

# **Guidance Note on Audit of Banks (2019 Edition) Section B - Foreign Exchange Transactions and Integrated Treasury**

## **Attention**

Members' attention is invited to relevant directions/circulars issued by the Reserve Bank of India up to January 1, 2019 included in a Pen Drive/CD accompanying this Guidance Note for ease of use and reference. Members are advised to keep track of legislative/regulatory developments, for example, circulars of the Reserve Bank of India, issued subsequent to the aforementioned date and having a bearing on the statutory audit of banks/bank branches for the year ended March 31, 2019.



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

# Foreword

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The banking sector in India is one of the largest in the world as far as its extensive network of branches is concerned. The role of the sector in the overall growth and development of the Indian economy is quite significant and laudable. Over the years, the sector has been through a long journey and has also achieved new heights with the changing times. The widespread use of technology has completely changed the working of banks resulting in lesser requirements for people to visit banks physically. Nevertheless, the fundamental aspects of banking i.e. trust and confidence of people on banking sector remains the same. This trust and confidence come on the back of strong quality of audit system and practices in place in India.

The Guidance Note on Audit of Banks is issued by the Auditing and Assurance Standards Board (AASB) of ICAI every year with the objective to provide detailed and updated guidance to the members on various aspects of bank audits. The Guidance Note is an important resource for the members carrying out audits of banks and bank branches. I am happy that AASB has come out with this revised 2019 edition of the Guidance Note on Audit of Banks for the benefit of the members. I am also happy that the Guidance Note is comprehensive and self-contained reference document for the members.

I wish to place my appreciation for CA. Shyam Lal Agarwal, Chairman, CA. Sanjay Vasudeva, Vice-Chairman and other members of AASB for bringing out this revised Guidance Note to help the members in maintaining quality in bank audits.

I am confident that the members would find the Guidance Note highly useful in their professional assignments.

January 13, 2019  
New Delhi

**CA. Naveen N.D. Gupta**  
President, ICAI

# Preface

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Every year, the Auditing and Assurance Standards Board (AASB) of ICAI brings out the publication, “Guidance Note on Audit of Banks” to provide detailed guidance to the members who undertake audits of banks and bank branches. The Guidance Note is updated every year to incorporate the impact of developments that have taken place in the banking sector which require attention of statutory auditors, such as, master directions/circulars of RBI, other relevant circulars issued by RBI, relevant pronouncements of ICAI having bearing on bank audits, amendments/changes in applicable laws or regulations.

I am happy to place in hands of the members, this revised 2019 edition of the Guidance Note on Audit of Banks. The Guidance Note covers in detail various aspects like knowledge of the banking industry, initial considerations, special considerations in a CIS Environment, risk assessment and internal control, various items of banks’ financial statements and their peculiarities, manner of disclosure in financial statements, the RBI prudential guidelines thereon, audit procedures, reporting on Long Form Audit Reports both at central and branch level, Ghosh and Jilani Committee recommendations, special purpose reports and certificates, etc.

For benefit of the members, the pen drive/CD accompanying the Guidance Note contains illustrative formats of engagement letter, illustrative formats of auditor’s report both in case of nationalized banks and banking companies, illustrative formats of management representation letter, illustrative list of special purpose/ exception reports in CBS, illustrative audit checklist for capital adequacy, illustrative checklist on audit considerations in a CIS Environment, Features of the Gold Monetization Scheme, Suggested Abbreviations used in the Banking Industry, Basis of Selection of Advances Accounts in case of bank branch audit, updated bank branch audit programme for the year 2018-19, Verification of the aspects of the Treasury/ Investments of the Bank in Statutory Audit, Flow Charts for Use of Core Banking Solution software in case of Bank Branch Audit, the text of Master Directions, Master Circulars and other relevant Circulars issued by RBI.

Readers may note that this edition of the Guidance Note has been divided in three separate sections as follows:

- Section A - Statutory Central Audit.
- Section B - Foreign Exchange Transactions and Integrated Treasury.
- Section C - Bank Branch Audit other than Foreign Exchange Transactions.

At this juncture, I wish to place on record my gratitude to all the members of Mumbai study group viz., CA. Dhananjay J. Gokhale (Convenor), CA. Viren H. Mehta, CA. Shriniwas Y. Joshi, CA. Sandeep D. Welling, CA. Sanjay Khemani, CA. Niranjana Joshi, CA. Abhijit Sanzgiri, CA. Vipul K. Choksi, CA. Abhay V. Kamat, CA. N. Sampath Ganesh, CA. Sanat Ulhas Chitale, CA. Gautam V. Shah, CA. Manish Sampat, CA. Nilesh Joshi, CA. Parag Hangekar, CA. Shivratana Agarwal, CA. Vikas Kumar, CA. Ketan Jogalekar, CA. Nachiket Deo, CA. Parag V. Kulkarni, CA. Dilip Dixit, CA. Jitendra Ranawat, CA. Prakash P. Kulkarni, CA. Kuntal P. Shah, CA. Giriraj Soni, CA. Vitesh Gandhi, CA. Hitesh Pomal, CA. Pankaj Tiwari, CA. Saurabh Peshwe, and CA. Pankaj Mittal for their dedicated efforts in revising the Guidance Note despite the demands of their professional and personal lives under the overall supervision of CA. Nihar Niranjana Jambusaria, Central Council Member, ICAI. I am thankful to CA. M P Vijay Kumar, Central Council Member, ICAI and his team for their efforts.

My sincere thanks to all the Members of Jaipur Study Group constituted under my convenorship viz., CA. Bhupendra Mantri (Dy. Convenor), CA. Vimal Chopra, CA. Prahalad Gupta, CA. Vikas Gupta, CA. Vishnu Dutt Mantri, CA. Ajay Atolia, CA. Jugal Kishore Agrawal, CA. P. D. Baid, CA. Mukesh Gupta, CA. Vikas Rajvanshi, CA. Thalendra Sharma, CA. Varun Bansal, CA. Sandeep Jhanwar, and CA. Keshav Garg for reviewing exposure draft of the Guidance Note and providing their valuable suggestions thereon.

I wish to express my sincere thanks to CA. Naveen N.D. Gupta, Honourable President, ICAI and CA. Prafulla P. Chhajed, Honourable Vice-President, ICAI for their guidance and support to the activities of the Board.

I am also thankful to all my Central Council colleagues for their guidance and support to the activities of the Board. I also express my gratitude to CA. Sanjay Vasudeva (Vice-Chairman, AASB) and all the members and special invitees on AASB for their guidance and support in finalizing this Guidance Note. I also thank CA. Megha Saxena (Secretary), CA. Rajnish Aggarwal (Assistant Director), CA. Nitish Kumar (Executive Officer) and other staff of the Board for their hard work in giving the Guidance Note its final shape.

I am sure that the members would find the Guidance Note useful while conducting audits of banks/ bank branches.

January 13, 2019  
Jaipur

**CA. Shyam Lal Agarwal**  
Chairman,  
Auditing and Assurance Standards Board

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# **PART – I**

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# Knowledge of the Banking Industry

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1.01 The banking industry is the backbone of any economy as it is essential for sustainable socio-economic growth and financial stability in the economy. There are different types of banking institutions prevailing in India which are as follows:

- (a) Commercial Banks
- (b) Regional Rural Banks
- (c) Co-operative Banks
- (d) Development Banks (more commonly known as 'Term-Lending Institutions')
- (e) Foreign Banks
- (f) Payment Banks
- (g) Small Finance Banks
- (h) EXIM Bank

1.02 All these banks have their unique features and perform various functions / activities subject to complying with the RBI guidelines issued from time to time. Section 6 of the Banking Regulation Act, 1949, lists down the forms of business in which banking companies may engage. The text of the Section 6 has been reproduced in **Appendix I** of the Guidance Note (given in Pen Drive/CD accompanying the Guidance Note).

1.03 Of these banks, commercial banks are the most wide spread banking institutions in India. Commercial banks provide a number of products and services to general public and other segments of economy. Two of the main functions of commercial banks are (1) accepting deposits and (2) granting advances. In addition to their main banking activities, commercial banks also



undertake certain eligible Para Banking activities which are governed by the RBI guidelines on Para Banking activities.

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

1.05 The provisions regarding the financial statements of banks are governed by the Banking Regulation Act, 1949. The Third schedule to the aforesaid Act, prescribes the forms of balance sheet and profit and loss account in case of banks. Readers may refer **Appendix II** of the Guidance Note (given in Pen Drive/CD accompanying the Guidance Note) for text of third schedule to the Banking Regulation Act, 1949. Further, in case of banking companies, the requirements of the Companies Act, 2013, relating to the balance sheet, profit and loss account and cash flow statement of a company, in so far as they are not inconsistent with the Banking Regulation Act, 1949, also apply to the financial statements, as the case may be, of a banking company. It may be noted that this provision does not apply to Nationalised Banks, State Bank of India, its Subsidiaries and Regional Rural Banks (RRBs).

1.06 The provisions regarding audit of Nationalised Banks are governed by the Banking Regulation Act, 1949 and the RBI Guidelines. The provisions regarding audit of Banking Companies are governed by the Banking Regulation Act, 1949, RBI Guidelines and the provisions of the Companies Act, 2013. The illustrative formats of auditor's report are given in **Appendices III to IV** of the

Guidance Note (given in Pen Drive/CD accompanying the Guidance Note) as follows:

Appendix III - Illustrative Format of Report of the Branch Auditor of a Nationalised Bank

Appendix IV - Illustrative Format of Report of the Branch Auditor of a Banking Company

1.07 The auditors (both central statutory auditors and branch auditors) should also ensure that their audit report complies with the requirements of SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements", SA 705 (Revised), "Modifications to the Opinion in the Independent Auditor's Report" and SA 706 (Revised), "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report".

1.08 Besides the main audit report, the terms of appointment of auditors of public sector banks, private sector banks and foreign banks (as well as their branches), require the auditors to also furnish a Long Form Audit Report (LFAR). The matters to be dealt with by auditors in LFAR have been specified by the RBI. If the auditor intends to issue modified opinion, reasons for such modified opinion need to be mentioned.

1.09 For the reference and benefit of the members, **Appendices V to VII** of the Guidance Note (given in Pen Drive/CD accompanying the Guidance Note) provide the illustrative formats of Engagement Letter in case of a Nationalised Bank, Engagement Letter to be sent to the Appointing Authority of the Banking Company, and Engagement Letter to be sent to the Appointing Authority of the Banking Company (Separate only for Internal Financial Control u/s 143(3)(i) of Companies Act, 2013).

1.10 Further various Illustrative Audit Checklists and Broad features of the Gold Monetization Scheme are given in **Appendices VIII to X** of the Guidance Note (given in Pen Drive/CD accompanying the Guidance Note) as follows:

Appendix VIII- Illustrative Checklist on Audit Considerations in a CIS environment for Treasury Operations

Appendix IX - The Broad features of the Gold Monetization Scheme

Appendix X - Illustrative Audit Checklist for Capital Adequacy

**Important Note**

Readers may refer the Pen Drive/CD accompanying the Guidance Note wherein the details of the following Chapters of “Part I - Knowledge of the Banking Industry” have been given:

Chapter 1: Banking in India

Chapter 2: Accounting and Auditing Framework

Chapter 3: Accounting Systems

Chapter 4: Legal Framework

# **PART - II**

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## Initial Considerations

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1.01 The auditor's primary objective in audit of investments is to satisfy itself as to existence and valuation of investments. Examination of compliance with statutory and regulatory requirements is also an important objective. The auditor should consider these aspects while designing his audit procedures relating to investments.

1.02 The auditors should review the investment policy of the bank to ascertain that the policy conforms, in all material respects, with RBI, FEMA, FEDAI guidelines as well as any statutory provisions applicable to the bank. The auditor should review the internal controls over investments so as to decide on overall audit program in this regard. The auditor should go through the concurrent audit reports of treasury transactions and follow-up action taken by the management thereon as well as the half yearly review of portfolio by the Board of Directors of the bank and also reviewing annual inspection report of the RBI carried out under Section 35 of the Banking Regulation Act, 1949. This shall help the auditor to gain the required understanding and to plan the audit.

1.03 The banks normally have documented standard operating procedures (SOPs), hence auditor can peruse SOPs for understanding and documenting significant processes. During the process understanding, auditors may identify various control points in the process like reconciliation, maker checker, segregation of duties, etc.

1.04 In today's scenario, most of the treasury functions of banks are performed in an automated environment (for example, trade booking, settlement and accounting). In such a situation, it becomes imperative for the auditors understanding the functioning of the systems involved and to plan to deploy the competent resources with understanding of such systems.

1.05 An illustrative format of engagement letter in case of a Nationalised Bank is given in **Appendix-V** of this Guidance Note. An illustrative format of engagement letter to be sent to the appointing authority of the Banking Company (Where auditor's responsibility regarding reporting on Internal Financial Controls is contained within the same Engagement Letter) is given in **Appendix – VI** of this Guidance Note. An illustrative format of Engagement Letter to be sent to the appointing authority of the Banking Company (Containing auditor's responsibility regarding reporting on Internal Financial Controls only) is given in **Appendix –VII** of the Guidance Note.

# II-2

## Special Considerations in a CIS Environment

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### Introduction

2.01 Treasury is an important and most critical function of the bank and is managed centrally. The role of treasury department is to manage the funds of the bank in an efficient and effective manner to optimise the return in case of investment and to minimise the cost in case of borrowing with the limitation/restriction imposed by Regulatory bodies and internal guidelines of the bank.

2.02 Broadly the functions can be classified as under

- a) *Planning*: Assess the daily fund position, whether there will be surplus /deficit.
- b) *Investment*: Invest the surplus funds in either domestic market or Forex market depending on the requirement of management.
- c) *Borrowings*: Borrow the deficit funds either from domestic market or from Forex market depending on the requirement of management.
- d) *Risk Management*: To manage and contain the treasury risks of the bank within the approved and prudential norms of the bank and regulatory authorities.

2.03 Treasury also act as a facilitator for branches to carry out transaction on behalf of customers in following cases:

- a) Purchase or sale of forward contract which was executed at branch level.
- b) Purchase, sale or settlement of foreign exchange transactions such as borrowing, lending, trade transaction done at branch.
- c) Investment in government securities through CSGL Accounts.

### Responsibilities of Central Statutory Auditors

2.04 The overall review of IT environment at treasury has to be taken up at central level to ensure that the computerised accounting systems are working properly and effectively. The roles and responsibilities of bank, and the SCA can be enumerated as under.

***Role and responsibilities of the Bank***

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

- Overall IT Policy, structure and environment of the bank's IT system and changes/developments, if any, thereto.
- Data processing and data interface under various systems.
- Data integrity and data security.
- Business Continuity Plans and Disaster Recovery Plans.
- Accounting manual and critical accounting entries (including month-end and year-end) and the processes and involvement of IT systems.
- Controls over key aspects, such as, account codes and mapping thereof, use of various account heads including other assets and other liabilities, asset classification, income recognition, expense booking, overdue identification, month-end and year-end procedures, valuation and re-valuation of various items of the financial statements, KYC, ALM, etc.
- Controls and recording of various e-banking and internet banking products & Channels.
- Manual processing of key transactions.
- MIS reports being generated and the periodicity thereof.
- Hard copies being generated and the periodicity thereof.
- Process of generating information related to various disclosures in the financial statements and the involvement of the IT systems.
- Major exception reports and the process of generation thereof along with logic embedded in generation of such reports.
- Major IT related issues (including frauds and failures) faced and resolved/unresolved during the year, such as, data/system corruption, system break-down, etc., having bearing on the preparation and presentation of financial statements.
- Significant observations of internal auditors, concurrent auditors, system auditors, RBI inspection and internal inspection, etc., related to computerised accounting and overall IT systems.

- In order to ensure that the technology deployed to operate the payment system/s authorised is/are being operated in a safe, secure, sound and efficient manner and as per the process flow submitted by the bank for which authorisation has been issued, banks are required to get a System audit done by a firm of Chartered Accountants / Certified Information System Auditor. The scope of the System audit would include evaluation of the hardware structure, operating systems and critical applications, security and controls in place, including access controls on key applications, application controls, system generated reports (and controls over them to ensure their integrity), disaster recovery plans, training of personnel managing systems and applications, documentation, etc. The system auditor is also required to check system interfaces (i.e. flow of treasury data to accounting system) and control over them. The system auditor is also required to comment on the deviations, if any, in the processes followed from the process flow submitted to RBI while seeking authorisation.<sup>1</sup>
- Compliance documentation with RBI IT and Security directives and guidelines.

## **Audit in a CIS environment**

### **Assessment of Inherent and Control Risks**

2.06 The nature of banking operations is such that the auditors may not be able to reduce audit risk to an acceptably low level by the performance of substantive procedures alone. This is because of factors such as the following:

- The extensive use of IT and EFT systems, which means that much of the audit evidence is available only in electronic form and is produced by the bank's own IT systems.
- The high volume of transactions processed by banks, which makes reliance on substantive procedures alone impracticable.
- The geographic spread of banks' operations.
- Complex trading transactions (Highly inter connected and automated systems such as card, mobile banking and payment systems).

2.07 In most situations, the auditors' ability to reduce audit risk to an acceptably low level would be affected by the internal control systems established by the management that allow the auditors to be able to assess the

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



level of inherent and control risks as less than high. The auditors obtain sufficient appropriate audit evidence to assess the level of inherent and control risks.

2.08 The auditor's procedures would need to be adapted as the circumstances warrant and in respect of each account, different procedures may be necessary.

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

- A. *Deterrent controls* - Deterrent Controls are designed to deter people, internal as well as external, from doing undesirable activities. For example, written policies including the punitive measures may deter people from doing undesired activities.
- B. *Preventive Controls* - Preventive Controls prevent the cause of exposure from occurring or at least minimise the probability of unlawful event taking place. For example, security controls at various levels like hardware, software, application software, database, network, etc.
- C. *Detective Controls* - When a cause of exposure has occurred, detective controls report its existence in an effort to arrest the damage further or minimise the extent of the damage. Thus, detective controls limit the losses if an unlawful event has occurred.
- D. *Corrective Controls* - Corrective Controls are designed to recover from a loss situation. For example, Business Continuity Planning is a corrective control. Without corrective controls in place, the bank has risk of loss of business and other losses due to its inability to recover essential IT based services, information and other resources after the disaster has taken place.

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

deployed. If this sensitisation level is low, the auditor may need to perform more extensive audit procedures.

### **Security Control Aspects**

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

- Ensure that authorised, accurate and complete data is made available for processing.
- Ensure that in case of interruption due to power, mechanical or processing failures, the system restarts without distorting the completion of the entries and records.
- Obtain the list of employee in treasury department (including new joinee and resigned employee). Verify whether “access controls” assigned to the staff-working match with the responsibilities as per manual. It is important for the auditor to ensure that access and authorisation rights given to employees are appropriate. The auditor should also verify that the access control to resigned employee is de-activated on timely basis.
- Verify the process followed for programme change (from the list of programme change done during the period) in the system.
- Verify that segregation of duties is ensured while granting system access to users and that the user activities are monitored by performing an activities log review.
- Verify that changes made in the parameters or user levels are authenticated.
- Verify that exceptional transaction reports are being authorised and verified on a daily basis by the concerned officials. It is important for auditor to understand the nature of exception and its impact on financials.
- Verify that the security master and balance cannot be modified/amended/alterd except by the authorised personnel.
- Verify that all the general ledger accounts codes authorised by Head Office are in existence in the system.
- Verify that balance in general ledger tallies with the balance in subsidiary book.

### *Credit Risk*

2.12 Generally, the bank’s credit risk is not increased by the mere fact that a transaction is in foreign currency, is originated through an e-banking channel.

However, the bank should ensure that additional precautions are in place when originating and approving loans in foreign currency electronically including assuring management information systems effectiveness by preparing a track of the performance of portfolios originated through e-banking channels. The following aspects of on-line loan origination and approval tend to make risk management of the lending process more challenging:

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

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

### *Compliance/ Legal Risk*

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

- Uncertainty over the legal jurisdictions applicable to the transaction taking place through e-banking;
- Delivery of credit and deposit related disclosures/notices as required by law or regulation;
- Retention of required compliance documentation for on-line advertising, applications, statements, disclosures, notices; and
- Establishment of legally binding electronic agreements.

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

*Reputational Risk*

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

**IT Architecture and Audit at Treasury**

2.16 With the adoption of technology by banks, it is important for auditors to understand the design of IT system to get an insight on controls. IT setup for treasury is significantly different from the setup at branches.

2.17 IT set up at treasury would generally include the following:

1. Various dealing platforms.
2. Multiple Information channels.
3. Hotline with brokers.
4. Voice logger systems.
5. Rate information channels.
6. Dealing terminals.
7. Back office software.
8. CBS.

**Special Consideration for Audit in CIS environment**

2.18 Various terms used for treasury operations, concepts and process are given in separate chapter and special considerations from IT are discussed here.

Verification of treasury transactions can be divided in 3 parts:

- a) Securities Transactions.
- b) Money market operation.
- c) Forex.

2.19 An Illustrative Checklist on Audit Considerations in CIS Environment for Treasury Operations is given in **Appendix VIII** of the Guidance Note.

# **PART - III**

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# III-1

## Cash, Balances with RBI and Other Banks, and Money at Call and Short Notice

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1.01 Cash, Balances with RBI and Other Banks, and Money at Call and Short Notice constitutes one of the important items of balance sheet of a bank. Of these items, only a few select branches in each bank handle the transactions relating to money at call and short notice.

### Balance Sheet Disclosure

1.02 The Third Schedule to the Banking Regulation Act, 1949, requires the following disclosures to be made in the Schedule 6 & Schedule 7 of balance sheet regarding cash, balances with RBI, balances with other banks, and money at call and short notice.

### Cash and Balances with Reserve Bank of India-Schedule 6

- I. Cash in hand (including foreign currency notes)
- II. Balance with Reserve Bank of India
  - (i) in Current Account
  - (ii) in Other Accounts

### Balances with Banks and Money at Call and Short Notice-Schedule 7

- I. *In India*
  - (i) Balances with other banks
    - (a) in Current Accounts
    - (b) in Other Deposit Accounts
  - (ii) Money at call and short notice
    - (a) with banks
    - (b) with other institutions
- II. *Outside India*
  - (i) in Current Accounts
  - (ii) in Other Deposit Accounts
  - (iii) Money at call and short notice

## **Balances with Reserve Bank of India, Balances with Other Banks**

1.03 Banks maintain accounts with RBI and other Banks for Banking Operations however only select branches maintain account with RBI. The branches also maintain accounts with other banks for banking operations.

## **Money at Call and Short Notice**

1.04 Money at call and short notice represents short-term investment of surplus funds in the money market. Money lent for one day is money at 'call' or 'call money' means deals in overnight funds, while money lent for a period of more than one day and up to fourteen days is money at 'short notice'. The lender bank does not get any security for money lent at call or short notice. The participants of call and notice money market are scheduled commercial banks (excluding RRBs), co-operative banks (other than land development banks) and primary dealers (PDs), both as borrowers and lenders. Non-bank institutions (other than PDs) are not permitted to participate in call/notice money market. Scheduled commercial banks usually borrow from this market to meet the requirements relating to cash reserve ratio or statutory liquidity ratio. The decisions to borrow from, or lend in, the market are taken usually at the head office level and communicated to select branches for effecting the borrowing/lending.

1.05 RBI vide its Master Direction no. RBI/FMRD/2016-17/32 FMRD. Master Direction No. 2/2016-17 dated July 7, 2016 on "Money Market Instruments: Call/ Notice Money Market, Commercial Paper, Certificates of Deposit and Non-Convertible Debentures (original maturity up to one year)" provides the detailed guidelines on the prudential limits in respect of both outstanding and lending transactions in call/notice money market for scheduled commercial banks, co-operative banks and PDs. The eligible participants are free to decide the interest rates in call/notice money market. Computation of interest payable would be based on the methodology given in handbook of market practices brought out by the Fixed Income Money Market and Derivates Association of India (FIMMDA) and the eligible participants may adopt the documentation suggested by FIMMDA from time to time. The Call/Notice Money transactions can be executed either on NDS-Call, a screen-based, negotiated, quote-driven electronic trading system managed by the Clearing Corporation of India (CCIL), or over the counter (OTC) through bilateral communication. NDS-Call (a screen-based, negotiated, quote-driven system), do not require separate reporting, however, it is mandatory that all OTC deals should be reported within 15 minutes on NDS-Call reporting platform irrespective of the size of the deal.

## **Audit Approach and Procedures**

### **Cash**

1.06 The auditor should carry out verification of the balance of cash on hand. As far as possible, the auditor should visit the branch at the close of business on the last working day of the year or before the commencement of business on the next day for carrying out the physical verification of cash. If, for any reason, the auditor is unable to do so, he should carry out the physical verification of cash as close to the balance sheet date as possible, at the time of audit and also reconcile with the cash register/balance in CBS. In few banks, the branch deposits a large portion of its cash balance with the RBI or the State Bank of India or any other bank on the closing day, in such cases, the auditor must request the branch to provide sufficient appropriate evidence for the same and also ensure that the same is effected in books of accounts and is not appearing as a bank reconciliation item.

1.07 Care should be taken to ensure that if cash is kept separately in different departments or at different locations (e.g., at extension counters, onsite ATMs linked with the branch, all the balances are verified by the auditor simultaneously. The auditor should also ensure that there is no movement of cash till such cash is physically verified.

1.08 The auditor should evaluate the effectiveness of the system of internal controls in branch regarding daily verification of cash, maintenance of cash balance registers and vault register, custody of cash, custody of vault keys, daily cash holding and retention limit of the branch, etc. The auditor should examine/inquire whether there is a global (insurance) policy taken for safety of cash from theft or burglary and such policy is effective as on reporting date. This would be relevant for a bank as a whole and there would not be any insurance policy available at the branch level, however, the branch auditor should seek a Xerox copy of the same from the Head office or confirmation from the head office seeking details of the insurance coverage of the branch. The Statutory Auditor should also make an analysis of the quantum of cash holding and whether the insurance cover is adequate. This will also be important from the perspective of reporting in Long Form Audit Report (LFAR) under (I) Assets-Cash.

1.09 For physically verifying the cash-on-hand, the auditor may proceed as below:

- (a) Physically verify the cash-on-hand available at the branch. The extent of verification would depend upon the auditor's assessment of the efficacy of internal control system including adherence to cash retention limits fixed by the head office, mode of custody of cash (whether single or joint) and



frequency of cash verification by branch officials and/or by internal or concurrent auditors. Normally, in a bank, 100 notes of each denomination and thereafter 10 packets of 100 notes each are bundled together. Wherever sample checking is conducted, it is advisable that number of bundles of 100's is fully counted. Besides, the number of notes in samples of bundles of old notes of different denominations may also be checked, the sample size for larger denomination notes being higher than that in the case of smaller denomination notes. The number of notes in a small sample of bundle of new notes of larger denominations (say, Rs. 100 or more) may also be counted. In any event, care should be taken to ensure that all bundles produced for audit verification are properly sealed. Loose/soiled notes should be counted in full. Coins may be counted, or weighed and converted into monetary value as per RBI guidelines. The processed and unprocessed notes should be separately kept and the denomination of the same should be separately mentioned in the cash balance register.

- (b) Obtain a certificate from the bank indicating denomination-wise cash balance as on the date of verification.

1.10 Notes/coins in sealed packets may be accepted based on a written representation from the branch management and cross-checked with subsequent entries in the books of account.

1.11 The cash balance as physically verified should be agreed with the balance shown in the cash book and the books of account. When the physical verification of cash is carried out by the auditor before or after the date of the balance sheet, the auditor should perform the additional audit procedure to reconcile the results of verification with the cash balance as at the balance sheet date.

1.12 Foreign currency notes should also be verified at the time of physical verification of cash. The auditor should also ensure that these notes are converted at the market rate prevailing on the closing day as notified by the Foreign Exchange Dealers' Association of India (FEDAI) in accordance with the accounting policy followed by the bank.

1.13 Special care needs to be exercised in cases where the branch operates currency chest and/or small coin deposits. In respect of currency chest operations, the branch merely acts as an agent of the RBI to facilitate the distribution of bank notes and rupee coins. The balance in currency chest at any point of time is the property of the RBI and not of the bank. Therefore, while the auditor may not physically count the balance in currency chest on closing day, but should take sufficient safeguards to ensure that currency chest balance is not mixed up in the cash balances produced for physical verification.

Also, it should be recognised that the bank may be contingently liable for any shortfall in the currency chest balance. Accordingly, the branch auditor should pay special attention to the system of operation of currency chest transactions, recording of such transactions, method and frequency of counting of cash, and reconciliation with the link office. The auditor should perform compliance tests to evaluate the effectiveness of the system of operation of currency chest. The auditor should also examine whether the system is such that the transactions relating to deposits into and withdrawals from, currency chest are recorded appropriately. In case the relevant transactions are required to be communicated to a link office of the bank (which maintains the account of RBI) for the purpose of reporting the same to the RBI, the auditor should evaluate the effectiveness of the system of reporting in terms of timeliness and accuracy.

1.14 In terms of the Master Direction No RBI/DCM/2018-19/62 Master Direction DCM (CC) No.G - 5/03.35.01/2018-19 dated July 03, 2018 on “Levy of Penal Interest for Delayed Reporting/Wrong Reporting/Non-Reporting of Currency Chest Transactions and Inclusion of Ineligible Amounts in Currency Chest Balances” the banks are required to report the minimum amount of deposit into/withdrawal from currency chest of Rs.1,00,000/- and thereafter, in multiples of Rs. 50,000/-. Further, the banks are obliged to follow the instructions regarding timely reporting of currency chest transactions by the banks for branches to which currency chests are attached; and non-compliance of the RBI instructions invite levy of penal interest for delayed reporting/wrong reporting/non-reporting of Currency Chest transactions and penal measures for cases involving shortages/inclusion of counterfeit bank notes in chest balances/ chest remittances.

1.15 All currency chest transactions (deposits into /withdrawals from currency chest) at the respective branch, must be reported through ICCOMS on the same day by 9 PM [by uploading data through the Secured Website (SWS)] to the link office to which the branch is attached for this purpose. Each link office must, in turn, report to the RBI Issue Office concerned, latest by 11 PM on the same day, the consolidated net position for all the linked branches; except in certain exceptional circumstances, like during strike period and on account of genuine difficulties faced by chests especially in hilly/remote areas and other chests affected by natural calamities, etc., where the default may be acceptable to the RBI, at its discretion. However, in case of wrong reporting representations for waiver will not be considered.

1.16 The said directions cover:

(a) Levy of penal interest for delays.

- (b) Wrong reporting and levy of penal interest.
- (c) Maximum penal interest to be charged.
- (d) Penal interest for inclusion of ineligible amounts in the currency chest balances.
- (e) Rate of penal interest (to be levied at the rate of 2% over the prevailing bank rate for the period of delayed reporting/wrong reporting/non-reporting /inclusion of ineligible amounts in chest balances).
- (f) Levy of penal interest in respect of currency chests at treasuries.

1.17 The operation of currency chests attached to the various branches of the bank, affects the balances in accounts of RBI maintained by the bank at the designated branches; and it is imperative that the transactions on value date basis are recorded (as it affects the cash balance and that with RBI, on the day of the cash withdrawal from or deposit into the currency chest). Designated branches that maintain the RBI account should pass the entries on the day of the transaction for currency chest attached to it; and as the Link Office for other branches operating currency chests, based on inward communication from such other branches linked to it.

1.18 Due to any delays in communication by such branches to the Link Office, the amount required to be debited or credited to RBI Account, remains in a nominal account (Inter branch Adjustments) and affects the RBI account balance in the books of the Link Office. On line communication system should remedy this to ensure recording of entries at the designated Link Office, simultaneously as they take place at all currency chest branches.

1.19 The auditor should examine whether the account of the RBI at the designated branch maintaining the RBI Account has incorporated all the currency chest transactions on a value date basis as at the year end. He should also enquire as to whether the bank has received any communication from RBI regarding any defaults in the operation of the currency chests, that may have penal consequences and whether during the year, any penalties have been levied on this account.

1.20 RBI Master Circular No. RBI/2018-19/3 DCM (NE) No.G-2/08.07.18/2018-19 dated July 02, 2018 on "Facility for Exchange of Notes and Coins" requires that all designated bank branches should display at their branch premises, at a prominent place, a board indicating the availability of note exchange facility with the legend, "Soiled/Mutilated notes are Accepted And Exchanged Here". Banks should ensure that all their designated branches provide facilities for exchange of notes and coins. The branches should ensure that the note exchange facility is not cornered by private money changers /

professional dealers in defective notes. The auditor should also inquire about the service charges levied by the bank on Exchange of soiled notes as per RBI Notification No. RBI/2016-17/15 DCM (NE) No.120/08.07.18/2016-17 dated July 14, 2016 to identify the revenue leakage in the bank.

1.21 The auditor should verify that the banks have not stapled the notes. Some banks in spite of RBI's instructions continue to follow the practice of stapling of note packets. This practice, apart from damaging notes, reduces the life span of notes and renders it difficult for customers to open note packets easily. Banks should do away with stapling of any note packets and instead secure them with paper bands. Further, RBI has issued, Master Circular No. RBI/2018-19/04 DCM(FNVD)G – 1/16.01.05/2018-19 dated July 02, 2018 on "Detection and Impounding of Counterfeit Notes" which provides operational guidance on detection and impounding of Counterfeit notes. The Government of India has framed Investigation of High Quality Counterfeit Indian Currency Offences Rules, 2013 under Unlawful Activities (Prevention) Act (UAPA), 1967. The Third Schedule of the Act defines High Quality Counterfeit Indian Currency Note. Activity of production, smuggling distribution and circulation of High Quality Counterfeit Notes has been brought under the ambit of UAPA, 1967.

1.22 Increasingly banks are entering into an agreement with third party vendors for management of their ATM operations. These vendors collect amount from banks and are responsible for loading amount in the ATM. They are also responsible for collecting amount (deposited by customers) from ATM and depositing it with bank. The auditor should verify an agreement entered with these vendors. The auditors should also understand the process of providing, collecting and reconciliation etc. with these vendors and test controls in the process.

At each period end, the auditor should send independent balance confirmation to these vendors about balance held by them and should verify reconciliation statements.

1.23 Also in respect of ATM operations, banks are centralizing the process of monitoring ATM balance. This division monitors balance as per the books and balance as per ATM machine (commonly termed as Switch balance) and their reconciliation and ensuring timely adjustment of reconciling entries. The auditor should understand the process of monitoring of balance, reconciliation etc. and based on the risk assessment should understand controls in the process and strategy of testing these controls.

1.24 Where ATMs are operated by bank themselves, auditor should verify the cash at ATMs also and tally the same with books of accounts. At each

reporting period end, the auditor should obtain the reconciliation statement and should verify the reconciliation statement.

1.25 In case of RRB each branch should maintain a set of marked notes consisting of new currency notes of various denominations. The numbers of such notes along with their prefixes and suffixes, if any, should be recorded on the last page of the Cash Summary Register under the initials of both the custodians of cash. During business hours, the set of marked notes should remain permanently in the cash at the counter. This will help the investigating agencies in the event of thefts burglary, robbery and dacoity.

### **Balance With RBI**

1.26 In a bank, only a few select branches are designated to have accounts (Deposit/Current) with the RBI, the main account generally being with the Treasury Branch. The procedures of confirmation/reconciliation are not different as compared to accounts and balances with other banks.

1.27 It is relevant to point out that, amongst others, currency chest operations involve entries in the accounts maintained with RBI. Where currency chest is attached to the branch maintaining RBI account, all deposits into and withdrawals from the currency chest trigger a debit /credit to the account maintained at the Branch itself. Other branches of the bank having currency chests but not maintaining the RBI Account would be linked to such Branch and would be required to transmit information forthwith for all deposits into/withdrawal from the attached currency chest through Inter branch mechanism. The effect of such entries is required to be considered in the RBI account on a value date basis.

1.28 The auditor of the Branch maintaining the RBI account should follow direct confirmation procedures of the balances in the RBI account and examine the reconciliation to ensure that all transactions originating in the account statement of the RBI are duly responded on value date basis.

1.29 The auditor should enquire into the reasons/justification for the following items appearing in the reconciliation statements:

- (i) cash transactions remaining unresponded;
- (ii) revenue items requiring adjustments/write-offs; and
- (iii) old outstanding balances remaining unexplained/ unadjusted for significant period.

### **Balance with Banks (Other than Reserve Bank of India)**

1.30 The auditor should also apply the procedures described in paragraphs above in examining the balances with banks other than RBI. While reviewing the reconciliation statements, the auditor should pay particular attention to the following:

- (a) Examine that no debit for charges or credit for interest is outstanding and all the items which ought to have been taken to books of accounts for the year have been considered. This should be particularly observed when the bills collected, etc., are credited with net amount and entries for commission, etc., are not made separately in the statement of account.
- (b) Examine that no cheque sent or received in clearing is outstanding. As per the practice prevalent among banks, any cheques returned unpaid are accounted for on the same day on which they were sent in clearing or on the following day.
- (c) Examine that all bills or outstanding cheques sent for collection and outstanding as on the closing date have been credited subsequently.

1.31 The auditor should also examine the large transactions in inter-bank accounts, particularly towards the year-end, to ensure that no transactions have been put through for window-dressing.

1.32 In respect of balances in deposit accounts, original deposit receipts should be examined in addition to confirmation certificates obtained from banks in respect of outstanding deposits. Balances in deposit accounts are usually (though not necessarily) in round figures. Where such balances are in odd figures, the auditor should enquire whether the account concerned is actually of the nature of a deposit account. The auditor should also ensure that interest on such deposits has been recorded on time proportion basis and interest has been recorded till the closing day.

1.33 The balances with banks outside India should also be verified in the manner described above. These balances should be converted into the Indian currency at the exchange rates prevailing on the balance sheet date.

1.34 Increasingly banks are automating the process of reconciliation with other banks. In case of system process, the auditor should understand the system, system controls and manual controls. The auditor should also assess the system access control and program change controls of the reconciliation system. (Also refer chapter 2, Special Considerations in a CIS Environment of Part II of Guidance Note).

## **Money at Call and Short Notice**

1.35 The auditor needs to enquire whether the bank has an approved risk policy of lending money at call or short notice and the same has been adhered before lending money at call or short notice. This would be more relevant at the head office rather than at the branch level.

1.36 The auditor should examine whether there is proper authorisation, general or specific, for lending of the money at call or short notice. Compliance with the instructions or guidelines laid down in this behalf by the head office or controlling office of the branch, including the limits on lending in inter-bank call money market, should also be examined.

1.37 Call loans should be verified with the certificates of the borrowers and the call loan receipts held by the bank. The auditor should examine whether the aggregate balances comprising this item as shown in the relevant register/account tally with the control accounts as per the general ledger. The auditor should also examine subsequent repayments received from borrowing banks to verify the amounts shown under this head as at the year-end. It may be noted that call loans made by a bank cannot be netted-off against call loans received.

1.38 Like deposits with banks, money at call and short notice are also usually (though not necessarily) in round figures. Any odd balances should, therefore, put the auditor to enquiry.

1.39 The auditor should also verify that borrowing or lending for more than 14 days are not classified under this head, but are classified as 'deposits' or 'advances', depending on the nature of lending and the parties to whom the moneys have been lent.

1.40 The auditor needs to verify monies at call to banks, whether they are fresh or roll over of the old transactions and ascertain whether any provision or write off is required.

1.41 It may be noted that as per the directions of the RBI, banks cannot pay any brokerage on deposit and call loans, except to the extent specified in paragraph 8(e) of the RBI circular dated July 22, 1971.

1.42 The auditor should examine whether interest has been properly accrued and accounted for on year-end outstanding balances of money at call and short notice by confirming the same from the opposite party.

## **Borrowings and Deposits**

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### **Borrowings**

2.01 Borrowings usually take place only at head office of the bank. In case of exception there is a borrowing at few designated branches authorised in this behalf by the head office or other controlling authority either generally or specifically in respect of a particular borrowing. As such, this item generally does not figure in the balance sheets of most branches of the bank.

### **Balance Sheet Disclosure**

2.02 Borrowings of a bank are required to be shown in balance sheet as follows.

#### *I. Borrowings in India*

- (i) Reserve Bank of India
- (ii) Other Banks
- (iii) Other Institutions and Agencies

#### *II. Borrowings outside India*

RBI *vide* its circular no. DBOD.BP.BC No.81/ 21.01.002/2009-10 dated March 30, 2010 on “Classification in the Balance Sheet - Capital Instruments” advised that the following classification may be adopted in the balance sheet from the financial year ending March 31, 2010:

Under Schedule 1 Capital

- 1) Perpetual Non-Cumulative preference shares (PNCPS).

Under Schedule 4 Borrowings

- 1. Innovative Perpetual Debt Instruments (IPDI).
- 2. Hybrid debt capital instruments issued as bonds/debentures.
- 3. Perpetual Cumulative Preference Shares (PCPS).
- 4. Redeemable Non-Cumulative Preference Shares (RNCPS).
- 5. Redeemable Cumulative Preference Shares (RCPS).
- 6. Subordinated Debt.

2.03 The total amount of secured borrowings included under the above



heads is to be shown by way of a note to the relevant schedule (Schedule 4). Secured borrowings for this purpose include borrowings/refinance in India as well as outside India. It may be noted that the inter-office transactions are not borrowings and therefore, should not be presented as such.

2.04 RBI, Export-Import Bank of India (EXIM Bank), National Bank for Agriculture and Rural Development (NABARD) and Small Industries Development Bank of India (SIDBI) are the major agencies providing refinance to banks, generally for loans extended to specified sectors. Borrowings from RBI include refinance obtained by the bank from the RBI. Similarly, borrowings from other banks include refinance obtained by the bank from commercial banks, co-operative banks, etc. Refinance obtained by the bank from EXIM Bank, NABARD, SIDBI and other similar institutions and agencies is to be included under 'Borrowings from other institutions and agencies'. This head will also include the bank's liability against participation certificates on non-risk sharing basis issued by it to participating banks.

2.05 VOSTRO Accounts which are akin to Current account balances and do not constitute borrowings unless an overdraft/borrowing facility is obtained and evidenced on record.

If NOSTRO Mirror Account as well as NOSTRO Account is having adverse balance, the same represents borrowings from banks outside India.

If NOSTRO Mirror Account is representing an adverse balance but NOSTRO Account is not having an adverse balance, the same indicates that there are certain unresponded reconciliation entries resulting in NOSTRO Mirror adverse balance. The auditor needs to review such reconciliation entries and ensure that the same are effected appropriately to ensure that the NOSTRO Mirror Account is not reflecting adverse balance in Financials (wherein NOSTRO Account is not having an adverse balance).

2.06 'Borrowings outside India' include borrowings of Indian branches abroad as well as borrowings of foreign branches. Funds raised by foreign branches by way of certificates of deposit, notes, bonds, etc. have to be classified as 'deposits' or as 'borrowings' depending upon documentation. The Notes and Instructions for Compilation of balance sheet and profit and loss account, issued by the RBI, clarify that since refinance obtained by a bank from the RBI and various institutions is to be shown under the head 'borrowings', the related advances should be shown on the assets side at the gross amount.

2.07 Money at call or short notice taken by the bank is also shown under this head. RBI through its "Master Direction no. RBI/FMRD/2016-17/32 FMRD. Master Direction No. 2/2016-17 on "Money Market Instruments: Call/Notice Money Market, Commercial Paper, Certificates of Deposit and Non-Convertible

Debentures (original maturity up to one year)" dated July 07, 2016 has set down the prudential limit for transactions in call/notice money market. In terms of the said circular, on a fortnightly average basis, the borrowings should not exceed 100 percent of the capital funds (i.e., sum of Tier I and Tier II capital) of latest audited balance sheet. However, banks are allowed to borrow a maximum of 125 percent of their capital funds on any day, during a fortnight.

Certificates of deposits are to be treated (at the discounted value at the year-end), as deposits and not as borrowings.

### **Inter Bank Liabilities (IBL)**

2.08 Liability side management has its own merits from the point of view of financial stability. Controlling the concentration risk on the liability side of banks is, therefore, as important as controlling the concentration risk on the asset side. More particularly, uncontrolled IBL may have systemic implications, even if, the individual counterparty banks are within the allocated exposure.

2.09 Further, uncontrolled liability of a larger bank may also have a domino effect. In view of this, it has become important to put in place a comprehensive framework of liability management so that banks are aware of the risks inherent in following a business model based on large amount of IBL and the systemic risks such a model may entail. In order to reduce the extent of concentration on the liability side of banks, the following guidelines have been prescribed by the RBI (applicable from April 1, 2007) vide its circular no. DBOD.BP.BC.66/ 21.01.002/2006-07 dated March 6, 2007.

- (a) The IBL of a bank should not exceed 200% of its net worth as on 31st March of the previous year. However, individual banks may, with the approval of their Boards of Directors, fix a lower limit for their inter-bank liabilities, keeping in view their business model.
- (b) The banks whose CRAR is at least 25% more than the minimum CRAR as on March 31 of the previous year, are allowed to have a higher limit up to 300% of the net worth for IBL.
- (c) The limit prescribed above will include only fund based IBL within India (including inter-bank liabilities in foreign currency to banks operating within India). In other words, the IBL outside India are excluded.
- (d) The above limits will not include collateralised borrowings under CBLO and refinance from NABARD, SIDBI etc.
- (e) The existing limit on the call money borrowings prescribed by RBI will operate as a sub-limit within the above limits.

- (f) Banks having high concentration of wholesale deposits should be aware of potential risk associated with such deposits and may frame suitable policies to contain the liquidity risk arising out of excessive dependence on such deposits.

## **Deposits**

2.10 Deposits represent the most important source of funds for banks. Deposits are received from a large number of constituents, generally in small amounts.

### **Balance Sheet Disclosure**

2.11 Deposits are required to be classified in the balance sheet under the following heads.

A. I. *Demand Deposits*

- (i) From Banks
- (ii) From Others

II. *Savings Bank Deposits*

III. *Term Deposits*

- (i) From Banks
- (ii) From Others

B. I. *Deposits of branches in India*

II. *Deposits of branches outside India*

### **Types of Deposits**

2.12 Deposits accepted by banks are primarily of two types – those repayable on demand (demand deposits) and those repayable after a fixed term (term deposits), though in this case also, the deposits may be repaid prematurely at the request of the depositor.

#### ***Demand Deposits***

2.13 Current accounts are the most common form of demand deposits of banks. Though savings bank deposits are also, in substance in the nature of demand deposits, the Third Schedule to the Banking Regulation Act, 1949, does not consider them demand deposits. This may, perhaps, be due to the fact that withdrawals from savings bank accounts in excess of the limits prescribed by the bank can be made only with prior notice to the bank. Further it includes overdue/matured deposits, credit balance in overdraft account, deposits payable at call, in operating current account, VOSTRO account, merchant bankers and similar deposits, Interest accrued and due on deposits

and excluding margins by way of book adjustments if any against bill purchased and discounted.

2.14 Current accounts can be opened in the names of individuals, associations of persons, corporate bodies, trusts, societies, etc., i.e., for all kinds of customers. The operations on current accounts opened in joint names may be joint, single, by either holder or by surviving holder, depending on the mode of operation chosen by the account holders. The salient features of this type of accounts are:

- There is no restriction on the quantum of funds that can be withdrawn by the account holder at any one time.
- There is no restriction on the number of transactions in the account during any period of time.
- No interest is payable on this deposit except where it may be specifically permitted by the bank / RBI.

### ***Savings Bank Deposits***

2.15 Savings accounts are generally in the names of individuals – either singly or jointly, and sometimes, in the names of institutions which are specifically approved by the RBI for maintaining savings bank accounts with banks. In terms of RBI's guidelines, no bank can open a savings bank account for government departments, municipal corporations, municipal committees, any political party, or any trade, business or professional concern, whether such concern is a proprietary or a partnership firm or a company or an association. As in the case of current accounts, savings bank accounts can also be opened in joint names.

2.16 The salient features of this type of accounts are:

- Banks place restrictions on the maintenance of minimum balance (separate for accounts with cheque book facility and those without cheque book facility), amount of funds that can be withdrawn by the account holder at any point of time. Beyond this cut-off level, banks require the depositors to give notice of a specified period for withdrawal of the amount.
- Banks also place restrictions on the number of withdrawals from the account during a stated period of time, usually one year. For the number of withdrawals beyond this number, banks have the right to levy service charges. The intention behind putting this restriction is to ensure that the savings bank accounts (on which the account holder is entitled to payment of interest) are used to promote genuine savings and are not used as substitutes for current accounts (on which the account holder usually does not get interest).

- Interest is payable as per the RBI guidelines in force. In the past, interest was paid annually but now, banks pay interest at quarterly / half-yearly intervals on daily outstanding balances. Depending on the practice adopted by each bank provision for the balance period up to the year-end may be made at branches/Head Office.
- Interest on savings bank accounts is required to be calculated on a daily product basis in terms of Para 3.2.1 of the RBI Master Circular DBR.No.Dir.BC. 7/13.03.00/2015-16 dated 1-7-2015; and the banks have been given freedom to fix the rate of interest on savings accounts.

2.17 In the case of both current and savings bank accounts, if there are no operations on the account by the account holder during a prescribed period (such period may vary from bank to bank), such accounts are identified as 'dormant' or 'inoperative' accounts and may be transferred to a separate ledger. Further, transactions in these accounts are allowed only with authority of the official designated by the bank for this purpose. Removing of "Specimen signature" cards from active cards can be one of the controls.

### **Term Deposits**

2.18 Term deposits (known by different nomenclature in different banks) are repayable after a specified period of time. The minimum period of these deposits, at present, is 7 days. The salient features of this kind of deposits are given below:

- Interest is payable at periodic intervals to the depositors or as per their instructions.
- In case a depositor so desires, the periodic interest can be reinvested in fresh term deposits. Such schemes are generally called 'reinvestment plans'. In this case, the interest payable is compounded at the specified intervals and the resultant maturity value is indicated on the deposit receipt at the time of issuing the receipt. The head offices of banks issue maturity value charts for the guidance of their branches from time to time.

2.19 Recurring deposit accounts are an important variant of term deposit. In a recurring deposit, a specified sum is deposited at regular intervals, generally once a month, for a pre-determined period. On the expiry of this period, the maturity proceeds, which are known at the time of opening the account, are repaid to the depositors or as per their instructions. No recurring deposit is accepted under FCNR(B) Scheme. Some of the banks are offering fixed / flexible recurring deposit accounts in recent times where the customer chooses amount of deposit each time based on their convenience.

2.20 Cash Certificates and Certificates of Deposit (CD), in demat form or

otherwise, are two other variants of term deposits. Cash certificates are issued at discounted value, e.g., a certificate with face value of Rs. 100 and term of 5 years may be issued at, say, Rs. 49. The certificates of deposit are short-term negotiable money market instruments and are issued in only dematerialised form or as a Usance Promissory Note. However, according to the Depositories Act, 1996, investors have the option to seek certificate in physical form. Further, issuance of CDs will attract stamp duty. In this regard, the RBI has issued Master Direction No. RBI/FMRD/2016-17/32 FMRD. Master Direction No. 2/2016-17 dated July 07, 2016 on Money Market Instruments (which include Certificate of Deposit). CDs may be issued at a discount on face value. The rate of interest thereon is negotiable with the depositor and may vary on a daily basis. The maturity period of CDs issued by banks should not be less than 7 days and not more than one year. Banks are allowed to issue CDs on floating rate basis provided the methodology of compiling the floating rate is objective, transparent and market-based. The issuing bank/FI is free to determine the discount / coupon rate. The interest rate on floating rate CDs would have to be reset periodically in accordance with a pre-determined formula that indicates the spread over a transparent benchmark. CDs can be issued in Demat or in physical form, and in the latter case must be issued on security paper stationery, in denomination of Rs. 1 lac (for a single subscriber) or in multiple of Rs 1 lac and without the benefits of repatriation if issued to NRI. Other than for NRIs, CDs are transferrable by endorsement and delivery.

2.21 There is no grace period for repayment of CDs. If maturity date happens to be on holiday it should be paid on the immediately preceding working day. Banks may, therefore, so fix the period of deposit that the maturity date does not coincide with a holiday to avoid loss of discount / interest rate. All OTC trades in CDs shall be reported within 15 minutes of the trade on the FIMMDA reporting platform.

2.22 In respect of term deposits, banks issue Deposit Receipts. These receipts are not negotiable, and therefore, deposits cannot be transferred without the consent of the bank. Certificates of deposits are, however, transferable. CDs held in physical form are transferable by endorsement and delivery. CDs in dematerialised form can be transferred as per the procedure applicable to other demat securities. There is no lock-in period for CDs. Banks / FIs cannot grant loans against CDs. Furthermore, premature buyback is not permitted and no loans can be taken against CDs. However, the Reserve Bank may relax these restrictions for temporary periods through a separate notification.

2.23 Banks should include the amount of CDs in the fortnightly return under

Section 42 of the Reserve Bank of India Act, 1934 and also separately indicate the amount so included by way of a footnote in the return. Further, banks / FIs should report the data on issuance of CDs on the web-based module under the Online Returns Filing System (ORFS) within 10 days from the end of the fortnight to which it pertains.

2.24 Banks normally allow repayment of the deposits before the due date; however, the rate of interest paid to the depositor in case of premature repayment is lower than the rate contracted initially. Auditor has to verify the scheme of fixed deposits thoroughly. If a depositor does not take repayment on the date of expiry, the interest ceases to run from the date, though the bank continues to be a debtor of the depositor. A matured deposit can be renewed by the depositor for a further period. Where a deposit is renewed sometime after its maturity, banks generally allow interest from the date of maturity rather than from the date of renewal. In other words, the renewal is given a retrospective effect. In case the deposit is matured and not renewed by the customer, the rate of interest same as saving bank rate is provided on the same as per RBI Guidelines.

2.25 Pro-rated expenditure by way of discounts up to the year end on each certificate must be accrued / adjusted and included under the head "Other Liabilities", as the terms of issue warrant that the proceeds be paid only on maturity.

2.26 Rate of interest payable on fixed deposits as well as other deposits depends on current economic conditions, decided by banks from time to time. Interest rates are regulated by an Inter-Bank Agreement which is revised from time to time. The rate of interest on certificates of deposits is negotiable with the depositor, especially in the case of bulk/wholesale deposits.

2.27 Following are important issues in respect of different category of accounts which auditor must consider:

(a) **FCNR Accounts**

- Maintenance of position viz. details of deposits – tallying the position with reference to branches periodically.
- System of reporting to the position maintenance office by the branches including "C" category branch.
- Applicability of notional rate.
- Revaluation is done every reporting Friday for CRR purposes.
- Provisions/payment of interest on a regular basis to reflect the due liability.

- Is it debited to the proper Head of accounts?
- Random check of interest as interest is charged every month based on LIBOR.
- How the payment is effected-expeditiously?
- On payment whether the liability is reversed.
- Method of reconciliation of Nostro account with FCNR (B).
- It should not be revalued and taken to profit and loss.
- Many banks have a separate Nostro account for FCNR (B) balances converted on a notional basis.

Further, RBI, *vide* its Master Circular No. RBI/2015-16/40 DBR.No.Dir.BC.8/13.03.00/2015-16 dated July 1, 2015 on "Interest rates on deposits held in FCNR (B) Accounts", provides guidance on the interest rates on deposits held in FCNR(B) accounts. The Circular further prohibit banks to:

- (i) accept or renew a deposit over five years;
- (ii) discriminate in the matter of rate of interest paid on the deposits, between one deposit and another accepted on the same date and for the same maturity, whether such deposits are accepted at the same office or at different offices of the bank, except on the size group basis. The permission to offer varying rates of interest based on size of the deposits will be subject to the following conditions:
  - a. Banks should, at their discretion, decide the currency-wise minimum quantum on which differential rates of interest may be offered. For term deposits below the prescribed quantum with the same maturity, the same rate should apply.
  - b. The differential rates of interest so offered should be subject to the overall ceiling prescribed.
  - c. Interest rates paid by the bank should be as per the schedule and not subject to negotiation between the depositor and the bank.
- (iii) pay brokerage, commission or incentives on deposits mobilized under FCNR(B) Scheme in any form to any individual, firm, company, association, institution or any other person.
- (iv) employ/ engage any individual, firm, company, association, institution or any other person for collection of deposit or for selling any other deposit linked products on payment of remuneration or fees or commission in any form or manner.



(v) accept interest-free deposit or pay compensation indirectly.

**(b) Resident Foreign Currency Accounts**

- Exporters having good track record to open foreign currency account with banks.
- RBI will permit.
- Unit located in SEZ may hold an account in Foreign Currency.
- Diamond Dollar Accounts may be opened with permission from RBI to transact business in Foreign Currency.
- The returning Indians can have their foreign currency accounts to be covered into RFC same feature as of FCNR.

**(c) EEFC accounts**

- Non-interest bearing – No credit facilities against the security of the balances.
- 100% of inward remittance for Status Holder Exports, professional service rendered in personal capacity.
- 100% of EOU, STP and EHTP, 50% for other payments received from a unit DTA for goods supplied to SEZ.

**(d) Non-resident Bank Accounts**

- Name of such accounts and type of arrangement.
- Funding of these accounts – bonafide transactions – freely convertible balance.
- System of monitoring overseas bank not to take a speculative view on rupees.
- Forward purchase/sale of foreign currencies against rupee for funding is prohibited – offer two ways quote is also prohibited.
- Temporary overdrawals to overseas branch/ correspondent not to exceed Rs. 500.00 lakh in aggregate in all overseas branch/correspondent in the books of the bank.
- Purpose is essential.
- Period not to exceed 5 days.
- Statement to be sent to Forex Market Division of RBI.

Further, RBI, vide its Master Direction No. RBI/DBR/2015-16/19 DBR. Dir. No.84/13.03.00/2015-16 dated March 03, 2016 on Reserve Bank of India (Interest Rate on Deposits) Directions, 2016 provides guidance on the interest rates on rupee deposits held in Domestic, Ordinary Non-Resident (NRO) and Non-Resident (External) (NRE) Accounts.

Further, RBI Circular RBI/2009-10/408 DBOD. No. Dir. BC. 91/13.03.00/2009-2010 dated April 20, 2010, provides the guidelines with respect to the conversion of a term deposit, a deposit in the form of daily deposit or a recurring deposit for reinvestment in term deposit and states that a bank, on a request from the depositor, should allow conversion of a term deposit, a deposit in the form of daily deposit or recurring deposit, to enable the depositor to immediately reinvest the amount lying in the aforesaid deposits with the same bank in another term deposit. On a review and in order to facilitate better asset-liability management (ALM), with effect from April 20, 2010, banks are permitted to formulate their own policies towards conversion of deposits.

(e) ***Rupee Accounts (Exchange House)***

- Accounts opening require approval from RBI.
- Trade transaction per transaction upto Rs. 2.00 lakh is permitted.
- Reconciliation issues and concurrent auditor overseas report.
- Debits/claims outstanding as the branches pending receipt of the credit.
- Method of value dating the transactions and overdraft arisen thereon.
- Collection of overdue interest for such over drawn balances.

### ***Accounting***

2.28 Banks may account the CDs at issue price under the Head “CDs issued” and show the same under “Deposits”. Accounting entries towards discount will be same as in case of ‘Cash Certificate’. Banks should maintain a register of CDs issued with complete particulars. Banks will maintain “CD Redemption Account” represented by specific ISIN.

### ***Combinations of Demand and Term Deposits***

2.29 Although the above are the basic types of deposits, these days, most of the banks are also offering combinations of two or more of them. These blended products are known by different names in different banks.

### ***Unclaimed Deposits/ Inoperative Accounts***

2.30 As per RBI Circular no. DBOD No. Leg.BC.34/ 09.07.005/2008-09 dated August 22, 2008 on “Unclaimed Deposits/inoperative accounts in Banks”, a bank is required to make an annual review of accounts in which there are no operations (other than crediting of periodic interest or debiting of service charges) for more than one year. A savings as well as current account should be treated as inoperative/ dormant if there are no transactions in the account for over a period of two years. In case any reply is given by the account holder giving the reasons for not operating the account, banks should continue

classifying the same as an operative account for one more year within which period the account holder may be requested to operate the account. However, in case the account holder still does not operate the same during the extended period, banks should classify the same as inoperative account after the expiry of the extended period. If a Fixed Deposit Receipt matures and proceeds are unpaid, the amount left unclaimed with the bank will attract savings bank rate of interest. In terms of Foreign Exchange Management (Crystallization of Inoperative Foreign Currency Deposits) Regulations, 2014 and vide Notification No. FEMA 10A/2014-RB dated March 21, 2014, issued under Foreign Exchange Management Act (FEMA), 1999 relating to inoperative foreign currency deposits, directions have been issued under Sections 10(4) and 11(1) of FEMA; and as per Clause 2.7 of the RBI Master Circular DBOD.No.Dir.BC.14/13.03.00/2014-15 dated 1-7-2014, inoperative deposits having a fixed term and those with no fixed term maturity, after the expiry of a three month notice upon completion of three years, will get crystallized into Rupees.

### **Depositor Education and Awareness Fund (DEAF) Scheme 2014**

2.31 Reserve Bank of India *vide* its circular no. DBOD. DEAF Cell. BC. No. 101/ 30.01.002/2013-14 dated March 21, 2014 namely “The Depositor Education and Awareness Fund Scheme, 2014 - Section 26A of Banking Regulation Act, 1949” has laid down certain guidelines with respect to the said fund. Under the provisions of Section 26A of the Banking Regulation Act, 1949 the amount to the credit of any account in India with any bank which has not been operated upon for a period of ten years or any deposit or any amount remaining unclaimed for more than ten years shall be credited to the Fund, within a period of three months from the expiry of the said period of ten years. The Fund shall be utilised for promotion of depositors’ interest and for such other purposes which may be necessary for the promotion of depositors’ interests as specified by RBI from time to time. The depositor would, however, be entitled to claim from the bank the deposit or any other unclaimed amount or operate the account after the expiry of ten years, even after such amount has been transferred to the Fund. The bank would be liable to pay the amount to the depositor/claimant and claim refund of such amount from the Fund.

2.32 All such unclaimed liabilities (where amount due has been transferred to DEAF) may be reflected as “Contingent Liability – Others, items for which the bank is contingently liable” under Schedule 12 of the annual financial statements. Banks are also required to disclose the amounts transferred to DEAF under the notes to accounts.

### **Reserve Bank of India (Gold Monetization Scheme) Direction, 2015**

2.33 The RBI issued Master Direction No.DBR.IBD.No.45/23.67.003/2015-16 dated 22-10-2015 (updated June 07, 2018) to all Scheduled Commercial Banks

that decide to implement the Scheme (*excluding Regional Rural Banks*), requiring such banks that decide to implement the Scheme (Designated Bank), to formulate a comprehensive policy with approval of their respective boards.

2.34 The Gold Monetization Scheme, 2015 (GMS) which includes the Revamped Gold Deposit Scheme (R-GDS) and Revamped Gold Metal Loan Scheme (R-GML) was intended to mobilise gold held by households and institutions to facilitate its use for productive purposes, and to reduce country's reliance on the import of gold.

2.35 Designated Banks are authorised to accept deposits, the principal and interest of which, under the scheme, shall be denominated in gold. Such deposits can be accepted from eligible persons viz., Resident Indians (Individuals, HUFs, Trusts including Mutual Funds/Exchange Traded Funds registered under SEBI (Mutual Fund) Regulations and Companies. Joint deposits of two or more eligible depositors can be made on the same basis as other joint deposit accounts and with nomination facility. The Broad features of the Gold Monetization Scheme are summarised in **Appendix IX** of the Guidance Note.

### **Procedural Aspects**

2.36 Some banks use a single application form for opening various types of accounts, viz., Savings, Current and Term Deposits while some others adopt the system whereby, for each type of account, a different type of form is used. The form essentially provides for particulars of the account holder(s), mode of operation on the account, term of the deposit (if applicable), signatures of the account holder(s), photograph of the account holder(s) etc. In the case of partnership firms, a copy of the partnership deed and in the case of companies, copies of the memorandum and articles of association, certificate of incorporation and resolution passed by the board for opening the account/making the deposit are obtained. Particulars of all new accounts opened are recorded in a register.

### **Know Your Customer Requirements (KYC)**

2.37 Reserve Bank of India *vide* its master direction no. RBI/DBR/2015-16/18 DBR.AML.BC.No.81/14.01.001/2015-16 updated as on July 12, 2018 on "Know Your Customer (KYC) norms/Anti-Money Laundering (AML) standards/Combating Financing of Terrorism (CFT)/Obligation of banks and financial institutions under PMLA, 2002" has laid down certain guidelines to prevent banks from being used, intentionally or unintentionally, by criminal elements for money laundering or terrorist financing activities. The guidelines prescribed in this circular, popularly known as KYC guidelines, also enable banks to know/understand their customers and their financial dealings better

which in turn help them manage their risks prudently.

These guidelines contain detailed requirements for banks in respect of customer acceptance policy, customer identification procedures, monitoring of transactions and risk management.

## **Audit Approach and Procedures**

### **Borrowings**

2.38 Where borrowings are shown by branch, the auditor must ensure that the borrowings/refinance:

- i) is separately disclosed as required by law;
- ii) balance confirmation certificates are obtained in evidence of borrowings from each lender; and
- iii) the nature and extent of security is determined and disclosed.

2.39 The auditor should understand process of new borrowing, repayment of borrowings and test controls around these processes.

2.40 Borrowings from RBI, other banks/financial institutions, etc., should be verified by the auditor with reference to confirmation certificates and other supporting documents such as, application form, sanction letter, agreements, interest rate, security, correspondence, etc. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties / lenders may assist the auditor in obtaining audit evidence that the auditor requires to respond to significant risks of material misstatement. The auditor is required to comply with the requirements of Standard on Auditing (SA) 505, "External Confirmations" which contains guidance on designing and performing external confirmation procedures to obtain relevant and reliable audit evidence.

2.41 The auditor should also examine whether a clear distinction has been made between 'rediscount' and 'refinance' for disclosure of the amount under the above head since rediscount does not figure under this head.

2.42 The auditor should examine whether borrowings of money at call and short notice are properly authorised. The rate of interest paid/payable on, as well as duration of such borrowings should also be examined by the auditor.

2.43 The auditor should similarly examine the relevant correspondence or other documents to verify whether the branch has been authorised by the head office to borrow/retain other borrowings and that the terms on which borrowings have been made are in accordance with the authorisation.

2.44 The auditor should examine whether the amount shown in the branch accounts is properly classified based on security or otherwise.

2.45 In case of borrowing through bonds and debentures, generally banks appoint the registrar for maintenance of records of borrowing such as bond holders etc. The auditor can obtain the balance confirmation from registrar of the bonds including other parameters of borrowing at each period end.

### **Deposits**

2.46 In carrying out audit of deposits and liabilities, the auditor is primarily concerned with obtaining reasonable assurance that all known liabilities are recorded and stated at appropriate amounts.

The auditor may verify various types of deposits in the following manner.

#### ***Current Accounts***

2.47 The auditor should verify the balances in individual accounts on a test check basis and should also examine whether the balances as per subsidiary ledgers tally with the related control accounts in the General Ledger. In case of any differences, the auditor should examine the reconciliation prepared by the branch in this regard.

2.48 Some banks have a procedure for obtaining confirmation of balances periodically. The auditor should examine whether the procedure laid down in this behalf has been followed consistently throughout the year. He should also examine, on a test check basis, the confirmations received.

2.49 The auditor should examine whether the debit balances in current accounts are not netted out on the liabilities side but are appropriately included under the head 'Advances'.

2.50 Inoperative accounts are a high risk area of frauds in banks. While examining current accounts, the auditor should specifically cover in his sample some of the inoperative accounts revived / closed during the year. The auditor should also ascertain whether inoperative accounts are 'revived' only with proper authority. For this purpose, the auditor should identify cases where there has been a significant reduction in balances compared to the previous year and examine the authorisation for withdrawals. Ratio analysis and comparatives can be used to select / identify such variation.

#### ***Savings Bank Deposits***

2.51 The auditor should verify the balances in individual accounts on a test check basis and should also examine whether the balances as per subsidiary ledgers tally with the related control accounts in the General Ledger. In case of

any differences, the auditor should examine the reconciliation prepared by the branch in this regard.

2.52 The auditor should also check the calculation of interest on a test check basis. In case of branch under Core Banking Solution (CBS) the product sheet for calculation of interest on saving bank accounts can be obtained in selected sample and auditor can verify the calculation.

2.53 Similar to inoperative current accounts, the auditor should pay special attention to inoperative savings bank accounts.

### ***Term Deposits***

2.54 While evaluating the internal controls over term deposits, the auditor should specifically examine whether the deposit receipts and cash certificates are issued serially and all of them are accounted for in the registers. The auditor should also satisfy himself that there is a proper control over the unused forms of deposit receipts and cash certificates to prevent their misuse.

2.55 As stated earlier, the rate of interest on Certificates of Deposits (CDs) is negotiable with the depositor. This area is quite sensitive. The auditor should bear this fact in mind while examining the efficacy of prescribed internal controls with regard to rates of interest on CDs.

2.56 The auditor should verify the deposits with reference to the relevant registers. The auditor should also examine, on a test check basis, the registers with the counter-foils of the receipts issued and with the discharged receipts returned to the bank. The reconciliation of subsidiary records for various types of term deposits with the related control accounts in the General Ledger should be examined. The auditor should also examine whether provision has been made for interest accrued on the deposits up to the date of the balance sheet. Auditor should also examine whether the proper provision for interest payable on deposits is made.

2.57 In some cases, banks employ some persons as 'collectors' to collect the deposits from depositors, e.g., in case of recurring deposits. In such cases, the auditor should specifically examine the efficacy of the internal control procedures for reconciling the records of the bank with those of the collectors.

2.58 Term deposits from banks are usually (though not necessarily) in round figures. Any odd balances in term deposits should therefore be selected by the auditor for verification on a sample basis.

2.59 If a Fixed Deposit Receipt matures and proceeds are unpaid, the amount left unclaimed with the bank will attract savings bank rate of interest as given in Para 3.4 of the Master Circular on Interest Rates on Rupee Deposits held in Domestic, Ordinary Non-Resident (NRO) and Non-Resident (External) (NRE) Accounts.

***Deposits Designated in Foreign Currencies***

2.60 In the case of deposits designated in a foreign currency, e.g., foreign currency non-resident deposits, the auditor should examine whether they have been converted into Indian rupees at the rate notified in this behalf by the head office. The auditor should also examine whether any resultant increase or decrease has been taken to the profit and loss account. It may also be seen that interest on deposits has been paid on the basis of 360 days in a year:

- i) For deposits up to one year, at the applicable rate without any compounding effect.
- ii) In respect of deposits for more than 1 year, the interest on FCNR (B) deposits should be calculated at intervals of 180 days each and thereafter for remaining actual number of days, till normal maturity.

Further, in case of conversion of FCNR (B) deposits into NRE deposits or vice versa before maturity has been subjected to the provisions relating to premature withdrawal.

***Interest Accrued But Not Due***

2.61 The auditor should examine that interest accrued but not due on deposits is not included under the relevant deposits but is shown under the head 'other liabilities and provisions'.

***Overall Reconciliation***

2.62 The procedures of banks usually provide for periodic correlation of outstanding deposits with the cost of deposits. The auditor should ascertain from the management whether such an exercise has been carried out and if so, he should review the same. The auditor should examine that interest accrued but not due has also been considered for this purpose.

***Inoperative Accounts***

2.63 Internal controls over inoperative accounts, is imperative. A response to the letter addressed to the Branch will assist the auditor to take a view on the system of dealing with inoperative Accounts. Attention needs to be sharply focused on debits/withdrawals to ascertain whether these are unauthorised. In testing the debits, attention should be specially paid to large and repetitive debits out of otherwise dormant accounts. Centralisation of these needs to be encouraged and such a recommendation needs to be made through the LFAR.

2.64 While scrutinising deposit ledgers, it is appropriate to ensure whether there are any stagnant/ inoperative accounts, which remain to be transferred. Computer generated exception reports will also reveal the status of the inoperative accounts.



### ***Window-dressing***

2.65 There are several ways in which the deposits of a bank may be inflated for purposes of balance sheet presentation. For example, some of the constituents may be allowed overdraft on or around the date of the balance sheet, the overdrawn amounts may be placed as deposits with the bank, and further advances may be given on the security of the deposit receipts, thus inflating deposits as well as advances. The transactions may be reversed immediately after the close of the year. Where the auditor comes across transactions, which indicate the possibility of window-dressing, he may report the same in his long form audit report. In appropriate cases, the auditor should consider making a suitable qualification in his main audit report also.

2.66 Unauthorised Deposits, particularly, during the period that deposits of demonetized currency notes were allowed, comprise the bank's liability and can be treated as Deposits, pending completion of any enquiry/investigation, with the safeguards the bank may take to avoid any wrongful claim thereon. The auditor may consider reporting the same in the LFAR by way of information.

### **Know Your Customers Norms**

2.67 RBI has issued instructions to all banks to implement without fail certain procedural norms on KYC. Failure would attract levy of penalty and if penalty has been levied the same is to be disclosed in the notes to accounts. In view of the nature of the directive the audit procedure may be suitably adopted to enquire the system of implementation and review of other reports in respect of this area. The auditor should examine that there exists proper procedure in place to ensure that framework relating to 'Know Your Customer' and Anti-Money Laundering measures is formulated and put in place by the bank.

# III-3

## Other Liabilities and Provisions

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### Balance Sheet Disclosure

3.01 The Third Schedule to the Banking Regulation Act, 1949, requires disclosure of the following items under the head 'Other Liabilities and Provisions':

- |                                    |                                   |
|------------------------------------|-----------------------------------|
| (a) Bills payable                  | (c) Interest accrued              |
| (b) Inter-office adjustments (net) | (d) Others (including provisions) |

### Bills Payable

3.02 Bills payable represent instruments issued by the branch against moneys received from customers, which are to be paid to the customer or as per his order (usually at a different branch). These include demand drafts, telegraphic transfers, mail transfers, traveller's cheques, pay-orders, banker's cheques and similar instruments issued by the bank but not presented for payment till the balance sheet date.

### Inter-office Adjustments

3.03 The balance in inter-office adjustments account, if in credit, is to be shown under this head. Chapter 11 of Part III of the Guidance Note on Audit of Banks, 2019 edition (Section A - Statutory Central Audit) provides the detailed guidelines on the aspects of Inter-office Transactions. Further at branch SBA should take the confirmation from the Head Office regarding the Inter-office adjustment account and its reconciliation

### Interest Accrued

3.04 Interest due and payable and interest accrued but not due on deposits and borrowings are to be shown under this head. The interest accrued in accordance with the terms of the various types of deposits and borrowings are considered under this head. Such interest is not to be clubbed with the figures of deposits and borrowings shown under the head 'Deposits and Borrowings'. Further auditor should check provisioning of interest on Matured Term Deposits.

### Others (Including Provisions)

3.05 According to the Notes and Instructions for compilation of balance

sheet and profit and loss account, issued by the RBI, the following items are to be included under this head:

- (a) Net provision for income tax and other taxes like interest tax, less advance payment and tax deducted at source.
- (b) Surplus in bad and doubtful debts provision account (such surplus is in the nature of a reserve).
- (c) Surplus in provisions for depreciation in securities (such surplus is in the nature of a reserve).
- (d) Contingency funds, which are actually in the nature of reserves but are not disclosed as such.
- (e) Proposed dividend/transfer to Government.
- (f) Other liabilities, which are not disclosed under any of the major heads such as unclaimed dividend, provisions and funds kept for specific purposes, unexpired discount, outstanding charges like rent, conveyance, etc. and tax deduction by bank payable on or before the due date.
- (g) Certain types of deposits like staff security deposits, margin deposits, etc., which are repayable only subject to compliance with certain conditions. (The interest on such deposits would also be included under this head).
- (h) Blocked Account arising from transfer of credit entries in inter-branch accounts outstanding for more than five years.

3.06 Besides the above items, the following are other important items usually included under this head:

- (a) Collections in respect of suit-filed accounts. These are not adjusted against advances till final settlement. (However, for the purpose of provisioning against non-performing advances, such credit balances are taken into account for ascertaining net outstanding).
- (b) Collection of income-tax on behalf of the Government.
- (c) Collection from DICGC. These are carried till final realisation/write-off of the concerned advance account.
- (d) Provisions for frauds. These are ultimately adjusted by way of a write-off.
- (e) Insurance claims received in respect of frauds. These are retained separately till final write-off in respect of fraud.
- (f) Provision for gratuity, pension and other staff benefits.
- (g) Provision for bank's share in the expenses of the Banking Services Recruitment Board.
- (h) Provision for audit fees.

(i) Unamortized interest income on the bills purchased/ discounted.

3.07 It may be noted that many of the items to be disclosed under this head are accounted for at the head office level and would not therefore form part of balance sheet of a branch.

## **Audit Approach and Procedures**

3.08 The auditor may verify the various items under the head 'other liabilities and provisions' in the following manner.

### **Bills Payable**

3.09 The auditor should evaluate the existence, effectiveness and continuity of internal controls over bills payable. Such controls should usually include the following:

- (a) Demand drafts, mail transfers, traveller's cheques, etc., should be made out in standard printed forms.
- (b) Unused forms relating to demand drafts, traveller's cheques, etc., should be kept under the custody of a responsible officer.
- (c) The bank should have a reliable private code known only to the responsible officers of its branches coding and decoding of the telegrams<sup>2</sup> should be done only by such officers.
- (d) The signatures on a demand draft should be checked by an officer with the specimen signature book.
- (e) All the telegraphic transfers and demand drafts issued by a branch should be immediately confirmed by advices to the branches concerned. On payment of these instruments, the paying branch should send a debit advice to the originating branch.
- (f) If the paying branch does not receive proper confirmation of any telegraphic transfers or demand draft from the issuing branch, it should take immediate steps to ascertain the reasons.
- (g) In case an instrument prepared on a security paper, e.g., demand draft, has to be cancelled (say, due to error in preparation), it should be examined whether the manner of cancellation is such that the instrument cannot be misused. (For example, in the case of demand drafts, banks generally cut the distinctive serial number printed on the form and paste it in the book in which demand drafts issued are entered.) Cases of

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<sup>2</sup> Telegrams have been discontinued since 15<sup>th</sup> July, 2013 and this is now just for academic purposes.

frequent cancellation and re-issuance of demand drafts, pay orders, etc., should be carefully looked into by a responsible official.

3.10 Based on auditor's evaluation of the efficacy of the relevant internal controls, the auditor should examine an appropriate sample of outstanding items comprised in bills payable accounts with the relevant registers. Reasons for old outstanding debits in respect of drafts or other similar instruments paid without advice should be ascertained. Correspondence with other branches after the year-end (e.g., responding advices received from other branches, advices received from other branches in respect of drafts issued by the branch and paid by the other branches without advice) should also be examined specially in so far as large value items outstanding on the balance sheet date are concerned.

### **Others (Including Provisions)**

3.11 It may be noted that the figure of advances and investments in the balance sheet of a bank excludes provisions in respect thereof made to the satisfaction of auditors. The issue of determining the adequacy of provision for doubtful advances is discussed in detail under Chapter on Assets Classification, Income Recognition and Provisioning of this Guidance Note. The auditor should examine other provisions and other items of liabilities in the same manner as in the case of other entities. Specifically, in case of tax deducted by the bank and payable to the government authorities on or before the due date, this function may be centralized or de-centralized. While verifying this, the auditor must check whether tax has been correctly deducted from payments as per the provisions of the Income Tax Act, 1961 and paid on or before the due date as specified under the Act or Rules thereunder. Many a times in case of branch audit, reporting has to be done before the due date of paying tax deducted at source for the month of March. In such cases the auditor should report delays observed till the date of his verification and clearly bring out the fact that he has not verified the payment of tax, due date of which would be after the date of the audit report.

## Contingent Liabilities and Bills for Collection

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### Introduction

#### Contingent Liabilities

4.01 The term 'contingent liabilities' can take two forms. On the one hand, a contingent liability refers to possible obligations arising from past transactions or other events or conditions, the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise. On the other hand, a contingent liability may also take form of a present obligation that arises from past events or transactions but is not recognised due to the fact that either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a reliable estimate of the amount of obligation cannot be made. Thus, contingent liabilities may or may not crystallise into actual liabilities. If they do become actual liabilities, they give rise to a loss or an expense. The uncertainty as to whether there will be any obligation differentiates a contingent liability from a liability that has crystallised. Contingent liabilities should also be distinguished from those contingencies which are likely to result in an obligation on the entity (i.e., the obligation is not merely possible but probable) and which, therefore, require creation of a provision in the financial statements. (*Members may refer to Accounting Standard (AS) 29, "Provisions, Contingent Liabilities and Contingent Assets"*)

#### Letter of Credit, Bank Guarantees and Letters of Comfort, Letter of Undertaking<sup>3</sup>

4.02 The concepts of Letters of Credit, Bank Guarantees and Letters of Comfort, Letter of Undertaking have been discussed in the Chapter 2 "Advances-Other than Agriculture" of Part III of the Guidance Note on Audit of Banks, 2019 edition (Section C - Bank Branch Audit other than Foreign Exchange Transactions).

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<sup>3</sup> The reserve bank of India has issued circular dated March 13, 2018, to discontinue the practice of issuance of LoUs/ LoCs for Trade Credits for imports into India by AD Category –I banks with immediate effect.

### **Liability on Partly Paid Investments**

4.03 If the bank holds any partly paid shares, debentures, etc., the auditor should examine whether the uncalled amounts thereof are shown as contingent liability in the balance sheet.

### **Liability on Account of Outstanding Forward Exchange Contracts and Derivatives Contract**

4.04 All branches which undertake foreign exchange business (i.e., those which are authorised foreign exchange dealers) usually enter into forward exchange contracts. The amount of forward exchange contracts, which are outstanding on the balance sheet date, is to be shown under this head. The treasury of the bank enters into derivatives contracts like Interest Rate Swap, Cross currency Swaps, etc. The notional amount of these contracts should be disclosed either separately or under this head as separate sub head.

### **Guarantees Given on Behalf of Constituents**

4.05 The amount of all guarantees outstanding on the balance sheet is to be shown under the above head after deducting therefrom any cash margin.

### **Acceptances, Endorsements and Other Obligations**

4.06 This item includes the following balances:

- (a) Letters of credit opened by the bank on behalf of its customers; and
- (b) Bills drawn by the bank's customers and accepted or endorsed by the bank (to provide security to the payees).

4.07 The total of all outstanding letters of credit as reduced by the cash margin and after deducting the payments made for the bills negotiated under them should be included in the balance sheet. In case of revolving credit, the maximum permissible limit of letters of credit that may remain outstanding at any point of time as reduced by the cash margin should be shown. If the transactions against which the letter of credit was opened have been completed and the liability has been marked off in the books of the bank, no amount should be shown as contingent liability on this account.

### ***Other Acceptances and Endorsements***

4.08 Sometimes, a customer of the bank may issue a usance bill payable to his creditor and drawn on the bank. The bank, on accepting such a bill, becomes liable to pay it on maturity. In turn, it has to recover this amount from its customer.

4.09 The total of all outstanding acceptances and endorsements at the end

of the year, as reduced by the cash margin, should be disclosed as contingent liability.

### Other Items for Which the Bank is Contingently Liable

4.10 Under this head are to be included such items as arrears of unpaid dividend on cumulative preference shares bills re-discounted, commitments under underwriting contracts, estimated amounts of contracts remaining to be executed on capital account, disputed tax liabilities, credit enhancement in respect of securitised loans to which the assignee or the special purpose vehicle has recourse, etc.

4.11 Underwriting involves an agreement by the bank to subscribe for the shares or debentures which remain unsubscribed in a public issue, in consideration of commission.

4.12 Rediscounting is generally done with the RBI, or other financial institutions or, in the case of foreign bills, with foreign banks. If the drawer dishonours the bill, the re-discounting bank has a right to proceed against the bank as an endorser of the bill.

4.13 Tax demands, which has been disputed are in the nature of contingent liability and should be disclosed. Where an application for rectification of mistake has been made by the entity, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of tax is for a certain amount and the dispute relates to only a part and not the whole of the amount, only such amount should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure as per provisions of Accounting Standard (AS) 29, "Provisions, Contingent Liabilities and Contingent Assets".

4.14 Disputed tax liabilities in respect of income-tax and similar central taxes would not form part of balance sheet of a branch as these items are dealt with at the head office level.

4.15 The liability involved in cases lodged against the bank in various courts including consumer dispute redressal forums, Banking Ombudsman as per Reserve Bank of India and any other Authority are in the nature of contingent liability and should be disclosed.

4.16 **Depositor Education and Awareness Fund:** As per RBI circular dated RBI/2013-14/ 614 DBOD. No. DEAF Cell. BC. 114/ 30.01.002/ 2013-14 dated May 27, 2014, all such unclaimed liabilities (where amount due has been transferred to DEAF) may be reflected as "Contingent Liability – Others, items for which the bank is contingently liable" under Schedule 12 of the annual financial statements.



## **Bills for Collection**

4.17 Bills held by a bank for collection on behalf of its customers are to be shown as a footnote to the balance sheet.

4.18 These bills are generally *hundies* or bills of exchange accompanied by documents of title to goods. Frequently, no bills of exchange are actually drawn; the bank is asked to present invoices and documents of title with instructions to collect the amount thereof from the party in whose name the invoice has been made. The documents of title enclosed with the bills for collection are usually not assigned to the bank.

4.19 A bank may get bills for collection from -

- (a) its customers, drawn on outstation parties; or
- (b) its other branches or other outstation banks or parties, drawn on local parties.

4.20 On receipt of the bills drawn on outstation parties, the bank forwards them to its branch or other correspondent at the place where they are to be collected. Such bills are called Outward Bills for Collection.

4.21 Bills received by the bank from its outstation branches and agents, etc. for collections are called Inward Bills for Collection.

4.22 It may be noted that if a bill is received by one branch of the bank from a customer and sent by it to another branch of the bank for collection, the same bill will be shown as an Outward Bill at the first branch and as an Inward Bill at the other branch. In the consolidated balance sheet of the bank, however, all such bills should be shown only once. Therefore, Inward Bills for Collection are excluded from the balance sheet of each branch.

## **Co-acceptance of Bills**

4.23 In its Master Circular No. RBI/2015-16/76 DBR. No. Dir. BC.11/13.03.00/2015-16 dated July 1, 2015 on "Guarantees and Co-acceptances", the RBI had reiterated the need for the banks to be cautious while co-accepting bills of their customers and discounting the same so as to avoid loss to banks arising on account of frauds perpetrated in the guise of bills. The circular requires the banks, *inter alia*, not to extend their co-acceptances to house bills/ accommodation bills drawn by group concerns on one another. In the circular, the RBI had also listed a number of safeguards to be undertaken by banks while co-accepting bills.

## **Audit Approach and Procedures**

### **Contingent Liabilities**

4.24 In respect of contingent liabilities, the auditor is primarily concerned with seeking reasonable assurance that all contingent liabilities are identified and properly valued. To this end, the auditor should, generally follow the audit procedures given below:

- (a) The auditor should verify whether there exists a system whereby the non-fund based facilities to parties are extended only to their regular constituents, etc.
- (b) Ascertain whether there are adequate internal controls to ensure that transactions giving rise to contingent liabilities are executed only by persons authorised to do so and in accordance with the laid down procedures.
- (c) The auditor should also examine whether in case of LCs for import of goods, as required by the abovementioned Master Circular on guarantees and co-acceptances, the payment to the overseas suppliers is made on the basis of shipping documents and after ensuring that the said documents are in strict conformity with the terms of LCs.
- (d) Ascertain whether the accounting system of the bank provides for maintenance of adequate records in respect of such obligations and whether the internal controls ensure that contingent liabilities are properly identified and recorded.
- (e) Performs substantive audit tests to establish the completeness of the recorded obligations. Such tests include confirmation procedures as well as examination of relevant records in appropriate cases.
- (f) Review the reasonableness of the year-end amount of contingent liabilities in the light of previous experience and knowledge of the current year's activities.
- (g) Review whether comfort letters issued by the bank has been considered for disclosure of contingent liabilities.
- (h) The auditor should also examine whether the bank has given any guarantees in respect of any trade credit (buyer's credit or seller's credit)<sup>4</sup>. The period of guarantees is co-terminus with the period of credit reckoned from the date of shipment.

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<sup>4</sup> In terms of the Circular No. A.P. (Dir. Series) 60 dated January 31, 2004, any trade credit extended for a period of three years and above comes under the category of external commercial borrowings.

- (i) Verify whether the bank has extended any non-fund facility or additional/ad hoc credit facilities to persons other than its regular customers. In such cases, auditor should examine the existence of concurrence of existing bankers of such borrowers and enquire regarding financial position of those customers.
- (j) If the Bank is using separate application for communicating, transacting, executing any co-acceptance / guarantees, the auditor should verify the interface controls in respect of these applications and CBS. If the system-based interface is not available and manual intervention is involved then Auditor should verify controls put in place by Bank for confirming completeness and correctness of transactions.
- (k) Obtain representation from the management that:
  - (i) all contingent liabilities have been disclosed;
  - (ii) the disclosed contingent liabilities do not include any contingencies which are likely to result in a loss/ expense and which, therefore, require creation of a provision in the financial statements;
  - (iii) the estimated amounts of financial effect of the contingent liabilities are based on the best estimates in terms of Accounting Standard 29, including any possibility of any reimbursement;
  - (iv) in case of guarantees issued on behalf of the bank's directors, the bank has taken appropriate steps to ensure that adequate and effective arrangements have been made so that the commitments would be met out of the party's own resources and that the bank will not be called upon to grant any loan or advances to meet the liability consequent upon the invocation of the said guarantee(s) and that no violation of section 20 of the Banking Regulation Act, 1949 has arisen on account of such guarantee; and
  - (v) such contingent liabilities which have not been disclosed on account of the fact that the possibility of their outcome is remote include the management's justification for reaching such a decision in respect of those contingent liabilities.

4.25 The specific procedures to be employed by the auditor to verify various items of contingent liabilities are discussed in the following paragraphs. It may be noted that many of the items discussed in the following paragraphs, may be designated in foreign currencies.

***Claims Against the Bank Not Acknowledged as Debts***

4.26 The auditor should examine the relevant evidence, e.g.,

correspondence with lawyers/others, claimants, workers/officers, and workmen's/officers' unions. The auditor should also review the minutes of meetings of board of directors/committees of board of directors, contracts, agreements and arrangements, list of pending legal cases, and correspondence relating to taxes, and duties, etc., to identify claims against the bank. The auditor should ascertain from the management the status of claims outstanding as at the end of the year. A review of subsequent events would also provide evidence about completeness and valuation of claims. Based on the circumstances of each case, the auditor should verify whether the item would remain a claim against the bank not acknowledged as debt or it would be a liability requiring provisioning. The auditor may ask for an opinion from empanelled lawyer of the Bank in respect of crystallisation of claim against the Bank. The auditor should use professional judgement to determine as to which claims can be construed as a contingent liability and which needs to be provided.

### ***Liability on Account of Outstanding Forward Exchange Contracts & Derivatives Contracts***

4.27 Forward Exchange Contract: The auditor may verify the outstanding forward exchange contracts with the register maintained by the branch and with the broker's advice notes. In particular, the net "position" of the branch in relation to each foreign currency should be examined to see that the position is generally squared and not uncovered by a substantial amount. The net "position" as reported in the financial statements may be verified with reference to the foreign exchange position report prepared by the back office.

4.28 Derivatives Contract: The auditor may verify outstanding derivatives contracts (options, cross currency swaps, interest rate swaps, etc.) with report generated from treasury application. The 'notional' amount of these derivatives contracts should be shown as contingent liability in financial statements.

### ***Guarantees Given on Behalf of Constituents***

4.29 The auditor should ascertain whether there are adequate internal controls over issuance of guarantees, e.g., whether guarantees are issued under proper sanctions, whether adherence to limits sanctioned for guarantees is ensured, whether margins are taken from customers before issuance of guarantees as per the prescribed procedures, etc.

4.30 The auditor should ascertain whether there are adequate controls over unused guarantee forms, e.g., whether these are kept under the custody of a responsible official, whether a proper record is kept of forms issued, whether stock of forms is periodically verified and reconciled with the book records, etc.

4.31 The auditor should examine the guarantee register to seek evidence whether the prescribed procedure of marking off the expired guarantees is being followed or not.

4.32 The auditor should check the relevant guarantee registers with the list of outstanding guarantees to obtain assurance that all outstanding guarantees are included in the amount disclosed in this behalf. The auditor should also examine that expired guarantees are not included in this head. He should verify guarantees with the copies of the letters of guarantee issued by the bank and with the counter-guarantees received from the customers. He should also verify the securities held as margin. If a claim has arisen, the auditor should consider whether a provision is required in terms of the requirements of AS 29, "Provisions, Contingent Liabilities and Contingent Assets".

4.33 The auditor should obtain a written confirmation from the management that all obligations in respect of guarantees have been duly recorded and that there are no guarantees issued upto the year-end which are yet to be recorded. Many a times it is observed that in certain cases, old and expired bank guarantees are not cancelled from the records. This would result in excess capital adequacy provisioning for the bank. Also, it should be confirmed that the margins are recorded at their proper value including the interest accrued. The auditor should verify the Bank Guarantee register for the purpose.

#### ***Acceptances, Endorsements and Other Obligations***

4.34 The auditor should evaluate the adequacy of internal controls over issuance of letters of credit and over custody of unused LC forms in the same manner as in the case of guarantees.

4.35 The auditor should verify the balance of letters of credit from the register maintained by the bank. The register indicates the amount of the letters of credits and payments made under them. The auditor may examine the guarantees of the customers and copies of the letters of credit issued. The security obtained for issuing letters of credit should also be verified.

#### ***Other Acceptances and Endorsements***

4.36 The auditor should study the arrangements made by the bank with its customers. He should test check the amounts of the bills with the register maintained by the bank for such bills. The auditor should also examine whether such bills are marked off in the register on payment at the time of maturity.

4.37 In respect of letters of comfort, the auditor should examine whether

the bank has incurred a potential financial obligation under such a letter. If a comfort letter does not cast any such obligation on the bank, no disclosure under contingent liability is required on this account.

### *Common Procedures*

4.38 The auditor should obtain a written confirmation from the management that all obligations assumed by way of acceptances, endorsements and letters of credit have been duly recorded and there are no such obligations assumed upto the year-end, which are yet to be recorded.

4.39 The auditor should ascertain whether a contingent obligation assumed by a bank either by way of acceptance, endorsement etc., has resulted in an actual obligation owing to any act or default on the part of its constituent. In such a case, a provision would have to be made in the accounts for the bank's obligation. The amount of the provision should be determined taking into account the probable recovery from the customer.

### ***Other Items for Which the Bank is Contingently Liable***

4.40 The auditor should examine whether commitments under all outstanding underwriting contracts have been disclosed as contingent liabilities. For this purpose, the auditor should examine the terms and conditions of the relevant contracts.

4.41 Rediscounting is generally done with the RBI, Industrial Development Bank of India or other financial institutions or, in the case of foreign bills, with foreign banks. If the drawer dishonours the bill, the rediscounting bank has a right to proceed against the bank as an endorser of the bill. The auditor may check this item from the register of bills rediscounted maintained by the branch. He should satisfy himself that all the bills are properly marked off on payment at the time of maturity.

4.42 In respect of disputed tax demands, the auditor should examine whether there is a positive evidence or action on the part of the bank to show that it has not accepted the demand for payment of tax or duty. Where an application for rectification of mistake has been made by the entity, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of tax is for a certain amount and the dispute relates to only a part and not the whole of the amount, only such amount should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure as per provisions of AS 29, "Provisions, Contingent Liabilities and Contingent Assets". In determining whether a provision is required, the auditor should, among other procedures, make appropriate inquiries with management, review minutes of the meetings of the board of directors and correspondence with the entity's lawyers, judgments on similar matters of other banks and obtain

appropriate management representations.

4.43 Disputed tax liabilities in respect of income-tax and similar central taxes would not form part of balance sheet of a branch as these items are dealt with at the head office level. However, the principles enunciated above should be followed in dealing with taxes and duties (such as, local taxes) dealt with at the branch level.

4.44 The auditor should check whether any liability is involved in cases lodged against the bank.

4.45 The auditor may verify other items under this head in the same manner as in case of other entities.

### **Bills for Collection**

4.46 The auditor should examine whether the bills drawn on other branches of the bank are not included in bills for collection.

4.47 Inward bills are generally available with the bank on the closing day and the auditor may inspect them at that time. The bank dispatches outward bills for collection soon after they are received. They are, therefore, not likely to be in hand at the date of the balance sheet. The auditor may verify them with reference to the register maintained for outward bills for collection.

4.48 The auditor should also examine collections made subsequent to the date of the balance sheet to obtain further evidence about the existence and completeness of bills for collection.

4.49 Regarding bills for collection, the auditor should also examine the procedure for crediting the party on whose behalf the bill has been collected. The procedure is usually such that the customer's account is credited only after the bill has actually been collected from the drawee either by the bank itself or through its agents, etc. This procedure is in consonance with the nature of obligations of the bank in respect of bills for collection.

4.50 The commission of the branch becomes due only when the bill has been collected. The auditor should, accordingly, examine that there exists adequate internal control system that debits the customer's account with the amount of bank's commission as soon as a bill collected is credited to the customer's account. The auditor should also examine that no income has been accrued in the accounts in respect of bills outstanding on the balance sheet date.

### **Co-acceptance of Bills**

4.51 The auditor should examine whether the bank has instituted an adequate internal control system to comply with the safeguards as set out by

the RBI's Master Circular No. RBI/2015-16/76 DBR. No. Dir. BC.11/13.03.00/2015-16 dated July 1, 2015 on "Guarantees and Co-acceptances" to ascertain whether such system, *inter alia*, captures all such items, appropriately records the same and also determines all the material items forming contingent liabilities, whether any item needs a provision in the books.

## **Disclosures**

### **Balance Sheet Disclosure**

4.52 The Third Schedule to the Banking Regulation Act, 1949, requires the disclosure of the following as a footnote to the balance sheet.

(a) *Contingent Liabilities*

- I. Claims against the bank not acknowledged as debts
- II. Liability for partly paid investments
- III. Liability on account of outstanding forward exchange contracts & Derivatives Contracts
- IV. Guarantees given on behalf of constituents
  - (a) In India
  - (b) Outside India
- V. Acceptances, endorsements and other obligations
- VI. Other items for which the bank is contingently liable

(b) *Bills for Collection*



## Treasury Operations - Domestic

- A. Introduction and Bank's Process
- B. Regulatory requirements/ restrictions & updates
- C. Accounting Aspects
  - I. Balance Sheet/ Profit and Loss presentation (including RBI guidance on composition)
  - II. Disclosures required per RBI guidelines
  - III. Disclosures required per Accounting Standards
  - IV. Accounting Standards considerations including Ind AS
- D. Audit approach and procedures
- E. Internal Financial Controls Over Financial Reporting including IT Controls
- F. Certificate/ Reports (cover the requirements and approach/ procedures)

### **a) Introduction and Bank's Process**

5.01 Treasury operations is one of the most important function of a bank, responsible for the processing of all financial market transactions and usually much more, including a crucial role in managing risk. Treasury comprises two main components – Investments (comprising transactions related to domestic investments and money market operations) and Forex & Derivatives.

### **Core functions of Treasury Operations in Bank**

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

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

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

### **Front Office (Dealing Room)**

- Money and fixed income dealings
- Forex & Derivatives
- Treasury Sales
- Equities
- Primary Dealers
- Debt Sales
- Credit Default Swaps

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

- Identification, measurement and monitoring of risk
- Monitoring counter party, product and dealer limits

### **Back Office**

- Settlement and follow up
- Reconciliations
- Accounting
- Valuation

5.04 Increasing regulation and compliance requirements and the need for risk management have made 'treasury front and back office efficiency' as one of the most critical factors in ensuring the well-being of any bank today. This is certain to continue as the operations of treasury becomes more onerous while financial products become increasingly complex, despite streamlining of processing systems.

### **Front office Operations**

5.05 The front office operations consist of dealing room operations wherein the dealers transacts 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.

5.06 The dealers are primarily responsible to check for counterparty exposure limits, eligibility, and other requirements of the Bank before initiating any deal with the counter-party. Dealers must ensure that all risk/credit limits are available before transacting a deal. Also, the deal must not contravene the

current regulations regarding dealing in INR with overseas banks/counterparties. All counterparties are required to execute the International Swaps and Derivatives Association ('ISDA') agreement as well as pass a board resolution allowing it to enter into derivative contract. As soon as the deal is struck with counterparty, the deal details are noted in a dealers' deal pad and thereafter captured in front office system of the Bank which gets queued in for authorization by back office.

### **Middle office Operations**

5.07 Middle office is responsible for online risk measurement, monitoring and management reporting. The other functions of Mid-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**

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

5.09 An important development in the back office has been the advent of straight-through processing (STP), also called 'hands-off' processing. This has been made possible through enhancement of computer system to real time

online input in the trading platform, which in turn has meant that the back office can authorise/confirm deals pending for authorisation in the trading platform. In practice this is done automatically by matching incoming data from counterparties and thereby focussing on investigating exceptions. With the introduction of online trading systems, the deal is 'confirmed' as it is done, allowing the back office to concentrate principally on handling exceptions, settlement and monitoring and risk control. This is a completely different approach than the earlier system of input and checking of written paper-based deals that represented only a dealer's version of what the deal was before external verification could even commence.

5.10 One of the basic tenets for a treasury area in a bank is the strict segregation and allocation of duties between the front, middle and back office, the latter controlling confirmations, settlement and accounting of transactions. These are even more important in an era of straight-through processing where the checks are fewer and must essentially be independent. However, while this is straight forward for the processing functions, the independent monitoring and management of complex trading risks can be much more problematical, requiring the ability and market knowledge to understand how the trades and hedges in the dealer's book are structured.

### **Functions of Back Office**

#### ***Input and completion***

5.11 The first core function for the back office is to extract the details of the deal either through the input system or by accessing the online platform and authorise/confirm the same after verifying the deal details with the external evidence i.e. incoming data from counterparty, Reuters'/ Bloomberg's conversation, broker notes. Deals input through front-end data capture or agreed on one of the proprietary trading systems are subjected to numerous system checks to ensure that the transaction details are technically correct. Some deals will require settlement instructions to be added, but for straightforward foreign exchange and derivative deals done with other banks and large corporates, standard settlement instructions (SSIs) may have already been added as per the agreement. This could also be true for derivatives transactions in the larger treasuries. However, these types of transactions generally need more checking and manual intervention because of the wide variety of their use. Bank normally releases its own confirmation to the counterparty, particularly for over the counter ('OTC') deals.

### ***Counterparty confirmation***

5.12 The second core function for the back office is to verify the deal from the counterparty as soon as possible after the transaction has been done. For bank-to-bank trading, the verification can take the form of a confirmation of a deal done through Reuters conversation or trading systems, or a broker's confirmation if the deal has been done through a broker. Telephone confirmations are also sought for immediate authorisation. Further, the banks have entered into bilateral agreement with counterparty banks who are members of CCIL; whereby exchange of confirmations for Forex Interbank deals (matched on CCIL) have been discontinued.

5.13 Deals done with customers (non-banks) will normally be confirmed by e-mail, with instructions swapped on the telephone, depending on the arrangements. Increasingly, however, corporate customers are using automatic confirmation-matching services. It is essential that the deal is confirmed independently of the trader before any kind of value is given or payment is made.

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

5.14 It is to be noted that all entities regulated by RBI, IRDA and PFRDA have to mandatorily report secondary market Corporate Bond trades on F-TRAC. Other entities regulated by SEBI or any other regulators have been mandated to report OTC secondary market Corporate Bond on F-TRAC, or any other SEBI authorised reporting platform. All entities have to report CP's & CD's only on F-TRAC.

### ***Settlement***

5.15 The third core function in the processing chain is that of settlement. This can take the form of a clean currency payment/receipt at the bank's accounts or through the medium of CCIL. The CCIL settlement process is a multilateral netting system for Inter-bank transactions that will net the member's payment and receipts in a currency, even if they are due to or due from him from different counter parties and settles the net position in both legs of the transaction.

### ***Reconciliation***

5.16 Operations areas are typically involved in a number of reconciliation processes, including the reconciliation of dealers' overnight positions, NOSTRO accounts and brokerage payments. This can also mean reconciling positions for margin calls in futures trading or reconciling custody accounts to the underlying securities in securities trading. However, the basic reconciliation function is to agree or reconcile the entries that have passed over an account with correspondent bank against those that have been passed internally in the books

of the bank to a NOSTRO account. After reconciliation, the unmatched items in both accounts then represent those that have not been responded to in either the books of the bank or its correspondent and should therefore requires to be investigated.

### **Important Terms**

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

#### ***Approved Securities***

5.18 Section 5(a) of the Banking Regulation Act, 1949 defines 'approved securities' to mean securities in which a trustee may invest money under clauses (a) to (d) and (f) of section 20 of the Indian Trusts Act, 1882. Approved securities comprise primarily the securities issued or guaranteed by the Central or State Government, or any other security expressly authorised by the Central Government by notification in the official gazette.

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

5.19 This is a ledger maintained by the Public Debt Office (PDO) of RBI in which accounts of different banks are maintained regarding their holding of Government securities. The transactions through SGL Accounts should be in compliance of Master Circular on Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Bank dated July 1, 2015.

#### ***Repo and Reverse Repo Transactions***

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

5.21 The RBI has issued 'Repo in Corporate Debt Securities (Reserve Bank) Directions, 2015' on 3<sup>rd</sup> February 2015 and allowed banks to undertake repo transactions in corporate debt securities. Further, the RBI *vide* its circular no. RBI/2015-2016/403 FMRD.DIRD. 10 /14.03.002/2015-16 dated 19<sup>th</sup> May, 2016 on "Repo/Reverse Repo Transactions with RBI" (effective from 3<sup>rd</sup> October 2016) has decided to: (a) align the accounting norms to be followed by

market participants for repo/reverse repo transactions under LAF and the Marginal Standing Facility (MSF) of RBI with the accounting guidelines prescribed for market repo transactions.

Accordingly, all repo/ reverse transactions are required to be accounted as lending and borrowing transactions with effect from 3<sup>rd</sup> October 2016.

5.22 Banks shall classify the balances in Repo A/c under Schedule 4 (Borrowing). Similarly, the balances in Reverse Repo A/c shall be classified under Schedule 7 (Balances with banks and money at call and short notice). The balances in Repo interest expenditure A/c and Reverse Repo interest income A/c shall be classified under Schedule 15 (Interest expended) and under Schedule 13 (Interest earned) respectively.

5.23 RBI vide notification RBI/2016-2017/156 FMOD.MAOG No. 117/01.01.001/2016-17 dated November 25, 2016 has decided that the Oil Bonds issued by GOI will qualify as eligible securities for Repos, Reverse Repos and MSF, on E-Kuber system. In terms of RBI notification no. RBI/2016-17/49 FMRD.DIRD.6/14.03.002/2016-17 dated August 25, 2016, repo transactions are now allowed between the permitted entities, namely, (a) SGL A/c holders; (b) A SGL A/c holder and its own gilt account holder (GAH); (c) A SGL A/c holder and a GAH under another custodian; (d) GAHs under the same custodian; and (e) GAHs under two different custodians, subject to the conditions as specified in the said notification.

### **Short Sale**

5.24 Short Sale is defined as sale of securities which one does not own, i.e., selling of a security without possessing stock of such securities. A bank can also undertake 'notional short sale' wherein it can sell a security short from HFT even though the stock of said security is held under HFT / AFS / HTM category. Thus, short sales include actual as well as 'notional' short sale. A short sale can be undertaken by the bank subject to certain conditions as stipulated by RBI and within specified limits. Securities which are sold short are invariably required to be delivered on the settlement. A bank may meet the delivery obligation for a security sold short, by utilising the securities acquired under 'reverse repo' mechanism (except under RBI's Liquidity Adjustment Facility). However, as announced in paragraph 13 of the Statement on Developmental and Regulatory Policies, of the fourth Bi-monthly Monetary Policy Statement for 2017-18 dated October 04, 2017, it has now been decided that market participants undertaking 'notional' short sale need not compulsorily borrow securities in the repo market. While the short selling entity may ordinarily borrow securities from the repo market, in exceptional situations of market stress

(e.g. short squeeze), it may deliver securities from its own HTM/AFS/HFT portfolios. If securities are delivered out of its own portfolio, it must be accounted for appropriately and reflect the transactions as internal borrowing. All 'notional' short sales must be closed by an outright purchase in the market. It may be ensured that the securities so borrowed are brought back to the same portfolio, without any change in book value. The short selling entity must adhere to the extant regulations and accounting norms governing sale or valuation of securities in its portfolios. The bank may frame a Board approved policy for this purpose. Even though reverse repos can be rolled over, short sale position needs to be covered within a maximum period of three months including day of trade.

### **STRIPS**

5.25 STRIPS stand for Separate Trading of Registered Interest and Principal Securities. Stripping is a process of converting periodic coupon payments of an existing Government Security into tradable zero-coupon securities, which will usually trade in the market at a discount and are redeemed at face value. For instance, stripping a five-year Government Security would yield 10 coupon securities (representing the coupons), maturing on the respective coupon dates and one principal security representing the principal amount, maturing on the redemption date of the five-year security. Reconstitution is the reverse process of stripping, where, the Coupon STRIPS and Principal STRIPS are reassembled into the original Government Security. Detailed guidelines outlining the process of stripping/reconstitution and other operational procedures regarding transactions in STRIPS are given in Master Circular on Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Bank dated July 1, 2015.

#### ***When Issued Securities***

5.26 'When, as and if issued' (commonly known as 'when-issued' (WI)) security refers to a security that has been authorized for issuance but not yet actually issued. 'WI' trading takes place between the time a new issue is announced and the time it is actually issued. All 'when issued' transactions are on an 'if' basis, to be settled if and when the actual security is issued.

The NDS-OM members have been permitted to transact on 'When Issued' basis in Central Government dated securities, subject to the guidelines of RBI.

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

5.27 It is a negotiable money market instrument and issued in dematerialized form or as a Usance Promissory Note against funds deposit at a bank or eligible Financial Institution for a specified time period. CDs can be



issued by a bank with a maturity period which is not less than 7 days and not more than one year, from the date of issue and should have a minimum deposit size from a single subscriber not less than Rs. 1 lakh. CDs may be issued at a discount to face value or at a fixed / floating coupon rate.

5.28 Banks have to maintain appropriate reserve requirements, i.e., CRR and SLR, on the issue price of the CDs. There is no lock-in period for the CDs. Though, NRIs may also subscribe to CDs (but only on non-repatriable basis), such CDs cannot be endorsed to another NRI in the secondary market.

Banks/FIs may account the issue price under the Head "CDs issued" and show it under deposits. Accounting entries towards discount will be made as in the case of "Cash Certificates".

### ***Commercial Paper (CP)***

5.29 It is an unsecured money market instrument issued in the form of a promissory note by Corporates, PDs, FIs subject to compliance with the guidelines issued by RBI vide Master Direction on Money Market Instrument: Call/Notice Money Market, Commercial Paper, Certificate of Deposit and Non Convertible Debentures dated July 7, 2016. The tenure of CP should not be less than 7 days and not more than one year, from the date of issue.

5.30 Options (Call/Put) are not permitted on CP. Also, underwriting or co-acceptance to the issue of CP is not allowed. The minimum credit rating shall be 'A3' as per rating symbol and definition prescribed by SEBI, which should be ensured by the issuers.

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

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

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

### **REITs & InvITs**

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

5.34 Reserve Bank of India vide Circular no. RBI/2016-17/280 DBR. No. FSD. BC. 62/24.01.040/2016-17 April 18, 2017 has allowed banks to participate in Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs) within the overall ceiling of 20 per cent of their net worth permitted for direct investments in shares, convertible bonds/ debentures, units of equity-oriented mutual funds and exposures to Venture Capital Funds (VCFs) [both registered and unregistered]. Before making investments, Banks are required to put in place a Board approved policy on exposures to REITs/ InvITs which should lay down an internal limit on such investments within the overall exposure limits in respect of the real estate sector and infrastructure sector. Banks are not permitted to invest more than 10 per cent of the unit capital of a REIT/ InvIT. Banks need to ensure adherence to the prudential guidelines issued by RBI from time to time on Equity investments by Banks, Classification and Valuation of Investment Portfolio, Basel III Capital requirements for Commercial Real Estate Exposures and Large Exposure Framework, as applicable.

### **State Development Loans**

5.35 Paragraph 2 of the Statement on Developmental and Regulatory Policies, issued as part of the second Bi-monthly Monetary Policy Statement for 2018-19 dated June 06, 2018 states that with effect from September 30, 2018, Securities issued by each state government, i.e State Development Loans (SDL's), shall be valued in manner which would objectively reflect their fair value based on observed prices/yields made available by Financial Benchmarks India Pvt Ltd (FBIL).

## **b) Regulatory requirements/ restrictions & updates**

### **Legal Requirements**

5.36 For the purposes of section 24 of the Banking Regulation Act, 1949, the valuation of securities is to be done with reference to the cost price, market price, carrying cost or face value, or a combination of these methods, as may be specified by the RBI from time to time.

5.37 Section 19 of the Act places restrictions on overall holding of investments by banks in the shares of companies (except in the shares of subsidiary company. As per Section 19(2) of the Act, no banking company shall

hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding thirty per cent of the paid-up share capital of that company or thirty per cent of its own paid up share capital and reserves, whichever is less.

5.38 It should be observed that the limit of thirty per cent, as specified in section 19 of the Act, applies to all shares whether held as investments or as pledgee or mortgagee. Securities pledged by borrowers against advances are, therefore, to be taken into account. Securities held for safe custody are, however, not to be taken into account.

5.39 Under section 15(2) of the Act, it is necessary that before distributing dividends, a banking company provides for depreciation in the value of its investments in shares, debentures or bonds (other than the investments in approved securities) to the satisfaction of its statutory auditors. Investments in approved securities are exempted from this requirement provided such depreciation has not actually been capitalised or otherwise accounted for as a loss. In this regard, it may be noted that the RBI guidelines require banks to provide for depreciation in the value of certain approved securities also. Depreciation in respect of such approved securities accounted for, as a loss by the bank would not therefore be covered by the exemption granted under the section.

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

- (a) Shares in a subsidiary may be held in the name(s) of the company's nominee(s) to the extent necessary to ensure the minimum number of members as required by law.
- (b) Investments may be deposited with the bankers of the company for collection of dividend or interest.
- (c) Investments may be deposited with, or transferred to, or held in the name of, the State Bank of India or a scheduled bank to facilitate transfer thereof, subject to the conditions laid down in this behalf.
- (d) Investments may be deposited with, or transferred to, any person by way of security for repayment of a loan or performance of an obligation undertaken by the company.
- (e) Investments in the form of securities may be held in the name of a depository.

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

5.42 The provisions of section 179 of the Companies Act, 2013, also need to be noted. This section provides that normally, the power to invest the funds of a company shall be exercised by its board of directors only by means of resolutions passed at meetings of the Board. The section, however, permits the Board, by means of a resolution passed at a meeting, to delegate this function to a committee of directors, managing director, manager or any other principal officer of the company or, in the case of a branch office, to a principal officer of the branch office provided that such a resolution for delegation specifies the amount up to which the investments may be made and the nature of the investments.

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

5.43 The Reserve Bank of India has issued the Master Circular dated July 1, 2015 on "Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks", consolidating instructions/guidelines issued to banks on matters regarding prudential norms for classification, valuation and operation of Investment portfolio of banks. It may be noted that the Reserve Bank of India has not issued consolidated master circular after issuing the above said circular. The amendments are being issued through various Notifications and Circulars and accordingly auditors are advised to refer various circulars and notifications related to treasury operations issued after 1<sup>st</sup> July, 2015.

### **Classification of Investments**

5.44 Banks are required to classify their entire investments portfolio (including SLR securities and non-SLR securities) into three categories: held-to-maturity, available-for-sale and held-for-trading.

(i) *Held-to-maturity (HTM)*

This category would comprise securities acquired by the bank with the intention to hold them up to maturity.

(ii) *Held-for-trading (HFT)*

The investments classified under HFT would be those from which the bank expects to make a gain by the movement in interest rates/market rates. These securities are to be sold within 90 days.

*(iii) Available-for-sale (AFS)*

This category will comprise securities, which do not qualify for being categorised in either of the above categories, i.e., those that are acquired neither for trading purpose nor for being held till maturity.

5.45 Banks should decide the category of the investment at the time of acquisition and the decision should be recorded on the investment proposal/deal slip. Investments under HTM category should not normally exceed 25% of the total investments of the bank, except as specified in the Master Circular, wherein the limit of 25% can be exceeded. The Banks may hold the following securities under HTM:

- (a) SLR Securities upto prescribed percentage of their DTL as on the last Friday of the second preceding fortnight (updated vide RBI notification RBI/2017-18/70 DBR.No.Ret.BC.90/12.02.001/2017-18 dated October 4, 2017), to the extent of 19.50%
- (b) Non-SLR securities included under HTM as on September 02, 2004.
- (c) Fresh re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in Investment portfolio, excluding re-capitalisation bonds of other bank acquired for investment purpose.
- (d) Fresh investment in the equity of subsidiaries and joint ventures.
- (e) RIDF/SIDBI/RHDF deposits.
- (f) Investment in long-term bonds (with a minimum residual maturity of seven years) issued by companies engaged in infrastructure activities.

5.46 The banks will have the freedom to decide on the extent of holdings under HFT and AFS. This will be decided by them after considering various aspects such as basis of intent, trading strategies, risk management capabilities, tax planning, manpower skills, capital position. RBI vide its circular dated 16th July 2015 decided that for accounting periods commencing on or after April 1, 2015, deposits placed with NABARD/ SIDBI/ NHB on account of shortfall in priority sector targets should be included under Schedule 11- 'Other Assets' under the subhead 'Others' of the Balance Sheet instead of disclosing under Schedule 8 "Investments".

## Exposure Limits

5.47 The RBI, *vide* its Master Circular dated July 1, 2015 on “Exposure Norms” provides requirements in respect of exposure limits for banks. Further, the Reserve Bank of India *vide* Notification No. RBI/2016-17/167 DBR.No.BP. BC.43/21.01.003/2016-17 December 01, 2016 has issued guidelines on Large Exposure Framework (LEF). These guidelines shall come into effect with effect from April 1, 2019.

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

The auditor needs to check compliance with above mentioned circulars, while auditing equity investments in financial services company by the bank.

## c) Accounting Aspects

### Disclosure Requirements

5.49 Investments of banks should be disclosed as per following 6 classifications:

- (i) Governments Securities;
- (ii) Other Approved Securities;
- (iii) Shares (both equity as well as preference);
- (iv) Debentures and Bonds;

- (v) Subsidiaries/ Joint Ventures/ Associates;
- (vi) Other investments, such as, Commercial Papers, Certificate of Deposits, Security Receipts (SR), Pass Through Certificates (PTC), Units of Mutual Funds, Venture Capital Funds, Real Estate Funds, Real Estate Investment Trust (REITs), Infrastructure Investment Trust (InvITs) etc.

However, banks are not permitted to make investments in immovable properties for earning rentals, though it can gainfully deploy any business premises, which is not being used for the business. Thus, banks will not have immovable properties as part of their investment portfolio. (Section 6 of Banking Regulation Act, 1949)

### **Balance Sheet Presentation**

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

- I. *Investments in India in:*
  - (i) Government securities
  - (ii) Other Approved Securities
  - (iii) Shares
  - (iv) Debentures and Bonds
  - (v) Subsidiaries and/or Joint Ventures
  - (vi) Others (to be specified)
- II. *Investments outside India in:*
  - (i) Government securities (including local authorities)
  - (ii) Subsidiaries and/or Joint Ventures Abroad
  - (iii) Other Investments (to be specified)

5.51 In addition to other disclosures regarding investments, the Notes and Instructions for Compilation of Balance Sheet, also require the following information to be disclosed in the balance sheet:

- (a) gross value of investments in India and outside India;
- (b) aggregate of provisions for depreciation, separately on investments in India and outside India;
- (c) net value of investments in India and outside India; and

- (d) movement of provisions held towards depreciation on investments including opening balance by adding provisions made during the year and after deducting write-off/ write-back of excess provisions during the year.

5.52 The gross value of investments and provisions need not, however, be shown against each of the categories specified in the Schedule. The break-up of net value of investments in India and outside India (gross value of investments less provision) under each of the specified category need only be shown.

### **Audit Approach and Procedures**

5.53 The auditor's primary objective in audit of investments is to satisfy themselves as to their existence and valuation. Examination of compliance with statutory and regulatory requirements is also an important objective in audit of investments in as much as non-compliance may have a direct and material impact on the financial statements.

5.54 The latter aspect assumes special significance in the case of banks where investment transactions have to be carried out within the numerous parameters laid down by the relevant legislation and directions of the RBI. The auditors should keep this in view while designing their audit procedures relating to investments. The Reserve Bank of India has started issuing Master Directions on all regulatory matters beginning January 2016.

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

5.55 For the purpose of identifying significant processes, the auditor may identify significant accounts and processes linked to significant accounts. They may carry out detailed understanding of process from inception of transaction to its final accounting. The banks normally have documented standard operating procedures (SOPs), hence auditor can peruse SOPs for understanding and documenting significant processes. During the process understanding, auditors may identify various control points in the process like reconciliation, maker checker, segregation of duties, etc. The auditors may carry out walk through of few transactions for validating process understanding and existence of identified controls. Identified controls needs to be further segregated to manual controls and IT controls for testing of those controls for sample transactions. This sample needs to be selected randomly from total population of transactions as per the methodology.

5.56 In today's scenario, most of the treasury functions of banks are performed in an automated environment (for example, trade booking, settlement and accounting). In such a situation, it becomes imperative for the



auditors to test the general information technology controls and system application controls around the functioning of the systems involved and also the interfaces between various systems.

5.57 Some of the typical audit procedures include:

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

### **Substantive Audit Procedures**

5.58 Considering that the investments comprise a substantial portion of a bank's balance sheet, a combination of test of operating effectiveness of controls and substantive audit procedures (including substantive analytical procedures) would be necessarily carried out by the auditor to conclude effectively on the completeness, recognition and measurement, accuracy and existence of the banks' investments, related income/ expenses and associated balances.

### **Examination of Reconciliation**

5.59 The auditor should examine the reconciliation of the investment balances as per the financial statements with that of the balances with the custodians (PDO or a depository for investments held in dematerialised form), account statements of mutual fund, physically verify the securities on hand, obtain independent confirmations from custodians, counter-party banks for BRs on hand, to examine the control and reconciliation of BRs issued by the bank. In addition to examining the period end reconciliations, the auditor needs to examine such reconciliations at other interim intervals, to ensure that the process is followed throughout the audit period. Needless to add, the actual control and reconciliations etc., are to be carried out by the bank's management; however, the auditor needs to examine the same.

5.60 Some typical audit procedures would include:

- perusing the process, frequency of reconciliation and controls over same.

- perusing the reconciliation (period end as well as interim) and examining whether proper impact has been given for reconciling items.
- obtaining direct balance confirmations.

### Inspection of Documents

5.61 The auditor should ascertain whether the investments made by the bank are within its authority. In this regard, the auditor should examine whether the legal requirements governing the bank, relating to investments, have been complied with and the investments made by the bank are not *ultra vires* the bank. Apart from the above, the auditor should also ascertain that any other covenants or conditions which restrict, qualify or abridge the right of ownership and/or disposal of investments, have been complied with by the bank.

5.62 The auditor should satisfy himself that the transactions for the purchase/sale of investments are supported by approval of due authority and documentation. The acquisition/disposal of investments should be verified with reference to the broker's contract note, bill of costs, receipts and other similar evidence. The auditors may also check whether brokers note is dated and time stamped or not. The auditors should also check the segregation of duties within the bank staff in terms of executing trades, settlement and monitoring of such trades, and accounting of the same (generally termed as front office, middle office and back office functions' segregation).

5.63 Some typical audit procedures would include:

- checking compliance with all applicable legal requirements.
- checking approval and all supporting documents for purchase and sale of investments.
- checking segregation of duties.
- ensure that the inherent risk of management overriding controls is mitigated.

### Examination of Existence of Investments

5.64 The auditor may advise the bank to list out investments held in physical form separately from those held in dematerialised form with the PDO or with a depository. Banks are permitted to make fresh investments and hold bonds and debentures, privately placed or otherwise, and equity instruments only in dematerialised form.

5.65 The auditor should verify the investments held with PDO, custodians and the depository, at the close of business on the date of the balance sheet

with the statement of holdings. The auditor should circulate and maintain control over independent investments' balance confirmation requests to the custodian and other constituents (for example, RBI for SGL and CSDL balances) in accordance with SA 505, "External Confirmations" issued by ICAI. Furthermore, the auditor should design sufficient alternative audit procedures in situations where the independent confirmations are not received back (after reasonable follow up procedures) before the auditor signs off on the bank's financial statements. These alternative procedures should also be designed in such a way that independent data points are used for corroborating investment balances. (e.g.: the auditor gets the bank personnel download the investment statement in his own presence e.g. from E-Kuber for Government Securities, DP's website for Shares and Bonds etc.)

5.66 The auditor should peruse banks process of periodic physical verification of investments and satisfy himself with adequacy of process and controls. Based on assessment of physical verification process of bank, the auditor may verify the investment scrips physically at the close of business on the date of the balance sheet. In exceptional cases, where physical verification of investment scrips on the balance sheet date is not possible, the auditor may carry out the physical verification on a date as near to the balance sheet date as possible. In such a case, they should take into consideration any adjustments for subsequent transactions of purchase, sale, etc. In the current environment, where the banks generally have their investment securities in dematerialised form, the importance of independent audit confirmation requests multiplies. Auditors may also check feasibility of converting physical shares in dematerialised form. If feasible, auditors may suggest banks to convert physical shares into dematerialised form.

5.67 Investments are normally dealt with at the head office and not at the branches. However, sometimes, for realisation of interest etc., and other similar purposes, some of the investment scrips may be held at branch offices. In such cases, the auditor needs to examine the records maintained at the head office to record details of scrips held at other locations and request the respective branch auditors to physically verify such scrips as a part of their audit. The auditor needs to obtain a written confirmation to this effect from the branch auditors. The branch auditors should also be requested to report whether adequate records are maintained by the branch for the securities held by it on behalf of the head office.

5.68 The auditor may specifically request the branch auditors to examine and report any cases of non-receipt of income against investments for a long period or of scrips being held without being redeemed long after the

redemption date, as these situations might be indicative of the scrips being forged or otherwise unrealisable. In case the investment scrips are held at an unaudited branch, the auditor should request the management to obtain the scrips at the head office for his examination.

### **Cut-off Procedures**

5.69 In terms of testing completeness of investments balances at the reporting date, the auditor should carefully devise cut-off procedures. This should be designed after understanding the bank's procedures for ensuring the appropriate period of accounting for investments. The banks should follow 'Settlement Date' accounting for recording transactions in Government securities. In respect of transactions other than in Government securities, the bank should follow the accounting policy consistently either 'Trade Date' or 'Settlement Date' accounting.

5.70 Some typical audit procedures would include:

- Obtaining list of transactions executed on period end date and examining whether the same is correctly recorded and accounted.
- Checking first few sample transactions of subsequent period and ascertaining whether the same pertains to current reporting period.
- Checking control over transaction numbering by the system and ascertaining whether the transaction with last number for period end is recorded in current period and next transaction is recorded in subsequent period.

5.71 In respect of BRs issued by other banks and on hand with the bank at the year-end, the auditor should examine confirmations of counterparty banks about such BRs. Where any BRs have been outstanding for an unduly long period, the auditor should obtain written explanation from the management for the reasons thereof. This procedure may not, however, be necessary where scrips are received from counterparty banks before the completion of the audit.

5.72 The auditor should examine the reconciliation of BRs issued by the bank. He should also examine whether the securities represented by BRs issued by the bank and outstanding at the year-end have been excluded from investments disclosed in the balance sheet.

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

5.73 The auditor should examine whether the shifting of the investments to/from HTM category is carried out only once during a financial year and at the

beginning of the financial year unless otherwise stipulated by RBI under special dispensation. Such shifting is required to be duly approved by the Board of Directors of the bank. As regards the shifting of investments from AFS to HFT, the auditor should verify the same as having been duly approved by the Board of Directors / ALCO / Investment Committee. In case of exigencies, the shifting from AFS to HFT may be done with the approval of the Chief Executive of the Bank/ Head of ALCO, but should be ratified by the Board of Directors later. Shifting of investments from HFT to AFS is generally not allowed. However, it will be permitted only under exceptional circumstances like not being able to sell the security within 90 days due to tight liquidity conditions, or extreme volatility, or market becoming unidirectional. Such transfer is permitted only with the approval of the Board of Directors/ ALCO/ Investment Committee.

5.74 Transfer of scrips from AFS / HFT category to HTM category should be made at the lower of book value or market value. In other words, in cases where the market value is higher than the book value at the time of transfer, the appreciation should be ignored and the security should be transferred at the book value. In cases where the market value is less than the book value, the provision against depreciation held against this security (including the additional provision, if any, required based on valuation done on the date of transfer) should be adjusted to reduce the book value to the market value and the security should be transferred at the market value.

5.75 In the case of transfer of securities from HTM to AFS / HFT category,

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

5.76 It is to be noted that in case if the bank is following 'Weighted Average Method', the cost of acquisition of the security is required to be considered redundant and instead book value (which would be weighted average value) needs to be considered for the purpose of above mentioned both clauses.

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

5.78 The audit procedures in this regard would include:

- obtaining list of shifting of investments during the reporting period.
- checking compliance with RBI guidelines and existence of proper approvals for same.
- checking proper recording/ accounting of book value and depreciation on date of shifting.

### **Examination of Accounting and Valuation**

5.79 Investments in securities now-a-days constitute a substantial part of total assets of many banks. Method of valuation of investments followed by a bank may, therefore, have a significant effect on its balance sheet and profit and loss account. The auditor should examine whether the method of accounting followed by the bank in respect of investments, including their year-end valuation, is appropriate, consistent and in conformity with RBI guidelines.

5.80 The auditor should examine the appropriateness of accounting policies followed by the bank. In case any of the accounting policies are not appropriate, the auditor should consider the effect of adoption of such policy on the financial statements and, consequently, on his audit report. In this regard, it may be noted that Accounting Standard (AS) 13, "Accounting for Investments", does not apply to banks.

5.81 According to RBI guidelines, in respect of shares which are unquoted or for which current quotations are not available, the market value has to be determined on the basis of break-up value (excluding Revaluation Reserves, if any) as per the latest balance sheet of the company (which should not be more than one year prior to the date of valuation). In case the latest balance sheet is not available the shares are to be valued at Re.1 per company. This might create a problem in the case of new companies whose first annual reports are not yet available. It appears that in such a situation, it would be appropriate to value the shares at cost except where the evidence available indicates the deterioration in the value.

5.82 RBI guidelines require that individual scrip in the available-for-sale ('AFS') category should be marked to market at quarterly or more frequent intervals. It is further required that net depreciation in respect of each of the

categories in which investments are presented in the balance sheet should be provided for and net appreciation should be ignored. As regards the scrips in Held for Trading (HFT) category, the same should be marked to market at monthly or at more frequent intervals in the similar manner, except in the following cases:

- i) Equity shares should be marked to market preferably on daily basis, but at least on a weekly basis;
- ii) Banks which undertake short sale transactions, the entire HFT portfolio including the short position should be marked to market on daily basis.

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

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

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

5.85 In determining the market value of debt securities under HFT and AFS categories, interest accrued up to the balance sheet date should be reduced from the market price, if the market price includes the accrued interest, to avoid its double counting of interest - first as accrued interest and secondly as a part of market value.

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

statistical sampling approach which is a matter of auditor's judgment. Particular focus should be on investments which involve management judgment or are not simple rule based valuations (preference shares and pass through certificates). While the auditor checks the valuation of investment securities across products in line with RBI prescribed methodology, he should also carefully focus on assessing the appropriateness of inputs used in various valuation models/formulae. This would include a check of:

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

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

5.88 In case the bank does not have automated means of valuation of investments (for example, valuation is computed over excel spreadsheets), the auditor should check end user computing controls over such spreadsheet usage. This would include a check of access controls over such files, change management controls, etc. This would help auditor conclude that the files for valuation of investments are not manipulated. This can also be classified as an anti-fraud control.

5.89 The auditor should examine whether the profit or loss on sale of investments has been computed properly. The carrying amount of investments disposed off should be determined consistently on similar basis. In case of HTM investments, Net Profit on sale of investments in this category should be first taken to the Profit & Loss Account, and thereafter be appropriated to the 'Capital Reserve Account' net of taxes and Net Loss will be recognised in the Profit & Loss Account.

5.90 The classification of investments into held-to-maturity, held-for-trading and available-for-sale categories is based on the intention with which the



respective investments have been acquired by the bank. The auditor should examine whether the investments have been properly classified into the three categories at the time of acquisition based on such intention as evidenced by dealers' pad or equivalent, along with reference to the decision of the competent authority such as Board of directors, ALCO or Investment Committee.

5.91 Equity, debentures and other financial instruments acquired by way of conversion of outstanding principal and / or interest should be classified in the AFS category, and valued in accordance with the extant instructions on valuation of banks' investment portfolio. Equity classified as standard asset should be valued either at market value, if quoted, or at break-up value, if not quoted (without considering the revaluation reserve, if any) which is to be ascertained from the company's latest balance sheet. In case the latest balance sheet is not available, the shares are to be valued at Re.1. Equity instrument classified as NPA should be valued at market value, if quoted, and in case where equity is not quoted, it should be valued at Re.1. Depreciation on the instruments acquired by way of conversion, whether classified as standard or NPA, should not be offset against the appreciation in any other securities held under the AFS category.

5.92 As per RBI guidelines, investments classified under held-for-trading category should be sold within 90 days of their acquisition, failing which they should be shifted to the available-for-sale-category. The auditor should accordingly ascertain that no investments purchased more than 89 days before the balance sheet date have been classified under this category.

5.93 In respect of debt securities, interest accrued upto the balance sheet date is usually recognised as income in the profit and loss account. One of the essential conditions for accrual of income is that it should not be unreasonable to expect ultimate collection thereof.

5.94 A change in the method of valuation of investments constitutes a change in accounting policy and adequate disclosure regarding the fact of the change along with its financial effect should be made in the balance sheet. If the valuation of Investment is outsourced to an agency, certain audit procedures would need to be applied at such processing agency also.

5.95 Some of the typical audit procedures would include:

- obtaining list of investment as at reporting period from Bank and ascertaining completeness of the same by reconciliation process as highlighted above.

- checking the carrying amount of investments and ensuring that same is calculated on consistent basis. This is normally calculated by system, hence need to check IT controls and calculation on sample basis for ensuring accuracy.
- In case quotes are available, checking source of capturing market price/ fair value as at reporting date.
- In case quotes are not available, checking calculation for fair value as at reporting date to ensure compliance with RBI guidelines.
- checking calculation of Marked to Market Gain/ loss and accounting for same in compliance with RBI guidelines.

**5.96 Chart of basis of Marked to Market procedure based on type of investments (Unquoted)**

<b>Type of Investment</b>	<b>Basis of Valuation</b>
Unquoted Central Government Securities	Prices / YTM rates put out by FBIL
Treasury Bills	Carrying Cost (acquisition cost plus discount accrued)
State Government Securities	By YTM method by marking it up by 25 basis point above Central Government Securities' Yield as put in by FBIL
Other Approved Securities	By YTM method by marking it up by 25 basis point above Central Government Securities' Yield as put in by FBIL
Debentures / Bonds	Valued with appropriate mark-up (which would be graded based on rating assigned to the security, and subjected to minimum of 50 basis point) over Central Government Securities' Yield as put in by FBIL
Bonds issued by State Distribution Companies (DISCOM) under Financial Restructuring Plan	Same as above except that the mark-up would be 50, 75 and 100 basis point, when the liability is with the respective state government, guaranteed by respective state government or not guaranteed by state government, respectively
Zero Coupon Bonds (ZCBs)	Present Value (PV) to Face Value (FV) of ZCBs to be calculated by using 'Zero Coupon Yield Curve (ZCYC)' with

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Type of Investment	Basis of Valuation
	appropriate mark up as per zero coupon spread put out by FBIL
Preference Shares	Valued with appropriate mark-up (which would be graded based on rating assigned to the security) over Central Government Securities' Yield as put in by FBIL, subjected to an upper cap of redemption value of preference shares
Equity Shares	Valued at break-up value without considering 'revaluation reserves', if any
Units of Mutual Funds	Latest Re-purchase price or NAV and if NAV is not available, at cost
Commercial Papers	Carrying Cost (acquisition cost plus discount accrued)
Investments in RRBs	Carrying Cost (i.e., at book value)
Securities issued by Securitisation Company (SC) / Reconstruction Company (RC)	Lower of redemption Value or Net Book Value (NBV)
Venture Capital Funds (VCFs)	For first three years, VCFs may be classified under HTM and subsequently under AFS and valued for Units / Equity / Bonds as per specified norms

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

**Spreading of MTM Losses and Creation of Investment Fluctuation Reserve (IFR)**

5.97 Banks has the option to spread provisioning for their mark to market (MTM) losses on all investments held in AFS and HFT equally over up to four quarters, commencing with the quarter ending June 30, 2018.

Banks that utilise the above option shall make suitable disclosures in their notes

to accounts/ quarterly results providing details of -

- (a) the provisions made for depreciation of the investment portfolio for the quarter ending June 2018 and
- (b) the balance required to be made in the remaining quarters.
- (c) creation of IFR

### **Non-Performing Investments (NPI)**

5.98 In respect of securities included in any of the three categories where interest/ principal is in arrears, banks should not reckon income on the securities and should also make appropriate provisions for the depreciation in the value of the investment. The banks should not set-off the depreciation requirement in respect of these non-performing securities against the appreciation in respect of other performing securities.

5.99 An NPI, similar to a non performing advance (NPA), is one where:

- (i) Interest/ installment (including maturity proceeds) is due and remains unpaid for more than 90 days.
- (ii) The above would apply *mutatis-mutandis* to preference shares where the fixed dividend is not paid. If the dividend on preference shares (cumulative or non-cumulative) is not declared/paid in any year it would be treated as due/unpaid in arrears and the date of balance sheet of the issuer for that particular year would be reckoned as due date for the purpose of asset classification.
- (iii) In the case of equity shares, in the event the investment in the shares of any company is valued at Re.1 per company on account of the non availability of the latest balance sheet in accordance with the instructions contained in paragraph 3.5.5 of the RBI Master Circular on Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks dated July 1, 2015, those equity shares would also be reckoned as NPI.
- (iv) If any credit facility availed by the issuer is NPA in the books of the bank, investment in any of the securities, including preference shares issued by the same issuer would also be treated as NPI and *vice versa*. However, if only the preference shares are classified as NPI, the investment in any of the other performing securities issued by the same issuer may not be classified as NPI and any performing credit facilities granted to that borrower need not be treated as NPA. The Auditor should review the mechanism adopted by the Bank for classifying the investments as NPI

where the credit facility has been classified as NPA and vice versa and test the effectiveness of the mechanism followed particularly the timeliness of such classification.

- (v) The investments in debentures / bonds, which are deemed to be in the nature of advance would also be subjected to NPI norms as applicable to investments.
- (vi) In case of conversion of principal and / or interest into equity, debentures, bonds, etc., such instruments should be treated as NPA *ab initio* in the same asset classification category as the loan if the loan's classification is substandard or doubtful on implementation of the restructuring package and provision should be made as per the norms. Further movement in the asset classification of these instruments would also be determined based on the subsequent asset classification of the restructured advance.

### **Classification of State Government guaranteed investments as NPI**

5.100 With effect from the year ending March 31, 2006, investment in State Government guaranteed securities, including those in the nature of 'deemed advance', attract prudential norms for identification of NPI and provisioning, when interest/installment of principal (including maturity proceeds) or any other amount due to the bank remains unpaid for more than 90 days.

5.101 The prudential treatment for Central Government Guaranteed bonds has to be identical to Central Government guaranteed advances. Hence, bank's investments in bonds guaranteed by Central Government need not be classified as NPI until the Central Government has repudiated the guarantee when invoked. However, this exemption from classification as NPI is not for the purpose of recognition of income.

5.102 The audit procedures would include:

- Identifying Non Performing Investments based on RBI guidelines as defined above. In case advances given to a party is classified as NPA, investment in securities issued by same party also needs to be classified as NPI and *vice-versa* except in case of preference shares, wherein if a preference share is classified as NPI, the performing securities and performing credit facilities granted to the said party need not be treated as NPI / NPA.
- Ascertaining whether the bank has made appropriate provision for the depreciation in the value of the NPI.

- Ensuring that the banks have not off-set the depreciation on NPI against the appreciation in respect of other performing securities.
- Obtaining separate list of investments as a result of conversion of interest/principal. These investments need to be classified as NPI *ab initio*, if the loan's classification is NPA on implementation of the restructuring package.

### **Special Aspects**

5.103 The auditor should pay special attention to ascertaining whether the investments have been purchased or sold cum-dividend/ex-dividend, cum-interest/ex-interest, cum-right/ex-right, or cum-bonus/ex-bonus. He should check whether appropriate adjustments in this regard have been made in the cost/sales value of securities purchased or sold.

5.104 In the case of a right issue, the offer letter should be examined. The auditor should check control over recording, exercising, renouncing of rights and also valuation of rights yet to be exercised. Where the rights have been renounced or otherwise disposed off or not exercised, the auditor should examine that same have been duly accounted for. Similarly, the auditor should examine the relevant documents in the case of detachable warrants. He should also examine that these have been properly accounted for.

5.105 As regards bonus shares, the intimation to the bank regarding such issue should be examined with a view to ascertaining the receipt and recording of the requisite number of shares in the records maintained by the bank in this regard.

### **Investment Fluctuation Reserve (IFR), Market Risk & Investment Reserve Account (IRA)**

5.106 The RBI specifies the following guidelines with respect to IFR and IRA:

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

- (i) Banks were advised to build reserves towards investment fluctuation, of a minimum 5% of the investment portfolio within 5 years period.
- (ii) To ensure smooth transition to Basel II norms, banks have been advised to build adequate reserve towards capital charge for market risks in a phased manner over a two year period as follows:
  - (a) In respect of securities included in the HFT category, open gold position limit, open foreign exchange position limit, trading positions in derivatives and derivatives entered into for hedging trading book

exposures by March 31, 2005; and

- (b) In respect of securities included in the AFS category by March 31, 2006.
- (iii) As advised by RBI in October, 2005, Banks maintaining capital of at least 9 per cent of the risk weighted assets for both credit risk and market risks for both HFT (of items - open gold position limit, open foreign exchange position limit, trading positions in derivatives and derivatives entered into for hedging trading book exposures) and AFS category as on March 31, 2006 may treat the entire balance of IFR as Tier I capital, may transfer the balance in the IFR 'below the line' in the Profit & Loss Appropriation account to statutory reserve, general reserve or balance of Profit and Loss Account.

***Investment Reserve Account***

- (i) Provisions created for depreciation on investments in the AFS and HFT categories if found excessive should be credited to the Profit & Loss Account and equivalent amount (net of taxes, if any and net of transfer to Statutory Reserve as applicable to such excess provision) should be appropriated to an Investment Reserve Account in Schedule 2 – “Reserves and Surplus” under the head “Revenue and Other Reserves” and would be eligible for inclusion under Tier II capital within the overall ceiling of 1.25% of total risk weighted assets prescribed for general provisions/ Loss Reserves.
- (ii) The Investment Reserve Account can be utilised in the prescribed manner.
- (iii) The amounts debited to the Profit & Loss Account for provision should be debited under the head "Expenditure - Provisions & Contingencies". The amount transferred from the Investment Reserve Account to the Profit & Loss Account should be shown as "below the line" item in the Profit and Loss Appropriation Account after determining the profit for the year. Provision towards any erosion in the value of an asset is an item of charge on the profit and loss account and hence should appear in that account before arriving at the profit for the accounting period. Adoption of the following would not only be adoption of a wrong accounting principle but would, also result in a wrong statement of the profit for the accounting period:
  - (a) the provision is allowed to be adjusted directly against an item of reserve without being shown in the profit and loss account; or

- (b) a bank is allowed to draw down from the Investment Reserve Account before arriving at the profit for the accounting period (i.e., above the line); or
- (c) a bank is allowed to make provisions for depreciation on investment as a below the line item, after arriving at the profit for the period.

Hence none of the above options are permissible.

- (iv) The withdrawal from the Investment Reserve Account cannot be used for dividend declaration. Dividends should be payable only out of current year's profit. However, the balance in the Investment Reserve Account transferred 'below the line' in the Profit and Loss Appropriation Account to Statutory Reserve, General Reserve or balance of Profit & Loss Account would be eligible to be reckoned as Tier I capital.

5.107 The auditor should also examine whether the bank, as required by the RBI, is maintaining separate accounts for the investments made by it on its own Investment Account, on PMS clients' account, and on behalf of other constituents (including brokers). As per the RBI guidelines, banks are required to get their investments under PMS separately audited by external auditors. The auditor should review the report of such external auditors, if available, and check whether the discrepancies pointed out in the report have been adequately dealt with. The auditor should also verify that PMS transactions are carried out through a separate SGL account, and that there is no switching between the bank's own investment account and PMS clients' account except in accordance with the guidelines laid down by the RBI in this regard.

5.108 Investments should not normally be held by any other person (as laid down in the City Equitable Fire Insurance Co. case). If any investments are so held, proper enquiry should be made to ensure that there is some justification for it, e.g., shares may be held by brokers for the purpose of transfer or splitting-up etc. Shares may also be lodged with the companies concerned for transfer etc. When investments are held by any other person on behalf of the bank, the auditor should obtain a certificate from him. The certificate should state the reason for holding the investment (e.g., in safe custody or as security). The receipt originally issued by such person while taking delivery of the investment is not adequate for audit purposes. In the case of inscribed stock also, a certificate should be obtained which should certify the holding of the bank as at the date of the balance sheet.

5.109 Where securities lodged for transfer have not been received back within a reasonable period, or where share certificates, etc., have not been received within a reasonable period of the lodging of the allotment advice, the



auditor should examine whether adequate follow-up action has been taken. He may, in appropriate cases, also enquire from the issuers, or their registrars, about the reasons for the delay. In cases where the issuer/registrar has refused to register the transfer of securities in the name of the bank, the auditor should examine the validity of the title of the bank over such securities.

5.110 If certain securities are held in the names of nominees, the auditor should examine whether there are proper transfer deeds signed by the holders and also an undertaking from them that they hold the securities on behalf of the bank. The auditor may also check compliance with Section 89 of the Companies Act, 2013 - Declaration in respect of beneficial interest in any share.

5.111 While examining the investment portfolio, the auditor should pay special attention to securities whose maturity dates have already expired. It is possible that income on such investments may also not have been received. In case the amount of such investments or the income accrued thereon is material, the auditor should seek an explanation from the management on this aspect. They should also consider whether the income accrued requires reversal as also whether any provision for loss in respect of such investments is required. Similarly, where income on any security is long overdue, the auditor should consider whether provision is required in respect of such income accrued earlier.

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

### **Income from investments**

5.113 The auditor should examine whether income from investments is properly accounted for. This aspect assumes special importance in cases where the bank has opted for receipt of income through the electronic/on line medium.

5.114 Some of the typical audit procedures would include:

- Re-computation of amortisation of premium / discount on investment securities.
- Re-performance of profit / loss on sale of investments keeping into consideration the method of allocating cost to securities (FIFO or weighted average).
- Assessing the dividend recognition policy of bank considering revenue recognition principles of Accounting Standard 9, Revenue Recognition.

- Re-computation of interest income on investments and checking the treatment of broken period interest, including ensuring proper cut-offs at reporting period ends.
- Checking of proper recognition of investment valuation loss as at reporting date
- Checking of interest accrual in respect of interest-bearing investment outstanding at reporting date.

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

5.116 There may be cases where the certificates of tax deduction at source (TDS) received along with the dividend/interest on investments are found missing. This increases the incidence of tax on the bank. The auditor should see that there is a proper system for recording and maintenance of TDS certificates received by the bank. The auditor may also review Form 26AS to ensure that the proper credit will be made available to the bank.

5.117 A part of the outstanding principal amount can be converted into debt or equity instruments as part of restructuring. In the case of restructured accounts classified as 'standard', the income, if any, generated by these instruments may be recognised on accrual basis. In the case of restructured accounts classified as non-performing assets, the income, if any, generated by these instruments may be recognised only on cash basis. Auditor should verify that recognition of assets on conversion / restructuring does not exceed the amount restructured.

#### **d) Internal Financial Controls Over Financial Reporting including IT Controls**

5.118 The auditors should familiarise themselves with the instructions/directions issued by the RBI regarding transactions in investment securities. The Banks should frame Internal Investment Policy Guidelines and obtain the Board's approval. The investment policy may be suitably framed / amended to include Primary Dealer (PD) activities also. Further, the Reserve Bank of India has issued Master Directions on Operational Guidelines for Primary Dealers dated July 1, 2016 (updated November 22, 2018), which should be complied by Banks. The auditor should review the investment policy of the bank to ascertain that the policy conforms, in all material respects, to the RBI's guidelines as well as to any statutory provisions applicable to the bank.

5.119 The Banks' management should ensure that there are adequate internal control and audit procedures for ensuring proper compliance in regard to the conduct of the investment portfolio. The banks should institute a regular system of monitoring compliance with the prudential and other guidelines issued by the Reserve Bank of India. While examining the internal controls over investments the auditor should particularly examine whether the same are in consonance with the guidelines of the RBI a gist of which has also been included in the Master Circular on Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Bank dated July 1, 2015. They should also judge their efficacy. By efficacy, it is meant that not only the auditor would check the operating effectiveness of various internal controls but also at the first place check and evaluate the design of such internal controls.

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

5.121 Some of the typical audit procedures would include:

- perusing the investment policy and preparing brief note on key points of compliances.
- examine whether the Investment policy has been periodically reviewed by the Management.
- verify whether investment policy lays down clear parameters for stop loss limits or there exists any separate stop loss policy.
- perusing the minutes of board/board appointed committee for approval of investment policy and obtain the list of modification made in the policy compared to earlier approved policy.
- examining whether the investments made by the bank are in accordance with the laid down investment policy and are also in compliance with the RBI guidelines w.r.t. exposure norms.
- verification of valuation of investments as per the method and frequency as defined by RBI.
- perusing reports on concurrent audit of treasury transactions, system audit report, if any and follow-up action taken by the management thereon.

- perusing the half yearly review of portfolio by the Board of Directors of the bank and also reviewing annual inspection report of the RBI carried out under Section 35 of the Banking Regulation Act, 1949.
- Verification of voice recording mechanism and to ensure user ids of dealers left / transferred/ on leave is deactivated / suspended on timely basis.

## **e) Certificate/ Reports (cover the requirements and approach/ procedures)**

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

5.122 It may be noted that pursuant to RBI's circulars, issued from time to time, banks require their Central Statutory Auditors to issue the following certificates regarding investments of the bank (in addition to their main audit report and the long form audit report).

- (i) Certificate on reconciliation of securities by the bank (both on its own Investment Account as well as PMS clients' account). The reconciliation is to be presented in a given format.
- (ii) Certificate on compliance by the bank in key areas of prudential and other guidelines relating to such transactions issued by the Reserve Bank of India.

5.123 The auditor may consider relying on the work done during the course of audit for the purposes of such certificates. The certificate should reach the Regional Office of the DBS, RBI, under whose jurisdiction the bank's head office is located within one month from the close of the accounting year, and thus for banks whose accounts have not been audited by the stated period may issue the certificate based on the unaudited books of account.

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

5.124 Apart from making investments on its account, a bank may also deal in securities on behalf of its customers only with the prior approval from RBI. These activities of banks are in the nature of trust or fiduciary activities. The accounting implications of the trust activities of banks may be noted. Banks commonly act as trustees and in other fiduciary capacities that result in holding or placing of assets on behalf of individuals, trusts, retirement benefit plans and other institutions. Provided the trustee or similar relationship is legally supported, these assets are not assets of the bank and, therefore, are not

included in its balance sheet. If the bank is engaged in significant trust activities, disclosure of that fact and indication of the extent of those activities is made in its financial statements because of the potential liability if it fails in its fiduciary duties. For this purpose, trust activities do not encompass safe custody functions.

5.125 The auditor should examine whether bank's income from such activities has been recorded and is fairly stated in the bank's financial statements. The auditor also needs to consider whether the bank has any material undisclosed liability from a breach of its fiduciary duties, including the safekeeping of assets. The auditor also needs to give certificate for reconciliation of securities held by the bank as custodian. The text of Illustrative Checklist for the Verification of the aspects of the Treasury/Investments of the Bank in Statutory Audit is given in Pen Drive/CD.

## **Section D: Compliance with CRR and SLR requirements**

### **Introduction**

5.126 Due to the nature of their operations, banks need to maintain sufficient liquid assets in the normal course of their business. The failure of a bank to meet its liabilities to depositors, as and when called upon to do so, undermines the confidence of the depositors not in the particular bank alone but in the entire banking system. While ensuring some liquid money against deposits is the primary purpose of CRR, its secondary purpose is to allow the RBI to control liquidity and rates in the economy. In the short term, interest rates swing up or down depending on how much liquidity is available for lending. Too much money leads to a collapse in rates, and too little, a spike.

### **Regulatory Requirements**

5.127 Recognising the need to safeguard the interests of depositors by ensuring that banks do not over-extend their resources and thereby to maintain the confidence of the public in the banking system, Section 24(2A) of the Banking Regulation Act, 1949 requires that a scheduled bank shall maintain in India, in addition to the average daily balance which it is, or may be, required to maintain under Section 42 of the RBI Act, 1934, and every other banking company, in addition to the cash reserve which it is required to maintain under section 18 of the Banking Regulation Act, 1949, assets the value of which shall not be less than such percentage not exceeding forty per cent of the total of its

demand and time liabilities (DTL) in India as on the last Friday of the second preceding fortnight in such form and manner as the RBI may by notification in the official gazette, specify from time to time. This is referred to as 'Statutory Liquidity Ratio' (SLR). The Friday with reference to which the amount of liquid assets has to be maintained during a fortnight is determined is commonly, referred to as the 'reporting Friday'. The prescribed percentage of liquid assets has to be maintained as at the close of business on every day. It may be noted that the statutory liquidity ratio is to be maintained with reference to the bank as a whole, and not for individual branches.

5.128 The RBI *vide* its Master circular No. RBI/2015-16/98 DBR.No.Ret.BC.24/12.01.001/2015-16 on "Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)" dated July 1, 2015, has specified that consequent upon amendment to the Section 24 of the Banking Regulation Act, 1949 through the Banking Regulation (Amendment) Act, 2007 replacing the Regulation (Amendment) Ordinance, 2007, effective January 23, 2007, the Reserve Bank can prescribe the Statutory Liquidity Ratio (SLR) for Scheduled Commercial Banks in specified assets. The value of such assets of a SCB shall not be less than such percentage not exceeding 40 per cent of its total demand and time liabilities in India as on the last Friday of the second preceding fortnight as the Reserve Bank may, by notification in the Official Gazette, specify from time to time.

5.129 Further, Reserve Bank has specified *vide* notification RBI/2016-17/83 DBR.No.Ret.BC.15/12.02.001/2016-17 dated October 13, 2016 that every Scheduled Commercial Bank shall continue to maintain in India assets as detailed below, the value of which shall not, at the close of business on any day, be less than 20.75 per cent from October 1, 2016, 20.50 per cent from January 7, 2017, 20 per cent from June 24, 2017 and 19.5 per cent from October 14, 2017 on the total net demand and time liabilities (NDTL) as on the last Friday of the second preceding fortnight valued in accordance with the method of valuation specified by the Reserve Bank of India from time to time:

This is now amended by RBI notification dated 5.12.2018 which has reduced the SLR by 0.25% in a phased manner beginning from 5.1.2019 till it reaches 18% by 11.4.2020 as follows –

## Guidance Note on Audit of Banks (Revised 2019)

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

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

5.130 Provided that the instruments referred to in items (1) to (3) above that have been acquired under reverse repo with Reserve Bank of India, shall not be included as SLR securities for the purpose of maintenance of SLR assets up to

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

October 2, 2016. From October 3, 2016 such securities acquired from Reserve Bank shall be considered as eligible assets for SLR maintenance.

5.131 However, in term of Master Circular on Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks dated July 1, 2015, the regulatory treatment of market repo transactions in Government securities will continue as hitherto, i.e., the funds borrowed under repo will continue to be exempt from CRR/SLR computation and the security acquired under reverse repo shall continue to be eligible for SLR.

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

5.133 If a banking company fails to maintain the required amount of SLR, it shall be liable to pay to RBI in respect of that default, the penal interest for that day at the rate of three per cent per annum above the bank rate on the shortfall and if the default continues on the next succeeding working day, the penal interest may be increased to a rate of five per cent per annum above the bank rate for the concerned days of default on the shortfall.

5.134 As section 24 of the Banking Regulation Act, 1949 is also applicable to nationalised banks, State Bank of India and its subsidiaries, and regional rural banks too have to comply with the above requirements. According to Section 24(3) of the Banking Regulation Act, 1949, for the purpose of ensuring compliance with this section, every banking company is required to furnish to the RBI, in the prescribed form and manner, a monthly return showing particulars of its assets maintained in accordance with this section and its demand and time liabilities in India at the close of the business on each alternate Friday during the month. In case any such Friday is a public holiday, the computation of SLR is to be done at the close of business on the preceding working day. The return in form VIII is to be furnished within 20 days after the end of the month to which it relates. The banks should also submit a statement as annexure to the form VIII giving daily position of –

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

As per Circular RBI/2016-17/302 Ref: DBR.CO.No.Ret.BC/66/12.07.144/2016-17 dated May 11, 2017, the reporting of SLR has been moved from PCRPCD to



XBRL (Extensible Business Reporting Language) platform from April 2017 onwards.

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

5.136 The statutory auditor should verify and certify that all items of outside liabilities, as per the bank's books had been duly compiled by the bank and currently reflected under demand and time liabilities (DTL) and net demand and time liabilities (NDTL) in the fortnightly/monthly statutory returns submitted to the RBI for the financial year.

### **Computation of CRR**

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

### **Computation of SLR**

5.138 Refer Master circular No. DBR.No.Ret.BC.24/12.01.001/2015-16 on "Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)" dated July 1, 2015, for guidance on computation of SLR. Further, RBI notification RBI/2016-17/83 DBR.No.Ret.BC.15/12.02.001/2016-17 dated October 13, 2016 has been issued in this regard.

### **Audit Approach and Procedures**

5.139 The certificate of the statutory auditors in relation to compliance with SLR requirements has to cover two aspects:

- (a) Correctness of the compilation of DTL position; and
- (b) Maintenance of liquid assets as specified in section 24 of the Act.

5.140 The statutory central auditor should acquaint himself with the circulars/ instructions of the RBI regarding composition of items of DTL. For this purpose, he may request the management to provide him a copy of the relevant

circulars/instructions. He should keep these circulars/instructions in mind while examining compliance with the SLR requirements.

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

5.142 To comply with the requirements relating to statutory liquidity ratio, banks have evolved system of consolidating trial balances of all branches and head office to compile consolidated trial balance of bank as a whole at its head office. Based on this consolidation, the DTL position is determined for every reporting Friday. The statutory central auditor should request the branch auditors to verify the correctness of the trial balances relevant to the dates selected by him. The statutory central auditor should also request the branch auditors to verify the cash balance at the branch on the dates selected by him. It should be ensured that such request is communicated to the branch auditors well in advance of commencement of the audit so that they can draw up their audit programme accordingly.

5.143 In many Banks, the consolidated trial balance (related to branches) for selected dates can be generated through core banking system; hence, the verification by Branch Statutory Auditors may not warranted.

5.144 Most of the liquid assets for the purpose of compliance with the SLR requirements comprise of approved securities, which are usually dealt with at the head office and a few large branches. The auditors should test check the relevant records maintained by the bank in respect of investments to verify the amount of approved securities held by the bank on the dates selected by him. The auditor should ascertain the valuation basis applicable at the relevant time and examine whether the valuation of securities done by the bank is in accordance with the guidelines prescribed by the RBI.

5.145 The auditor should examine the consolidations prepared by the bank relevant to the dates selected by him. He should test check the figures in the consolidations with the related returns received from the branches. He should also test check the arithmetical accuracy of the consolidations.

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

- a) Paid up capital, reserve, any credit balance in Profit and loss Account of the bank, amount of any loan taken from the RBI and amount of refinance taken from EXIM Bank, NHB, NABARD, SIDBHI.

- b) Bills discounting by a bank with eligible financial institutions as approved by RBI.
- c) Net Income tax provision
- d) Amount received from DICGC towards claims and held by banks pending adjustments thereof.
- e) Amount received from ECGC by invoking the guarantee.
- f) Amount received from insurance companies for adhoc settlement of claims pending judgement of court.
- g) Amount received from court receiver
- h) Net unrealized gain/loss arising from derivatives transactions under trading portfolio.
- i) Income flows received in advance such as annual fees and other charges which are not refundable.
- j) Liabilities arise on account of utilisation of limit under bankers acceptance facility (BAF).
- k) Part amounts of recoveries from the borrowers in respect of debts considered bad and doubtful of recovery.
- l) Amounts received in Indian currency against import bills and held in sundry deposits pending receipts of final rates.
- m) Un-adjusted deposits/balances lying in link branches for agency business like dividend warrants, interest warrants, refund of application money, etc., in respect of shares/debentures to the extent of payment made by other branches but not adjusted by the link branches.
- n) Margins held and kept in sundry deposits for funded facilities.

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

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

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

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

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

- a) The Minimum eligible credit (EC) and outstanding Long term bonds (LB) to finance Infrastructure loans and affordable housing loan, as per RBI circular DBOD.BP.BC.No.25/08.12.014/2014-15 dated July 15, 2014.
- b) The eligible amount of incremental FCNR(B) and NRE deposits of maturities of three years and above.

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

5.150 As per RBI circular RBI/2018-19/34/ DBR.Ret.BC. No.01/ 12.01.001 /2018-19 dated August 02, 2018 for conversion of foreign Currency Assets/ Liabilities reference rate from FBIL should be taken. If reference rate is not available from FBIL, Banks may continue to use New York closing for conversion of such currency in USD.

5.151 The auditor should also, particularly, examine whether the balances in Branch Adjustment Accounts of foreign branches have been taken into account in arriving at the net balance in Branch Adjustment Accounts.

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

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

5.154 As stated in preceding paragraphs, a considerable part of the information required by the central auditor for reporting on compliance with the SLR requirements will flow from the branches. It is suggested that the relevant information pertaining to the branches within a region may be consolidated at the regional level. The auditor of the region concerned should verify the same in the manner described in the above paragraphs and report on the same. The consolidated statement should also be counter-signed by the regional manager. The auditor at the central level should apply the audit procedures listed in the above paragraphs to the overall consolidation prepared for the bank as a whole. Where such a procedure is followed, the central auditor should adequately describe the same in his certificate.

5.155 While reporting on compliance with SLR requirements, the auditor should specify the number of unaudited branches and state that he has relied on the returns received from the unaudited branches in forming his opinion. Necessary audit procedures should be developed based on introduction of Automated Data Flow (ADF) for CRR & SLR reporting.

# III-6

## Treasury Operations-Foreign Exchange and Derivative Transactions

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### Introduction

6.01 Banks transact in various treasury instruments with an objective of hedging their risks and also to generate trading profits. Apart from regular proprietary business, the treasury operations of a bank aim to continue to focus on enhancing returns from customer relationships that have been built, and successfully capitalise on this to rapidly increase income from foreign exchange and derivative transactions from customers, as also to assist them in covering and hedging their foreign currency and derivative positions.

6.02 The foreign exchange market encompasses transactions in which funds of one currency are sold for funds in another currency. These transactions take the form of contracts calling for the parties in the contract to deliver to each other on a fixed date a specified sum in a given currency. The exchange, the delivery of one currency on receipt of another, can take place at the time the contract is negotiated or at some future date, as stated in the contract.

6.03 Foreign exchange transactions, to be distinguished from transactions in foreign currencies, consist of contracts in which each party is committed to deliver one currency while, at the same time, receive another. Until the time of delivery, when settlement is to be made on the contract, the contract represents a future commitment of the Bank's resources. Thus, the maturity of a contract culminates in the realisation of the transaction envisaged in the contract, at which time the counterparties are given value for the currencies the contract says they are to receive.

6.04 In foreign exchange contracts, the value date is the date on which the contract matures, that is the date on which settlement is to be made. For loans and borrowings, including those in the money markets, on the other hand, the value date is that date on which the borrower receives constructive use of the funds loaned, while the maturity date is that future date on which it will repay the funds it has borrowed.

## **Derivatives**

6.05 In India, different derivatives instruments are permitted and regulated by various regulators, like Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI). Broadly, RBI is empowered to regulate the interest rate derivatives, foreign currency derivatives and credit derivatives. For regulatory purposes, derivatives have been defined in the Reserve Bank of India Act, vide circular No. DBOD. No. BP.BC. 86/21.04.157/2006-07 dated 20 April 2007 as follows:

6.06 “Derivative” is a contract that changes in value in relation to the price movements of a related or underlying securities like change in interest rate, foreign exchange rate, credit rating or credit index, price of securities or a combination of more than one of them and includes interest rate swaps, forward rate agreements, foreign currency swaps, foreign currency-rupee swaps, foreign currency options, foreign currency-rupee options or such other instruments as may be specified by the RBI from time to time.

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

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

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

- DBOD.No.BP.BC. 44/21.04.157/2011-12 dated 2 November 2011 modifying the 20 April 2007 circular.
- DBOD.BP.BC.No. 61/21.06.203/2011-12 of 30th November 2011 regarding credit default swaps.
- IDMC.MSRD.4801/06.01.03 dated June 3, 2003 on Exchange-Traded Interest Rate Derivatives.
- IDMD.PDRD.No. 1056/03.64.00/2009-10 dated September 1, 2009 on Guidelines on Exchange Traded Interest Rate Derivatives.

## Treasury Operations- Foreign Exchange and Derivative Transactions

- RBI/2010-11/147 A.P. (DIR Series) Circular No. 05 dated July 30, 2010 on "Guidelines on trading of Currency Options on Recognised Stock /New Exchanges.
- DBOD.No.BP.BC.51 / 21.06.101 / 2010-11 dated October 28, 2010 on Introduction of Exchange Traded Currency Options – Permitting Banks to Participate in Currency Options on Recognized Stock / New Exchanges.
- RBI/2016-17/199 FMRD.DIRD.12/14.01.011/2016-17, December 29, 2016 on Introduction of Interest Rate Options in India, detailed directions of which are given in Notification No. FMRD-DIRD.11/2016 dated December 28, 2016.

Further, RBI vide its circular RBI/2017-18/198 FMRD.DIRD.9 /14.01.020/2017-18 dated June 14, 2018 decided to permit Interest Rate Swaptions in Rupees so as to enable better timing flexibility for the market participants seeking to hedge their interest rate risk and issued a Notification No.FMRD.DIRD.8/2018 dated June 14, 2018 enabling the introduction of swaptions.

### Derivatives Markets

6.09 Derivatives can be traded on or off an exchange and are known as:

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

RBI vide its circular RBI/2017-18/134 A. P. (DIR Series) Circular No. 18 dated February 26, 2018 permit persons resident in India and FPIs to take positions (long or short), without having to establish existence of underlying exposure, upto a single limit of USD 100 million equivalent across all currency pairs involving INR, put together, and combined across all exchanges.

### Participants

6.10 Participants of this market can broadly be classified into following two functional categories:

- User: A user participates in the derivatives market to manage an underlying risk.



- Market-maker: A market-maker provides bid and offer prices to users and other market-makers. A market-maker need not have an underlying risk.

At least one party to a derivative transaction is required to be a market-maker.

## **Purpose**

6.11 Users can undertake derivative transactions to hedge an existing identified risk on an ongoing basis during the life of the derivative transaction or for transformation of risk exposure, as specifically permitted by RBI. Market-makers can undertake derivative transactions to act as counterparties in derivative transactions with users and also amongst themselves. Banks use derivatives to hedge, to reduce the risks involved in the bank's operations. The major objectives/purpose for undertaking derivative transactions has been explained below:

<b>Objectives/Purpose</b>	<b>Reasons</b>
Balance Sheet Management	<ul style="list-style-type: none"> <li>• Use of derivatives by the Bank to manage its balance sheet exposures.</li> <li>• The Bank will use derivatives as a means for managing the interest rate, liquidity and foreign exchange risks arising from its banking operations.</li> </ul>
Client servicing	<ul style="list-style-type: none"> <li>• Offering derivative products to existing and new clients as an additional product from the Bank.</li> <li>• The Bank will offer derivative products to enhance product offerings to its existing clients as well as to build new client relations.</li> </ul>
Proprietary Trading	<ul style="list-style-type: none"> <li>• The Bank will undertake derivative transactions to earn trading profits.</li> <li>• The Bank's treasury may take view-based transactions as well as offer two-way quotes on derivatives within the limits prescribed by this policy.</li> </ul>
Hedging On-Balance sheet transactions	<ul style="list-style-type: none"> <li>• Banks are exposed to interest-rate risk from their on-balance-sheet activities when their assets do not reprice at the same time as their liabilities. So, banks undertake derivatives transactions to hedge their Balance sheets transactions such as banks may use swaps to hedge on-balance-sheet interest-rate risk.</li> </ul>

## **Bank's Process, Regulatory requirements/ restrictions & updates**

6.12 The major requirements for undertaking any derivative transaction include:

- In addition to generic derivative products, market-makers may also offer structured derivative products to users as long as they do not contain any derivative instrument as underlying and have been specifically permitted by RBI in its Master Direction No. 1/2016-17 dated July 5, 2016 (updated April 02, 2018) on 'Risk Management and Inter-Bank Dealings' and guidelines contained in RBI's Circular DBOD.No.BP.BC.86/21.04.157/ 2006-07 dated 20 April 2007 on Comprehensive Guidelines on Derivatives and further amendments issued vide circulars DBOD.No.BP.BC. 27 / 21.04.157/2011-12 dated 2 August 2011 and DBOD.BP.BC.44/ 21.04.157/2011-12 dated 2 November 2011 on 'the Comprehensive Guidelines on derivatives'.
  - a. The following derivative instruments used to hedge an existing interest rate and forex exposure, on a standalone basis, may be treated as generic derivative products:
    - Forex Forward Contracts
    - Forward Rate Agreements
    - Interest rate caps and floors (plain vanilla only)
    - Plain Vanilla Options (call option and put option)
    - Interest Rate Swaps
    - Currency Swaps including Cross-Currency Swaps
    - Exchange traded Currency Futures
    - Exchange traded currency options
    - Interest Rate Options.
  - b. The following derivative products may be treated as structured derivative products:
    - Instruments which are combination of either cash instrument and one or more generic derivative products.
    - Instruments which are combination of two or more generic derivative products.

Market-makers should be in a position to arrive at the fair value of all derivative instruments, including structured products on the basis of the following approach:

- a. Marking the product to market, if a liquid market in the product exists.

- b. In the case of structured products, marking the constituent generic instruments to market.
- c. If (a) and (b) are not feasible, marking the product to model, provided:
- All the model inputs are observable market variables.
  - Full particulars of the model, including the quantitative algorithm are documented.
  - It may be ensured that structured products do not contain any derivative, which is not allowed on a standalone basis. Further,
  - All permitted derivative transactions, including roll over, restructuring and novation can be contracted only at prevailing market rates.
  - All risks arising from derivatives exposures should be analysed and documented, both at transaction level and portfolio level.
  - The management of derivatives activities should be an integral part of the overall risk management policy and mechanism. It is desirable that the board of directors and senior management understand the risks inherent in the derivatives activities being undertaken.
  - Market-makers should have a 'Suitability and Appropriateness Policy' vis-à-vis users in respect of the products offered, on the lines indicated in the guidelines given in the Circular.
  - Market-makers may, where they consider necessary, maintain cash margin/liquid collateral in respect of derivative transactions undertaken by users on mark-to-market basis.

### **Risk Management and Corporate Governance Aspects**

6.13 The Comprehensive Guidelines on derivatives also sets out the basic principles of a prudent system to control the risks in derivatives activities. These include:

- (a) Appropriate oversight by the board of directors and senior management;
- (b) Adequate risk management process that integrates prudent risk limits, sound measurement procedures and information systems, continuous risk monitoring and frequent management reporting; and
- (c) Comprehensive internal controls and audit procedures.

### **Suitability and Appropriateness**

6.14 While undertaking any derivative transactions with a user, a market-maker should:

- (a) Document how the pricing has been done and how periodic valuations will be done. In the case of structured products, this document should contain a dissection of the product into its generic components to demonstrate its permissibility, on the one hand, and to explain its price and periodic valuation principles, on the other. The following information may be shared with the user:
  - (i) Description of the transaction.
  - (ii) Building blocks of the transaction.
  - (iii) Rationale along with appropriate risk disclosures.
  - (iv) Sensitivity analysis identifying the various market parameters that affect the product.
  - (v) Scenario Analysis encompassing both the possible upside as well as the downsides.
- (b) Analyse the expected impact of the proposed derivatives transaction on the user.
- (c) While selling structured products, the selling banks should make available a calculator or at least access to a calculator (say on the market-maker's website) which will enable the users to mark to market these structured products on an ongoing basis.

6.15 Before offering any derivative product to a client, obtain Board resolution from the corporate which contains the details specified in the Comprehensive Guidelines on derivatives.

- (a) Identify whether the proposed transaction is consistent with the user's policies and procedures with respect to derivatives transactions, as they are known to the market-maker.
- (b) Ensure that the terms of the contract are clear and assess whether the user is capable of understanding the terms of the contract and of fulfilling its obligations under the contract.
- (c) inform the customer of its opinion, where the market-maker considers that a proposed derivatives transaction is inappropriate for a customer. If the customer nonetheless wishes to proceed, the market-maker should document its analysis and its discussions with the customer in its files to lessen the chances of litigation in case the transaction proves unprofitable to the customer. The approval for such transactions should be escalated to next higher level of authority at the market-maker as also for the user.
- (d) ensure the terms of the contract are properly documented, disclosing the inherent risks in the proposed transaction to the customer in the form of a

Risk Disclosure Statement which should include a detailed scenario analysis (both positive and negative) and pay outs in quantitative terms under different combination of underlying market variables such as interest rates and currency rates, etc., assumptions made for the scenario analysis and obtaining a written acknowledgement from the counterparty for having read and understood the Risk Disclosure Statement.

- (e) guard against the possibility of misunderstandings all significant communications between the market-maker and user should be in writing/email or recorded in meeting notes.
- (f) ensure to undertake transactions at prevailing market rates and to avoid transactions that could result in acceleration/deferment of gains or losses.
- (g) should establish internal procedures for handling customer disputes and complaints. They should be investigated thoroughly and handled fairly and promptly. Senior management and the Compliance Department/Officer should be informed of all customer disputes and complaints at a regular interval.
- (h) The market-makers should carry out proper due diligence regarding 'user appropriateness' and 'suitability' of products before offering derivative products to users. Each market-maker should adopt a Board-approved 'Customer Appropriateness & Suitability Policy' for derivatives business.

It may also be noted that the responsibility of 'Customer Appropriateness and Suitability' review is on the market-maker.

6.16 As per Comprehensive Guidelines on Derivatives: Modifications dated April 6, 2018 vide RBI/2017-18/151 DBR.No.BP.BC.103/21.04.157/2017-18 it has now been decided that stand-alone plain vanilla forex options (without attached structures) purchased by clients will be exempt from the 'user suitability and appropriateness' norms, and the regulatory requirements will be at par with forex forward contracts.

### **Documentation**

6.17 This can range from simple customer mandates through to full legal documentation with both banks and customers. The bank's legal department is responsible for legal agreements depending on what types of business is being conducted and, crucially, whether the counterparties intend to net payments at settlement. Organizationally, this area can be viewed in a similar way to the accounting function. If documentation forms part of the back office then the business will be more understood by management and better controlled as a result. The Comprehensive Guidelines on derivatives also requires the market

participants to ensure that documentation requirements in respect of derivative contracts are complete in all respects.

6.18 The comprehensive guidelines on derivatives circular require the market participants to ensure that documentation requirements in respect of derivative contracts are complete in all respects.

6.19 The following instructions in this regard may, therefore, be strictly adhered to:

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

### **Identification and Management of Risk**

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

- credit risk
- market risk
- liquidity risk
- interest risk
- operational risk
- legal risk

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

### **Risk limits**

6.21 Risk limits serve as a means to control exposures to the various risks associated with derivative activities. Limits should be integrated across all activities and measured against aggregate risks. Limits should be compatible with the nature of the entity's strategies, risk measurement systems, and the board's risk tolerance. To ensure consistency between limits and business strategies, the board should annually approve limits as part of the overall budget process.

### **Independent Risk control**

6.22 There should be a mechanism within each entity for independently monitoring and controlling the various risks in derivatives. The inter-relationship between the different types of risks needs to be taken into account.

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

### **Operational Controls**

6.24 Operational risk arises as a result of inadequate internal controls, human error or management failure. This risk in derivatives activities is particularly important, because of the complexity and rapidly evolving nature of some of the products. The nature of the controls in place to manage operational risk must be commensurate with the scale and complexity of the derivatives activity being undertaken. The operational controls could in addition to segregation of duties, cover aspects such as:

- trade entry and transaction documentation
- confirmation of trades
- settlement and disbursement
- reconciliations
- revaluation
- exception reports

- accounting treatment
- audit trail

### **Prudential Norms Relating to Derivatives**

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

### **Asset Classification of Derivatives**

6.26 RBI vide its Circular No. DBOD.No.BP.BC.57/ 21.04.157/2008-09 dated October 13, 2008 on "Prudential Norms for Off-Balance Sheet Exposures of Banks" and Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 dated July 1, 2015 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances" advised the banks including foreign branches of Indian banks as under:

- i. The overdue receivables representing positive mark-to-market value of a derivative contract will be treated as a non-performing asset, if these remain unpaid for a period of 90 days from the specified due date for payment.
- ii. In case the overdues arising from forward contracts and plain vanilla swaps and options become NPAs, all other funded facilities granted to the client shall also be classified as non-performing asset following the principle of borrower-wise classification as per the existing asset classification norms.
- iii. However, any amount, representing positive mark-to-market value of the foreign exchange derivative contracts (other than forward contract and plain vanilla swaps and options) that were entered into during the period April 2007 to June 2008, which has already crystallised or might crystallise in future and is / becomes receivable from the client, should be parked in a separate account maintained in the name of the client /counterparty. This amount, even if overdue for a period of 90 days or more, will not make other funded facilities provided to the client, NPA on



account of the principle of borrower-wise asset classification, though such receivable overdue for 90 days or more shall itself be classified as NPA, as per the extant IRAC norms. The classification of all other assets of such clients will, however, continue to be governed by the extant IRAC norms.

- iv. If the client concerned is also a borrower of the bank enjoying a Cash Credit or Overdraft facility from the bank, the receivables mentioned at item (i) above may be debited to that account on due date and the impact of its non-payment would be reflected in the cash credit/overdraft facility account. The principle of borrower-wise asset classification would be applicable here also, as per extant norms.
- v. In cases where the contract provides for settlement of the current mark-to-market value of a derivative contract before its maturity, only the current credit exposure (not the potential future exposure) will be classified as a non-performing asset after an overdue period of 90 days.
- vi. As the overdue receivables mentioned above would represent unrealised income already booked by the bank on accrual basis, after 90 days of overdue period, the amount already taken to 'Profit and Loss a/c' should be reversed.

6.27 RBI vide its Circular No. DBOD.No.BP.BC.48 / 21.06.001/2010-11 dated October 1, 2010 on "Prudential Norms for Off-Balance Sheet Exposures of Banks - Bilateral netting of counterparty credit exposures" has decided that since the legal position regarding bilateral netting is not unambiguously clear, bilateral netting of mark-to-market (MTM) values arising on account of such derivative contracts cannot be permitted. Accordingly, banks should count their gross positive MTM value of such contracts for the purposes of capital adequacy as well as for exposure norms.

6.28 RBI vide its Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 dated July 1, 2015 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances" advised banks that credit exposures computed as per the current marked to market value of the contract, arising on account of the interest rate & foreign exchange derivative transactions, credit default swaps, shall also attract provisioning requirement as applicable to the loan assets in the 'standard' category, of the concerned counterparties. All conditions applicable for treatment of the provisions for standard assets would also apply to the aforesaid provisions for derivative exposures.

6.29 RBI vide its circular no. DBOD.BP.BC.28/21.04.157/2011-12 dated August 11, 2011 has further clarified that:

- In cases where the derivative contracts provide for more settlements in future, the MTM value will comprise of (a) crystallised receivables and (b) positive or negative MTM in respect of future receivables.
- If the derivative contract is not terminated on the overdue receivable remaining unpaid for 90 days, in addition to reversing the crystallised receivable from Profit and Loss Account as stipulated in para 1 of aforementioned circular, the positive MTM pertaining to future receivables may also be reversed from Profit and Loss Account to another account styled as 'Suspense Account – Positive MTM'. The subsequent positive changes in the MTM value may be credited to the 'Suspense Account – Positive MTM', not to P&L Account.
- The subsequent decline in MTM value may be adjusted against the balance in 'Suspense Account – Positive MTM'. If the balance in this account is not sufficient, the remaining amount may be debited to the P&L Account.
- On payment of the overdues in cash, the balance in the 'Suspense Account-Crystallised Receivables' may be transferred to the 'Profit and Loss Account', to the extent payment is received.
- If the bank has other derivative exposures on the borrower, it follows that the MTMs of other derivative exposures should also be dealt with / accounted for in the manner as described above, subsequent to the crystalised/settlement amount in respect of a particular derivative transaction being treated as NPA.
- Since the legal position regarding bilateral netting is not unambiguously clear, receivables and payables from/to the same counterparty including that relating to a single derivative contract should not be netted.
- Similarly, in case a fund-based credit facility extended to a borrower is classified as NPA, the MTMs of all the derivative exposures should be treated in the manner discussed above.
- These guidelines are applicable to both outstanding derivatives contracts and the derivatives transactions undertaken from the date of the circular.

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

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

- i. Banks should have a Board approved policy in this regard.
- ii. Banks should permit repayment in instalments only if there is a reasonable certainty of repayment by the client.
- iii. The repayment period should not extend beyond the maturity date of the contract.
- iv. The repayment instalments for the crystallized MTM should be uniformly received over the remaining maturity of the contract and its periodicity should be at least once in a quarter.
- v. If the client is permitted to pay the crystallized MTM in instalments and
  - a. if the amount becomes overdue for 90 days from the date of partial / full termination of the derivative contract, the receivable should be classified as NPA.
  - b. if the amount becomes overdue for 90 days from the due date of payment of subsequent instalments, the receivable should be classified as NPA.
- vi. Banks should reverse the entire MTM which has been taken to Profit and Loss account on accrual basis in case of (v) (a) and (v) (b) above. For the accounting of reversed MTM in these cases, banks should follow an approach similar to the one stipulated in circulars DBOD.No.BP.BC.57/21.04.157/2008-09 dated October 13, 2008 and DBOD.No.BP.BC.28/21.04.157/2011-12 dated August 11, 2011 on 'Prudential Norms for Off-balance Sheet Exposures of Banks'. Accordingly, the crystallized MTM of these derivative contracts should be reversed from Profit and Loss account and credited to another suspense account styled as 'Suspense Account - Crystallised Receivables'.

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

6.33 There may be cases, where the derivative contract has been terminated, either partially or fully, and crystallized MTM has been permitted to

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

### **Re-structuring of derivative contracts**

6.34 In cases where a derivative contract is restructured, the mark-to-market value of the contract on the date of restructuring should be cash settled. For this purpose, any change in any of the parameters of the original contract would be treated as a restructuring. RBI vide Notification RBI/2016-17/45 DBR.No.BP. BC.7/21.04.157/ 2016-17 dated August 25, 2016 has clarified that cash settlement is required of the change in mark-to-market value of the restructured derivative contract. Banks are permitted to restructure derivative contract at prevalent market rates, and not on the basis of off-market rates.

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

#### **Purpose**

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

#### **Products**

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

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

6.37 The AD Category I banks can opt for either Model I or Model II as mentioned in RBI circular vide RBI/2017-18/75 A.P. (DIR Series) Circular No. 08 dated October 12, 2017.

### **Provisions in case of foreign branches and subsidiaries of the Indian Banks**

6.38 The RBI vide its circular No. DBOD.No.BP.BC.89 /21.04.141/2008-09 dated December 1, 2008 on "Operations of foreign branches and subsidiaries of the Indian banks – Compliance with statutory/regulatory/administrative prohibitions/ restrictions" provides that transactions by the foreign branches / foreign subsidiaries, in financial products which are not available in the Indian market and on which no specific prohibition has been currently placed by the

RBI, no prior approval of the RBI would be required for the purpose provided these are merely plain-vanilla financial products. Banks should, however, ensure that their foreign branches / subsidiaries, dealing with such products in foreign jurisdictions, have adequate knowledge, understanding, and risk management capability for handling such products. Such products should also be appropriately captured and reported in the extant off-site returns furnished to the RBI. These products would also attract the prudential norms such as capital adequacy, credit exposure, periodical valuation, and all other applicable norms. In case the current RBI norms do not specify prudential treatment of such financial products, it would be incumbent upon the banks to seek specific RBI guidance in the matter. RBI vide Notification NO./2013-14/588 DBOD.No.BP. BC.111/21.04.157/2013-14 May 12, 2014 permitted that if foreign branches / subsidiaries of Indian banks propose to offer structured financial and derivative products that are not specifically permitted by the Reserve Bank in the domestic market, they may do so only at the established financial centers outside India like New York, London, Singapore, Hong Kong, Frankfurt, Dubai, etc. subject to compliance with the conditions stipulated therein.

### **Risk management**

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

6.40 This is a function that can sit well in the middle office provided it is properly staffed by officers who understand fully the business and risks involved – which usually means ex-market practitioners. It can range from agreeing overnight cash positions for the trading room through to full-risk modeling associated with derivatives trading and hedging. In between can come monitoring of counterparty, country, dealer and market-related limits that have been set and approved in other areas of the bank such as the credit department. Bank shall comply with guidelines issued by RBI with regard to Internal Controls vide circular FE.CO.FMD. No. 18380 /02.03.137/2010-11 February 3, 2011.

### **Risk Identification Process**

#### **Price or Rate Risk**

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

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

due to maturity mismatching of foreign currency positions, default of counter parties or settlement risk.

6.42 Foreign exchange rate movement risk arises from net exchange position in a currency. If the position is long or overbought and there is depreciation in the currency, a loss occurs. On the other hand, if an appreciation occurs while the dealer is holding a long net position, there will be a profit from such change in exchange rates. The opposite will occur if the net positions were short or oversold in that currency. Price risk of this kind also exists on execution of a swap. This is also known as the 'tail', which arises because in a swap the effects of two foreign currency amounts, inflow and outflow, are different on account of present valuing all cash flows.

6.43 The three important issues that need to be addressed in this regard are:

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

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

6.44 Forward points (premia/discount) in the Indian markets are not entirely a function of interest rate differentials but a function of demand and supply of forward currency. As a result, normally banks treat traded forward points (up to 1-year) as a market factor, and use this to compute the implied INR rate (MIFOR) up to the 1-year segment. Beyond 1-year, forward points are computed from the INR currency swap/ MIFOR quotes and US\$ swap curve.

### **Timing Risk**

6.45 As per market practice, FX contracts with timing discretion (Option Period Forwards or OPFs) versus INR are typically for a period of one week to a maximum of one month. The customer has the discretion to pick up the contract on any day of the window period. In case the customer is buying the foreign currency ('FCY'), the swap points/contract rate is fixed based on the last date of the period in case the FCY is at a premium against the INR or the first date in case the FCY is at a discount. Hence, unless the swap points change from premium to discount or vice versa after entering into the contract, the counterparty would not benefit by taking delivery before last date in case of premium or after first date in case of discount. In the unlikely event of this happening and if the bank has not hedged the contract similarly with another contract with discretion period, an adverse impact on Profit and Loss Account could arise. In such a case, the market counterparty could pick up the contract early while the hedge contract would still be outstanding and the gap would have to be covered again at incremental cost.

## **Credit Risk**

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

6.47 Credit risk is the risk that the counterparty to a financial transaction - here a foreign exchange contract - may become unable to perform its obligation. The extent of risk depends on whether the other party's inability to pay is established before the value date or is on the same value date of the foreign exchange contract.

### **Pre-Settlement Likely Exposure**

6.48 Trading (or pre-settlement) exposure occurs when a counterparty defaults on its contractual obligation before the settlement date and the bank has to defend the position in the market with another counterparty at the then prevailing rate. The bank is exposed to possible adverse price fluctuations between the contract price and the market price on the date of default or final liquidation.

### **Settlement Risk**

6.49 This occurs when items of agreed upon original equal value are not simultaneously exchanged between counter parties; and/or when Bank's funds are released without knowledge that counter value items have been received by the bank. Typically, the duration is overnight/over weekend, or in some cases even longer i.e., until bank receives the confirmation of receipt of funds. The risk is that bank delivers but does not receive delivery. In this situation 100% of the principal amount is at risk.

## **Market risk**

6.50 Market risk is the risk of loss due to adverse changes in the market value (the price) of an instrument or portfolio of instruments. Such exposure occurs with respect to derivative instruments when changes occur in market factors such as underlying interest rates, exchange rates, equity prices, and commodity prices or in the volatility of these factors.

### Liquidity Risk

6.51 Liquidity risk refers to the ease with which a foreign exchange spots position or gap can be liquidated. The approved spot DV01 limit factors in the liquidity risk associated with the product. Tenor wise DV01 limits in the case of US\$INR gaps factor in the liquidity in the forward markets. Institutions involved in derivatives activity face two types of liquidity risk: market liquidity risk and funding liquidity risk.

#### Market Liquidity Risk

6.52 Market liquidity risk is the risk that an institution may not be able to exit or offset positions quickly, and in sufficient quantities, at a reasonable price. This inability may be due to inadequate market depth in certain products (e.g. exotic derivatives, long-dated options), market disruption, or inability of the bank to access the market (e.g. credit down-grading of the institution or of a major counterparty).

#### Funding Liquidity Risk

6.53 Funding liquidity risk is the potential inability of the institution to meet funding requirements, because of cash flow mismatches, at a reasonable cost. Such funding requirements may arise from cash flow mismatches in swap books, exercise of options, and the implementation of dynamic hedging strategies.

### Sovereign Risk or Cross Border Risk

6.54 This is the risk that the Government of a particular country may interfere with a payment due to the Bank from a client resident in that country and preclude the client from converting and/or transferring the funds. In such cases, bank's obligor may be economically sound and capable of repaying its obligation, but its country's Government may place an embargo on remittances for political/economic reasons.

### Operations Risk

6.55 Basel I defined operational risk as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events". Basel II, however, defined operational risk as, "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events". For emergence of such a risk four causes have been mentioned and they are people, process, systems and external factors.

- (a) **People risk** – Lack of key personnel, lack of adequate training/experience of dealer (measured in terms of opportunity cost/employee turnover), unauthorised access to the dealing room, tampering voice recorders, nexus between the front and back offices, etc.



- (b) **Process risk** - Wrong reporting of important market developments to the management resulting in faulty decision making, errors in entry of data in deal slips, non-monitoring of exposure in positions, loss of interest owing to the liquidity beyond prescribed limits, non-revision of card rates in cases of volatility, non-monitoring of closing and opening positions, wrong funding of accounts (wrong currency, wrong way swap), lack of policies, particularly in respect of new products.
- (c) **Systems:** Losses due to systems failure such as CCII- not maintaining secrecy of system passwords.
- (d) **Legal and regulatory risk:** Treasury activities should comply with the regulatory and statutory obligation.

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

6.56 All banks, managements should have a risk management policy, laying down clear guidelines for concluding the transactions and institutionalise the arrangements for a periodical review of operations and annual audit of transactions to verify compliance with the regulations.

### **Overnight Net Exchange Position Limit/Factor Sensitivity Limits for Spot FX**

6.57 NOOPL may be fixed by the boards of the respective banks and communicated to the Reserve Bank immediately. However, such limits should not exceed 25 percent of the total capital (Tier I and Tier II capital) of a bank, refer RBI Master Directions – Risk Management and Inter Bank Dealings dated July 5, 2016 (updated as on April 02, 2018). This limits the maximum allowable excess of assets plus exchange bought contracts over liabilities plus exchange sold contracts ("overbought" position) and the reverse ("oversold" position) that may be carried overnight in foreign currencies.

### **Daylight Limit**

6.58 As mentioned for NOOPL these refer to the maximum net positions that can be taken during the trading day in each currency. In case of large intra-day flows and positions, it is expected that the desk will keep the risk department informed about the same.

### **Value at Risk ('VAR') limits**

6.59 These limits are designed to restrict the amount of potential loss from certain types of derivatives products or the whole trading book to levels (or percentages of capital or earnings) approved by the board and senior management. To monitor compliance with the limits, management calculates the current market value of positions and then uses statistical modeling techniques to

assess the probable loss (within a certain level of confidence) given historical changes in market factors.

6.60 The advantage of value-at-risk (VAR) limits is that they are related directly to the amount of capital or earnings which are at risk. The level of VAR limits should reflect the maximum exposures authorized by the board and senior management, the quality and sophistication of the risk measurement systems and the performance of the models used in assessing potential loss by comparing projected and actual results. A drawback in the use of such models is that they are only as good as the assumptions on which they are based (and the quality of the data which has been used to calculate the various volatilities, correlations and sensitivities).

### **Gap or Matured band limits**

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

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

6.63 The Gap DV01 for USDINR FX forwards is monitored on MIFOR & LIBOR curve. Gap DV01 is computed as the effect of 1 basis point change in the MIFOR/ LIBOR for the tenor on the P&L. The Gap VAR is computed using volatilities for each tenor of the MIFOR/ LIBOR curve and the correlation between them.

6.64 The Banks are also required to compute VAR on a daily basis as per the RBI model on the overall bank gap. The bank has to maintain a separate VAR limit for derivative transactions as mentioned in the RBI Circular No. MPD.BC.187/07.01.279 dated July 7, 1999.

As of the last reporting Friday of every month, treasury operations has to prepare the GAP report in prescribed format as given by the RBI for the overall gap position of the Bank.

### **Aggregate Contract Limit**

6.65 This limits the gross outstanding spot and future exchange contracts, both bought and sold. It is computed by adding the US\$ equivalents of the sum total of all outstanding contracts across all currencies. It restrains overall trading volume and its monitoring provides an indication of any unusual activity.

### **Options Limit**

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

- Delta is a measure of the amount an option's price would be expected to change for a unit change in the price of the underlying instrument.
- Gamma is a measure of the amount delta would be expected to change in response to a unit change in the price of the underlying instrument.
- Vega is a measure of the amount an option's price would be expected to change in response to a unit change in the price volatility of the underlying instrument.
- Theta is a measure of the amount an option's price would be expected to change in response to changes in the options time to expiration.
- Rho is a measure of the amount an option's price would be expected to change in response to changes in interest rates.

### **Stop Loss Limit**

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

6.68 Some institutions also establish management action trigger (MAT) limits in addition to stop loss limits. These are for early warning purposes. For example, management may establish a MAT limit at 75 per cent of the stop loss limit. When the unrealized loss reaches 75 per cent of the stop loss limit, management will be alerted of the position and may trigger certain management actions, such as close monitoring of the position, reducing or early closing out the position before it reaches the stop loss limits. The above loss triggers complement other

limits, but they are generally not sufficient by themselves. They are not anticipatory; they are based on unrealized losses to date and do not measure the potential earnings at risk based on market characteristics. They will not prevent losses larger than the stop loss limits if it becomes impossible to close out positions, e.g., because of market illiquidity.

### Limit Exceptions

6.69 A limit exception is a trade or position specific authorization to exceed a limit for a defined period of time. All limit exceptions must be approved in advance of establishing a position that would exceed a limit.

Normally Market Risk Management is responsible for maintaining all documentation of the excess including the agreed upon corrective action and the resolution date and is responsible for the ongoing monitoring of the excess to ensure the corrective action is carried out.

Check whether all exceptions along with the reasons are reported to senior management and approvals were taken for the same.

### Regulatory Reporting Requirements

6.70 Derivatives are governed by the Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000. Derivatives are allowed only under the provisions of these regulations and amendments since, or with the prior permission of the Reserve Bank of India. The reporting requirements under RBI Master Direction No. 1/2016-17 dated July 5, 2016 (updated as on April 02, 2018) on 'Risk Management and Inter-Bank Dealings' and RBI Circular No. DBOD. No. BP.BC.86/21.04.157/2006-07 dated April 20, 2007 on "Comprehensive Guidelines on Derivatives" should be adhered to.

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

- i) Daily statements of Foreign Exchange Turnover in Form FTD and Gaps, Position and Cash Balances in Form GPB.
- ii) Statement of Nostro / Vostro Account balances.
- iii) Consolidated data on cross currency derivative transactions undertaken by residents on half yearly basis.
- iv) Details of exposures in foreign exchange as at the end of every quarter as per those details of exposures of all corporate clients who meet the prescribed criteria have to be included in the report. The AD banks should submit this report based on bank's books and not based on corporate returns.
- v) Details of option transactions (FCY-INR) undertaken on a weekly basis.

- vi) Total outstanding foreign currency borrowings under all categories as on the last Friday of every month.
- vii) Monthly report (as on the last Friday of every month) on the limits granted and utilized by their constituents under the facility of booking forward contracts on past performance basis.
- viii) Statement in form BAL giving details of their holdings of all foreign currencies on fortnightly basis through Online Returns Filing System (ORFS).
- ix) A monthly statement, in respect of cover taken by FIIs, indicating the name of the FII / fund, the eligible amount of cover, the actual cover taken, etc.
- x) List (in triplicate) of all bank's offices/branches, which are maintaining Rupee accounts of non-resident banks as at the end of December every year.
- xi) Quarterly report on the forward contracts booked and cancelled by SMEs and Resident Individuals.
- xii) Consolidated data on the transactions undertaken by non-residents under the scheme.
- xiii) Doubtful transactions involving frequent cancellation of hedge transactions and / or the underlying trade transactions by non-residents under the scheme.
- xiv) Report of Commodity Hedging in Overseas Market on Quarterly basis.

6.72 Another significant feature of the foreign exchange business of banks in India is the requirement of reporting of transactions, at specified intervals, by the branches to the Reserve Bank of India by means of 'R' returns, as enumerated in the Exchange Control Manual. Those branches which handle foreign exchange transactions and are under obligation to report them directly to Reserve Bank are called the 'Authorised Dealers' (AD—also called 'position maintaining branches'). The ADs can be nominated only with the approval of the Reserve Bank of India and each AD would have a unique Code Number, which must be mentioned in all reports to the Reserve Bank. In addition to these ADs, individual banks may also, subject to report to the Reserve Bank, nominate some other branches to handle the specified type of foreign exchange business but these branches will have to route their transactions through an AD only (such branches are often called 'reporting branches').

Moreover, ADs have to provide forms A2 for all interbank cross-currency deals done with overseas banks maturing during a fortnight to the RBI through the R-Return which is submitted on a fortnightly basis.

ADs also have to submit a report (MAP/ SIR) in the format as prescribed by the RBI. This is required to be prepared for 4 major currencies (i.e. US\$, GBP, YEN and CHF). MAP will be prepared for the last reporting Friday of each month.

6.73 As required by RBI circular FMD.MSRG.No.67/02.05.002/2011-12 dated March 9, 2012, all inter-bank OTC foreign exchange derivatives are required to be reported on a platform to be developed by the Clearing Corporation of India (CCIL). All/selective trades in OTC foreign exchange and interest rate derivatives between the Category-I Authorised Dealer Banks/market makers (banks/PDs) and their clients are required to be reported on the CCIL platform subject to a mutually agreed upon confidentiality protocol.

6.74 As per RBI circular FMD.MSRG.No.72/02.05.002/2012-13 dated October 12, 2012, it is decided with effect from November 5, 2012 and RBI/2013-14/400 FMD.MSRG.No.94/02.05.002/2013-14 dated December 4, 2013 that following derivative products need to be reported to CCIL by the banks:

- FCY(excluding USD)-INR forwards.
- FCY(excluding USD)-INR FX swaps.
- FCY-FCY forwards.
- FCY-FCY FX Swaps.
- FCY-FCY options.
- Inter-bank and client transactions in Currency Swaps.
- Inter-bank and client transactions in FCY FRA/IRS.
- Client transactions in INR FRA/IRS.

### **ACCOUNTING**

6.75 Accounting is generally handled by the back office which acts as an intermediary between the treasury business unit and the finance department to ensure that the accounting of treasury products is accurate and correct.

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

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

6.78 It also enables treasury operations staff to understand the accounting that is peculiar to treasury, such as the 'trading account' and 'base currency' concepts. This is vital as most of the accounting is 'hidden' by being automatically systems generated as a result of deal input of various types. Indeed, this problem is self-perpetuating as the more complex the deals become the more likely a bank will be to automate to prevent errors.

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

### **Rate Reasonability**

6.80 The bank's risk department will perform the rate reasonability process as per the Price Verification Policy of the bank and for any transaction that falls outside the band specified, the same should be enquired into for reasons.

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

6.81 This is one of the most important controls on deals position which is carried out by the bank's risk department / back office. The trader's net currency-wise exchange position as per front office system should be matched on a daily basis by risk department / back office with the back office systems position. The position exceptions should be communicated to the front office and a resolution is arrived at.

### **Valuation of foreign exchange forwards and derivative products**

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

6.83 As part of its normal day to day operations and for managing its interest rate and foreign exchange risk, a bank or financial institution may deal with a number of financial instruments. Depending on the type of financial instrument and the purpose for which it was entered into, it is necessary to value the deals periodically. Some of the financial instruments in which banks and financial institutions transact are complex in nature.

6.84 The valuation models used for these financial instruments are sophisticated and involve complex algorithms. Generally, inputs into these models are sourced from market available data points. Given the enormous

“leverage” provided by various derivative financial instruments and the track record of significant losses reported in the industry, the valuation of these instruments will generally have a high inherent risk.

6.85 The valuation of derivatives should be based on marked to market (MTM) and on net present value (NPV) basis.

### **Audit Approach**

6.86 While innovative products and ways of trading create new possibilities for earnings for the bank, they also introduce novel and sometimes unfamiliar risks that must be identified and managed. Failure to do so can result losses entailing financial and reputational consequences that linger long after the loss has been recognized in financial statements. Hence, auditor should assess controls as part of audit work.

6.87 It is imperative that the auditor obtains a complete overview of the treasury operations of a bank before the commencement of the statutory audit. After conducting appropriate risk assessment of the treasury processes, the audit program needs to be designed in a manner that it dovetails into not just the control assessments of the treasury process but there is an assurance that the figures appearing in the financial statements as well as the disclosures are true and reflect fairly the affairs of the bank’s treasury operations.

### **Audit Programming and Procedures**

6.88 In framing the audit program, the auditor needs to take into consideration their findings of the adequacy of controls within the processes as explained in this Guidance Note. Reserve Bank of India prescribes concurrent audit /internal audit for a 100% verification of treasury transactions. Hence, the selection of samples can be influenced by the nature, extent and timings of concurrent/internal audit function including the compliance mechanism of the Bank. Further, RBI requires compliance reports on derivatives separately to be prepared by the Bank as per RBI Guidelines on Derivatives vide circular no. DBOD.No.BP.BC.44/21.04.157/ 2011-12 dated November 2, 2011 which the auditor should take into consideration.

6.89 The following are illustrative audit procedures/ approach that may form part of the audit program.

### **Product Program and Policy**

6.90 The auditor should obtain the approved product policy and procedures of the Bank relating to foreign exchange and derivative business and review



them for adequacy and coverage and check whether the policy is commensurate with the nature of operations and adequately covers all the activities of the Bank.

Further, in accordance with the Comprehensive Guidelines on derivatives, the auditor should obtain and verify full particulars of the model used for valuation and the documented algorithms used by the Bank.

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

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

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

### **Credit limits**

6.93 For the selected samples, the auditor should check whether appropriate credit limits are in place for foreign exchange and derivative transactions. Additionally, the auditor should:

- Check whether the name of the counterparty is in the approved counterparty list for the purpose of treasury transactions.
- Check whether the credit limits (both pre settlement and settlement) are set for different customers and they are adhered to in a consistent manner and for any limit breaches, appropriate sanctions / ratifications are in place.
- Check whether the counterparty exposure limit reports for all brokers, lenders, etc., are generated and monitored on a regular basis.
- Check whether the limits are properly entered in the bank's system.
- Check dealer limits- Maximum amount a dealer can transact without seeking higher-level approval and sanctions/ratifications for any breaches.
- Check product limits- Maximum exposure the entity should have in a particular instrument or product.
- Check sector limits – Maximum investment in a particular sector (for example, exposures to companies incorporated with limited liability in India).
- For the selected samples, confirm and review signed and authorized ISDA agreement, signed and authorized collateral agreement, credit risk assessment of the customer and confirm, whether credit positions are within established limits for each customer.

- Check whether the above limits are entered into the software system being used by the Branch for conducting the said transactions.

### **Deal Initiation and Recording**

6.94 For the selected samples, the auditor should check whether deals carried out by the front office are appropriately recorded in the deal slips and whether the same is correctly entered in the front office deal recording system.

- For the selected samples check whether the deal ticket is complete and accurate with respect to all transaction details like counterparty name, contract rate, notional amount, transaction date / maturity date, value date / settlement agent and buy / sell date.
- Check the flow of transaction from initiation of deal to the verification and approval.
- Check whether deal tickets are generated automatically by front office systems, or trader should use sequentially numbered deal tickets.
- Check whether the dealers use dedicated calling lines and all the telephone lines are linked to a voice recording machine.
- Verify the adherence to the voice recording mechanism.
- Check whether the proper back-up of voice recordings is being maintained.
- Verify whether user IDs of dealers left / transferred/ on leave is deactivated / suspended on timely basis.
- Verify whether, the Use of Mobile Phones is restricted in the Dealing Room and mechanism for ensuring adherence thereto.
- Verify the recordings for few of the selected samples to ascertain that the recording machine is working in order.
- Check whether there is access of unauthorized persons in the dealing room. If yes, whether proper approvals have been taken.
- Check whether dealers entering the deals have signed the code of conduct.

### **Deal Authorisation**

6.95 Following audit procedures may be followed by the auditor while checking the procedures for deal authorisation.

- Check the process flow of authorizations of deals in the system and check areas of manual intervention in the system.
- Check whether proper authorization levels are set for treasury operations and observe and verify whether the prescribed procedure is followed.

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- For the selected samples, check whether deals entered in front office system are authorised by the back office team after verifying the deal details with external evidences like Reuters' conversation, telephonic conversation with customers' back office, etc.
- Examine the selected deals from the front office and establish that they are confirmed by the back office operations.
- Check that all sampled deals are authorised at the proper levels of authority against the deal slip.
- Check whether alterations and cancellations on deal slips are duly authorised.
- Check whether bank is preparing trade amendments sheets and whether the reasons for such amendments are mentioned in the sheet.
- Check whether any exceptional reports are being generated.

### **Segregation of Duties**

6.96 For this, the audit procedure may include:

- There will be complete segregation between Dealing room, Market risk group and Back office.
- Checking and ascertaining that segregation of duties is in place. Under no circumstances staff involved in initiating deals should be involved in checking or receiving deal related documents.
- Verify whether there is any overlapping of duties.
- Verifying that there is clear segregation, functionally and physically, between the front office, back office and middle office in respect of derivative transactions.
- Checking that there is segregation between functions of authorisation, execution and recording of transactions.
- In cases where management override has taken place, ascertain that satisfactory reasons for doing so were recorded and produced for audit verification.
- Checking whether treasury personnel have availed minimum leave during the financial year.
- Check whether any duties have been outsourced to external parties.

### **Counterparty confirmations**

6.97 For this, the auditor would inter alia:

- Understand the process of sending and tracking the confirmations including follow – up procedures.
- Exchange of deal confirmations is mandatory. The counterparties should exchange the rate fixing notices. However, in the case of an OTC Overnight Index Swap (OIS) the trades are reported to CCIL. If the counterparties have a bilateral agreement waiving the requirement to exchange of confirmations, then exchanging of physical confirmations may not be required for such IRS deals.
- Understand the process of MIS reporting to the senior management in respect of the non-receipt of counterparty confirmations.
- Verify that confirmations from Bank to counterparty are sent within a reasonable time and there exists a mechanism for follow-ups for pending counterparty confirmations.
- Determine the status of any missing / pending confirmations (currently in the Confirmation Tracking List) and assess whether there are any provisioning concerns on the trades.
- Check whether the format of the counterparty confirmation is as approved by the Local Legal Counsel of the Bank from time to time.
- Verify controls implemented by the bank to ensure completeness of all deal confirmations.
- Check whether there is any persisting non receipt of Counterparty confirmation.
- Inquire of any exception report or other mechanism of tracking missing confirmations.

### **Customer Complaints**

6.98 As per the Comprehensive Guidelines on Derivatives, while undertaking derivative transactions with or selling structured derivative products to a user, a market-maker should establish internal procedures for handling customer disputes and complaints. They should be investigated thoroughly and handled fairly and promptly. Senior management and the Compliance Department/Officer should be informed of all customer disputes and complaints at a regular interval. For this, the auditor should verify controls over recording and handling of customer disputes and complaints and ensure the Bank's adherence to RBI requirements.

### **Underlying document**

6.99 The audit procedures for this aspect include:

- Understand the process and policy of the Bank in respect of the underlying documents.

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

### **Accounting of transactions in the general ledger**

6.100 The audit procedures for this aspect include:

- Checking whether there is a direct hands-off between front end system and the accounting system for passing accounting entries in the general ledger.

- Checking whether correct accounting entries are recorded in the general ledger and the back office regularly reviews the accounting entries passed in the general ledger.
- Checking whether the treasury department generates a daily P&L (desk-wise) and same has been reviewed and compared to the general ledger to identify any mismatches.
- Understand the accounting scheme for the various products. Further, inquire about the routine and non – routine accounting entries with the bank.
- Check whether any exceptional reports are being generated by the system.
- For the selected samples, verify the accounting entries passed.

### **Position Reconciliation**

6.101 The audit procedures include:

- Checking whether daily position reconciliations are performed between front office deal positions and back office deal positions by the treasury back office and position differences if any are appropriately enquired into.
- Checking whether the Bank maintains customer wise, currency wise and deal wise positions on a daily basis in-order to monitor customer limit breaches and sectoral limit breaches.
- Checking whether the inter branch reconciliations between the Treasury Branch and the Authorised Branches are carried out on a periodic basis and there are no old and long outstanding items uncleared.

### **Deal Settlements**

6.102 The audit procedures include:

- Checking whether there exists effective mechanism for settlement of deals on due date and whether deals due for settlement are generated on a daily basis by back office.
- Examining whether customer intimations are sent across as soon as the deal is settled and the respective customer accounts are debited / credited.
- Check whether separate responsibilities are in place between authorization and release of settlement.
- Examining whether the Settlement desk ensures proper settlement of funds through CCIL/RTGS/SWIFT networks. Any deal rejected by CCIL should be examined and settlement through any other means should be taken up only

after thoroughly examining the deal/deal confirmation as in most of the cases the rejection is on account of improper deal entry.

- Examining whether deal is settled / cancelled in case no confirmation is received from customers till expiry dates.
- Check whether any settlements defaults were made.

### **Realised profit / loss on derivative transactions**

6.103 The audit procedures include:

- Recalculating the profit or loss for sample trades selected and agree to the general ledger.
- Test the general and IT application controls for automated computation of profit or loss.
- Vouch to cash settlement in the case of realized gains and losses.
- Verify if the bank is reckoning only the NOSTRO balances for adjustment of the profit / loss revealed in mirror account or did it also consider the outstanding forward transactions as at the date of valuation.
- The increase / decrease in profit is in line with increase / decrease in volume of transactions.
- Check marking-to-market of risk exposures and reconciliation of risk positions and profit/loss between the front and back offices.
- Verify preparation of management reports, including daily profit/loss results and gross and net risk positions.
- Verify exceptional reports showing details of deals resulting in exceptional profits and losses.

### **Valuation of FX contracts and Derivatives**

6.104 The audit procedures for valuation of FX contracts and Derivatives include:

- For spot and tom contracts checking whether correct FEDAI rates are used by the Bank for marking them to market. In case of automatic feed of FEDAI rates, verifying whether the rates are correctly uploaded into the system. At the end of the reporting period, sight the process and verify the process of downloading rates from external source and the process of uploading of rates in the system by the middle/back office for all FX contracts and derivatives.
- Process of computation of net present value of rates.

- Re-performing and checking on a sample basis the accuracy of the MTM gain / loss booked by the bank on the outstanding forex contract.

6.105 In case of valuations of swaps, options and other derivative products most of the banks have proprietary valuation models developed by them or standard valuation software installed. In case of proprietary valuation models, a model validation coupled with checking of input parameters would provide reasonable comfort on valuations. In case of standard valuation models, the auditor can resort to checking of input parameters along with limited re-performance of derivative valuations. In such cases, the auditor should also check system controls and if deemed necessary, consider involving an expert to check the integrity of system logic. Further, the auditor can select certain samples as per the methodology or depending upon the nature, timing and extent for getting it revalued from the valuation expert. Auditor should also obtain the understanding of rate upload process and verify the timing of rates upload in the system for valuation of derivative contracts. The Auditor should carry out the valuation of the samples selected in a spreadsheet and compare the end results with the valuation as provided by the software system. Sometimes the software systems are not capable of valuing certain treasury products such as partly redeemable perpetual bonds, Security Receipts etc., for which the Bank has to value such products manually and the auditor should gain sufficient knowledge to understand and confirm their valuation.

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

6.106 As a general rule, for an instrument that is actively traded on a recognized public exchange, the price quoted by the exchange where the instrument is traded is used as an appropriate valuation price to arrive at the fair value of the instrument.

6.107 In case of instruments that are actively traded over the counter, the quoted bid price for long positions and quoted offer price for short positions is used as an appropriate indicative valuation price. These may be obtained through relevant market makers or brokers.

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

6.109 In case of the following instruments, fair value can be arrived at using the market data as mentioned there against:



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FX spot / forwards	Prices as published by Foreign Exchange Dealers Association of India ('FEDAI'). With effect from 31 December 2014, these are further required to be adjusted for arriving net present value.
Exchange traded interest rate futures	Prices quoted on the relevant exchange.
Commodity futures	Prices quoted on the relevant exchange.
OTC derivatives:	
Options	Black Scholes Merton Method.
Swaps / Forward Rate Agreements	Discounted cash flows using the applicable Interest Curves (ROI can be taken from FIMMDA / NSE / Reuters' site based on the nature and currency of the product.

6.110 The valuation of derivatives is based on exchange rate and the swap rate prevailing on the valuation date. Various banks use different in-house/vendor developed model for valuation of their derivative products. However, the general benchmarks used for valuation are OIS/MIBOR, MIFOR, MITOR, LIBOR and INBMK as per the end of the day quotes appearing on the Bloomberg or Reuters page.

6.111 In case of hedge swaps, the income/ expense is accounted for on an accrual basis except the swap designated with an asset or liability that is marked to market or lower of cost or market value in the financial statements. In that case, the swap should be marked to market with the resulting gain or loss recorded as an adjustment to the market value of designated asset or liability. Whereas, the trading swaps are marked to market as per the instructions contained in the RBI circular NO. MPD. BC. 187/07.01.279/1999-2000 dated July 7, 1999.

6.112 The marked to market gain/ loss on forward financial derivatives contract is derived from the difference between the agreed-upon contract price of an underlying item and the current market price (or market price expected to prevail) of that item, times the notional amount, approximately discounted. The notional amounts, sometimes described as the nominal amount, is the amount underlying a financial derivatives contract that is necessary for calculating payments or receipts on the contract. This amount may or may not be exchanged.

6.113 In the specific case of a swap contract, the market value is derived from the difference between the expected gross receipts and gross payments, appropriately discounted; that is, its net present value.

6.114 The market value for a forward contract can therefore be calculated using available information – market and contract prices for the underlying item, time to maturity of the contract, the notional value, and market interest rates. From the viewpoint of the counter parties, the value of a forward contract may become negative (liability) or positive (asset) and may change both in magnitude and direction over time, depending on the movement in the market price for the underlying item. Forward contract settled on a daily basis, such as those traded on organized exchanges - and known as futures - have a market value, but because of daily settlement it is likely to be zero value at each end-period.

6.115 The price of an option depends on the potential price volatility of the price of the underlying item, the time to maturity, interest rates, and the difference between the contract price and the market price of the underlying item.

6.116 For traded options, whether they are traded on an exchange or not, the valuation should be based on the observable price. At inception the market value of a non-traded option is the amount of the premium paid or received. Subsequently, non-traded options can be valued with the use of mathematical models, such as the Black-Scholes formulae, that take account of the factors mentioned above that determine option prices. In the absence of a pricing model, the price reported for accounting or regulatory purposes might be used. Unlike forwards, options cannot switch from negative to positive value, or vice versa, but they remain an asset for the owner and a liability for the writer of the option.

6.117 It may be mentioned that counter party wise netting is only allowed where specific legally enforceable bilateral netting arrangement such as International Swaps and Derivative Association (ISDA) master agreement, etc., exists.

### **Examples for the Calculation of Market or Fair Values of Derivative Contracts**

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

6.119 For a forward, a contract to purchase USD against EUR at a forward rate of say, 1.00 when initiated has a positive market value if the EUR/ USD forward rate at net present value at the time of reporting for the same settlement date is lower than 1.00. It has a negative market value if the forward rate at net present value at the time of reporting is higher than 1.00, and it has a zero market value if the forward rate at the time of reporting is equal to 1.00.

6.120 For swaps, which involve multiple (and sometimes two-way) payments, the market or fair value is the net present value of the payments to be exchanged between the counter parties between the reporting date and the contracts maturity, where the discount factor to be applied would normally reflect the market interest rate for the period of the contract's remaining maturity. Thus, a fixed/floating swap which at the interest rates prevailing at the reporting date involves net annual receipts by the reporter of say, 2% of the notional principal amount for the next three years has a positive marked to market (or replacement) value equal to the sum of three net payments (each 2% of the notional amount), discounted by the market interest rate prevailing at the reporting date. If the contract is not in the reporter's favour (i.e., the reporter would have to make net annual payments), the contract has a negative net present value.

6.121 Unlike forwards or swaps, OTC options have a market or fair value at initiation which is equal to the premium paid to the writer of the option.

6.122 Throughout their life, option contracts can only have a positive market or fair value for the buyer and a negative market or fair value for the seller. If a quoted market price is available for a contract, the market value to be reported for that contract is the product of the number of trading units of the contract multiplied by that market price. If a quoted market price is not available, the market or fair value of an outstanding option contract at the time of reporting can be determined on the basis of secondary market prices for options with the same strike prices and remaining maturities as the options being valued, or by using option pricing models.

6.123 In an option pricing model, current quotes of forward prices for the underlying (spot prices for American options) and the implied volatility and market interest rate relevant to the option's maturity would normally be used to calculate the market values. Options sold and purchased with the same counter party should not be netted against each other, nor should offsetting bought and sold options on the same underlying. RBI vide its Circular DBOD. No.BP.BC.76/21.04.157/2013-14 dated December 09, 2013 has issued operational Guidelines on "Novation of OTC Derivative Contracts"

### **Rate Scan**

6.124 The audit procedures for this would include:

- Checking whether for the selected deals, the rates taken are the prevailing rates in the market at the time of striking the deal. In doing so the auditor needs to assess the process of advising card rates to customers, though its branches or relevant operating departments.

- Checking whether in outright deals the back office checks the rate scans for the veracity of the rate at which the dealer has struck the deal. Any deviation should be enquired into compliance with AS 11.
- Check whether any exceptional reports are being generated in this respect.
- In case of deviations, reasons should be obtained and check whether the same have been reported to the senior management.

### **Margins held with exchanges / margins held under Credit Support Annex ('CSA')**

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

- Sending independent third party confirmations to confirm the balances held as at the reporting date.
- Agreeing the balances to underlying supporting such as margin statements.
- Check whether margin statements are being sent to the clients and check the correctness of the same.

### **Assessment of controls**

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

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

appropriate training mechanism and whether signoffs have been regularized after the new superior has taken over the responsibilities.

- On a test check basis, verifying whether the review process and controls were working effectively during the transition period.
- Obtaining and reviewing on test check basis, the daily Profit and Loss prepared for MIS purpose and assessing the granularity and exhaustiveness of the same.
- Assessing whether such Profit and Loss is granular enough to provide desk wise, product wise and various price component wise Profit and Loss.
- Assessing whether gross position reviews are undertaken and also whether such Profit and Loss are prepared and reviewed at a gross trade level.
- Reviewing the Bank's policy on valuation. On a test check basis, verifying whether the material valuation adjustments are reviewed, authorized and are appropriate.
- Verifying whether these valuation adjustments are disclosed / visible in the reconciliation.
- Assessing whether there is an independent 'Valuation Control' team.
- Checking whether dealers have access to adjust or modify trade values.
- Checking whether the reconciliations are prepared on a timely basis and the un-reconciled items are independently inquired by the back office.
- Reviewing the ageing and quantum of the un-reconciled items and inquire for the high value and long outstanding reconciling items.
- Assessing whether the escalations are done in a timely manner for the large / unusual / recurring reconciliation items.

### **Market Risk System**

- Reviewing the key market risk reports generated and verifying that these reports are in sync with risk attributes of the products being traded and convey the risk positions appropriately.

Cancelled / amended / late (C/A/L) booking of futures trades into the Front Office risk system

- Reviewing the policy of the bank as regards the cancelled / amended / late booked trades and whether there is a clear policy describing the Front office supervisor's responsibility in respect of reviewing and signing off on these instances.

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- Reviewing whether these instances are reported to the senior management as per the policy and are ratified.
- Verifying whether the system is capable to capture the C/A/L and obtaining a complete inventory of these instances.
- Reviewing the frequency of such instances during the period and verifying on a test check basis whether there is a justification of such cancellations / amendments / delays.
- Checking the process relating to late trades – how does these get captured in risk reporting's (if there is a time cut off when such reports are generated).
- Check the approval and control process of the said transactions.
- Sample check of the same can be done by putting dummy entries for verification purpose.

Fictitious trades with deferred settlement dates and/or at off-market prices and subsequent amendments

- Reviewing the controls over cancellation of trades before reaching settlement dates and checking whether these are ratified by the authorized personnel with appropriate justifications.
- Reviewing the “Rate scan” process performed by mid-office and whether the exceptions noted in the rate scan are inquired and reasons are obtained for the same.
- Reviewing the Day 1 Profit or Loss assessment process and verify whether the Day-1 Profit or Loss is sufficiently assessed and explained.
- Verifying whether the change in pricing / other criterion is approved and confirmed with the counterparty.

Breaches of the Net Delta Limits

- Verifying whether the breaches to the delta limits set by the Bank are monitored on a frequent basis and whether the breaches (if any) are ratified by the authorized personnel and the reason is recorded for such breaches.

Failure to identify and escalate risk issues

- Verifying whether a process is in place to educate employees about escalation mechanism to report any events that represent a risk to the institution and is embedded in the code of conduct. This may include directly reporting the incidences to the highest authorities on a no name basis, hotline numbers etc.

### Quality of supervision

- Assessing and determining the nature of comments and queries that are posed by the reviewer on any reconciliation breaks, long unexplained balances, exceptional trades, follow up on responses, etc.
- Determining and assessing whether the review function is not a mere sign off and it is conducted with appropriate supervisory intent.
- Verification of training sessions conducted by the bank.

### Temporary discontinuance of a process or control

- Verifying that the controls identified and tested have been operational throughout the period and where there has been a temporary discontinuance (for any reason) verify whether there were alternative controls.

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

- Reviewing the remuneration policy and independently assess how and to what degree it addresses matters relating to risk and compliance with control policies as part of the employee remuneration for treasury staff members.

### Outsourced/Hubbed process

- Reviewing the Service Level Agreements (SLAs) and agreements with such agencies and verify the robustness of the controls that reside in house in the bank to review and understand the work undertaken at outsourced / hub locations.
- Reviewing and verifying the documentary evidence of the communication the bank has with these agencies on a regular basis. The forward contracts in banks are now a days increasingly being collateralized and using Customer Support Annex (CSA) margins, which form part of the ISDA agreement. The auditor should devise audit procedures required to be performed for verification of these margin balances as per the underlying agreements.

## **NOSTRO and VOSTRO Accounts**

6.127 A fundamental feature of foreign exchange transactions is that the useful possession of any currency can be had only in the country in which it is a legal tender or countries in which it is circulated. (e.g., US Dollar is widely circulated in Russia, CIS countries). Therefore, in order to be able to put

through foreign exchange transactions, banks normally maintain stocks of foreign currencies in the form of bank accounts (usually current accounts) with their overseas branches/correspondents. Such a foreign currency account maintained by a bank at an overseas centre is usually designated by it as 'NOSTRO Account' (i.e. "Our account with you"). Thus, banks in India may maintain a pound-sterling account with its London office/correspondent; such account would be called by it as NOSTRO Account. Conversely, if a foreign bank is to deal in a local currency of another country, it would maintain a 'VOSTRO Account' (i.e. 'your account with us') with the local bank, e.g. a bank in England may maintain a 'VOSTRO Account' in Indian Rupee with a correspondent bank in India. A VOSTRO account is in substance no different from any other account in the local currency.

### **NOSTRO / VOSTRO Reconciliation**

6.128 In respect of old unreconciled entries in NOSTRO Accounts, the RBI vide its Circular DBOD No.BP.BC.67/21.04.048/99 dated July 1, 1999 has allowed, as a onetime measure, a netting off procedure.

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

- Whether a system of periodical reconciliation is in place and is upto date.
- Whether the reconciliation process followed ensures matching of each item and not for overall matching of total amount.
- Whether logs are generated for any change made in entry and whether maker checker is implemented for authorising changes made in entry, if any, for reconciliation.
- Whether confirmations from the foreign banks are obtained on a periodic basis. This may be either through physical confirmations, swift messages, emails, etc.
- Whether Information to the controlling office is sent on a timely basis.
- Whether long outstanding are taken up and cleared.
- Random check of the method of reconciliation.
- Debits outstanding in the NOSTRO accounts are to be verified and recommend for provision wherever necessary.
- Set off the credit against debits only at the permission of the head office for long outstanding entries.



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- Whether payments are promptly advised and effected and receipts are suitably recorded in the “Nostro” account.
- Whether large balance has been held in an inoperative account, for along period and if so, the reasons thereof.
- Whether bank has been submitting the BAL Statements periodically to RBI.

6.130 RBI’s circular no. DBOD.BP.BC.16/21.04.018/2001-02 dated August 24, 2001 has also clarified that the balances carried in “Sundry Debtors/ Unclaimed Deposits Accounts” under NOSTRO Accounts, represent unreconciled entries which may be large in a few cases and hence susceptible to frauds. Accordingly, the banks should transfer the following balances in the “Sundry Debtors/ Unclaimed Deposits Accounts” appearing in the books of the bank as on September 30, 2001 to distinct “Blocked Accounts” and shown under “Other Liabilities and Provisions” (item no. iv of Schedule 5) in the balance sheet:

- (i) the net credit balance arising out of the netting of entries pertaining to the period prior to April, 1996; and
- (ii) credit entries originated on or after April 1, 1996 and remaining unreconciled in NOSTRO/ mirror accounts for more than three years.

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

Any adjustment from the Blocked Accounts should be permitted with the authorisation of the two officials, one of whom should be from outside the branch concerned, preferably from the Controlling branch/ head office if the amount exceeds Rs. one lakh.

6.131 The audit considerations for this aspect include:

- Examining whether currency wise NOSTRO reconciliation is performed on a day-to-day basis and check for long outstanding items.
- Checking whether there exists a policy of following up for outstanding reconciliation items with the counterparties or with the respective banks.
- Outstanding debit items over 90 days attract provisioning under RBI provisioning norms.
- Examining whether the statement of account is sent to the Vostro account holder and periodic confirmation is obtained and discrepancies, if any, is properly dealt in the books of accounts.

- To verify the bank submitted statement of Nostro / Vostro account balances on monthly basis to RBI.
- Verify if reconciliation is done by separate department and not by treasury department who operates Nostro accounts.
- Check for write off any un-reconciled item / number / amount and see if details are sent to RBI for approval.
- Whether MIS of unreconciled entries of NOSTRO account is being to senior management periodically.

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

6.132 The audit considerations for this aspect include:

- Examining whether treasury transactions are separately subjected to concurrent audit by internal auditors / external auditors and monthly reports containing their findings are submitted to the management for corrective action.
- Obtaining the monthly concurrent audit reports of the treasury operations and check whether deficiencies if any, mentioned in the report are rectified or noted for corrective action by the management.
- In internal audit reports, examining whether major control weaknesses are highlighted and a management action plan to remedy the weaknesses are agreed with a timeframe.
- Check whether any persisting irregularities are being highlighted in the audit reports.

Management should periodically monitor newly implemented systems and controls to ensure they are working appropriately. Failure of management to implement recommendations within an agreed timeframe should be reported to the Audit Committee.

### **Risk Management**

6.133 The audit considerations for this aspect include:

- Checking whether the bank has adequate risk management process, sound risk measurement procedures, sound information systems, continuous risk monitoring and frequent management reporting for treasury operations.
- Examining whether the mid-office monitors the exchange and gap positions for cut loss limits, overnight limits, daylight limit, liquidity, counterparty exposure limit and aggregate gap limit fixed in the banks trading policy/guidelines.

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- Reviewing the adequacy and effectiveness of the overall risk management system, including compliance with policies, and procedures.
- Investigating unusual occurrences such as significant breaches of limits, unauthorized trades and unreconciled valuation or accounting differences.
- Inquiring whether there is a 'New Product Approval' process prior to undertaking transactions in new or structured derivative products and verifying whether the 'New Product Paper' for all new derivative products is approved and signed-off by the Chief Compliance Officer of the bank.
- Obtaining the 'Risk Management Policy' of the bank and verifying whether risk management pertaining to derivative transactions is an integral part of the policy.
- Verify whether the Policy is updated on a periodic basis in line with the dynamic market and regulatory changes.
- The Board should have overall responsibility for management of risks and should decide the risk management policy of the bank and set limits for liquidity, interest rate, foreign exchange and equity price risks and verifying that the policy inter alia covers the following aspects:
  - i. Defines the approved derivative products and the authorized derivative activities;
  - ii. Details requirements for the evaluation and approval of new products or activities;
  - iii. Ensures appropriate structure and staffing for the key risk control functions, including internal audit;
  - iv. Establishes management responsibilities;
  - v. Identifies the various types of risks faced by the bank and establishes a clear and comprehensive set of limits to control these;
  - vi. Establishes risk measurement methodologies which are consistent with the nature and scale of the derivative activities;
  - vii. Requires stress testing of risk positions;
  - viii. Details the type and frequency of reports for monitoring risks which are submitted to the Board (or committees of the Board);
  - ix. Typical risks and commonly used risk limits in respect of derivative transactions;
  - x. It is essential that banks have interest rate risk measurement systems

that capture all material sources of interest rate risk and that assess the effect of interest rate changes in ways that are consistent with the scope of their activities. The assumptions underlying the system should be clearly understood by risk managers and bank management.

### Information Technology ('IT') Controls

6.134 The audit considerations for this aspect include:

- Check controls over creation of all masters, eg. counterparty, broker, limit, dealer, etc.
- Check the integration of various treasury application with Core Banking Application.
- Check interface controls between various applications used in treasury department ( viz. SWIFT and CBS, Finacle Treasury and Finacle core, etc.)
- To verify the integration of CBS, including Trade Finance and/or aligned software/modules, with SWIFT system and status of automation thereon.
- The auditor should specifically verify whether any special privileges or rights are given for operating SWIFT system allowing direct initiation of transactions through SWIFT without initiating the transactions through CBS. And whether such transactions are reflected correctly in CBS?
- Obtain IT related information from the bank for treasury operations and review, as appropriate, minutes of any committees responsible for overseeing and coordinating IT resources and activities to determine user involvement and organizational priorities.
- Check functional separation in the system.
- Verification of limit system and determination and reconciliation of positions and results.
- Check whether were any changes in EDP systems.
- Review organizational charts, job descriptions, and training programs to ascertain that the bank has sufficient number of technology personnel and that these personnel have the expertise the bank requires.
- Review MIS reports for significant IT systems and activities to ascertain that risk identification, measurement, control, and monitoring are commensurate with the complexity of the bank's technology and operating environment.

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- Evaluate the separation of duties and responsibilities in the operation and data processing of treasury functions.
- Evaluate the adequacy of input/output controls and reconciliation procedures for batch capture and image capture systems.
- Review controls and audit trails over master file change requests (such as address changes, due dates, commission / interest rates, and service charge indicator) and also consider individuals authorized to make changes and potential conflicting job responsibilities and documentation/audit trail of authorized changes and procedures used to verify the accuracy of master file changes.
- Assess adequacy of controls over changes to systems, programs, data files, and PC-based applications and consider procedures for implementing program updates, releases, and changes.
- Check if controls are in place to restrict and monitor use of data-altering utilities and adequate process management to select system and program security settings (i.e., whether the settings were made based on using sound technical advice or were simply default settings).
- Check whether controls are established to prevent unauthorized changes to system and programs security settings.
- Evaluate the effectiveness of password administration for employee and customer passwords considering the complexity of the processing environment and type of information accessed and consider confidentiality of passwords - (whether only known to the employee/customer), procedures to reset passwords to ensure confidentiality is maintained, frequency of required changes in passwords, password design (number and type of characters), security of passwords while stored in computer files, during transmission, and on printed activity logs and reports.
- Check whether any system audit has been conducted by the bank.
- Determine whether the bank has removed/reset default profiles and passwords from new systems and equipment and determine whether access to system administrator level is adequately controlled.
- Check whether the data hands off process from one product processor to another or to any other system is conducted under a secure environment and without or with least but controlled manual intervention.
- Check whether proper backup of records is being maintained.

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

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- Whether any dealer/employee has accessed the dealing room on holidays. If yes, verify the reasons and approvals for the same.
- Check mandatory leave policy has been adhered to.
- Check BCP details of the bank.
- Check compliance with Internal Control Guidelines issued by RBI vide FE.CO.FMD. No. 18380 /02.03.137/2010-11 February 3, 2011.

# III-7

## **Profit and Loss Account**

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7.01 Sub-section (1) of section 29 of the Banking Regulation Act, 1949, requires the preparation of Profit and Loss Account in Form B of Third Schedule to the Act or as near thereto as the circumstances admit. This sub-section is applicable to Banking Companies, Nationalised Banks, State Bank of India and its Subsidiaries, and Regional Rural Banks.

### **Disclosures**

7.02 The Profit and Loss Account as set out in Form B has four broad heads:

- Income
- Expenditure
- Profit/ Loss
- Appropriations

The information to be provided under each of the above heads is also specified in the Schedule. It would be pertinent to note that knowledge of the Bank's accounting policies is of utmost importance before verifying the items within the profit and loss account. The auditor must make enquiries with the management to ascertain whether there have been any changes in the accounting policies and also review the closing circulars issued by the controlling authorities of the Bank.

### **Applicability of AS 5 and Materiality**

7.03 Accounting Standards are intended to apply only to items that are material. Since materiality is not objectively defined, RBI, vide its Circular No. DBOD. No.BP. BC. 89 /21.04.018/2002-03 dated March 29, 2003 on "Guidelines on compliance with Accounting Standards (AS) by banks", has advised that all banks should ensure compliance with the provisions of accounting standards in respect of any item of prior period income or expenditure, which exceeds one per cent of total income/ total expenditure of the bank if the income or expenditure is reckoned on gross basis or one per cent of the net profit before taxes or net losses as the case may be if the income is reckoned on net of costs.

7.04 Since the format of the profit and loss accounts of banks prescribed in Form B under Third Schedule to the Banking Regulation Act, 1949 does not specifically provide for disclosure of the impact of prior period items on the

current year's profit and loss, such disclosures, wherever warranted, may be made in the Notes on Accounts to the balance sheet of banks.

## **Income**

### **Interest Earned**

7.05 The following items are included under this head:

- (a) *Interest Income on Investments:* This includes all income derived from Government securities, bonds and debentures of corporates and other investments by way of interest and dividend, except income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India. Broken period interest paid on securities purchased and amortisation of premium on SLR investments is net off from the interest income on investments.
- (b) *Interest on Balances with RBI and Other Inter-bank Funds:* This includes interest on balances with Reserve Bank and other banks, call loans, money market placements, etc.

### **Income from Investments**

7.06 Interest and dividend on investments will include

- *Profit on Sale of Investments:* Investments are dealt in the course of banking activity and hence the net profit or loss on sale of investments is taken to profit and loss account.
- *Profit/Loss on Revaluation of Investments:* In terms of guidelines issued by RBI, investments are to be valued at periodical intervals and depreciation or appreciation in valuation should be recognized under this head. The net profit or loss on account of the revaluation of investments held by the bank is reported under this head.

### **Other Income**

7.07 The following items are included under this head:

- (i) *Commission, Exchange and Brokerage: Following heads will be applicable for treasury:*
  - (a) Commission/exchange on remittances and transfers, e.g. demand drafts, NEFT, RTGS, etc.
  - (b) Commission on other permitted agency business including consultancy and other services.
  - (c) Brokerage on securities.



- (d) Fee on insurance referral.
  - (e) Commission on referral of mutual fund clients.
  - (f) Service/transaction banking charges including charges levied for transaction at other branches.
  - (g) Income from rendering other services like custodian, demat, investment advisory, cash management and other fee based services.
- (ii) *Profit on sale of Land, Buildings and Other Assets:* This item includes profit (net of any loss) on gold, silver, etc.
- (iii) *Profit on exchange transactions:* This includes revaluation gains/losses on forward exchange contracts and other derivative contracts, premium income/expenses on options, etc.
- (iv) Income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India.
- (v) Miscellaneous income.

***Profit on Exchange Transactions***

7.08 This item includes profit (net of loss) on dealings in foreign exchange. All income earned by way of foreign exchange commission and charges on foreign exchange transactions except interest are to be included under this head. The audit procedures in this regard would include:

- a) Checking that the year-end outstanding entries are translated /restated at appropriate rates of exchange as communicated by the Controlling-authority, for recording profit/ loss on exchange transactions. After the introduction of CBS, this has become a systems driven adjustment. The auditor should understand the process of foreign exchange rate upload in the system for revaluation of forward contracts and derivative contracts. Each bank has a process to daily upload of day's foreign exchange rate and curves etc. in the system at the specific time. The auditor should verify independently rates on sample basis which are uploaded in the system. The auditor should verify the internal controls in place for such centralized system upload including whether the same are done under appropriate authority. The auditor should also obtain the audit trail from the system to understand whether subsequent modification in system has been made and reason for the same.
- b) Obtaining the revaluation report of outstanding forward exchange contracts and other derivative contracts as on the reporting date and agreeing the currency-wise notional amounts of the forward exchange

contracts and other derivative contracts with the foreign currency general ledger to ascertain completeness of revaluation report. Further, on a sample basis, recompute the valuation of the forward exchange contracts and other derivative contracts using a valuation tool. Further As per AS-11, in recording a forward exchange contract intended for trading or speculation purposes, the premium or discount on the contract is ignored and at each balance sheet date, the value of the contract is marked to its current market value and the gain or loss on the contract is recognised.

- c) Obtaining the bank's risk policy to understand the bank's process of classification of hedge, assessment of hedge effectiveness and accrual of hedge cost. The auditor should obtain the report of hedge transaction outstanding on reporting date and hedge effectiveness.
- d) Testing large transactions and check whether these are recorded in compliance with the directions of the controlling authority.
- e) Scrutinising transactions recorded in the post-balance sheet period to ascertain that no material items have been ignored up to the year end.
- f) Enquiring and obtaining explanations regarding unusual large transactions/entries involving huge gains/ losses for the year and the same needs to be documented in the work paper.

***Income Earned by Way of Dividends, etc. from Subsidiaries and Joint Ventures abroad/in India***

7.09 It may be noted that any income derived from the investment portfolio by way of interest and dividend is not to be included under this head but under the sub-head 'income on investments' under the head 'interest earned'. As investments are usually dealt with at the head office level, this item may not appear in the profit and loss account of a branch.

***Miscellaneous Income***

7.10 This head generally includes following items of income:

Other income from carrying out other services like selling of gold coins etc.

**Expenses**

7.11 Expenditure is to be shown under three broad heads: interest expended; operating expenses; and provisions and contingencies.

## **Interest Expended**

7.12 The following items are included under this head:

- (a) *Interest on Deposits:* This includes interest paid/ payable on all types of deposits including deposits from banks and other institutions. Usually, the rates of term deposits of banks are amended from time to time by the ALCO or the Board. The auditor must verify the internal controls in place to give effect to changes in the CBS system of the Bank.
- (b) *Interest on Reserve Bank of India/ Inter-Bank Borrowings:* This includes interest/ discount on all borrowings and refinance from the RBI and other banks.
- (c) *Others:* This includes discount/ interest on all borrowings/ refinance from financial institutions. All other payments like interest on participation certificates, penal interest paid, etc. may also be included here.

## **Operating Expenses**

7.13 The following items are included under this head:

- (i) *Payments to and Provisions for Employees:* This item includes salaries and wages of staff, allowances, bonus, other staff benefits like provident fund, pension, gratuity, leave fare concession, staff welfare, medical allowance to staff, etc. It may be noted that provision for terminal benefits like pension and gratuity is usually made only at the head office level. Salaries and allowances payable to the bank's staff and officers are usually governed by agreement with the employee unions or awards of a judicial tribunal. The payroll process is generally centralized in all banks. Auditors should ascertain the control available to branch level and test check sample working.
- (ii) *Rent, Taxes and Lighting:* This item includes rent paid by the bank on buildings, municipal and other taxes, electricity charges and other similar charges and levies. Auditor should specifically review cases where rental increases are in dispute & unpaid. Necessary provisions / disclosures should be appropriately made. It may be noted that income-tax and interest on tax are not to be included under this head. Similarly, house rent allowance and other similar payments to staff would not appear under this head.
- (iii) *Printing and Stationery:* This item includes books and forms and stationery

used by the bank and other printing charges except those incurred by way of publicity expenditure. While some stationery may have been purchased by the branch, other stationery (security paper like draft forms, cheque books) would have been received by the branch from the head office. Auditor should specifically note the bank policy in this regard whether the same is expensed out on purchase or on usage. In any case any unusable or outdated stationery should be expensed out. If any Stationery is shown as an asset, necessary physical verifications should be done.

- (iv) *Advertisement and Publicity*: This item includes expenditure incurred by the bank for advertisement and publicity, including printing charges of publicity material. Auditor should specifically review such agreements to find out commitments made for such expenses in future periods.
- (v) *Depreciation on Bank's Property*: This item includes depreciation on bank's own property, motor cars and other vehicles, furniture, electrical fittings, vaults, lifts, leasehold properties, non-banking assets, etc. Depending on the procedure followed in the bank, provision for depreciation may be either centralised at the head office level through fixed asset management software or decentralized and manual at branches and other offices. Auditor should specifically review the useful life at the year end and provide for additional depreciation in case there is any downward revision in the useful life. Auditor should ensure that fixed assets are accounted from the date the asset is put to use. Necessary accounting of the asset to be done & depreciation calculated from this date. Generally, banks account for fixed assets on date of final payment irrespective of the asset being put to use much earlier.

Auditor should note the process for verifying assets booked by branch but allotted to employees & located at Bank residential premises allotted to these employees.

Auditors should verify the calculation of depreciation by exporting the relevant report from software.

- (vi) *Directors' Fees, Allowances and Expenses*: Expenditure incurred in this regard is recorded under this head. This item is dealt with at the head office level and would not therefore be relevant at the branch level.
- (vii) *Auditors' Fees and Expenses*: Remuneration payable to Statutory Auditors and Branch auditors and expenses in connection with audit like

reimbursements are recorded under this head. This item is usually dealt with at the head office level and would not therefore be relevant at the branch level.

- (viii) *Law Charges*: All legal expenses and reimbursement of expenses incurred in connection with legal services are to be included here. Auditor should specifically review the Legal agreements to note future commitments for payables. Expenses paid to advocates recovered from Borrowers by direct debit to that account should be specifically noted for consistency in accounting. The auditor should also co-relate law charges with the contingent liability appearing in financial statement or with the specific annexure/report to be certified by the Branch Auditors'.
- (ix) *Postage, Telegrams, Telephones, etc.*: This item includes all postal charges like stamps, telegrams, telephones, teleprinters, etc. Issuance of Telegrams has been discontinued since 15<sup>th</sup> July 2013 and this head is now just for academic purposes.
- (x) *Repairs and Maintenance*: This item includes repairs to bank's property, their maintenance charges, etc. Amortization of such expenses should be specifically noted.
- (xi) *Insurance*: This item is usually dealt with at the head office level and may not therefore be relevant at the branch level. This includes Premium paid to DICGC, Insurance of Cash on Hand, in ATM & in transit and also Insurance of Fixed Assets, Employee Fidelity Insurance, Fraud Covers, Coverage for Cyber Risks. Auditor should specifically ensure that all risks are insured adequately. Decision not to insure specific risks / assets should be approved at appropriate Management levels & Auditor should obtain the relevant documents for record.
- (xii) *Direct Marketing Expenses*: These are the expenses incurred majorly for sourcing of retails loans/credit cards and collection of retail overdue loans. RBI circular RBI/2006/167/DBOD.NO.BP.40/21.04.158/2006-07 dated 3<sup>rd</sup> November 2006 clearly states that activities of internal audit, compliance function and decision making functions like compliance with KYC norms for opening deposit accounts, according sanction for loans (including retail loans) and management of retail loans cannot be outsourced.
- (xiii) *Other Expenditure*: This item includes all expenses other than those

included in any of the other heads, like, license fees, donations<sup>6</sup>, subscriptions to papers, periodicals, entertainment expenses, travel expenses, etc. The Notes and Instructions for compilation of profit and loss account, issued by the Reserve Bank, require that in case any particular item under this head exceeds one per cent of the total income, particulars thereof may be given in the notes. Auditor should check such large value items reported under this head. Auditors should identify the nature of items and if appropriate account head is available it should be classified in that head. Expenses should be accounted on accrual basis and not on cash basis. The auditor may review payment vouchers of April month to ascertain the correctness of provision made for expenses.

### **Provisions and Contingencies**

7.14 This item represents the aggregate of the provisions made in respect of the following:

- (a) Non-performing investments
- (b) Taxation.
- (c) Diminution in the value of investments.
- (d) Provisions for contingencies.

### **Appropriations**

7.15 Under this head, the net profit/ loss for the year as well as profit/ loss brought forward have to be shown. The appropriations of the aggregate thereof are to be shown under the following heads:

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<sup>6</sup> The Reserve Bank of India, from time to time, prescribes the limits up to which banks can make donations. As per the Reserve Bank of India's circular no. DBOD. No. Dir. BC. 50/ 13.01.01/ 2005–06 dated December 21, 2005, the policy relating to donations given by banks to various entities may be formulated by the Board of Directors of the banks. While formulating any such policy, the circular requires the directors to take into account *inter alia*, the following principles:

- (i) profit making banks, during a financial year, may make donations upto one percent of the published profits for the previous years. This limit of one percent would include contributions made by the bank to any fund created for specific purposes such as encouraging research and development. However, donations/ subscriptions to the Prime Minister's National Relief Fund and to professional bodies related to banking industry, such as the Indian Banks Association, Indian Institute of Banking etc., is excluded from such limit of one percent.
- (ii) loss making banks can make donations upto Rs. 5 lakhs in a financial year including donations to the Prime Minister's National Relief Fund and other professional organisations listed in (i) above.

The circular has clarified that the unutilised portion of one percent cannot be carried forward to the next year. The Circular also outlines the procedure for making contribution to the Prime Minister's National Relief Fund.

- (a) Transfer to Statutory Reserves.
- (b) Transfer to Capital Reserves.
- (c) Transfer to Investment Fluctuation Reserve.
- (d) Transfer to Debenture Redemption Reserve.
- (e) Transfer to Other Reserves.
- (f) Transfer to Government/ Proposed Dividend.
- (g) Transfer to Tax on Dividend.

7.16 The appropriations of profits are decided at the head office level. This item would not therefore appear in the profit and loss account at Treasury

7.17 The auditor should obtain the list of the dividend income booked during the period and agree the total with the general ledger. Income on NPI should be realised on cash basis only.

Readers may note that income on investments has been explained in detail in Chapter 5 of Part III of the Guidance Note.

7.18 *Profit on Sale of Investments:* As per Circular DBOD/BP.BC.34/21//04.19/2010-11 dated 6 August, 2010, investments are dealt in the course of banking activity and hence the profit or losses on sale of investments are taken to Profit & Loss account. The auditor should obtain the investment policy of the bank and understand whether the bank is using FIFO method or weighted average cost method for computing the profit/loss on sale of investments. As investments are usually dealt with at the head office level, this item may not appear in the profit and loss account of a branch.

*Valuation of investment*

7.19 Held to maturity - investment classified under HTM category need not be marked to market and will be carried at acquisition cost, unless it is more than the face value, in which case the premium should be amortized over the period remaining to maturity.

7.20 AFS - the individual scrip in the category will be marked at quarterly or at more frequent intervals.

7.21 *Profit/Loss on Revaluation of Investments:* In terms of guidelines issued by RBI, investments are to be valued at periodical intervals and depreciation or appreciation in valuation is to be recognised under this head. As investments are usually dealt with at the head office level, this item may not appear in the profit and loss account of a branch.

# **PART - IV**

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# IV-1

## Basel III

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### Introduction

1.01 Basel capital adequacy norms are meant for the protection of depositors and shareholders by prescriptive rules for measuring capital adequacy, thereby evolving methods of determining regulatory capital and ensuring efficient use of capital.

1.02 Basel III accord strengthens the regulation, supervision and risk management of the banking sector. It is global regulatory standard on capital adequacy of banks, stress testing as well as market liquidity risk.

1.03 The Basel III accord, aims at:

- a. improving the banking sector's ability to absorb shocks arising from financial and economic stress, whatever may be the source;
- b. improving risk management and governance practices; and
- c. strengthening banks' transparency and disclosure standards.

1.04 Basel II has been fully implemented in all commercial banks (except RRBs and LABs) in India by March 31, 2009. In this regard, the RBI has also issued a Master Circular no. DBR.No.BP.BC.4/21.06.001/2015-16 dated July 1, 2015 on "Prudential Guidelines on Capital Adequacy and Market Discipline - New Capital Adequacy Framework (NCAF)".

1.05 The major changes made in Basel III over Basel II are as under:

- (a) **Quality of Capital:** One of the key elements of Basel III is the introduction of much stricter definition of capital, which means the higher loss-absorption capacity, which in turn would lead to banks becoming stronger with enhanced capacity to withstand periods of stress.
- (b) **Capital Conservation Buffer:** Beginning 31<sup>st</sup> March, 2016, Banks are required to hold capital conservation buffer of 0.625%, which will gradually increase to 2.5% by 31<sup>st</sup> March, 2019. This is to ensure that banks maintain a cushion of capital that can be used to absorb losses during periods of financial and economic stress.

- (c) **Counter cyclical Buffer:** The counter cyclical buffer ensures increased capital requirements in good times and decrease the same during bad times.
- (d) **Minimum Common Equity and Tier 1 Capital Requirement:** The minimum requirement for common equity, the highest form of loss-absorbing capital, has been increased to 5.50% of RWA. The Minimum Tier 1 capital has been increased to 7%, which means that Additional Tier I (AT 1) capital can be maximum of 1.50% of RWA. Though, the minimum total capital (Tier I plus Tier II) requirement remains at 9%, which means that the Tier 2 capital can be admitted maximum of 2% of RWA. With the requirement of gradually maintaining 2.5% of RWA as Capital Conservation Buffer in the form of CET 1, the minimum total capital requirement shall increase to 11.50% of RWA by 31<sup>st</sup> March, 2019.
- (e) **Leverage Ratio:** Analysis of 2008 financial crisis indicates that value of assets went down much more than what was perceived based on their risk rating, which leads to stipulation of Leverage Ratio. Therefore, under Basel III, a simple, transparent, non-risk based leverage ratio has been introduced. A Leverage Ratio is the relative amount of capital to total assets (not risk-weighted). Basel III guidelines recommend leverage ratio of 3% but RBI has currently set the leverage ratio of more than 4.5% for Indian Banks.
- (f) **Liquidity Ratios:** Under Basel III, a framework for liquidity risk management has been set up. Liquidity Coverage Ratio (LCR) has become operational since 1<sup>st</sup> January, 2015.

1.06 Basel III capital regulation has been implemented from April 1, 2013 in India in phases and it will be fully implemented as on March 31, 2019. In view of the gradual phase-in of regulatory adjustments to the Common Equity component of Tier 1 capital under Basel III, certain specific prescriptions of Basel II capital adequacy framework (e.g. rules relating to deductions from regulatory capital, risk weighting of investments in other financial entities etc.) will continue to apply till March 31, 2018 on the remainder of regulatory adjustments not treated in terms of Basel III rules. In this regard, the RBI has also issued a Master Circular no. DBR.No.BP.BC.1/21.06.201/2015-16 dated July 1, 2015 on “Basel III Capital Regulations”.

## **Guidelines on BASEL III Capital Regulations**

1.07 The RBI had issued a circular no. DBOD.No.BP.BC.98/21.06.201/2011-12 dated May 2, 2012 on the subject “Guidelines on Implementation of Basel III Capital Regulations in India”. *Vide* this circular, the RBI has prescribed the final guidelines on Basel III capital regulations. RBI

issued a master circular no. DBR.No.BP.BC.1/21.06.201/ 2015-16 dated July 1, 2015 on Basel III Capital Regulations. Following are main features of these guidelines:

- These guidelines became effective from April 1, 2013 in a phased manner. The Basel III capital ratios will be fully implemented as on March 31, 2019.
- The capital requirements for the implementation of Basel III guidelines may be lower during the initial periods and higher during the later years. While undertaking the capital planning exercise, banks should keep this in view.
- Liquidity Coverage Ratio has been introduced in a phased manner starting with a minimum requirement of 60% from January 01, 2015 and reaching minimum 100% on January 01, 2019.
- The banks are required to disclose capital ratios under Basel III from quarter ending June 30, 2013.

### **Components of Capital**

1.08 Total regulatory capital will consist of the sum of the following categories:

- (i) Tier 1 Capital (going-concern capital)
  - (a) Common Equity Tier 1
  - (b) Additional Tier 1
- (ii) Tier 2 Capital (gone-concern capital)

### **Limits and Minima**

	<b>Regulatory Capital</b>	<b>As % to RWAs</b>
(i)	Minimum Common Equity Tier 1 Ratio	5.5
(ii)	Capital Conservation Buffer (comprised of Common Equity)	2.5
(iii)	Minimum Common Equity Tier 1 Ratio plus Capital Conservation Buffer [(i)+(ii)]	8.0
(iv)	Additional Tier 1 Capital	1.5
(v)	Minimum Tier 1 Capital Ratio [(i) +(iv)]	7.0
(vi)	Tier 2 Capital	2.0
(vii)	Minimum Total Capital Ratio (MTC) [(v)+(vi)]	9.0
(viii)	Minimum Total Capital Ratio plus Capital Conservation Buffer [(vii)+(ii)]	11.5

## Capital – What Constitutes Tier 1 and Tier 2 – a Representative Sample

1.09 The Master Circular on Basel III Capital Regulations discusses the capital funds in two categories – capital funds for Indian banks and capital funds of foreign banks operating in India. The following table shows the components of the capital funds for Indian *vis a vis* foreign banks operating in India:

	Indian Banks	Foreign Banks operating in India
<b>Tier I Capital Common Equity Tier I (CET 1)</b>	Paid up equity capital (ordinary shares) <sup>7</sup>	Interest free funds from Head Office <sup>8</sup>
	Share premium on issue of common shares	
	Statutory reserves	Statutory reserves kept in Indian books
	Capital reserves representing surplus arising out of sale proceeds of assets	Capital reserves representing surplus arising out of sale of assets in India held in a separate account and which is not eligible for repatriation so long as the bank functions in India
	Other disclosed free reserves, if any	Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India
	Revaluation reserves with discount of 55% (with effect from 1 <sup>st</sup> March 2015), subject to meeting conditions prescribed in RBI circular dated 1 <sup>st</sup> March 2016	Revaluation reserves with discount of 55% (till 29 <sup>th</sup> February 2016), subject to meeting conditions prescribed in RBI circular dated 1 <sup>st</sup> March 2016
	Foreign currency translation reserve arising due to translation of financial statements of their foreign operations in terms of Accounting Standard (AS) 11 at a discount of 25%, subject to meeting conditions	Foreign currency translation reserve arising due to translation of financial statements of their foreign operations in terms of Accounting Standard (AS) 11 at a discount of 25%, subject to meeting conditions prescribed in RBI circular dated 1 <sup>st</sup> March 2016

<sup>7</sup> Refer Annexure 1 to Master Circular on Basel III Capital Regulations for criteria.

<sup>8</sup> Refer Annexure 2 to Master Circular on Basel III Capital Regulations for criteria.

	prescribed in RBI circular dated 1 <sup>st</sup> March 2016	
	Balance in Profit & Loss Account at the end of the previous financial year	
	Profits of current financial year on a quarterly basis provided the incremental provisions made for NPA at the end of any of the four quarters of the previous financial year have not deviated more than 25% from the average of the four quarters with certain adjustments given in the Master Circular	
		Interest free funds remitted from abroad for the purpose of acquisition of property and held in a separate account in Indian books provided they are non-repatriable and have the ability to absorb losses regardless of their source
	Less: Regulatory adjustments / deductions applied in the calculation of Common Equity Tier 1 capital	Less: Regulatory adjustments / deductions applied in the calculation of Common Equity Tier 1 capital
<b>Additional Tier I (AT 1)</b>	Perpetual non-cumulative preference shares <sup>9</sup>	Head office borrowings in foreign currency by foreign banks operating in India as per criteria <sup>10</sup>
	Share premium on instruments included in AT 1 capital	
	Debt Capital instruments including Perpetual Debt instruments <sup>11</sup>	
	Any other instrument notified by RBI from time to time	Any other instrument notified by RBI from time to time

<sup>9</sup> Refer Annexure 3 to Master Circular on Basel III Capital Regulations for criteria.

<sup>10</sup> Refer Annexure 4 to Master Circular on Basel III Capital Regulations for criteria.

<sup>11</sup> Refer Annexure 4 to Master Circular on Basel III Capital Regulations for criteria.

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	Less: Regulatory adjustments / deductions applied in the calculation of Additional Tier 1 capital	Less: Regulatory adjustments / deductions applied in the calculation of Additional Tier 1 capital
<b>Tier II Capital</b>	Revaluation reserves with discount of 55% (till 29 <sup>th</sup> February 2016)	Revaluation reserves with discount of 55% (till 29 <sup>th</sup> February 2016)
	General provisions and loss reserves	General provisions and loss reserves
	Debt Capital instruments <sup>12</sup>	Head Office (HO) borrowings in foreign currency received as part of Tier 2 debt capital
	Perpetual Cumulative Preference Shares (PCPS)/ Redeemable Non-Cumulative Preference Shares (RNCPS) / Redeemable cumulative preference shares(RCPS) <sup>13</sup>	Perpetual Cumulative Preference Shares (PCPS)/ Redeemable Non-Cumulative Preference Shares (RNCPS)/ Redeemable cumulative preference shares (RCPS) <sup>14</sup>
	Premium on instruments included in Tier 2	
	Less: Regulatory adjustments / deductions applied in the calculation of Tier 2 capital	Less: Regulatory adjustments / deductions applied in the calculation of Tier 2 capital

1.10 In case of foreign banks operating in India, RBI's Master Circular on Capital Adequacy also lays down certain additional provisions in respect of capital to be followed by such banks.

1.11 Capital instruments which no longer qualify as AT 1 capital or Tier 2 capital (e.g. IPDI and Tier 2 debt instruments with step-ups) will be phased out beginning January 1, 2013. Fixing the base at the nominal amount of such instruments outstanding on January 1, 2013, their recognition will be capped at 90% from January 1, 2013, with the cap reducing by 10% in each subsequent year. This cap will be applied to Additional Tier 1 and Tier 2 capital instruments separately and refers to the total amount of instruments outstanding which no longer meet the relevant entry criteria. The following chart graphically depicts the provisions relating to such instruments:

<sup>12</sup> Refer Annexure 5 to Master Circular on Basel III Capital Regulations for criteria.

<sup>13</sup> Refer Annexure 6 to Master Circular on Basel III Capital Regulations for criteria.

<sup>14</sup> Refer Annexure 6 to Master Circular on Basel III Capital Regulations for criteria.



**Deductions from CET I, AT I and Tier II**

1.12 The deductions from CET I, AT I and Tier II are tabulated below:

Item	Extent of Deduction (in %)		
	CET I	AT 1	Tier II
Intangible assets including Goodwill	100	---	
Losses in the current period	100	---	
Losses brought forward from previous periods	100	---	
Deferred tax asset associated with accumulated losses	100	----	
Cash Flow hedge reserve	100	---	
Shortfall of provisions to expected losses	100	---	
Gains on sale related to securitisation transactions	100	---	
Cumulative Gains and losses due to changes in own credit risk on fair valued liabilities	100	---	
Defined benefit pension fund liabilities and un-amortised employees' benefits	100	-	
Investments in own shares (if not already netted off paid-up capital on reported balance sheet) including indirect investments	100	---	
DTAs which relate to timing differences (other than those related to accumulated losses)	Excess of 10% of CET-1	----	
DTAs on timing difference along with limited recognition of significant investments in the common shares of unconsolidated financial (i.e. banking, financial and insurance) entities taken together	Excess of 15% of CET-1		
Equity investments in insurance subsidiaries	100		
Investments in equity instruments of other subsidiaries and capital of other Banks, insurance companies etc. which is more than 10% of Bank's CET1	100		
Equity investments in non-financial subsidiaries	100		
Intra group transactions beyond permissible limits	100		



Reciprocal cross investments in capital of other banks in the same component of capital	Full	Full	Full
Securitization exposure	50	50	
Investment in financial subsidiaries and associates which is above 30 per cent in the paid up equity of entity and not consolidated for the capital adequacy purposes	50	50	
Shortfall in the regulatory capital requirements in the de-consolidated entity	50	50	
Such amount of investment in the following which is in excess of 10% of investing bank's capital funds: <ul style="list-style-type: none"> <li>• Equity shares;</li> <li>• Perpetual Non- Cumulative Preference Shares;</li> <li>• Innovative Perpetual Debt Instruments;</li> <li>• Upper Tier II Bonds;</li> <li>• Upper Tier II Preference Shares;</li> <li>• Subordinated debt instruments; and</li> <li>• Any other instrument approved as in the nature of capital.</li> </ul>	50	50	
Investments made by a banking subsidiary/associate in the equity or non-equity regulatory-capital instruments issued by its parent bank	50	50	
If net overseas placements with Head Office/other overseas branches/other group entities exceed 10% of the bank's minimum CRAR requirement, the amount in excess of this limit would be deducted from Tier I capital	100	---	

### Capital to Risk-weighted Assets Ratio (CRAR)

1.13 The RBI requires banks to maintain a minimum CRAR of 9 per cent on an ongoing basis. The Master Circular on Capital Adequacy contains detailed guidelines on calculation of risk weighted assets and off-balance sheet items and CRAR.

1.14 The CRAR is computed as follows:

$$\frac{\text{Eligible Total Capital funds} \times 100}{\text{Credit Risk RWA} + \text{Market Risk RWA} + \text{Operational Risk RWA}}$$

1.15 The minimum CRAR is required to be maintained at consolidated level also as per Basel III guidelines. The requirements mentioned above relates to standalone Bank only. For the requirement for the consolidated capital, the readers may refer the Master Circular on Basel III Capital Regulations.

### **Board Oversight**

1.16 The board of directors and senior management of each subsidiary/overseas branch should be responsible for conducting their own assessment of the subsidiary's/overseas branch's operational risks and controls and ensuring the subsidiary/overseas branch is adequately capitalised in respect of those risks.

### **Disclosure (Pillar 3)**

1.17 Pillar 3 aims primarily at disclosure of a bank's risk profile and capital adequacy. It is recognised that the Pillar 3 disclosure framework does not conflict with requirements under accounting standards, which are broader in scope. The banks in India have to follow Pillar 3 disclosure over and above the RBI master circular on "Disclosure in Financial Statements - Notes to Accounts". Information would be regarded as material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information. Pillar 3 disclosures will be required to be made by the individual banks on a standalone basis when they are not the top consolidated entity in the bank.

### **Role of Auditors of Banks**

1.18 Based on RBI appointment letter, the external auditors of the bank are required to provide a certification on the capital adequacy ratio computation. The auditor needs to understand more comprehensively the approach and mechanism adopted by the bank, and accordingly certify the computation. Considering the intricacies involved in the computation itself further supplemented by enhanced judgement factor, it would be prudent for the certifying auditor to obtain an adequate understanding of the Basel III norms as prescribed by RBI and also deploy more senior members of its staff to audit the capital adequacy computations.

1.19 Further, some banks may also avail services of their external auditors to review the quality of internal controls and systems, and assess the scope and adequacy of the internal audit function.

1.20 In the concept of Basel III, the capital computation is primarily aimed from central/head office perspective. Basel III is not only about capital adequacy but is also about creating a robust risk management structure. Hence, apart from the capital adequacy computation, the auditors should verify the robustness of the risk management structure embedded in the bank, across its branches. This risk management spreads across all the types of risk, i.e., credit risk, market risk and operational risk. Hence, the auditors also play a critical role in ensuring that the bank has adopted a consistent practice and as part of their attest function report on its appropriateness of risk management practice as well on the RWA.

### **Role of Branch Auditors**

1.21 In case of credit risk management, the underlying computation for Basel III is based on credit ratings, which may be driven centrally and passed on to branches such that branches follow head office instructions in its entirety. This way the bank branch auditors check only the computation process and test check the source rather than getting into the credit rating process. The branch auditors can assess any issues relating to completeness and correctness of the data, which is used to compute the underlying risks emanating from credit market and operational risk. It is finally the pyramid approach whereby all the data from branches will get consolidated at head office. The statutory central auditors may choose to test check certain source data and also verify the basis considered at the head office.

1.22 It will not be practical to expect the branch to comprehensively understand the Basel III requirements in its entirety. The bank branch auditor should assess the sufficiency of the instructions provided to the branch by the head office and its adherence at the branch level. Any errors at bank branch level can have a cascading effect at the head office, especially when a large number of branches are involved.

1.23 The Statutory Central Auditors should primarily look into the computation of components of various capital as part of their attest function. As regards the overall capital adequacy computation, particularly with respect to RWAs, while the granular data may have been audited by the Branch Statutory Auditors, the Statutory Central Auditors, apart from verifying the consolidation of data emanating from branches/regions/zones/circles etc. should perform the test

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of reasonableness as well as completeness. As per requirements set by the RBI, the Statutory Central Auditors are required to certify the capital adequacy computation. The Statutory Central Auditors may review the work done by internal auditors, as may be stipulated by the management or the regulators. The Basel Accord does provide specific areas where internal auditors play a role. An Illustrative Audit Checklist for Capital Adequacy is given in **Appendix X** of the Guidance Note.

## IV-2

# Special Purpose Reports and Certificates

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### Introduction

2.01 The SBAs / SCAs have to issue various certificates at branch / Head Office level. SBAs/SCAs should ensure the correctness of financial implication caused due to such frauds and confirm that the adequate provision for the same has been effected.

### Regulatory Requirements

2.02 The Reserve Bank of India *vide* its Master Direction No: DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 Dated July 01, 2016 (updated July 03, 2017) on “Frauds- Classification and Reporting”, issued guidelines for classification of frauds and reporting of frauds to RBI, Central Office as well as the concerned regional office of the Department of Banking Supervision / Financial Conglomerate Monitoring Division (FCMD) at Central Office under whose jurisdiction the bank’s Head Office/branch is situated. The reporting requirements for various categories of frauds based on financial exposure are specified in the aforesaid Master Directions.

2.03 While issuing a special purpose report or certificate, the auditors should bear in mind the recommendations made in the Guidance Note on Reports or Certificates for Special Purposes (Revised 2016) issued by the Institute of Chartered Accountants of India (ICAI).

### Audit Approach

2.04 The SBAs may verify the contents of certificates to be issued at branch level. All the Returns submitted by branch to various higher authorities of the respective bank and also to various authorities of the regulators as per the Master Directions dated July 03, 2017 shall be verified. Branch Auditors should ensure the correctness of financial implication caused due to such frauds and confirm that the adequate provision for the same has been effected.

2.05 SCAs of the bank may verify the compilation of all such reports received from SBAs regarding the frauds and check whether adequate provision for the same is effected at Head Office. SCAs should also verify the returns submitted by the bank to regulators regarding such frauds during the year under audit.

2.06 SCAs may verify the methodology used by the bank in reporting of such frauds from branches to regional / zonal / circle offices and to head office. SCAs shall verify the existence of internal control mechanism in place to ensure completeness and correctness of such reporting and classification of frauds in the bank.

2.07 SCAs may also check the reporting and classifications of frauds at the Head Office level, where the cases other than those reported through reports SBAs are considered.

2.08 SCAs may also check that the Board of Directors and Audit Committee of bank are being regularly updated with reporting and classification on frauds throughout the year under audit.

## **Certificates and Reports**

2.09 In addition to their audit reports, the SBAs and SCAs may also be required by their terms of engagement or statutory or regulatory requirements to issue other reports or certificates. For example, presently, the branch auditors are required to issue reports/certificates on the following matters besides their main audit report:

- Long Form Audit Report for Branch.
- Report on whether the income recognition, asset classification and provisioning have been made as per the guidelines issued by the RBI from time to time.
- Report on audit of DICGC items, wherein auditors have to specifically verify and certify the correctness of the data in various returns and the insurance premiums paid to DICGC.
- Report on status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to

frauds and malpractices and of the recommendations of the Jilani Committee on internal control and inspection/credit system.

- Certificate for Prime Minister Rozgar Yojna for Unemployed Youth.
- Certificate of cash and bank balances.
- Certificate relating to MOC entries of the previous years being accounted for.
- Certificate relating to credit/ deposit ratio.
- Certification of technology up gradation fund scheme (TUFS) – non SSI textile centre.
- Certification for advances to infrastructure project and income generated thereon.
- Statement of accounts Re-structured/ Re-scheduled/ Re-negotiated related to CDR and non-CDR accounts.
- Certificate of advances exceeding Rs.10 Crores.
- Certificate regarding Special Deposit Scheme, 1975.
- Certificate regarding Compulsory Deposit (Income-tax Payers) Scheme, 1974.
- Certificate relating to recoveries in claim paid accounts under Small Loans Guarantee Scheme 1971/Small Loans (SSI) Guarantee Scheme, 1981.
- Certification of Borrowal Companies by Chartered Accountants/Company Secretaries (as per RBI circular on “Lending under Consortium Arrangements/ Multiple banking Arrangements” dated December 08, 2008.
- Certificate on Capital Adequacy.
- Certificate for Gold Stocks held for Sale of Gold/Metal Gold Loans.
- Certificate for Gold Coins Held.
- Certificate for Gold Deposit Scheme.
- Certificate for IRAC Status of Credit Exposure in respect of Non-Performing Investments.

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- Certificates for IRAC Status of Credit Exposure in respect of borrowers having exposure with foreign offices.
- Certificate for agricultural interest subvention claim @2% for residual period of repayment of the loans disbursed during Financial Year.
- Certificate for agricultural interest subvention claim @2% for disbursements made during Financial Year.
- Certificate for additional interest subvention (Incentive @3%) for prompt repayment for short term production loans disbursed during Financial Year. Certain other certificates as may be prescribed by the concerned bank in their respective closing instructions or appointment letters.
- Certificate on Unhedged Foreign Currency Exposure in case of Borrowal having exposure of 1 crore or more.
- Certificate on exposure to sensitive sectors, i.e. exposure to Capital Market, Infrastructure & Real Estate Sector.

2.10 Besides this, SCAs are required to give following certificates/reports:

- Certificate on Corporate Governance.
- Report on whether the treasury operations of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.
- Certificate on reconciliation of securities by the bank. (Both on its own investment account as well as PMS clients' account).
- Certificate on compliance by the bank in key areas of prudential and other guidelines relating to such transactions issued by the RBI.
- Certificate in respect of custody of unused BR forms and their utilisation. (as such banks do not use BR forms any more. Further it is difficult to certify unused forms as they are not available for verification. This certificate should be strictly based on and against the management representation. The auditor is advised to bring out this fact clearly in the certificate.)
- Various ratios and statements in the "Notes on Accounts".
- Report on instances of adverse credit- deposit ratio in the rural areas.



- Certification on correctness of computation of DTL / NDTL.
- Report on compliance with CRR and SLR requirements.
- Certification in respect of subsidy claimed by the bank under the PMRY Scheme during the financial year.
- Certificate on compliance by bank on recommendations of:
  - Ghosh Committee, regarding frauds and malpractices in banks.
  - Jilani Committee, regarding internal control system in banks.
  - Dr. N. L. Mitra Committee, regarding maintenance of legal compliance certificate for credit sanction and other transactions of Rs. 1 crore and above.
- In line with the Master Directions on frauds, the SCAs to ensure that all the branches have complied with the reporting as required by the said circular and respective SBA certificates are being received. A separate Report should be given on any matter susceptible to be a fraud or a fraudulent activity or any foul play in any transaction. In cases where the amount of fraud brought to the notice during audit and has remained to be reported, the auditors are advised to report such instances directly to the CGM, Central office of Department of Banking Supervision, RBI, Mumbai.
- Certain other certificates as may be prescribed by the concerned bank in their respective closing instructions or appointment letters.

# IV-3

## Compliance with Implementation of Ghosh & Jilani Committee Recommendations

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### Introduction

3.01 The RBI had set up a High Level Committee on Frauds and Malpractices in Banks under the Chairmanship of Shri A. Ghosh, the then Deputy Governor, RBI to enquire into various aspects of frauds and malpractices in banks with a view to make recommendation to reduce such incidence. The Committee submitted its Report in June, 1992. The recommendations contained in the report are related to frauds and malpractices in banks.

3.02 The RBI had set up a “Working Group to Review the Internal Control and Inspection and Audit System in Banks” under the Chairmanship of Mr. Rashid Jilani. The Working Group was constituted in February, 1995 to review the efficiency and adequacy of internal control and inspection and audit system in banks with a view to strengthening the supervision system, both on-site and off-site, and ensuring reliability of data.

### Regulatory Requirements

#### Ghosh Committee Recommendations

3.03 The RBI in its efforts towards ensuring a strong, efficient and resilient banking system in the country, vide its Circular No. DBS.Co.PPP.BC.No.39/ND-01.005/99-2000 dated November 1, 1996, issued instructions relating to frauds and malpractice in banks. The Circular was issued for the implementation of the 44<sup>th</sup> report of the Committee on Government Assurances – Ghosh and Jilani Committees’ Recommendations.

3.04 The recommendations are divided into four groups as under:

- (i) *Group-A*: Recommendations, which have to be implemented by the banks immediately.
- (ii) *Group-B*: Recommendations requiring RBI’s approval.
- (iii) *Group-C*: Recommendations requiring approval of Government of India.

(iv) *Group-D*: Recommendations requiring further examination in consultation with IBA.

3.05 The RBI has summarised each of these recommendations for the purpose of reporting of their implementation by the banks, in a 'yes' or 'no' format. The RBI has also categorised these recommendations into:

- (i) applicable to branches;
- (ii) applicable to Controlling Offices like, Regional and Zonal Offices (some banks may have some other name for controlling offices);
- (iii) applicable to Head Office; and
- (iv) applicable to Treasury Operations.

3.06 The report of the Ghosh Committee deals, mainly with the issues related to day-to-day administrative functions that take place in a bank. The main objective behind the recommendations contained in the Ghosh Committee Report is to ensure that there exists a proper system in banks to ensure the safety of assets, compliance with the laid down policies and procedures, accuracy and completeness of the accounting and other records, proper segregation of duties and responsibilities of the staff and also timely prevention and detection of frauds and malpractices.

## **Jilani Committee Recommendations**

3.07 The 44<sup>th</sup> Report of the Committee on Government Assurances expressed concern that despite reporting of the compliance with recommendations of the Jilani Committee, by the controlling office/branches, the same might have not been implemented. Accordingly, RBI laid down the following procedure to ensure the implementation of recommendations:

- A format containing 25 questions was issued to indicate the answer as either "Implemented" or "Not Implemented".
- Information received from all branches and ROs/ZOs to be consolidated at Head Office level and submission of consolidated statement to RBI.
- Implementation of recommendations to be verified during concurrent audit/inspection of branches/controlling offices and comment on the same to be included in their report.

3.08 The report of the Jilani Committee contains twenty five (25) recommendations which can broadly be divided into three categories, (i) dealing with the EDP environment in the banks, (ii) dealing with the inspection/internal audit system in the bank and (iii) deal with other

miscellaneous aspects of functioning of a bank. The RBI has summarised each of these recommendations for the purpose of reporting of their implementation by the banks, in a 'Implemented' or 'not implemented' format. Some of the recommendations of Jilani Committee are to be implemented by the banks at the branch office level, whereas some others are applicable to the regional/zonal/head office level. However, some recommendations find applicability at all levels.

## **Responsibility of the Management**

3.09 The RBI, vide its subsequent Circular dated June 28, 2002, issued to the banks has required the concurrent auditors and inspectors of the bank branches/controlling offices to verify and comment in their reports as to the status of implementation of the recommendations of the Ghosh and the Jilani Committees in the banks.

3.10 In terms of the letters issued to the banks regarding appointment of the statutory central auditors by the RBI, the auditors are also required to verify and comment upon the compliance by the bank in regard to the status of the implementation of the recommendations of the Ghosh and the Jilani Committees.

3.11 From the above it is clear that the implementation of the recommendations of the Ghosh and the Jilani Committees is the responsibility of the management of the banks. The responsibility of the statutory auditors is to verify and report on the status of implementation of these recommendations, thus far and no further. The results of the verification carried out by the statutory auditor and his comments thereon would be given in a separate report.

3.12 RBI through its Master Circular No. DBR. No. Dir. BC.11/13.03.00 /2015-16 dated July 1, 2015 on "Guarantees and Co-acceptances" has required that Banks should implement the following recommendations made by the Ghosh Committee:

- (i) In order to prevent unaccounted issue of guarantees, as well as fake guarantees, as suggested by IBA, bank guarantees should be issued in serially numbered security forms.
- (ii) Banks should, while forwarding guarantees, caution the beneficiaries that they should, in their own interest, verify the genuineness of the guarantee with the issuing bank.

3.13 RBI through its Master Circular "Loans and Advances – Statutory and Other Restrictions" (DBR.No.Dir.BC.10/13.03.00/2015-16) dated July 1, 2015

requires that banks should ensure compliance with the recommendations of the Ghosh Committee and other internal requirements relating to issue of guarantees to obviate the possibility of frauds in the areas of issuance of Bank Guarantees in favour of Financial Institutions, credit facilities extending to bank against the guarantees issued by other banks/FIs and advancement of Gold (Metal) Loans.

3.14 In this regard, it may be noted that the RBI has also issued Master Directions on Frauds – Classification and Reporting by commercial banks and select FIs (RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 dated July 1, 2016 updated July 03, 2017)). These directions deal with Classification of Frauds, Reporting of Frauds to RBI, Quarterly Returns, Reports to the Board, Fraud Monitoring Returns, etc. and the auditor should verify the compliance of the same.

3.15 The RBI has issued a Master Circular on “Willful Defaulters” (DBR.No.CID.BC.22/20.16.003/2015-16 dated July 01, 2015) which also specifies the role of auditors including recommendations about action to be taken against negligent / deficient auditors wherein falsification of accounts on the part of borrower is observed. Further, it specifies that to monitor end-use of funds, if the lenders desire a specific certification from the borrowers’ auditors regarding diversion / siphoning of funds by the borrower, the lender should award a separate mandate to the auditors for the purpose. In addition to this, banks are advised that with a view to ensuring proper end-use of funds and preventing diversion/siphoning of funds by the borrowers, lenders could consider engaging their own auditors for such specific certification purpose without relying on certification given by borrower’s auditors. However, this cannot substitute bank’s basic minimum own diligence.

3.16 In order to ensure that directors are correctly identified and in no case, persons whose names appear to be similar to the names of directors appearing in the list of willful defaulters, are wrongfully denied credit facilities on such grounds, bank/FI have been advised to include the Director Identification Number (DIN) as one of the fields in the data submitted by them to RBI/CIC.

3.17 In terms of Para 2.9 of Master Circular on Willful Defaulters as stated above, Banks / FIs have already been advised to submit the list of suit-filed accounts and non-suit filed accounts of willful defaulters of Rs. 25 lakh and above on a monthly or more frequent basis to all the four Credit Information Companies. This would enable such information to be available to the banks / FIs on a near real time basis.

3.18 Further, in terms of RBI Circular RBI/2016-17/284 Ref. DBS.CO.PPD.BC.No.9/11.01.005/2016-17 dated April 20, 2017, compliance to the

Ghosh Committee recommendation also need not be reported to Audit Committee of the Board of Directors (ACB). However, banks are advised to ensure that:

- i) Compliance to these recommendations is complete and sustained,
- ii) These recommendations are appropriately factored in the internal inspection/audit processes of banks and duly documented in their manual/ instructions, etc.

## **Audit Approach and Procedures**

3.19 The RBI has prescribed separate formats to be filled in by the banks for reporting on compliance with/ implementation of the recommendations of the Ghosh and Jilani Committees. The responsibility of the statutory auditors is to certify the status of compliance with/ implementation of the recommendations of the Ghosh and Jilani Committees. Accordingly, the following procedures may be adopted by the statutory auditors of branches as well as the Statutory Central Auditors for certifying the compliance/ implementation status of the Ghosh and Jilani Committees recommendations.

- In case of the branch, the SBA shall enquire from the management of the branch whether it has prepared the prescribed report on the implementation status of the recommendations of the Ghosh and Jilani Committees. If yes, then whether the same has been forwarded to the Head Office for necessary action. If no, then the auditor should obtain necessary representation from the management as to why the report has not been prepared and/ or submitted and should appropriately qualify his report.
- In case of the Head Office, the SCA shall obtain a confirmation from the management whether it has received the report on the implementation status of the recommendations of the Ghosh and Jilani Committees from all the branches, regional/ zonal offices, etc. and also whether it has prepared the status report as applicable to the Head Office level. The SCA shall obtain a list of the branches, regional/ zonal offices which have not submitted the prescribed report. Such a list would help the SCA to have a broad idea as to the extent of implementation of the recommendations by the bank as a whole.
- The SCA should obtain and review a copy of the implementation status report(s) so prepared and submitted. Such a review would help the auditors identify areas which are susceptible to fraud/ malpractices. The results of such a review may also require the auditor to re-consider the

nature, timing and extent of the procedures adopted by him for carrying out the audit as well as his audit findings.

- In case of Branch audit, where the concerned branch has been subjected to a concurrent audit, then the report of the concurrent auditor on the status of implementation of the recommendations of the Ghosh and Jilani Committees should also be obtained. In case, the branch is not subject to a concurrent audit, the SBA should enquire whether it had been subjected to any inspection either by the in-house inspection department or by the inspectors of the RBI. The auditor should review the comments, if any, of the concurrent auditor or such inspectors on the said implementation status report.
- The SCA may also request the management to provide a list of branches which had been subject to a concurrent audit/ inspection by the in-house inspection department or the inspectors from the RBI. SCA may, if considered necessary, select some such branches and review the comments of the concurrent auditors/ inspectors on the status of implementation of the recommendations. This would help to identify any common cause of concern among the bank branches.
- Where the status report, as prepared by the management indicates that any of the recommendations have not been implemented, the SCA/SBA should request the concerned management to give a written representation as to why the particular recommendation(s) has/have not been implemented.
- The SBA/SCA may also consider it necessary to carry out test checks to ensure whether the recommendations which have been said to have been implemented in the status report have indeed been implemented by the management.

3.20 In case, SBA/SCA examination reveals that any of the recommendations indicated as having been implemented have in fact not been implemented by the management, or where there is a failure to comply with any of the recommendations of the two Committees, would not only indicate a weakness in the internal control system in the bank but also raise doubts as to the integrity of the management. The auditor may, accordingly, also need to re-consider the nature, timing and extent of other audit procedures as also the truth and accuracy of any other management re-presentations obtained by the auditor.

## **Certificate / Report**

3.21 Based on the work done, the auditor should assess whether any information obtained during the verification indicates that any of the recommendations of the Ghosh and Jilani Committees have not been implemented, either in full or in part. The auditor may consider expressing either disclaimer or appropriate comments in respect of certain clauses such as Item Nos. 1.1 and 1.11 of Part II of Group A of Ghosh Committee.

3.22 The above-mentioned Certificate should describe the scope of the verification undertaken to enable the readers to understand the nature of work performed and make it clear that a full-fledged investigation had not been undertaken. The Certificate of the auditor should also draw attention to the following facts:

- That the responsibility for the implementation of the recommendations of the Ghosh and the Jilani Committees is solely that of the management of the bank.
- That the auditor has also considered the reports of all or certain, as the case may be, concurrent auditors/inspectors of the bank branches on the status of implementation of the recommendations of the Ghosh and Jilani Committees at the branch office and controlling offices.
- That the verification was limited primarily to enquiries and obtaining confirmations from the management and other appropriate persons.
- That the auditor has carried out test checks to assess the status of implementation of the recommendations of the Ghosh and Jilani Committees.

3.23 The *Annexure A* to this Chapter provides an illustrative format of the auditor's certificate w.r.t. compliance with/ implementation of the recommendations of the Ghosh and Jilani Committees.



**Annexure A**

**Illustrative Format of Certificate w.r.t. Compliance/ Implementation Status of the Recommendations of the Ghosh and Jilani Committees**

We have examined the attached Format of compliance/ implementation by \_\_\_\_\_ (*name of bank/ bank branch/Department/Zonal Office*) with the recommendations of the Ghosh Committee relating to Frauds and Malpractices in Banks and Format of Progress in Implementation of Jilani Committee recommendations, as prepared by the management. The responsibility for compliance with/ implementation of the recommendations of the Ghosh and the Jilani Committees is that of the management of the \_\_\_\_\_ (*name of the bank/ bank branch/Department/Zonal Office*). Our responsibility is to examine the report on the status of compliance therewith as contained in the attached Formats, as prepared by the management, thus far and no further.

We have not carried out an investigation into the status of compliance by/ implementation of the management with the recommendations of the Ghosh and Jilani Committees. Our examination is limited to inquiries and obtaining confirmations from the management and other appropriate persons and test checks of the attached status of recommendations.

Based on our above examination, subject to the matter highlighted below, we certify that to the best of our knowledge and belief and according to the information and explanation given to us and as shown by the records examined by us, the attached Formats of compliance with the recommendations of the Ghosh and Jilani Committees, as prepared by the management is correct.

1. ....
2. ....

Date:

Place:

For and on behalf of  
Chartered Accountants  
(Firm Registration No.)

.....  
(Name and Designation)  
(Membership Number)

## Other Aspects

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### Introduction

### Regulatory Requirements

#### Head Office

4.01 Apart from examination of consolidation of branch returns, verification of capital and reserves, and verification of investments and provisioning in respect thereof, the Statutory Central Auditors also usually deal with the following items:

- depreciation on assets like, premises, etc. where the recording of the relevant fixed assets is centralised at the head office;
- provisions for certain employee costs, such as, bonus/ex-gratia in lieu of bonus, gratuity, leave encashment, pension and other retirement benefits;
- provision for taxation;
- provision for audit fee;
- provisions to meet any other specific liabilities or contingencies the amount of which is material, for example, provision for revision in pay-scales of employees, provision for foreign exchange fluctuations, etc; and
- dividends.

#### Provisioning for Non-performing Assets

4.02 The prudential norms issued by the RBI prescribe the percentage of provision to be made in respect of advances classified under different categories, viz., standard, sub-standard, doubtful and loss assets. In this context, the RBI has issued “Master Circular – Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances” (DBOD.No.BP.BC.2/21.04.048/2015-16) dated July 1, 2015. The primary responsibility for making adequate provisions for any diminution in the value of loan assets, investment or other assets is that of the bank management and the statutory auditors. The assessment made by the inspecting officer of the RBI is furnished to the bank to assist the bank management and the statutory auditors in taking a decision in regard to making adequate and necessary provisions in terms of prudential guidelines. It may be emphasised that the

percentages prescribed by the RBI reflect the minimum proportion of an advance that a bank ought to provide for to comply with the guidelines. A bank can, at its discretion, make a higher provision than that required under the prudential guidelines. Further, the bank needs to ensure that the bank complies with the PCR (Provision Coverage Ratio) as prescribed by RBI.

4.03 As per RBI Circular RBI/2016-17/283 DBR.BP.BC.No.63/21.04.018/2016-17 dated April 18, 2017 issued under the provisions of Section 35A of the Banking Regulation Act, 1949, Banks are required to make disclosures as per Annexure to the said circular, wherever either (a) the additional provisioning requirements assessed by RBI exceed 15 percent of the published net profits after tax for the reference period or (b) the additional Gross NPAs identified by RBI exceed 15 percent of the published incremental Gross NPAs<sup>1</sup> for the reference period, or both. The disclosures, as above, shall be made in the Notes to Accounts in the ensuing Annual Financial Statements published immediately following communication of such divergence by RBI to the bank. The disclosures in the Notes to Accounts to the Annual Financial Statements may be included under the sub-head Asset Quality (Non-Performing Assets) as referred to in paragraph 3.4 of Master Circular - Disclosure in Financial Statements - Notes to Accounts Ref. DBR.BP.BC No.23 /21.04.018/2015-16 dated July 1, 2015. RBI has further stated that any contravention / non-compliance of the above instructions shall attract penalties under the Act. While the requirement is to make disclosures in the annual financial statements, auditors of listed banks may consider including such disclosures in the quarterly financial results in the quarter in which the RBI inspection report is received.

4.04 It has also been mentioned earlier that provisions in respect of non-performing assets are usually not made at the branch level but at the head office level. The amount of provision (or minimum amount) to be made at the head office level is based on classification of assets into standard, sub-standard, doubtful and loss assets. Branch returns contain analysis of the advances into these categories. The central auditor examines prima facie the correctness of the classification as a part of his examination of consolidation of branch returns. The branch auditors' reports may also point out cases where in their opinion, there are threats to recovery that warrant a higher amount of provision than that arrived at on the basis of the percentages specified by the RBI.

4.05 The auditor should examine whether the provision made by the management at the head office level meets the minimum provisioning requirements prescribed by the RBI and also takes into account the threats to recovery in specific cases. With regard to the latter, the auditor should ensure that the provision made by the management is not less than that recommended

by the respective branch auditors unless, based on the information and explanations, which were not available to the branch auditors, he holds a contrary view, or unless he otherwise believes that the branch auditors' objections have been met or are not of such nature and significance as to warrant a provision in the overall context of the bank as a whole.

4.06 The Third Schedule to the Banking Regulation Act, 1949 lays down the requirements of disclosure concerning advances. Accordingly, advances are required to be classified under various heads (Notes and Instructions for Compilation of Balance Sheet and Profit and Loss Account, issued by the RBI require that provisions made to the satisfaction of the auditors should be excluded from advances under each head). The concern of the auditor is with the overall adequacy of provisions in respect of each of the heads under which advances are required to be shown in the balance sheet of a bank. Thus, for example, the auditor has to examine the adequacy of the overall provisions recommended by the bank separately in respect of (a) bills purchased and discounted, (b) cash credits, overdrafts and loans repayable on demand, and (c) term loans. Similarly, the auditor should examine the overall adequacy of the provisions recommended under each of the other heads of advances in the balance sheet. If, in his opinion, the overall provision recommended by the bank in respect of any of the heads is inadequate, 'the auditor should consider if his report needs to be modified with reference to the requirements of Standard on Auditing (SA) 705 (Revised), Modifications to the Opinion in the Independent Auditor's Report.

4.07 The RBI has specified that advances against book debts may be included under the head 'secured by tangible assets'.

### **Recognition of Certain Expenses**

4.08 Certain expenses, such as the following, are usually recognised at the head office level (or at zonal or regional level):

- (a) Directors' fees, allowances and expenses;
- (b) Insurance;
- (c) Auditors' fees and expenses; and
- (d) GST, etc.

### **Audit Approach and Procedures**

#### ***Directors' Fees, Allowances and Expenses***

4.09 This item includes sitting fees and all other items of expenditure incurred in relation to directors. The daily allowance, hotel charges, conveyance charges, etc., though in the nature of reimbursement of expenses

incurred, may be included under this head. Similar expenses of local Committee members may also be included under this head. Under the Companies Act, 2013 a director may receive remuneration by way of a fee for each meeting of the Board or a Committee attended by him. Local Committees are appointed by banks as advisory bodies in respect of the areas allotted to them. Their members are also paid fees or allowances.

4.10 The auditor may check the sitting fees and allowances with reference to the articles of the banking company, agreements, minutes of the Board and Local Committees, etc. It may be noted that in the case of nationalised banks, the fees and the basis of reimbursement of travelling expenses are fixed by the Central Government in consultation with the RBI. Copies of the relevant orders may be examined in this behalf.

### ***Insurance***

4.11 This item includes insurance charges on bank's property. It also includes insurance premium paid to DICGC, etc., to the extent they are not recovered from the parties concerned.

4.12 Banks submit a Return on Total Insurable Deposits to RBI on a periodic basis. Insurance premium is payable on such deposits. The auditor should check the basis of computation of insurable deposits and the insurance premium paid on same.

4.13 The DICGC guarantee fees payable by banks are based on the outstanding amount of priority sector advances covered by DICGC as on 31st March every year. The auditor should check the basis of payment/provision for such guarantee fees.

### ***Auditors' Fees and Expenses***

4.14 This item includes the fees paid to the statutory auditors and auditors for professional services rendered and all expenses for performing their duties, even though they may be in the nature of reimbursement of expenses. If external auditors have been appointed by banks themselves for internal inspections and audits and other services, the expenses incurred in that context including fees incurred for such assignments may not be included under this head but shown under 'other expenditure'.

### ***Provision for Depreciation***

4.15 As mentioned earlier, practices differ amongst banks with regard to accounting for fixed assets and provision for depreciation thereon. In case these accounting aspects in respect of all or certain categories of fixed assets are centralised at the head office level, the central auditor should examine the same. The procedures to be followed by the auditor in this respect would be

similar to those discussed in Chapter 2 of Part IV on “Fixed Assets and Other Assets” of the Guidance Note on Audit of Banks, 2019 edition (Section C - Bank Branch Audit other than Foreign Exchange Transactions) at the branch level, except that the central auditor may request the respective branch auditors to examine the evidence of physical existence of fixed assets that, as per the records, are located at the branch or have been provided to employees for use (such as residential premises).

### **Provisions for Certain Employee Costs**

4.16 Provisions for certain employee costs such as bonus/ex-gratia in lieu of bonus, and gratuity, leave encashment, pension and other retirement benefits are usually made at the head office level.

4.17 The auditor should examine whether the liability for bonus is provided for in accordance with the Payment of Bonus Act, 1965 and/or agreement with the employees or award of competent authority.

4.18 The auditor should examine whether provisions in respect of employee benefits are made in accordance with the requirements of Accounting Standard (AS) 15, “Employee Benefits”. The auditor should particularly examine whether provision for leave encashment has been made by the bank. As per AS 15, employee benefits include all forms of consideration given by an enterprise in exchange for services rendered by employees. It includes short-term employee benefits such as wages, salaries and social security contributions and non-monetary benefits, post-employment benefits, other long-term employee benefits and termination benefits. The auditor should examine the adequacy of the provisions made with reference to such documentary evidence such as reports of actuaries or certificates from the Life Insurance Companies, as appropriate under the facts and circumstances of the case.

4.19 In the case of employee benefits, the Master Circular on “Disclosure in Financial Statements – Notes to Accounts” (DBR.BP.BC No. 23 /21.04.018/2015-16) dated July 1, 2015 issued by the RBI with reference to Accounting Standard 15, specifies that Banks may follow the disclosure requirements prescribed under AS 15 (revised), ‘Employees Benefits’ issued by ICAI.

### **Provision for Taxation**

4.20 Provision for taxation relates to income-tax, (including corporate dividend tax). The auditor must ensure compliance with AS 22, “Accounting for Taxes on Income”.

#### ***Income-tax***

4.21 Some of the items which have an effect on the liability of a bank for income-tax and therefore, need to be specifically considered by the auditor are discussed in the following paragraphs.

The Statutory Auditor should consider impact of Income Computation and Disclosure Standards (ICDS) issued vide notification dated 31 March 2015 by CBDT while calculating provision of Tax. The notification requires income computation and disclosure standards to be followed by all assessees, following the mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head "Profit and gains of business or profession" or "Income from other sources".

ICDS No.	Name
I	Accounting Policies
II	Valuation of Inventories
III	Construction Contracts
IV	Revenue Recognition
V	Tangible Fixed Assets
VI	Effects of Changes in Foreign Exchange Rates
VII	Government Grants
VIII	Securities
IX	Borrowing Costs
X	Provisions, Contingent Liabilities & Contingent Assets

Vide Notification dated 29<sup>th</sup> September 2016, the Central Government notified amended ICDS which are applicable with effect from the assessment year 2017-18.

***Bad Debts and Provision for Bad and Doubtful Debts***

4.22 Section 36(1)(vii) of the Income-tax Act, 1961 deals with the allowability of bad debts and section 36(1)(viia) deals with the allowability of provision for bad and doubtful debts. According to section 36(1)(vii), bad debts written off are admissible deduction subject to the conditions prescribed under section 36(2), i.e.,—

- (i) no such deduction shall be allowed unless such debt or part thereof has been taken into account in computing the income of the assessee of the previous year in which the amount of such debt or part thereof is written off or of an earlier previous year, or represents money lent in the ordinary course of the business of banking or money-lending which is carried on by the assessee;

- (ii) if the amount ultimately recovered on any such debt or part of debt is less than the difference between the debt or part and the amount so deducted, the deficiency shall be deductible in the previous year in which the ultimate recovery is made;
- (iii) any such debt or part of debt may be deducted if it has already been written off as irrecoverable in the accounts of an earlier previous year, but the Assessing Officer had not allowed it to be deducted on the ground that it had not been established to have become a bad debt in that year;
- (iv) where any such debt or part of debt is written off as irrecoverable in the accounts of the previous year and the Assessing Officer is satisfied that such debt or part became a bad debt in any earlier previous year nor falling beyond a period of four previous years immediately preceding the previous year in which such debt or part is written off, the provisions of sub-section (6) of section 155 shall apply;
- (v) where such debt or part of debt relates to advances made by an assessee to which clause (viia) of sub-section (1) applies, no such deduction shall be allowed unless the assessee has debited the amount of such debt or part of debt in that previous year to the provision for bad and doubtful debts account made under that clause.

4.23 The said deduction is limited to the amount by which the bad debts exceed the credit balance in the provision for bad and doubtful debts account made under section 36(1)(viia). According to section 36(1)(viia), a specified percentage of the total income and a specified percentage of the aggregate average advances made by the rural branches of the bank, both computed in the prescribed manner, is allowable as a deduction in respect of provision for bad and doubtful debts made by banks other than foreign banks.

4.24 A scheduled bank/non-scheduled bank has the option to claim a further deduction for an amount not exceeding the income derived from redemption of securities in accordance with a scheme framed by the Central Government. This is in addition to the deduction specified in paragraphs above with respect to section 36(i)(viia). However, for the purpose of claiming this deduction, it is necessary that such income should be disclosed in the return of income under the head 'Profit and gains of business or profession'.

4.25 Section 36(1)(vii) requires the amount of any bad debt or part thereof to be written off as irrecoverable in the accounts of the assessee for the previous year. It is sufficient compliance of the section if the write off is done at Head Office level.

### ***Special Reserve***



4.26 Deduction in respect of a special reserve created and maintained by a banking company –

- (a) Section 36(1)(viii) provides deduction in respect of any special reserve created and maintained by a specified entity, which includes a banking company.
- (b) The quantum of deduction, however, should not exceed 20% of the profits derived from eligible business computed under the head “Profits and gains of business or profession” (before making any deduction under this clause) carried to such reserve account.
- (c) The eligible business, in case of a banking company, means the business of providing long-term finance for –
  - (i) industrial or agricultural development or development of infrastructure facility in India; or
  - (ii) development of housing in India.
- (d) However, where the aggregate amount carried to such reserve account exceeds twice the amount of paid up share capital and general reserve, no deduction shall be allowed in respect of such excess.
- (e) The Reserve Bank of India has issued circular No.: DBOD. No.BP.BC.77/21.04.018/2013-14 dated December 20, 2013 for creation of deferred tax liability on special reserves created under section 36(1)(viii) and entire Special Reserves may be reckoned for the purpose computation of Tier-I Capital.

***Interest on Non-Performing Accounts (NPAs)***

4.27 According to section 43D, read with Rule 6EA of the Income-tax Rules, 1962, the income of a scheduled bank by way of interest in relation to such categories of bad or doubtful debts as may be prescribed having regard to the guidelines issued by the RBI in relation to such debts, shall be chargeable to tax only in the previous year in which it is credited to the Profit and Loss Account or in the year of actual receipt, whichever is earlier.

***Transactions with Foreign Banks/Foreign branches of Indian banks***

4.28 The applicability of any Double Taxation Avoidance Agreement is to be taken into account for the purpose of computation of tax in respect of transactions with foreign banks or foreign branches of Indian banks.

4.29 Similarly the applicability of Transfer Pricing Regulations is to be taken into account for the purpose of computation of tax in respect of international transactions with Associated Enterprises covered under section 92E of the

Income-tax Act, 1961. Reference may also be made to the “Guidance Note on Report on International Transactions under section 92E of the Income-tax Act, 1961 (Transfer Pricing)” issued by ICAI.

4.30 In respect of any provision for bad and doubtful debts made by a foreign bank, an amount not exceeding 5% of the total income (computed before making any deduction under Chapter VI-A) is allowable as deduction.

### ***Corporate Dividend Tax***

4.31 A holding company receiving dividend from its subsidiary company can reduce the same from dividends declared, distributed or paid by it. For this purpose, a holding company is one which holds more than 50% of the nominal value of equity shares of the subsidiary.

4.32 There are certain conditions to be fulfilled to avail this benefit. They are -

- the subsidiary company should have actually paid the dividend distribution tax;
- the holding company should be a domestic company; and
- It should not be a subsidiary of any other company.

4.33 It may be noted that the matching principle does not apply, i.e., dividend received from the subsidiary company during the year can be reduced from the dividend distributed by the holding company during the same year, irrespective of the period to which the dividends relate to. Even if the dividend received and dividend distributed relate to different periods, the same can be adjusted and tax can be paid by the holding company on the net figure. However, the dividend shall not be taken into account for reduction more than once.

4.34 According to the “Guidance Note on Accounting for Corporate Dividend Tax”, issued by the Institute of Chartered Accountants of India (ICAI), the liability for such tax should be recognised in the accounts of the same financial year as appropriation of profit and not as a charge against profit in which the dividend concerned is recognised.

### ***Tax Refunds/Demands***

4.35 Where an assessment order is received during the year, the auditor should examine the assessment order and if any interest is determined on the amount of refund, the same should be considered as income. In case where the assessment results in fresh demand, the auditor should consider the need for additional provisioning. Where an assessment order is received during the course of audit, the auditor should examine the same and consider its impact, if

any, on the accounts under audit.

4.36 It is not prudent to recognise interest on possible refund which is not determined by any order from tax authorities.

**Pending Proceedings**

4.37 The auditor should review the appellate orders received during the year and consider the need for any additional provision/reversal.

**Method of Accounting**

4.38 Many banks account for commission, exchange, brokerage, interest on bills, locker rent and other fees as income upon realisation. Section 145 of the Income-tax Act, 1961 provides, *inter alia*, that income chargeable under the head "Profits and Gains of Business and Profession" shall be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. Auditors of banks to whom the Companies Act applies are required to follow accrual basis of accounting. Further, accrual being a fundamental accounting assumption, the auditor would need to consider modification/ reference to/ in the auditor's report wherever cash basis of accounting is followed.

**Reversal of Earlier Year's Provision**

4.39 It is possible that subsequent judicial pronouncements/ appellate orders may make the provisions of earlier years excessive. As per Accounting Standard (AS) 29, "Provisions, Contingent liabilities and Contingent Assets", a provision should be recognised only when (a) an enterprise has a present obligation as a result of a past event, (b) it is possible that an outflow of resources embodying economic benefits will be required to settle the obligation, and (c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision should be recognised.

4.40 Only in rare cases, e.g., a law suit, it may not be clear whether an enterprise has a present obligation. In such a case, an enterprise determines whether a present obligation exists at the balance sheet date by taking into account all available evidence. On the basis of such evidence, if it is more likely than not that a present obligation exists at the balance sheet date a provision is recognised (if other recognition criteria are also met). However, where it is more likely that no obligation exists at the balance sheet date, a contingent liability is disclosed unless the possibility of an outflow of resources embodying economic benefits is remote.

4.41 On the above considerations, if there is no requirement to retain a provision, it can be reversed and the amount of liability is included in contingent liability. A suitable note on the following lines is recommended:

- (a) Provision for Income Tax is arrived at after due consideration of decisions of the Appellate authorities and advice of counsels; and
- (b) No provision is made for the disputed demands of Income tax keeping in view the judicial pronouncements and/or legal counsels' opinion.

### **Items Requiring Special Consideration**

#### ***Tax Implications of Valuation of Investments***

4.42 The RBI has issued various circulars on valuation of investments, according to which the difference between the market value/value as per yield to maturity method (YTM) will have to be provided in the books of accounts for certain types of investments. The various judicial decisions on the allowability of depreciation in valuation of investments, including implication of ICDS VIII, should be considered while provisioning.

#### ***Notional Gain/Loss on Foreign Exchange Translations***

4.43 Banks are required to translate their foreign exchange balances / obligations in foreign currency as per FEDAI Guidelines. While recognising gains or loss for tax purposes the following decisions may be considered by the auditor along with FEDAI Guidelines:

- The Madras High Court in the case of *Indian Overseas Bank Vs. Commissioner of Income-tax (1990) 183 ITR 200* has held that notional profits on translation of foreign exchange forward contracts is not taxable.
- The Madras High Court in the case of *Commissioner of Income-tax Vs. Indian Overseas Bank (1985) 151 ITR 446* has held that notional loss on translations of foreign exchange contracts is not tax deductible.

#### ***Carry forward of unabsorbed business loss and depreciation on amalgamation of a banking company with a banking institution***

4.44 Section 72AA of the Income Tax Act, 1961 deals with Provisions relating to carry forward and set-off of accumulated loss and unabsorbed depreciation allowance in Scheme of amalgamation of banking company in certain cases.

#### ***FATCA /CRS***

4.45 Foreign Account Tax Compliance Act (known in short as FATCA) is a legislation to counter tax evasion in the United States of America (USA). FATCA was introduced by US Dept of Treasury (Treasury) and US Internal Revenue Service (IRS) to encourage better tax compliance by preventing US persons from

using banks and other financial organisations to avoid US taxation on their income and assets.

4.46 As on 13th July 2015, 112 countries have agreed to comply with FATCA agreements (67 signed IGAs, 45 IGAs agreed in substance). As on 4th June 2015, 61 countries are signatories of Multilateral Competent Authority Agreement (MCAA) committed to reciprocal tax information exchange. India and the USA have signed the reciprocal version of model 1 IGA for FATCA on 9th July 2015. India signed the OECD's CRS (Common Reporting Standards) on 3rd June 2015. The IGA has 2 models – India has signed Model 1 IGA wherein banks will have to report information to the prescribed authority who in turn will submit information to the IRS.

4.47 In Model 1 IGA, the Foreign Financial Institution (FFI) has to report all FATCA related information to their governmental agencies, which would then report the FATCA related information to the IRS. Some Model 1 IGAs are reciprocal, requiring the US to provide certain information about residents of the Model 1 country to the Model 1 country in exchange for the information that country provides to the USA. An FFI covered by a Model 1 IGA will not need to sign an FFI agreement but needs to register on the IRS's FATCA Registration Portal or file Form 8957.

4.48 Like FATCA, Common Reporting Standard (CRS) is a reciprocal exchange of information on financial accounts on an automatic basis with other countries/ non-sovereign territories so as to combat the menace of offshore tax evasion and avoidance and stashing of unaccounted money abroad.

4.49 India would be obligated to get its financial institutions to share financial account information of accountholders who are tax residents in any of these countries. Likewise, India would also get similar information through financial institutions of such treaty countries.

4.50 CBDT has notified Rule 114H for Due Diligence Requirement under FATCA, major requirements for the Bank as under:

All the concerned financial institutions should register on the related e-filing portal of Income Tax Department as Reporting Financial Institution by submitting the requisite details. Thereafter, the reports can be submitted online by using the digital signature of the 'Designated Director' by either uploading the Form 61B or 'NIL' report.

4.51 As per RBI Circular RBI/2015-16/165 DBR.AML.BC.No.36 /14.01.001/2015-16, dated August 28, 2015, for the new accounts opened after September 1, 2015, the due diligence procedures specified in Rule 114H (4) and 114H (6) would be applicable.

4.52 All the FIs have to submit reports online using the digital signature of the designated director by either uploading Form 61B or Nil Report by September 10, 2015. The first reporting will be with respect to calendar year 2014 if an account has been identified as US reportable account consequent to completion of due-diligence procedures as laid down in Rule 114H. Therefore, the reasons for the Nil report should be captured as under:

a. For pre-existing accounts:

Option 1: Due diligence procedure not completed.

Option 2: Due diligence procedure completed but no reportable US account identified.

b. For new accounts:

Option 1: Alternative procedure invoked.

Option 2: Due diligence procedure as applicable to new accounts completed but no reportable US account identified.

4.53 All the regulated entities should take appropriate action for the implementation of due diligence and reporting requirements as laid down in the Rules and ensure compliance in a manner that lends itself to credible auditability including audit of the IT system which should be suitably upgraded to not only maintain the information required under the Rules but also to record and store the due diligence procedures. In due course, the detailed guidelines for carrying out audit of IT system for ascertaining the degree and level of compliance with due diligence procedures as laid down in the Rules will be issued.

4.54 Statutory Auditor should verify whether the Bank has put a process in place for complying with guidelines under FATCA/CRS and submitted reports as required by FATCA.

### ***Indirect Taxes***

4.55 Readers may refer publication of ICAI related with compliances of GST.

# **Contents of Accompanying Pen Drive/CD**

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# **Foreword and Preface of Past Years**

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# **Foreword to Thirteenth Edition**

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Independent audit of financial statement of banks is essential for a healthy, safe and sound banking system. Audit of banks involves number of peculiarities e.g. huge volumes and complexity of transactions in banks, wide geographical spread of banks' network, large range of products and services offered by banks, extensive use of technology in banks, oversight by the banking regulator etc. All these factors make the task of the bank auditors quite challenging in doing the audits.

The *Guidance Note on Audit of Banks* brought out by the Auditing and Assurance Standards Board of ICAI every year is an important resource which provides detailed guidance to the members on various aspects of statutory bank audits. I am happy that the Auditing and Assurance Standards Board has brought out the revised 2018 edition of the *Guidance Note on Audit of Banks* for the benefit of the members. The revised Guidance Note was initially developed by an expert group constituted by the Board and thereafter it was finalised with the contribution of the Board members. The Guidance Note is comprehensive and self-contained reference document for the members.

At this juncture, I wish to place my appreciation for CA. Shyam Lal Agarwal, Chairman, CA. Sanjay Vasudeva, Vice-Chairman and other members of the Auditing and Assurance Standards Board & the expert group for their efforts in bringing out this Guidance Note to help the members in maintaining quality in bank audits in a timely manner.

I am confident that the members would find the Guidance Note very useful in their professional assignments.

New Delhi  
March 09, 2018

**CA. Naveen N. D. Gupta**  
President, ICAI

## Preface to Thirteenth Edition

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Banking sector is the backbone of any economy as it provides finances to various segments of economy and helps in sustainable socio-economic growth of the economy. Like other economic activities, the banking sector is also exposed to various risks in its operations. For financial stability in the economy, it is essential that banking sector stays healthy, safe and sound. For safe and sound banking sector, one of the most important factors is reliable financial information supported by quality bank audits. By conducting audits of financial statements of banks, the auditors play an important role in building a resilient banking sector.

The Auditing and Assurance Standards Board of ICAI has been helping the members in maintaining quality in bank audits by bringing out the publication “Guidance Note on Audit of Banks” every year. Since the issuance of the last edition of the Guidance Note in 2017, apart from the Master Directions and Circulars issued by RBI, certain important developments have also taken place in the banking sector. It is, therefore, essential that the members undertaking statutory audit of banks and bank branches keep themselves abreast with the latest developments in the banking sector.

I am happy to place in hands of the members, this revised 2018 edition of the Guidance Note on Audit of Banks. The Guidance Note discusses in depth the various important items on the financial statements of banks, its peculiarities, manner of disclosure in the financial statements, the RBI prudential directions thereon, audit procedures, reporting on Long Form Audit Reports both at central and branch level, Ghosh and Jilani Committee recommendations, special purpose reports and certificates, etc. The Guidance Note, *inter alia*, has been updated for the impact of the Master Directions, Master Circulars and other relevant circulars issued by RBI, the relevant pronouncements of the ICAI, GST provisions. The Guidance Note also includes a new Chapter on Scrutiny of Advance Accounts presented in Ind AS by Borrowers. For the benefit of the members, the CD accompanying the Guidance Note contains Illustrative formats of engagement letter, auditor’s report, written representation letter, Features of the Gold Monetization Scheme, Abbreviations used in the Banking Industry, Basis of Selection of Advances Accounts in case of bank branch audit, updated bank branch audit programme for the year 2017-18, Verification of the aspects of the Treasury/ Investments of the Bank in Statutory Audit, Flow Charts for Use of Core

## **Guidance Note on Audit of Banks (Revised 2019)**

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Banking Solution software in case of Bank Branch Audit, the text of Master Directions, Master Circulars and other relevant Circulars issued by RBI.

At this juncture, I wish to place on record my gratitude to all the members of the Mumbai study group viz., CA. Shriniwas Y. Joshi (Convenor), CA. Gautam Shah, CA. Sandeep D Welling, CA. Vipul K Choksi, CA. Vikas Kumar, CA. Abhijit Sanzgiri, CA. Niranjan Joshi, CA. Ashutosh Pednekar, CA. Dhananjay Gokhale, CA. Manish Sampat, CA. G. N. Sampath, CA. Shivratn Agarwal, CA. Parag Hangekar, CA. Sanjay Khemani, CA. Sanjay Rane, CA. Abhay Kamat, CA. Pankaj Tiwari, CA. Ketan Jogalekar, CA. Nachiket Deo, CA. Parag Kulkarni, CA. Dilip Dixit, CA. Jitendra Ranawat and CA. Prakash Kulkarni for working on this herculean project despite the demands of their professional and personal lives. My sincere thanks to (i) all the Members of Jaipur Study Group constituted under my convenorship, viz., CA. Bhupendra Mantri, CA. Vishnu Dutt Mantri, CA. Vikas Gupta, CA. Ajay Atolia, CA. Anil Mathur, CA. Vijay Kumar Jain, CA. Prahalad Gupta, CA. Jugal Kishore Agrawal, CA. P. D. Baid, CA. Mukesh Gupta, CA. Ram Avtar Sharma, CA. Vikas Rajvanshi, CA. Vimal Chopra, CA. Thalendra Sharma, CA. Varun Bansal, CA. Mukesh Khandelwal, and CA. Keshav Garg (ii) all the Members of Delhi Study Group constituted under the convenorship of CA. Sanjay Vasudeva, Vice Chairman, AASB, viz., CA. V Rethinam, CA. Rajiv Puri, CA. M. M. Khanna, CA. Simran Singh, CA. Bupinder Singh, CA. Rakesh Gupta, CA. Lalit Ahuja, CA. D. S. Rawat, CA. Bhuvnesh Maheshwari, CA. Nitin Jain, CA. Ashish Agarwal, CA. Anuj Dhingra, CA. Himanshu Garg and Mr. Rakesh Sharma (iii) all the Members of Kolkata Study Group constituted under the joint convenorship of CA. Debashis Mitra and CA. Ranjeet Kumar Agarwal viz., CA. Dipankar Chatterji, CA. Santanu Ghosh, CA. Veena Hingarh, CA. Arif Ahmed, CA. Rajendra Nath Basu, CA. Sukamal Chandra Basu, CA. Mrityunjay Ray, CA. Nirupam Haldar CA. Krishanu Bhattacharyya, CA. Sunil Singhi, CA. Vikash Banka, CA. Ajay Agarwal, CA. Selu Jhunjunwala, CA. M. R. Jain, CA. Anindra Nath Chatterjee, CA. Tushar Basu and CA. Ashok Kumar Samanta (iv) all the Members of Chennai Study Group constituted under the joint convenorship of CA. G. Sekar, CA. M P Vijay Kumar, CA. K. Sripriya viz., CA. R. Sundararajan, CA. Sivaprasad N., CA. Sukumaran T. G., CA. G.N. Ramaswami, CA. Anusha Sreenivasan, CA. Asir Raja Selvan M, CA. S. Ramesh, CA. Vijay T. C., Dr. S. Gurusamy, CA. V. Chandrasekaran, CA. T. R. Chandrasekaran, CA. Mahesh Krishnan, CA. Uttamchand Jain and CA. Vittalraj to review the exposure draft of Guidance Note on Audit of Banks 2018 edition.

I wish to place on record my sincere thanks to Honourable President, ICAI, CA. Naveen N. D. Gupta, Honourable Immediate Past President, ICAI, CA. Nilesh S. Vikamsey and Honourable Vice President, ICAI, CA. Prafulla Premeesukh Chhajed for their whole hearted support to the activities of the Board.

I am also thankful to all my Central Council colleagues for their support and guidance to the activities of the Board. I also wish to place on record my gratitude to CA. Sanjay Vasudeva, Vice Chairman, AASB and all the members and special invitees on the Board for the year 2017-18, without whose support, the Guidance Note would not have been possible in the given time. I also wish to thank CA. Megha Saxena, Secretary, CA. Rajnish Aggarwal, CA. Nitish Kumar and other staff members of her team for their hard work in giving the Guidance Note its final shape.

I am sure that the members would find the Guidance Note useful as its earlier editions while conducting the audits of banks/ bank branches.

Jaipur  
March 09, 2018

**CA. Shyam Lal Agarwal**  
Chairman  
Auditing and Assurance Standards Board

# Foreword to Twelfth Edition

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Banking sector is the backbone of any economy as it is essential for sustainable socio-economic growth and financial stability in the economy. The banking sector is also crucial as it deals with mammoth amounts of public monies and is highly sensitive to reputational risk. Like all economic activities, the banking sector is also exposed to various risks in its operations. It is of utmost importance to ensure that banking sector stays healthy, safe and sound. For safe and sound banking sector, one of the most important factors is reliable financial information supported by quality bank audits.

The Guidance Note on Audit of Banks brought out by the Auditing and Assurance Standards Board of the ICAI every year is an important resource which provides detailed guidance to the members on various aspects of bank audits. It is heartening that the Auditing and Assurance Standards Board has come out with this revised 2017 edition of the Guidance Note on Audit of Banks for the benefit of the members. The revised Guidance Note was initially developed by an expert group constituted by the Board for this project and thereafter it was finalised with the contribution of the Board members and the Central Council members of ICAI. I am happy that the Guidance Note is comprehensive and self-contained reference document for the members.

I wish to place my appreciation for CA. Shyam Lal Agarwal, Chairman, CA. Sanjay Vasudeva, Vice-Chairman and other members of the Auditing and Assurance Standards Board for bringing out this revised Guidance Note to help the members in maintaining quality in bank audits.

I am confident that the members would find the Guidance Note highly useful in their professional assignments.

New Delhi  
February 7, 2017

**CA. M. Devaraja Reddy**  
President, ICAI

## Preface to Twelfth Edition

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Independent audit of financial statement of banks is important for a healthy, safe and sound banking system. Audit of banks involves a number of peculiarities e.g. huge volumes and complexity of transactions, wide geographical spread of banks' network, large range of products and services offered, extensive use of technology, strict vigilance by the banking regulator etc. All these factors make the task of the auditors quite challenging in maintaining quality in bank audits.

The Auditing and Assurance Standards Board of ICAI has been helping the members in maintaining quality in bank audits by bringing out its benchmark publication "Guidance Note on Audit of Banks" every year. Since the issuance of the last edition of the Guidance Note in 2016, apart from the Master Directions and Circulars issued by RBI, certain important developments have also taken place in the banking sector, including the recent demonetisation, warranting appropriate attention of the auditors. It is, therefore, essential that the members undertaking statutory audit of banks, both at the branch as well as the central level, keep themselves abreast with the latest developments in the banking sector.

I am happy to place in your hands this revised 2017 edition of the Guidance Note on Audit of Banks. The Guidance Note discusses in depth the various important items on the financial statements of banks, its peculiarities, manner of disclosure in the financial statements, the RBI prudential directions thereon, audit procedures, reporting on Long Form Audit Reports, Ghosh and Jilani Committee requirements, special purpose reports and certificates, etc. The Guidance Note, *inter alia*, has been updated for the impact of the Master Directions and other relevant circulars issued by RBI in 2016, guidance on demonetization at appropriate places, relevant pronouncements of the ICAI having bearing on bank audits. For the benefit of the members, the CD accompanying the Guidance Note contains illustrative formats of engagement letter, auditor's report, written representation letter, updated bank branch audit programme for the year 2016-17, the text of Master Directions issued by RBI in 2016, the text of Master Circulars and relevant General Circulars issued by RBI.

At this juncture, I wish to place on record my gratitude to all the members of the Mumbai study group viz., CA. Nihar Niranjan Jambusaria, Convenor, CA. Shriniwas Y. Joshi, CA. Sandeep D Welling, CA. Vipul K Choksi, CA. Vikas Kumar, CA Abhijit Sanzgiri, CA. Niranjan Joshi, CA. Kuntal Shah, CA. Dhananjay Gokhale, CA Ashutosh Pednekar, CA. Manish Sampat, CA. G. N. Sampath, CA

## **Guidance Note on Audit of Banks (Revised 2019)**

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Zubin Billimoria, CA. Gautam Shah, CA. Giriraj Soni, CA. Shivratan Agarwal, CA. Parag Hangekar, CA. Sanjay Khemani, CA. Sanjay Rane, CA. Ketan Saiya, CA. Abhay Kamat and CA. Sanat Chitale for working on this herculean project despite the demands of their professional and personal lives. My sincere thanks to (i) all the Members of Jaipur Study Group under my convenorship, viz., CA. Bhupendra Mantri, CA Vijay Kumar Jain, CA Vishnu Dutt Mantri, CA Vikas Gupta, CA Prahalad Gupta, CA Ajay Atolia, CA Jugal Agrawal, CA Mukesh Gupta, CA Sandeep Jhanwar, CA Ashok Singhal, CA Vijay Jain, CA. Abhishek Sharma, CA Shailendra Agarwal, CA Keshav Garg and CA Anil Jain (ii) all the Members of Delhi Study Group constituted under the convenorship of CA. Sanjay Vasudeva, Vice Chairman, AASB, viz., CA. K.A. Balasubramanian, CA. V Rethinam, CA. Rajiv Puri, CA. Anil Sharma, CA. Rohit Mehta, CA. M M Khanna, CA. Simran Singh, CA. Pramod Kr Maheshwari, CA. Parveen Kumar, CA. Nitin Jain, CA. Anuj Dhingra and CA. Himanshu Garg (iii) all the Members of Kolkata Study Group constituted under the convenorship of CA. Debashis Mitra viz., CA. Dipankar Chatterjee, CA. Santanu Ghosh, CA. Veena Hingarh, CA. Arif Ahmed, CA. Abhijit Bandyopadhyay, CA Vivek Newatia, CA. Rajendra Nath Basu, CA. Sukamal Chandra Basu, CA. Mrityunjay Ray and CA. Nirupam Haldar (iv) all the Members of Kolkata Study Group constituted under the convenorship of CA Ranjeet Kumar Agarwal viz., CA. Krishanu Bhattacharya, CA. Jay Narayan Gupta, CA. Sunil Singhi, CA. Ajit Verma, CA. R K Roy Choudhary, CA. Vikash Banka, CA. Ajay Agarwal, CA. Niraj Jhunjhunwala, CA. Binay Singhanian, CA. H K Verma, CA. Kshitiz Chhawchharia, CA. Mrityunjay Ray and CA M R Jain (v) all the Members constituted under the convenorship of CA. M P Vijay Kumar at Bengaluru Study Group, viz., CA. K Raghu, CA. Madhukar Narayan Hiregange, CA. Cotha S Srinivas, CA. B. P. Rao, CA. Nityananda N, CA. Manohar Gupta P, CA. Ananthan, CA. R Shasidhara and CA. Gururaj Acharya and CA. Vivek Krishna Govind from Cochin to review the exposure draft of Guidance Note on Audit of Banks 2017 edition.

I wish to place on record my sincere thanks to CA. M. Devaraja Reddy, President ICAI and CA. Nilesh S. Vikamsey, Vice President ICAI for their whole hearted support to the activities of the Board.

I am also thankful to all my Central Council colleagues for their all-time support and guidance to the activities of the Board. I also wish to place on record my gratitude to all the members and special invitees on the Board for the year 2016-17, viz., CA. Sanjay Vasudeva, Vice Chairman, AASB, CA. Nandkishore Chidamber Hegde, CA. Nihar Niranjana Jambusaria, CA. Dhinal Ashvinbhai Shah, CA. Babu Abraham Kallivayalil, CA. Madhukar Narayan Hiregange, CA. G. Sekar, CA. K. Sriprya, CA. M P Vijay Kumar, CA. Ranjeet Kumar Agarwal, CA.

Sushil Kumar Goyal, CA. Debashis Mitra, CA. Manu Agrawal, CA. Kemisha Soni, CA. Sanjiv Kumar Chaudhary, CA. Mangesh Pandurang Kinare, Shri Vithayathil Kurian, Dr. P.C. Jain, Shri Vijay Kumar Jhalani, CA. Abhijit Bandyopadhyay, CA. Harinderjit Singh, CA. Murali Krishna, CA. Vijay Kumar Jain, CA. Akhil Bhalla, CA. Sandeep Dinanath Welling, CA. V. Balaji, CA. Sandeep Sharma and CA. Khushroo B. Panthaky without whose support, the Guidance Note would not have been possible in the given time. I also wish to thank CA. Megha Saxena, Secretary, CA. Rajnish Aggarwal, Sr. Education Officer, CA. Nitish Kumar, Executive Officer to the Board and other officers and staff of AASB for their hard work.

I am sure that the members would find the Guidance Note useful as its earlier editions while conducting the audits of banks/ bank branches.

Jaipur  
February 11, 2017

**CA. Shyam Lal Agarwal**  
Chairman  
Auditing and Assurance Standards Board



# Foreword to Eleventh Edition

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Banking industry plays a critical role in driving the economic growth. It is closely regulated and supervised to channelize the growth in the desired direction and keep economy in proper shape. The sector helps in overall social good by facilitating the growth that reaches all strata of society. In fact, the sector is helping in the financial inclusion so that the fruits of growth are enjoyed by the economically weaker sections and their overall interests are protected.

To monitor the sector and bring synergies with other sectors, the Government and the banking regulator need credible financial and non-financial information. This further enables them to fulfil the promise of “*greater good for greater number of people*” that democracy like India endeavours for.

The Government and the regulators require credible information from banks to be able to make informed decisions. In this context, statutory audits of banks’ financial statements are highly crucial. For quality bank audits, it is essential that the statutory auditors are well equipped in terms of knowledge of the banking sector and keep themselves abreast with the latest developments.

The Guidance Note on Audit of Banks brought out by the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India every year is an important resource that provides detailed guidance to the bank auditors on the basic tenets of a bank audit. I am, therefore, very happy to note that the Auditing and Assurance Standards Board has come out with the revised 2016 edition of the Guidance Note on Audit of Banks.

At this juncture, I wish to place my appreciation for CA. Abhijit Bandyopadhyay, Chairman, CA. J. Venkateswarlu, Vice Chairman and other members of the Auditing and Assurance Standards Board for their zeal and commitment in bringing out this literature to help the members in maintaining quality in bank audits.

I am confident that the readers will find the 2016 Guidance Note highly useful in their professional assignments in a similar manner as its previous editions.

New Delhi  
January 25, 2016

**CA. Manoj Fadnis**  
President, ICAI

## Preface to Eleventh Edition

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The economic development of any country, especially an emerging economy like ours, depends significantly on the depth and reach of its banking sector. As the recent global experience amply shows, an economy would survive only so long as its banking sector stands on sound banking fundamentals and is supported by a regulatory environment that, on the one hand, provides a fair opportunity to the banks to promote economic activity and on the other hand provides control mechanism that ensures that public monies and public interest remain protected.

The statutory audit of banks forms an integral and important part of such control mechanism of the regulators. It provides the stakeholders a comfort with regard to credibility of the financial information that a bank generates at every year end. Given the nature, scope and volume of transactions undertaken by banks in India, coupled with their geographical spread and the various regulatory directions to which they are subject, audit of the financial statements of banks indeed becomes very challenging for their auditors.

The Auditing and Assurance Standards Board of ICAI has been actively supporting the members in their role as statutory auditors of banks by bringing out a number of technical publications dealing with the various aspects of bank audit. The Guidance Note on Audit of Banks has always been a benchmark publication in this context.

The Guidance Note is updated every year to reflect the important developments that have taken place in the banking sector, warranting attention of the statutory auditors, for example, RBI's master circulars, general circulars of relevance, consequential updation of guidance for the auditors, where required, various pronouncements of ICAI, etc.

I am, therefore, happy to place in your hands the 2016 edition of the Guidance Note on Audit of Banks. In addition to the updations required on account of Master Circulars issued in 2015, the Guidance Note, *inter alia*, has been revised to include the new developments in the banking industry, such as, introduction of payment and small finance banks, how RBI exercises control over banking industry, some international developments of importance in the global banking industry, risk assessment and controls related to products regulated by SEBI and other regulators, Red Flag Accounts and Early Warning System, developments in respect of anti money laundering provisions, additional examples of IT and related frauds, verification of IT assets, guidance on capitalization of assets, FIMMDA Trade Reporting and Confirmation System, explanation of terms commonly used in case of investments by banks, audit procedures for loss on derivative transactions and margins held with exchanges, margins held under

## **Guidance Note on Audit of Banks (Revised 2019)**

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credit support annex, additional guidance on consolidation of branch accounts, new chapter on consolidation of financial statements, etc.

The CD accompanying the Guidance Note contains Illustrative formats of the engagement letter, the auditor's report and the written representation letter, updated bank branch audit programme for the year 2015-16, the text of Master Circulars issued by RBI on July 1, 2015 and the text of General and Other Circulars of RBI.

At this juncture, I wish to place on record my gratitude to all the members of the Mumbai study group viz., CA. Shrinivas Y. Joshi, Convenor, CA. Gautam Shah, CA. Vikas Kumar, CA. Sandeep D. Welling, CA. Shivratna Agarwal, CA. N. Sampath Ganesh, CA. Vipul Choksi, CA. Niranjan Joshi, CA. Manish Sampat, CA. Sanjay Khemani, CA. Abhay V. Kamat, CA. Ashutosh Pednekar, CA. Dhananjay J. Gokhale, CA. Mrudul Gokhale, CA. Parag Hangekar, CA. Sanjay Rane, CA. Kedar Mehendale, Mr. Prabhat Gupta, CA. Rukshad Daruvala, CA. Abhijit Sanzgiri, CA. Nilesh Joshi and CA. Nitant Trilokekar for their dedication in taking up this herculean project despite the demands of their professional and personal lives.

I take this opportunity to place on record my sincere thanks to CA Manoj Fadnis, President ICAI and CA M Devaraja Reddy, Vice President ICAI for their support to the activities of the Board.

I am also thankful to all my Central Council colleagues for their support and guidance to the activities of the Board. I also wish to place on record my gratitude to all the members and special invitees on the Auditing and Assurance Standards Board for the year 2015-16, viz., CA. J. Venkateswarlu, Vice Chairman, AASB, CA. Prafulla Premeek Chhajed, CA. Pankaj Inderchand Jain, CA. Nihar Niranjan Jambusaria, CA. Dhinal Ashvinbhai Shah, CA. Nilesh S. Vikamsey, CA. Babu Abraham Kallivayalil, CA. K. Raghu, CA. G. Sekar, CA. Sumantra Guha, CA. Shyam Lal Agarwal, CA. Sanjiv Kumar Chaudhary, CA. Naveen N.D. Gupta, CA. Charanjot Singh Nanda, Shri P.K. Mishra, Shri Salil Singhal, Shri R.K. Jain, CA. V. Balaji, CA. Radha Krishna Agrawal, CA. Kamlesh Amlani, CA. Aseem Trivedi, CA. Krishna Kumar T., CA. Rajeevan M., CA. Sanjay Vasudeva, CA. Vijay Sachdeva, Dr. Sanjeev Singhal, Shri Narendra Rawat, CA. Aniruddh Sankaran and Shri R. Kesavan without whose support, the Guidance Note would not have been possible.

I am sure that the members would find this edition of the Guidance Note as useful as its earlier editions. I would, however, be happy to have your feedback on the Guidance Note.

Kolkata  
January 25, 2016

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

# Foreword to Tenth Edition

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The banking sector in India, perhaps, is one of the largest in the world as far as its extensive branch network is concerned. The role of the banking sector in the overall growth and development of the Indian economy is also quite significant and laudable. Like all economic activities, the banking sector is also exposed to various risks in the conduct of their operations. For safe and sound banking sector, one of the most important factors is reliable financial information supported by audits performed in accordance with the established performance benchmarks.

I am happy that the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India, in order to help the members in maintaining quality in bank audits, has come out with the revised 2015 edition of the Guidance Note on Audit of Banks. The Revised edition incorporates the impact of the various circulars of the Reserve Bank of India, provisions of the Companies Act, 2013 and certain important pronouncements of the Institute which would be relevant to bank audits for the financial year ending March 31, 2015.

At this juncture, I wish to place my appreciation for CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board for his zeal and commitment to reach out to the members in the profession in maintaining quality in the audit services rendered by them.

I am confident that the members would find the 2015 edition of the Guidance Note immensely helpful.

New Delhi  
February 19, 2015

**CA. Manoj Fadnis**  
President, ICAI

## **Preface to Tenth Edition**

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Banking is a very dynamic industry. Its contours are always on the change, in tandem with the changes in the sentiments of the national as well as global economy. On the other hand, it is a tool in the hands of the policy makers to create the desired sentiments and level of activity in the economy as also social development.

Given the huge spread of the banking sector in terms of nature of activities undertaken, client profile, geography, etc., as also the fact that the banking industry is inextricably linked to the various players in the economy, it is also exposed to a large number of risks that can affect their financial stability. Banks, therefore, function under the tight supervisory and regulatory directions of the Reserve Bank of India to minimise these internal and external risks that face the banking industry. Accordingly, banks also have extensive systems for internal controls to comply with these directions and to otherwise also protect them from these risks.

These aspects make audit of the financial statements of banks extremely typical. For example, understanding the bank and its operating environment, its controls environment at macro and micro levels, risk of misstatements in the financial statements, etc., can be very challenging and time consuming. As a corollary, the audit planning too would require considerable attention of the auditor. Similarly, deciding audit materiality, sample size, application of analytical procedures too would need careful exercise of professional judgment by the auditors. I would not hesitate to add that audit of a bank is one of the best example how application of Standards on Auditing, including the concept of exercise of professional scepticism by the auditors, ensures audit quality.

I am, therefore, happy to place in your hands this 2015 Guidance Note on Audit of Banks. The Guidance Note provides an insight into the banking industry in India and how they carry out their day to day functions. It also discusses in depth the various important items on the financial statements of a bank, its peculiarities, manner of disclosure in the financial statements, the RBI prudential directions thereon, audit procedures, etc. Similarly, the Guidance Note has Chapters on audit procedures for reporting on long form audit reports for banks and bank branches, reporting under Ghosh and Jilani Committee requirements, special purpose reports and certificates, etc. At this juncture, I may also mention that, as

the members may be aware, the Auditing & Assurance Standards Board has been working closely with the Reserve Bank of India for bringing out revised and more contemporary Long Form Audit Reports (LFARs) for banks and bank branches. As and when the revised LFARs are notified by the RBI, we will separately bring out relevant guidance for the auditors. Accordingly, as of now, this edition of the Guidance Note contains the existing LFARs and auditors' guidance relevant thereto.

The Guidance Note, *inter alia*, has been updated for the impact of RBI Master Circulars issued in 2014, Basel III, service tax requirements, etc. Importantly, the auditors of the banking companies, in addition to the reporting requirements under the Banking Regulation Act, 1949, would also need to report pursuant to section 143 of the Companies Act, 2013. The auditors would accordingly need to amend their audit engagement letters and the auditor's report. Illustrative formats of an engagement letter and an auditor's report for a banking company, meeting the requirements of the Banking Regulation Act, 1949 as well as the Companies Act, 2013, have also been given in the Appendices given in the CD. Similarly, an updated bank branch audit programme for 2014-15 audits is also given.

I am sure the readers appreciate that updating this Guidance Note is a herculean task. Accordingly, my thanks are due to the Mumbai study group viz., CA Shriniwas Y Joshi, convenor, CA Abhay Kamat, CA Ashutosh Pednekar, CA Ganesh Sampath, CA Gautam Shah, CA Manish Sampat, CA Niranjana Joshi, CA Sandeep Welling, CA Sanjay Khemani, CA Shivratana Agarwal, CA Shrawan B Jalan, CA Vikas Kumar, CA Vipul Choksi, CA Zubin Billimoria and CA Sandeep Sarawgi, for their dedication in taking up this task despite the demands of their professional and personal lives.

I take this opportunity to place on record my sincere thanks to CA Manoj Fadnis, President ICAI and CA M Devaraja Reddy, Vice President ICAI for their support to the activities of the Board.

I am also thankful to all my Central Council colleagues for their support and guidance extended by them at all junctures. I also wish to place on record my gratitude to all the members and special invitees on the Auditing & Assurance Standards Board (2014-15), viz., CA. K. Raghu, CA. Rajkumar S. Adukia, CA. Nihar Niranjana Jambusaria, CA. Sanjeev K. Maheshwari, CA. Nilesh S. Vikamsey, CA. Shiwaji Bhikaji Zaware, CA. V. Murali, CA. S. Santhanakrishnan, CA. J. Venkateswarlu, CA. Subodh Kumar Agrawal, CA.

## **Guidance Note on Audit of Banks (Revised 2019)**

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I am sure that the members would find the 2015 edition of the Guidance Note as useful as its earlier editions. I would, however, be happy to have your feedback on the Guidance Note.

Kolkata  
18<sup>th</sup> February 2015

**CA ABHIJIT BANDYOPADHYAY**  
Chairman,  
Auditing & Assurance Standards Board

# Foreword to Ninth Edition

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

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

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

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

New Delhi  
February 24, 2014

**CA. K. Raghu**  
President, ICAI



## **Preface to Ninth Edition**

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

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

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

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

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

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

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

Kolkata  
February 24, 2014

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

# Foreword to Eighth Edition

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

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

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

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

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

New Delhi  
March 14, 2013

**CA. Subodh Kumar Agrawal**  
President, ICAI

## Preface to Eighth Edition

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

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

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

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

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

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

Kolkata  
March 14, 2013

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

# Foreword to Seventh Edition

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

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

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

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

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

New Delhi  
March 11, 2011

**CA. G RAMASWAMY**  
President, ICAI

## Preface to Seventh Edition

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

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

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

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

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

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

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

Kolkata  
March 11, 2011

**CA. Abhijit Bandyopadhyay**  
Chairman  
Auditing and Assurance Standards Board



# Foreword to Sixth Edition

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

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

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

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

New Delhi  
February 04, 2009

**Ved Jain**  
President, ICAI

## Preface to Sixth Edition

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

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

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

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

New Delhi  
February 04, 2009

**Harinderjit Singh**  
Chairman  
Auditing and Assurance Standards Board

# Foreword to Fifth Edition

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Sounding clichéd as I may do, yet I would begin with stating what has been said at a number of for a number of times that the economic growth and development of the society hinges to a large extent on the soundness of the accountancy profession. It is one profession which has had a reach and has enjoyed unwavering trust of one and all, notwithstanding the political, cultural or economic barriers that might have separated them.

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

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

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

New Delhi  
February 4, 2008

**Sunil H. Talati,**  
President, ICAI

## Preface to Fifth Edition

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

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

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

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

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

New Delhi  
February 4, 2008

**Harinderjit Singh**  
Chairman  
Auditing and Assurance Standards Board

# Foreword to Fourth Edition

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

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

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

New Delhi  
March 14, 2006

**T.N. Manoharan**  
President

## **Preface to Fourth Edition**

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

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

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

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

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

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

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

New Delhi  
March 16, 2006

**Sunil Goyal**  
Chairman  
Auditing and Assurance Standards Board



# Foreword to Third Edition

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

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

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

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

New Delhi  
March 31, 2005

**(Kamlesh S. Vikamsey)**  
President

## Preface to Third Edition

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

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

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

## **Guidance Note on Audit of Banks (Revised 2019)**

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

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

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

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

New Delhi  
March 30, 2005

**Amarjit Chopra**  
Chairman  
Auditing and Assurance Standards Board

# Foreword to Second Edition

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

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

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

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suggestions in enriching the contents of the revised Guidance Note.

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

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

New Delhi  
March 20, 2001

**(N.D. Gupta)**  
President

## **Preface to Second Edition**

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

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

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

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

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

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

## **Guidance Note on Audit of Banks (Revised 2019)**

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

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

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

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

Hyderabad  
March 20, 2001

**(S. Gopalakrishnan)**  
Chairman  
Auditing Practices Committee

# Foreword to First Edition

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

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

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

It is noteworthy that the earlier edition of this publication on 'Audit on Banks' was in the form of a 'Study'. However, considering the importance of the banking sector in the economy, it has been decided to bring out the present edition in the form of a Guidance Note. As the members are aware, Guidance Notes are recommendatory in nature. Accordingly, while carrying out the statutory audit of a bank or a branch of a bank, a member should ordinarily follow the recommendations made in this Guidance Note except where he is satisfied that



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in the circumstances of the case, it may not be necessary to do so.

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

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

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

New Delhi  
November 22, 1994

**B.P. Rao**  
President

## Preface to the First Edition

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

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

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

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

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

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

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

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

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

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

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

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

Calcutta  
November 21, 1994

**Dipankar Chatterji**  
Chairman  
Auditing Practices Committee

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# Knowledge of the Banking Industry

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# Banking in India

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## A. An Overview of Banking Institutions in India

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

02. As per Section 5(b) of the Banking Regulation Act 1949, "banking" means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, or otherwise. Further, as per Section 5(c) of the said Act, "banking company" means any company which transacts the business of banking and by way of Explanation, states that 'any company which is engaged in the manufacture of goods or carries on any trade and which accepts deposits of money from the public merely for the purpose of financing its business such as manufacturer or trader shall not be deemed to transact the business of banking within the meaning of this clause'.

03. Further, section 6 of the said Act lists down the forms of business in which banking companies may engage. The text of the section is reproduced in **Appendix I** of the Guidance Note.

## B. Presently, the following types of banking institutions prevail in India:

- (a) Commercial Banks;
- (b) Regional Rural Banks;
- (c) Co-operative Banks;
- (d) Development Banks (more commonly known as 'Term-Lending Institutions');
- (e) Foreign Banks;

- (f) Payment Banks;
- (g) Small Finance Banks; and
- (h) EXIM Banks.

**(a) Commercial Banks**

04. Commercial banks operating in India can be divided into two categories based on their ownership—public sector banks and private sector banks. However, irrespective of the pattern of ownership, all commercial banks in India function under the overall supervision and control of the RBI.

05. Public sector banks comprise the State Bank of India, IDBI Bank Ltd. and the nationalized banks. While the majority stake in the Share Capital of all Public Sector Banks is with the Government of India, there are private individual/institutional shareholders also. The majority stake in the share capital of associate banks of State Bank of India has been subscribed to by the parent i.e. State Bank of India. On 10th August, 2017 Lok Sabha had passed State Banks (Repeal and Amendment) Bill 2017 to merge five Associate with parent State Bank of India.

06. The ownership of private sector banks is with institutional shareholders, private individuals and bodies corporate. Private Sector Banks are of the following types:

- (a) Indian scheduled commercial banks other than public sector banks. These include the 'old' private banks which were in existence before the guidelines for floating new private banks were issued in 1993, the 'new' generation private banks, and Bandhan Bank and IDFC Bank that were granted licenses by RBI in March 2014. (The term 'scheduled commercial banks' refers to commercial banks which are included in the Second Schedule to the Reserve Bank of India Act, 1934.) Under Section 2(e) of the RBI Act, a scheduled bank is conferred two main privileges (a) availing of refinance from RBI and (b) permission to participate in the call/notice money market. It may be noted that not all scheduled banks are commercial banks; some co-operative banks are also scheduled banks. Commonly known as 'banking companies', these banks are 'companies' registered under the Companies Act, 1956 (now the Companies Act, 2013), or an earlier Indian Companies Act.
- (b) Non-scheduled banks.
- (c) Indian branches of banks incorporated outside India, commonly referred to as 'foreign banks'.

07. Some of the banks have set up subsidiaries – wholly-owned or partly owned – to operate in some specialized spheres of activity such as merchant banking, funds management, housing finance, primary dealership, pension fund management, insurance business, stock broking, credit card activity, factoring, etc. These subsidiaries do not carry on all the principal functions of a commercial bank. Modern commercial banks function as universal banks. According to the Financial Times, universal banks are financial service conglomerates that combine retail, wholesale and investment banking services under one roof and reaping synergies between them which is made possible from economies of scale in information technology and access to capital to serve companies and retail customers around the world.

***Branch Network of Commercial Banks***

08. Commercial banks are arguably the most important constituent of the banking system in India. To carry out their functions effectively, these banks have established a large network of branches in India. Based on their location, these ‘domestic’ branches are commonly classified into rural branches, semi-urban branches, urban branches and metro branches. Apart from these domestic branches, some banks have also established offices abroad.

09. The foreign offices of banks are generally of the following types:

- *Full-fledged branches* – Such branches transact all kinds of banking business.
- *Off-shore banking units* – Such branches transact foreign exchange business of any kind except domestic banking business with the residents/corporations, etc., domiciled in the country concerned.
- *Branches in International Financial Services Centres* - Indian banks viz. banks in the public sector and the private sector authorized to deal in foreign exchange will be eligible to set up IFSC Banking Units (IBUs). Minimum capital of US\$ 20 million or equivalent is required for opening of a branch at IBU. Operations from IBU are governed by operational guidelines issued by RBI time to time.
- *Subsidiaries* – The laws in some countries do not permit foreign banks to open their branches in those countries. Therefore, Indian banks have to set up wholly or partly-owned subsidiaries in such countries. Further, for operational reasons, commercial banks may prefer to operate through subsidiaries, if permitted, instead of opening branches.

- *Representative offices* – Such offices do not transact any banking business. The objective behind setting up of such offices is to maintain close liaison with the important bodies there to promote mutual business interests.

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

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



**Commercial Banks: Services & Products**

11. Commercial banks are by far the most widespread banking institutions in India. Typically, commercial banks provide the following major products and services:

- (a) *Acceptance of Deposits:* Acceptance of deposits from the public is one of the most important functions of a commercial bank. Commercial banks accept deposits in various forms: term deposits, savings bank deposits, current account deposits, etc.
- (b) *Granting of Advances:* This again is an important function of commercial banks. Advances granted by commercial banks take various forms such as cash credit, overdrafts, purchase or discounting of bills, term loans, etc. Apart from granting traditional facilities, banks are also providing facilities like External Commercial Borrowings (ECB) on behalf of bank/borrower, securitization of receivables, etc.
- (c) *Remittances:* Remittances involve transfer of funds from one place to another. Common modes of remittance of funds are drafts, telegraphic/mail transfers (TT/MT) and Electronic Funds Transfer (EFT). In the case of telegraphic/mail transfer, no instrument is handed over to the applicant; the transmission of the instrument is the responsibility of the remitting branch.

Generally, the payee of both the TT and the MT is an account holder of the paying branch. In the case of Electronic Funds Transfer (EFT), as the name suggests, the funds are transferred electronically between two banks. The common modes of EFT are Real Time Gross Settlement (RTGS), which can be used for remittance of an amount within a prescribed limit of Rs. 2 Lakhs and above and National Electronic Funds Transfer (NEFT), which can be used for transfer of any amount. Another form of EFT is Immediate Payment Service (IMPS).

Pay Orders/Demand Drafts issued against amounts received by a bank, comprise instruments, the liability in respect whereof is discharged at the same or another branch of the bank or other banks.

- (d) *Collections:* The customers can lodge various instruments such as cheques, drafts, pay orders, travellers cheques, dividend and interest warrants, tax refund orders, etc., drawn in their favour and the trade bills drawn by them on their buyers with their bank for collection of the amount from the drawee (the bank or the drawee of the bill). They can also lodge their term deposit receipts and other similar instruments with the bank for collection of the proceeds from the bank with which the term deposit, etc., is

maintained. Banks also collect instruments issued by post offices, like national savings certificates, postal orders, etc.

The instruments mentioned above may be payable locally or at outside centres.

Clearing house (CH) settles the inter-bank transactions among the local participating member banks. Generally, post offices are also members of the house. There may be separate clearing for CTS (Cheque Truncation System) and non-CTS instruments. The clearing house is managed by the RBI, State Bank of India or any other bank nominated by RBI. In case a bank has many branches within the area of a clearing house, it nominates one branch to act as the 'nodal' branch of that bank for all the branches within that area. This nodal branch collects instruments to be presented by other branches also. The accounts of all member banks are maintained by the clearing house. All member banks have to pay an agreed sum to the bank managing the clearing house for meeting the cost of infrastructure and services it provides to them.

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

- In the case of ECS credit, there is a single receiver of funds from a large number of customers, e.g., public utilities, mutual funds, etc.

The beneficiary (i.e., the receiver of funds) obtains mandate from its customers to withdraw funds from their specified bank accounts on a particular date. These customers may have accounts with different banks in the same clearing house area. Before the specified date, the beneficiary compiles bank-branch-wise particulars of the accounts to be debited and furnishes the details to its own bank which, in turn, arranges to provide them to the banks concerned, through the clearing house, for verification of particulars of accounts. Any discrepancies are rectified and, on the specified date, the accounts are debited by the respective banks and the beneficiary gets the credit.

- In the case of ECS debit, there is a single account to be debited against which a number of accounts with a number of banks in the same clearing house area are credited. This system is useful for distribution of dividend/interest, payment of salaries by large units, etc.

Roll-out of Speed Clearing is one of the many initiatives taken by RBI for improving efficiency in the time frame for and process of collection

of cheques. It implemented Cheque Truncation System (CTS) in phase wise manner starting from February 1, 2008. In CTS, the presenting bank (or its branch) captures the data (on the MICR band) and the images of a cheque using their Capture System (comprising of a scanner, core banking or other application). The collecting bank (Presenting Bank) sends the data and captured images duly signed and encrypted to the central processing location (Clearing House) for onward transmission to the paying bank (destination or drawee bank). For the purpose of participation, the presenting and drawee banks are provided with an interface / gateway called the Clearing House Interface (CHI) that enables them to connect and transmit data and images in a secure and safe manner to the Clearing House (CH). The Clearing House processes the data, arrives at the settlement figure and routes the images and requisite data to the drawee banks. This is called the presentation clearing. The drawee banks through their CHIs receive the images and data from the Clearing House for payment processing. The drawee CHIs also generates the return file for unpaid instruments, if any. The return file / data sent by the drawee banks are processed by the Clearing House in the return clearing session in the same way as presentation clearing and return data is provided to the presenting banks for processing. The clearing cycle is treated as complete once the presentation clearing and the associated return clearing sessions are successfully processed. The entire essence of CTS technology lies in the use of images of cheques (instead of the physical cheques) for payment processing.

- (e) *Receipt of Foreign Contribution on behalf of the registered persons/ organization:* Scheduled Banks also handle the foreign contribution receipt on behalf of the registered persons/ organization as per the Foreign Contribution (Regulation) Act, 2010. Banks receiving foreign contribution need to ensure that the concerned persons/organization are registered with the Central Government or has obtained the prior permission to receive such foreign contribution if required by law, and that no branch other than the specified branch accepts 'foreign contribution'.
- (f) *Cash Management Product:* It is a derivative of the collection business. This facility is provided for expeditious transfer of funds collected by a customer at the specified centres in the country to his central account with the use of computers/satellites. It is particularly useful for large units which have their sales/collection network in a very wide geographical area. Only selected branches of a bank may handle the business due to the infrastructural requirements.

- (g) *Issuance of Letters of Credit and Guarantees*: These are two important services rendered by banks to customers engaged in business, industrial and commercial activities. A letter of credit (LC) is an undertaking by a bank to the payee (the supplier of goods and/or services) to pay to him, on behalf of the applicant (the buyer) any amount up to the limit specified in the LC, provided the terms and conditions mentioned in the LC are complied with. The guarantees are required by the customers of banks for submission to the buyers of their goods/services to guarantee the performance of contractual obligations undertaken by them or satisfactory performance of goods supplied by them, or for submission to certain departments like excise and customs, electricity boards, or to suppliers of goods, etc., *in lieu* of the stipulated security deposits.
- (h) *Merchant Banking Business*: Many bank branches act as collection agents to issue business for merchant bankers. The customer and the bank have to agree to the modalities of the scheme, like names of branches authorized as collecting branches, the procedure for retaining the subscription and its remittance periodically, the documents required by the customer from the collecting branches, etc.
- (i) *Credit Cards*: The processing of applications for issuance of credit cards is usually entrusted to a separate division at the Central/Head office of a bank. The dues against credit cards are collected by specified branches, preferably by direct debit to accounts of the credit card holders. Many of them also act as 'cash points' to provide cash to the cardholder on demand up to the specified limits. Most credit cards issued by banks are linked to one of the international credit card networks like VISA, Master or Amex.
- (j) *Technology-based Services*: Banks also provide internet banking services and phone banking services. The fast changing technology has synchronized the banking facility in such a way that the customer need not come physically to the bank for any transactions. The banks are now providing the facility for payment of utility bills, railway reservation, tax deposition through ATM/internet and also provide recharge facility to mobile phone users.
- (k) *Dividend/Interest/Refund Warrants/redemptions*: Many entities require facilities for distribution of funds to their shareholders and others. Direct electronic transmission of funds is made to the accounts of the recipients. In other cases, warrants are issued in favour of shareholders/others, including those payable at designated branches of specified banks. The aggregate amount of the liability to be discharged by the constituent, including

warrants or other instruments issued, is funded to the bank by such constituent.

- (l) *Safe-keeping Services*: Banks provide services for safe keeping/custody of the scrips and valuables of customers in their vaults. Appropriate records are maintained in evidence of receipts/delivery and evidence of holdings is verified from time to time.
- (m) *Lockers*: This facility is provided to customers for safe-keeping of their valuables, etc., in lockers. The branch has no knowledge of the contents of the locker. Only the account holder (the hirer) or his *bona fide* representative, duly authorized by the account holder, can operate on the locker. Each access to the locker is properly recorded in the appropriate registers.
- (n) *Handling Government Business*: Banks act as agents of RBI for receipts and payments on behalf of various government departments. There are authorized branches to handle the specified type of work. Normally, a specified branch acts as a nodal branch for a particular segment of the government business within a given geographical area. The responsibility of the nodal branch includes obtaining details of transactions from the linked branches and to reconcile their accounts *inter se* and with the department concerned. Banks are remunerated by Government for handling this business by way of service charges which are usually as agreed or a stated percentage of the collections or payments, as the case may be.
- (o) *Depository Participant (DP) Services*: The depository system is meant to facilitate quick transfer of stock market securities in a dematerialized form from the seller to the buyer by using satellite connectivity. The depository scheme is operated presently by two depositories – Central Depository Services Limited (CDSL) and National Securities Depository Limited (NSDL). Depository participants, i.e., bank branches providing depository services are in effect agents of the depository concerned. Each participating branch has to get itself registered with a depository. The customer has to open an account with the branch which provides the DP services. This account is credit by the branch with the securities sold by the account holder and debit with the purchases.
- (p) *Automated Teller Machines (ATMs) and Cash Deposits Machines / Recyclers*: Operations on ATMs are through a card which contains information about the cardholder in a magnetic form. The cardholder has to also use the password (also known as Personal Identification Number, i.e.

PIN) to carry out any transaction through ATM. Earlier, ATMs were used merely as cash dispensing machines but now-a-days, other services like issue of drafts, deposit of cash and instruments, balance enquiry, etc., are also being provided by many banks. ATMs may be on-site (i.e., housed in the branch premises) or off-site. The transactions routed by the customers through the ATMs may be entered into the books of account of the branch either on-line (i.e., simultaneously with the transactions) or off-line.

However, on an off-line mode, the proper recording of transactions needs to be ensured. RBI has permitted banks to install Cash Deposit Machines (CDM) with specific guidelines w.r.t. security arrangements, handling of suspect / counterfeit notes and availability of audit trail. The recycler machines accept as well as dispense cash from the same machine.

- (q) *Exchange of Notes*: Following the 'clean note policy' RBI provides the facility of exchange of soiled/mutilated /unusable notes.
- (r) *Debit Cards*: Debit cards are issued by the bank to its account holders to provide facility of access to cash at ATMs/ purchase of goods and services there against, where the debit to the bank account of the holder is simultaneous.
- (s) *Auto Sweep facility in saving accounts*: Banks offer auto sweep facility in saving accounts of their customers where the balances in excess of those stipulated limit, automatically get transferred to term deposit accounts to avail of a higher rate of interest and also automatically get reversed to replenish any shortfall in such stipulated limits.
- (t) *Derivatives*: Financial derivatives are gaining importance in India. Banks are offering derivative options against exchange fluctuation losses.
- (u) *Prepaid Payment Instruments in India*<sup>1</sup>: Pre-paid payment instruments are payment instruments that facilitate purchase of goods and services against the value stored on such instruments. The value stored on such instruments represents the value paid for by the holders by cash, by debit to a bank account, or by credit card. The pre-paid instruments can be issued as smart cards, magnetic stripe cards, internet accounts, internet wallets, mobile accounts, mobile wallets, paper vouchers and any such instrument which can be used to access the pre-paid amount (collectively called Prepaid Payment Instruments or PPI hereafter). The pre-paid payment instruments

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<sup>1</sup> RBI vide its circular no. DPSS.CO.PD.PPI.No.01/02.14.006/2016-17 dated July 1, 2016 on "Policy Guidelines for issuance and operation of Prepaid Payment Instruments in India" provides the broad guidelines on this subject.

that can be issued in the country are classified under three categories viz. (i) Closed system PPI (ii) Semi-closed system PPI and (iii) Open system PPI. Issuer may be the persons operating the payment systems issuing prepaid payment instruments to individuals/organizations.

The money collected is retained by these persons and they make payment to the merchants who are part of the acceptance arrangement directly, or through a settlement arrangement.

Banks who comply with the eligibility criteria are permitted to issue all categories of pre-paid payment instruments. However, only those banks which have been permitted to provide Mobile Banking Transactions by the Reserve Bank of India shall be permitted to launch mobile based pre-paid payment instruments (mobile wallets & mobile accounts). Banks are also permitted to issue prepaid instruments to principal agents approved under the Money Transfer Service Scheme (MTSS) of the Reserve Bank of India or directly to the beneficiary under the scheme for loading of the funds from inward remittances.

Further, the regulatory guidelines require that other non-bank persons issuing PPI need to maintain their outstanding balance in an escrow account with any scheduled commercial bank subject to the following conditions:

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

Further, as per RBI/DPSS/2017-18/58 Master Direction DPSS.CO.PD.No. 1164/02.14.006/2017-18 dated October 11, 2017 (updated as on December 29, 2017) "Issuance and operation of Prepaid Payment Instruments in India – Auditor Certificate on the balances in Escrow account" requires a quarterly certificate on the balances held in the Escrow account in accordance with the above Guidelines, from an auditor within a fortnight from the end of the quarter to which it pertains.

### *Para-banking Activities*

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

- (i) *Equipment Leasing, Hire Purchase and Factoring Services*: Banks also undertake equipment leasing, hire purchase and factoring services as departmental activities.
- (ii) *Investment in Venture Capital Funds (VCFs)*: Bank should obtain prior approval of RBI for making strategic investment in venture capital funds i.e. investment equivalent to more than 10% of the equity/unit.
- (iii) *Mutual fund business*: Banks are not permitted to directly undertake mutual fund business but sponsor mutual funds, subject to the RBI guidelines in this regard. Banks normally refer clients to these mutual funds and earn a commission<sup>2</sup> in return.

Banks may enter into agreements with mutual funds for marketing the mutual fund units subject to the terms and conditions specified in the RBI Master Circular RBI/2015-16/30 BR.No.FSD.BC.19/24.01.001/2015-16 dated July 1, 2015 on "Para Banking Activities".

- (iv) *Money Market Mutual Funds (MMMFs)*: Banks can also sponsor MMMFs business subject to the prior approval of the RBI. The MMMFs are, however, subject to regulation by the Securities and Exchange Board of

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<sup>2</sup> Keeping in view the need for transparency in the interest of the customers to whom the products are being marketed / referred, the banks are advised to disclose to the customers, details of all the commissions / other fees (in any form) received, if any, from the various mutual fund / insurance / other financial services companies for marketing / referring their products. This disclosure would be required even in cases where the bank is marketing/ distributing/ referring products of only one mutual fund/ insurance companies, etc.



India (SEBI). Banks also, at time, provide cheque-writing facilities for MMMFs subject to the RBI guidelines in this regard.

- (v) *Entry of banks into insurance business*: Banks intending to set up insurance joint ventures with equity contribution on risk participation basis or making investments in the insurance companies for providing infrastructure and services support should obtain prior approval of Reserve Bank of India before engaging in such business. However, insurance business will not be permitted to be undertaken departmentally by the banks.
- (vi) *Primary Dealership (PD) Business* – Banks can undertake primary dealership business subject to the approval of the RBI and after satisfying certain eligibility criteria prescribed by the RBI:
- A) Banks, which do not at present, have a partly or wholly owned subsidiary and fulfill the following criteria:
- Minimum Net Owned Funds of Rs. 1,000 crore.
  - Minimum CRAR of 9%.
  - Net NPAs of less than 3% and a profit making record for the last three years.
- B) Indian banks which are undertaking PD business through a partly or wholly owned subsidiary and wish to undertake PD business departmentally by merging/taking over PD business from their partly/wholly owned subsidiary subject to fulfilling the criteria mentioned in A (a) to (c) above.
- C) Foreign banks operating in India who wish to undertake PD business departmentally by merging the PD business being undertaken by group companies subject to fulfilment of criteria at A (a) to (c).
- (vii) *Pension Funds Management*: Banks have been permitted to undertake Pension Funds Management (PFM) through their subsidiaries set up for the purpose subject to their satisfying the eligibility criteria prescribed by Pension Fund Regulatory and Development Authority (PFRDA) for Pension Fund Managers. PFM cannot be undertaken departmentally. Banks intending to undertake pension funds management should follow the guidelines set out in the RBI Master Circular No.DBR.No. FSD.BC. 19/24.01.001/ 2015-16 dated July 1, 2015 on “Para – Banking Activities”.
- (viii) *Portfolio Management Services (PMS)*: The general powers vested in banks to operate Portfolio Management Services and similar schemes have

been withdrawn vide RBI circular DBOD.No.BC.73/27.07.001/94-95 dated June 7, 1994 on Acceptance of Deposits/Funds under Portfolio Management Scheme. No bank therefore is permitted to, restart or introduce any new PMS or similar scheme in future without obtaining specific prior approval of the RBI. However, bank-sponsored NBFCs are allowed to offer discretionary PMS to their clients, on a case-to-case basis. The banks operating PMS or similar scheme with specific prior approval of RBI have to strictly observe the conditions given in RBI Master Circular No. DBR.No.FSD.BC.19/24.01.001/2015-16 dated July 1, 2015 on "Para Banking Activities".

- (ix) *Referral Services*: Banks can offer referral services to their customers for financial products subject to the following conditions:
- a) The bank/third party issuers of the financial products should strictly adhere to the KYC/AML guidelines in respect of the customers who are being referred to the third party issuers of the products.
  - b) The bank should ensure that the selection of third party issuers of the financial products is done in such a manner so as to take care of the reputational risks to which the bank may be exposed in dealing with the third party issuers of the products.
  - c) The bank should make it explicitly clear upfront to the customer that it is purely a referral service and strictly on a non-risk participation basis.
  - d) The third party issuers should adhere to the relevant regulatory guidelines applicable to them.
  - e) While offering referral services, the bank should strictly adhere to the relevant RBI guidelines.
- (x) *Underwriting of Corporate Shares and Debentures*: Banks can undertake underwriting of corporate shares and debentures within the ceiling prescribed for the bank's exposure to capital markets and subject to the provisions contained in the Section 19(2) and 19(3) of the Banking Regulation Act, 1949. The guidelines contained in the SEBI (Underwriters) Rules and Regulations, 1993 and those issued from time to time are also to be complied with. Moreover, banks should not underwrite issue of Commercial Paper by any Company or Primary Dealer and not extend Revolving Underwriting Facility to short term Floating Rate Notes/Bonds or debentures issued by corporate entities. However, with effect from April 16, 2008, banks may exclude their own underwriting commitments, as also the underwriting commitments of their subsidiaries, through the book running

process for the purpose of arriving at the capital market exposure both on a solo and consolidated basis.

- (xi) *Underwriting of bonds of Public Sector Undertakings:* Banks can play a supportive role in relation to issue of bonds by Public Sector Undertakings (PSUs) by underwriting a part of these issues. They may also subscribe outright initially but sell them later to the public with the aid of their wide branch network. It should, however, be ensured that the increase in the holdings of public sector bonds by banks arising out of their underwriting or subscription is kept within reasonable limits. While undertaking the underwriting of bonds of PSUs, banks should formulate their own internal guidelines as approved by their Boards of Directors on investments in and underwriting of PSU bonds, including norms to ensure that excessive investment in any single PSU is avoided and that due attention is given to the maturity structure of such investments.
- (xii) *Retailing of Government Securities:* Banks are permitted to undertake the business of retailing of Government securities with non-bank clients subject to the following conditions:
- a) Banks are free to buy and sell Government Securities on an outright basis at prevailing market prices without any restriction on the period between sale and purchase.
  - b) Banks shall not undertake ready forward transactions in Government Securities with non-bank clients.
  - c) The retailing of Government Securities should be on the basis of ongoing market rates / yields emerging out of secondary market transactions.
  - d) No sale of Government Securities should be effected by banks unless they hold the securities in their portfolio either in the form of physical scrips or in the Subsidiary General Ledger (SGL) Account maintained with the Reserve Bank of India.
  - e) Immediately on sale, the corresponding amount should be deducted by the bank from its investment account and also from its (Statutory Liquidity Ratio (SLR) assets.
  - f) Banks should put in place adequate internal control checks/mechanism in this regard.
  - g) These transactions should be subjected to concurrent audit as per RBI's extant instructions and should also be looked into by the auditors at the time of bank's statutory audit.

(xiii) *Sponsors to Infrastructure Debt Funds (IDF)* - In order to accelerate and enhance the flow of long term funds to infrastructure projects for undertaking the Government's ambitious programme of infrastructure development, scheduled commercial banks have been allowed to act as sponsors to Infrastructure Debt Funds (IDFs). IDFs can be set up either as Mutual Funds (MFs) or as Non-Banking Finance Companies (NBFCs). While IDF-MFs are regulated by SEBI, IDF-NBFCs are regulated by RBI.

Banks can sponsor IDF-MFs and IDF-NBFCs with prior approval from RBI subject to the conditions given in the RBI Master Circular No. DBR.No.FSD.BC.19/24.01.001/2015-16 dated July 1, 2015 on "Para - Banking Activities".

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

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

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

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

(xv) *Partner in Financial Inclusion programme – Pradhan Mantri Jan Dhan Yojna:* Pradhan Mantri Jan-Dhan Yojana (PMJDY) which was launched on 28th August 2014 is a National Mission for Financial Inclusion to ensure access to financial services, namely, Banking/ Savings & Deposit Accounts, Remittance, Credit, Insurance, Pension in an affordable manner. Bank Account can be opened in any bank branch or Business Correspondent (Bank Mitra) outlet. PMJDY accounts are being opened with Zero balance and certain other benefits.

(xvi) *MUDRA Loans* -Micro Units Development and Refinance Agency(MUDRA) loans are extended by banks, NBFCs, MFIs and other eligible financial intermediaries as notified by MUDRA Ltd. The Pradhan Mantri MUDRA Yojana (PMMY) announced by the Hon'ble Prime Minister on 8th April 2015, envisages providing MUDRA loan, upto Rs. 10 lakh, to income generating micro enterprises engaged in manufacturing, trading and services sectors. The overdraft amount of Rs. 5000 sanctioned under PMJDY has been also classified as MUDRA loans under Prime Minister MUDRA Yojana (PMMY). The MUDRA loans are extended under different categories. During the Financial Year 2017-18, 4,81,30,593 Pradhan Mantri MUDRA Yojana (PMMY) has been sanctioned. The total amount sanctioned is 2,53,677.10 Crore out of which 2,46,437.40 was disbursed. According to finance ministry data Mudra Yojana had a gross NPA ratio of only 4 per cent as of December 2017 - much lower than average 10 per cent for other loans in the case public sector lenders. However, some of the experts have calculated the Mudra Yojana NPA figures at over 14,350 crore in the short span of three years. In Financial year 2018-19, till 10th October 2018 2,08,83,896 MUDRA Loans has been sanctioned amounting to Rs.110576.98 Crore.

According to finance ministry data Mudra Yojana had a gross NPA ratio of only 4 per cent as of December 2017 - much lower than average 10 per cent for other loans in the case public sector lenders. Since almost all the Mudra Loans are without collaterals and Unsecured, Banks need to monitor the same carefully to ensure end use of funds and recovery to avoid NPA classification.

### **(b) Regional Rural Banks (RRBs)**

13. These banks have been established “with a view to developing the rural economy by providing, for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas, credit and other facilities, particularly to the small and marginal farmers, agricultural labourers and artisans and small entrepreneurs” (Preamble to the Regional Rural Banks Act, 1976). While regional rural banks can carry on any business in which a bank is legally permitted to engage, section 18 of the Regional Rural Banks Act, 1976, specifically lists the following businesses which such a bank may undertake:

- (a) the granting of loans and advances, particularly to small and marginal farmers and agricultural labourers, whether individually or in groups, and to co-operative societies, including agricultural marketing societies, agricultural processing societies, co-operative farming societies, primary

agricultural credit societies or farmers' service societies, for agricultural purposes or agricultural operations or for other purposes connected therewith;

- (b) the granting of loans and advances, particularly to artisans, small entrepreneurs and persons of small means engaged in trade, commerce or industry or other productive activities, within the notified area in relation to the RRB.

14. In order to strengthen and consolidate RRBs, the government in 2005 initiated the process of amalgamation of RRBs in a phased manner. Consequently, the total number of RRBs has reduced from 196 to 56<sup>3</sup>. Further, the Government of India has issued a notification dated May 17, 2007 specifying 'Regional Rural Bank' as 'bank' for the purpose of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002.

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

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

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

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<sup>3</sup> As per the information available from the website of the Reserve Bank of India at the following URL: <http://www.rbi.org.in/scripts/AboutUsDisplay.aspx?pg=RegionalRuralBanks.htm>.

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

### **(c) Co-operative Banks**

19. These are banks in the co-operative sector which cater primarily to the credit needs of the farming and allied sectors. Co-operative banks include central co-operative banks, state co-operative banks, primary co-operative banks and land development banks. Of these, primary co-operative banks operate in metropolitan cities, urban and semi-urban centres to cater principally to the credit needs of small industrial units, retail traders, etc. Due to their existence primarily in urban areas, primary co-operative banks are more commonly known as 'Urban Co-operative Banks' (UCB). Land development banks provide long-term finance for agriculture and have a two-tier structure – State Land Development Banks and the Primary Land Development Banks, the latter being at District or Block level. In a few states, however, the structure is unitary where the State Land Development Bank directly carries out activities through its own branches at district level.

20. Each co-operative bank operates within a specific geographic jurisdiction as determined by its bye-laws. Co-operative banks can lend monies only to their members or to registered societies. The single most important regulatory and supervisory feature in the co-operative banking sector is the prevalence of dual control. While incorporation/registration and management-related activities are regulated in the states by the Registrar of Co-operative Societies or the Central Registrar of Co-operative Societies (for multi-state co-operative banks), banking related activities are under the regulatory/supervisory purview of the Reserve Bank of India or NABARD (in the case of rural co-operatives).

### **(d) Development Banks**

21. Development banks also known as 'term-lending institutions' are specialized financial institutions that provide medium and long-term finance to the industrial, agricultural, housing, and export-import sectors. As multipurpose financial institutions, they provide financial assistance to both private and public sectors. Development banking was started primarily to provide financial assistance to war-ravaged industries essentially to reconstruct their buildings and equipment which were destroyed in the war.

22. In India, development banks are classified into four groups such as Industrial Development Banks which include Industrial Finance Corporation of India (IFCI) set up in 1948, Industrial Development Bank of India (IDBI) set up in 1964, and

Small Industries Development Bank of India (SIDBI) set up in 1990, Agricultural Development Banks which include National Bank for Agriculture & Rural Development (NABARD) set up in 1982, Export-Import Development Banks which include Export-Import Bank of India (EXIM Bank) set up in 1982 and Housing Development Banks which include National Housing Bank (NHB). In addition, the Industrial Investment Bank of India (IIBI) which was set up in 1991 and the MUDRA Bank which was set up in 2015 are also in existence apart from State Industrial Development Corporations (SIDCs) and State Financial Corporation (SFC) which function as part of 'development banks'.

23. Development Banks came to be established to with the objective of providing financial assistance to entrepreneurs to establish and expand their businesses and helping companies to raise money from the capital market. Major functions of Development Banks include raising capital for the companies, providing loans and advances, performing underwriting of new issues, providing guarantee for loans, etc.

24. The major difference between Development Bank and Commercial Bank is that development Banks's main emphasis lies on development through various promotional activities while commercial banks are mere credit suppliers. Similarly, development banks do not accept deposits from public while commercial banks accept deposits. Further, it is also important to note that development banks are normally viewed to provide medium and long-term finance while commercial banks provide short term finance.

25. Two development institutions viz.: ICICI and IDBI have been since converted in to full-fledged commercial banks whereas IFCI is now categorised as a NBFC, SIDBI, NHB and EXIM Bank are the existing term lending institutions.

### **(e) Foreign Banks**

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

27. Foreign banks operate with limited branch network in the country and in a structure wherein most of their operations are centralized. Bank branches



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

28. In the aftermath of the global financial crisis and building on the lessons therefrom, RBI issued a Discussion Paper in January 2011 on the mode of presence of foreign banks in India. Taking into account the feedback received on the Discussion Paper, a Scheme for setting up of locally incorporated Wholly Owned Subsidiary (WOS) by foreign banks in India was finalized in November 2013. The scheme provided, as hitherto, allowing foreign banks to operate in India either through branch presence or setting up a wholly owned subsidiary (WOS) with near national treatment. The foreign banks in India have to choose one of the above two modes of presence and shall be governed by the principle of single mode of presence. The policy is guided by the two cardinal principles of (i) reciprocity and (ii) single mode of presence. As a locally incorporated bank, the WOS will be given near national treatment which will enable them to open branches anywhere in the country at par with Indian banks (except in certain sensitive areas where RBI's prior approval would be required). They would also be able to participate fully in the development of the Indian financial sector. The policy incentivizes the existing foreign bank branches which operate within the framework of India's commitment to the World Trade Organisation (WTO) to convert into WOS due to the attractiveness of near national treatment. Such conversion is also desirable from the financial stability perspective. To provide safeguards against the possibility of the Indian banking system being dominated by foreign banks, the framework has certain measures to contain their expansion if the share of foreign banks exceeds a critical size. Certain measures from corporate governance perspective have also been built in so as to ensure that the public interest is safeguarded.

## (f) Payment Banks

29. On 27th November Payment Banks have been introduced in the Indian financial system, with the basic objective of furthering financial inclusion by providing (i) small savings accounts and (ii) payments/ remittance services to migrant labour workforce, low income households, small businesses, other unorganised sector entities and other users. Their scope of activities include the acceptance of demand deposits, presently restricted to holding a maximum balance of Rs. 100,000 per individual customer, payments and remittance services through various channels, acting as Business Correspondents (BC) of another bank etc. Payments Banks cannot undertake any lending activities. Apart from amounts maintained as Cash Reserve Ratio (CRR) with RBI on its outside demand and time liabilities, they are required to invest a minimum of 75 per cent of their "demand deposit balances" in Statutory Liquidity Ratio (SLR) eligible Government securities/treasury bills with maturity up to one year and hold maximum 25 per cent in current and time/fixed deposits with other scheduled commercial banks for operational purposes and liquidity management.

30. Payments banks are new model of banks conceptualized by Reserve Bank of India (RBI) to meet government's financial inclusion target. They are being set up as differentiated bank and its activities are confined to acceptance of demand deposits, remittance services, internet banking and other specified services but not lending services.

31. This differentiated banking model allows mobile firms, supermarket chains and others to cater to banking requirements of individuals and small businesses.

32. Payments banks can accept deposits upto Rs. 1 lakh per account from individuals and small businesses. They can issue ATM/debit cards but not credit cards. They can also issue other prepaid payment instruments. They can also distribute non-risk sharing simple financial products like mutual funds and insurance products.

33. Operating guidelines have been issued vide Circular No. RBI/2016-17/80 DBR. NBD. No.25/16.13.218/2016-17 Dated October 6, 2016.

34. Recently, the Union Government has announced that India Post Payments Bank (IPPB) will become operational in all 650 districts of the country by April 2018 to facilitate financial inclusion.

35. This bank will be linked to 1.55 lakh rural post offices for its operations and carry out banking services. This will be largest banking network in the country.

36. IPPB has been set up as a Public Limited Company under Department of Posts with 100% Government of India (GOI) equity. It leverages DoP's network,

resources and reach to make low-cost, quality and simple financial services easily accessible to customers in the country. Its purpose is to further cause of financial inclusion by providing basic banking, remittance services and payments services to customers. It will facilitate spread of financial services like insurance, pensions, mutual funds to customers especially from rural areas and the unbanked and under-banked segments.

It will also generate opportunities for propagating financial literacy across the country by using state of the art banking and payments technology. It will also generate new employment opportunities for skilled banking professionals. It will encourage citizens to move towards a cashless economy.

37. RBI has approved for 11 provisional Payments Bank Licenses which are as follows-

- a) Aditya Birla Nuvo Limited
- b) Airtel M Commerce Service Limited
- c) Cholamandalam Distribution Services Limited
- d) India Department of Posts
- e) FinoPayTech Limited
- f) National Securities Depository Limited
- g) Reliance Industries Limited
- h) Shri Dilip Shantilal Shanghvi
- i) Shri Vijay Shekhar Sharma
- j) Tech Mahindra Limited
- k) Vodafone m-pesa Limited

Of these 11 licenses, 6 Banks have already commenced banking operations.

### **(g) Small Finance Banks**

38. Small Finance Banks have also been introduced in the Indian financial system since November 2014, with the basic objective of furthering financial inclusion by (a) provision of savings vehicles, and (b) supply of credit to small business units; small and marginal farmers; micro and small industries; and other unorganised sector entities, through high technology-low cost operations. Their scope of activities primarily include undertaking basic banking activities of acceptance of deposits and lending to unserved and under-served sections

including small business units, small and marginal farmers, micro and small industries and unorganized sector entities.

39. Operating guidelines have been issued vide Circular No. RBI/2016-17/81 DBR. NBD.No.26/16.13.218/2016-17 dated October 6, 2016. Guidelines w.r.t. Investment Classification, Restrictions on Loan and Advances, Income Recognition and Asset Classification as applicable to Scheduled Bank will be applicable to Small Finance Banks. In addition to it, specific guidelines have been issued for Capital Adequacy Framework, Leverage Ratio, Liquidity Coverage Ratio and Net Stable Funding Ratio, etc.

40. On 17th September 2015, The RBI announced that it had given licenses to 10 entities namely Au Small Finance Bank, Capital Small Finance Bank, Jana Small Finance Bank, Ujjwan Small Finance Bank, Equitas Small Finance Bank, Fincare Small Finance Bank, ESAF Small Finance Bank, North East Small Finance Bank, Suryoday Small Finance Bank, Utkarsh Small Finance Bank.

#### **(h) EXIM Bank**

41. EXIM Bank (Export – Import Bank of India) was set up by the Government of India under Export-Import Bank of India Act, 1981 and it started its functioning in January 1982. It was established with the objective of providing financial assistance to exporters and importers, functioning as the principal financial institution for coordinating the working of institutions engaged in financing export and import of goods and services with a view to promoting the country's international trade.

42. It also provides refinance facilities to the commercial banks and financial institutions against their export-import financing activities.

43. As on 31st march 2018, the net funded loan assets of the bank stood at Rs. 10753.20 Crore and non- funded advances were Rs. 1324Crore.

44. Functions of EXIM Bank:

1. Financing of export and import of goods and services both of India and of outside India.
2. Undertaking merchant banking functions of companies engaged in foreign trade.
3. Providing finance for joint ventures in foreign countries.
4. Offering buyers' credit and lines of credit to the foreign governments and banks.
5. Providing technical and administrative support to the parties engaged in export and import business.

6. Providing business information and advisory services to Indian exports in respect of multilaterally funded projects overseas.

### **C. Organizational Structure of Banks**

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

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

- Laying down policies and procedures for smooth and efficient functioning of the bank and to review them periodically.
- Deciding on the extent of powers – financial and administrative – which may be vested in various functionaries of the bank.
- Planning and performance budgeting.
- Asset-liability management.
- Laying down lending policy of the bank, the risk management guidelines and the rehabilitation and recovery guidelines including policies for compromise, settlement and write-off.
- Deciding about the interest rates on both deposits and the loans as well as about charges for various services and review interest rates and charges periodically.
- Treasury and investment management (usually handled by the head office, though in some cases, select large branches may also be involved in this function).
- Monitoring and controlling the functioning of various offices of the bank.

47. Periodic inspections and internal audit are important constituents of such monitoring and control mechanism.

- Reconciling the transactions among various offices of the bank
- Introducing new products and services and reviewing the existing ones.
- Issuing instructions to branches and other offices from time to time on matters deserving their attention or requiring compliance by them.

48. At the second level are the zonal offices which are responsible for overall working of the branches in their areas of operation. Zonal offices act as a link

between the branches and the head office, either directly or through regional offices.

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

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

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

## **D. Role of the Reserve Bank of India as the Central Bank**

52. The Reserve Bank of India (hereinafter referred to as RBI) acts as the monetary authority and the central bank of the country. In an effort to bring greater coordination among financial regulators, the Government of India has constituted an over-arching body - the Financial Stability and Development Council ("FSDC" or "Council") in December 2010. The Council is headed by the Honorable Finance Minister and composed of the Governor of the RBI, the chairs of the SEBI, the IRDA and the PFRDA, and other Ministry of Finance ("MoF") officials. It envisages strengthening and institutionalizing the mechanism of maintaining financial stability, financial sector development, inter-regulatory coordination along with monitoring macro-prudential regulation of the Indian economy. On February 20, 2015 the RBI and Government signed the Monetary Policy Framework Agreement. In addition to it after amendment in RBI Act, the Monetary Policy Committee (MPC) headed by Governor was setup. The MPC is entrusted with the task of fixing the benchmark policy interest rate (repo rate) to contain inflation within the target level.

53. The RBI is the central bank of our country. As such, RBI is responsible for development and supervision of the constituents of the Indian financial system (which comprises banks and non-banking financial institutions) as well as for determining, in conjunction with the Central Government, the monetary and credit policies keeping in with the need of the hour. Among its important functions are

issuance of currency; regulation of currency issue; acting as banker to the central and state governments; and acting as banker to commercial and other types of banks including term-lending institutions. Besides, RBI has also been entrusted with the responsibility of regulating the activities of commercial and other banks. Banks can commence business by opening the branches as per branch opening policy of RBI. The RBI also has the power to inspect any bank. The Banking Regulation Act, 1949 provides the legal framework for regulation and supervision of banks. This statute, together with some provisions in the Reserve Bank of India Act, 1934, State Bank of India Act, 1955, State Bank of India (Subsidiary Banks) Act, 1959 and Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970 & 1980, empowers the RBI to prescribe standards and monitor liquidity, solvency and soundness of banks, so as to ensure that depositors' interests are protected at all times.

54. Periodic inspections of banks under section 35 of the Banking Regulation Act, 1949 are undertaken as a follow-up of the bank licensing regulation and objectives as laid down in section 22 of the Banking Regulation Act, 1949. The substantive objective of the statutory inspections has been to verify whether the conditions subject to which the bank has been issued license to undertake banking business in terms of sub-section (3) of section 22 [including sub-section (3A) for foreign banks] continue to be fulfilled by it. The conditions include:

- (a) the bank "is or will be in a position to pay its present or future depositors in full as their claims accrue" (i.e. it is solvent and has adequate liquidity);
- (b) the bank "has adequate capital structure and earning prospects";
- (c) "the affairs of the (banking) company are not being, or are not likely to be, conducted in a manner detrimental to the interests of its present or future depositors"; and
- (d) "the general character of the management of the bank is not prejudicial to the public interest or the interest of its depositors" (i.e. it has sound operational systems and adequate controls operated by a prudent management).

Section 22(4) of the Banking Regulation Act, 1949 authorizes the RBI to cancel the banking license "if at any time, any of the conditions referred to in sub-section (3) and sub-section (3A) is not fulfilled".

55. Based on the recommendations of a High Level Steering Committee (HLSC) for Review of Supervisory Processes of Commercial Banks, the Reserve Bank of India had in September 2012, introduced a Supervisory Program for Assessment of Risk and Capital (SPARC) for commercial banks under RBS. This Risk Based

Supervision (RBS) approach, helps the regulator in focusing on evaluating both present and future risks, identifying incipient issues and facilitating prompt intervention/ early corrective action - as against the earlier compliance-based and transaction testing approach (CAMELS) which was more in the nature of a 'point in time' assessment. The RBS approach also benefits the regulator by optimizing its use of supervisory resources and assisting the regulated entities in improving their risk management systems, oversight and controls.

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

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

58. Under Base Rate system which came into effect from July 1, 2010, all categories of domestic rupee loans of banks are priced only with reference to the Base Rate, subject to certain conditions. For monetary transmission to occur, lending rates have to be sensitive to the policy rate. At present, banks follow different methodologies for computing their Base Rate like average cost of funds method, marginal cost of funds, blended cost of funds (liabilities) etc.

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

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

61. A major development that has implications for banks throughout the world is the "International Convergence of Capital Measurement and Capital Standards"



generally known as the Basel Accord. Basel III ensures better quality of capital and robust liquidity risk management.

62. The smooth functioning of the payment and settlement systems is a prerequisite for stability of the financial system. In order to have focused attention on payment and settlement systems, a Board for Regulation and Supervision of Payment Systems (BPSS) was set up in March, 2005. The launch of the Real Time Gross Settlement System (RTGS) and NEFT (National Electronic Funds Transfer) has led to a reduction of settlement risk in large-value payments in the country. Similarly, IMPS (Inter bank Mobile Payment Service/Immediate Payment Service) is a mobile based payment mechanism introduced by the National Payments Corporation of India to allow customers to transfer money instantly, facilitating instant remittance across multiple platforms. The setting up of NSDL and CDSL for the capital market settlements and CCIL for G-sec, forex and money market settlements have improved efficiency in market transactions and settlement processes. A series of legal reforms to enhance the stability of the payment systems have been carried out. With the introduction of the Payments and Settlement Act in 2008, the Reserve Bank has the legislative authority to regulate and supervise payment and settlement systems in the country.

63. In India, deposit insurance is provided by the Deposit Insurance and Credit Guarantee Corporation (DICGC), a wholly owned subsidiary of the Reserve Bank of India. Deposit insurance in India is mandatory for all banks (commercial/cooperative/ RRBs/LABs). It covers all kinds of deposits except those of foreign governments, Central/State Governments, inter-bank, deposits received abroad and those specifically exempted by DICGC with prior approval of the Reserve Bank. The premium charged for deposit insurance is on a flat rate basis, which is currently 10 paise per Rs.100 of assessable deposits with a statutory ceiling on premium at 15 paise. The premia to be paid by the insured banks are computed on the basis of their assessable deposits. Insured banks pay advance insurance premia to the Corporation semi-annually within two months from the beginning of each financial half year, based on their deposits as at the end of previous half year. The amount of coverage is presently limited to Rs.1 lakh per depositor and extends to deposits held in the same right and in the same capacity.

64. Banks and financial institutions (FIs) have also been advised by RBI to follow certain customer identification procedure for opening of accounts and monitor transactions of suspicious nature for the purpose of reporting the same to appropriate authority. These 'Know Your Customer' (KYC) guidelines have been revisited in the context of the recommendations made by the Financial Action Task Force (FATF) on Anti Money Laundering (AML) standards and on

Combating Financing of Terrorism (CFT). Detailed guidelines based on the recommendations of FATF and the paper issued on Customer Due Diligence (CDD) for banks by the Basel Committee on Banking Supervision (BCBS), with suggestions wherever considered necessary, have been issued. Banks/FIs have been advised by RBI to ensure that a proper policy framework on 'Know Your Customer' and Anti-Money Laundering measures is formulated and put in place with the approval of their Boards. The objective of KYC/AML/CFT guidelines is to prevent banks/FIs from being used, intentionally or unintentionally, by criminal elements for money laundering or terrorist financing activities. KYC procedures also enable banks/FIs to know/understand their customers and their financial dealings better and manage their risks prudently. Foreign Account Tax Compliance Act (FATCA) is a US law, which was enacted in March 2010 by the US Government which was aimed at preventing tax evasion through off shore assets by US citizens and US residents. Foreign Financial Institutions (FFIs) such as the Bank that enter into a FATCA FFI agreement with the US government are required to conduct certain due-diligence to identify its US clients (individual and entity) and report on their accounts to the US Internal Revenue Service (IRS).

65. India has signed the Inter-Governmental Agreement (IGA) with USA for improving international tax compliance and implementing the Foreign Account Tax Compliance Act (FATCA). India has also signed a multilateral agreement on June 3, 2015, to automatically exchange information based on Article 6 of the Convention on Mutual Administrative Assistance in Tax Matters under the Common Reporting Standard (CRS), formally referred to as the Standard for Automatic Exchange of Financial Account Information (AEOI). In this regard, On August 7, 2015 Government of India has notified the amendments to Income Tax Rules (Rules) and have added Rule 114F (definitions), 114G (Information to be maintained and reported) and 114H (due diligence requirement) for operationalization of IGA and CRS. This information regarding US reportable persons and other reportable persons have to be furnished in a form 61B.

Banks have modified their account opening forms to include FATCA Compliance Declarations. Banks are internally monitoring transactions over the defined thresholds to verify if any transactions need reporting as per the guidelines. Auditors also review whether the Bank has ensured compliance with the FATCA guidelines.

66. Apart from directions relating to operational matters, RBI also issues, from time to time, guidelines on accounting matters to be followed by banks. These guidelines have a profound effect on annual accounts of banks. The text of the

notifications/circulars/guidelines, etc., issued by RBI are normally also available on its website [www.rbi.org.in](http://www.rbi.org.in).

### **Prompt Corrective Action (PCA) framework for NPAs**

67. Reserve Bank of India under its supervisory frame work uses various measures/ tools to maintain sound financial health of the bank. PCA frame work is one of such supervisory tools which involve monitoring of certain performance indicators of the banks as early warning exercise and is initiated once such thresh holds as relating to capital, asset quality etc. are breached.

68. Its objective is to facilitate the banks to take corrective measures including those prescribed by RBI, in a timely manner to realize financial health of the bank.

69. PCA frame work is in operations since December 2002 & the guidelines have been issued from time to time and on 13th April 2017, revised frame work was issued by the RBI.

70. RBI has come up with a notification titled "Revised Prompt Corrective Action (PCA) framework for banks." The revised framework would apply to all banks operating in India including small and foreign banks. The new set of provisions will be effective from April 1 based on the financials of banks as of March 2017. The revised framework will override the existing PCA framework. The revised framework will be again reviewed after three years.

In 2018 11 PSU Banks were under PCA Framework which were Dena Bank, Allahabad Bank, United Bank of India, Corporation Bank, IDBI Bank, UCO Bank, Bank of India, Central Bank of India, Indian Overseas Bank, Oriental Bank of Commerce and Bank of Maharashtra.

### ***Salient guidelines of revised PCA***

71. Capital, Asset Quality and profitability would be the basis on which the banks would be monitored. Banks would be placed under PCA framework depending upon the audited annual financial results and RBI's supervisory assessment. RBI may also impose PCA on any bank including migration from one threshold to another if circumstances so warrants. RBI has defined three kinds of risk thresholds and the PCA will depend upon the type of risk threshold that was breached

72. If a bank breaches the risk threshold, then mandatory actions include the restriction on dividend payment/remittance of profits, restriction on branch expansion, higher provisions, restriction on management compensation and director's fees. Specifically, the breach of 'Risk Threshold 3' of CET1 (common

equity tier 1) by a bank would call for resolution through tools like amalgamation, reconstruction, winding up among others.

73. RBI in its discretion can also carry out the following actions:

- Recommend the bank owner be it government/promoters/parent of foreign bank branch to bring in new management/board.
- Advise bank's board to activate the recovery plan as approved by the supervisor.
- Advise bank's board to carry out a detailed review of business model, the profitability of business lines and activities, assessment of medium and long term viability, balance sheet projections among others.
- Review short term strategies and medium-term business plans and carry out any other corrective actions like the removal of officials and supersession or suppression of the board.

### **Legal Entity Identifier (LEI) mandatory for all large corporate borrowers**

74. On 2nd November, 2017, RBI *vide* notification DBR.No.BP.BC.92/21.04.048/2017-1 has made 20-digit Legal Entity Identifier (LEI) compulsory for companies having aggregate fund-based and non-fund based exposure over Rs. 5 crore.

75. The move is aimed at improving risk management in wake of huge stressed assets in banking system. Before this, RBI had made LEI mandatory for transactions in interest rate, forex and credit derivative market

76. LEI mechanism will help banks to effectively monitor debt exposure of corporate borrowers. It will also enable banks in preventing multiple loans to companies against the same collateral.

77. LEI is a 20-digit unique code to identify parties to financial transactions worldwide. It is a global reference number that uniquely identifies every legal entity or structure that is party to a financial transaction, in any jurisdiction. It is defined by ISO 17442. LEI code has been conceived as key measure to improve quality and accuracy of financial data systems for better risk management post the global financial crisis.

78. The LEI system was developed by G20 in response to inability of financial Institutions to identify organizations uniquely, so that their financial transactions in different national jurisdictions can be fully tracked. The first LEIs were issued in December 2012.

79. Legal Entity Identifier India Limited (LEIL), a wholly-owned subsidiary of Clearing Corporation of India (CCI), acts as a local operating unit (LOU) for issuing globally compatible legal entity identifiers (LEIs) in India. Besides, entities can also obtain LEI from any of local operating units (LOUs) accredited by Global Legal Entity Identifier Foundation (GLEIF) – the entity tasked to support implementation and use of LEI.

80. Borrowers with fund and non-fund exposure of Rs 1,000 crore and above will have to get LEI by March 2018. Those having exposure between Rs 500 crore and Rs. 1,000 crore have to obtain LEI code by June 2018 and those having between Rs. 100 crore and Rs 500 crore by March 2019.

## **E. Role of the Union Government for strengthening and improving the Banking Sector in India**

81. The Union Government is also initiating various measures from time to time in order to strengthen the Banking Sector in India.

82. As a part of measure, Union Government has launched a seven pronged plan called Indradhanush Mission in August 2015 to revamp functioning of public sector banks (PSBs). The plan envisaged inter alia, infusion of capital in PSB's by the Government to the tune of Rs. 70,000 crore over a period of four financial years to meet their capital requirement in line with global risk Basel-III norms to keep these banks fully solvent. Government has so far infused capital of Rs. 59,435 crore in PSB under Indradhanush.

83. The seven shades of Indradhanush mission include appointments, de-stressing PSBs, capitalisation, empowerment, framework of accountability Bank Board Bureau and governance reforms.

84. It seeks to achieve the objective of economic growth revival through improving credit and minimising the political interference in the functioning of PSBs.

85. One of the shed of mission Indradhanush, Bank Board Bureau (BBB) was earlier announced in the 2015-16 budgets and which was implemented with the announcement of the Indradhanush Mission. It is the first step used to make bank as a full fledged bank holding company.

- BBB replaced all the earlier procedure of appointment of whole time directors and non executive chairman of Public Sector Banks and formalized the appointment procedures by comprising the eminent professionals and officials, who will follows the proper election methodology for appointment of CEO and MD for the required posts in banks.

- BBB consists of a chairman and six members team in which three officials and three experts, who will constantly involve themselves with the Board of Directors of the other Public Sector Banks to formulate the growth and development strategies.

86. The Bank Board Bureau (BBB) has recommended that Government should bring in reforms in the compensation process in public sector banks (PSBs) on the lines of Central Public Sector Enterprises (CPSEs).

87. BBB has suggested compensation reforms in PSBs so that best practices can be introduced 'on the lines already prevalent in CPSEs.

88. It will play important role in attracting high-quality talent for non-executive directors and chairmen. It will also maintain a level-playing field with the private sector with respect to role, responsibility and remuneration.

- BBB is the super authority (autonomous body) of eminent professionals and officials for public sector banks (PSBs). It had replaced the Appointments of Board of Government.
- It is set up in April 2016 as part of seven point Indradhanush Mission to revamp the Public Sector Banks (PSBs).
- *Functions:* Give recommendations to Government for appointment of fulltime Directors as well as non-Executive Chairman of PSBs.
- Give advice to PSBs in developing strategies for raising funds through innovative financial methods and instruments to deal with stressed assets.
- Guide banks on mergers and consolidations and also ways to address the bad loans problem and among other issues.

### **Bank Recapitalization Plan**

89. Indian PSBs are saddled with high, non-performing assets (NPAs) and facing prospect of having to take haircuts on loans stuck in insolvency proceedings. Due to this, PSBs were unable to give fresh loans.

90. The Union Government has announced Bank Recapitalization Plan to infuse Rs. 2,11,000 crore (\$32.4 billion) capital over next two years into public sector banks (PSBs) and prioritized financing support for MSMEs in 50 clusters. The capital infusion will be accompanied by a series of banking sector reforms that will be revealed in the coming months. Key Facts Under this plan, PSBs will get Rs. 1,35,000 crore from Recapitalization Bonds, Rs. 18,139 crore from Budgetary support and remaining Rs 57,861 crore will be raised through sale of share of banks. The nature of recapitalization bonds will be decided in coming

months and these bonds will be frontloaded over next four quarters with maximum timeframe of two years.

91. It will increase lending capacity of PSBs which will in turn boost economy and improve private sector investment especially when International Monetary Fund (IMF) projected growth to 5.7% which is lowest in three-year and create jobs. The supply of money to PSBs will enable banks lend lower interest rates. Depending on nature of recapitalization bonds, their issuance can also impact the government's fiscal deficit target i.e. government's total expenditures may exceed the revenue that it generates (apart from money from borrowings).

### **Consolidation of Banks**

92. During the year, era of consolidation of banks started with merger of 6 association of State Bank of India, namely State Bank of Bikaner and Jaipur, State Bank of Hyderabad, State Bank of Mysore, State Bank of Patiala and State Bank of Travancore & Bharatiya Mahila Bank. With this merger, SBI joined the league of top 50 banks globally in terms of assets.

93. On September 17<sup>th</sup>, 2018, the government had announced the merger of Bank of Baroda, Vijaya Bank and Dena Bank, to create the country's third largest lender. The boards of all the three banks have approved (the merger proposal) and sent the recommendations to the government. The next step would be the government approving formally the merger process, and then the swap ratio. The merger is expected to take four to six months to complete. More Banks are expected to merge and consolidate going forward.

94. BOM has already announced closure of 51 Branches wef from 1st October 2018 all in Urban Center across India which have been identified for the cost cutting action.

95. The idea of bank mergers was around since 1991, when former Reserve Bank of India (RBI) governor M. Narasimham had recommended the government to merge banks into three-tiered structure, with three large banks with an international presence at top. In 2014, PJ Nayak Committee also had suggested that government either merge or privatize state-owned banks.

### **96. Significance of PSBs consolidation**

- Reduce their dependence on government for capital.
- Open up more capital generation avenues, both internally and from market, for the merged entity.
- From a government point of view, it will increase stream of dividends which forms part of their non-tax revenue.

- Increase the role of internal and market resources and thus reduce dependence of merged bank on government for the future capital infusion.
- It will lead to greater concentration of payment and settlement flows as there will be fewer parties in the financial sector.
- Operational risks could increase post-merger as size of operations grows and distance between management and operational personnel is greater as the administrative systems become more complex.
- It will help to deal better with their credit portfolio, including stressed assets. Consolidation will also prevent multiplicity of resources being spent in the same area and strengthens banks to deal with shocks.

97. With the merger, SBI's market share has increased to 22.5-23% from 17% with total business of over 37 lakh crore rupees. The merged entity now has a deposit base of more than Rs. 26 lakh-crore and advances level of Rs 18.50 lakh crore accounting for one-fourth of the deposit and loan market in the country. SBI now has 2.77 lakh employees, 50 crore customers and more than 25,000 branches and 58,000 ATMs. Its total customer base has reached to 37 crore across the country and these all customers will enjoy the benefits of a wide array of digital products and services offered by SBI.

98. Thereupon the Union Government has constituted Alternative Mechanism Panel headed by Union Finance Minister Shri Arun Jaitley to oversee merger proposals of public sector banks (PSBs). The other members of the panel include Railway and Coal Minister Shri Piyush Goyal and Defence Minister Smt. Nirmala Sitharaman.

99. This alternative mechanism has been set up by the government to fast-track consolidation among public sector banks to create strong lenders. The mechanism will oversee the proposals coming from boards of PSBs for consolidation.

- Alternative mechanism being created to give in-principle approval to proposals of banks to prepare schemes of amalgamations.
- After in-principle approval, the banks will take steps in accordance the law and SEBI's requirements.
- The final scheme will be notified by Central Govt. in consultation with Reserve Bank of India.
- Alternative mechanism aims to create strong and competitive banks in public sector space to meet the credit needs of a growing economy, absorb shocks



and have the capacity to raise resources without depending unduly on the state exchequer.

- The decision regarding creating strong and competitive banks would be solely based on commercial consideration.

## **Amendments in the Banking Regulation Act, 1949**

100. The banking sector in India is saddled with non-performing assets. The Union Government in May 2017 had promulgated an ordinance authorizing the RBI to issue directions to banks to initiate insolvency resolution process under the Insolvency and Bankruptcy Code, 2016. The RBI in June 2017 had identified 12 accounts each having more than Rs. 5000 crore of outstanding loans and accounting for 25% of total NPAs of banks for immediate referral for resolution under the bankruptcy law. Further in August, 2017, the RBI identified 28 accounts those were materially NPA as on June 30,2017, i.e. where more than 60 percent of the total outstanding was classified as NPA on CRILC, shall be given time till December 13,2017 for resolution outside IBC. In the event that a viable resolution plan is not finalized and implemented before that said date, insolvency proceedings under the provisions of the IBC may be initiated before December 31, 2017, unless already initiated. The bulk of the NPAs are in certain sectors including power, steel, road infrastructure and textiles.

101. The Union Government has notified the Banking Regulation (Amendment) Act, 2017. The Parliament had approved the Banking Regulation (Amendment) Bill, 2017 which replaced an ordinance in this regard.

102. It amended the Banking Regulation Act, 1949 by adding provisions for handling cases related to stressed assets or non-performing assets (NPAs) of banks.

103. The Act empowers the Central government to authorize the Reserve Bank of India (RBI) to direct banking companies to resolve specific stressed assets by initiating insolvency resolution process under the Insolvency and Bankruptcy Code, 2016.

104. The RBI can specify authorities or committees to advise banks on resolution of stressed assets. The members on the committees will be appointed or approved by the RBI. The Act also makes these provisions applicable to the SBI and its subsidiaries and also Regional Rural Banks (RRBs).

# Accounting and Auditing Framework

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01. The guidance note is based on DBOD and other circulars issued by RBI which are applicable to scheduled commercial banks. Thus, this guidance note is to be referred to in the context of audit of Scheduled Commercial Bank only and not for the purpose of Urban Co-operative Banks, Regional Rural Banks and District Central and State Apex Co-operative Bank. This Chapter discusses the statutory provisions and regulatory requirements affecting the accounts and audit of banks.

## Form and Content of Financial Statements

02. Sub-sections (1) and (2) of section 29 of the Banking Regulation Act, 1949, deal with the form and content of financial statements of a banking company and their authentication. These sub-sections are also applicable to nationalised banks, State Bank of India, subsidiaries of the State Bank of India, and Regional Rural Banks.

03. Sub-section (1) of section 29 requires every banking company to prepare a balance sheet and a profit and loss account in the forms set out in the Third Schedule to the Act as near thereto as the circumstances admit. These financial statements have to be prepared as on the last working day of each financial year (i.e., 31st March) in respect of all business transacted during the year. A foreign banking company (i.e., a banking company incorporated outside India and having a place of business in India) has to similarly prepare a balance sheet and a profit and loss account every year in respect of all business transacted through its branches in India. As per Accounting Standard 3, the bank should prepare the cash flow statement also. Hence the financial statements of the bank shall include the cash flow statement along with the balance sheet and profit and loss account as well.

## Salient Features of the Third Schedule

04. Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of balance sheet and Form B contains the form of profit and loss account. The text of the Third Schedule to the Banking Regulation Act, 1949 is given in **Appendix II** of this Guidance Note.

05. The balance sheet as well as the profit and loss account are required to be presented in vertical form. Capital and liabilities are to be presented under the following five broad heads:

- Capital
- Reserves and Surplus
- Deposits
- Borrowings
- Other liabilities and provisions

06. Assets are required to be presented under the following six broad heads:

- Cash and Balances with Reserve Bank of India
- Balances with Banks and Money at call and short notice
- Investments
- Advances
- Fixed assets
- Other assets

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

08. The aggregate amounts of contingent liabilities and bills for collection are to be presented on the face of the balance sheet. While details of contingent liabilities are to be presented by way of a schedule.

09. The following items are required to be presented on the face of the profit and loss account.

- I. *Income*
  - Interest earned
  - Other income
- II. *Expenditure*
  - Interest expended
  - Operating expenses
  - Provisions and contingencies
- III. *Profit (Loss)*
  - Net profit (loss) for the year
  - Profit/loss brought forward
- IV. *Appropriations*

- Transfer to statutory reserves
- Transfer to other reserves
- Transfer to Government/Proposed Dividend
- Balance carried over to balance sheet

10. Prescribed details of interest earned, other income, interest expended and operating expenses are required to be given by way of schedules to the profit and loss account.

### **Disclosures Prescribed by RBI**

11. In addition to the disclosures to be made in the balance sheet and profit and loss account in pursuance of the requirements of the Third Schedule to the Act, the RBI has, vide its Master Circular no. DBR.BP.BC No 23/21.04.018/2015-16 dated July 1, 2015 on “Disclosure in Financial Statements – ‘Notes to Accounts’”, prescribes disclosures to be made in the Notes to Accounts in respect of certain significant aspects of the items of financial statements of banks. Further the RBI vide its Circular No. DBR.BP.BC.No.63/21.04.018/2016-17 has prescribed an additional disclosure to be made in the Notes to Accounts from the Financial Year 2016-17 with respect to divergences observed by the RBI in the asset classification and provisioning. The disclosures in connection with Accounting Standards as mentioned in the circular is only the minimum required and other disclosures as prescribed by the Accounting Standards is mandatory to the extent they are not inconsistent with RBI circular.

### **Disclosures Required Under Accounting Standards**

12. The disclosure requirements under the various Accounting Standards, as specified under Section 133 of the Companies Act, 2013, read with Rule 7 of the Companies (Accounts) Rules 2014, in so far as they apply to banking companies or Accounting Standards issued by the ICAI are also to be complied with.

### **Requirements of the Banking Regulation Act, 1949, vis-a-vis Companies Act, 2013**

13. The requirements of the Companies Act, 2013, relating to the balance sheet, profit and loss account and cash flow statement of a company, in so far as they are not inconsistent with the Banking Regulation Act, 1949, also apply to the financial statements, as the case may be, of a banking company [sub-section (3) of section 29 of the Act]. It may be noted that this provision does not apply to nationalised banks, State Bank of India, its subsidiaries and regional rural banks.

14. The Union Budget for 2014-15 emphasised the urgent need for convergence of the current Indian accounting standards with International Financial Reporting Standards (IFRS). The Ministry of Corporate Affairs (MCA), Government of India notified the rules for IFRS converged Indian Accounting Standards (Ind AS) along with its implementation road map for corporates in a phased manner from 2016-17 onwards. Pursuant to Companies (Indian Accounting Standards) (Amendment) Rules, 2016 the following roadmap for Ind AS implementation in case of insurance companies, banking companies and non-banking financial companies (NBFCs) has also been announced:

“Roadmap drawn-up for implementation of Indian Accounting Standards (Ind AS) converged with International Financial Reporting Standards (IFRS) for Scheduled Commercial Banks (Excluding RRBs), Insurers/Insurance Companies and Non-Banking Financial Companies (NBFCs)”

15. In pursuance to the Budget Announcement by the Union Finance Minister Shri Arun Jaitley, after consultations with Reserve Bank of India (RBI), Insurance Regulatory and Development Authority (IRDA) and Pension Fund Regulatory and Development Authority (PFRDA), the following roadmap for implementation of Indian Accounting Standards (Ind AS) converged with International Financial Reporting Standards (IFRS) for Scheduled commercial banks (excluding RRBs), insurers/insurance companies and Non-Banking Financial Companies (NBFCs) has been drawn up.

The RBI has issued a Press Release on April 05, 2018 specifying deferment of Ind AS implementation for Scheduled Commercial Banks excluding RRBs by one year. The aforesaid Press Release provides that Scheduled Commercial Banks (SCBs), excluding Regional Rural Banks (RRBs), were required to implement Indian Accounting Standards (Ind AS) from April 1, 2018 vide our Circular dated February 11, 2016. However, necessary legislative amendments - to make the format of financial statements, prescribed in the Third Schedule to Banking Regulation Act 1949, compatible with accounts under Ind AS - are under consideration of the Government. In view of this, as also the level of preparedness of many banks, it has been decided to defer implementation of Ind AS by one year by when the necessary legislative changes are expected. Scheduled commercial banks (excluding RRBs)/NBFCs/insurance companies/insurers shall apply Indian Accounting Standards (Ind AS) only if they meet the specified criteria, they shall not be allowed to voluntarily adopt Indian Accounting Standards (Ind AS). This, however, does not preclude an insurer/insurance company/NBFC from providing Ind AS compliant financial statement data for the purposes of preparation of consolidated financial

statements by its parent/investor, as required by the parent/investor to comply with the existing requirements of law.

### **Banks Listed on a Stock Exchange**

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

### **Consolidated Financial Statements in case of one or more Subsidiaries**

17. Banks are required to prepare Consolidated Financial Statements incorporating the Financial Statements of all the subsidiaries in the same form and manner as that of its own. In case the Bank is a Company, then such Consolidated Financial Statements shall also be laid before the annual general meeting of the company along with the laying of its financial statement by virtue of sub – section (3) of section 129 of Companies Act, 2013.

Further a separate statement containing the salient feature of the financial statement of its subsidiary or subsidiaries in such form as may be prescribed shall also be attached along with its financial statement.

### **Notes and Instructions Issued by RBI**

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

### **Signatures**

19. Sub-section (2) of section 29 of the Act requires that the financial statements of banking companies incorporated in India should be signed by the manager or principal officer of the banking company and by at least three directors (or all the directors in case the number is less than three). The financial statements of a foreign banking company are to be signed by the manager or agent of the principal office in India. It may be noted that the accounts of a branch are usually signed by the manager of the branch and/or the accountant.

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

### **Auditor's Report**

20. In the case of a nationalised bank, the auditor is required to make a

report to the Central Government in which the auditor has to state the following:

- (a) whether, in his opinion, the balance sheet is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the bank, and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory;
- (b) whether or not the transactions of the bank, which have come to his notice, have been within the powers of that bank;
- (c) whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit;
- (d) whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and
- (e) any other matter which he considers should be brought to the notice of the Central Government.

21. The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalised bank.

22. The auditor's report in the case of subsidiaries of State Bank of India is identical to the auditor's report in the case of a nationalised bank, except that all references to Central Government have to be construed instead as references to the State Bank of India. Similar is the position in the case of regional rural banks, except that the references are instead to the bank concerned.

### **Format of Audit Report**

23. The auditors, central as well as branch, should also ensure that the audit report issued by them complies with the requirements of SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements", SA 701, "Communicating Key Audit Matters in the Independent Auditor's Report" and where required with the SA 705 (Revised), "Modifications to the Opinion in the Independent Auditor's Report" and/or SA 706 (Revised), "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", as may be applicable. ICAI has revised SA 700, 701, 705 and 706 on 17th May, 2016 which will be effective for audits of financial statements for periods beginning on or after 1st April, 2018. SA 701 "Communicating Key Audit Matters in the Auditor's Report", this SA deals with auditor's responsibility to communicate key audit matters in the auditor's report. Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial

statements of the current period. These matters are selected from matters communicated with those charged with governance. The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters", the auditor should ensure that not only information relating to number of unaudited branches is given but quantification of advances, deposits, interest income and interest expense for such unaudited branches has also been disclosed in the audit report. Such disclosure in the audit report is not only in accordance with the best international trends but also provides useful information to users of financial statements, for example, though the absolute number of unaudited branches might be quite large but in relation to overall operations of the bank such unaudited branches are quite miniscule and thus, not material. Therefore, the auditor should ensure that the complete information in respect of unaudited branches is collected and disclosed in the audit report.

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

25. The auditor of a banking company is required to state in his report the followings in terms of provisions of Section 30(3) of The Banking Regulation Act, 1949:

- (a) whether or not the information and explanations required by the auditor have been found to be satisfactory;
- (b) whether or not the transactions of the company which have come to the notice of the auditor have been within the powers of the Bank;
- (c) whether or not the returns received from the branch offices of the Bank have been found adequate for the purpose of audit;
- (d) whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and
- (e) any other matter which the auditor considers should be brought to the notice of the shareholders of the company.



In addition to the aforesaid, the auditor of a banking company is also required to state in his report in respect of matters covered by Section 143(2) & (3) of the Companies Act, 2013.

26. As per reporting requirements cast through Rule 11 of the Companies (Audit and Auditors) Rules, 2014 the auditor's report shall also include their views and comments on the following matters, namely:

- i) whether the bank has disclosed the impact, if any, of the pending litigations on its financial position in its financial statements.
- ii) whether the bank has made provision, as required under the law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts.
- iii) whether there has been any delay in transferring amounts, required to be transferred to the Investment Education and Protection Fund by the bank.

### **Long Form Audit Report**

27. Besides the audit report as per the statutory requirements discussed above, the terms of appointment of auditors of public sector banks, private sector banks and foreign banks (as well as their branches), require the auditors to also furnish a long form audit report (LFAR). The matters which the banks require their auditors to deal with in the long form audit report have been specified by the RBI.

28. The LFAR is to be submitted before 30<sup>th</sup> June every year. To ensure timely submission of LFAR, proper planning for completion of the LFAR is required. While the format of LFAR does not require an executive summary to be given, members may consider providing the same to bring out the key observations from the whole document.

### **Reporting to RBI**

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

“If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything

susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action”.

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

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

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

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

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

34. RBI has issued a Master Direction on Fraud no. DBS.CO.CFMC.BC.No. 1/23.04.001/2016-17 dated July 1, 2016 (updated July 03, 2017) on “Frauds – Classification and Reporting by Commercial banks and select FIs” on the matters relating to classification and reporting of frauds and laying down a suitable reporting system. As per the said direction, the primary responsibility for preventing frauds is that of bank management. Banks are required to report frauds to the board of directors and also to the RBI.

35. In the aforesaid context, it may be emphasised that such a requirement

does not extend the responsibilities of an auditor in any manner whatsoever as far as conducting the audit is concerned. The requirement has only extended the reporting responsibilities of the auditor. As far as conduct of audit is concerned, the auditor is expected to follow the Standards on Auditing issued by the ICAI and perform his functions within that framework. SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" states that an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

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

## **Reporting of Frauds to Central Government under the Companies Act, 2013**

37. In case of a banking company, in term of provision of section 143(12) of the Companies Act, 2013:

"Notwithstanding anything contained in this section, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed:

Provided that in case of a fraud involving lesser than the specified amount, the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed:

Provided further that the companies, whose auditors have reported frauds under this sub-section to the audit committee or the Board but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed".

The audit procedure in this regard would be guided by the Guidance Note on Reporting on Fraud under Section 143(12) of the Companies Act, 2013, issued by ICAI.

## **Audit of Branches**

38. Audit of branches of banking companies is required under sub-section (8) of section 143 of the Companies Act, 2013. It is thus obligatory for a banking company to get the financial statements of each of its branch offices audited except where exemption from audit is obtained in respect of certain branches under the guidelines of the RBI issued from time to time.

39. The branch auditor has the same powers and duties in respect of audit of financial statements of the branch as those of the central auditors in relation to audit of head office. The branch auditor's report on the financial statements examined by him is forwarded to the central auditors with a copy to the management of the bank. An illustrative format of report of the branch auditor of a Nationalised Bank is given in the **Appendix III** of this Guidance Note. The branch auditor of a public sector bank, private sector bank or foreign bank is also required to furnish a long form audit report to the bank management and to send a copy thereof to the central auditors. The central auditors, in preparing their report on the financial statements of the bank, deal with the branch audit reports in such manner as they consider necessary. An illustrative format of report of the branch auditor of a Banking Company is given in the **Appendix IV** of this Guidance Note.

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

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

41. There is a significant difference in the scope of audit at a branch of a bank (conducted by branch auditors) and at head office (conducted by central auditors) as well as other controlling offices such as zonal offices and regional offices (usually conducted by central auditors). This difference stems from the fact that the banking business – receiving deposits and making loans and advances – as well as most other banking services take place at the branch level; in the normal course, the head office and the regional/zonal offices do not

conduct any banking business. They are generally responsible for administrative and policy decisions which are executed at the branch level. However, accounting for certain transactions, for example, those relating to treasury functions (viz., investments, funds management, bill re-discounting) is usually centralised, i.e., carried out at the head office. Specialised activities like merchant banking are carried on by separate divisions which operate at the head office and/or at the large designated branches.

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

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

- Depreciation on assets like premises, furniture, fixture, computer assets, UPS etc., where the recording of the relevant fixed assets is centralised at the head office.
- Valuation of investments, and provisions for depreciation in value thereof.
- Provisions in respect of non-performing advances and doubtful elements of other current assets.
- Provision for restructured assets, MTM for fair value etc.
- Provisions for gratuity, pension and other retirement benefits.
- Provision for payment of bonus or ex-gratia in lieu of bonus.
- Provision for Standard Assets.
- Provision for interest on overdue term deposits.
- Provision for interest on saving bank deposits beyond the date up to which interest has been provided at the branch level. [For expeditious finalisation of financial statements of branches, some banks follow the practice of requiring the branches to provide for interest on savings bank deposits based on balances therein as at a cut-off (say, 25th March). The interest for the remaining period is provided at the head office level on an estimated basis.]

- Provision in respect of losses arising from frauds discovered.
- Provision for taxation.
- Provision for audit fee.
- Provisions to meet any other specific liabilities or contingencies, the amount of which is material, for example, provision for revision in pay-scales of employees, provision for foreign exchange fluctuations, etc.
- Transfers to reserves.
- Dividends.
- Any other matter dealt with at the head office.

44. Another area which is of utmost importance for the central auditors in the present-day context is that related to inter-office reconciliation. Such reconciliation is mostly centralised at the head office. Each bank has laid down methods and procedures for reconciling the transactions among the various offices of the bank.

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

46. Generally, in case of private sector banks there are no separate branch auditors. The statutory auditors appointed are supposed to carry out the entire audit. RBI requires the auditors to mention about the number of branches visited and the coverage of business in the audit report.

### **Other Important Provisions Relating to Accounts and Audit**

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

48. Section 32 of the Act requires a banking company (but not other types of banks) to furnish three copies of its annual accounts and auditor's report thereon to the Registrar of Companies at the same time when it furnishes these documents to the RBI. This is considered compliance with section 137 of the Companies Act, 2013 also.

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

## **Accounting Policies**

50. The term 'accounting policies' refers to the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

51. The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation and presentation of the financial statements. The accounting policies followed vary from enterprise to enterprise. An accounting policy may be significant because of the nature of the entity's operations even if amounts for current and prior periods are not material. The principle consideration should be whether disclosure of an accounting policy would assist users in understanding how transactions, other events and conditions are reflected in the balance sheet and profits/loss account.

52. Recognising the need for disclosure of accounting policies by banks, the RBI has required all scheduled banks to disclose their significant accounting policies. The accounting policies are required to be disclosed at one place along with the notes on accounts. A specimen form in which accounting policies may be disclosed has also been given by the RBI. The specimen indicates broadly the areas in respect of which the accounting policies followed by a bank should be disclosed. Banks can, however, make necessary modifications to suit their individual needs.

53. The specimen form given by the RBI recommends the disclosure of the fact that the financial statements are prepared on the historical cost basis and conform to the statutory provisions and practices prevailing in the country. Besides, disclosure of accounting policies relating to the following areas is recommended in the specimen form:

- a) Transactions involving foreign exchange, viz., monetary assets and liabilities, non-monetary assets, income and expenditure of Indian branches in foreign currency and of overseas branches, and profit/loss on pending forward contracts.

- b) Investments.
- c) Provisions in respect of doubtful advances.
- d) Fixed assets and depreciation.
- e) Staff benefits.
- f) Significant provisions deducted in computing net profit, e.g., provision for income-tax, provision for doubtful advances, etc.
- g) Grouping of contingency funds in presenting balance sheet.

54. The specimen form of accounting policies was issued by the RBI in 1991. Since then, the RBI has issued a number of guidelines relating to income recognition, asset classification, provisioning and investments. These guidelines have a profound impact on the accounting policies of banks in the relevant areas. Disclosure of accounting policies formulated by banks to comply with these guidelines is essential to enable the users to properly understand the financial statements. Besides, in the case of banks having overseas branches, the methodology adopted for translating the financial statements of such branches may also constitute a significant accounting policy.

### **Conformity of Accounting Policies with Accounting Standards**

55. The Institute of Chartered Accountants of India (ICAI) issues, from time to time, Accounting Standards for use in the preparation of general purpose financial statements issued to the public by such commercial, industrial or business enterprises as may be specified by the Institute from time to time and subject to the attest function of its members. The Central Government has notified the Accounting Standards issued by the Institute of Chartered Accountants of India under the Companies (Accounting Standards) Rules, 2006<sup>4</sup> and Companies (Accounting Standards) Amendment Rules, 2016. Reference may be made to the Announcement “Harmonisation of various differences between the Accounting Standards issued by the ICAI and the Accounting Standards notified by the Central Government” issued by the ICAI. The following is the list of Accounting Standards issued by ICAI and notified by the Central Government as on 30.10.2017:

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<sup>4</sup>Rule 7(2) of Companies (Accounts) Rule 2014 has clarified that to facilitate proper administration of the notified sections of the Companies Act 2013, in respect of the Section 133, “Till the Standards of Accounting or any addendum thereto are prescribed by Central Government in consultation and recommendation of the National Financial Reporting Authority, the existing Accounting Standards, notified under the Companies Act, 1956 shall continue to apply.”



**Guidance Note on Audit of Banks (Revised 2019)**

AS 1	Disclosure of Accounting Policies
AS 2(R)	Valuation of Inventories
AS 3	Cash Flow Statements
AS 4(R)	Contingencies and Events Occurring After the Balance Sheet Date
AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 7	Construction Contracts (Revised-2002)
AS 9	Revenue Recognition
AS 10 (R)	Property, Plant and Equipment
AS 11	The Effects of Changes in Foreign Exchange Rates (Revised-2003)
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments
AS 14(R)	Accounting for Amalgamations
AS 15	Employee Benefits(Revised-2005)
AS 16	Borrowing Costs
AS 17	Segment Reporting
AS 18	Related Party Disclosures
AS 19	Leases
AS 20	Earnings Per Share
AS 21(R)	Consolidated Financial Statements
AS 22	Accounting for Taxes on Income
AS 23	Accounting for Investments in Associates in Consolidated Financial Statements
AS 24	Discontinuing Operations
AS 25	Interim Financial Reporting
AS 26	Intangible Assets
AS 27	Financial Reporting of Interests in Joint Ventures
AS 28	Impairment of Assets
AS 29 (R)	Provisions, Contingent Liabilities and Contingent Assets

56. Of the above Standards notified under the Companies (Accounting Standards) Rules, 2006<sup>5</sup>, presently, the following standards are not applicable to banks to the extent specified.

- (a) AS 13, "Accounting for Investments", does not apply to investments of banks.
- (b) AS 11, "The Effects of Changes in Foreign Exchange Rates", does not apply to accounting of exchange difference arising on a forward exchange contract entered to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction. However, it shall apply to exchange differences in respect of all other forward exchange contracts.

57. RBI has issued Circular no. DBOD.No.BP.BC.76/ 21.04.018/2004-05 dated March 15, 2005 and Circular no. DBOD.BP.BC.76/21.04.018/2005-06 dated April 5, 2006, containing the guidelines on compliance with AS 11 (Revised 2003). Further the RBI has issued Circular No.DBR.BP.BC.No.61/21.04.018/2016-17 which clarifies the accounting treatment for recognizing gains in profit & loss account from Foreign Currency Translation Reserve (FCTR) on repatriation of accumulated profits / retained earnings from overseas branch(es).

## **Audit of Accounts**

58. Sub-section (1) of section 30 of the Banking Regulation Act, 1949 requires that the balance sheet and profit and loss account of a banking company should be audited by a person duly qualified under any law for the time being in force to be an auditor of companies. Similar provisions are contained in the enactments governing nationalised banks [Section 10 of the Banking Companies (Acquisition and Transfer of Undertakings) Act of 1970/1980], State Bank of India [section 41 of the State Bank of India Act, 1955], subsidiaries of State Bank of India [section 41 of the State Bank of India (Subsidiary Banks) Act, 1959], and regional rural banks [section 19 of the Regional Rural Banks Act, 1976]. It is important to note that section 41 of the State Bank of India Act, 1955, specifically provides that the affairs of the bank shall be audited by "two or more auditors".

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<sup>5</sup>Rule 7(2) of Companies (Accounts) Rule 2014 has clarified that to facilitate proper administration of the notified sections of the Companies Act 2013, in respect of the Section 133, "Till the Standards of Accounting or any addendum thereto are prescribed by Central Government in consultation and recommendation of the National Financial Reporting Authority, the existing Accounting Standards, notified under the Companies Act, 1956 shall continue to apply."

59. Banks operate through a network of branches. The financial statements of branches (comprising branch's profit and loss account, balance sheet and various returns to head office) are incorporated in preparing the financial statements of the bank as a whole. The requirements of section 30 of the Act and the corresponding requirements of other enactments governing different types of banks, referred above, relate to audit of financial statements of the bank as a whole and not to audit of financial statements of branches. The discussion in paragraphs 61 to 67 below & paragraphs 20 to 37 above is also in the context of audit of financial statements of the bank as a whole. The provisions relating to audit of financial statements of branches are discussed in paragraphs 38 to 46 above.

60. Further, the members, while carrying out audit of a bank (head office or branches) are required to comply with the Engagement and Quality Control Standards issued by the ICAI.

### **Qualifications of Auditor**

61. According to sub-section (1) of section 141 of the Companies Act, 2013, a chartered accountant or a firm whereof majority of partner practicing in India are qualified for appointment as chartered accountants with their firm name may be appointed as an auditor of a company. Sub-section (2) of aforesaid Act provides where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm. However, the following persons shall not be eligible for appointment as an auditor of a company, namely:

- (a) a body corporate other than limited liability partnership;
- (b) an officer or employee of the company;
- (c) a person who is a partner, or who is in the employment of an officer or employee of the company;
- (d) a person who or his relative or partner-
  - i. is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company;
  - ii. Provided that the relative may hold security or interest in the company of face value not exceeding one thousand rupees or such sum as may be prescribed;

- iii. is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of such amount as may be prescribed; or
  - iv. has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, for such amount as may be prescribed;
- (e) a person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company of such nature as may be prescribed;
  - (f) a person whose relative is a director or is in the employment of the company as a director or key managerial personnel;
  - (g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies;
  - (h) a person who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction;
  - (i) any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialised services as provided in section 144.

As per sub-section (4) of section 141 of Companies Act, 2013 where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

62. The qualification for appointment as an auditor as prescribed in law are the minimum qualifications and a regulatory authority (or an individual bank) may lay down further conditions to determine the eligibility of a chartered accountant or a firm of chartered accountants for appointment as an auditor. The further conditions (which, of course, must be reasonable) may relate to such matters as experience of the chartered accountant /firm/partners of the firm, staff strength, etc. and may be laid down to ensure that the chartered accountants/firms of chartered accountants appointed as auditors possess the requisite skills and resources to carry out the audit effectively.

### **Appointment of Auditor**

63. As per the provisions of the relevant enactments, the auditor of a banking company is to be appointed at the annual general meeting of the shareholders, whereas the auditor of a nationalised bank is to be appointed by the bank concerned acting through its Board of Directors. In either case, approval of the RBI is required before the appointment is made. The auditors of the State Bank of India are to be appointed by the Comptroller and Auditor General of India in consultation with the Central Government. The auditors of the subsidiaries of the State Bank of India are to be appointed by the State Bank of India. The auditors of regional rural banks are to be appointed by the bank concerned with the approval of the Central Government.

64. As mentioned earlier, the State Bank of India Act, 1955, specifically provides for appointment of two or more auditors. Besides, nationalised banks and subsidiaries of State Bank of India also generally appoint two or more firms as joint auditors.

### **Remuneration of Auditor**

65. The remuneration of auditor of a banking company is to be fixed in accordance with the provisions of sub-section (1) & (2) of section 142 of the Companies Act, 2013 (i.e., by the company in general meeting or in such manner as the company in general meeting may determine). As per proviso of sub section (1) of section 142 remuneration of the first auditor may be fixed by the Board. Further remuneration under sub-section (1) shall, in addition to the fee payable to an auditor, included the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him but does not include any remuneration paid to him for any other service rendered by him at the request of the company. The remuneration of auditors of nationalised banks and State Bank of India is to be fixed by the RBI in consultation with the Central Government. The remuneration of auditors of subsidiaries of State Bank of India is to be fixed by the latter. In the case of regional rural banks, the auditors' remuneration is to be determined by the bank concerned with the approval of the Central Government.

### **Powers of Auditor**

66. The auditor of a banking company or of a nationalised bank, State Bank of India, a subsidiary of State Bank of India, or a regional rural bank

has the same powers as those of a company auditor in the matter of access to the books, accounts, documents and vouchers. He is also entitled to require from the officers of the bank such information and explanations as he may think necessary for the performance of his duties. In the case of a banking company, he is entitled to receive notice relating to any general meeting. He is also entitled to attend any general meeting and to be heard thereat on any part of the business, which concerns him as an auditor.

67. It is important to note that under section 10 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980, the auditor of a nationalised bank may employ accountants or other persons at the expense of the bank to assist him in audit of accounts. Similar provisions exist in section 41 of the State Bank of India Act, 1955 and the State Bank of India (Subsidiary Banks) Act, 1959. These provisions are aimed at facilitating the work of auditors of these banks by empowering them to appoint the auditors of branches and are particularly important in the context of the fact that the above enactments do not contain any specific provisions for audit of branches of these banks. This is unlike banking companies where audit of branches is required under sub-section (8) of section 143 of the Companies Act, 2013. It may be noted that the Regional Rural Banks Act, 1976, does not contain any provisions relating to audit of branches. Accordingly, in the case of such banks, audit of branches is also carried out by the auditors appointed for the bank as a whole.

# Accounting Systems

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01. An accounting information system (AIS) is a system of collecting, storing and processing financial and accounting data. Accounting information systems are designed to support all accounting functions and activities including auditing, financial accounting & reporting. The accounting systems of different banks vary in terms of hardware configuration, software capabilities, levels of hardware and software security, and nature of transactions processed. It is, therefore, not possible to identify a single accounting system that would describe all the features of such systems in operation in different banks.

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

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

## **Salient Features of Accounting Systems of Banks**

04. Banks, like most other large-sized entities, follows the mercantile system of accounting. Thus, the system of recording, classifying and summarising the transactions in a bank is in substance, no different from that followed in other entities having similar volume of operations. However, in the

case of banks, the need for the ledger accounts, especially those of customers, being accurate and up-to-date on a real time basis is much stronger than in most other types of enterprises. A bank cannot afford to ignore its ledgers particularly those containing the accounts of its customers and has to enter each and every transaction in its ledgers as soon as it takes place.

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

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

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

### **Accounting and Financial Control Manual ('AFCM')**

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

09. The manual should be reviewed centrally at the Head office level on an on-going basis at-least annually.

10. The salient features of the AFCM should include:

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



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

## **Reconciliation of sub-systems and suspense accounts**

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

12. A sundry suspense account is an account in the general ledger in which amounts are temporarily recorded. All Sundry Suspense accounts should also be tracked by the Bank on a regular basis. The Bank should have defined procedures for reconciling and monitoring sundry/suspense accounts at periodical intervals and escalating issues, if any, to the concerned departments/branches for speedy resolution of open items. Suspense account should be cleared at some point, because they are for temporary use. Suspense accounts are a control risk which could lead to frauds, errors, issues, etc.

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

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

## **Audit Considerations**

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

14. Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based and includes the information contained in the accounting records underlying the financial statements and other information. Accounting records generally include the records of initial entries and supporting records, such as cheques and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries,

and other adjustments to the financial statements that are not reflected in formal journal entries; and records such as worksheets and spreadsheets supporting cost allocations, computations, reconciliations, and disclosures. The entries in the accounting records are often initiated, authorized, recorded, processed, and reported in electronic form. In addition, the accounting records may be part of integrated systems that share data and support all aspects of the entity's financial reporting, operations, and compliance objectives.

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

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

### ***Elements of IPE***

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

- (1) *Source data*: The information from which the IPE is created. This may include data maintained in the IT system (e.g., within an application system or database) or external to the system (e.g., data maintained in an Excel spreadsheet or manually maintained), which may or may not be subject to general IT controls.

- (2) *Report logic*: The computer code, algorithms, or formulas for transforming, extracting or loading the relevant source data and creating the report. Report logic may include standardized report programs, user-operated tools (e.g., query tools and report writers) or Excel spreadsheets, which may or may not be subject to the general IT controls.

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

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

### ***Understanding the IPE***

18. The following questions may assist the auditor in understanding the IPE:

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

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

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

### **Segregation of Duties**

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

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

segregated (representing a segregation of duties conflict). The configuration of the access privileges within segregation of duties applications and spreadsheets, and any changes to these privileges, should be approved by management. Management should periodically review access to these applications. Any issues noted during the review should be remediated on a timely basis.

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

### **Journal Entry Testing**

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

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

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

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

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

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

- Journal entries or other adjustments processed outside the normal course of business.

27. SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" lays down that the use of Information Technology (IT) affects the way control activities are implemented. From the auditor's perspective, controls over IT system are effective when they maintain the integrity of the information and the security of the data such systems process, and includes effective IT controls and application controls. Chapter 2, "Special Considerations in a CIS Environment" of Part II contains further guidance on this.

### **Principal Books of Account**

28. The principal books of account, subsidiary books and statistical records generally maintained by banks are described in the following paragraphs. It may, however, be emphasised that the exact nature of such books may differ from one bank to another, depending upon the individual requirements of each bank.

#### **General Ledger**

29. The general ledger contains control accounts of all personal ledgers, the profit and loss account and different asset and liability accounts. There are certain additional accounts also (known as contra accounts) which are kept with a view to keeping control over transactions which have no direct effect on the assets and liabilities of the bank, and represent the agency business handled by the bank on which it earns service charges, e.g., letters of credit opened, bills received or sent for collection, guarantees given, etc.

#### **Profit and Loss Ledger**

30. For managerial purposes, the account heads in the profit and loss ledgers are more detailed than those shown in the published profit and loss accounts of banks. For example, there are separate accounts for basic salary, dearness allowance and various other allowances, which are grouped together in the published accounts. Similarly, various accounts comprising general charges, interest paid, interest received, etc., are maintained separately in the profit and loss ledgers.

### **Subsidiary Books**

#### **Personal Ledgers**

31. Each control account in the general ledger is supported by a subsidiary ledger. Thus, in respect of control accounts relating to accounts of customers, subsidiary ledgers are maintained for:

- (a) Various types of deposit accounts (savings bank, current account, recurring deposits, etc.) which contains accounts of individual customers. Each account holder is allotted a separate folio in the ledger;
- (b) Various types of loan and related accounts (cash credit, term loans, demand loans, bills purchased and discounted, letters of credit opened, bank guarantees issued) wherein the liability of each customer is reflected.

32. Separate registers are maintained to record the particulars of term deposits (including derivatives like call deposits, certificates of deposits, etc.). Banks generally do not allot separate folios to each customer. The register is divided into various sections, each section for a particular period of deposit and/or the rate of interest payable on deposits. As mentioned earlier, postings to these registers are made directly from vouchers and all the vouchers entered in each ledger/register in a day are summarised into voucher summary sheets. The voucher summary sheets are prepared in the department which originates the transactions, by persons other than those who write the ledgers. They are subsequently checked with the vouchers by persons generally unconnected with the writing of ledgers/registers or the voucher summary sheets. However, most of the banks are now under Core Banking and, hence, all the deposits received are automatically recorded in the respective registers.

### **Bills Registers**

33. Details of different types of bills are kept in separate registers which have suitable columns. For example, bills purchased, inward bills for collection, outward bills for collection etc., are entered serially on a daily basis in separate registers. In the case of bills purchased or discounted, party-wise details are also kept in normal ledger form. This is done to ensure that the sanctioned limits of parties are not exceeded.

34. Entries in these registers are made with reference to the original documents. A voucher for the total amount of the transactions of each day is prepared in respect of each register. This voucher is entered in the day book. When a bill is realised or returned, its original entry in the register is marked off. A daily summary of such realisations or returns is prepared in separate registers whose totals are taken to vouchers which are posted in the day book.

35. In respect of bills for collection, contra vouchers reflecting both sides, i.e., debit and credit, are prepared at the time of the original entry, and this entry is reversed on realisation.

36 Outstanding entries are summarised at stipulated intervals and their

totals agreed with the balances of the respective control accounts in the general ledger.

### **Other Registers/Records**

37. There are different registers/records to record detailed particulars of various types of transactions. These registers/records do not form part of books of account but support the entries/balances in the various accounts. Some of the important registers/records relate to the following:

- (a) Drafts issued (separate registers may be maintained for drafts issued by the branch on other branches of the same bank and those on the branches of its correspondents in India or abroad).
- (b) Drafts paid (separate registers may be maintained on the same pattern as in the case of drafts issued).
- (c) Issue and payment of –
  - (i) Telegraphic transfers.
  - (ii) Mail transfers.
  - (iii) Bankers' cheques/pay orders/Traveller's cheques/gift cheques.
- (d) Letters of credit.
- (e) Letters of guarantee.

38. Entries in these registers are made from original documents which are also summarised on vouchers every day. These vouchers are posted into the day book.

39. Outstanding entries are summarised at stipulated intervals and their totals agreed with the respective control accounts in the general ledger.

40. There are frequent transactions amongst the branches of the bank which are settled through the mechanism of inter-office accounts. The examples of such transactions include payment/realisation of bills/cheques, etc., sent for collection by one branch to the other, movement of cash between them, transfer of funds where one branch acts as an agent of the other, e.g., for government-related business. All such transfers of funds are channelised through a nodal account (this account has different names in different banks, e.g., Head Office Account, Inter-office Account, and so on). This is a crucial account both for banks as well as the auditors for two reasons – first, many frauds have been perpetrated on banks through this account and second, banks are now required to make provision for entries routed through this account which remain unreconciled beyond a time period specified by the RBI.



41. Banks maintain a Suspense Ledger to record various suspense accounts. Sometimes, transactions of a transitory nature, e.g., travel advances to employees, are recorded in a suspense account pending their adjustment in the related expense/income account. Some banks maintain separate ledgers for suspense accounts and sundry deposits accounts. The amounts lying in these accounts need regular monitoring to clear them.

42. Suitable registers with back-up registers to record classification under numerous sub-heads are maintained for:

- (a) Establishment expenses.
- (b) Interest and discount income.
- (c) Incomes by way of commission.
- (d) Interest expenditure.
- (e) Provision for interest accrued but not due on deposits.
- (f) Fixed assets.
- (g) Stationery consumed/in hand.
- (h) Interest payable to, and receivable from head office, in respect of advances and deposits respectively. A peculiar feature of accounting systems of banks is that the branches, notionally, have no funds of their own. All deposits accepted at the branch are deemed to have been passed on to the bank's head office and all loans made at the branch are deemed to have been made out of funds received from the head office. The head office pays interest to the branch for its deposits and charges interest from the branch for its advances. The rates of such interest charged and paid by head office are decided by the head office during the course of the year and are an important factor in calculating the profit or loss of a branch. The mechanism may be known by different names in different banks. All calculations in this regard are done at the branches only and suitable entries are passed, generally at the year-end. These entries, however, get offset in the process of consolidation of accounts and have no effect on the financial statements of the bank as a whole.
- (i) Instruments received from customers for payment/collection by the branch. Clearing of locally payable instruments is an important function of banks. Some banks maintain separate registers to record details of various types of instruments lodged by customers whereas some other banks use a common book to record all kinds of instruments lodged by customers.

43. Separate registers are maintained to record and summarise the transactions relating to a particular head of account like Current Account,

Savings Bank, Cash Credit, and Term Loans. Such books may be called Log Books, Day Books, etc. The totals in this book are carried over to the Cash Book.

## Departmental Journals

44. Each department of a bank maintains a journal to note the transfer entries passed by it. These journals are memoranda books only, as all the entries made there are also made in the day book through voucher summary sheets. The purpose of such a journal is to maintain a record of all the transfer entries originated by the department. For example, the loans and overdrafts department will pass transfer entries for interest charged on various accounts every month, and as all these entries will be posted in the journal of that department, the officer concerned can easily find out the accounts in respect of which the interest entry has been passed. Since all the vouchers passed during the day are entered into the day book only in a summary form, it may not be possible to get this information from the day book without looking into the individual vouchers.

45. As has been mentioned earlier, a 'composite voucher' (or two separate vouchers for debit and credit) is generally prepared for each transfer entry. The composite voucher is generally prepared by and entered into the journal of the department which is accordingly credited to the other department. For example, if any amount is to be transferred from current account of a customer to his savings bank account, the voucher will be prepared by the current accounts department and entered in the journal of that department.

46. Besides the books mentioned above, various departments of a bank have to maintain a number of books to facilitate their work. Some of the important departmental books are described below.

### Cash Department

47. The following books are usually maintained by the cash department:

- (a) Receiving cashiers' cash book
- (b) Paying cashiers' cash book
- (c) Head cashier's book
- (d) Cash balance book

48. Cash Book may have one column, or two or three columns, depending upon the system adopted by the bank to record cash, transfer and

clearing transactions separately or to treat all of them as cash transactions. Two points may be noted here:

- (a) 'Transfer' relates to only those transactions where both debit and credit transactions are made in the accounts at the same branch and includes operations on non-customer accounts also. Clearing transactions essentially relate to customer accounts and the branch handles either payment or receipt of the underlying amount.
- (b) Banks generally maintain a register (commonly called Transfer Scroll) wherein brief particulars of the debit and credit sides of a transaction are entered. At the end of the day, the register shows the total value of transfer transactions handled which has to agree with the 'Transfer' column of the Cash Book, if there is such a system. In the case of a single-column Cash Book, the total of the day's transactions must agree with the total of cash and transfer transactions, as per the cash and transfer scrolls of the branch.

49. Banks have introduced different systems to facilitate quick payments to customers. The most prevalent system is the teller system. Under this system, the tellers keep both cash as well as ledger cards and the specimen signature cards of each customer in respect of current and savings bank accounts. The teller is authorised to make payment up to a particular amount. On receipt of the cheque, he checks it, passes it for payment, enters in the ledger card and makes the payment to the customer.

### **Outward Clearing Department**

50. The following books are usually maintained by the outward clearing department:

- (a) Clearing cheques received book for entering cheques received from customers for clearing;
- (b) Bank-wise list of the above cheques, one copy of which is sent to the clearing house along with the cheques.

### **Inward Clearing Department**

51. The inward clearing department maintains a memorandum book to record the number of cheques given to each department. Most of the banks have centralised debiting of inward clearing cheques at the respective service branches. In such cases, the inward cheques will be retained at the service branch itself.

### **Loans and Overdrafts Department**

52. The Loans and Overdrafts Department usually maintains the

following books:

- (a) Registers to record details of documents executed by the borrowers and guarantors in respect of credit facilities.
- (b) Securities registers for recording details of securities in respect of credit facilities.
- (c) Pending documents and document deficiency register.
- (d) Godown registers maintained by the godown-keepers of the bank.
- (e) Price register giving the wholesale prices of commodities pledged with the bank.
- (f) Overdraft sanction register.
- (g) Drawing power book.
- (h) Delivery order books.
- (i) Storage books.
- (j) Stock statements registers for loan accounts.
- (k) Suit filed register.
- (l) Inspection register for loan accounts.

### **Deposits Department**

53. The Deposits Department usually maintains the following books:

- (a) Account opening and closing register.
- (b) Fixed Deposits, Rate Register giving analysis of fixed deposits rates.
- (c) Due date diary.
- (d) Specimen signature cards, containing specimen signatures of deposit account holders.

### **Establishment Department**

54. The Establishment Department usually maintains the following books:

- (a) Salary and allied registers, such as, attendance register, leave register, overtime register, etc.
- (b) Register of fixed assets, e.g., furniture and fixtures, vehicles, etc.
- (c) Registers to record receipt, issue and balance of stationery including security papers, e.g., draft forms, cheque books, etc.
- (d) Old records registers.

## **General**

55. Besides the above, banks also maintain the following books:
- (a) Specimen signature book (of the bank's officers).
  - (b) Private telegraphic code and cyphers.
  - (c) Back up registers for various types of returns/statements.
  - (d) Safe Deposit Lockers / Safe Custody registers.
  - (e) Registers to record particulars of lost instruments (drafts, cheques, etc.) based on details received from the head office.
  - (f) Transit books through which instruments are sent to the cash department for payment by the official authorising such payment.
  - (g) Registers to record particulars of outstanding inter-office entries received from the reconciliation department of the bank which are to be responded to by the branch.
  - (h) Cheque books issued register.
  - (i) Token register.
  - (j) Stop payment register.

## **Flow of Transactions**

56. The books of account and other books and records maintained by banks have been described above. It is necessary for the auditor to understand how various kinds of transactions executed by a bank get reflected in various books. The following paragraphs accordingly provide a brief overview of the flow of transactions commonly carried out by banks. The emphasis is on transactions carried out at the branch level since it is at this level that banking business and most other types of transactions usually take place.

### **Customers' Accounts**

57. Transactions with customers (both depositors as well as borrowers) generally account for a substantial proportion of the total transactions at the branch level. These transactions involve either a credit or a debit to the respective customer accounts.

#### ***Credits to Customers' Accounts***

58. The customers may deposit cash, instruments payable at the branch itself (e.g., cheques issued by other customers of the branch/drafts issued by another branch of the bank or another bank as per approved arrangement, which is payable at the branch), or instruments drawn on other branches of

the bank/other banks located within the area of the clearing house of which the branch is a member. Generally, clearing houses are managed by the RBI or branches of State Bank of India having currency chest. In some cases, the clearing house may be managed by other banks also. Besides, there may be separate clearing houses managed by the same or by different banks for MICR (Magnetic Ink Character Recognition) and non-MICR instruments. Deposits in a customer's account can be made by any other person also (besides the customer himself).

59. All deposits are made by filling-in the relevant pay-in-slips. All pay-in-slips have two portions – one becomes the voucher for the bank and the other (the counterfoil) is returned to the depositor as acknowledgement of deposit.

60. For deposit of cash, the amount is deposited with the cashier authorised to receive cash who puts a scroll number and his initials on the voucher as also on the counterfoil. The counterfoil, duly signed and stamped, is handed over to the depositor and the voucher is eventually sent to the official responsible for maintaining the customer's account. The official enters the voucher in the account and puts his initials on it in token of having posted it in the customer's account. After posting, the voucher is sent to the cash book section or other section, as per the bank's procedure, which supervises the work relating to Day Books, at the end of the day.

61. For deposits of 'transfer' instruments, there is a designated counter which receives the pay-in-slips<sup>6</sup>, tallies the particulars filled in the slip with the enclosed instruments, returns the duly signed, stamped and dated counterfoil to the depositor and records the particulars of the customer's account and the instrument in a register maintained for the purpose. This register is generally supervised by an official who sends both the pay-in-slip and the instrument to the desk where the instrument is to be handled, against

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<sup>6</sup> The concept of having cheque drop boxes has also come into vogue wherein banks have almost done away with the system of having a separate counter for receiving cheques. Instead banks now maintain a locked cheque drop box in their premises alongwith a receiving acknowledgment stamp of the bank. The customers now fill up the cheque deposit slip and themselves put the bank's cheque receiving acknowledgement stamp on the bank's copy of the deposit slip as well as their own counterfoil and drop the cheque in the box. However, both the options are available to the customer as RBI Circular No. RPCD.CO.RF.BC.NO./40/07.40.06/2006-07 dated December 26, 2006 on "Cheque Drop Box Facility and the facility for acknowledgement of cheques" requires the banks to invariably display on the Cheque Drop-Box itself that "Customers can also tender the cheques at the counter and obtain acknowledgement on the pay-slips". Further, RBI vide its circular no.DPSS.CO.CHD.No. 485 / 03.06.01 / 2010-11 dated September 1, 2010 on "Dishonour / Return of Cheques - Need to Mention the 'Date of Return'in the Cheque Return Memo" mandates the banks to indicate the 'date of return' in the Cheque Return Memo.

the acknowledgement of the receiving official. (It may be clarified that a number of instruments can be tendered with one pay-in-slip provided they are all 'transfer' transactions, i.e., payable at the branch). The debit instrument is posted in the account concerned by the official handling the desk who then marks it with a 'Transfer' stamp with date and sends both the debit and the credit vouchers to the passing officer (details given later in the chapter). The officer puts his initials or signatures (as per the procedure in the bank) on both the vouchers. Thereafter, the credit voucher is sent to the Transfer Scroll in-charge who records brief particulars of both the debit and the credit vouchers in the scroll and sends the credit voucher to the desk where the customer's account is handled. Only the credit voucher 'passed' by the competent official is posted in the account. In case the debit instrument cannot be paid for some reasons (insufficient funds/post-dated/different signatures/stale/ payment stopped by the drawer, etc.), the counter clerk records the particulars in a register, usually called 'Cheques Returned' register and seeks instructions from the branch manager or officer designated by the bank to deal with such matters. The competent official records his decision (to either pay or return the instrument) on the register. Normally, in case of payment of such instruments, the official records 'Pay' on the instruments also. If unpaid, the instrument is returned to the customer.

62. It is possible that there is more than one instrument along with a single pay-in-slip and these instruments are handled at different desks. In such cases, though the procedure outlined above is followed for passing the debit vouchers, the credit voucher may be authenticated, generally, by the official who passes the last debit voucher. Besides, it is also possible that out of many debit instruments, only a few are paid and the others returned. This would mean that the customers' account cannot be credited with the amount shown in the pay-in-slip. In such cases, banks generally credit the account with the amount mentioned in the slip and separately raise a debit for the amount of instruments returned. This is because the banks, on their own, cannot change the amount in the slip after having given the counterfoil to the depositor.

63. The customer can also deposit the 'clearing' instruments with the bank. When a customer deposits a clearing instrument with his bank, the designated desk in-charge checks the voucher and the instruments, gives stamped, signed and dated counterfoil to the depositor, enters the particulars in a register maintained for recording the pay-in-slips received from the customers, and sends the credit voucher along with the instrument to the clearing section in the branch. Once the clearing section receives confirmation of payment of an instrument lodged by it in the clearing house

(local clearing usually takes 1-4 days and an instrument is generally deemed to be cleared if it is not received back within a certain time stipulated for the purpose, by the clearing house rules), its in-charge passes the credit vouchers which are sent to the section where the customer's account is handled, for posting in the customer's account. As regards the instruments received back unpaid, there are two ways of dealing with them. One is to credit the customer's account with the amount of pay-in-slip and then to debit the account with the amount of instruments returned. The other method is not to post the credit voucher at all and treat it as cancelled; this is, however, done only in cases where all the instruments lodged along with a particular pay-in-slip are returned unpaid. Credits also may come from RTGS (Real Time Gross Settlement), NEFT (National Electronic Fund Transfer) or ECS (Electronic Clearing System) which do not involve physical movement of cheques/payment instruments.

64. The customers also deposit various kinds of bills (including cheques), as under, payable in India or abroad:

- Bills for collection (against which the bank does not grant any advance to the customer).
- Bills for negotiation (against which the bank provides advance to the customers) – purchase of demand bills and discounting of usance bills.

65. Bills for collection are generally tendered along with apay-in-slip whereas those for negotiation are tendered along with a letter from the customer. Where the instruments are for collection, these are handled by the Bills Collection Section. This section or any other designated desk in the branch accepts the pay-in-slip and the enclosed bills and gives acknowledgement (counterfoil) to the depositor. The details of the bills are entered in a Bill Collection Register. Each bill is allotted a distinctive number which is recorded on all vouchers/documents pertaining to the transaction. A forwarding schedule (or collection schedule) is prepared giving details of the instruments like drawee, date of instrument, any special instructions given by the drawer, etc. The bill is enclosed to this schedule and sent to the branch which has to collect the proceeds from the drawee. On receipt of the advice of the payment of the bill, the originating branch credits the customer's account with the amount of the bill paid (less any charges deducted by the collecting branch) and simultaneously recovers its own commission for handling the transaction by debit to the customer's account. The procedure stated above is common to both the demand and usance bills, though nomenclature of the registers and the forwarding schedules used for the purpose may be different.

66. As regards the bills tendered for negotiation, the transaction may



relate to either the customers who have been granted regular limits for the facility or those who need this facility only occasionally. In the latter case, the bank would have prescribed an authority to approve the negotiation. Generally, bills are submitted by customers along with a forwarding letter while the cheques are submitted with a pay-in-slip, along with a request to negotiate the same. The cases of regular limits are handled by the Loan Section and the official dealing with the accounts or other designated authority approves the bills for negotiation after ensuring that the limit can accommodate the bills or that, in case of any overdrawing, these have been permitted by a competent authority. The bills negotiated are entered in the Purchase/Discount registers and the customer's bill account. Like the collection schedule, the Purchase/ Discount schedules are prepared and sent along with the bills to the branch concerned for realisation. The amount of the bills negotiated is immediately credited to the customer's account, after deducting the prescribed bank charges. In due course, on receipt of payment of the bills, along with overdue interest (if the bills are paid by the drawees after the due dates) or on return of the bills, if unpaid, the entry in the customer's account is reversed. In case of return, the amount of the bill, together with overdue interest at the rates prescribed by the bank, is recovered from the customer. The negotiation of the bills can also be done under the letters of credit (LCs) issued by a bank in favour of the customer. The accounting procedure in case of negotiation under LC is the same as explained above, however, the recording of such bills may be done in a separate set of registers. The negotiating branch also maintains a record of the due dates of bills negotiated and follows up with the realising branches if the proceeds are not received in time.

67. The accounting procedure for export bills – whether for collection or for negotiation – is essentially the same as that for domestic bills as discussed above; the books and registers may, however, have different names and columns, as these transactions involve conversion of a foreign currency into Indian rupees.

68. Some credits are made in customers' accounts by the bank itself, the most common example being the periodic interest on a deposit account and refund of any excess recoveries made earlier. In such cases, the bank may prepare either the pay-in-slip or the plain credit voucher. These vouchers also follow the same route as for those tendered by the customers except that such vouchers are not entered in the register meant for recording the instruments lodged by customers.

69. The cardinal principle followed by banks is that the credit is given to

the customer only after the corresponding debit has been approved by an authorised official at the branch.

***Debits to Customers' Accounts***

70. In respect of a running account (mainly current/savings bank/cash credit), the most common source of debit is the cheque (or withdrawal form in the case of a savings bank account) or a letter of authority signed by the customer or RTGS/NEFT. In case the customer or the holder of the instrument wants to withdraw cash against this instrument, he presents it to the designated counter which maintains the ledger containing the drawer's account and, in acknowledgement, is given a token bearing a distinctive number. The counter staff records the token number on the instrument and obtains the presenter's signatures on the reverse of the instrument. He then verifies the balance in the account (credit balance in deposit accounts and limit sanctioned in advances accounts). If it is sufficient to meet the amount mentioned in the instrument, he posts it in the account, puts his initials on the instrument in token of having posted it and marks it with a 'pay cash' stamp. The instrument is then sent to the official in charge of that particular counter for authorising the payment. He authorises the payment of the instrument by signing it which serves as an instruction to the cash department to pay the amount to the presenter of the instrument. Each passing official maintains a payment scroll in which he records the account no., token no. and amount of the instrument passed by him. The serial number at which a particular instrument is noted in the official's scroll is recorded on the instrument also. Thereafter, duly passed instrument is sent for payment to the cash department in a 'passed voucher book' or 'transit voucher book'. The paying cashier acknowledges the receipt of the instrument by initialling the relative entry in the book which is returned to the passing official. The cashier obtains the token from the presenter as also his signatures on the reverse of the instrument which is an acknowledgement of receipt of amount by the presenter and makes payment to him. The particulars of payment including the denomination of notes/coins given in payment are recorded in the cashier's scroll. The serial number in the scroll at which the payment is entered is also recorded on the instrument and the 'cash paid' stamp affixed on it under signatures or initials of the cashier.

71. The customer may want to purchase an instrument/receipt like Demand Draft, Mail Transfer, Telegraphic Transfer, Pay Order, Banker's cheque, Term Deposit, Call Deposit, Travellers' cheque, Gift cheque, or any other similar product of the bank, or make any payment to the government. For the purpose, he tenders the debit instrument (cheque/authority letter,

etc.) at the counter where his account is maintained, along with the appropriate credit voucher duly filled in (application form, pay-in-slip, challan, etc.). The counter staff verifies that the vouchers are in order and that sufficient balance is available in the account. He then posts the instrument in the account and the same procedure, as in case of cash payments, is followed upto the stage of authorisation by the official concerned except that instead of a 'Pay Cash' stamp, a 'Transfer' stamp is put by the counter staff on both the instrument and the credit voucher there against. After passing the debit and the credit vouchers, the official sends all the vouchers to the transfer scroll desk where the particulars of all the debit and credit vouchers are recorded and the credit vouchers sent to the respective desks which handle those products.

72. Customer's accounts are debited on account of instruments received in clearing also. All the instruments received through the clearing house, which are payable at the branch, are received by the clearing section and handed over to the desks concerned against acknowledgement. Subsequent procedure is the same as for transfer instruments except that there is no credit voucher with the instrument. The passing official has only to pass the debit instruments which bear the clearing stamp of the bank presenting them. The consolidated credit voucher is passed by the clearing section in-charge.

73. In case the counter staff notices that the balance in the account is inadequate to pay the instrument or the instrument is defective, he has to seek the instructions of the designated authority through the Cheques Returned Register.

74. Paragraphs 70 to 72 above deal with cases where the customer's account is debited on account of the instruments signed by him. In addition, there are cases in which the bank raises the debits to the customer's account on its own (though, of course, under intimation to the customer). The examples of such debits are:

- Carrying out the standing instructions received from the customer (including charges for executing these instructions).
- Payment of bills under letters of credit opened by the branch on behalf of the customer.
- Payment for guarantees issued at the request of the customer, which are duly invoked by the beneficiary.
- Periodic interest on loan accounts.
- Rectification of any erroneous entry in the account.

- Recovery of bank charges for which the bank holds an express or implied authority like loan application processing charges, ledger fees, inspection charges, locker rent, ATM annual charges, bill handling charges, issue of duplicate drafts etc., noting of 'stop payment instructions' given by the customer, return of cheques issued by the customer due to insufficiency of funds in the account, and so on.

75. A separate mention deserves to be made of the bills received by the branch for collection from its customer (being the drawee of the bill). On receipt of such a bill, the branch sends intimation to the drawee giving the details of the bill. The drawee presents a debit instrument for the amount to be paid (bill amount plus bank charges plus overdue interest, if applicable) to the Bills Section at the branch, along with the intimation received by him from the branch. He does not submit any credit voucher to the branch in such cases. The credit vouchers are internal to the branch and are prepared by the branch itself. The debit instrument given by the customer is processed like any other 'transfer' instrument, as discussed above.

76. Two points should be kept in view with regard to debits to the customers' account:

- Only the customers or their duly constituted attorneys can authorise a debit to the account (unlike a credit which can be made by any person).
- Debit instrument has to be passed first and the credit voucher only thereafter.

### **Issue of Drafts**

77. Each bank has its own standard application form which has to be filled in by the applicant. Many banks have opened service branches at important centres. Wherever such branches exist, the outstation branches are instructed to draw the drafts only on them. In some cases, the drafts may be made payable on other banks also if there is such an arrangement between the issuing bank and the paying bank. Such type of transactions are quite common in international banking area.

78. If the customer wants to tender cash for purchase of the draft, he tenders the draft application and the required amount of cash (amount of draft and the bank commission) to the cashier concerned. The cashier, after making necessary entries in his books, releases the voucher which is sent to the drafts issue desk. The counter staff prepares the draft as per the customer's instructions, enters it in the Drafts Issued register, gets it signed by an authorised official, and hands it over to the applicant against his acknowledgement.

79. If the customer wants a draft against a transfer transaction (generally, a cheque drawn on his account), the voucher is prepared after the customer's account has been debited.

80. The branch may, at times, need to issue drafts (or banker's cheque or pay order) on its own account, e.g., for remittance of proceeds of a bill received for collection directly from the drawer of the bill. In such cases, the draft application is signed on behalf of the bank, giving particulars of the Bill No. paid; the remaining procedure is the same as described above.

81. In respect of drafts issued, an advice is generally sent to the drawee branch. Besides, some banks have a system whereby issue of drafts above a prescribed amount is also confirmed to the drawee branch by a coded telegram/by telephone or in any other mode.

82. Some important points to be noted with regard to issue of drafts are as follows:

- For drafts of small value (based on the cut-off level fixed by the bank), the advice regarding issue of draft may not be sent to the drawee branch.
- Some banks also fix a ceiling upto which the draft may be signed by a single official. Beyond this level, normally two officials have to sign the draft. Besides, the specimen signature, number of the official(s) signing the draft has to be mentioned on the draft.
- There is generally a ceiling (fixed by the RBI in consultation with the Central Government) upto which the drafts can be issued against deposit of cash. The ceiling may undergo revision from time to time.

83. At the end of the day, the counter staff works out the total amount of drafts issued on that day and the commission earned thereon. This figure is carried over to the Cash Book.

### **Issue of Mail Transfer/Telegraphic Transfer**

84. These are two other modes of remittance of funds from one place to the other. The difference between the two is in the manner of transmission. Mail Transfer (MT) is sent by post to the paying branch whereas Telegraphic Transfer (TT) is sent by telegram (these days, some banks use fax also). MTs and TTs differ from drafts only in one respect. MTs/TTs are sent to the paying centre by the branch itself (under intimation to the customer) whereas draft is handed over to the customer who arranges to send it to the beneficiary. In terms of procedure, MTs/TTs are similar to draft.

### **Issue of Pay Orders/Banker's Cheques**

85. These instruments are normally issued for local payments including local payments to be made by the issuing branch itself. The procedure is basically the same as for issue of drafts except that no advice is required.

### **Issue of Term Deposit/Call Deposits and Receipts and Similar Instruments**

86. These instruments are issued in favour of the customers only and are akin to other accounts of the customers except that these are not running accounts (these days, however, some banks have developed hybrid products which contain features of term deposit, saving bank account and current account. For example, many banks have now started offering a facility of automatic transfer of the amount standing to the credit of the savings account of a customer to a fixed deposit account, subject to a certain minimum balance left therein. As and when the customer needs to withdraw an amount or issues an instrument of a value higher than the minimum balance in his account, the bank automatically transfers amount from the fixed deposit account to his savings account). Upto the point of receipt of credit voucher in the TDFR section, the procedure is same as that for credit to any other account of a customer. After receipt of the credit voucher, the procedure is generally on the following lines:

- (a) The receipt is prepared in the bank's pre-printed standard format and contains the name of the account holder, the mode of payment of proceeds on maturity, the term of deposit, the interest rate, and the due date.
- (b) In case the amount has been deposited under Re-investment Scheme, this fact is mentioned on the receipt. The maturity amount is also mentioned.
- (c) Banks normally have separate sections in their Term Deposit registers, interest rate-wise and/or maturity period-wise, to record the issue of term deposit receipts in a chronological order.
- (d) The official in charge of the term deposit section verifies the particulars on the receipt with reference to the deposit voucher, and signs the receipt which is then delivered to the depositor against acknowledgement.
- (e) The banks maintain a Daily List to record the due dates of deposits as also the dates of payment of periodic interest on deposits, wherever applicable. Necessary entries are made in the list upon issuance of a term deposit receipt.

87. Instruments other than term deposit receipts (e.g., cash certificates) are entered in the relevant register in a similar manner.

### **Opening of Letters of Credit**

88. Generally, this facility is provided by banks to their regular borrowers but there is no bar on extending this facility to other applicants also. The procedure for opening of letters of credit in either case is generally on the following lines:

- (a) The applicant submits an application in the prescribed format to the branch wherein he mentions the name of the beneficiary, documents required from the beneficiary, and the expiry date of the validity of the letter of credit (LC) for the purpose of shipment as well as negotiation of documents by a bank.
- (b) In case the bank agrees and issues the LC, it makes contra entries in its books. Necessary vouchers are prepared by the LC section. Normally, a composite voucher is used for these entries.
- (c) The transaction is recorded in the LC Issued Register. In the case of customers who have been sanctioned regular LC limits (like a cash credit limit), to ensure that the outstanding LCs do not exceed the sanctioned limit, all issues of LCs are debited to the account (all payments or cancellations of LC are credited).
- (d) LC opening charges are recovered from the customer, either by debit to his account or in cash.
- (e) Banks generally maintain margin for each LC. It may be retained in any form – in current account, term deposit, lien on drawing power, etc.
- (f) LC is prepared by the bank on pre-printed formats of the bank. Each LC has a distinctive number. The original (which is a negotiable copy) and one or two non-negotiable copies of the LC are sent to a bank (known as 'advising bank') for transmitting it to the beneficiary. Copies of the LC are given to the applicant also and at least one copy is retained on the branch records.
- (g) The number of officials who have to sign the LC may differ from bank to bank.

89. In terms of issue procedure, there is hardly any difference between an inland LC and a foreign LC. However, foreign LCs can be issued only by branches authorised to undertake foreign exchange transactions. Also, foreign LCs outstanding at the year-end require re-statement in rupee terms.

90. On 13th March, 2018 RBI vide Notification RBI/2017-18/139A.P. (DIR

Series) Circular No. 20 decided to discontinue the practice of issuance of LOU's/ LoCs/guarantees for Trade Credit for imports into India by AD-Category Banks with immediate effect. Letters of Credit and Bank Guarantees for Trade Credits for imports into India may continue to be issued subject to compliance with the provisions contained in Department of Banking Regulation Master Circular No. DBR. No. Dir. BC.11/13.03.00/2015-16 dated July 1, 2015 on "Guarantees and Co-acceptances", as amended from time to time.

### **Issue of Bank Guarantees**

91. In terms of procedure, bank guarantees are similar to LCs. However, the original guarantee is also handed over to the applicant who submits it to the beneficiary. Also, bank guarantees are issued on non-judicial stamp papers whereas LCs are issued in bank's pre-printed formats.

### **Issue of Traveller's Cheques/Gift Cheques**

92. There are prescribed application forms for these cheques and the procedure for issue is similar to issue of banker's cheques. However, in the case of Traveller's Cheques, the applicant has to sign on the cheque once in the presence of the bank's authorised official. The branch may issue Travellers' Cheques of its own bank and/or those of its correspondents in terms of an approved arrangement.

93. In each bank, there is a nodal office for Traveller's Cheques. Particulars of all cheques issued by the branch are required to be advised by the branch to the nodal office through the inter-office accounting system. The Branches do not normally have a Traveller's Cheques account in their General Ledger as they act merely as agent of the nodal office in issuing (and paying) Traveller's Cheques.

94. Gift cheques are payable by the issuing branch only. Each branch maintains a Gift Cheques account. All issues are credited to the account and details of the cheques entered in a register. Payments are debited to this account. For the sake of operational convenience, the Gift Cheques register is divided into separate sections, denomination-wise.

### **Payment of Drafts**

95. The drafts issued by banks are invariably payable 'to order' and never 'to bearer' since the issuance of drafts as 'payable to bearer' would tantamount to issuing currency, which banks are not authorised to do.

96. When a draft is presented to the branch on which it is made payable (whether for payment in cash or transfer to an account at the same branch or through the clearing house), the instrument is sent to the Drafts Payment



Section. The section usually maintains two kinds of Drafts Paid Registers:

- (a) To record payment of drafts for which no advice is required from the issuing branch as per the bank's procedure.
- (b) To record payment of drafts for which the aforesaid advice is required.

97. The counter staff enters the particulars in the relevant register after ensuring the *prima facie* correctness of the draft, particularly the drawee branch code number. In respect of drafts falling in category (b) above, though the advice from the issuing branch is required, the branch has to make payment of the draft even if it has not received its advice from the issuing branch till the time of payment. The advices received are marked off in the drafts paid register at the time of payment if advice has been received, or later, on receipt of the advice. For those entries in the register in respect of which the advice is not received, the matter is followed up with the issuing branch. After recording the particulars of the draft in the register, it is sent to the official in-charge along with the draft for verification of the correctness and for authorising the payment (in cash or by credit to the customer's account). The subsequent procedure is the same as that for other payment instruments. It may be mentioned here that separate registers are maintained for payment of drafts drawn by the correspondent banks.

98. Banks generally have a Drafts account to which all drafts issued are credited and all payments debited. Some banks have separate accounts for 'Drafts Issued' and 'Drafts Paid'.

99. Sometimes, the buyer of the draft may want to have it cancelled. This can be done only by the issuing branch. In addition to the usual procedures for payment of drafts, the following steps are also required to be taken:

- (a) The fact that it is a case of cancellation is mentioned in the Drafts Paid Register and against the relative entry in the Drafts Issued Register.
- (b) It is a common practice amongst banks to obtain a receipt from the buyer of the draft by endorsement on its reverse.

100. At the end of the day, a summary of the total drafts paid is prepared. This figure is carried over to the Cash Book.

### **Payment of MTs/TTs**

101. As soon as the MTs are received by the branch, these are paid by crediting the account mentioned in the MT. These are entered in an MT paid register and the day's total of the register is debited to an inter-office account. The treatment of TTs is slightly different. The advice of remittance

sent by telegram is followed by a written advice signed by the authorised officials of the issuing branch. Payment of TTs is also routed through the inter-office account. As the signed advices are generally not available when the telegraphic advice reaches the paying branch, the payment may be effected by debit to the Suspense Account or an Items in-Transit Account and the account of the beneficiary, stated in the TT, credited. Besides the above, the transaction is also recorded in TTs Paid Register. All entries in this register show the date of receipt of the signed advice from the issuing branch.

102. MTs and TTs are not paid in cash; they are credited to the accounts of the payees maintained at the branch; in case the payee does not maintain account with the branch, a Pay Order is issued in his favour.

103. The entry in Suspense Account/Items in-Transit Account is adjusted on receipt of advice from the issuing branch.

### **Payment of Banker's Cheques/Pay Orders**

104. The procedure followed is similar to payment of any other cheque drawn on the branch, except that the date of payment is recorded against the original issue entry.

### **Payment of Term Deposit Receipts and Similar Instruments**

105. These instruments are 'Not Transferable' and have to be paid strictly in accordance with the mandate of the deposit-holder received at the time of acceptance of the deposit or as modified subsequently by the deposit-holder. The deposit may be repaid before maturity (at the request of the account holder), on the date of maturity, or after the date of maturity. The salient features of the payment procedure are as under:

- (a) The deposit receipt, duly discharged, has to be presented for payment. In case the receipt is in the custody of the branch (under lien for any loan or as margin for any facility), it is withdrawn by making necessary entries in the Safe Custody Ledger/Register.
- (b) The deposit may be repaid in cash (subject to any ceiling on such cash payments, under statutory or regulatory requirements) or by way of a 'transfer' transaction. As these receipts are not negotiable, these are not routed through the clearing house but sent to the issuing branch for collection of proceeds.
- (c) The 'transfer' transaction is either for renewal of the deposit or for credit in full or part to any account maintained at the branch, or for issue of draft /MT/TT/Pay order, etc.

- (d) The payment is recorded as a debit to the relevant deposit account and the date of payment recorded against the original entry of issue. The principal amount of the deposit is debited to the deposit account to which it was credited at the time of issue. Interest paid is debited to the concerned provision account for the deposit if such an account is created by the bank or to the account in which such provision is held (amount of interest paid is net of TDS, if applicable). In this regard, it may be noted that generally, the branches create an Interest Provision Account for all interest-bearing deposits to which the amounts calculated at the rates advised by the Head Office are credited every month. This is done to arrive at the profit/loss of the branch and to calculate the bank's liability on an ongoing basis. All payments during the day are totalled and carried over to the Cash Book.
- (e) Banks generally do not hold the matured deposits in their regular deposit accounts. On the due dates, those deposits which remain unpaid are transferred in a separate account, usually called as 'Overdue Deposits Account'. These deposits are eventually paid or renewed.
- (f) For deposits paid before their scheduled maturity, interest is paid only for the actual period of deposit and not the contracted period. Also, banks may decide to levy some penalty for premature payment.
- (g) Normally, for each renewal of the original deposit, banks issue a fresh deposit receipt. Of late, however, some banks have started the facility of automatic renewal of deposits on the due dates and may not issue any fresh receipt but just record the fact of renewal on the original receipt.
- (h) The deposits are freely transferable at the request of the depositors from one branch of the bank to another. In such cases, the issuing branch transfers the deposit amount, together with the accrued interest amount held in its books, to the transferee branch along with an advice of transfer (the funds may be remitted by draft/TT/any other mode as per the Bank's procedure).

### **Payment of Recurring Deposits**

106. Banks provide a Pass Book to the depositor wherein entries are made at the time of deposit or later, as demanded by the account holder. At the time of payment (before/on/after maturity), the depositor has to produce this Pass Book to the branch to record the fact of closure of the account. Generally, banks have a provision to recover from the interest payable on the deposit a specified sum for late deposit of any instalment under the scheme. At the time of payment, the principal amount deposited is debited to the

Recurring Deposit Account and the interest paid is debited to the concerned interest provision account. The procedure for payment in cash/by transfer is the same as in the case of Term Deposits.

### **Payment of Call Deposits**

107. Most of the call deposits are required by the customers for submission to various authorities like Excise & Customs, PWD, Railways, etc., in connection with their tenders/orders. The deposits are in the names of these authorities only and not in the names of the customers. For payment of such deposits to the customers, the banks demand a release letter or an authority letter from the authority in whose favour the deposit was issued. These deposits are, generally, non-interest bearing. The procedure for payment is the same as in the case of Term Deposits.

### **Payments under Letters of Credit**

108. Payments under letters of credit involve:

- (a) Payment of the bills by the branch named in the LC as the 'negotiating bank'. Such payment may be made even in a case where no such name is mentioned in the LC.
- (b) Eventual payment of the bills by the LC opening branch to the negotiating bank.

109. In some cases, the same branch may act as both the LC opening bank and the negotiating bank, i.e., it opens the LC for customer 'A' in favour of 'B' and also negotiates bills under the same LC when presented by 'B' who may or may not be an existing customer of the branch. The procedure for payment of the bills, described below, is equally applicable to both the cases. However, for the sake of clear understanding, the terms 'Opening Bank' (OB) and the 'Negotiating Bank' (NB) have been used though it is recognised that in some cases, the same branch may perform the functions of both of them.

- (a) The original LC is in the custody of the customer, i.e., the beneficiary of the LC. He may approach any bank to negotiate the documents if there is no NB designated in the LC. The bank may agree to the request or may refuse it. In case the NB has been designated, the customer has to approach that bank only. This bank cannot generally refuse negotiation because its name would have been mentioned only in accordance with an approved arrangement.
- (b) The customer has to produce the original LC and all the documents stipulated in the LC to the NB.

- (c) NB examines all the documents and compares them with what has been stipulated in the LC. NB also ensures that the shipment took place within the validity mentioned in the LC and that the documents have been presented for negotiation within the validity stipulated in the LC. If there is any difference in compliance with the terms and conditions mentioned in the LC, the OB may refuse to make payment to NB.
- (d) In case NB observes certain discrepancies in the documents submitted by the customer, it may still decide to negotiate them at the risk of the customer. Such negotiations are referred to as 'negotiations under reserve' in the banking parlance. In such cases, NB obtains a written undertaking from the customer to make good the amount (together with bank charges) if payment is ultimately refused by OB. Another common practice for such bills is that before negotiation, NB brings the discrepancies to the notice of OB and seeks instructions. In turn, OB seeks the customer's instructions which are conveyed to NB.
- (e) Once a decision to negotiate has been taken by the branch, it enters the particulars of the bills in a Bill Negotiation Register (generally, banks maintain a separate register for negotiation under LCs). A distinctive number is allotted to each negotiation which is recorded on each document of the bill. The date and amount of negotiation are mentioned on the reverse of the LC and signed by an authorised official. Charges on negotiation are to be borne by the party mentioned in the LC – it may be either the beneficiary or the opener of the LC. In case the beneficiary has to bear the charges, the bank will deduct these charges from the bill amount and pay only the net amount to the customer. In case the charges are to the opener's account, the NB will pay the bill amount to the customer and claim the bill amount plus the negotiation charges from OB. The account to be debited by NB at the time of negotiation is different in different situations, as under:
  - (i) In case of demand LCs, where OB and NB are the same bank, the LC would generally state that NB should debit the OB through the inter-office account on negotiation. For usance LCs in this situation, the LCs normally authorise NB to debit the OB, through the inter-office account, on due date of the bill. In the latter case, the NB normally debits its own Bills account (may be called Bills Discounted account) at the time of negotiation – the entry is reversed on the due date by debiting OB through the inter-office account.
  - (ii) In case of LCs (both demand and usance) where OB and NB are different banks, the LC itself states the manner in which the NB

should obtain reimbursement of the bills negotiated from the OB. The NB acts accordingly. Pending receipt of reimbursement, the NB generally keeps the debit in its own Bills Account.

110. After negotiation, the documents are sent by NB to OB for final payment. When the documents are received at the OB, the procedure followed is on the following lines:

- (a) The designated section at the branch records receipt of bills in a specified register.
- (b) The documents received from NB are compared with the terms of the LC. In case of any discrepancy, it is immediately brought to the notice of the NB as well as the opener. The branch seeks instructions of the customer whether he wants to accept the documents despite these discrepancies or not.
- (c) In case the documents are discrepant and are not acceptable to the customer, OB returns the entire set of documents unpaid to NB. In turn, NB recovers the amount of bill, its own charges as also the charges levied by OB, if any, from the beneficiary of the LC. The fact of return is recorded by the OB in its registers.
- (d) In case the bill is in order or the discrepancies are acceptable to the customer, OB recovers the amount of bill and the other charges, if any, from the customer.
- (e) In addition to the above debit and credit entries, the contra entries made at the time of issue of LC are also reversed by the amount of LC utilised on payment of bills. This is done by way of a composite voucher. Besides, the amount and date of payment are recorded in the LC register and the Bill register.
- (f) On expiry of the validity of the LC, the OB waits for a reasonable period from that date for receipt of negotiated documents from NB. In case no documents are received, the OB reverses the amount of unutilised LC in its contra accounts.
- (g) In case the beneficiary does not want the bills to be negotiated and instead, wants these to be sent for collection by his bank, he may do so. The accounting procedure at OB in this case is broadly similar to negotiated bills.

### **Payments Under Bank Guarantees**

111. The following procedure is followed where the customer fails to discharge his contractual obligations and the beneficiary invokes the

guarantee:

- (a) The section handling the guarantees business at the branch examines the notice of invocation to ascertain that it is strictly in accordance with the terms of the guarantee. The branches generally seek legal opinion on the issue either from inside or outside.
- (b) In case the invocation is not in order, suitable reply is sent to the beneficiary.
- (c) In case the invocation is in order, the amount demanded by the beneficiary, not exceeding the amount guaranteed, is remitted to the beneficiary. The contra entry in the Bank Guarantee Account, made at the time of issue of the guarantee, is reversed by the total amount of the guarantee if the guarantee has been treated as fully discharged by the beneficiary, notwithstanding that the amount actually paid is different. The branch, in turn, recovers the amount from the customer.
- (d) In case the beneficiary does not want the bills to be negotiated and instead, wants these to be sent for collection by his bank, he may do so. The accounting procedure at OB in this case is broadly similar to that followed in the case of negotiated bills.

### **Payments Under Deferred Payment Guarantees**

112. On due dates of instalments, the bank remits the principal and the interest due to the beneficiary. Procedurally, payments under deferred payment guarantees are similar to payments under the bank guarantees or under LC. One distinctive feature is that the bank's liability to the beneficiary and the corresponding liability of the customer to the bank get reduced with each payment. On each such payment, the contra entries are reversed by the amount paid.

### **Payment of Gift Cheques**

113. These cheques are honoured by all branches of a bank irrespective of the branch which has issued them. In case the cheque is presented to the issuing branch for payment, the branch records the payment in its Gift Cheques Register. The date of payment is mentioned against the relative issue entry also. The other procedures are the same for as payment of any other cheque. The amount of gift cheques paid during a day is debited to the Gift Cheques Account.

114. In case the cheque is presented to any other branch of the bank, it is paid by that branch by way of a debit to the issuing branch through the inter-office account.

## Payment of Traveller's Cheques

115. Mostly, these cheques are presented for payment in cash by the purchaser of the cheque. In some cases, where the hotels, merchant establishments, etc., accept these cheques in payment of their bills, they obtain signatures along with date from the customers and then deposit these cheques with their bank for payment.

116. When presented for payment in cash, these are presented to the paying cashier in whose presence the customer has to put his signatures with date. The cashier tallies these signatures with the first signatures appearing on the cheque (which were obtained in the issuing branch) and, on being satisfied about the genuineness of the transaction, makes the payment. In the process, he may also refer to the list of lost/stolen Traveller's Cheques available at the branch, which is received from the head office. The amount of all cheques paid during the day is debited to the nodal office designated for these cheques. In case payment of cheques is by way of a transfer transaction, the desk concerned records the particulars of payment in a register and the official in-charge authorises the credit voucher; the debit voucher is normally prepared at the end of the day for all Traveller's Cheques paid on that day.

117. It is possible in some cases that the customer may deposit the unused Traveller's Cheques with the issuing branch itself. In such cases also, the procedure is similar to that for other 'transfer' transactions.

## Cash Transactions

118. Many of the transactions described above involve receipt or payment of cash by the bank. In describing such transactions above, the emphasis has been on the other aspect of each transaction rather than on cash receipt/payment. The following paragraphs deal with flow of cash transactions – receipts as well as payments – primarily from the angle of accounting for, and controls over, cash receipts and payments irrespective of the nature of transaction giving rise to cash receipt or cash payment.

119. 'Receipt' and 'payment' of currency are two of the most important functions of a bank. 'Cashiers' and 'tellers' perform these functions. The tellers provide only limited services (types of services and monetary ceiling may differ from bank to bank) while cashiers have no such limitations. The tellers do not generally make payments out of loan accounts. Cash and other valuable items like security forms are kept in the strong room and held in the



joint custody of two or more officials of the branch, one of whom is the Head Cashier and the other, normally, the Accountant.

120. Currency notes are packed in packets of 100 pieces each, irrespective of the denomination. A slip is put on each packet which carries the initials or signatures of the staff members who have verified and re-verified the quality and quantity of the notes, along with the date of such checking (the procedure may vary slightly among different banks). Coins are stocked in bags. These are weighed and then valued according to a specific weight-value ratio for each type of coin.

121. Depending upon the possession and ownership of cash, branches are divided into three categories:

- (a) **Currency Chest Branches:** These branches hold cash as an agent of RBI. Each chest branch is linked to a currency office of RBI through a link branch of its own bank. Loose packets are not kept in the chest. Every day, the branch withdraws cash from and deposits cash into the chest according to its requirements. At the end of the day, the branch works out the net position as compared to the previous day's closing balance in the chest and sends an advice to link branch (the position of the repository branches is also included, as explained later). The balances in the chest are periodically verified by the bank's officials as well as by RBI officials. Even in a currency chest, the branch will maintain some cash in hand on its own account, though such balance may be nominal.
- (b) **Repository Branches:** These branches carry smaller cash holding than the chest branches but act as a part of the chest. They are linked to a chest branch and report the net withdrawal/net deposit position each day to the link branch.
- (c) **Hand Balance Branches:** These branches carry cash only as their own hand balances. The limit for peak holding at such branches on any day is fixed by their controlling authorities. Whenever the branch has any surplus cash, it deposits the amount with a currency chest branch.

## **Receipts**

122. The steps involved in physical receipt of cash and its accounting are as follows:

- (a) The cash tendered by the depositor is checked by the cashier for the genuineness of the notes and to cross check the number of notes as mentioned by the depositor in the pay-in-slip.

- (b) If found in order, the cashier records the particulars of notes received and the account to be credited in the book maintained by him (usually called Cashier's Receipt Scroll). He then puts 'Cash Received' stamp on the pay-in-slip and the counterfoil and signs them; the counterfoil is returned to the depositor.
- (c) The pay-in-slips are sent from the cash department to a desk which notes down all receipts of cash in the department in a jotting book. The total of this book thus reflects the total cash received at the branch during the day.
- (d) After noting in the jotting book, the voucher is sent to the concerned desk for credit to the relevant account.
- (e) After the day's transactions are over, all the receiving cashiers hand over the cash, which should agree with the total of cash receipt scroll, to the Head Cashier.
- (f) Banks also deposit cash with other banks, usually for credit to their accounts. At times, the receiving branch is unable to cope up with the volume of work and does not count all the notes on the same day. In such circumstances, the uncounted amount is held as a 'Bond' system in which the depositing bank gives a written confirmation of the correctness of the amount and undertakes to make good the shortage, if found during the actual counting later. This amount may be counted at the convenience of both the banks in due course.

123. The steps involved in making cash payments and their accounting are as follows:

- (a) All paying cashiers (including tellers) are given some amount of cash at the start of the day by the Head Cashier against acknowledgement for their expected requirements during the day. They may be given cash in instalments also during the course of the day. They receive instruments for payment either directly at the counter (for tellers) or instruments authorised for payment through the voucher books (for cashiers). They obtain the signatures/thumb impression of the person receiving the payment. Each payment is recorded in a payment scroll maintained by each paying cashier and teller. The instruments paid by the tellers are then sent to the concerned desks for debiting the relevant accounts and authorisation by the officials' in-charge of the desks. The instruments paid by cashiers are sent to the desk which carried out the Day Book related work at the end of the day.

- (b) After the day's transactions are over, the cashiers return the cash balance with them to the Head Cashier. The balance should agree with the books, i.e., cash received by the cashier less the total of his payment scroll.

124. The 'receipts' and 'payments' have been discussed above separately for the sake of a clear understanding. In practice, a single cashier may perform both the activities. Likewise, a single teller may receive cash, pay cash, issue drafts, pay Traveller's Cheques, and so on.

125. After accounting for all the cash received from the cashiers, the Head Cashier prepares a summary of the day's transactions and the cash balance register and signs them. If any excess cash is found during counting, the amount is held in a special account and is refunded to the genuine claimant on demand or if there is no such claimant, the bank treats it as income. However, shortage in cash has to be made good by the cashiers concerned and the matter has to be reported to the higher authorities.

126. The currency chest branches meet their requirement of notes by remittances from the RBI. They also send remittances of soiled notes in their custody to RBI from time to time. In case RBI comes across any shortage in the remittance sent to it during counting in the presence of a cashier from the remitting branch, it informs the branch which has to make good the amount.

### **Incomplete Records**

127. In some situations, the auditor may find that certain accounting and other records are not up-to-date. In such a situation, the auditor should first ascertain the extent of arrears in house-keeping, and the areas in which accounting and other records are not up-to-date. In case it is found that the General Ledger, the main cash book, or the trial balances are in arrears or that they do not tally, the auditor should consider expressing a qualified opinion, adverse opinion or disclaimer of opinion, as may be appropriate in the circumstances. In case any subsidiary ledgers are in arrears, the auditor should consider the impact of such arrears on the financial statements of the bank. It may be pointed out that in the absence of balanced and up-to-date subsidiary ledgers, verification of transactions or of year-end balances may become difficult. In such cases also, the auditor should consider expressing a qualified opinion, adverse opinion or disclaimer of opinion, as may be appropriate in the circumstances. It may also be noted that in Long Form Audit Report (LFAR), the auditor has to make detailed observations on such arrears of house-keeping. Therefore, from this point of view also, it is important for the auditor to satisfy himself about the completeness of all records before submitting his audit report.

## CIS Systems in Banks

128. CIS(Computer Information Systems) systems of different banks differ in terms of hardware configuration, software capabilities, levels of hardware and software security, and nature of transactions processed. It is, therefore, not possible to identify a single CIS system that would describe all the features of such systems in operation in different banks. However, the following description of the CIS system of a large bank illustrates the usual manner of computerised information processing and the various controls built into the CIS system. Auditor should check the accuracy, correctness of data and also see that data has been correctly transferred from the previous years audited statements and for this he need to go through the audit trail of modifications/change made. Most of the Banks are working on Core banking now a days and hence the accounting system under the same and the control in place for the same are very important from the bank's perspective as well as from auditors perspective.

### Controls

129. The system provides for a number of controls which seek to ensure that the system is not put to unauthorised use, the transactions entered in the system are valid and accurate, and exceptional matters as well as other significant matters are reported on a timely basis or preferably on a daily basis to ensure early prevention of error and frauds. For example, the following controls seek to ensure that the system is not put to unauthorised use:

- A valid login name and password are essential to enter the system.
- A user can login from a specified workstation only.
- A minimum password length is required.
- The password needs to be changed at least once during a prescribed period.
- The maximum number of attempts to enter the system from a workstation is specified. Thus, if an incorrect password(s) is entered from a workstation, as soon as the number of attempts reaches the specified limit, the user is locked out and a message to this effect, identifying the workstation, is flashed on the system administrator's console/other workstations.
- Access to the system is available only between stipulated hours and specified days only.
- Individual users can access only specified directories and files.

- The access to various menus (such as opening of an account, closing of an account, change in limit or drawing power in a cash credit account, interest rate change, cheque book issue, etc.) is controlled through passwords. Thus, while an operator may enter the system using his login name and password, he cannot access the menus that have been password protected for use by systems administrator only.
- The access to systems software is restricted through password protection. *(The systems software contains several utilities such as copy, delete, etc. that can be used for unauthorised copying or deletion of files.)*
- Exception situations such as limit excess, reactivating dormant accounts, etc., can be handled only with a valid supervisory level password.
- A user timeout is prescribed. If the keyboard of a workstation remains inactive for the specified duration (say 30 seconds), the user has to re-enter the system using his password. This control prevents any unauthorised use when a workstation is left unattended.
- Wherever any rectification or alteration is carried out by more than one level of the officers, such alterations or changes are made as an additional entry and not by changing or deleting an existing recorded entry.
- Once the end-of-the-day process is over, the ledgers cannot be opened without a supervisory level password.
- The system maintains a record of all log-ins and log-outs. The access to this record is not possible without the systems administrator's password.

130. Similarly, the following controls seek to ensure the validity and accuracy of transactions entered in the system.

- The operation instructions such as single operation, joint operation, either or survivor operation, are flashed on the screen when the account is accessed.
- The system checks for cheque number range and stop payment instructions before processing a transaction.
- The system checks whether the amount to be withdrawn is within the drawing power.
- The system flashes a message if the balance in a lien account would fall below the lien amount after the processing of the transaction. The transaction processing is halted and can be proceeded with only with a supervisory password.
- If the transaction is sought to be posted to a dormant (or inoperative)

account, the processing is halted and can be proceeded only with a supervisory password.

131. The branch manager is required to send a certificate to the controlling authority at stipulated intervals regarding the functioning of the entire computerised system including compliance with prescribed procedures and processes.

### **Structure**

132. The system is multi-currency, on-line real time system which allows accounts to be maintained in a number of currencies. A separate General Ledger is maintained for each currency.

133. While the General Ledger (GL) provides the topmost level in aggregation of transactions and balances, the lowest level is a detail account which may be a customer's account or other account such as commission on drafts, locker rent, bill handling charges, etc. The number of levels between the GL and detail accounts is dependent on the requirements of the management and may differ from system to system. In the system under discussion, the GL (for each currency) is divided into a number of 'controls' each of which in turn is divided into a number of the 'memos'. A 'control' is similar to a General Ledger Account in a manual system, with the difference that unlike a GL account in the manual system to which debit and credit transactions can be posted directly, a control is merely a sub-division of the GL and is not an account. For example, 'Current Account' is one of the 'controls'. 'Memos' provide sub-divisions of a 'control'. For example, separate memos under 'Current Accounts' may be maintained for commercial and institutional customers' Current Accounts, agriculture-sector current accounts, and so on. The number of 'controls' that can be opened under General Ledger for each currency and the number of memos that can be opened under a control may differ from system to system (in the system under discussion, the maximum number of controls is 36 while the maximum number of memos under each control is 1296.). Detail accounts are opened under a memo. For example, all current accounts of C & I will be opened under the memo 'Current Account (C & I)'.

134. A transaction is posted to a detail account only. The detail account balances are updated as the transactions take place, i.e., on a real-time basis. The control and memo balances are updated only at the end of the day. All the books are balanced every day.

### **'Start-of-the-Day' Process**

135. Each computerised branch has one or two designated officials to perform the role of the Systems Administrator. The computer operations everyday begins with a 'start-of-the-day' (SOD) process carried out by the System Administrator. Unless SOD is completed, the system cannot be used for data entry. Among the major activities undertaken by the system as part of SOD are changing the date, clearing the log files, diary processing interest application in those accounts where it is due on that day, deposits due for payment on the day, standing orders<sup>7</sup>, and list of stopped cheques/drafts<sup>8</sup>.

### **Recording of Transactions**

136. As already stated, the transactions are processed on a real-time based on vouchers. The debit and credit aspects of a transaction have to be posted to the respective ledger accounts simultaneously in all cases. The accounts to which the credit aspect of a transaction is to be posted get updated simultaneously when the account to which the debit pertains is posted.

### **Single Transaction Update of Multiple Computer Files**

137. A single transaction input into a CIS system may automatically update all records associated with the transaction. For example, if credit voucher for issue of a Fixed Deposit is input, information in the following types of records will get entered simultaneously and automatically:

- FD day book.
- Customer's account. (if a running account for issue of FDs is maintained in terms of the Bank's system)
- Daily list. (to record payment of periodic interest and repayment of principal)
- Classification of deposit into proper interest rate profile and maturity profile.
- FD interest account

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<sup>7</sup>Some customers give standing instructions to the bank to make certain remittances on pre-determined dates. The system will generate a list of those standing instructions which are to be carried out on that day.

<sup>8</sup>In some cases, the customers may have advised the bank not to make payments of certain cheques issued by them. These instructions are duly recorded in the system upon receipt from the customers. Besides, it may happen that the bank itself may stop payment of certain instruments, in particular drafts, if some draft forms are lost or stolen. Particulars of such instruments are entered in the system and these are treated as stopped instruments.

138. Single transaction update of multiple files ensures that all relevant records are kept up-to-date. However, it also implies that if one erroneous input is made, many records will contain errors.

### **Vulnerability of Data and Program Storage Media**

139. Floppy disks, magnetic tapes, hard disks, etc. – the usual media on which data and programs are stored –are susceptible to intentional or accidental destruction. Portable media are also particularly prone to theft, loss, etc., as well as to computer virus. The vulnerability of CIS systems requires extensive internal controls against thefts, loss, and destruction or unauthorised alteration of programs and data.

### **On-line Checking**

140. All transactions posted at a terminal by an operator need to be checked by a supervisor on-line as soon as practicable after its entry to ensure that the data has been correctly fed into the system. All checked transactions are marked by the supervisory with his ID. (Usually, the operator, while posting the voucher, indicates the ID of the supervisor who has to authenticate the entry. When the supervisor opens the screen, he will find 'yes/no' command against the entry under a suitable heading for authenticating it. If he presses 'y' the entry is taken as passed.)

### **'End-of-the-Day' Process**

141. After all the transactions for the day have been inputted and passed by the supervisor concerned; the 'end-of-the-day' (EOD) process begins. EOD involves the following major activities:

- Verification of the integrity of all the transactions entered in the system by comparing the total of balances in detail accounts under each memo with the aggregate of the opening balance of memo and the transactions for the day. Similar checking is done for integrity of memos by comparing the total of all memos under a control with the updated balance of the control.
- Diary processing.
- Interest re-calculation and interest accrual.
- Standing orders.
- Generating statements of account.
- Generating various types of reports, including exception reports.
- Printing of logs.
- Daybook printing.



While the SOD or EOD processes are on, the system does not allow any data entry.

### **Backups**

142. After EOD, the stipulated numbers of backups are taken on the prescribed media. The system provides for off-site backup of at least one copy of the updated data. The backup is required to be retained as part of the branch records as per the policy formulated by the bank for retention of records.

### **Exception Reports and Other Reports**

143. The generation of exception reports is an important aspect of the system. These reports relate to cases which deserve the attention of appropriate levels of branch management. While most of these reports relate to operational aspects of transactions, some relate to the functioning of the CIS system. Besides, some other reports are also generated for the purposes of record. Some of the major reports generated by the system daily are:

- Debit/credit balance change
- Value dated before last rate change
- Value dated before last interest application date
- Maturity record deleted
- Automatically generated accounts
- Inactive accounts
- Dormant accounts reactivated
- Excess allowed over the limits/drawing power
- Irregular term loan accounts with number of arrears of instalments and interest with amounts
- Debits to income head account
- Debits to head office accounts
- Overdue pre-shipment and post-shipment accounts
- Overdue bills and bills returned
- Withdrawals against clearings
- Time barred demand promissory notes
- Unchecked transactions
- Sign-on attempt from two terminals

- Exit to operating system
- Password errors
- Sign-on report
- Sign-off report
- Deposit accounts – debit balances
- Zero balance and non-zero accrued interest accounts<sup>9</sup>
- Debit balance accounts without interest rate
- Loans and advances – credit balances
- Temporary overdrafts allowed beyond the sanction period.
- Items pending in clearing.
- Inter-branch transactions with age-wise details.<sup>10</sup>

## Computerised Accounting and Core Banking Solutions

144. In the preceding paragraphs, the conventional book keeping and manual accounting practises were discussed. The developments in the field of user-friendly systems and solutions have brought a sea change in the accounting atmosphere in the banking industry. Systems and solutions have been developed to cater to the banking requirements without compromising on the basic principle of integrity of information and recording of each and every transaction at any stage. Banks cannot afford to have an error level of even 0.0001% and hence the solutions have been developed to maintain the sterile levels.

145. These systems and solutions are generally audited, reviewed and examined at frequent intervals by the banks to ensure correctness of the data. The banks generally document such reviews and these documents

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<sup>9</sup>This relates to closed advances account. Whenever an account is closed, it should be squared off together with the interest due thereon till the date of closure. It may sometimes happen that the account may be brought to nil balance but the accrued interest may remain unrealised. As the system calculates the accrued interest everyday as part of the SOD process, it will show the accounts of the above type as unusual.

<sup>10</sup>Banks have an 'inter-branch-items-in-transit' account wherein the entries are parked when a telegraphic advice is received from the other branch. These entries are reversed in the IBIT account by debit to 'Branch Clearing General Account' when the normal advice in the bank's prescribed format, duly signed, is received from the other branch by post. Such advices must be received within a reasonable time after the telegraphic advice. The intention behind the report in question is to keep a check on the receipt of written advices for such items kept in IBIT account. The age-wise details will show whether the entry has been outstanding in the IBIT account for less than 15 days, more than 30 days, more than 90 days or so on. Such entries require special attention because non or delayed receipt of advices may indicate fraud or other malpractices.

would throw light on the effectiveness of the accounting system of the bank and reliability of its accounting data.

146. SA 315, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment" lays down that the use of Information Technology (IT) affects the way control activities are implemented. From the auditor's perspective, controls over IT system are effective when they maintain the integrity of the information and the security of the data such systems process, and includes effective IT controls and application controls. In recent years, many banks have moved towards computerisation of their operations. The degree of computerisation, however, varies among different banks and also among various branches of the same bank. While some branches have been fully computerised, some others have been partly computerised while many others are non-computerised. In fully computerised branches, all the customers' transactions as well as internal transactions of the bank, which enter the books of the account of the branch, are routed through a computer system, which may comprise either a computer network or stand-alone personal computers.

147. It may be stated here that even in a fully computerised branch, some work is presently carried out manually, e.g., preparation of vouchers, preparation of letters of credit and guarantees, preparation of some returns and statements, etc. In partly computerised branches, generally the back-office work (i.e., the internal processing of transactions of the branch) is carried out on computers whereas the customers' transactions (i.e., the front-office work) are processed manually. Many of the banks in the private sector have networked all or most of their branches in the country; this has given them the capability of handling most of the transactions of their customers at any of the branches.