer the repayment schedule to the extent of the time frame as specified in the above chart, the account will not be considered as restructured and the account will be able to retain the class of asset. However, if deferent and consequential shift in repayment schedule is for more than the duration specified above, the same would be considered as restructuring and accordingly the account would be required to be downgraded.

(b) 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 above, banks may permit extension of the DCCO of the project up to two years in addition to the period specified in the above table, without any change in asset classification of the account subject to the extant conditions stipulated.

(c) In case, if change in repayment schedule is caused due to increase in project outlay on account of increase in scope and size of the project & following conditions are fulfilled:

1. The increase in scope and size of the project takes place before commencement of commercial operations of the existing project;
2. The rise in cost excluding any cost- overrun in respect of the original project is 25% or more of the original outlay;
3. The bank re-assesses the viability of the project before approving the enhancement of scope and fixing a fresh DCCO;
4. On re-rating, (if already rated) the new rating is not below the previous rating by more than one notch.

(d) An additional provision of 5% is required to be maintained on Standard Project loans from the date of such restructuring till the revised DCCO or 2 years from the date of restructuring, whichever is later, w.r.t.:

1. If the DCCO is extended 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;
2. If the DCCO is extended beyond one years and upto two years from the original DCCO, for non-infrastructure projects (including real estate projects)

(e) It is pertinent to note that if there is a moratorium for payment of interest granted, income should not be booked 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.

(f) In case of financing of Cost Overruns for Projects under Implementation, the banks may 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 or alternatively, the banks can 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 fulfilment of extant conditions specified in RBI Master Circular.

(g) In case if a project loan is classified as NPA due to non-achievement of DCCO, the said account would be eligible for upgradation on achievement of commencement of commercial operations. 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 extant conditions specified in the Master Circular.

(ii) MSME Relief

The RBI has issued a circular dated May 05, 2021 w.r.t. Resolution Framework 2.0 – Resolution of Covid-19 related stress of Micro, Small and Medium Enterprises (MSMEs) granting relief for MSME Borrowers. The said circular was issued in continuation of circular dated August 06, 2020, whereby facility for restructuring existing loans without a downgrade in the asset classification subject to the following conditions:

1. 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.
2. 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 as on March 31, 2021.
3. The aggregate exposure, including non-fund based facilities, of all lending institutions to the borrower does not exceed ₹ 25 crore as on March 31, 2021.
4. The borrower's account was a 'standard asset' as on March 31, 2021.
5. The borrower's account was not restructured in terms of the MSME restructuring circulars issued earlier (dated August 06, 2020, February 11, 2020 and January 01, 2019)

6. 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 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.

7. The restructuring of the borrower account is implemented within 90 days from the date of invocation. The necessary changes are made in the CBS such as changes in the repayment cycle, revision in the rate of interest etc.

8. 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.

9. Upon implementation of the restructuring plan, the lending institutions shall keep provision of 10 percent of the residual debt of the borrower.

10. All other instructions specified in the circular DOR.No.BP.BC/4/21.04.048/2020-21 dated August 6, 2020 shall remain applicable.

In respect of restructuring plans implemented as per conditions stipulated 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.

In respect of accounts of borrowers which were restructured in terms of the MSME restructuring circulars, banks 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 auditor should check, post this date such cases are treated as restructing. The reassessed sanctioned limit / drawing power shall be subject to review by the bank 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.

These measures shall be contingent on the bank satisfying themselves that the same is necessitated on account of the economic fallout from Covid-19.

(iii) Covid 19 Relief Measure

RBI issued circular RBI/2021-22/31 DOR.STR. REC.11/21.04.048/2021-22 dated May 5, 2021 on Resolution Framework – 2.0: Resolution of Covid-19 related stress of Individuals and Small Businesses, whereby banks were permitted to offer a limited window to eligible individual borrowers and small businesses to implement resolution plans in respect of their credit exposures while classifying the same as Standard upon implementation of the resolution plan subject to stipulated conditions. These relief measures were broadly in line with the contours of the Resolution Framework - 1.0, with stipulated modifications.

The credit facilities / investment exposure to the borrower is required to be classified as Standard by the lending institution as on March 31, 2021 for availing benefit under this circular.

It is to be noted that the borrower accounts / credit facilities shall not belong to the categories listed in sub-clauses (a) to (e) of the Clause 2 of the Annex to the Resolution Framework 1.0, read with the response to Sl. No. 2 of FAQs on Resolution Framework for Covid-19 related stress (Revised on December 12, 2020).

Any resolution plan implemented in breach of the stipulations of this circular shall be fully governed by the Prudential Framework for Resolution of Stressed Assets.

The resolution process under this window shall be treated as invoked when the lending institution and the borrower agree to proceed with the efforts towards finalising a resolution plan to be implemented in respect of such borrower.

On receipt of applications from borrowers for invoking resolution process under this window, the assessment of eligibility for resolution as per the instructions contained in this circular and the Board approved policy of the bank, is required to be completed, and the decision on the application shall be communicated in writing to the borrower within 30 days of receipt of such applications.

In case of consortium / multiple banking, the decision to invoke the resolution process under this window 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.

The last date for invocation of resolution permitted under this window is September 30, 2021.

The para 11 to 13 of the circular stipulates features of resolution plans and implementation permitted, with specific non-inclusion of compromise settlement and extension of moratorium period beyond two years as part of resolution plan. The moratorium period, if granted, may be for a maximum of two years, and shall come into force immediately upon implementation of the resolution plan. The extension of the residual tenor of the loan facilities may also be granted to borrowers, with or without payment moratorium. The overall cap on extension of residual tenor, inclusive of moratorium period if any permitted, shall be two years.

The resolution plan should be finalised and implemented within 90 days from the date of invocation of the resolution process under this window. The resolution plan shall be deemed to be implemented only if all the conditions in Paragraph 10 of the Annex to the Resolution Framework – 1.0 are met.

If a resolution plan is implemented in adherence to the provisions of the circular, the asset classification of borrowers' accounts classified as Standard may be retained as such upon implementation, whereas the borrowers' accounts which may have slipped into NPA between invocation and implementation may be upgraded as Standard, as on the date of implementation of the resolution plan.

The borrower accounts should not have availed of any resolution in terms of the Resolution Framework – 1.0 except to the extent where the resolution plans had permitted no moratoria or moratoria of less than two years and / or extension of residual tenor by a period of less than two years, banks are permitted to use this window to modify such plans only to the extent of increasing the period of moratorium / extension of residual tenor subject to the caps as specified above, and the consequent changes necessary in the terms of the loan for implementing such extension.

(iv) Agricultural advances

In case of Agricultural Advances, if a borrower is affected by natural calamity, a bank can restructure the said advances in terms of Master Direction – RBI (Relief Measures by Banks in Areas affected by natural calamities) Directions, 2018 dated October 17, 2018, whereby the accounts are not required to be downgraded subsequent to restructuring provided are in compliant with the stipulated conditions.

In case of Short Term Agricultural Advances, if the loan is not overdue at the time of occurrence of natural calamity, if the crop loss in between 33% to 50%, the maximum repayment period extension can be given upto 2 years and if the crop loss is 50% or more, the maximum repayment period extension can be given upto 5 years. The said period of extension is inclusive of moratorium period which is required to be of minimum period of one year. The bank can convert Principal and interest due in the year of natural calamity into Term Loan.

In case of Long Term Agricultural Advances, if (a) only Crop for that year is damaged and the productive assets are not damaged, reschedule instalment during the year of natural calamity and extension of loan period by one year is permitted and the payment of interest may be postponed and (b) productive assets are damaged, partially or totally, the repayment period can be restructured provided generally it shouldn't exceed 5 years.

It is to be noted that upon restructuring, (a) Restructured portion to be considered as current dues; (b) Un-restructured portion to be governed by original terms and conditions; (c) Additional finance to be treated as 'Standard Asset'; (d) Second restructuring would not considered as 'repeated restructuring' and (e) Insurance Proceeds received in relation thereto should be adjusted against restructured loans wherein fresh loans are granted.

Important points to be checked by Auditor while auditor cases of restructuring done by the Bank Branches:

1. Restructuring should have been carried out for genuine reasons and not for ever-greening the account.
2. Should be carried out on the basis of the request of the borrower and not SUO MOTO by the branch.
3. Check the note on proposal put up by the Branch based on the request of the borrower.
4. Viability of the proposal is established properly through TEV Study Report and Cash Flows/ Business Plans which should be realistic and not very optimistic.
5. Valuation of the securities has been carried out by registered valuer.
6. The restructuring has been implemented in the CBS by carving out the additional limits like WCTL, FITL etc.
7. The master of the borrower in the CBS has been updated accordingly and on proper dates. There should not be any back dating of the entries.
8. The proposal has been dealt with as per the laid down policy of the Bank which is as per the RBI guidelines.
9. The necessary waivers and restructured limits have been duly approved by the appropriate Bank officials as per the delegation of powers.
10. In case of COVID related restructuring, ascertain whether actually, the borrower's business suffered due to the pandemic.

    Also as certain that no ------ done under the Covid Relief Ciculats after prescribed cut-off ----
11. To check whether the interest components on the TL, CC, WCTL have been transferred to FITL on the specified dates. Check the interest debited on 31.3.23.
12. FITL is provided 100% being notional income hence the transfer has to be checked properly.
13. Usually, the interest on FITL is to be serviced by the borrower and hence many a times the branch fails to recover that amount from the borrower and the account even after proper restructuring has to be classified as NPA.
14. Confirm that the upfront amount has been infused by the borrower and CA certificate is obtained to that extent.
15. If the restructuring fails, then the account needs to be downgraded back dated considering the restructuring to be void and accordingly the classification and provisioning needs to be ensured.
16. Compliance of the specific terms and conditions in the sanction letter.

Note : Verification of restructured advance is a very vast subject and only important aspects are selectively covered in this article. It is therefore suggested that reader should refer "Guidance Note on Audit of Banks" issued by the Institute of Chartered Accountants of India along with the relevant RBI Master Circulars, Master Directions and RBI Circulars in this regard. As regards the applicability of Prudential Framework for Resolution of Stressed Assets, kindly refer to para 9 of RBI Master Circular dated April 1, 2022 which is applicable to borrowers with aggregate exposures to lenders more than ₹ 1,500 crores.

■■■

FAQs On Priority Sector & Msme For Bank Audit

CA. Arvind Nagda

- **What is the different between MSME Manufacturing & services?**

➢ Units engaged in Manufacturing are called MSME Manufacturing. They are classified as Micro, Small & Medium Enterprises based on investment in plant & machinery and turnover.

Units engaged in Service are called MSME Service Industry. They are classified as Micro, Small & Medium Enterprises based on investment in Equipments.

- What is the Crietria of bifurcation of Micro, small and medium Enterprises?

The recent changes in the definition of micro, small, and medium-sized enterprises (MSME) made as a part of the Atmanirbhar Bharat Abhiyaan relief package and now the investment and turnover figures were changed to larger values as indicated below. MSMEs are defined based on the criteria of investment in plant and machinery and turnover.

Composite Criteria: Investment in Plant / Machinery			
Sl. No	**Type of Enterprises**	**Investment in Plant and Machinery or Equipment**	**Turnover**
1	Micro enterprises	Less than Rs.1 Crore	Less than Rs.5 Crore
2	Small enterprises	Less than Rs.10 Crore	Less than Rs.50 Crore
3	Medium enterprises	Less than Rs.50 Crore	Less than Rs.250 Crore

- **Whether Udyog Aadhar is required to take MSME advantage?**

➢ Yes

- **What is the margin, Rate of Interest, Processing Fee & Security Norms for MSME?**

➢ Varies from Bank to Bank

- **In case of a Partnership firm, if majority of the partners belong to one or the other of the specified minority communities, whether advances granted to such partnership firms can be treated as advances granted to minority communities. Further, in case of Private / Public Ltd. Company, if any of the borrowers belong to Minority Community, can the loan be classified under weaker section category?**

➢ As per extant guidelines, priority sector loans are eligible for classification as loans to minority communities as per the list notified by the Government of India from time to time. "In the case of a partnership firm, if the majority of the partners belong to one or the other of the specified minority communities, advances granted to such partnership firms may be treated as advances granted to minority communities. Further, if the majority beneficial ownership in a partnership firm belongs to the minority community, then such lending can be classified as advances to the specified communities. A company has a separate legal entity and hence advances granted to it cannot be classified as advances to the specified minority communities."

- **Can banks rely on customer's declaration for Minority / SC / ST category to be included under Weaker section?**

➢ It is not mandatory for banks to obtain documentary evidence for classifying credit facilities to Minorities and SCs/STs under weaker section. Therefore, declaration by the customer in the application form would suffice.

- **Whether retail and wholesale trade can be classified under MSME?**
- ➢ The Ministry of Micro, Small and Medium Enterprises has allowed Udyam registration for retail and wholesale trade.

- **Is there any provision for grant of composite loans by banks?**
- ➢ A composite loan limit of ₹1 crore can be sanctioned by banks to enable the MSME entrepreneurs to avail of their working capital and term loan requirement through Single Window. All scheduled commercial banks were advised that the banks which have sanctioned term loan singly or jointly must also sanction working capital (WC) limit singly (or jointly, in the ratio of term loan) to avoid delay in commencement of commercial production thereby ensuring that there are no cases where term loan has been sanctioned and working capital facilities are yet to be sanctioned.

- **What are the RBI guidelines on interest rates for loans disbursed by the commercial banks?**
- ➢ As part of the financial sector liberalisation, all credit related matters of banks including charging of interest have been deregulated by RBI and are governed by the banks' own lending policies.

- **Is credit rating mandatory for the MSE borrowers?**
- ➢ The credit rating by external rating agencies is not compulsory from regulatory capital perspective, if the maximum aggregate exposure to one counterparty does not exceed the threshold limit of ₹7.5 crore, subject to meeting certain other conditions.

- **Whether KYC compliance is mandatory for availing loans under MSME?**
- ➢ Yes

- **What are all the documents to be submitted for availing loans under MSME?**
- ➢ As required for other loans.

- **What is the method of assessing working capital requirement for MSME unit?**
- ➢ For units requiring working capital limits up to ₹ 5 crore, requirement is assessed as 25% of the projected turnover for the next year and the working capital limit shall be 20% of the projected turnover. The balance shall be brought by promoters as their contribution by way of equity / loans. For limits above ₹ 5 crore, the working capital requirement is assessed under Maximum Permissible Bank Finance Method. It may also vary from bank to bank.

- **Are there any targets prescribed for lending by banks to MSMEs?**
- ➢ As per extant policy, certain targets have been prescribed for banks for lending to the Micro and Small enterprise (MSE) sector. In terms of the recommendations of the Prime Minister's Task Force on MSMEs banks have been advised to achieve a 20 per cent year-onyear growth in credit to micro and small enterprises, a 10 per cent annual growth in the number of micro enterprise accounts and 60% of total lending to MSE sector as on preceding March 31st to Micro enterprises.

- **How do you define MSEs owned by SC I ST enterprises?**
- ➢ Definition of MSEs owned by SCI ST, as per clarification dated 25.6.2013 by Ministry of MSME under the provision of para 16 of Public Procurement Policy for Micro and Small Enterprises (MSEs) Order, 2012, is as given under: (a) In case of proprietary MSE, proprietor(s) shall be SC /ST. (b) In case of partnership MSE, the SCI ST partners shall be holding at least 51% shares in the unit. (c) In case of Private Limited Companies, at least 51% share shall be held by SC/ ST promoters.

- **What were the salient features of the CLCSS?**
- ➢ Under the scheme, 15 per cent capital subsidy, limited to maximum of Rs 15 lakh is provided to the Micro and Small Enterprises for upgrading their technology with the well-established and improved technology as approved under the scheme.

- **How many products/sub-sectors have been approved under the CLCSS?**
- ➢ 51 products / sub-sectors have been approved under the CLCSS till date. List is available in the Scheme guidelines at www.dcmsme.gov.in.

- **Whether individual MSEs can directly apply for subsidy?**
- ➢ No, this scheme is applicable to those units who have availed term loan from banks to acquire

upgraded technology/machines. Units cannot apply directly online but banks will forward the application to Office of Development Commissioner (MSME).

- **What is the mechanism for disbursement of subsidy to the unit?**

➢ Subsidy is to be kept in the form of Term Deposit Receipt (TOR) for 3 years by bank after release by Office of DC (MSME) in the concerned unit account and interest amount on the term loan should be reduced accordingly. The beneficiary unit shall remain in commercial production for a period of at least three years after installation of eligible plant & machinery on which subsidy under CLCSS has been availed. If the unit fulfils the condition, the TOR will be transferred to unit's account after three years.

- **Who can apply for assistance under CGTSME scheme?**

➢ Any MSME registered unit in Manufacturing or Service sector can apply for assistance under this scheme.

- **Whether borrowers from all service sector enterprises are eligible under the CGTSME Scheme?**

➢ As of now, all activities that come under service sector as per MSMED Act, 2006 except retail trade are eligible for coverage under the scheme.

- **Which type of borrowers can be covered under the CGTSME Scheme?**

➢ New and existing Micro and Small Enterprises engaged in manufacturing or service activity excluding Retail Trade, Educational Institutions, Agriculture, Self Help Groups (SHGs), Training Institutions etc.

- **What is quantum of credit facility that can be covered under the CGTSME Scheme?**

➢ Fund and non-fund based (Letters of Credit, Bank Guarantee etc.) credit facilities up to ₹ 200 lakh per eligible borrower are covered under the guarantee scheme provided they are extended purely on the project viability without collateral security or third party guarantee.

- **Is it possible to cover credit facilities, which have already become NPA?**

➢ No, the credit facility that has already become NPA cannot be covered under the CGTSME Scheme.

- **Can a credit facility extended to a borrower against a collateral security be covered under the Guarantee Scheme, if the lending institution relinquishes its rights on the collateral security?**

➢ Yes, provided the lending institution relinquishes its rights on the collateral assets and releases the same in favour of the borrower before seeking guarantee cover and subject to fulfilment of the other norms of the Scheme. Further, in case the MLIs has to retain the collateral security for the existing credit facility, a new credit facility extended to same borrower, without taking collateral can be covered under the scheme provided, the MLI is not extending the charge on the existing collateral to new facility.

- **How long the guarantee cover is available for credit facilities extended to a particular borrower?**

➢ Guarantee will commence from guarantee start date and shall run through the agreed tenure of the term loan / composite loans. Where working capital facilities alone are extended to eligible borrowers, it would be for a period of 5 years or block of 5 years on renewal of the guarantee cover, provided MLI pays the Annual Service Fee due as on March 31, latest by within 60 days from the date of demand by CGTMSE.

- **What is MUDRA Loan?**

➢ Announced be the Hon'ble Finance Minister during Union Budget for FY 2016, MUDRA, which stands for Micro Units Development & Refinance Agency Ltd., is a new institution being set up by Government of India for development and refinancing activities relating to micro units.

- **Who are the target clients of MUDRA/ What kind of borrowers are eligible for assistance from MUDRA??**

➢ Non –Corporate Small Business Segment (NCSBS) comprising of millions of proprietorship/ partnership firms running as small manufacturing units, service sector units, shopkeepers, fruits/ vegetable vendors, truck operators, food-service units, repair shops, machine operators, small industries, artisans, food processors and others, in rural and urban areas.

- **What are the offerings of MUDRA? How will MUDRA function?**

➢ Under the aegis of Pradhan Mantri MUDRA Yojana, MUDRA has already created its initial products /

schemes. The names of the schemes i.e 'Shishu', 'Kishor' and 'Tarun', signies the stage of growth / development and funding needs of the beneficiary micro unit / entrepreneur and also provide a reference point for the next phase of graduation / growth to look forward to :

Sr No	Scheme	Advance Amount
i	Shishu	Upto Rs 50,000/-
ii	Kishor	Rs 50,001/- to Rs 5,00,000/-
iii	Tarun	Rs 5,00,001/- to Rs 10,00,000/-

- **What is Guaranteed Emergency Credit Line (GECL)?**

➢ The GECL is a loan for which 100% guarantee would be provided by National Credit Guarantee Trustee Company (NCGTC) to Member Lending Institutions (MLIs), and which will be extended in the form of additional working capital term loan facility and non-fund based facility in case of Scheduled Commercial Banks (SCBs) and Financial Institutions (FIs), and additional term loan facility in case of Non-Banking Financial Companies (NBFCs), to eligible MSMEs/ Business Enterprises.

- **What is the objective of GECL Scheme?**

➢ The Scheme is a specific response to the unprecedented situation arising out of COVID-19, providing relief to the MSMEs/businesses by incentivizing MLIs to provide additional credit of up to ₹ 5 lakh crore at low cost for enabling MSMEs/businesses to meet their operational liabilities and restart their businesses

- **What is the duration of GECL Scheme?**

➢ The Scheme would be applicable to all loans sanctioned under GECL during the period from May 23, 2020 to March 31, 2023, or till guarantees for an amount of ₹ 5 lakh crore are issued by NCGTC, whichever is earlier.

- **Will GECL be extended as a separate loan account, or as part of the existing loan account of the borrower?**

➢ A separate loan account shall be opened for the borrower for extending additional credit under GECL. This account will be distinct from the existing loan account(s) of the borrower.

- **Will the interest rate on GECL be capped?**

➢ Yes, interest rates on GECL shall be capped as under:

➢ For Banks and FIs, one of the RBI prescribed external benchmark linked rates (for MSMEs) and Marginal Cost based Lending Rate (for non-MSMEs) +1% subject to a maximum of 9.25% per annum

➢ For NBFCs, the interest rate on GECL shall not exceed 14% per annum

➢ For loans to hospitals/nursing homes/clinics/ medical colleges/units engaged in manufacturing of liquid oxygen, oxygen cylinders etc. For setting up on-site oxygen generation plants, rate of interest shall be capped at 7.5% p.a.

The Scheme may also be operated in combination with applicable interest subvention schemes, as far as feasible.

- **Is there any moratorium period prescribed under GECL Scheme? What is the repayment period under this scheme**

➢ The moratorium and repayment period under the scheme are as follows:

Type of facility	Moratorium period on principal repayment	Total repayment period including moratorium
GECL 1.0 (without restructuring)	1 year	4 years
GECL 1.0 (Extension)	2 years	5 years
GECL 2.0	1 year	5 years
GECL 2.0 (Extension)	2 years	6 years
GECL 3.0 & 3.0 (Extension)	2 years	6 years
GECL 4.0	6 months	5 years

- Is there any additional collateral required for the GECL facility?

➢ No additional collateral shall be asked by MLIs for additional credit extended under GECL.

- What will be the security on credit extended under GECL Scheme?

➢ The credit under GECL will have paripasu charge on the existing securities of the borrower.

■■■

Long Form Audit Report in Case of Bank Branches

CA. Abhijit Sanzgiri

Reserve Bank of India had originally introduced a system of LFAR submission by Branch Bank Auditors in 1985, which was subsequently revised in 1993, 2003 and 2020. Branches LFAR are consolidated at the Head Office and comments made by Branch Auditors are brought to the notice of the Management for deficiencies in internal control and transactional failures

The overall objective of the Long Form Audit Report (LFAR) is to provide observations that identify and assess gaps and vulnerable areas in business operations, risk management, compliance, efficacy of internal and concurrent audit and provide an independent opinion on the same to the Board of the bank.

LFAR serves as vital tool for auditors and their team members for conducting the Branch Audit. Auditors have to offer comments/ feedback on the questionnaires enumerated on the Profit & Loss Account, Balance sheet, Advances and all other matters. LFAR also has questions for specialized branches such as Forex Branches, Service Branches and Branches dealing in recovery of Non-Performing Assets such as Assets Recovery Branch.

Reserve Bank of India has prescribed two formats for LFAR viz. LFAR for Bank as a whole and LFAR for branches of the Bank. The branch auditors are expected to submit the LFAR in the format prescribed for the branches of the bank. The Central Statutory Auditor is expected to review the LFARs submitted by the branch auditors and prepare his LFAR in the format prescribed for the bank as a whole. Therefore, it is necessary for the branch auditors to provide the LFAR carefully with a clarity so that relevant issues if any, at the branch are duly bought to the attention of the Central Statutory Auditors.

Branch Auditors should go through LFAR well in advance and study the same thoroughly LFAR is in a questionnaire from which the auditors have to reply and replies should be specific. Auditor should refrain from giving vague and general replies like 'Yes/ No', 'Not Applicable', 'Nil' etc and therefore auditor should give specific comments as expected in the questionnaire. The detailed check List based on questions can be prepared and this will help as ready tool for verification of the each area of audit. In whole exercise of LFAR audit, Documentation plays very vital role and branch auditors must collect all relevant and important documents as working papers to support the views expressed in the report. It should be noted that specific disclosure, such as, extent of checking, manner of sample selection, limitations of documents verified, representations received, etc., should be made in the LFAR. The reliance placed on the computer system, which the auditor has not tested in depth for its reliability, should be clearly brought out in the LFAR. The auditor should also seek written representation from management on matters as he deems appropriate in preparation of LFAR, the auditor should examine and review the previous reports to ascertain whether in respect of the accounts for the year under audit, there are any comments of a material nature in which remedial action was warranted.

In deciding whether a qualification in the Main Audit Report is necessary, the auditors should use their judgement based on the available evidences / facts and circumstances of each case. Many time auditors are giving cross references in LFAR/ of LFAR in other report, that needs to be avoided. Main Auditor's Report is self-contained document. Same way matters of Main Statutory Auditor's Report should not be reported in LFAR. The scope and coverage of LFAR will broadly be as per the given format given below. However, if the Branch Auditors feels a need of some material additions, etc. in the scope, this may be done by giving specific justification.

It is to be noted that the branch auditor is physically present in the branch for only a few days of the current year as the appointment is generally done in the last week of March. Hence replies to most of the questions will be done based on his reviews done in the next year post March and also based on representations obtained from the Branch Management and Concurrent audit reports / Previous year LFAR comments. This has to be specifically brought out at the start of the LFAR.

Indicative Format / Coverage in the Long Form Audit Report (LFAR) by the Statutory Branch Auditors (SCB)

To read scan QR Code

Conclusion:

The LFAR exercise should be completed simultaneously along with audit with adherence to Standards of Auditing especially on Documentation. SQC-1 guidelines to be adhered. Audit Team should bifurcate the question- based area being audited by each team member. Answers to be specific to the questions asked stating extent and depth of coverage. When irregularities are reported, the same should be reported with sufficient details. Once the report is ready same shall be discussed with the Branch Head.

Management Representation letter as mandated by SA 580 must be obtained. It is to be noted that the LFAR covers the entire year while the verification is done only for few days while the comments on process followed and gaps therein is for the year. Hence obtaining MRL is key.

Discussion with Concurrent Auditors if the branch has such a system and with the previous statutory auditors is must. Clarifications or guidance if needed could be obtained from the Central statutory auditors.

Since the audit is a time bound exercise, details needed for compilation of LFAR should be given from DAY1. Daily follow up of pending date to be done. Escalations to Regional Office for non-receipt or delayed receipt of data to be immediately done.

Necessary disclaimers or qualifications to be done if material information and explanations as required for conduct of audit are not obtained. In no case should the auditor succumb to time and other pressures to report incorrectly.

Checklist for verification of advances & reporting in LFAR

In respect of common irregularities, the Auditors can give their comments borrower–wise in the LFAR in the format given hereunder:

Name of Borrower	Name of Branch	Region	IRAC Status	Sanctioning Authority	Facility	Limit	Amount o/s. as at the year end	Irregularity No.
1	2	3	4	5	6	7	8	9

Audit in CBS Environment

CA. Diti Shah & CA. Kuntal P. Shah

Technology has played a pivotal role in speeding up globalization, while globalization itself has been a constant driving force for the newer technologies to surface. To meet the needs the advancement of technology and increase complexities in business, banks have to upgrade to provide smooth and easy banking experience with assurance of safety. Need for anywhere banking, real time updation of data, user friendly interfaces, seemless experience have emerged the requirement updation. Core banking solution is the outcome of these requirements.

CBS stands for CORE Banking Solutions. It is a Centralized Online Real-time Exchange. An advanced IT infrastructure links together every branch of the individual banks. Branch banking is no longer practiced. It's banking at a bank. The customer is not required to just conduct business with branches. The customer's account is accessible from any branch; it does not need the branch where they are currently having their bank account. In other words, access is not restricted to any specific branch but rather the entire bank. CBS has to great extent removed geographical limitations and now banking is possible from anywhere and anytime.

Core Banking Solution (CBS) refers to a common IT solution wherein a central shared database supports the entire banking application. The characteristics of CBS are:

- There is a common database in a central server located at a Data Center, which gives a consolidated view of the bank's operations.
- Branches function as delivery channels providing services to its customers.
- CBS is centralized Banking Application software that has several components which have been designed to meet the demands of the banking industry.
- CBS is supported by advanced technology infrastructure and has high standards of business functionality.
- Core Banking Solution brings significant benefits such as a customer is a customer of the bank and not only of the branch.
- CBS is modular in structure and is capable of being implemented in stages as per requirements of the bank.
- CBS software also enables integration of all third-party applications, including in-house banking software, to facilitate simple and complex business processes.

CBS has been a disguised gift for the banking industry. Transactions are now completed more quickly, and the bank's internal tasks have been made simpler without manual intervention.

Few CBS used in India are:

Package	Provider
Finacle	Infosys
Flexcube	Oracle Financial Services.
TCS BaNCS	Tata Consultancy services (TCS)

"Technology is useful servant but a dangerous Master"

With the advancement of technology has emerged the threat misuse of technology to the disinterest of the society. Recently, we have come acrossed various scams in the banking sector. This has raised the need for auditors to be more cautious during the audit. Auditors first need to understand the CBS System. There are following common myths about CBS:

- Since CBS is computerized system, it is full-proof and has in built controls
- Data given by the branch are all the data that can be made available and auditors have

to rely on that. Since it is centralized system, data are only processed at center and no one has access to it

- Staff/ operators have full knowledge of operations and that all the processes are executed as per SOP
- NPAs are system generated.

Further, we are made to believe that CBS is a robust system and all transactions are captured and processed seamlessly. All calculations are automated and are correct. Statements are generated from CBS without any manual intervention. This cannot be denied completely. One needs to understand that all the processes can give desired results only when the data fed in i.e Input data is correct. Hence, as an auditor in the CBS environment, the approach needs to be changed. Traditional practice of audit had to be widened. Uses of technology and audit tools has become essential. Auditor's role can be broadly divided into following:

1. Software related checks.
2. Review of Controls.
3. Checking manual documents which is the basis for input into the system

Overview of Various CBS and Basic Concepts

Introduction to FINACLE

A Financial Package, for Banking Solution developed by Infosys on the platform of Oracle, is thus named as FINACLE. Presently, many Indian Public Sector Banks, Private Sector Banks and Foreign Banks operating in India are using this software as banking solution due to high flexibility and scalability. Finacle is an integrated, on-line, enterprise banking system designed to provide the "e-platform".

Prior to 1995 it was known as BANC 2000, a Total Branch Automation package with a distributed network. After 1995 Infosys developed the same as FINACLE, a Core Banking Solution.

Functionalities

- Finacle facilitates anywhere banking
- It is menu driven software with easy navigation.
- It is functionality rich and addresses the retail and corporate banking requirements.
- Customization and parameterization are two special features of Finacle.
- Finacle provides multi-lingual support
- Finacle provides multi-level security i.e. operation, database and application level security
- It supports workflow based Transaction Processing.
- It has High level of security control and audit capabilities
- It has a common transaction interface for all type of transactions.
- It provides a browser based GUI interface to Finacle
- SQL & PL SQL is used for generation of MIS, Reports, Queries at Centralized Level.
- Designed for optimum Usage Of Network Bandwidth
- There are two Functional Modules -
  a. Retail and Corporate Module - Encompassing Saving Accounts, Current Accounts, Term Deposits, Cash Credit Accounts, Overdraft Accounts, Term Loans, Demand Loans.
  b. Trade Finance Module - Encompassing Inland & Foreign Bills, Forward Contracts, Inland & Foreign Documentary Credits, Inland & Foreign Bank Guarantees, Inland & Foreign Remittances and Pre-shipment Credits.

Finacle Overview

Finacle User Menu	
Menu Block	**Favorites !**
Main Menu -> Sub Menu -> Menu Description [Menu Code]	User Defined Favorites

MESSAGE AREA								(A)
Menu Option	(B)	Btn. 1	Btn. 2	Btn. 3	Btn. 4	Btn. 5	Btn. 6	Btn. 7
		Action Bar						

A = Progress Indicator

B = Field to Specify Menu Option

- *Menu Block:* The block houses all the menu and sub-menu options available in Finacle.
- *Menu Option Block:* Menu Code to be entered to gain access to the respective menu.
- *Action Bar:* User can execute the process of Finacle Operations by clicking on various options on this bar. The Hot-Keys are also assigned for all options, which appear on the bar.
- *Action Buttons:* Every action button has a specific purpose. E.g. On clicking WhoAmI button, system will display user_id of the user who is currently logged in & other information viz. date, name of SOL in a message box.
- *Message Bar:* The message bar displays warnings, exceptions, errors or Lists under a specific field code.
- *Favorites:* Menu items which are required and used on Regular basis can be put in favorites by copying from Menu Block. As a onetime process Specific Menu Item which is required to be copied to Favorites should be located in Menu Block and with the use of Drag and Drop the function can be stored under Favorites menu.

Progress Indicator: It shows the progress of the action initiated through the use of Colours (i.e. **Green** indicates that the System is "Ready" for processing, **Red** indicates that the "System is busy in Processing Activity and **Yellow** indicates that browser is performing internal processing like assembling / painting screen as per requirement. User should not operate the system)

Introduction to TCS BaNCS

A Financial Package, for Banking Solution offered by Tata Consulting Services. The Core Banking solution TCS BaNCS is an integrated solution that automates all aspects of core banking operations across entities, languages and currencies. BaNCS is built on open architecture, component-based product suite to leverage service-oriented and event-driven architectures.

Functionalities

- Entire range of banking products including savings, checking, overdraft and deposit accounts
- Entire range of lending products
- Complement of transactional services including remittance, foreign exchange, cards and trade finance
- Accessibility through multiple channels, including mobile banking and web.
- Full integration of front-, middle-, and back-office processes
- Accurate, timely and actionable information about customer relations
- Single view between bank and customer
- "Anytime anywhere" banking.

Introduction to Oracle FlexCube

FlexCube provides a comprehensive, integrated, interoperable, and modular solution that enables banks to manage evolving customer expectations.

Functionalities

- 24/7 processing of large transaction volumes, with high availability
- Multiple delivery channel support
- Security management covering application and role-based access
- Service-oriented architecture supports agile business process management
- Componentized architecture helps build scalable and reusable solutions

Quick access screens through Hot Keys in Flexcube

Hot Keys	Screen Name	Description
Alt + B	Balance Inquiry	This screen displays the account details of the savings and checking account balances such as the available balance, nucleated balance, current book balance, passbook balance, net balance, etc.
Alt + C	Customer Name And Address Inquiry	This screen displays the details such as the name, address, city, country, SSN/ TIN number, etc of the selected customer

Hot Keys	Screen Name	Description
Alt + A	Account Details	This screen displays the account details of the customer such as account number, account branch, account currency, customer name, etc.
Alt + S	Amount based Account Image Display	This screen displays the images on the basis of the details maintained in the Amount Based Operating Instruction Maintenance (Fast Path: 7116) option
Alt + P		This will enable the user to print the receipt of the transaction.
F8		This will enable the user to return to the same screen.

Auditing through Core Banking System

- Auditors Access to the System:

  Insist on having the Auditors Login for the CBS on the commencement of audit.

- Understanding the Core Banking Software.

  The Auditor should seek basic understanding of the software. How data is entered, how are the masters created and what all data need to be furnished manually. User manually can be used for reference.

- Document list of Softwares, Applications and interface details associated with CBS There are various add on back office softwares for NPA, Loan Processing etc that are used in the bank. Auditor need to understand how those softwares are connected to CBS.
- Document list of reports available in CBS & its menu codes eg. CC review renewal pending, NPA classification, Exception Reports etc.
- Review Internal Controls in CBS and review risk assessment reports
- Review transaction flow & Audit trail
- Sample test can be done for ensuring the transaction flow.

  Substantive procedures in and around CBS can be carried out.

- Apply Exception approach.
- Determine Sample Size based on review.
- Documentation of Audit procedures.
- Prepare report on audit findings and prepare final report.

List of preliminary Reports required by the auditor at the commencement of audit (below mentioned are illustrative list):

1. Initial Reports for comparision and analysis:
   - Opening and closing Trial Balance
   - Balance Sheet as on 31st March
   - Profit & Loss Statement for the period ending 31st March
2. Review of Other audit Reports to understand the current scenario and plan audit:
   - Concurrent Audit Reports for all months for the period
   - Previous year statutory Audit Report and LFAR
   - Audit Reports for any audit conducted during the year like revenue Audit, Internal Audit, System Audit etc
   - Closing Manual as on 31st March of the bank
3. Exception Report:
   - Reports for the month end and two days prior and after month end should be verified.
   - Exceptions of following natures should be closely verified.
   - Balance exceeded Account Limit
   - Manual debits to Income Account
   - Value Dated Transactions
   - Manual entry for SI Failure cases
   - Instrument passed against Clearing
4. Irregularity Report:
   - Reports for the month end and two days prior and after month end should be verified.
   - Report contains details of Accounts where Balance in Accounts are greater than the Limits Sanctioned. Check whether the same is due to,

- Application of Interest
- Granting of Intra Day TOD
- Passing of Instruments against Clearing Effects.

5. Accounts where Interest Code is '0':
   - Interest will not be charged from Accounts where Interest Code is selected as '0'. Hence, a detailed checking is required. Possible reasons can be,
   - Whether NPA Account
   - Accounts with Moratorium?

6. Report containing all Advance Accounts with Limits:
   - Generally, CBS Software generates a Report wherein details of all Advance Accounts are listed.
   - CC Renewal Pending Report
   - TOD Limit Sanction Report, TOD Interest, Adhoc TOD Limit Report
   - Excel can be used to verify cases of DP > SL, Margin Requirement etc.
   - Limits Reports with Bifurcation of Funded and Non Funded Limits
   - Balancing Report for Bills
   - Reports for Guarantee Expired , Guarantee Revoked
   - LC Expired Report
   - Collateral Report
   - Insurance Report
   - Lien Mark Report

7. Report on Probable NPA/Health Code Accounts / Special Mention Accounts:
   - Obtain reports containing list of Accounts with various deficiencies.
   - System identifies such accounts and a report on Probable NPA Account. Banks classify the accounts as Health Code Type 1, Health Code Type 2, SMA – 1, SMA - 2 etc.
   - These accounts should be closely monitored.
   - Conduct of the account should be checked and any manual intervention should be checked and verified.

8. Report on NPA Accounts:
   - Report will contain list of all NPA Accounts.
   - Such accounts should be closely monitored.
   - Verify whether account is correctly classified as per IRAC Norms?
   - Conduct of these accounts to be monitored.

9. List all Accounts Report
   - Complete List of Savings, Current, Advances Account opened and closed during the year
   - List of Dormant accounts activated during the year and conduct of the accounts

10. Interest Reports
    - Interest reports for all accounts
    - Interest Rate Report.

11. Reconciliation Reports
    - Reports for Unreconciled items (Inquire on Transaction), Audit BGL report, Outstanding Report

12. Office Stationery and Inventory Reports
    - Inventory Report
    - BGL Reports
    - BGL Ledger Report
    - Expense Ledger

Maker and Checker Matrix for Valid Transaction

Under CBS the transactions are processed by atleast two officials of the bank under Maker and Checker mode. The same is tracked through the transaction events (viz. entry, posting and verification). Posting is the event which updates the GL Balance. Posting activity depends on the rights assigned to each user ID.

Manual updation in CBS and its verification aspects

Under any CBS the transactions are processed as per predefined process. Majority of the processes in CBS are automated and based on masters. A manual intervention in automated process leads to error in transaction processing.

Following are few manual changes / modification in system which affects the transaction processing. The auditor must review the manual updation in CBS.

Manual Entry	Probable impact
Advances	
Interest Rate change	Revenue Leakage, Excess collection of Interest
Change in EMI	Revenue Leakage, NPA Identification
Processing of transactions against uncleared outward clearing effect	Recovery of amount from customer in case of cheque return
Backdated Renewal Date updation (Updating Date of Renewal on running date with past date)	NPA Identification
Change in Limit – From Non Fund Base to Fund Base	NPA Identification
Account & Customer Master	
Tax exemption updation	Noncompliance with TDS provisions
Dormant to Active	Susceptible to fraud
Interest Table Code as “0”	Revenue Leakage
Interest Collection Flag “N”	Revenue Leakage
Reclassification of Agriculture Advance as per revised RBI norms dt. April 23, 2015	Sectorial Classification
Foreign Exchange Transactions	
Erroneous Foreign Exchange Rate	Revenue Leakage, Accommodation to customer
Full BOE received flag marked as “Y” wherein BOE for	Reporting to RBI under BEF Return
entire transaction is not received	Duplicate issuance of FIRC without “Duplicate FIRC” inscription.
FIRC Issuance (without updating flag printed “Y”)	Reporting to RBI
Transaction Processing & Housekeeping	
Changes / Modification in Auto Calculated charge amount at the time of posting of transaction	Revenue Leakage
Ineligible Credits to NRE and FCRA Accounts	Non compliance of FEMA Guidelines
ATM Replenishment entries	Susceptible to Fraud
Payment for FD Closure proceeds in Cash through	
Office Accounts in excess of ` 20,000	Non compliance with Income Tax Guidelines
Revalidation of Old DDs	Susceptible to Fraud
Value Dating (Credit Transactions in CC / OD Account with Value Date without Value Dating at Debit Leg)	Revenue Leakage
Debit to Income Account (though Transaction Maintenance Menu)	Revenue Leakage
Manual Credit to Income Account (though Transaction Maintenance Menu)	Revenue Leakage (Computation of Income credited to be verified)
RTGS / NEFT in cash through office accounts > 49,999	Noncompliance with AML guidelines
Delay in posting of clearing cheque return	Accommodation to customer
Manual Transfer of Security Stationery from Inventory location to External Location	Susceptible to Fraud (Avoid reporting of missing inventory)

Guide on Audit Activity through CBS for LFAR and Tax Audit Requirements

To read scan QR Code

Following is the list of various important menu commands for concurrent auditors based on area of operations in the bank:

To read scan QR Code

Audit Report & Certificates & Audit of Profit & Loss Accounts

CA. Ramesh Shetty

A) Audit Reports & Certification

Audit of bank is like audit of any other entity, a unique aspect of it is that there are number of stakeholders and all of them depend on one independent entity -Statutory auditor. Besides the regular report, many specific reports and certificates needs to be authenticated by the Independent Auditors to comply with requirements of these stakeholders. Due to COVID and other developments in the banking sectors and the economy, proper monitoring by the bank is must. Various types of audit is an important mechanism to ensure proper monitoring over the functioning of the bank.

In additions to this, effective and quality audit assumes greater importance. While all these reports/certificates to the stakeholders are to be provided by the Central Statutory Auditors, they in turn rely on the Branch Statutory Auditors. Bank branch auditor is required to issue various reports/certificates as per respective Banks Closing Instructions keeping in view RBI Guidelines, Guidelines of the respective schemes notified by the Central/State Government, etc. Therefore, at the Branch level, a number of reports/certificates have to be issued, some of them are as follows:

Bank Branch Independent Audit Report:

- Audit Report format is as prescribed under the Banking Regulation Act, 1949.
- All Standards on Auditing (SA) for the conduct of the Audit and issue of the Audit Report are equally applicable to Bank Audit.
- Statutory Audit Report, LFAR, other reports & certificates are independent. Therefore, cross referencing for any comments or qualifications should not be done. These are standalone reports & therefore all critical issues must be addressed in the respective reports only.
- Auditor need to keep in mind the matters specified under the paragraph 'Auditors' Responsibility'. For deciding on audit procedures, he also needs to evaluate internal controls, appropriate accounting policies, accounting estimates & finally overall presentation of the financial statements. Auditor must also follow the Guidelines issued by ICAI.
- ICAI has provided Audit Report formats specifically for bank branch audit report keeping in line with the requirements of the revised SA 700.
- It is the responsibility of the Auditors to ensure that adequate information, records & documents are obtained which enables him to form his opinion. In case, where the auditor is required to issue a qualified report it would be necessary on his part to substantiate the facts and reasons for giving a qualified report.
- At branch level it is not possible for branch auditor to conclude on the appropriateness of management's use of the going concern basis of accounting and as such Bank's ability to continue as a going concern.
- Other Matters paragraph in the branch audit report require auditor to give information in the prescribed format for MOCs under different heads of income, expenditure, assets, liabilities, NPAs, classification of advances, Risk Weighted Assets & other matters with number of entries.
- Branch auditor is also required to ensure that no adjustments/provisions have been made in the accounts of the branch in respect of matters usually dealt with at Central Office.

Memorandum of Changes(MOC):

Generally, a bank prescribes three types of MOC formats to report the discrepancies Noted in the accounts by the Auditor

1. Assets and Liabilities
2. Income and Expenditure
3. Changes in Asset classification

Like the Branch Returns, submission of MOC, Duly certified by the Auditor is mandatory. If There are no changes to be made, the Auditor Is required to submit a 'NIL' MOC.

These MOCs are required to be signed by the Branch Manager as a token of acceptance of the changes being recommended in the MOCs.

However, it may happen that the Branch Manager does not agree with the changes Suggested by the Auditor and may not Sign the MOCs. In that case, the Auditor Is required to submit the MOC without The branch Manager's concurrence, giving explanations why he is recommending those changes.

Long Form Audit Report (LFAR):

The LFAR is a report to the Management of the Bank, unlike the Statutory Audit Report, which is for the shareholders of the Bank, Hence, while drafting he LFAR, the Auditor should keep in mind the following issues :

- Since LFAR is Management Report it shall be reported to the Management with a copy to central Statutory Auditors in the prescribed format. LFAR is not a substitute for the Statutory Audit Report.
- The format is devised in such a way so as to point out lacunae in the operations & internal control mechanism of the Bank.
- As LFAR is in a questionnaire format, answer to all questions should be given specifically stating what is checked, how and to what extent it is checked
- Though LFAR and Statutory Audit Report are two different documents, nevertheless, they are comments on the same accounts and hence they should not contradict each other.
- In order to give the management a fair idea about the irregularities noted, some examples/ illustrations should be given in to give an exhaustive list.
- However, it is necessary that comments given should be specific to enable the management to take corrective steps. Vague comments must be avoided as fas as possible.

Tax Audit Report (u/s. 44 AB of The Income Tax Act)

- Tax Audit has limited scope at the branches and necessary provisions of the Income Tax Act must be kept in mind while uploading digitally.
- All deviations, which are required to be reported are checked and reported. Special importance to be given for TDS, rent agreements, staff income tax, profession tax and other professional fees paid by the branches.
- Form 3CA- Audit Report & Form 3CD-Statement of Particulars
- Information in most of the clauses is pre filed by the Bank in the printed format provided. As some of the items are applicable at Head Office level, only few clauses required reporting on the part of branch auditor. In some banks the Tax Audit is not done by SBA's
- Since all the banks follow, digital upload of the information in the Tax Audit Report, Auditor may carefully check and report the same.

Certificates

Besides the above reports, branch auditor is required to issue various certificates, some of the are as below:

- Cash position on different dates

  Certificate for claim of Interest Subvention for Short term Crop Loans:
- Certificate of Priority Sector Classification of advances

  DICGC Claims

  Certificate for Cash and Bank Balances
- Certificate is required to arrive at CRR/SLR position for the Bank to ensure verification with the compliance norms

- Branch auditors are required to certify the same for 26 non-reporting Fridays of the year
- Since in current times all banks are on CBS platform, many banks are not asking for such certification from branch auditors
- Certificate of Investment Held : This certificate is required in connection with investments held by the branch on behalf of HO/Central Office
- Certificate on Risk Weighted Assets for Basel-CRAR : Branch auditors are expected to be aware of detailed guidelines issued by RBI on CRAR
  - — The details of credit risk weights for various on-balance sheet & off-balance sheet items, based on the degree of credit risks and methodology of computing the risk weighted assets for the credit risks as well as the procedure for calculating capital charge for prescribed by the Reserve Bank of India

Certificate on NPAs

- Branch auditor should be completely aware of RBI guidelines with regard to Asset Classification & Income Recognition' and provisioning norms
- If auditor disagrees with the classification done by the branch, he should clearly bring out the fact with proper justification note. He is also required to give the complete details of the same in the statement of MOCs in the format prescribed
- Auditors are expected to properly verify new slippages during the year
- Auditors are expected to verify the statement of movement in NPAs – Gross NPAs and Net NPAs and adequacy of provision on existing NPAs under various categories considering the value of security.

❑ **Certificate on Amounts Transferred to DEAF**

- As per RBI guidelines inoperative deposits of more than 10 years to be transferred to RBI under Depositor Education and Awareness Fund

❑ **Certificate with Compliance with Assets Liability Management (ALM) Norms**

❑ **Certificate on Compliance of Ghosh & Jilani Committee Recommendation**

❑ **Ghosh Committee Recommendations**

High level committee on Frauds & Malpractices in Banks under the chairmanship of Shri A. Ghosh was set up by RBI to enquire into various aspects of fraud and malpractices in bank with a view to reduce such incidences.

These recommendations were summarized by RBI for the purpose of reporting & implementation by the bank, in a 'Yes' or 'No' format. Recommendations were further categorized into

a) applicable to controlling offices like, Regional and Central Offices,

b) applicable to Head Office and

c) applicable to Treasury Operations.

The main objective of this report is to ensure existence of proper systems in bank so as to provide for

- Safety of Assets
- Compliance of laid down procedures,
- Accuracy and completeness of accounting and other records,
- Proper segregation and rotation of duties and responsibilities of staff,
- Measures of prevention of frauds and,
- Timely detection of frauds and malpractices and taking corrective corrections

Questionnaire relating to recommendations of Ghosh Committee are required to be answered by auditors. This questionnaire is provided to all branch auditors by respective branches.

❑ **Jilani Committee Recommendations**

Jilani committee made various recommendations for strengthening internal control, inspection & audit systems in banks under three broad categories based on areas of operations of the Banks:

- EDP Environment in Banks
- Inspection/Internal Audit in Banks

- Other Miscellaneous Matters

Bank management is required to prepare this report on implementation of Jilani Committee Recommendations (25 questions to be answered in implemented/ not implemented format) & the auditor is supposed to verify the answers given by the branch.

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.

Questionnaire relating recommendations of Jilani Committee are required to be answered by auditors. This questionnaire is provided to all branch auditors by respective branches.

Central Statutory Auditors have reported in the past that the reports received from branches

- On Ghosh & Jilani Committee recommendations are not properly verified by auditors & that they are replica of previous reports. The auditor is supposed to verify the correctness of the reports prepared by the branch – in case of negligence, the auditor may be held accountable.

Additional Certificates

Some other certificates which branch auditors may require to issue relates to-

- Certificate relating to credit/deposits ratio
- Certificate relating to MOC entries of the previous year being accounted for
- Certificate relating to advances to infrastructure projects and income generated thereon Statement of accounts restructured/ rescheduled/ renegotiated related to CDR & non-CDR accounts
- Certificate on advances exceeding ` 10 crores
- Certificate on interest subvention claims under various categories
- Certificate of Contingent Liabilities
- Certificate on exposure to sensitive sectors, i.e. exposure to Capital Markets, infrastructure and real estate sector.
- Certificate on unhedged foreign currency exposure in case of borrower having exposure of 1 crore or more.
- Subsidy claim under Prime Minister Rojgar Yojna or any other scheme of the Central/State Government.

Conclusion:

Certificates to be signed by SBA's are primarily as per the RBI Circulars. However, certain other additional certificates as may be prescribed by the concerned bank in their respective closing instructions or appointment letters.

The audit report/certificates as discussed in the above paragraphs are required to be printed on the letterhead of the firm & signed in person by the partner by mentioning firm name, membership number & firm's registration number & UDIN.

The Central Statutory Auditors compiles the reports issued by the SBA and therefore it is necessary that SBA ensure that various reports and certificates issued by them are specific and clear as possible

B) Audit of Profit & Loss Account

Generally Auditors lay more stress on audit and classification of advances in respect of bank branch statutory audit. This could lead to a situation where less time is devoted to verification of items related to the Profit and Loss Account. Certifying the financial statements as true and fair, of which the profit and loss account is an integral part should ensure that sufficient emphasis is laid on verification of aspects of Profit & Loss account such as interest income, other income, interest expenses, other expenses, depreciation, etc. Also in view of number of frauds being perpetrated in banks, an auditor needs to be extra vigilant while carrying out statutory audit in respect of bank branches.

There is also an additional duty to report in the LFAR as per questions asked specifically or on any other matters needing attention of Central Statutory auditors or Management in terms of process or control deficiencies.

The auditor states in his audit report that he has conducted his audit in accordance with the **Standards on Auditing (SA)** & hence the auditor must be duly aware of various (SA) more specifically SA 230-Audit Documentation, SA 240-Responsibility in relation to Fraud, SA 300-Planning an audit of Financial Statements, SA 315-Identifying and assessing the risk of material misstatement through understanding of the entity and it's environment, SA 320-Materiality, SA 530-Audit Sampling, SA 600/610/620–Using work of another auditor/expert, SA 520-Analytical procedures, SA 580-Written representations.

The Profit and Loss Account as set out in Form B, has following broad heads:

- Income
- Expenditure

Since the Branch finalizes the accounts & submits it onwards for consolidation, any changes will be reported through a Memorandum of Change (MOC) only.

The entire accounting in banks is done on the CBS therefore the Auditor should plan the audit procedures based on controls testing. If he is not satisfied with the controls in place for accounting and recording of items of income and expenses correctly, he should resort to more of substantive checking of documents and records.

The auditor could also check system audit reports generated at Bank level. Auditor should obtain **Exception reports** of interest reversals, waivers, debits to income accounts, debit freeze, flagging, de-flagging of accounts & ensure they are duly authorized as per approved policy. He should also check that tax has been deducted appropriately on interest on deposits. Necessary Written representations could be obtained from the Branch in this regard.

Verification of Income:

In carrying out an audit of income, the Auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transactions, which took place during the relevant period and pertain to the bank, that there is no unrecorded income, and that income is recorded in proper amounts and is allocated to the proper period.

1) Interest on Advances

Interest on advances is charged as per Bank schedule of charges. The changes in interest rates are communicated by way of circular from the head office to branches. Such circulars should be obtained and changed rates' effective dates should be verified.

We need to verify 100% OF the charging of interest in Major Advances Accounts and in rest on test check basis. One can verify overall interest income earned on the basis of the average monthly advances outstanding in each category of advances and percentage of such average interest earned.

The key is the correct input of the interest rate from the correct date. This is because rates keep on changing during the year depending on the rates notified by the Bank. There should be no unauthorized changes/alterations to interest rates. If the auditor is satisfied on implementation of controls over accurate feeding in of interest rates & modifications thereon & the operative effectiveness, then he has to test check only a few sample entries end to end to ensure that the actual computation is accurate.

Reversal of interest income in case of NPA & adequacy of provision thereon as per IRAC norms is another key area of verification. Hence NPA identified by the auditor in course of his audit will impact profitability & entries will have to be passed through Memorandum of Changes appropriately.

On the new advances, we need to examine processing fees is charged on not? On the advances not utilized , commitment charges needs to be recovered.

In case of recovery in written off accounts based on bank's policy, if income is credited to other income, proper updation of dummy ledgers should be checked. Sundry creditors or other liabilities should be scrutinized to check whether any recovery in written off account is credited therein. Any such amount should be credited to income.

Penal interest charged can be verified on selective basis with respect to different types of defaults and non-compliances for delay in submission, non-submission of periodical data such as late submission of financial statement and other period data – stock/book debt statement etc. Not providing information for renewal of facility will also attract penal interest. Also in case of cash credit accounts, penal interest needs to be charged if the outstanding balance in the account exceeds its drawing power.

Method of charging renewal fees and its actual debits needs to be examined. For verification of other income like commission on DD etc. applicable rates needs to be taken and it needs to be verified on test check basis. In certain cases DD issued to staff, valued customers etc are not recovered or recovered at concessional rates, authorization for this need to be verified.

In respect of accounting of commission on guarantees or L\C, it has been observed that banks follow different practices for accounting commission as income. Some banks account as and when income is collected, whereas some banks account income over the period of guarantee, thus commission for unexpired period of guarantee is treated as 'received as advance' and is shown as liability. Thus one should ensure that the accounting policy adopted by the bank is consistently followed by the branch

2) **Other Income:**

a) Loan processing, arranger and syndication fees.

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 and bills for collection

d) Mobile banking fees.

e) Locker Rent

f) Income from rendering other services like custodian, demat, investment advisory, cash management and other fee based services.

g) Commission on Government business.

h) Fee on insurance referral.

i) Commission on referral of mutual fund clients.

j) Service/transaction banking charges including charges levied for transaction at other branches.

k) Investment income (if done at the branches).

l) Commitment charges for unutilized sanctions/ draw downs, Penalty on premature repayments Cheque book issuance & cheque bouncing charges Stock inspection charges or fees paid to external stock auditors as per contractual terms Legal fees paid as per contractual terms Processing Fees are collected for the entire year & no miss outs have happen for any months due to delays in renewal of advances.

m) Stop payment Charges DD/PO/RTGS/NEFT charges. Charges for non-maintenance of minimum balances Folio charges Locker rent – Auditor should note that vacant lockers are an opportunity loss to the bank & should report in LFAR on steps taken to market usage of lockers.

Auditor should specifically check accuracy of interest subvention claimed by the Bank as per Government sponsored Education, Housing & other applicable schemes.

Verification of Expenses:

Interest on Deposits: Interest on deposits is a major expenses in the Profit and loss account and these are based on the Bank's Circulars and schedule of charges.

Followings need to be checked:

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) 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 Rate mentioned in the Fixed Deposit Receipt/Certificate.

c) Interest on Savings Accounts should be checked on a test check basis in accordance with the rules framed by the bank in this behalf.

d) Other items of expense payments that need checking are –

i. Printing & Stationery – Auditor should note whether the same is expensed out on initial purchase or shown as stock in which case he should verify if the items in stock exist or are usable. Necessary provisions for impairments to be made accordingly.

ii. Lease Rent – Necessary provision & payment to be made as per agreement. Attention to be drawn to disputes on increase of rent or non-refund of security deposit of vacated premises for necessary disclosures & additional provisions.

For Improvements to Leasehold premises, depreciation has to be consistently made over primary lease period as per bank policy. If asset is impaired, necessary impairments will have to be provided for.

iii. Professional/Legal/Audit Fees – Provision to be done on accrual basis on completion of service basis & not on payment basis.

iv. All other establishment expenses like Telephones, Electricity charges, etc.

v. Payment of Tax Deducted at Source or GST done monthly needs to be verified for accuracy of calculation, timeliness of payments & return filing with appropriate authorities.

CONCLUSION

Auditor shall do proper checking of Income & Expenditure of the Branch to ensure proper presentation of true & fair view of Profit & Loss Account of the Bank Branch. Any suggestion shall be reported in LFAR whereas substantive deviations may also be reported by drawing a suitable MOC in the Main Audit Report.

■■■

Audit of Foreign Exchange Transactions in a Bank Branch

CA. Mehul Shah

Introduction:

Banks have specialised branches that deal in foreign exchange transactions besides branches that also facilitate foreign exchange transactions of customers. Foreign exchange transactions involve exchange of funds in different currencies and are entered by way of contracts wherein exchange takes place on fixed date for the committed currencies.

Branches also handle foreign currency transactions such as transactions related to import and export of goods and services; credit facilities availed by borrowers in foreign currency; remittance and receipt of funds in foreign currency. In such branches foreign currency transactions are categorised under deposits and advances as funded on-balance sheet items and under contingent liabilities relating to non-funded exposures such as letters of credit and guarantees.

The typical setup in most PSU Banks is that foreign exchange transactions are centrally undertaken by the Bank's treasury office and the branches merely act as a link between the customers and the treasury office and also document the transaction with customer.

Reserve Bank of India (RBI) has laid down broad guidelines within with foreign exchange and foreign currency transactions are carried out by Banks.

Reporting Requirements under Bank Branch Audit

The branch Long Form Audit Report (LFAR) has an appendix for branches dealing in foreign exchange business. The auditors are required to review and give comments on four broad points as under:

1. Furnishing of particulars of any adverse features in foreign currency deposit accounts noted by concurrent auditors, internal auditors and/or RBI.
2. Compliance with instructions and guidelines of controlling authorities of Bank in relation to foreign exchange
3. Comment on matters relating to Nostro Accounts maintained by Banks.
4. Compliance on procedures relating to maintenance of Vostro Accounts by Banks.

These are discussed in following paragraphs followed by discussion on other areas where foreign exchange transactions are involved.:

Point 1.

Are there any material adverse features pointed out in the reports of concurrent auditors, internal auditors and/ or the Reserve Bank of India's inspection report which continue to persist in relation to NRE/ NRO/ FCNR-B/ EEFC/ RFC and other similar deposits accounts. If so, furnish the particulars of such adverse features.

Bank branches maintain various foreign deposit accounts such as Non Resident (External) Rupee (NRE), Non Resident Ordinary (NRO), Foreign Currency (Non Resident) Account (Banks) (FCBR-B), Special Non-Resident Rupee (SNRR), Exchange Earners Foreign Currency (EEFC), Resident Foreign Currency (RFC), Resident Foreign Currency (Domestic) [RFC-(D)], Diamond Dollar Account (DDA) accounts for which detailed operational guidelines have been specified by RBI. Of these, EEFC, RFC, RFC (D) are foreign currency accounts that can be held in India by a person resident in India while NRE, NRO, SNRR are accounts maintained in India by a person resident outside India. The RBI requires such accounts to be monitored closely as per guidelines in terms of KYC, anti-money laundering as well as the transactions being carried out in these accounts and accordingly also seeks specific comments from branch auditors. The branches handling such accounts are typically specialised branches and are subject to concurrent audit system in view of the compliance requirements of RBI for operations in such accounts. The auditors are required to review internal/ concurrent audit reports as well as RBI inspection reports for any material adverse features noted therein which have continued persist and furnish particulars of such adverse features.

The auditors should also review operations in such accounts for non-compliances if any with RBI directions in these regards. RBI has issued Master Directions on Deposits and Accounts (FED Master Direction No.14/2015-16 dated January 1, 2016 as updated thereafter) that basically lists out the accounts that can be opened, the permitted debits and credits in these accounts and other guidelines pertaining to operations in the accounts. Some of these are briefly given below:

Accounts held in India:

<table>
<tr><th>Particulars</th><th>NRE Account</th><th>FCNR (B) Account</th><th>NRO Account</th></tr>
<tr><th>(1)</th><th>(2)</th><th>(3)</th><th>(4)</th></tr>
<tr><td>Who can open an account</td><td colspan="2">NRIs and PIOs</td><td>Any person resident outside India for putting through bona fide transactions in rupees. Savings or Current Account can also be opened for by a foreign national (except of Pakistan and Bangladesh origin which required RBI approval) of non-Indian origin visiting India with funds remitted from outside India through Banking channel or by sale of foreign exchange brought by him to India</td></tr>
<tr><td></td><td colspan="2">Individual/entities of Pakistan and Bangladesh shall require prior approval of the Reserve Bank of India</td><td>Authorized Dealers may open only one Non- Resident Ordinary (NRO) Account for a citizen of Bangladesh or Pakistan, belonging to minority communities in those countries, namely Hindus, Sikhs, Buddhists, Jains, Parsis and Christians, residing in India and who has been granted a Long Term Visa (LTV) by the Central Government. (A.P.(DIR Series) Circular No.28 March 28, 2019). Individuals/entities of Pakistan nationality/origin and entities of Bangladesh origin require the prior approval of the RBI.</td></tr>
<tr><td>Currency</td><td>Indian Rupees</td><td>Any permitted currency i.e., a foreign currency which is freely convertible</td><td>Indian Rupees</td></tr>
<tr><td>Type of Account</td><td>Savings, Current, Recurring or Fixed Deposit</td><td>Fixed Deposit only</td><td>Savings, Current, Recurring, Fixed Deposit</td></tr>
<tr><td>Permissible Credits</td><td colspan="2">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 NRE account provided income tax thereon has been deducted/paid/provided for, as the case may be</td><td>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.</td></tr>
</table>

Particulars	NRE Account	FCNR (B) Account	NRO Account
	Care: Only those credits which have not lost repatriable character		
Permissible Debits	Permissible debits are local disbursements, remittance outside India, transfer to other NRE/ FCNR(B) accounts and investments in India. (Note: Equity instruments shall be issued to the person resident outside India making such investment within sixty days from the date of receipt of the consideration, failing which the consideration shall be refunded within 15 days of completion of sixty dates. Notification No. FEMA.395/2019-RB dated October 17, 2019)		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 Management (Remittance of Assets) Regulations, 2016. Funds can be transferred to NRE account within this USD 1 million facility.
Repatriability	Repatriable		Repatriable as per limits stated above.
Taxability	Income from interest on balances standing to the credit of NRE Accounts is exempt from Income Tax.		Taxable
Loans in India	AD can sanction loans in India to the account holder/third parties against security of funds held in these accounts, 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.		Loans against the deposits can be granted in India to the account holder or third party in rupees 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.
	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 deposits to enable the resident individual/firm/company to obtain such facilities.		The term "loan" shall include all types of fund based/non-fund based facilities.
	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.		
	The facility for premature withdrawal of deposits is not available where loans against such deposits are availed of.		
	The term "loan" shall include all types of fund based/non-fund based facilities.		
Rate of Interest	As per guidelines issued by the Department of Banking Regulations		

Particulars	NRE Account	FCNR (B) Account	NRO Account
Change in residential status from Non-resident to resident	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 of the account holder to India for taking up employment or on change in the residential status.	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) 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.	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. In case of account opened by person belonging to minority community of Bangladesh or Pakistan, such account will be converted to a resident account once such a person becomes a citizen of India within the meaning of the Citizenship Act, 1955 Likewise, when a resident Indian leaves India for a country (Other than Nepal or Bhutan) for taking up employment or for carrying on business or vocation outside India or for any purpose indicating his intention to stay outside India for an uncertain period, his existing resident account should be designated as NRO account.

Note1: The detailed instructions for opening and maintaining NRE account are laid down in Schedule 1, FCNR(B) in Schedule 2 and NRO in Schedule 3 to Foreign Exchange Management (Deposit) Regulations, 2016, as amended from time to time.

Note2: RBI has advised Banks that with effect from the reporting fortnight beginning July 30, 2022, incremental FCNR (B) deposits as also NRE Term deposits with reference to base date of July 1, 2022, mobilised by banks will be exempt from maintenance of CRR and SLR. However, any transfer from Non-Resident (Ordinary) (NRO) accounts to NRE accounts will not qualify for such exemptions. Further, the exemptions are valid for deposits raised till November 04, 2022. The exemption on reserves maintenance will be available for the original deposit amounts till such time the deposits are held in the bank books.

Foreign currency accounts by a person resident in India

Particulars	EEFC Account	RFC(D) Account	RFC Account
(1)	**(2)**	**(3)**	**(4)**
Who can open the account	Exchange Earners	Resident Individuals	Individuals
Type of Ac-count	Current only	Current only	Current/savings/term depos-its
Interest	Non-interest earning	Non-interest earn-ing	De-regulated (As decided by the AD bank)
Permitted Credits	1) 100% of foreign exchange earnings by way of inward remittances through normal banking channel (other than loans or investments)	1) payment while on a visit abroad for services not arising from any business or anything done in India	1) Foreign exchange received by him as superannuation or other monetary benefits from overseas employer

Particulars	EEFC Account	RFC(D) Account	RFC Account
(1)	(2)	(3)	(4)
	2) Advance remittance received by an exporter towards export of goods or services	2) Unspent amount of foreign exchange acquired from AD for travel abroad	2) Foreign exchange realised on conversion of assets acquired by him when he was a non-resident.
	3) Repayment of trade related loans/ advances (which were granted to the account holder's importer customer out of balances held in EEFC account)	3) Honorarium or gift for services rendered or in settlement of lawful obligation from any person not resident in India and who is on visit in India	3) Gift/inheritance received from a person referred to in Section 6(4) of FEMA by a person resident outside India and repatriated to India
	4) Disinvestment proceeds on conversion of shares held by him to ADRs/ GDRs under the GDR Scheme, 2014	4) Disinvestment proceed received on conversion of shares held by him to ADRs/GDRs under the GDR Scheme, 2014	4) Foreign exchange acquired before July 8, 1947 or any income arising on it held outside India with general or special RBI permission
	5) Professional earnings including director's fees, consultancy fees, lecture fees, honorarium and similar other earnings received by a professional by rendering services in his individual capacity	5) Foreign exchange received as earnings of Life insurance policy claims/maturity/ surrender values settled in foreign currency from an Indian insurance company permitted to carry on life insurance business	5) Foreign exchange received as earnings of LIC claims/ maturity/ surrendered value settled in forex from an Indian Insurance company permitted to undertake life insurance business
	6) Interest earned on the funds held in the account	6) Honorarium or gift while on a visit to any place outside India	
	7) Recredit of unutilised foreign currency earlier withdrawn from the account	7) Earning through export of goods/ services, royalty	
	8) Payments received in foreign exchange by an Indian startup arising out of sales/export made by the startup or its overseas subsidiaries	8) Gift from a relative	
	9) Payments received for the purpose of counter trade		

Particulars	EEFC Account	RFC(D) Account	RFC Account
(1)	(2)	(3)	(4)
Permitted Debits	1) Any permissible current or capital account transaction	Can be used for any permissible current/ capital account transactions in accordance with related FEMA provisions	The balances in account are free from all restrictions regarding utilisation of foreign currency balances outside India.
	2) Cost of goods purchased from 100% EOU or unit in EPZ/STP/ EHTP		
	3) Payment of customs duty in accordance with provisions of Export Import Policy		
	4) Trade related loans/ advances by exporter to his importer customer outside India subject to FEMA regulations		
	5) Payment to a person resident in India for supply of goods/ services including payments for air fare and hotel expenditure		
Other Provisions	1) The sum total of the accruals in the account during a calendar month should be converted into Rupees on or before the last day of the succeeding calendar month after adjusting for utilization of the balances for approved purposes or forward commitments.	1) The sum total of the accruals in the account during a calendar month should be converted into Rupees on or before the last day of the succeeding calendar month after adjusting for utilization of the balances for approved purposes or forward commitments.	1) Such accounts can be held jointly with resident relative as joint holder on 'former or survivor' basis. However, such resident Indian relative joint account holder cannot operate the account during the life time of the resident account holder
	2) Balances held in the account may be credited to NRE/ FCNR (B) Accounts, at the option/ request of the account holders consequent upon change of their residential status from resident to non-resident	2) Balances may be credited to NRE/ FCNR (B) Accounts, at the option/ request of the account holders consequent upon change of their residential status from resident to non-resident	2) The balances in the NRE Account and FCNR (B) Account can be credited to the RFC account when the residential status of the non resident Indian or person of Indian origin changes to that of a Resident.
	3) Fund-based/ non-fund based credit facilities should not be granted against the balances held in EEFC Accounts.		

Diamond Dollar Account (DDA) Scheme – DDA Account

Firms and companies which comply with the eligibility criteria stipulated in the Foreign Trade Policy of the Government of India may open DDA accounts. The salient features of the Scheme are:

1. Realisation of export proceeds and local sales (in USD) of rough, cut, polished diamonds; and pre and post shipment finance availed in USD can be credited to such account.
2. Payments for purchase of rough, cut and polished diamonds can be made from DDA account. Funds can also be transferred to rupee account of the exporter.
3. The account should be maintained in the form of a non-interest bearing current account.
4. The sum total of the accruals in the account during a calendar month should be converted into Rupees on or before the last day of the succeeding calendar month after adjusting for utilization of the balances for approved purposes or forward commitments.

Special Non-Resident Rupee Account - SNRR account

Any person resident outside India, having a business interest in India, may open a SNRR account with an authorised dealer for putting through bona fide transactions in rupees, not involving any violation of the provisions of the Act, rules and regulations made thereunder. Opening of SNRR accounts by Pakistan and Bangladesh nationals and entities incorporated in Pakistan and Bangladesh requires prior approval of RBI. The business interest, apart from generic business interest, shall include the following INR transactions, namely:

a) Investments made in India in accordance with Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 dated October 17, 2019 and Foreign Exchange Management (Debt Instruments) Regulations, 2019 notified vide Notification No. FEMA 396/2019-RB dated October 17, 2019, as applicable and as amended from time to time.

b) Import of goods and services in accordance with Section 5 of the Foreign Exchange Management Act 1999 (42 of 1999), read with Notification No. G.S.R. 381(E) dated May 3, 2000, viz., Foreign Exchange Management (Current Account Transactions) Rules, 2000, as amended from time to time;

c) Export of goods and services in accordance with Section 7 of the Foreign Exchange Management Act 1999 (42 of 1999), read with Notification No. G.S.R. 381(E) dated May 3, 2000, viz. Foreign Exchange Management (Current Account Transactions) Rules, 2000, as amended from time to time, and further read with FEMA Notification No.23(R)/2015-RB dated January 12, 2016, as amended from time to time;

d) Trade credit transactions and lending under External Commercial Borrowings (ECB) framework in accordance with Foreign Exchange Management (Borrowing and Lending) Regulations, 2018, as amended from time to time; and

e) Business related transactions outside International Financial Service Centre (IFSC) by IFSC units at GIFT city like administrative expenses in INR outside IFSC, INR amount from sale of scrap, Government incentives in INR, etc. The account will be maintained with a bank in India (outside IFSC).

SNRR account shall carry the nomenclature of the specific business for which it is in operation and shall not earn any interest. Indian bank may, at its discretion, maintain separate SNRR account for each category of transactions or a single SNRR Account for a person resident outside India engaged in multiple categories of transactions provided it is able to identify/segregate and account them category-wise.

The debits/ credits and the balances in the account shall be incidental and commensurate with the business operations of the account holder.

The tenure of the SNRR account should be concurrent to the tenure of the contract/ period of operation/ the business of the account holder and in no case should exceed seven years. Approval of RBI shall be obtained in cases requiring renewal. The restriction on tenure does not apply in case where the account is opened for ECBs, trade credits in INR, Trade (Export/Import) invoicing in INR and Business related transactions outside International Financial Service Centre (IFSC) by IFSC units at GIFT city like administrative expenses in INR outside IFSC, INR amount from sale of scrap, government incentives in INR, etc.

The operations in the SNRR account should not result in the account holder making available foreign exchange to any person resident in India against reimbursement in rupees or in any other manner.

The balances in the SNRR account shall be eligible for repatriation and transfers from any NRO account to the SNRR account are prohibited.

All transactions in the SNRR account will be subject to payment of applicable taxes in India.

SNRR account may be designated as resident rupee account on the account holder becoming a resident.

Foreign Currency Account for remittances to International Financial Services Centres (IFSCs) in India

With a view to deepen the financial markets in IFSCs and provide an opportunity to resident individuals to diversify their portfolio, resident individuals are permitted to make remittances under Liberalised Remittance Scheme to IFSCs set up in India under the Special Economic Zone Act, 2005 subject to following conditions:

a) The remittance shall be made only for making investments in IFSCs in securities, other than those issued by entities/companies resident (outside IFSC) in India.

b) Resident Individuals may also open a non interest bearing Foreign Currency Account (FCA) in IFSCs, for making the above permissible investments under LRS. Any funds lying idle in the account for a period upto 15 days from the date of its receipt into the account shall be immediately repatriated to domestic INR account of the investor in India.

c) Resident Individuals shall not settle any domestic transactions with other residents through these FCAs held in IFSC.

It may be noted that The International Financial Services Centres Authority (IFSCA) was set up in April 2020 to develop a strong global connect and focus on the needs of the Indian economy as well as to serve as an international financial platform for the entire region and the global economy as a whole. Specifically, the Authority is aiming to develop GIFT-IFSC as a destination for fund-raising by both Indian and foreign issuers, fintech start-ups and innovations, sustainable and green financing, bullion trading, aircraft leasing and financing, global in-house centres, fund management, international banking and reinsurance. It introduced frameworks for Regulatory Sandbox, Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs) in IFSC and listing of depository receipts in IFSC, among others.

Auditors Responsibilities:

The auditor should acquaint himself with the process adopted by the Bank while opening account and for reviewing transactions carried out by customers in these accounts vis-à-vis the regulations. Besides reporting of adverse features noted by concurrent/internal/RBI audit, auditor should also report in LFAR any adverse features noted by him during his review.

Point 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

The auditor should obtain the latest guidelines and instructions issued by Head Office of the branch under audit related to foreign exchange transactions. The auditor should also review the concurrent audit scope covering areas stated above including non-funded advances in foreign currency. RBI also issues master directions which cover the aforesaid areas which would have been incorporated in the Head Office guidelines/instructions of the Bank.

A. Deposits:

The regulatory guidelines in respect of deposits in foreign exchange are already discussed in previous point.

B. Advances:

The general operational guidelines in relation to exports and imports of goods and services are laid down by RBI in following Master Directions which are updated from time to time:

FED Master Direction No. 17/2016-17 dated January 1, 2016 on Import of Goods and Services

FED Master Direction No. 16/2015-16 dated January 1, 2016 on Export of Goods and Services FED Master Direction No.5/2018-19 dated March 26, 2019 on External Commercial Borrowings, Trade Credit and Structured Obligations

EXPORT FINANCING

To boost up the exports of the country, the RBI has directed banks to grant credit at a concessional rate. It helps Indian Exporter to procure raw material and can produce the goods to be exported.

Banks provide finance for purchase, processing, manufacturing or packing of goods prior to shipment/ working capital expenses towards rendering of services. It is also known as Pre- Shipment Credit Facility.

In addition to it, Banks provide finance to exporters by way of loan or advance post the Shipment by way of Export Bill Discounting, Export Bill Purchase, Advances against Export collection bills.

A. Pre-Shipment Credit to Exporters

Important Points:

- Export packing credit can be in Indian Rupees (EPC) and in Foreign Currency (PCFC).
- Banks should decide the period for which a packing credit advance may be given, having regard to the various relevant factors such that the period is sufficient to enable the exporter to ship the goods / render the services. Maximum period for Packing credit is 360 days.
- EPC/PCFC is disbursed against specific orders, in one lumpsum tranche or against the requirement as per export orders.
- EPC/PCFC is also disbursed as per Running Account Facility where availability of Letter of Credit/Confirmed orders before disbursement are not insisted.
- The packing credit / pre-shipment credit granted to an exporter may be liquidated out of export proceeds or proceeds of bills drawn for the exported commodities on its purchase, discount etc., thereby converting pre-shipment credit into post-shipment credit. Further, subject to mutual agreement between the exporter and the banker it can also be repaid / prepaid out of balances in Exchange Earners Foreign Currency A/c (EEFC A/c) as also from rupee resources of the exporter to the extent exports have actually taken place. Liquidation by any other means than by way of exports will attract higher rate of interest as per Bank's Policy.

Accounting Aspect

- Banks open separate Loan account in CBS for EPC/ PCFC. It helps in monitoring the utilisation and liquidation.
- Bank at the request of the borrower may convert the amount of Pre-Shipment credit into Post-Shipment credit by discounting/ purchasing the export bills.

Compliance Aspect

End use of funds

- Banks should keep a close watch on the end-use of the funds and ensure that credit at lower rates of interest is used for genuine requirements of exports. 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.

Liquidation Methodology

- If the liquidation of Export Credit is by other than the way of Export of Goods / Services within the maximum period of 360 days, the advance will cease to qualify for prescribed concessionary rate of interest for export credit ab initio. It means that the bank will have to collect the difference in concessional rate of interest and normal rate of interest. The rate of interest to be applied will be as per the Bank's Policy.

Auditing Aspect

- Generate the list of EPC/PCFC accounts opened and maintained by the branch.
- Examine if the liquidation of EPC/PCFC is as per RBI guidelines. If not, verify that interest rate as per Bank's Policy is charged. Banks have been permitted to extend export credit using any widely accepted Alternative Reference Rate in the currency concerned for referencing the rate of interest to charge on PCFC.
- Verify documents evidencing end use of funds.
- Examine if genuineness of Export LC is confirmed before sanctioning EPC/PCFC

B. Post-Shipment Credit to Exporters:

Export Bills Discounted/Purchased

- Banks extend credit to exporters by way of purchasing/discounting of export bills. Banks also provide facility of advance against exports on collection basis.
- Facility of discounting/purchase of bill is available in both Indian Rupee and in Foreign Currency.
- The credit is provided by a bank to an exporter of goods/services from the date of extending credit after shipment of goods/rendering of services to the date of realisation of export proceeds.

Revenue Aspect

- Interest on Bill Discounting/Purchase is revenue for the bank and generally collected upfront.
- Bank also charges fees for export bill lodgement and claims courier and other charges for submission of Export Documents.

Accounting Aspect

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, if any.
- Discount shall be amortised over the underlying period
- 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 crystallisation.

Compliance Aspect

- In case of overdue bills, IRAC Norms for overdue bills will be applicable and the advance will be subject to Asset Classification. Further reporting to RBI is also done for overdue bills and the duplicate copies of EDF/SOFTEX forms continue to be held by the Bank.
- In case of usance Export Bills, credit can be granted for a maximum duration of 365 days from the date of shipment.

Auditing Aspect

- Generate a report on Export Bills purchased during the audit period.
- Generate a report on outstanding/realised during the audit period.
- In case of overdue bills check that interest has been charged as per Bank's Policy.
- Verify that the period of sanction is within the period prescribed by RBI.
- Examine the control put in place to ensure that liquidation is done only out of the underlying export bill that was purchased.
- Where the Bank has claimed reimbursement of interest equalisation benefit or subvention which is passed on to the eligible exporters, auditors should ensure that the claim amount is in accordance with the Government scheme in force. The interest equalisation scheme on pre and post shipment rupee export credit had been extended from October 1, 2021 and ends on March 31, 2024 with some changes in scope and coverage. The extended Scheme will not be available to those beneficiaries who are availing the benefit under any Production Linked Incentive (PLI) scheme of the government as well as beneficiaries from Telecom Instruments sector having six HS lines. With effect from April 1, 2022, banks shall reduce the interest rate charged to the eligible exporters upfront as per the guidelines and submit the claims in original within 15 days from the end of the respective month. The controls in place to ensure calculation of such claims should be examined for satisfaction regards the claim made by the bank. Further the amount claimed by Bank

and the amount recorded in books should be matched.

IMPORT FINANCING

Trade Credits:

Trade Credits ("TC") refer to the credits extended by the overseas supplier, bank, financial institution and other permitted recognised lenders for maturity as prescribed under the framework for imports permissible under the Foreign Trade Policy of Government of India. Depending on the source of finance, such trade credits include suppliers' credit and buyers' credit from recognised lenders. Suppliers' credit relates to the credit for imports into India extended by the overseas supplier, while buyers' credit refers to loans for payment of imports into India arranged by the importer from overseas bank or financial institution.

The period of TC, reckoned from the date of shipment, shall be up to three years for import of capital goods. For non-capital goods, this period shall be up to one year or the operating cycle, whichever is less. Suppliers' and Buyers' credit (trade credit) including the usance period of Letters of Credit opened for import of gold in any form, including jewellery made of gold/precious metals or/and studded with diamonds/semi- precious/ precious stones, should not exceed 90 days from the date of shipment.

Revenue aspect of Trade Credit

- Bank issuing Bank Guarantee for Buyers' credit Transaction earns commission / charges as that of Letter of Credit.

Accounting aspect of Trade Credit

- Issuance of Bank Guarantee for TC is a Non-Funded facility extended by banks.
- The important aspect is to ensure that the fields in CBS match with details reported in SWIFT Message sent for Bank Guarantee. The Bank Guarantee is generally communicated through MT760 which must be referred to for identifiable details for accounting aspects.
- Typically, the Bank Guarantee amount includes interest accrued on TC and thus the Bank Guarantee amount should be disclosed at principal amount plus accrued interest at Balance Sheet date

Compliance aspect of Trade Credit

- TC transaction should be within the prescribed tenure.
- Interest Rate and other costs for TC transaction must be within the prescribed All-in-Cost ceiling.
- SWIFT messages originated by overseas bank specifying the terms of TC should be available

Auditing aspect of Trade Credit

- Since the underlying transaction for TC is import, the auditors need to verify the evidence of Import such as exchange control copy of Bill of Entry/Entry in IDPMS which are documentary confirmations.
- Review documents specifying right of recovery against borrower, in case a borrower has defaulted in repayment of TC.
- Check the amount of bank guarantee recorded with underlying terms of TC and also amortisation of income on bank guarantee with the policy adopted by bank.

C. Export Bills:

Export bills include export bills discounted/ purchased, advance against export bills, bills sent for collection etc. Most aspects have been discussed in previous points on advances.

If, after a bill has been negotiated or sent for collection, its amount is to be reduced for any reason, AD Category – I banks may approve such reduction, if satisfied about genuineness of the request, provided:

a) The reduction does not exceed 25 per cent of invoice value:

b) It does not relate to export of commodities subject to floor price stipulations

c) The exporter is not on the exporters' caution list of RBI,

d) The exporter is advised to surrender proportionate export incentives availed of, if any.

In the case of exporters who have been in the export business for more than three years, reduction in invoice value may be allowed, without any percentage ceiling, subject to the above conditions as also subject to their track record being satisfactory, i.e., the export outstanding do not exceed 5 per cent of the average annual export realization during the preceding three financial years.

D. International Trade Settlement in Indian Rupees (INR)

In order to promote growth of global trade with emphasis on exports from India and to support the increasing interest of global trading community in INR, it has been decided to put in place an additional arrangement for invoicing, payment, and settlement of exports / imports in INR. Before putting in place this mechanism, AD banks are required to obtain prior approval from the Foreign Exchange Department of Reserve Bank of India, Central Office at Mumbai.

The broad framework for cross border trade transactions in INR under Foreign Exchange Management Act, 1999 (FEMA) is as delineated below:

Invoicing: All exports and imports under this arrangement may be denominated and invoiced in Rupee (INR).

Exchange Rate: Exchange rate between the currencies of the two trading partner countries may be market determined.

Settlement: The settlement of trade transactions under this arrangement shall take place in INR in accordance with the procedure laid down in AP (DIR series) circular no 10 dated July 11, 2022.

In terms of Regulation 7(1) of Foreign Exchange Management (Deposit) Regulations, 2016, AD banks in India have been permitted to open Rupee Vostro Accounts. Accordingly, for settlement of trade transactions with any country, AD bank in India may open Special Rupee Vostro Accounts of correspondent bank/s of the partner trading country.

E. Bills for collection:

Bills for collection include drafts drawn by a creditor on his debtor which are lodged with the bank for collection against documents already attached. These are numbered by the bank serially and all information about them is recorded by Bank in register. Until they are actually collected they are not recorded in any other account. After the export documents have been negotiated / sent for collection, banks shall report the transaction through Export Data Processing and Monitoring System (EDPMS) to the RBI and retain the documents at their end. Under Import bills for collection the Foreign Seller sends goods through shipping channel and underlying documents are sent to its banker with an instruction to send the same to the Importer's Banker. The documents so sent contain 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.

<u>Accounting Aspect</u>

In respect of collection bills, banks act only as mediators i.e. a communication link between the exporter and the importer. In case the importer does not honour the transaction on due date, bank only notifies about the same to the exporter's bank. The collection charges/ commission are accounted upfront by the bank.

Bills for collection in foreign currency are to be valued at closing exchange rates for disclosure in financials. These are booked by banks as a contra entry in books similar to contingent liability.

<u>Auditing Aspect</u>

Outstanding bills can be physically verified with the bill register

Unrecovered charges if any booked as income, should be reviewed for recoverability

Valuation of foreign exchange bills at year end exchange rates should be examined

F. Dealing Room Operations:

In terms of RBI guidelines (FE.CO.FMD. No. 18380/02.03.137/2010-11dated Feb 3, 2011 on Internal Control Guidelines), Banks should conduct special audit of the dealing rooms and the system in operation at least once in a year. Typically, the areas tested during the audit should include the following:

i. Dealing-room procedures to ensure that all deals executed are promptly captured by the accounting system.

ii. Reconciliation of foreign exchange positions between the dealers' records and the accounting system.

iii. Review of incoming deal confirmations.

iv. Full scrutiny of sample deals selected during review.

Further the annual risk-based audit should cover following main audit areas:

- limit system
- determination and reconciliation of positions and results
- changes in the EDP systems
- completeness, correctness and timeliness of the internal reporting system
- functional separation
- degree to which transactions are in line with market conditions
- confirmations and counter-confirmations

As advised by RBI from time to time, concurrent audit is to be regarded as a part of AD's early-warning signal system to ensure timely detection of irregularities and lapses aimed at prevention of fraudulent transactions at branches undertaking foreign exchange transactions. Bank's management shall bestow serious attention to the implementation of the same. While minor irregularities pointed out by the concurrent auditors are to be rectified on the spot, serious irregularities should be reported to the Controlling Authority for immediate action.

The RBI also typically covers the dealing room operations in its inspection of Banks.

Auditors should review all the available reports and list out the material discrepancies and adverse remarks if any along with the compliance status thereof in the LFAR.

A brief understanding of the dealing room operations is given in following paragraphs:

Banks dealing room operation covers the treasury functions of a Bank i.e. money market operations, transactions in foreign exchange contracts including derivatives, transactions in securities. Typically a dealing department should consist of dealers (front office), mid and back office staff, who are responsible for the follow up of the deals made by the dealers. The cardinal principle of operational procedures in the area of trading activities is the clear functional segregation of Dealing, Mid-Office, Back-Office (Processing and Control), Accounting and Reconciliation. In respect of banks which trade actively and offer the whole range of products, dealing activities may be segregated as under:

i) Front Office - Dealing Room. The dealers carry the deals on behalf of the Bank.

ii) Mid - Office - Risk Management; Accounting Policies and Management Information System. Limits monitoring and exception reporting are the responsibilities of Mid Office.

iii) Back Office - Settlement, Reconciliation, Accounting. Monitoring of receipt of confirmation of contracts from the counter party is also done by the Back Office.

Front Office Operations:

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 over communication platform such as Reuters', Bloomberg, telephonic conversation with counter party or through empanelled brokers.

A bank lays down various limits in relation to dealing room operations and dealers need to ensure that limits such as counter party exposure limits, overnight open positions, aggregate gap limits, broker limits and other requirements are met when entering into deals. As soon as the dealer strikes a deal 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. Unlike in past most banks have computerised their operations and the serially numbered deal tickets are now system generated and details need to be captured by dealer without time lag and passed on to the back office.

Middle Office Operations:

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 VAR;
- Stress testing and back testing of investment and trading portfolios;
- Risk-return analysis; and
- Marking open positions to market to assess unrealized gain and losses.

Back Office Operations:

Back office acts as a support to both the front and the mid office. It extracts the deal details from system and authorises/confirms the same after verifying them with external confirmations such as counter party confirmation, conversation of dealer with counter party over dealing platforms such as Bloomberg, Reuters, broker notes for deals done through brokers, CCIL confirmations for transactions done on CCIL platform, email or fax confirmations for deals done for customers. Upon confirmation of deals, the back office also carries out the settlement function to complete the transaction.

Accounting Aspect:

While reviewing the dealing room operations, year-end deals accounting needs to be verified if properly captured and accounted for as per policy adopted by bank. Accounting of deals is done on settlement date or trade date as per policy followed by bank and appropriate disclosure is made in financials where settlement date accounting is adopted by the bank. The outstanding foreign exchange contracts trading positions including spot contracts, forward contracts and currency swap contracts are revalued at closing rates notified by FEDAI/FBIL for specified maturities and interpolated for maturities falling in the interim. Contingent liabilities on foreign exchange contracts are disclosed at closing rates of exchange notified by FEDAI/FBIL.

Auditing Aspect:

- Obtain an understanding of dealing room operations and accounting done for deals. Carry out process walkthrough and test of controls on basis of explanations obtained from bank.
- Review valuation of year end outstanding forward and derivative contracts, accounting of mark to market losses, amortisation of premium on contracts in accordance with Banks accounting policies.
- Review reports of special dealing room audit, concurrent/internal audit and RBI inspection if any for material/adverse findings if any and its implications on financials and disclosures to financials and also report them in LFAR.
- Review if bank has an approved forex and money market policy in place and the same is being reviewed and complied with.
- Review functional segregation of duties between front, mid and back office.
- Ascertain adequacy of dealing room infrastructure facilities including backup systems.
- Review the rotation policy for dealers.
- Verify serial numbering of deal tickets.
- Ascertain any material discrepancies in rate scanning done by mid-office.
- Contracts on or after 1 January 2022 would be bench marked with reference to any widely accepted Alternative Reference Rate pursuant to transition away from LIBOR except for some instances where LIBOR was allowed to be referenced on exception basis under conditions specified by RBI. Some of the alternate reference rates that banks could use include SOFR (Secured Overnight Funding Rate) for USD, SONIA (Sterling Overnight Index Average) for GBP, €STR (Euro Short Term Rate) for EUR etc. Verify the process followed by the bank of communicating such transition to its customers as a part of customer awareness initiative. .

G. Any Other Area:

SWIFT transactions are amongst one of other areas important to be reviewed by auditor. SWIFT is an acronym for Society for Worldwide Interbank Financial Telecommunications, a Belgian co-operative society owned by various banks worldwide. The SWIFT system enables the member bank to transact amount themselves quickly through secured messaging. After detection of a large-value fraud relating to unauthorised issuance of Letters of Undertaking and the Foreign Letters of Credit, it was observed that there was ineffective implementation of the prescribed controls at the levels of business units, risk management and audit function and the regulatory/supervisory instructions on SWIFT had not been ensured by Banks. In February 2018, RBI decided that banks should take immediate steps to implement in letter and spirit, the controls prescribed in the said guidelines. Banks were advised to ensure that:

- No SWIFT message, creating funded or non-funded exposure of banks, is sent without first ensuring that the underlying transaction has been duly reflected in the CBS/accounting system.
- Straight-Through Processing between CBS/ accounting system and SWIFT messaging system is put in place.

Auditors should review the RBI guidelines and compliance of the same by the bank and report in the LFAR any deviances noted.

Point 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

A NOSTRO Account is an account maintained by a bank in India with a bank outside India and designated in currency other than Indian Rupee. Nostro Mirror Account is an account maintained in the books of account of a bank in India, i.e., bank book maintained with respect to the Nostro Account in the books of account. Ideally, list of Nostro accounts provided by the bank and the details of the mirror account should match.

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. Thereafter, based on transaction types and obtention of necessary documents, the bank will transfer amount in Nostro account to customer Rupee account post conversion or to the EEFC account maintained, if any.

Accounting Aspect:

The Nostro Accounts are maintained in foreign currency with a Bank outside India. The balances at year end need to be revalued at the year-end closing rates notified by FEDAI/FBIL. In terms of un-reconciled balances, it needs to ascertained if the entries not responded by bank need to be accounted for at the balance sheet date.

Auditing Aspect:

Auditors need to verify the transactions done through the Nostro account, obtain year-end balance confirmation from the Bank with whom Nostro Account is maintained, check reconciliation items and also the translation of balance at closing rates. Check entries in Nostro account subsequent to year-end for any entry that needs to be considered in current financials.

Ascertain if the reconciliation process followed ensures matching of each item and not for overall matching of total amount. Also ascertain if reconciliation is done by separate department and not by treasury department who operates Nostro accounts.

In case of un- reconciled debit entries outstanding for more than 3 years, 100% provision thereon needs to be made by Banks.

Likewise, all un- reconciled credit entries outstanding for more than 3 years are to be transferred by Banks to a Blocked Account which needs to be also reckoned for purpose of CRR/SLR.

If there are any adjustments from the Blocked Accounts ascertain if these are permitted with the authorisation of the two officials, one of whom is preferably from outside the branch concerned, preferably from the Controlling branch/ head office if the amount exceeds ₹ one lakh. Further if there are any write-off of any un-reconciled item, verify if these are done under proper authority and approval.

Verify if the branch had process of periodic reconciliation and confirmation of the same.

At times there could be amounts received in Nostro account towards export proceeds for which the bank would have given post shipment finance or done export bill discounting for a borrower and such entries are accounted subsequently by the bank. In such instances, ascertain if value dated credits are given by bank as a result of which the loan account is deemed settled on valued date and no interest needs to be accrued thereafter on such loan. Conversely there could be debit by other bank towards a customer transaction that would be part of reconciliation item and would need to inquiry if these would result in onward interest-bearing transaction for bank customer with value date or represent a borrowing/liability of the bank. Further, such items could also have an impact on the SLR/CRR to be maintained by bank and may need MOC to be passed to present the correct picture.

In case any Nostro account is overdrawn, verify if interest has been provided for and ascertain if tax compliances are made and such overdrawing is duly authorised within the bank as well as under prevailing regulations. Verify that overdrawn Nostro accounts are classified as borrowing by bank.

The transactions in Nostro Account need to be scrutinized for any unauthorized payments, unauthorized withdrawals or credits or significant amounts that do not appear to be genuine transaction. If any such transactions are noted, the same needs to be further verified with respect to documents and purpose and in case if the auditor is not satisfied, the same should be referred in LFAR.

In cases where there are no transactions in the Nostro account and the account has turned dormant, ascertain the reasons for keeping the account open, obtain statement of account for the accounting period to ascertain there are no transactions squared off during the year and report such accounts in LFAR.

In case the Nostro balances do not match with the mirror account, reason needs to be inquired into and its impact of financials and/or disclosures ascertained for further action.

Point 4

Does the branch follow the prescribed procedures in relation to maintenance of Vostro Accounts?

Vostro Account is an account maintained by a bank outside India with a bank in India and designated in Indian Rupee. Banks outside India and Non-Resident Exchange Houses may maintain Vostro account to facilitate own as well as their customer transactions in India. A Vostro account is in substance no different from any other account in the local currency. Vostro account are non-interest bearing accounts.

Auditing Aspect:

Many of the aspects mentioned for Nostro Accounts apply to Vostro Accounts as well and may accordingly be referred to.

In case a new Vostro account is opened during the year, auditor may verify the account opening form, authorisation of person requesting opening of account, KYC carried out as well as agreement entered with the account holder if these are done as per internal guidelines and if any discrepancy is noted, the same may be brought out in LFAR.

In case account is overdrawn, auditor may ascertain if such overdraft was authorised and appropriate interest is charged thereon. Verify that overdrawn Vostro accounts are classified as advance by bank.

Verify tax compliances in respect of transactions in Vostro account for credits made by Indian party into such accounts.

OTHER AREAS OF FOREIGN EXCHANGE/CURRENCY TRANSACTIONS

Besides reporting in LFAR, there would be other transactions involving foreign exchange such as import and export Letters of Credit, foreign currency Bank Guarantees, borrowing and lending in foreign currency, foreign exchange contracts that need to be examined by the auditors.

1. **Letters of Credit**

   Goods can be bought and sold wherein consideration can be paid in various forms like in cash, cash against delivery of goods, cash against documents, cash against acceptance of bill of exchange etc. However, in case of International

Sale transaction, there is a risk on the part of seller with respect to realisation of sale proceeds and on the other hand, the buyer is concerned about the quality and quantity of goods imported; resulting in a conflict of interest and, to overcome this situation, both the parties resort to Documentary Credit. The buyer approaches his bank (the issuing bank) to open a Letter of Credit (LC) in favour of the sellers Bank to the account of the seller (beneficiary) based in different country. An LC is an undertaking given by the issuing bank to honour the payment on due date upon receipt of necessary documents from the beneficiary or banker and upon acceptance of good by the buyer. The issuing bank honours the payment thereafter on due date irrespective of whether it is able to recover the money from the buyer. LC may be either revocable or irrevocable one. If nothing is specified, the LC will be deemed to be irrevocable one, wherein it cannot be cancelled before its expiry. LCs being an undertaking, these are disclosed under contingent liability of banks. Banks collect commission from customers for issuance of LC.

Auditing Aspect:

- Verify outstanding LCs at year end and in case there are any expired LCs, ascertain reason for bank in continuing to disclose under contingent liability.
- Ensure that the total of individual LCs tally with the amount disclosed under contingent liability.
- Verify accounting of commission on LC by the bank with the accounting policy prescribed by head office. Typically, banks amortise commission over the LC period and thus the unamortised LC commission should be related to the outstanding LC. In case of mismatch between the LCs outstanding and unamortised commission on those LCs, the reasons should be ascertained. Verify the calculation of amortisation of LC commission.
- Verify if LCs are issued on behalf of parties who are not regular customers of the bank and check the authorisations obtained within the bank and also the overall nature of transaction.
- In case of LCs for import of goods, the payments should be released to the foreign parties only after ensuring that the documents are strictly in conformity with the terms of the LCs. There have been irregularities in the conduct of LC business, such as the LC transactions not being recorded in the books of the branch by officials issuing them, the amount of issued LCs being in excess of the powers vested in the bank officials, fraudulent issue of LCs involving a conspiracy/collusion between the beneficiary and the constituent. The auditor should review LC register and also actual documents to ascertain any discrepancy therein. A review of internal control system and banks test of control over recording of LC issuance should be done.
- Review concurrent audit reports should be done for their observations pertaining to LC business.

2. Direct Import Bills

In the case of Bills under LC or Bills for collection, the documents are being delivered to the respective banker and the custody of the documents will be with the banker until the amount of bill is paid or accepted. However, when the import is directly done by the Importer, the Importer will receive the Documents and Goods from the Exporter directly. The importer will approach to its banker for the payment of the import that he has made. Importer’s Banker will verify the genuineness and process the transaction. The bills are lodged in CBS/recorded in Direct Import Bills. In case of CBS, the payment of Bill made through Bill module in CBS. The account of the Importer will be debited and the funds will be remitted to foreign exporter through Nostro Account.

Auditing Aspect:

- Verify that Bill of Entry is obtained/Entry in IDPMS is verified before remittance under Direct Import Bills
- Verify if facility of Direct Import Bill is extended to ineligible importer? (refer RBI Master Directions on Import of Goods and Services)
- Verify that the system is in place for compliance with GST, withholding of income tax with respect to remittance of charges/ commission to banks outside India.

- Verify the controls over collection of charges on direct import bills.

3. Advance Payment against Imports

In the case of advance payment against imports, the amount is remitted prior to import. There is a risk on the part of importer related to receipt of goods. The bankers are also concerned for conclusion of transaction (i.e., receipt of Bill of Entry as evidence of Import). The transaction is permitted subject to guidelines issued by RBI (Master Directions Import of Goods and Services). The bank follows up for submission of Bill of Entry/updation through IDPMS for actual Import against which the Advance Remittance is effected.

All payments towards advance remittance for imports shall be subject to the specified conditions and AD banks are required to create Outward Remittance Message (ORM) for all such outward remittances in IDPMS & follow other extant IDPMS guidelines.

In cases where relevant evidence of import data is not available in IDPMS on due dates against the Outward Remittance Message (ORM), AD Category–I bank shall follow up with the importer for submission of documentary evidence of import. Moreover, if Bill of Entry data is not settled against ORM within the prescribed period, AD Category–I banks shall follow-up with the importer for updating the Import details.

In case an importer does not furnish any documentary evidence of import, within 3 months from the date of remittance involving foreign exchange irrespective of value, the AD Category–I bank should rigorously follow-up for the next 3 months, by using various modes of communications. Banks should ensure that at least one communication with the importer in these regards is by issuance of registered letter.

AD Category–I banks can consider closure of BoE/ORM in IDPMS that involves write off to the extent of 5% of invoice value in cases where the amount declared in BoE varies from the actual remittance due to operational reasons and AD bank is satisfied with the reason/s submitted by the importer.

<u>Auditing Aspect</u>:

- There are various restrictions on advance against import transactions including requirement of obtaining Standby Letters of Credit/Bank Guarantees from foreign banks for transactions exceeding limits laid down under RBI guidelines. Verify compliance with said requirements and in case of discrepancies report them in LFAR.
- Ascertain if a single transaction has been split into multiple transactions below permissible limit which when aggregated exceed the prescribed threshold.
- In respect those instances where the entire transaction has not completed/settled within prescribed period, the follow-up and reporting measures done by bank needs to be verified including collection of any charges/penalties if any.

4. Foreign Exchange Contracts:

Typically, the foreign exchange contracts are entered by treasury office of Banks and the contract may be reflected in books of treasury. If the contracts are reflected at branches, the auditor should verify the contracts with the underlying customer requests and documentation which evidence that the customer request is for genuine business transaction and not intended for trading. While setting limits for customers branches, need to ensure that the limit requested is proportionate to the business requirements of borrowers and also need to have adequate documentation on record to evidence the underlying business transaction or as otherwise permitted by RBI.

<u>Auditing Aspect</u>:

- Auditor should check if mark to market of all forward exchange and derivative contracts is being done in books of branches. If so, study the manner in which the same is done and examine controls put in place by Bank to ensure accuracy of such entries. Auditors should obtain understanding of interface controls between various applications used by treasury department (viz. CBS, Finacle Treasury and Finacle core, etc.).
- Examine the process put in place by bank for monitoring partial closure of deals and accounting of the same.
- Auditor should examine if there are any overdue receivables representing mark-to-market value of derivative contracts and in

case these are unpaid for more than 90 days from specified due date of payment, classify the borrower and thereby all facilities as non-performing. All IRAC norms would thus need to be complied with for such borrowers classified as non-performing.

- In terms of RBI guidelines, credit exposures computed as per the current marked to market value of the contract, arising on account of the interest rate & foreign exchange derivative transactions, and gold, shall also attract provisioning requirement as applicable to the loan assets in the 'standard' category, of the concerned counterparties. If the said calculation is reflected at the branch level the same needs to be reviewed by the branch auditors.
- Auditors need to confirm that the amount of outstanding forward exchange contracts are included under Contingent Liabilities – "Liability on Account of Outstanding Forward Exchange Contracts and Derivatives Contract." Branches generally maintain a register of forward exchange contracts, which needs to be verified in order to ensure that all contracts that will mature subsequent to balance sheet date are included under contingent liability.
- Profit (net of losses) on forward exchange contracts are included in Other Income – "Profit on exchange transactions". The auditors may check and satisfy themselves on the entries in said account on last day of accounting year to corelate them with outstanding forward exchange contracts as well as mark to market entries relating to these contracts. Any entries other than these or those that are manual entries need to be inquired into. Besides, the auditors may extend their checks to other dates or transactions and make comparisons with previous data to obtain satisfaction on the amount reflected under this head.

5. Other Areas

- Obtain latest reviewed list of sensitive positions or areas of operations such as dealing room, treasury, heads of specialized branches etc. that the bank has drawn up and which are relevant to the branch being audited. Verify that the bank has put in place a 'mandatory leave' policy wherein the employees posted in sensitive positions or areas of operation are compulsorily sent on leave for a few days (not less than 10 working days) in a single spell every year, without giving any prior intimation to these employees. Verify that bank has ensured that the employees, while on 'mandatory leave', do not have access to any physical or virtual resources related to their work responsibilities, with the exception of internal/ corporate email which is usually available to all employees for general purposes.
- In case there exist any transaction linked to LIBOR inquire into RBI guideline permitting such referencing. Further, verify that the ARR used are from the permitted bechanmark rates as per Head Office guidelines. Verify banks transitioning to such ARR for any improvements or comments thereon.
- If the branch deals in foreign currency notes, the same need to be verified during the course of physical verification of cash. Further, auditor needs to also verify if the foreign currency notes are stated at closing exchange rate notified by Head Office which in turn are provided by FEDAI.
- The auditor should also evaluate the internal control with regard to inward/ outward messages. The inward/ outward messages should be properly authenticated and discrepancies noticed should be properly dealt with in the books of accounts. Auditors may also review compliance with Head Office guidelines for reporting requirements under Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standards (CRS).
- The auditors may verify on sample basis the details of shipping bills, inward remittance messages, bill of entries and outward remittance messages in terms of RBI AP (DIR Series) circular no. 109 dated February 28, 2014, circular no. 5 dated October 6, 2016 and other circulars issued on Export Data Processing and Monitoring System and Import Data Processing and Monitoring System from time to time and comment on

the outstanding position of shipping bills, inward remittance messages, bill of entries and outward remittance messages.

- Auditors may review 15CA and 15CB certificates with the Bank for ascertaining control exercised by Bank over tax compliances by its clients as well as comment on process implemented by Bank of checking the UDIN mentioned by chartered accountants on Form 15CBs.
- Auditors should review RBI reports/ observations if any, along with branch compliances on any adverse comments noted by RBI with regard to foreign exchange transactions. The implications of these observations to the current financials need to be also examined.
- Statutory Central Auditors of Bank may need information with regard to foreign exchange transactions that would be required for issue of certificates or for making provisions such as standard assets provision, calculating capital adequacy etc. for which the branch auditors may need to verify the accuracy of information compiled by Banks along with calculations carried out.

■■■

Audit Documentation in Bank Branch Audit

CA. Premal Gandhi

- Audit documentation should be sufficient and enable an experienced auditor, having no previous connection with the audit, to understand:
  - a) The nature, timing, and extent of the audit procedures performed to comply with the SAs and applicable legal and regulatory requirements;
  - b) The results of the audit procedures performed, and the audit evidence obtained; and
  - c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.
- In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:
  - a) The identifying characteristics of the specific items or matters tested;
  - b) Who performed the audit work and the date such work was completed; and
  - c) Who reviewed the audit work performed and the date and extent of such review.

  The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place. If the auditor identified information that is inconsistent with the auditor's conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency.
- **Role of audit documentation in general audit [SA-230]**
  - ❖ The Standard on Auditing (SA)-230 deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements. This audit documentation provides evidence of the auditor's basis for a conclusion and also provides an evidence that the audit was planned and performed in accordance with SA's.
  - ❖ The audit documentation serves a number of additional purposes including the following:
  - ❖ Assisting the engagement team to plan and perform the audit
  - ❖ Enabling the engagement team to be accountable for its work
  - ❖ Retaining a record of matters of continuing significance to future audits
  - ❖ Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements
- In the recent years, the Quality Review Board (QRB) has issued various reports on its finding with regards to the compliance of technical standards (Accounting Standard, Standard on Auditing etc.), after review of the audit documentation/audit working papers of several audit firms. The report inter alia includes several critical observations with respect to the compliance of audit documentation. These observations are discussed in the later part of the paper.

- Role of audit documentation in Bank Branch Audit (BBA)

  ❖ The importance of the audit documentation become more significant in the Bank Branch Audit due to the onerous responsibility on the branch auditor. The branch auditor is expected to complete the audit of any size of the branch in the maximum seven days. This creates lot of challenges on the part of the branch auditor to complete the statutory audit along with the audit documentation.

  ❖ The documentation of the audit work done by the branch auditor also becomes more important as the Statutory Central Auditors' (SCA's) place heavy reliance on the work done by the bank branch auditor (BBA).

  ❖ The documentation of work done in bank audit is very important considering as the same is open to the inspection by quality review board, peer review and other regulators.

  ❖ In the recent years, the quality review board has reported certain observations specifically relating to bank audit such as:

  ❖ Working for Provision of NPA's are not available in respect of the branches allocated to the firm.

  ❖ Computation of NPA for the Bank was not documented and without adequate documentation it was not clear how the assets were identified as standard or otherwise.

  ❖ Long Form Audit Report annexures were not linked to work papers wherever possible.

  ❖ In LFAR, there were unreconciled differences, wherein it was stated that pending final clearance the overall impact on the account in the opinion of the management of the company will not be material/significant. However, how this assertion was validated/ evaluated by the firm was not documented.

  ❖ In respect of classification of NPA on receivables, the Audit Firm did not have in their file, the veracity of the classification of NPAs.

  ❖ The above observation raised a significant doubt on the work performed by the Bank Branch Auditor/Statutory Central Auditor. These types of the observation also raise lot of concern on the quality of the audit work and its impact on the reliance placed by the other auditors.

  ❖ Key areas of documentation in Bank Branch Audit In the bank branch audit, there are several areas where the auditor needs to prepare audit documentation, however following are the key areas where the auditor should prepare the audit documentation with more diligence:

a. Documentation for appointment formality & planning

❖ It has been observed in various review reports that there is lack of audit documentation as far as planning of any audit is considered. It has also been seen that the auditor does not keep proper documentation with respect to the appointment formality.

❖ Like for e.g., in case of a new appointment the branch auditor should obtain the No-Objection Certificate from the previous auditor. The branch auditor should also ensure that the Code of Ethics are complied with before commencing the audit assignment.

❖ Generally, the appointment letter from the banks comes at very last minute and the auditor should take utmost care in completing the appointment formalities to avoid any non-compliance or any lapses in the same.

❖ The list of minimum documents to be kept in the audit file is separately given in Annexure to this paper.

b. Documentation while doing verification of advances

❖ This is one of the most significant areas of bank audit. This process starts with selection of the samples to verify the sanctioning and disbursement process of the advances and completes with the reporting on large advances in the LFAR.

❖ The documentation in this stage requires the auditor to include all the steps performed at various stages. The auditor should start documenting the basis of his/ her sample selection process or the key points kept in mind while selecting the sample for verification of documents.

- ❖ In documenting the sample selection process, the auditor should also include whether he/ she has selected certain sample based on comments made in the Inspection Report, Concurrent Reports etc. It is advisable that the auditor reviews and documents the sample and their basis in a structured manner.
- ❖ The auditor should prepare a comprehensive checklist which covers the requirement for various of facilities sanctioned and disbursed by the bank. This checklist should also include the various regulatory parameters prescribed by the RBI like for e.g., while verifying whether the housing loans are permitted within the prescribed LTV ratio, the audit team should also mention the actual ratio as well rather than stating 'Yes' or 'No'. The above checklist should be based on the latest guidelines issued by the RBI as well as based on their internal credit instructions.
- ❖ The auditor should ensure that the comprehensive checklist should be descriptive in nature rather than objective. Since the SA-230 requires identifying the characteristics of specific items tested so as to identify any inconsistencies or deviations. Like for e.g.:

Audit Process	Auditor's Reply	SA-230 requirement
Whether the loan has been sanctioned by an appropriate sanctioning authority?	Yes	Yes, by Mr. M S Dhoni (AGM Credit) on 11th September 2017

- ❖ The Auditor will have to document the requirements as mentioned in other Standards on Auditing like:
  1. SA-210 Agreeing the terms of Engagement.
  2. SA-320 Materiality in planning & performing the Audit.
  3. SA- 530 Audit Sampling
  4. SA- 580 Written Representation.
- ❖ The auditor should also include their specific observation on these samples selected for verification along with the management responses. Post receipt of the replies from the branches, it is advisable for the auditor to include its concluding remark on these observations. The remarks should clearly state whether these replies are to the satisfaction of the auditor or being taken to branch audit report or LFAR.
- ❖ The observation under the checklist should be linked to the comments in the LFAR wherever possible so as to ensure effective noting in the working papers.

c. Documentation while verifying IRAC Norm (Non-Performing Assets)

- ❖ This is second most critical area of any bank branch audit. The audit process at this stage again involves sample selection and specific testing based on the auditor judgment, which needs to be documented. Like for e.g., an auditor may do 100% verification of all the Non-Performing Accounts more than ₹ 5 crore and do a test check verification for all the loans below such threshold limit.
- ❖ The auditor should also prepare a complete working for the NPA computation. In all the Public Sector Banks (PSB) an auditor is expected to certify various annexure on Non-Performing Assets (NPA). While certifying these annexures the auditor should ensure that the figures reported in these annexures are reconciling with the working prepared by the team.
- ❖ The auditor should also include details of Valuation Reports, Financial Statements etc., considered while computing the NPA Provision. The auditor may take the photocopies or the scanned copies of these reports for the future reference.
- ❖ The auditor may sometime apply his/her professional judgment either in identifying an account as NPA or in evaluating the

adequacy of the provision. The auditor should adequately document these judgments and prepare a proper note for the same. The auditor also obtains specific representation required from the Branch Management on any of these issues.

- In certain cases, based on documents & his judgment the auditor may identify an account as NPA or suggest certain additional provisioning on the advances. The auditor should prepare a proper working for the same and keep this in the working papers.

- The auditor should document the discussion with the branch manager on the NPA accounts more particularly on high value advances.

- In many of these PSB's the identification and provisioning on the NPA's are through system, as per the documentation the auditor is advised to compute the date of NPA based on the IRAC Norms and compare the same with the system date. The auditor should also keep the relevant system screen shot wherever necessary keeping the client confidentiality in mind.

d. Documentation for other areas of audit & Certification of Annexures

- The audit of advances and the non-performing assets are the core areas of the audit in the bank branch audit. However, the auditor is also expected to audit the other areas of the bank to certify the true and fair view on the whole financial statement.

- The auditor should obtain adequate audit evidence for the other areas as well like for e.g., Cash Balance certificate along with Cash Balance Register, ATM balance, Fixed Asset verification reports etc.

- The auditor should also carry out the scrutiny of the Balance Sheet and Profit & Loss account to see any unusual item or any unusual trends. The auditor should direct its team member to carry out the variance analysis of the significant items of financial statement and should document the reason for the same. The auditor should also document the reason for any significant variation and should assess whether the same needs to be brought to the attention of the bank's management.

- In most of the PSB's, the auditor has to certify various annexures pertaining to different areas such as Priority Sector Advances, Sensitive Sector Advances etc. Some of these annexures are directly relied upon by the Statutory Central Auditor (SCA's) at the time of issuing the consolidated certificate or for other provisioning purpose. The branch auditor should ensure that these annexures/certificates issued by the auditor are properly supported with the documentary evidences. The auditor should carry out the audit of Priority Sector advances/ Sensitive sector advances on test check basis to check the correct classification of these advances.

- In certain cases, the branch auditor is required to issue certain certificate for certain benefits where there is a possibility that due to lapses on the part of the bank the ineligible customer may have received certain benefits. Like for e.g., Interest Subvention claims to the farmers, the auditor should ensure that he/she has obtained appropriate documents to certify these certificates which at later stage may be subject to scrutiny by the Reserve Bank of India or any other Regulator.

e. Documentation for Auditor's Report, LFAR & MOC's

- This is also one of the critical stages of the bank audit wherein the auditor finally concludes on all the points and issues a final report on the financial statement of the bank.

  The auditor should prepare a complete list of all the issues identified during the course of the audit across all the areas at the Branch. The auditor should incorporate the replies received from the branch management on each of these points.

- The auditor should include his/ her conclusion on each of these points so as to indicate whether he/she is satisfied with the reply from the branch management or the issue need to be included in the auditor's report or the same is to be reported in the LFAR.

- The below Master Sheet will help the auditor to have a complete control on all the points/ observation raised and the way the same have been concluded. The format of the master sheet can be as follows:

Query No.	Area of operation	Observation of BBA	Branch reply	Conclu-sion	Reference in LFAR/ AR

- The branch auditor is also required to issue a Long Form Audit Report (LFAR), wherein the auditor is required to state many factual information like for e.g. Cash Retention Limit etc. It has been observed that the Branch Auditors do not keep the supporting documents for these comments in the LFAR. Hence it is advisable to the branch auditor to prepare a complete set of audit documentation for the LFAR should be maintained in their voluntary files.

- The auditor is also required to comment upon the advances beyond a certain threshold limit. These annexures are normally prepared by the bank's management; the auditor is required to give his/her comments. The auditor should keep the appropriate audit evidences for these comments and should also keep the supporting evidences for the same.

- In the PSB branch audit, the audit adjustment entries are passed through Memorandum of Changes (MOC's) wherein the auditor needs to suggest the changes like for e.g., Classifying an Account as NPA, Additional Provisioning on NPA Accounts, correction in the returns etc. These MOC's are normally dealt at Regional/Zonal office level.

- The auditors should keep all the appropriate documents/relevant supporting for each MOC's suggested at the Branch. Like for e.g., if the MOC suggests classifying an account as NPA, the auditor should clearly document the reasons for the same. These evidences will be helpful to the auditor in replying to any query either from the Head office/ Regional office or by SCA's at later stage.

- There may be instance, where the auditor may have suggested MOC but the same may have not been accepted by the branch/ regional/ Zonal officer then the same needs to be documented by the auditor.

- The auditor at times will have to use his professional skills in drafting the representation letters from branches.

- During the course of verification of security documents, the auditor may have observed that the security values are not appropriately accounted which require certain additional provisioning. It has been observed that the auditor suggests the MOC's for the same however fails to produce any proper working paper or supporting document for these additional provisioning.

f. Documentation for Tax Audit u/s. 44AB

- As part of the bank branch audit, the auditor is also required to carry tax audit u/s. 44AB of Income- tax Act,1961. The format of the tax audit report and the relevant annexures are provided by the Head office to these branches.

- Out of the various clauses as per Form 3CD report, there are only 5 to 6 clauses which are required to be audited at the bank branch level. Like for e.g., reporting u/s 40A(2)(b) under clause 23, Input Tax Credit details under clause 27 are not applicable at the bank branch audit.

- The auditor should clearly identify the areas/ clauses which need to be verified at the branch audit level and the auditor should prepare its audit documentation for those areas. The clauses which are not applicable to the bank branch, the auditor should include its remarks against each of these clauses.

- One of the important clauses to be verified at the bank branch level is clause 34 pertaining to compliance of TDS provisions. The auditor should prepare its own working paper to certify the information reported under this clause.

- In cases where in the opinion of the auditor, the branch management has not complied with the TDS provision, the auditor should keep relevant necessary documents as part of it working paper.

g. Conclusion

- ❖ The audit documentation for any audit is incomplete without obtaining the management representation letter. The branch auditor should obtain specific representation on the matters identified during the course of the audit. It has been observed that sometime the branch auditor does not obtain management representation at all or sometime obtain the representation on the matter which is significant audit area. If the Auditor does not get the Management representation letter from the Branch, then he will have to consider whether circumstances warrant qualification of his report based on his assessment whether the non-obtention of information has a material impact on his true and fair view of the financials statements and accordingly he shall mention the same in his audit report or LFAR as the case maybe.
- ❖ The auditor at times will have to use his professional skills in drafting as well as obtaining the representation letters from the Branch.

■■■

Frauds in Banks and Precautions as Auditor

CA. Abhay V. Kamat & CA. Palash Kothari

1. Introduction

The meaning of the Fraud could be "Fraud is **where a person is financially cheated by another person.** Fraud occurs when an individual deceives another by inducing them to do something or not do something that results in a financial loss." In case of frauds in Bank such cheating happens in the bank or banking business. Thus the financial loss is to the Bank or any other person.

Reserve Bank of India (RBI) is the regulatory authority for the Banks. RBI is very conscious of the frauds taking place in the Banks. Hence it has issued a Master Circular on Frauds (DBS. CO.CFMC.BC.No.1/23.04.001/2016-17 dated July 1, 2016) In this master circular RBI has given guidance about Types of frauds, measures for controlling the frauds, reporting of frauds, review of the frauds and other precautions to be taken.

These directions are issued with a view to providing a framework to banks enabling them to detect and report frauds early and taking timely consequent actions like reporting to the Investigative agencies so that fraudsters are brought to book early, examining staff accountability and do effective fraud risk management. These directions also aim to enable faster dissemination of information by the Reserve Bank of India (RBI) to banks on the details of frauds, unscrupulous borrowers and related parties, based on banks' reporting so that necessary safeguards / preventive measures by way of appropriate procedures and internal checks may be introduced and caution exercised while dealing with such parties by banks.

In this article we are trying to understand the guidance given by the RBI and what are the precautions to be taken by the auditors.

2. Classification of Frauds

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.

3. Reporting of frauds to Reserve Bank of India

Banks need to furnish Fraud Monitoring Return (FMR) in individual fraud cases, irrespective of the amount involved, to RBI electronically using FMR Application in XBRL System supplied to them within three weeks from the date of detection.

In addition to the FMR, banks are required to furnish a Flash Report (FR) for frauds involving amounts of ₹5 crores and above within a week of such frauds coming to the notice of the bank's head office.

Further, banks are also required to furnish developments in the fraud case through the FMR Update Application supplied to them in XBRL system.

Banks should strictly adhere to the timeframe fixed in this circular for reporting of fraud cases to RBI failing which they would be liable for penal action prescribed under Section 47(A) of the Banking Regulation Act, 1949.

4. **Reports to the Board**

Banks should ensure that all frauds of ₹ 1 lakh and above are reported to their Boards promptly on their detection. Such reports should, among other things, take note of the failure on the part of the concerned branch officials and controlling authorities, and give details of action initiated against the officials responsible for the fraud.

Quarterly Review

Information relating to frauds for the quarters ending June, September and December shall be placed before the Audit Committee of the Board of Directors during the month following the quarter to which it pertains.

Annual Review

Banks should conduct an annual review of the frauds and place a note before the Board of Directors/Local Advisory Board for information. The reviews for the year-ended March shall be put up to the Board before the end of the next quarter i.e. quarter ended June 30th. Such reviews need not be sent to RBI but may be preserved for verification by the Reserve Bank's inspecting officers.

The main aspects to be taken into account while making such a review shall, inter alia, include the following:

(a) Whether the systems in the bank are adequate to detect frauds, once they have taken place, within the shortest possible time.

(b) Whether frauds are examined from staff angle and, wherever necessary, the cases are reported to the Vigilance Cell for further action in the case of public sector banks.

(c) Whether deterrent punishment is meted out, wherever warranted, to the persons found responsible.

(d) 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.

(e) 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 Government of India.

The annual reviews should also, among other things, include the following details:

(a) Total number of frauds detected during the year and the amount involved as compared to the previous two years.

(b) Analysis of frauds according to different categories detailed above and also the different business areas

(c) Modus operandi of major frauds reported during the year along with their present position.

(d) Detailed analysis of frauds of ₹ 1 lakh and above.

(e) Estimated loss to the bank during the year on account of frauds, amount recovered and provisions made.

(f) Number of cases (with amounts) where staff are involved and the action taken against staff.

(g) Region-wise/Zone-wise/State-wise break-up of frauds and amount involved.

(h) Time taken to detect frauds (number of cases detected within three months, six months and one year of their taking place).

(i) Position with regard to frauds reported to CBI/Police.

(j) Number of frauds where final action has been taken by the bank and cases disposed of.

(k) Preventive/punitive steps taken by the bank during the year to reduce/ minimise the incidence of frauds.

Banks shall place the copy of the circular on modus-operandi of fraud issued by them for alerting their branches/controlling offices etc., on specific frauds before the Audit Committee of Board (ACB) in its periodical meetings.

The major functions of the Special Committee would be to monitor and review all the frauds of ₹ 1 crore and above so as to:

- Identify the systemic lacunae if any that facilitated perpetration of the fraud and put in place measures to plug the same.
- Identify the reasons for delay in detection, if any, reporting to top management of the bank and RBI.
- Monitor progress of CBI/Police investigation and recovery position.
- Ensure that staff accountability is examined at all levels in all the cases of frauds and staff side action, if required, is completed quickly without loss of time.
- Review the efficacy of the remedial action taken to prevent recurrence of frauds, such as strengthening of internal controls.

5. Early Warning Signals (EWS) and Red Flagged Accounts (RFA)

RBI make it compulsory for the bank to identify the accounts as red flagged accounts (RFA) and mark them accordingly. The RBI has prescribed some criteria as to when the account could be marked as RFA. Such accounts should be monitored closely and it is prescribed that the red flagging should be removed within 6 months by marking the account as normal account or fraud account on the basis of the behaviour of the account.

The auditor should ensure that the red flagging is done properly. In fact any fraud account should be first marked as RFA in most of the cases.

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). These signals in a loan account should immediately put the bank on alert regarding a weakness or wrongdoing which may ultimately turn out to be fraudulent. A bank cannot afford to ignore such EWS but must instead use them as a trigger to launch a detailed investigation into a RFA.

An illustrative list of some EWS is given for the guidance of banks in Annex II to this circular.

1. a) Default in undisputed payment to the statutory bodies as declared in the Annual report.

   b) Bouncing of high value cheques
2. Frequent changes 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 invocations of BGs and devolvement of LCs.
6. Under insured or over insured inventory.
7. Invoices devoid of TAN 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 collaterals 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 I member bank/ lenders to the company.
21. LCs issued for local trade I 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 changes 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 debt high
34. Substantial increase in unbilled revenue year after year.
35. Large number of transactions with inter-connected companies and large outstanding 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 /sales tax/ central excise duty officials
41. Significant reductions 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

6. Role of Auditors

During the course of the audit, 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 top management and if necessary to the Audit Committee of the Board (ACB) for appropriate action.

The auditor should design the audit cheques to take care of the situations enumerated in the master circular by RBI.

1. Whether the bank has followed the process of identification and communication of the fraud as prescribed by the RBI
2. Whether red flagging is done properly and the RFAs are monitored properly
3. Minutes of the Audit Committee need to be seen for proper reporting of the fraud to ACB, its quarterly / annual review and the actions taken on the frauds.
4. The auditor should scrutinise the loans to ensure that proper appraisal is done. Normally when the appraisal is faulty the account is likely to become NPA or fraud account.
5. Related party transactions to be scrutinised to verify whether undue benefit is given to a particular party.
6. In case of consortium finance, whether sharing of information within the member banks of the consortium is done properly with appropriate frequency.

7. Scrutiny of accounts which are reflected in Other Assets and Other Liabilities. Similarly the office accounts needs to be seen from the angle of understanding that no amount is parked in such accounts for unreasonable period.
8. Scrutiny of Sundries and Suspense accounts to see the entries in the account and the clearance thereof.
9. Scrutiny of any transaction which is approved by the Branch Manager or any official which is not within his powers.
10. Status of existing frauds or any recovery out of them need to be seen.

The above list is the illustrative list. The auditor needs to be vigilant enough to sniff the transactions which may lead to fraud in future. For this he should carry out not only the transaction testing but also the analytical procedures while carrying out the audit at the bank.

7. Conclusions

Though it not necessarily the duty of the auditors to detect the frauds in the bank, the auditor should look into the areas of audit with professional scepticism. The auditor should see whether the guidelines given by RBI are followed properly in terms of the actions, reporting and the timelines. In case he come though the suspicious transaction, he needs to enhance the audit check and ensure that there are no situation which may lead to the fraud. For this he needs to follow the techniques of Observations, Interactions, Analysis, Verification and Meaningful Reporting.

■■■

Notes

eMSME SAARTHI

saarthi.emsme.com

One Stop Solution for All MSME Schemes

Exclusive Package for CA's

About eMSME Saarthi

eMSME Saarthi is an automated MSME government scheme discovery platform wherein CAs can generate the list of schemes their client is eligible for in less than 5 minutes, by providing basic minimum inputs such as age, category, location, industry etc.

CAs can also generate a Scheme Discovery Report which gives information like benefit amount, key eligibility criteria, application process etc.

India's first **Compliance Health Check** platform wherein the CAs can determine licenses and registrations required for their client's business type.

Saarthi in 3 Simple Steps

- Input Basic Details
- Get a list of Schemes Applicable for Your Business
- Generate Report and Avail Benefits with help of Dedicated Scheme Advisor

Corporate Office

407 Lodha Supremus, Off Mahakali Caves Road,
Andheri (E), Mumbai - 400069

Registered Office

203, Sumer Kendra, Pandurang
Budhkar Mard, Worli, Mumbai - 400018

Connect with us

info.saarthi@emsme.com

9893066357 | 8142622240