

# **Guidance Note on Audit of Banks (2019 Edition) Section A - Statutory Central Audit**

## **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**

# Contents

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*Foreword*

*Preface*

**Part I – Knowledge of the Banking Industry ..... 1-4**

**Part II – Risk Assessment and Internal Control..... 5-84**

Chapter 1: Initial Considerations.....5-17

Chapter 2: Risk Assessment and Internal Control .....18-71

Chapter 3: Special Considerations in a CIS Environment.....72-84

**Part III – Items of Bank’s Financial Statements and  
Auditing Aspects ..... 85-218**

Chapter 1: Cash, Balances with RBI and Other Banks, and Money at  
Call and Short Notice .....85-94

Chapter 2: Fixed Assets and Other Assets .....95-108

Chapter 3: Borrowings and Deposits ..... 109-126

Chapter 4: Capital, Reserves and Surplus ..... 127-137

Chapter 5: Other Liabilities and Provisions ..... 138-141

Chapter 6: Contingent Liabilities and Bills for Collection..... 142-152

Chapter 7: Profit and Loss Account ..... 153-174

Chapter 8: Disclosure Requirements in Financial Statements ..... 175-202

Chapter 9: Consolidation of Branch Accounts.....203-207

Chapter 10: Consolidation of Financial Statements .....208-212

Chapter 11: Inter Office Transactions .....213-218

**Part IV – Long Form Audit Report ..... 219-252**

Chapter 1: Long Form Audit Report in case of Banks... .....219-252

**Part V – Special Aspects ..... 253-290**

Chapter 1: Basel III .....253-265

Chapter 2: Special Purpose Reports and Certificates.....266-269

Chapter 3: Compliance with Implementation of Ghosh & Jilani  
Committee Recommendations .....270-277

Chapter 4: Other Aspects.....278-290

## Contents of Accompanying Pen Drive/CD

Foreword and Preface of Past Years.....	291-333
<b>1. Part I – Knowledge of the Banking Industry .....</b>	<b>334-454</b>
1. Banking in India.....	335-372
2. Accounting and Auditing Framework.....	373-393
3. Accounting Systems.....	394-438
4. Legal Framework.....	439-454
<b>2. Appendices.....</b>	<b>455-548</b>
I., Text of Section 6 of the Banking Regulation Act, 1949	
II., The Third Schedule to the Banking Regulation Act, 1949	
III., Illustrative Format of Report of the Auditor of a Nationalised Bank	
IV., Illustrative Format of Report of the Auditor on the Standalone Financial Statements of a Banking Company	
V., Illustrative Format of Engagement Letter in case of a Nationalised Bank	
VI., Illustrative Format of Engagement Letter to be sent to the Appointing Authority of the Banking Company	
VII., Illustrative Format of 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)	
VIII., Illustrative Format of Management Representation Letter to be obtained from Bank Management in case of Statutory Central Audit	
IX., Illustrative Format of Management Representation Letter to be obtained from Bank Management in connection with the Limited Review	
X., Illustrative Checklist on Audit Considerations in a CIS environment	
XI., Illustrative list of Special Purpose/Exception Reports in CBS	
XII., Features of the Gold Monetization Scheme	
XIII., Illustrative Audit Checklist for Capital Adequacy	
3. Suggested Abbreviations used in the Banking Industry .....	549-567
4. Illustrative Checklist for the Verification of the aspects of the Treasury/ Investments of the Bank in Statutory Audit .....	568-570
5. List of Relevant Master Directions issued by RBI .....	571-573
6. List of Relevant Master Circulars issued by RBI .....	574-576
7. List of Relevant General Circulars.....	577-607

# 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. Auditors have to emphasis on the fee income, revenue leakage and specific regulatory adherence for these services.

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 Auditor of a Nationalised Bank

Appendix IV - Illustrative Format of Report of the Auditor on the Standalone Financial Statements 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 IX** 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, 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), Management Representation Letter for Audit for financial year ended, and Management Representation Letter in connection with the Limited Review.

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

Appendix X - Illustrative Checklist on Audit Considerations in a CIS environment

Appendix XI - Illustrative list of Special purpose / Exception Reports in CBS

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

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Appendix XII- The Broad features of the Gold Monetization Scheme

Appendix XIII- 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

## Initial Considerations

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

1.02 Most banks, especially those in public sector, appoint more than two (depending upon their size and Board decision, as per RBI guidelines) firms of chartered accountants to act jointly as Statutory Central Auditors (SCAs).

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

- , Period of appointment.
- , Particulars of other SCAs.
- , Particulars of previous SCAs.
- , Procedural requirements to be complied with in accepting the assignment, e.g., letter of acceptance (the letter usually contains, *inter alia*, averment as to absence of disqualification for appointment, way in which the audit has to be conducted and confirmation of present name, constitution and address of the auditor), declaration of fidelity and secrecy, restriction on accepting other assignments from the bank, etc.
- , Scope of assignment which includes any special reports or certificates to be given by the SCAs in addition to the main report. Presently, the SCAs have to furnish the following reports/certificates in addition to their main audit report:
  - a), Report on adequacy and operating effectiveness of Internal Controls over Financial Reporting in case of banks which are registered as companies under the Companies Act in terms of Section 143(3)(i) of the Companies Act, 2013 which is normally to be given as an Annexure to the main audit report as per the Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the ICAI.
  - b), Long Form Audit Report.

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

### **Declaration of Indebtedness**

1.04 The RBI has advised that the banks, before appointing their statutory central/ branch auditors, should obtain a declaration of indebtedness in proforma 'A' given in Annexure to the Notification No. RBI/2004/161 Ref DBS.ARS No B.C.

09 /08.91.001/2003-04 dated April 20, 2004. In addition to this, the RBI has further advised the banks that no credit facility (including guaranteeing any facilities availed of by third party) should be availed by the proprietor/any of the partners of the audit firm/members for his/their families or by firm/ company in which he/they are partners/directors.

1.05 In terms of the existing guidelines, an audit firm which takes up statutory central audit assignment in private and foreign banks will not qualify to take up statutory audit in public sector banks during that particular year. These guidelines have come into effect from the year 2012-13. In case a firm is not appointed as SCA of any PSB, then such a firm can be appointed as SCA of four private sector banks and four foreign banks simultaneously each year. As per RBI guidelines, it has been decided that, an audit firm, after completing its four year tenure in a particular private/foreign bank, will not be eligible for appointment as SCA of the same bank for a period of six years.

1.06 With respect to PSBs and other Private banks which are listed on stock exchanges, there could be a possibility that the partner and/or his relatives are shareholders of such PSBs and other Private banks. Care should be taken to dispose off the shares held or take corrective action, as per the code of conduct of the ICAI, SEBI regulations, Companies Act and the firm's internal policies, prior to acceptance of the Statutory Audit.

### **Internal Assignments in Banks by Statutory Auditors**

1.07 The RBI, vide its circular no. Ref.DBS.ARS.No. BC. 02/ 08.91.001/2008-09 dated December 31, 2008 on "Internal assignments in banks by statutory auditors", decided that the audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the same bank during the same year. In case the firms are associated with internal assignment, it should be ensured that they relinquish the internal assignment before accepting the statutory audit assignment during the year.

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

### **Communication with Previous Auditor**

1.09 As per Clause 8 of the Part I of the first schedule to the Chartered Accountants Act, 1949, a chartered accountant in practice cannot accept position

as auditor previously held by another chartered accountant without first communicating with previous auditor in writing.

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

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

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

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

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

## **Some Important Standards on Auditing (SA) for the Initial Considerations**

### **Terms of Audit Engagements**

1.15 Standard on Auditing (SA) 210, "Agreeing the Terms of Audit Engagements" requires that for each period to be audited, the auditor should agree on the terms of the audit engagement with the bank before beginning significant portions of fieldwork. It is imperative that the terms of the engagement

are documented, in order to prevent any confusion as to the terms that have been agreed in relation to the audit and the respective responsibilities of the management and the auditor, at the beginning of an audit assignment.

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

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

- , The objective of the audit of financial statements.
- , Management's responsibility for the financial statements.
- , Management's responsibility for selection and consistent application of appropriate accounting policies, including implementation of the applicable accounting standards along with proper explanation relating to material departures from those accounting standards.
- , Management's responsibility for assessment of the entity's ability to continue as a going concern.
- , Management's responsibility for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the bank at the end of the financial year and of the profit or loss of the bank for that period.
- , Management's responsibility for the maintenance of adequate accounting records and internal controls for safeguarding the assets of the bank and for preventing and detecting fraud or other irregularities.
- , The scope of the audit, including reference to the applicable legislation, regulations, and the pronouncements of the RBI and the ICAI.
- , Unrestricted access to whatever records, documentation and other information requested in connection with the audit.
- , The fact that the audit process may be subjected to a peer review and/or quality review under the Chartered Accountants Act, 1949.

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

- , Arrangements regarding the planning and performing the audit, including the fact that the audit will be carried out in accordance with the auditing standards generally accepted in India. Further, it should be spelt out that the

audit would be performed to obtain reasonable assurance about whether the financial statements are free of material misstatements. It should clearly be spelt out that the audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements including assessment of the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. However, having regard to the nature of the audit and volume and complexity of transactions, persuasive rather than conclusive nature of audit evidence, together with inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements of financial statements, resulting from fraud, and to a lesser extent error, if either exists, may remain undetected.

- , Expectation of receiving from management written confirmation concerning representations made in connection with the audit.
- , Request for the bank to confirm the terms of the engagement by acknowledging receipt of the engagement letter.
- , Description of any other letters or reports the auditor expects to issue to the bank.
- , Basis on which fees are computed and any billing arrangements.
- , A reference to any further agreements between the auditor and the client.

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

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

1.20 An illustrative format of engagement letter in case of a Nationalised Bank is given in **Appendix-V** of this Guidance Note.

1.21 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.

### **Initial Engagements**

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

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

### **Assessment of Engagement Risk**

1.24 The assessment of engagement risk is a critical part of the audit process and should be done prior to the acceptance of an audit engagement since it affects the decision of accepting the engagement and also in planning decisions if the audit is accepted.

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

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

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

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

### **Planning**

1.29 The auditor needs to ensure compliance of SA 300, "Planning an Audit of Financial Statements":

1.30 Planning would involve establishing overall audit strategy to set the scope, nature, timing, extent of resources required and direction of audit. The audit plan needs to be properly documented with respect to timing, extent of checking, audit procedures to be followed at assertion level and should be flexible and updated or changed as and when necessary. Further the audit plan should be communicated to the audit team. SA 220, "Quality Control for an Audit of Financial Statements" establishes standards on the quality control, generally, and with regard to the work delegated to assistants on an individual audit. Before starting initial audit engagement, the auditor should perform procedures required under SA 220 regarding client acceptance etc. The auditor also needs to ensure that a proper communication has been sent to the predecessor auditor. The auditor should also keep in mind the requirements of SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements".

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

### **Establish the Engagement Team**

1.32 The selection of the engagement team is a key activity in the development and execution of an effective and efficient audit plan. The assignment of qualified and experienced professionals is an important

component of managing engagement risk. The size and composition of the engagement team would depend on the size, time available to complete the assignment, nature, and complexity of the bank's operations.

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

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

### **Understanding the Bank and its Environment**

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

1.36 Standard on Auditing (SA) 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" lays down that the auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement in the financial statements whether due to fraud or error, and sufficient to design and perform audit procedures.

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

1.38 The auditor can obtain knowledge of the bank from a number of sources

namely:

- , Discussion with management of the bank.
- , Discussion with internal/concurrent/other audit personnel regarding the nature, timing and extent of work done by them and review of their audit reports, especially how issues raised are closed.
- , Discussion with peers (other auditors) and with legal and other advisors who have provided services to the bank or within the industry.
- , RBI guidelines and other regulatory pronouncements.
- , Documents produced by the bank (for example, minutes of meetings, annual reports, etc.).
- , RBI inspection reports.
- , General reading and keeping abreast with the latest developments in the Industry and general economic scenario.
- , In case of audit of foreign branches, knowledge of the local laws and trade practices of the geographical location of bank would also be used.

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

### **Review of Closing Instructions and Communication with Branch Auditors**

1.39 It is a common practice that banks issue closing instructions to branches, based on which branches prepare their balance sheet, profit and loss account and other returns necessary for preparation of the financial statements of the bank as a whole. These instructions issued by the HO are generally called 'accounts closing instructions' and include the format of the financial statements and other relevant returns, significant accounting policies to be followed, other instructions necessary for the conduct and completion of the audit, timelines of audit completions and consolidations etc. Many a times, besides general instructions this may also include specific directions on review and verification of certain information required by the SCA for their audit. Considering the significance of these instructions, it is necessary that before these instructions are sent to branches, the SCA review them to assess whether the instructions are sufficiently comprehensive, clear and adequate to facilitate the compilation of branch financial statements and other relevant data accurately and expeditiously.

The SCA should particularly examine whether the instructions are in consonance with the accounting policies of the bank and are in such compliant that stand the test of SA 600 – Using the Work of Another Auditor, so that the SCA has the comfort and confidence in the procedures adopted by the branch auditors by relying on the information and assurance provided by them. The SCA should also include specific instructions for the conduct of audit detailing the areas of concern that require extra care and special notice by SBAs, wherever required, including any matters of significant nature which the branch auditor would like to bring to the notice of SCA in context of Statutory Audit or otherwise.

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

### **Co-ordination with Bank Management**

1.41 A proper and smooth co-ordination between the auditor and the bank management is essential for an effective audit and timely completion of the assignment. The audit work may get delayed due to non-availability of books, information, records, etc. To minimize the possibility of such an occurrence, it is advisable that after accepting the appointment, the SCA should send a formal communication to the bank management specifying the books, records, analyses and other information that the auditor would require in the course of his audit. Such a communication would enable the bank management to keep the requisite documents, information, etc., ready well in advance. Further it is also advisable to complete verification of certain non-financial areas (like documentation, verification of sanction and post sanction terms, review, monitoring and supervision etc.) before the year end so that the pressure of completion of audit post year end is minimal. An illustrative format of Management Representation Letter to be obtained from Bank Management in case of Statutory Central Audit is given in **Appendix - VIII**.

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

1.43 The bank's management can also be requested to have a training session

for the engagement team on the use of the CBS and the various reports that can be generated from it. This would help the engagement team to be well prepared before starting the actual audit on the field. Further an illustrative format of Management Representation Letter to be obtained from Bank Management in connection with the Limited Review is also given in **Appendix - IX**.

### **Relationship among Joint Auditors**

1.44 Public sector banks in India as well as some private sector banks appoint more than one firm as statutory auditors. There is also a rotation policy in place. The joint auditors should discuss and document the nature, timing and the extent of the audit procedures for common and specific allotted areas of audit to be performed by each of the joint auditor and the same shall be communicated to those charged with governance. The joint auditors should obtain common engagement letter and common management representation letter. The work allocation document should be signed by all the joint auditors and the same should be communicated to those charged with governance of the bank. With all banks on CBS platform and with the level of automation, the division of work is usually done based on various departments at the HO, like Treasury, central accounts, etc. or geographical areas. However certain areas of work, owing to their nature or importance would often not be divided and would be covered by all the joint auditors.

1.45 As per Standard on Auditing (SA) 299 (Revised), "Joint Audit of Financial Statements", in respect of audit work divided, each joint auditor is responsible only for the work allocated to him including proper execution of the audit procedures. All the joint auditors are jointly and severally responsible for-

- , the audit work which is not divided among the joint auditors and is carried out by all joint auditors;
- , decisions taken by all the joint auditors under audit planning in respect of common audit areas considering the nature, timing and extent of the audit procedures to be performed by each of the joint auditors.
- , matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;
- , examining that the financial statements of the entity comply with the requirements of the relevant statutes;
- , presentation and disclosure of the financial statements as required by the applicable financial reporting framework;
- , ensuring that the audit report complies with the requirements of the relevant

statutes, the applicable Standards on Auditing including (SA) 299 (Revised) and the other relevant pronouncements issued by ICAI.

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

1.47 In the case of audit of large banks with several branches, including those required to be audited by SBAs, the branch audit reports/returns may be required to be reviewed by different joint auditors in accordance with the allocation of work. In such cases, it is the specific and separate responsibility of each joint auditor to review the audit reports/returns of the branches allocated to him and to ensure that they are properly incorporated into the accounts of the bank. In case of a Bank having foreign branches, the SCA should review the completeness and accuracy of information obtained by the Bank from its foreign branches and the auditors of such branches.

1.48 There may be a situation, where foreign branches are located in jurisdictions, where the local law, does not mandatorily require such branch to be audited. Bank managements may in such case, voluntarily get the branch audited. The auditor should accordingly consider the status of the branch i.e., audited or unaudited while reporting on the financial statements of the bank.

1.49 Generally, the joint auditors may arrive at an agreed report. However, where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express own opinion through a separate report. Such separate report should make reference under the heading 'Other Matter Paragraph' (as per SA 706(Revised)) to the audit report issued by other joint auditors and vice versa. A joint auditor is not bound by the views of the majority of the joint auditors regarding matters to be covered in the report and should express own opinion in a separate report in case of a disagreement.

# II-2, Risk Assessment and Internal Control,

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## Characteristics of a Bank

2.01 Banks have certain characteristics distinguishing them from most other commercial enterprises e.g.,

- , Custody of large volumes of monetary items, including cash and negotiable instruments, whose physical security has to be ensured. This applies to storage and the transfer of monetary items making banks vulnerable to misappropriation and fraud necessitating establishment of formal operating procedures, well-defined limits for individual discretion and rigorous systems of internal control.
- , Significant dependence on third party agencies e.g. Cash Replenishment Agencies, Telcos, etc. bearing risks of outsourcing of certain important banking processes.
- , Engagement in a large volume and variety of transactions in terms of number and value which necessarily requires complex accounting and internal control systems and extensive use of Information Technology (IT).
- , Operation through a wide network of geographically dispersed branches and offices necessitating a greater decentralization of authority and dispersal of accounting and control functions, with consequent difficult challenges in maintaining uniform operating practices and accounting systems, particularly when the branch network transcends national boundaries.
- , Assumption of significant commitments including those without actual outflow of funds. These items, called 'off-balance sheet' items, may at times not involve accounting entries and the failure to record such items may be difficult to detect.
- , Engagement in transactions that are initiated at one location, recorded at a different location and managed at yet another location.
- , Direct Initiation and completion of transactions by the customer without any intervention by the bank's employees. For example, over the Internet or mobile or through automatic teller machines (ATMs).

- , Integration and linkages of national and international settlement systems could pose a systemic risk to the countries in which they operate.
- , Regulatory requirements by governmental authorities often influence accounting and auditing practices in the banking sector.
- , Continuing development of new products and services and banking practices.

The auditor should consider the effect of the above factors in designing his audit approach. It is imperative for SCAs to have detailed knowledge of the products offered by banks and risks associated with them, and appropriately address them in their audit plan to the extent they give rise to the risk of material misstatements in the financial statements.

In today's environment, the banks use different applications to carry out different transactions which may include data flow from one application to other application; the auditor while designing his plans should also understand interface controls between the various applications.

### **Identifying and Assessing the Risks of Material Misstatements**

2.02 Standard on Auditing (SA) 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" requires the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level for classes of transactions, account balances, and disclosures and paragraph 26 of SA 315 provides a basis for designing and performing further audit procedures.

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

2.03 The risk assessment and internal control assessment differs from the perspective of Statutory Central Auditor (SCA) and Statutory Branch Auditor (SBA) and needs to be considered based on the need of the work at respective levels. The level of work at SCA level would be much more comprehensive as compared to the work required at SBA level. The level of work required at SBA level would also differ based on the size of the branch and the nature of business being carried out at the branch level and would be a matter of professional judgement. The SCA as well as SBA would need to carry out certain common risk assessment and internal control assessment apart from specific assessment required to be carried out at their level.

## **Understanding the Bank and Its Environment including Internal Control**

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

2.05 An understanding of the bank and its environment, including its internal control, enables the auditor:

- , to identify and assess risk;
- , to develop an audit plan so as to determine the operating effectiveness of the controls, and to address the specific risks. Further, documentation of the auditor's understanding of the bank and its environment provides an effective mechanism for accumulating and sharing knowledge and experience and briefing the same to all the members of the engagement team, particularly in case of multi-location audit engagements; and
- , to assist in issuing audit report on internal financial controls in terms of Section 143(3)(i) of the Companies Act, 2013, wherever applicable<sup>1</sup>.

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

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

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

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<sup>1</sup> The ICAI has issued the Guidance Note on Audit of Internal Financial Controls over Financial Reporting in September 2015 in accordance with Section 143(3)(i) of the Companies Act, 2013. This Section casts a new reporting requirement for statutory auditors of companies under the Act, to state in their audit report whether the company has adequate internal financial controls system in place and to opine on the operating effectiveness of such controls. Members should refer the Guidance Note for comprehensive details on the aforesaid reporting.

2.08 Auditor should be aware of significant internal controls in transaction flow embedded in applications not only of the bank but also consider significant applications used by outsourced service providers in accordance with SA 402, "Audit Considerations Relating to an Entity Using a Service Organisation".

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

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

- , Understanding the bank's corporate governance structure, RBI has laid down specific guidelines to be complied with by the banks, with regard to the formation of various committees of board of directors and determination of their specific functions, extent of audit coverage, etc. Provisions related to listing also need to be complied by the listed banks.
- , Obtaining and maintaining a record of the understanding of the products and services offered by the bank. The auditor should be aware of the various deposit, loan and treasury products and services that are offered and continue to be developed and modified by the bank in response to market conditions and guidelines issued by the RBI from time to time. Similarly, the auditor should obtain an understanding of the nature of services rendered through off balance sheet and other similar instruments; inherent risks arising as a result thereof; and auditing, accounting and disclosure implications thereof.
- , Understanding the regulatory requirements of other regulatory authorities like SEBI, IRDA, etc. for other products like depository participants, investment banking, insurance, distribution, mutual fund selling, etc. The same is important, as the bank may face penal action in case of non-compliance with respective regulation.
- , The extent of use of service organisations needs to be evaluated, since it is the responsibility of the bank to ensure compliance with the rules and regulations, as well as to ensure that the service organisations have adequate internal controls. The auditor may ask for report under SA 402 "Audit Considerations Relating to An Entity Using a Service Organisation."

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

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

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

### **Structure of overall internal control environment of a bank**

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

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

#### ***I. Board of Directors or senior management and its Committees***

2.15 The organisational structure of a bank assists it in managing its responsibility of oversight and control. Banks usually have the following committees:

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

2.16 Banks also have an Audit Committee, Shareholder Grievance Committee, etc. Further, function specific committees such as, the Investment Committee, Credit Committee, Information Technology Committee, CSR Committee, etc. also exists, which report to the Board of Directors or the Executive Committee.

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

### **II. Internal Audit**

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

2.19 RBI has advised banks to adopt a framework for Risk-Based Internal Audit to ensure that the internal audit is undertaken in the bank in a risk focused manner. This would also facilitate in adoption of the Risk-based Supervision framework. Attention is invited to RBI circular No. DBS.CO.PP.BC.14 /11.01.005/ 2003-04, dated June 26, 2004 on “Risk Based Supervision – Follow up of Risk Management Systems in Banks”.

2.20 As per section 138 of Companies Act, 2013 and Rules thereunder, the following classes of companies shall be required to appoint an internal auditor or a firm of internal auditors, who shall either be a chartered accountant or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company:-

- (a) every listed company;
- (b) every unlisted public company having-
  - (i) paid up share capital of fifty crore rupees or more during the preceding financial year; or
  - (ii) turnover of two hundred crore rupees or more during the preceding financial year; or
  - (iii) outstanding loans or borrowings from banks or public financial

- institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or
- (iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and
- (c) every private company having-
- (i) turnover of two hundred crore rupees or more during the preceding financial year; or
  - (ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year:

Provided that an existing company covered under any of the above criteria shall comply with the requirements of section 138 and this rule within six months of commencement of such section.

Explanation- For the purposes of this rule –

- (i), the internal auditor may or may not be an employee of the company;
- (ii), the term “Chartered Accountant” shall mean Chartered Accountant whether engaged in practice or not.

2.21 The audit committee of the company or the Board shall, in consultation with the internal auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.

2.22 It should be noted that Internal Audit differs from Concurrent audit in certain ways. The Concurrent auditor examines transactions close to the occurrence to find errors so as rectify the same and understand the process gaps so that the process gaps can be remediated and the occurrence of errors is eliminated. Though Concurrent audit has also become risk based, the movement is from the transactional gap to the control. Internal audit is predominantly risk and control based with focus on control assurance. For example, if a design of a control is not in place, internal audit will highlight the same even if there is no transactional error.

2.23 RBI has issued circulars on risk based internal audit of banks where the focus is clearly on prioritizing the audit work based on the degree of the risk. Attention is invited to RBI circular RBI/2016-17/46 DBS.CO.PPD.05/11.01.005/2016-17 August 25, 2016 on “Risk Based Internal Audit”.

### **III. Revenue Audit**

2.24 Revenue audit is usually conducted depending on size and volume of

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

### **IV. Branch Inspection**

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

### **V. Head Office (HO) Inspection**

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

2.27 HR is a key area of HO inspection with focus on employee engagement, training based on current and future job roles and skill set gaps, employee selection and screening methods, employee attrition etc. Another key area is the audit of the Risk Assessment process or the manner in which risks are identified and periodically reviewed by the bank, controls are designed in response to mitigate the risks, ongoing review of efficacy of the controls to identify residual risks and whether they are within the risk appetite of the Bank.

### **VI. Concurrent Audit**

2.28 A system of concurrent audit at large and other selected branches has been in vogue in most of the banks for quite long. Recognising the importance of concurrent audit in the banking sector, the RBI, *vide* its Circular No. BC.182/16.13.100/93-94 dated October 11, 1993, addressed to all scheduled commercial banks (except regional rural banks) formally advised such banks to institute an appropriate system of concurrent audit. The RBI also specified the minimum extent of banking operations to be covered under concurrent audit within a defined time-frame, and also suggested the areas to be covered by concurrent audit.

2.29 On July 16, 2015, RBI issued circular no. DBS.CO.ARS. No. 2/08.91.021/2015-16 on Concurrent Audit System in Commercial Banks - Revision of RBI's Guidelines, which includes guidelines on scope of concurrent audit, coverage of business/branches, types of activities to be covered, appointment of auditors and accountability, facilities for effective concurrent

in audit of banks. Auditors of banking companies may also refer the aforesaid Guidance Note for further clarity.

2.86 The MCA issued the Companies (Amendment) Act, 2015 in May 2015 which, *inter alia*, amends section 143(12) of the Companies Act, 2013. The amended section 143(12) reads as follows:

“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.”

Further, the MCA through its notification dated 14 December 2015 has also amended Rule 13 of the Companies (Audit and Auditors) Rules, 2014. The amended Rule 13 requires the reporting of a fraud as follows:

- (1) If an auditor of a company, in the course of the performance of its duties as statutory auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of rupees one crore or above, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government.
- (2) The auditor shall report the matter to the Central Government as under:-
  - (a) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than two days of his knowledge of the fraud, seeking their reply or observations within forty-five days;
  - (b) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within fifteen days from the date of receipt of such reply or observations;

- (c) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of forty-five days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;
  - (d) the report shall be sent to the Secretary, Ministry of Corporate Affairs in sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;
  - (e) The report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with their seal and shall indicate Membership Number; and
  - (f) the report shall be in the form of a statement as specified in Form ADT-4.
- (3) In case of a fraud involving lesser than the amount specified in sub- rule (1), the auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than two days of his knowledge of the fraud and he shall report the matter specifying the following:-
- a), Nature of Fraud with description;
  - b), Approximate amount involved; and
  - c), Parties involved.
- (4) The following details of each of the fraud reported to the Audit Committee or the Board under sub-rule (3) during the year shall be disclosed in the Board's Report:-
- a), Nature of Fraud with description;
  - b), Approximate Amount involved;
  - c), Parties involved, if remedial action not taken; and
  - d), Remedial action taken.

The auditor of a banking company would need to comply with provisions of section 143(12) and the related Rules also.

2.87 RBI circular dated 7<sup>th</sup> May 2015 on framework for dealing with loan frauds has introduced the concept of a Red Flag Account (RFA), i.e., an account where suspicion of fraudulent activity is thrown up by the presence of one or more early warning signals (EWS).

2.88 Early Warning signals as advised by RBI which should alert the bank officials about some wrongdoings in the loan accounts which may turn out to be fraudulent include:

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

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- 1) Default in payment to the banks/ sundry debtors and other statutory bodies, etc., bouncing of the high value cheques.
- 2) Raid by Income tax /sales tax/ central excise duty officials.
- 3) Frequent change in the scope of the project to be undertaken by the borrower.
- 4) Under insured or over insured inventory.
- 5) Invoices devoid of TAN and other details.
- 6) Dispute on title of the collateral securities.
- 7) Costing of the project which is in wide variance with standard cost of installation of the project.
- 8) Funds coming from other banks to liquidate the outstanding loan amount.
- 9) Foreign bills remaining outstanding for a long time and tendency for bills to remain overdue.
- 10) Onerous clause in issue of BG/LC/standby letters of credit.
- 11) In Merchanting trade, import leg not revealed to the bank.
- 12) Request received from the borrower to postpone the inspection of the godown for flimsy reasons.
- 13) Delay observed in payment of outstanding dues.
- 14) Financing the unit far away from the branch.
- 15) Claims not acknowledged as debt high.
- 16) Frequent invocation of BGs and devolvement of LCs.
- 17) Funding of the interest by sanctioning additional facilities.
- 18) Same collateral charged to a number of lenders.
- 19) Concealment of certain vital documents like master agreement, insurance coverage.
- 20) Floating front / associate companies by investing borrowed money.
- 21) Reduction in the stake of promoter / director.
- 22) Resignation of the key personnel and frequent changes in the management.
- 23) Substantial increase in unbilled revenue year after year.
- 24) Large number of transactions with inter-connected companies and large outstanding from such companies.
- 25) Significant movements in inventory, disproportionately higher than the growth in turnover.
- 26) Significant movements in receivables, disproportionately higher than the growth in turnover and/or increase in ageing of the receivables.
- 27) Disproportionate increase in other current assets.

- 28) Significant increase in working capital borrowing as percentage of turnover.
- 29) Critical issues highlighted in the stock audit report.
- 30) Increase in Fixed Assets, without corresponding increase in turnover (when project is implemented).
- 31) Increase in borrowings, despite huge cash and cash equivalents in the borrower's balance sheet.
- 32) Liabilities appearing in ROC search report, not reported by the borrower in its annual report.
- 33) Substantial related party transactions.
- 34) Material discrepancies in the annual report.
- 35) Significant inconsistencies within the annual report (between various sections).
- 36) Poor disclosure of materially adverse information and no qualification by the statutory auditors.
- 37) Frequent change in accounting period and/or accounting policies.
- 38) Frequent request for general purpose loans.
- 39) Movement of an account from one bank to another.
- 40) Frequent ad hoc sanctions.
- 41) Not routing of sales proceeds through bank.
- 42) LC's issued for local trade / related party transactions.
- 43) High value RTGS payment to unrelated parties.
- 44) Heavy cash withdrawal in loan accounts.
- 45) Non submission of original bills.

2.89 Besides the above Red flags, auditor could also review –

- a) Cheque/bills discounting facility used for liquidation of funds without any physical collateral or just for deferment of liability.
- b) Repayment of third party loans despite bank's loan account irregular or out of order.
- c) Maintenance of bank accounts with other bank without consent of lender bank.
- d) Inordinate delay in conducting stock inspections by bank officials and/or stock auditors at the instance of the borrower not to show its weakness and misutilisation of funds.
- e) Unauthorised changes to CBS parameters, unauthorised/fraudulent direct entries, NPA date tampering etc.

2.90 RBI in the Master Direction No. RBI/DBS/2016-17/28 DBS.CO.CFMC.

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

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BC.No.1/23.04.001/2016-17 on “Frauds – Classification and Reporting by commercial banks and select FIs” dated July 1, 2016 (updated July 03, 2017) has stated that the following acts constitute fraud:

- , Fraudulent removal of pledged stocks / disposal of hypothecated stocks without the knowledge of the bank / inflating the value of stocks in the stock statements & drawing excess bank finance.
- , Diversion of funds, lack of interest or criminal neglect on the part of the borrowers partners etc., in adhering to financial discipline and managerial failure with *malafide* intent leading to the unit becoming sick and laxity in effective supervision over the operations in borrowable accounts on the part of bank functionaries rendering the advance difficult for recovery and resulting in financial loss to the bank.
- , The Master Direction states that banks should conduct an annual review of the frauds to consider-
  - a) Whether the systems in the bank are adequate to detect frauds, once they have taken place, within the shortest possible time.
  - b) Whether frauds are examined from staff angle and, wherever necessary, the staff side action is taken without undue delay.
  - c) Whether deterrent punishment is meted out, wherever warranted, to the persons found responsible without undue delay.
  - d) whether frauds have taken place because of laxity in following the systems and procedures or loopholes in the system and, if so, whether effective action has been taken to ensure that the systems and procedures are scrupulously followed by the staff concerned or the loopholes are plugged.
  - e) Whether frauds are reported to the local Police for investigation.

2.91 Diversion of Funds, inflating value of stocks, showing unpaid stocks as paid stocks, not providing for bad debts etc., are common practices by unscrupulous borrowers in Banks and frequently reported by Concurrent / Stock / other auditors in Banks.

2.92 Auditors should take due cognizance of the same and banks could be asked to report the same as frauds on a case to case basis after due consideration of the borrower's intent and the frequency of such instances, risk of default as a result of such practices, materiality of the amount financed by the bank and outstanding, availability of collateral and loan to value ratio or margin of safety.

## Assess the Risk of Money Laundering

2.93 Due to the nature of their business, banks are ready target for those who are engaged in the money laundering activities by which the proceeds of illegal acts are converted into proceeds from the legal acts. The RBI has framed specific guidelines that deal with prevention of money laundering and “Know Your Customer (KYC)” norms. The RBI has from time to time issued guidelines (“Know Your Customer Guidelines – Anti Money Laundering Standards”), requiring banks to establish policies, procedures and controls to deter and to recognise and report money laundering activities. The RBI, vide its master direction no. RBI/DBR/2015-16/18 Master Direction DBR.AML.BC.No.81/14.01.001/2015-16 dated December 08, 2016 (Updated July 12, 2018) on “Know Your Customer (KYC) Direction, 2016”, have advised the banks to follow certain customer identification procedure for opening of accounts and monitoring transactions of a suspicious nature for the purpose of reporting it to appropriate authority. These policies, procedures and controls commonly extend to the following:

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

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

2.95 Banks were advised to complete the process of risk categorization and compiling/updating profiles of all of their existing customers in a time-bound manner latest by end-March 2013.

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

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

2.97 The RBI master direction also advised the banks to pay special attention to any money laundering threats that may arise from new or developing technologies including, internet banking that might favour anonymity, and take measures, if needed, to prevent their use in money laundering schemes. Further, banks are required to report all frauds to the RBI on a periodical basis. The auditors should review the same to get an idea of the nature and extent of frauds.

“Money mules”<sup>2</sup> can be used to launder the proceeds of fraud schemes (e.g., phishing and identity theft) by criminals who gain illegal access to deposit accounts by recruiting third parties to act as “money mules.” In some cases, these third parties may be innocent while in others they may be having complicity with the criminals. In a money mule transaction, an individual with a bank account is recruited to receive cheque deposits or wire transfers and then transfer these funds to accounts held on behalf of another person or to other individuals, minus a certain commission payment. Money mules may be recruited by a variety of methods, including spam e-mails, advertisements on genuine recruitment web sites, social networking sites, instant messaging and advertisements in newspapers. When caught, these money mules often have their bank accounts suspended, causing inconvenience and potential financial loss, apart from facing likely legal action for being part of a fraud. Many a times the address and contact details of such mules are found to be fake or not up to date, making it difficult for enforcement agencies to locate the account holder. The operations of such mule accounts can be minimised if banks follow the guidelines contained in the Master Directions on Know Your Customer (KYC). Banks are, therefore, required to strictly adhere to the guidelines on KYC/AML/CFT issued from time to time and to those relating to periodical updation of customer identification data after the account is opened and also to monitoring of transactions in order to protect themselves and their customers from misuse by such fraudsters.

2.98 Money laundering involves three steps namely - Placement – Layering - Integration.

- , Placement involves introducing money in the financial system by some means.
- , Layering means carrying out transactions generally complex to camouflage the illegal source.
- , Integration means acquiring wealth generated from the transactions of the illicit funds.

2.99 Some methods in which money laundering takes place are as under -

- , Breaking up of cash into smaller amounts and depositing it in to the bank below the monitored reporting thresholds.

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<sup>2</sup>The RBI, vide its circular no. DBOD.AML.BC.No.65/14.01.001/2010-11 dated December 7, 2010 provides guidance on Operation of bank accounts & money mules.

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

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- , Physically moving the cash into locations or jurisdictions and depositing it in off shore banks with lesser stringent enforcement laws and regulations.
- , Using business typically known to receive revenue in cash to be used to deposit criminally derived cash.
- , Trade based laundering – Over or Under Invoicing.
- , Shell companies operating in jurisdictions not requiring reporting of beneficial owner to earn tax favored profits.
- , Round Tripping wherein money is deposited in a controlled foreign corporation offshore preferably a tax haven where minimal records are kept & then shipped back as FDI to earn tax favored profits through a shell company.
- , Use of Casinos – Chips are purchased with laundered cash and on winning, the buyer either gets back the winnings in cheque or gets a receipt for the winnings.
- , Real estate Transactions – seller agrees to understate the value of the property and collects the difference in cash.
- , Bank capture – Buying a controlling interest in a Bank in a jurisdiction with weak money laundering controls and then move money through the bank without much scrutiny.

2.100 Banks use computer software in place whereby they generate alerts based on thresholds as per parameters given in IBA guidance. The bank scans through these alerts and in case they find anything suspicious they have to report the same to the Financial Intelligence Unit. This reporting varies from bank to bank as the definition of “suspicious” is interpreted by various banks differently. Banks should have adequate documentation in place justifying why a transaction was not reported as Suspicious when they had alerts of the same. Banks also need to review these alerts from time to time. If a Suspicious Transaction Reports (STR) is reported in a Low risk account, the classification in the account may need upgradation to a High risk profile account.

2.101 Central Statutory Auditors should review the process of closure of AML alerts. AML alerts are transactions identified by AML application as exceptional. The same needs to be closed after getting explanation from customer regarding genuineness of transactions. In many Banks the AML alerts are closed based on information provided by Branch Managers, which he/she receives from customer. At Branch level the Statutory Branch Auditors may review process of documenting explanations received from customer regarding AML alerts.

Central Statutory Auditors should review the process of modifications/deletion in parameters entered in AML application for generation of alerts.

## Assess Specific Risks

2.102 The auditors should identify and assess the risks of material misstatement at the financial statement level which refers to risks that relate pervasively to the financial statements as a whole, and potentially affect many assertions. Risk of material misstatement at the assertion level for specific class of transactions, account balances and disclosures need to be considered because such consideration directly assists in determining the nature, timing and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence.

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

- , Identify risks throughout the process of obtaining an understanding of the bank and its environment, including applicable controls that relate to the risks, and by considering the account balances or disclosures in the financial statements.
- , Ascertain account balances or disclosures wherein control lapses or errors have been identified in the past.
- , Pinpoint each risk to one or more assertions relating to the account balances or disclosures.
- , Consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements.
- , Document the identified and assessed risks of material misstatement at the assertion level.

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

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

- , past misstatements strongly indicate about the likely occurrence of future misstatements;
- , the application systems are unreliable;
- , non-systematically processed transactions have a disproportionately higher likelihood of misstatement than those routine transactions that are

processed by reliable application systems;

- , absence of secondary review;
- , the incidence of misstatements is greater in transactions relating to accounting estimates and adjustments at or near to the end of an accounting period (i.e., cut-offs and accruals); and
- , the incidence of misstatements associated with unusual or complex transactions.

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

2.106 The auditor's assessment of the risks of material misstatement at the assertion level is based on available audit evidence which may change during the course of the audit as and when further audit evidence is obtained indicating the change in the previously obtained audit evidence (e.g., when performing substantive procedures, the auditor may detect misstatements in amounts or frequency greater than that of consistent with their risk assessment). In these circumstances, the auditor needs to consider whether it is appropriate to revise the risk assessment procedures and modify the further planned audit procedures accordingly. The auditor is required to document the identified and assessed risks of material misstatement at the assertion level.

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

### **Risk Associated with Outsourcing of Activities**

2.108 Further, the modern day banks make extensive use of outsourcing as a means of both reducing costs as well as making use of services of an expert not available internally. There are, however, a number of risks associated with outsourcing of activities by banks and therefore, it is quintessential for the banks to effectively manage those risks. RBI's circular no. DBOD.BP.40/21.04.158/2006-07 dated November 3, 2006 contains extensive guidelines on managing the risks associated with the outsourcing of financial services by banks. The circular, however, also mandates that banks which choose to

outsource financial services should not outsource core management functions including internal audit, compliance function and decision-making functions like, determining compliance with Know Your Customer ('KYC') norms for opening deposit accounts, according sanction for loans (including retail loans) and management of investment portfolio.

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

- (a) The need to process high volumes of transactions accurately within a short time through the large-scale use of IT.
- (b) The need to use electronic funds transfer (EFT) or other telecommunication system to transfer ownership of large sums of money, with the resultant risk of exposure to loss arising from payments to incorrect parties through fraud or error.
- (c) The conduct of operations in many locations with a resultant geographic dispersion of transaction processing and internal controls. As a result:
  - (i) there is a risk that the bank's worldwide exposure, customer-wise and product-wise may not be adequately aggregated and monitored; and
  - (ii) control breakdowns may occur and remain undetected or uncorrected because of the physical separation between management and those who handle the transactions.
- (d) The need to monitor and manage significant exposures that can arise over short timeframes. The process of clearing transactions / RTGS / NEFT may cause a significant build-up of receivables and payables during a day, most of which are settled by the end of the day. This is ordinarily referred to as intra-day payment risk. These exposures arise from transactions with customers and counterparties and may include interest rate, currency and market risks.
- (e) The handling of large volumes of monetary items, including cash, negotiable instruments and transferable customer balances, with the resultant risk of loss arising from theft and fraud by employees or other parties.
- (f) The inherent complexity and volatility of the environment in which banks operate, resulting in the risk of inappropriate risk management strategies or accounting treatment, in relation to such matters as the development of new products and services.
- (g) Overseas operations are subject to the laws and regulations of the countries in which they are based as well as those of the country in which the parent

entity has its headquarters. This may result in the need to adhere to differing requirements, thereby, leading to risk that operating procedures that comply with regulations in some jurisdictions do not meet the requirements of others.

## **Response to the Assessed Risks**

2.110 SA 330, “The Auditor’s Responses to Assessed Risks” deals with the auditor’s responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with SA 315. Further, it requires the auditor to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. The auditor should design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level. In designing the further audit procedures to be performed, the auditor should:

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

2.111 The auditor shall design and perform tests of controls and substantive procedures to obtain sufficient appropriate audit evidence, as to the operating effectiveness of relevant controls, and to detect material misstatements at the assertion level.

## **Risk Control Matrix (RCM)**

2.112 The various risks, both at the financial statement level and at the process level which are assessed together with the controls relevant against the same can be documented in the form of a RCM, which is a comprehensive

document which captures at one place, for each business cycle, the following information:

- , The risks of material misstatement including the fraud risks and any other significant risks which must be separately identified.
- , The account balances affected against each of the risks identified above.
- , The financial statement assertions which are addressed for each of the above risks and accounts balances.
- , The controls which address each of the risks and assertions. A control may address more than one risk or assertion as discussed earlier.
- , The frequency of the control.
- , Who is responsible for testing and reporting on the control and the document(s) which need to be prepared to evidence the exercise of the control.

2.113 An illustrative format of the RCM is given hereunder:

**RISK CONTROL MATRIX-----BUSINESS CYCLE#**

Risk (what could go Wrong?)	Account Balances Affected	Description of Control Activity*	Control Type Preventive / Detective	Manual / Automated control
<p>* Should also cover/address the responsibilities, frequency, and documentary evidence. The frequency could also be specified in separate column.</p> <p># The following are some of the common business cycles for which separate RCMs could be prepared, depending upon the nature of the entity's business and the materiality of the particular process, which are relevant from the point of view of Internal Financial Controls Over Financial Reporting:</p> <ul style="list-style-type: none"> <li>•, Financial Closing and Reporting.</li> <li>•, Bill to collect. (Revenue and Receivables)</li> <li>•, Procure to Pay. (Purchase / Expenses and Accounts Payables)</li> <li>•, Payroll.</li> <li>•, Treasury.</li> <li>•, Cash and Bank.</li> <li>•, Fixed assets and Depreciation.</li> <li>•, Taxation.</li> <li>•, Lending.</li> <li>•, Borrowing</li> <li>•, Deposits. (Separately for Term Deposits and Current and Savings</li> </ul>				

Accounts)

- , Derivatives and FX.
- , Payment and settlements systems and channel reconciliations.
- , Third party products / cross selling products.

2.114 An important element in the preparation of the RCM is to understand the interplay between the business cycles and the related activities / processes and the account balances affecting the same, to the extent it impacts the financial reporting. Finally, the RCM should also help to identify controls which are relevant and not relevant.

2.115 Preparation of a RCM is one of the documentation methods for the Internal Control Framework and would assist in reporting on the operating effectiveness of Internal Financial Controls, wherever applicable. Further, whilst the preparation of the same is recommended by the Management as a part of its assessment of the design and operating effectiveness of the controls for Board Reporting, in terms of Section 134(5)(e) of the companies Act, 2013, in case the same is not prepared, the auditor can use the same for testing the operating effectiveness of Internal Financial Controls over Financial Reporting. The requirement of IFCFR is applicable to the banks registered under the Companies Act, 2013. As such the other banks such as public sector banks, RRBs do not have to legally adhere to the requirements in the form mentioned in this paragraph. However, the banks may follow this voluntarily to help them monitor the control environment effectively. The Management should put in place a system to periodically test the effectiveness of the significant controls identified in the RCMs.

## **Value-at-risk ('VAR')**

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

## **Stress Testing**

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

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

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

2.119 RBI, vide its circular no. DBOD. No. BP. BC.101 / 21.04.103/ 2006-07 dated June 26, 2007 on "Guidelines on Stress Testing" has required that all commercial banks (excluding RRBs and LABs) shall put in place a Board approved 'Stress Testing framework' to suit their individual requirements which would integrate into their risk management systems. The circular further requires that the framework should satisfy certain essential requirements as listed therein.

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

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

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

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

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

- a) Reduction of risk limits;
- b) Reduction of risks by enhancing collateral requirements, seeking higher level of risk mitigants, undertaking securitisation, and hedging;
- c) Amend pricing policies to reflect enhanced risks or previously unidentified risks;
- d) Augmenting the capital levels to enhance the buffer to absorb shocks;
- e) Enhancing sources of funds through credit lines, managing the liability structure, altering the liquid asset profile, etc.

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

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

### **BASEL III Framework**

2.126 The Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB) had undertaken an extensive review of the regulatory framework in the wake of the sub-prime crisis. In the document titled 'Basel III: A global regulatory framework for more resilient banks and banking systems', released by the BCBS in December 2010, it had *inter alia* proposed certain minimum set of criteria for inclusion of instruments in the new definition of regulatory capital. The RBI 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" and also Master Circular No. DBR.No.BP.BC.1/21.06.201/2015-16 dated July 1, 2015 on "Basel III – Capital Regulations". Vide these circulars the RBI has prescribed the final guidelines on Basel III capital regulations. The reader may refer to the chapter 1,

“Basel III” of Part V of the Guidance Note for the detailed guidance on the New Capital Adequacy Framework, i.e., Basel III.

### **Entity Level Control (ELC)**

2.127 The SCA also needs to examine the ELC in the organization for proper evaluation of risk. This needs to be decided based on the case to case basis and based on the structure of the bank.

## Annexure 1

### Risks Associated with the Banking Activities

Risk is a function of probability or likelihood of occurrence and the significance of the impact. Risk implies vulnerability and threat. The key is the impact as an event may have a very low probability of occurrence or even remote probability but the impact could be disastrous. In such cases risks do not get identified or get due focus thus diluting controls necessary for their mitigation. Another key factor is the speed at which risks permeate through the entity once affected. Globalization of the economy has led to integration of world economies & increased the risks & an event occurring anywhere in the world can have an impact on Banks in India.

Risks associated with banking activities can be broadly categorised as follows:

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

- f) **Interest Rate Risk:** The risk that a movement in interest rates would have an adverse effect on the value of assets and liabilities or would affect interest cash flows.
- g) **Legal and Documentary Risk:** The risk that contracts are documented incorrectly or are not legally enforceable in the relevant jurisdiction in which the contracts are to be enforced or where the counterparties operate. This can include the risk that assets will turn out to be worthless or liabilities will turn out to be greater than expected because of inadequate or incorrect legal advice or documentation. In addition, existing laws may fail to resolve legal issues involving a bank; a court case involving a particular bank may have wider implications for the banking business and involve costs to it and many or all other banks; and laws affecting banks or other commercial enterprises may change. Banks are particularly susceptible to legal risks when entering into new types of transactions and when the legal right of the counterparty to enter into a transaction is not established.
- h) **Liquidity Risk:** The risk of loss arising from the changes in the bank's ability to sell or dispose of an asset. The risk of liquidity risk turning into a solvency risk needs to be monitored as risk can swiftly move across the entity.
- i) **Modelling Risk:** The risk associated with the imperfections and subjectivity of valuation models used to determine the values of assets or liabilities.
- j) **Operational Risk:** The risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.
- k) **Price Risk:** The risk of loss arising from adverse changes in market prices, including interest rates, foreign exchange rates, equity and commodity prices and from movements in the market prices of investments.
- l) **Regulatory Risk:** The risk of loss arising from failure to comply with regulatory or legal requirements in the relevant jurisdiction in which the bank operates. It also includes any loss that could arise from changes in regulatory requirements. For example, money laundering risk is a Regulatory risk. (The circular - DBS.CO.PP.BC.6/11.01.005/2006-07 dated April 20, 2007 on "Compliance Function in Banks" which lays down detailed requirements in respect of compliance related aspects such as compliance risk, responsibility of the Board of Directors, responsibility of the senior management, compliance policy, compliance structure, compliance principles, process, procedures, compliance programme, etc. is relevant).
- m) **Replacement/Performance Risk:** The risk of failure of a customer or counterparty to perform the terms of a contract. This failure creates the need

to replace the failed transaction with another counter party at the current market price. This may result in a loss to the bank equivalent to the difference between the contract price and the current market price.

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

Following are examples of some events/ transactions that give rise to one or more of the abovementioned risks (though they may not have a direct impact on the financial statements of a bank:

- , **Cyber Risks** - Use of Internet / Mobile Banking has changed the dimension of banking and with it resulted in new risks – Cyber risks or risks associated due to Identity Thefts, Hacking, Spam, Phishing / Vishing / Dos or DDos attacks, e-mail spoofing, virus attacks, Use of malicious codes, compromise of digital signatures etc., resulting in loss or compromise of data is very common. Risks associated with usage of Debit & Credit Cards or through ATM operations are also increasing.
- , Cyber criminals can commit a crime much faster than conventional fraudsters plus have the added advantage of anonymity. The level of anonymity makes attempting and successfully conducting a cybercrime relatively easier than conventional frauds. It also makes dealing with cyber criminals a daunting aspect.

- Usage of Social Networking sites has exploded over the past few years especially amongst the youth. Personal information is routinely exchanged on a real time basis on social networking sites. This is misused by people purporting to be trusted members of the group while in eventuality they may be fraudsters. Confidential private information exchanged over emails also can be easily tracked and misused.
- **Hacking or Cracking** means illegal intrusion into the information on a computer system or network. The motive could include greed, power, revenge, adventure, desire to access forbidden information, destructive mindset and wanting to sell to earn revenue.
- **Phishing** refers to the acquiring of sensitive information such as user names, passwords or credit card details by masquerading as a trustworthy entity in an electronic communication. The word is an eulogy of the fishing technique of using a bait to lure the victim. It directs users to enter details on a fake website whose look and feel are almost identical to the legitimate one. It exploits the user's trust in not being able to identify the site being visited or the program being used is not the real one.
- **Vishing and Smishing** are phone scams similar to "phishing". Vishing is a telephone call claiming to be from a legitimate company requesting your personal information to resolve an urgent financial matter Smishing is accomplished through text messages on a cell phone by asking a person to call a particular number or click on a link that could contain malicious code that could potentially steal information stored in that person's cell phone without his/her knowledge.
- **Data theft** is aided by use of hand held devices like flash drives, I-pods, digital cameras and the ability to transmit large amounts of data quickly vide e-mail, web pages, USB drives, DVD storages & other hand held devices.
- **E mail spoofing** is sending an email to another person in such a way that it appears that the email was sent by someone else. The mail appears to originate from one source but is actually sent from another source.
- **Denial of Service or DOS** attacks floods the bandwidth of the victim's network or fills his email box with spam mail depriving him of service that he is entitled to access or provide.
- **Dissemination of viruses** by use of malicious software that attaches itself to other software. Some of the common viruses are Virus worms, Trojan horse, Web jacking, Email bombing.
- **Impersonation:** A crime in which an imposter obtains key pieces of personal information in order to impersonate someone else. The imposter

assumes the identity of that person to make transactions, purchases or get loans or credits. This could also be done for illegal immigration, hiding from creditors or people who want to be anonymous for personal reasons. The person whose identity is assumed suffers various consequences as a result of being held responsible for the perpetrators actions.

- , **Botnets** - networks of compromised computers, controlled by remote attackers in order to perform such illicit tasks as sending spam or attacking other computers.
- , **Malvertising** – is a method whereby users download malicious code by simply clicking at some advertisement on any website that is infected.
- , **Cyber Extortion**: refers to blackmailing the victim and extorting money to stop the DOS attacks or give back the information stolen or discontinue vandalism etc.
- , **Cyber Terrorism / Warfare**: Refers to Distributed Denial of service attacks, hate websites and hate emails, attacks on service network etc.
- , **Computer Vandalism** refers to damaging or destroying data rather than stealing or misusing it. Programs are used which attach themselves to a file and then circulate.
- , **PUPs (Potentially Unwanted Programs)** are less harmful but annoying malware which installs unwanted software in your system including search agents and toolbars.
- , **Software piracy** through either theft or illegal copying of genuine programs or by counterfeiting and distribution of product intended to be passed as originals.
- , **Misuse of Digital Signature**: If the private key is not stored securely, it can be misused without the knowledge of the owner of the Private key to issue unauthorized digital certificates for cyber espionage, malware diffusion or sabotage.
- , **Man in the Middle Attacks (MITM)** refers to attacks where the attacker secretly relays or possibly alters the communication between two parties who believe they are directly communicating with each other. The attacker intercepts all messages between the two victims and injects new ones and in fact controls the entire conversation.
- , **Credit Card Frauds** – involving Debit or Credit cards for obtaining goods without paying or obtaining unauthorized funds from an account.
- , Use of fake identities, documentations or impersonation to obtain genuine cards.

- , Using a stolen or lost Credit card for illegal purchases before the holder notifies the issuing bank and the issuing bank puts a block on the account.
- , Skimming is the theft of payment card information used in a legitimate manner by using basic methods like photocopying receipts or advanced methods like using small electronic devices (skimmers) to swipe & store hundreds of victim card numbers.
- , Tele Phishing is obtaining a list of individuals with their name & phone numbers luring victims into thinking that they are speaking with a trusted organization while handing over sensitive information such as card details.
- , A Merchant at a POS(Point of Sale) terminal may allow a fraudster to get goods on a stolen credit card for consideration. He may provide the details of customer cards to the fraudster for a consideration. He can connive with the fraudster & allow him to substitute the imprinter to collect data which can then be used to multiply cards.
- , The merchant may at times swipe the card for a nonexistent transaction & accommodate another by lending him money from the value of the transaction he has received from the paying bank.
- , At times a card holder may himself declare the card as stolen or lost to the issuer. Soon after he himself uses the card to its limits. The loss on the card post intimation is the loss of the banker / issuer & gains are made in this manner.
- , Various credit cards are applied simultaneously at the same time by a fraudster with no previous default history & with the intention to use the card to the fullest and not to repay. At times the fraudster may agree to a one time settlement of the dues at a much lesser amount than what he owes.

Auditor has to review whether risks faced by the Branch are appropriately identified and assessed and whether appropriate controls are put in place, implemented and monitored to reduce/mitigate risks to an acceptable level. Testing of efficiency, effectiveness of controls and reporting to give an assurance thereon is a key audit function.

# II-3

## Special Considerations in a CIS Environment

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### Introduction

3.01 Over the years, the banking operations have been automated to a large extent and wide range of banking softwares have been developed for accounting of transactions and core banking operations. Bank software is becoming more sophisticated all the time. As new accounting methods develop and more people bank online, private banking software is being developed to streamline the processes.

3.02 In today's environment all banks have set up and implemented large scale computerisation projects, which has resulted in changes in the processing and storage of information. Information generated by IT systems are also used for decision making. The importance, extent of use and complexity of a bank's information systems affect the organisation and procedures employed by the entity to achieve adequate internal control. Moreover, the new systems bring with it an entire new set of risks. Thus, while the overall objective and scope of audit do not change simply because data is maintained on computers, the procedures followed by the auditor in his study and evaluation of the accounting system and related internal controls and the nature, timing and extent of his other audit procedures are affected in a CIS environment. The nature of audit evidence and the techniques used to evaluate them have also undergone a significant change. Audit procedures are now transformed from "Auditing around the computer" to "Auditing through the computer".

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

- , the procedures followed by the auditor in obtaining sufficient understanding of the accounting and internal control system;

- , the auditor's evaluation of inherent risk and control risk through which the auditor assesses the audit risk; and
- , the auditor's design and performance of tests of control and substantive procedures appropriate to meet the audit objective.

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

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

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

- , The use of IT to calculate and record substantially, all of the interest income and interest expense and profit/loss on sale of investment, which are ordinarily two of the most important elements in the determination of a bank's earnings.
- , The use of IT and telecommunications systems to determine the foreign exchange security and derivative trading positions, and to calculate and record the gains and losses arising from them.
- , The extensive, and in some cases almost total, dependence on the records produced by IT because they represent only readily accessible source of detailed up-to-date information on the bank's assets and liability positions, such as, customer loan and deposit balances.
- , The use of complex valuation models incorporated in the IT systems.
- , The models used to value assets and the data used by those models are often kept in spreadsheets prepared by individuals on personal computers not linked to the bank's main IT systems and not subject to the same controls as applications on those systems.
- , The use of different IT systems resulting in the risk of loss of audit trail and incompatibility of different systems.

- , The use of multiple channels of delivery of services to a bank's customers such as ATM, EFT, internet banking, card-based payment systems, etc.
- , The integrity of financial data moving through data interfaces between several systems.
- , Compatibility of data structure in communication between different systems.
- , Potential risk of management override of controls through privileged access to information systems.
- , Potential segregation of duty issues arising from access to multiple systems granted to users.
- , The extensive use of third party vendors (service organizations) to whom financial data processing activities or management of IT infrastructure is outsourced.

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

3.07 When auditing in a distributed IT environment, the auditor obtains an understanding of where the core IT applications are located. If the bank's Wide Area Network (WAN) is dispersed over several countries, specific legislative rules might apply to cross-border data processing, in such an environment, audit work on the access control system, especially on access violations, is an important part of the audit. Further, if the system is hosted outside India, Auditor can obtain report of service organization as per SAE 3402, "Assurance Reports on Controls At a Service Organisation" or equivalent work/report from that country.

### **Regulatory aspects**

3.08 Various sets of guidelines have been issued by RBI on different implementation of IT systems. In July, 2017 IDRBT in consultation with RBI has prepared "Core Banking Solutions Requirements of Urban Co-Operative Banks: Functional and Technical". Though the said report is prepared for Urban Co-Op Bank, it gives insight into the functional and technical aspect of an ideal CBS.

3.09 In addition to it, Reports and Recommendations of “Working Group on Information Security, Electronic Banking, Technology Risk Management and Cyber Frauds” headed by Mr. G. Gopalkrishna dt. January 14, 2011 gives insight into adequacy of controls w.r.t. systems, cyber frauds.

3.10 On June 2, 2016 RBI has issued (RBI/2015-16/418 DBS.CO/CSITE/BC.11/33. 01. 001 / 2015-16) cyber security framework in Banks. It provides valuable insight into cyber security setup to be maintained by the banks.

### **Categorisation of Banks based on level of Computerisation**

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

- , Non-computerised banks.
- , Partially Computerised banks.
- , Fully computerised banks.

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

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

3.14 With the extensive coverage of computer systems, softwares coupled with centralized processing in banks pose different set of risks and challenges for Auditors. This also calls for realignment of audit procedures, communication with management and Statutory Branch Auditors.

3.15 Banks, which have high level of computerisation and centralisation, equally have a high level of decentralisation of processes and underlying activities, e.g., in case of advances, the credit processing and accounting are centralised but at the same time there could be separate teams carrying out various parts of credit processing and day-to-day monitoring at the central level; and each team is aware of the specific part of activity only. The central auditor’s biggest challenge is to first get acquainted with all the decentralised processes and activities and then to co-ordinate with the relevant persons for the required information. Normally, the central auditor uses the work of an expert for reviewing the computerisation processes and systems, especially in case of core banking system. The findings and reservations, if any, of an expert should be communicated to the other joint auditors. Similarly, the central

auditor may consider necessary to communicate the findings and reservations, if any, of an expert to branch auditors to review certain specific aspects at the branch level. This will not only aid in enhancing the control review process of an audit but also enable the central auditor as well as the branch auditors to formulate their audit methodology and sampling techniques.

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

### ***Role and responsibilities of the central auditor***

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

- , Need to review whether there is clear segregation of work to be undertaken at central level and branch level under the bank's IT system for accounting of transactions.
- , Consider the need for sending a detailed note to the branch auditors explaining their roles and responsibilities in the light of what is stated above.
- , Review whether access to primary and subsidiary records is provided and use of data analysis tools is allowed at central and branch level.
- , Perform test of controls and substantive checking of sample transactions at the central level and if required, share the results with the branch auditors.

- , Based on the work undertaken, identify key issues to be taken up with the Audit Committee and the Board of the bank.
- , Consider whether the significant adverse observations in the periodic system audit reports need to be shared with the branch auditors and also be considered while framing the opinion of true and fair view of the financial statements of the bank.

### Review of specific aspects

#### a. Outsourcing of Financial Services by Banks

3.18 Outsourcing is a worldwide phenomenon, finding presence in every industry, including the banking industry. With a view to ensure that the banks adequately address the risks associated with outsourcing of some of their activities (especially financial services) by banks as also to bring such outsourced activities under the regulatory purview and protect the interests of the customers, the RBI issued circulars no. DBOD.BP.40/21.04.158/2006-07 dated November 3, 2006 on “Managing the Risks and Code of Conduct in Outsourcing of Financial Services by Banks” read with circular DBOD.No.BP.97/21.04.158/2008-09 dated December 11, 2008 and circular DBS.CO.PPD.BC.5/11.01.005/2008-09 dated April 22, 2009.

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

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

- , Activities that should not be outsourced.
- , Material outsourcing.
- , Bank’s role and regulatory and supervisory requirements.
- , Risk management practices for outsourced financial services.
- , Role of Board of Directors and senior management.
- , Evaluation of risks.
- , Evaluating the capability of the service provider.
- , Outsourcing agreement.
- , Confidentiality and security.
- , Responsibility of DSA/ DMA/ Recovery Agents.

- , Business continuity and management of disaster recovery plan.
- , Monitoring of outsourced activities.
- , Redressal of grievances related to outsourced services.
- , Reporting of transactions to Financial Intelligence Unit.
- , Off-shore outsourcing of financial services.
- , Self assessment/ proposed outsourcing arrangements.

3.21 Further, paragraph 5.9.3 of the circular envisages that regular audits either by the internal auditors or external auditors of the bank should assess the adequacy of the risk management practices adopted in overseeing and managing the outsourcing arrangement, the bank's compliance with its risk management framework and the requirements of these guidelines. RBI cyber security framework dated 2 June 2016 also mandates several controls over outsourced operations/vendor arrangements. The auditor should accordingly undertake procedures necessary to meet these requirements. The scope of the auditor's procedures would, however, be within the requirements of the SA 402, "Audit Considerations relating to an Entity Using a Service Organisation".

3.22 As per another circular no RBI/2014-15/497 DBR.No.BP.BC.76/21.04.158/2014-15 dated March 11, 2015, auditor needs to check that in certain cases, like outsourcing of cash management, which involve reconciliation of transactions between the bank, the service provider and its sub-contractors reconciliation of transactions between the bank and the service provider (and/ or its subcontractor), are carried out in a timely manner. An ageing analysis of entries pending reconciliation with outsourced vendors was placed before the Audit Committee of the Board (ACB). Auditor should also check the reason for old outstanding items therein.

### **b. Security and Risk Mitigation Measures for Electronic Payment Transactions**

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

3.24 With cyber-attacks becoming more unpredictable and electronic payment systems becoming vulnerable to new types of misuse, it is imperative

that banks introduce certain minimum checks and balances to minimise the impact of such attacks and to arrest/minimise the damage. Accordingly, banks are required by the RBI to put in place security and risk control measures vide its circular DPSS (CO) PD No.1462/02.14.003/2012-13 dated February 28, 2013 and circular no RBI/2015-16/418 DBS.CO/CSITE/BC.11/33.01.001/2015-16 dated June 2, 2016.

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

3.25 The use of Electronic/Online Payment modes for payments to merchants for goods and services like bill payments, online shopping etc., has been gaining popularity in the country. The increased facilitation by banks and prepaid payment instrument issuers of the use of electronic modes by customers for payments to merchants generally involves the use of intermediaries like aggregators and payment gateway service providers. Further, Electronic Commerce and Mobile Commerce (e-commerce and m-commerce) service providers have also been acting as intermediaries by providing platforms for facilitating such payments. In most existing arrangements involving such intermediaries, the payments made by customers (for settlement of e-commerce/m-commerce/bill payment transactions) are credited to the accounts of these intermediaries, before the funds are transferred to the accounts of the merchants in final settlement of the obligations of the paying customers. Any delay in the transfer of the funds by the intermediaries to the merchants account will not only entail risks to the customers and the merchants but also impact the payment system. With a view to safeguard the interests of the customers and to ensure that the payments made by them are duly accounted for by the intermediaries receiving such payments and remitted to the accounts of the merchants who have supplied the goods and services without undue delay, RBI vide its circular no. DPSS.CO.PD.No.1102 /02.14.08/ 2009-10 dated November 24, 2009 issued guidelines for opening and operation of accounts and settlement of payments for electronic payment transactions involving intermediaries to ensure safe and orderly conduct of such transactions. As per RBI Circular No BI/2010-11/339 DPSS.CO.OSD.No.1448/06.08.001/2010-2011 dated December 28, 2010, banks are required to obtain quarterly certificate from the concurrent auditor on the operations of the intermediaries' accounts including all the intermediaries accounts maintained with bank.

### **c. E –Banking**

3.26 E-banking may be defined as the automated delivery of new and traditional banking products and services directly to customers through electronic, interactive communication channels. E-banking includes the systems

that enable financial institution customers, individuals or businesses, to access accounts, transact business, or obtain information on financial products and services through a public or private network including internet. Customers access e-banking services using an intelligent electronic device, such as, a personal computer (PC), personal digital assistant (PDA), smart phones, automated teller machine (ATM), kiosk, etc.

***Risks associated with E-banking***

*Transaction/ Operations Risk*

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

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

3.29 The auditor should examine whether in order to mitigate transaction/operations risk, the bank has put in place effective policies, procedures, and controls to meet the new risk exposures introduced by e-banking. The basic internal controls would include segregation of duties, dual controls, and reconciliations. Information security controls, in particular, become more significant requiring additional processes, tools, expertise and testing.

**d. Mobile Banking**

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

3.31 With a view to ensure that the banks adequately address the risks associated with mobile banking, the RBI has issued Master Circular No. RBI/2016-17/17 DPSS.CO.PD. Mobile Banking No. 02/02.23.001/2016-17 dated July 1, 2016 on "Mobile Banking Transactions in India – Operative Guidelines for Banks". The guidelines are applicable to all scheduled commercial banks

(including Regional Rural Banks), Urban Cooperative Banks, State Cooperative Banks and District Central Cooperative Banks. A bank needs to obtain prior approvals of the RBI before commencement of mobile banking services in India.

3.32 In carrying out an audit of mobile banking transactions, the auditor is primarily concerned about aspects such as authentication procedures, understanding the information security framework, compliances with regulatory requirements, etc.

- , *Authentication procedures for mobile banking transactions:* All transactions affecting an account including those which lead to an account being debited or credited should be allowed only after authentication of the mobile number and the MPIN associated with it. Further, the accounts allowed to be transacted through mobile banking should be correctly linked with the mobile phones so as to safeguard against spoofing of the phone numbers. The auditor needs to ensure that the bank has put in place a system of document based registration with relevant details and with mandatory physical presence of the customers, before commencing mobile banking services.
- , *Information Security framework:* The auditor needs to ensure that the bank has proper infrastructure and information security policy put in place since information security is of paramount importance and critical to the business of mobile banking services and its underlying operations. Therefore, technology used for mobile banking should be secure and should be able to ensure confidentiality, integrity, availability and authenticity. Proper level of encryption should be implemented for communicating between the customer, mobile service provider and the bank. The bank needs to ensure that proper security checks have been made to ascertain the security levels of the service providers. The payment authorisation message from the user's mobile phone should be securely encrypted and checked for tampering by the service provider or the bank. It should not be possible for any interceptor to change the contents of the message. The statutory auditor should, accordingly, undertake procedures necessary to evaluate the bank's compliance with these requirements.
- , *Compliance with Regulatory Guidelines:* Banks need to ensure that the guidelines on KYC norms, anti-money laundering, risks and controls in computers and telecommunications, etc., issued by the RBI which apply to mobile banking are also adhered to. The auditor also needs to examine

whether the transaction limit, as stipulated by the RBI, is adhered to and imposed on mobile banking transactions.

3.33 The dependence of banks on mobile banking service providers may place knowledge of bank systems and customers in a public domain. Mobile banking system may also make the banks dependent on small firms (i.e., mobile banking service providers) with high employee turnover. It is therefore imperative that sensitive customer data, and security and integrity of transactions are protected. It is necessary that the mobile banking servers at the bank's end or at the mobile banking service provider's end, if any, should be certified by an accredited external agency. In addition, banks should conduct regular information security audits on the mobile banking systems to ensure complete security.

3.34 Transactions up to Rs. 5000 can be facilitated by banks without end-to-end encryption. The risk aspects involved in such transactions may be addressed by the banks through adequate security measures. (Circular DPSS.CO.No.2502/02.23.02/ 2010-11 dated May 4, 2011)

3.35 RBI Circular dated 4<sup>th</sup> December 2014 on Mobile Banking Transactions in India - Operative Guidelines for Banks has felt the need for greater degree of standardization in procedures relating to on-boarding of customers for mobile banking (new customers, existing account holders whose mobile numbers are available with the bank but not registered for mobile banking, and existing account holders where mobile number is not available with the bank), as also the subsequent processes for authentication, including accessible options for generation of MPIN by customers.

3.36 Where banks are providing E-Wallet facility, auditor should evaluate proper controls and checking of transactions through E-Wallets and presentation of the balances of E-Wallet in the financial statements based on underlying arrangement for providing such facility.

3.37 An illustrative checklist on audit considerations in a CIS environment as applicable to SCA is given in **Appendix X** of this Guidance Note.

### **Audit through CBS**

3.38 Under the CBS the transactions are recorded in a centralized database. The role of SCA is to review the data from various perspectives. With the volume of data, it is not feasible to review the data as is. The review of data is carried out through various exception reports / reports generated based on specific logic / trigger. It gives an insight into quality of data and correctness of disclosures and reporting. It also provides basis for arriving conclusion / designing audit procedure.

3.39 It is important for SCAs to understand the CBS architecture and defined process for transaction recording. One time activity of process walkthrough for each set of transaction origination to conclusion gives an insight into functioning of system. CBS contains various controls, validations. However, at times it is not feasible to embed all the controls and validations in it. It is important to understand the said limitations and gaps in system.

3.40 Moreover, there are various systems interconnected with CBS. Veracity of information flowing from different systems and manual intervention in system should be studied in detail.

3.41 Data from backend can be generated through different tools. Banks have dedicated team for MIS / Data generation. SCA should develop list of reports / tailor made reports which can be requested in advance to MIS / Data generation team. The said reports serve as tool for in-depth coverage in Audits. The auditor should understand control over the same. System generated reports on which auditor is planning to relied upon should be tested for their integrity, completeness.

3.42 An Illustrative list of special purpose/ exception reports in CBS is given in **Appendix XI** of this Guidance Note.

### **Audit of other aspects**

3.43 The Report and recommendation of “Working Group on Information Security, Electronic Banking, Technology Risk Management and Cyber Frauds” of RBI gives and insight on IT Governance, Information Security, IT Operations and Information System Audit. The SCAs should review adherence to the said recommendations by bank. The important aspects for review by SCAs are as follows.

- a., Implementation of IS Security Policy and adherence to the policy
- b., IS Audit reports and outstanding / unresolved issues
- c., Policy w.r.t. Physical Access Controls and its effectiveness
- d., Operating System, Application System, Database controls.
- e., Software Maintenance and Patch Management policy
- f., Backup, Recovery, purging procedure
- g., Outsourcing of IT Services and compliance with RBI Guidelines
- h., Disaster Recovery and Business Continuity Plan

3.44 An in-depth audit of the above parameters is not expected from SCAs. However, review of policies, procedures, audit reports and effectiveness of controls are part of audit by SCA.

**Centralized & Decentralized Processing of Transactions**

3.45 Various banks have adopted hybrid model for transaction processing, wherein, select units have been setup for certain set of work. In such an environment the roles and responsibility assumes utmost importance. If the bank is following mix of centralized and decentralized model or Hub & Spoke model, the SCA should go through the arrangement and should tweak the audit procedure in sync with the same.

# **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/2017-18/59 Master Direction DCM(CC) No. G-2/03.35.01/2017-18 dated October 12, 2017 (Updated 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-2/08.07.18/2018-19dated 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/2018-19/04DCM(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 have been recorded on time proportion basis and interest have 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 3, 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.

## III-2

# Fixed Assets and Other Assets

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### Fixed Assets

2.01 Fixed assets comprise premises and other fixed assets such as furniture and fixtures, motor vehicles, office equipment, computers, intangible assets such as application software and other computer software, etc.

2.02 In the case of most banks, fixed assets can be purchased by the head office, regional/zonal offices and branches up to the monetary ceiling specified (though purchase of land and buildings is usually centralised) for themselves as also for offices within their control. However, banks generally prefer to centralise the function of obtaining insurance and obtain a comprehensive policy for assets at numerous locations (to avail the benefit of rebate on bulk business). Fixed assets, particularly furniture and fixture, consumer durables, etc. are provided by banks to the staff and the account for the same is maintained at the office where the employee is posted. For disposal of fixed assets, powers are delegated to various levels in the bank.

2.03 As far as maintenance of records relating to fixed assets is concerned, practices vary among banks. In some banks, the offices acquiring the fixed assets have to maintain proper records including the provision of depreciation thereon whereas in case of some banks, the same is being done at the Head Office. In such a case, the acquisitions, disposals, etc. are advised by the branch/other office concerned to the head office through the inter-branch accounting mechanism. A variant of this practice involves the recording of depreciation by branches and other offices based on the advice received from the head office. In recent times, some of the banks have installed Fixed Asset Management Software and the information relating to purchase, sale of fixed assets and depreciation thereon (in some cases) is accounted for with the help of such software. This is usually done at a centralized HO level and reports are generated at branches and/or regional/zonal offices. In some cases, passing of entries of certain types of IT assets, like computers, printers, ATMs etc., are centralized at the HO. However, physical records need to be updated at branches. Also branches need to update records/inform HO in case there has been physical movement of assets from one branch/location to another including in case of transfers at staff quarters or disposal. At the branch level, an auditor

needs to conduct a physical verification of all assets particularly those acquired during the year and match the same with fixed asset management system (manual or electronic). At head office level SCAs should obtain reconciliation of inter-branch / inter-office transfers made during the year. Discrepancies, noticed if any, on such verification/transfer should have been properly dealt with in the books.

### **Balance Sheet Disclosure**

2.04 The Third Schedule to the Banking Regulation Act, 1949 requires fixed assets to be classified into two categories in the balance sheet, viz., Premises and Other Fixed Assets. Though not specifically mentioned under the Banking Regulation Act, 1949, the assets taken on lease and intangible assets should be shown separately for proper classification and disclosure and also to comply with the requirements of the Accounting Standards (ASs) issued by the Institute of Chartered Accountants of India (ICAI).

2.05 As per the Notes and Instructions for compilation of balance sheet, issued by the RBI, premises wholly or partly owned by the banking company for the purpose of business including residential premises should be shown under the head, 'Premises'. Furniture and fixtures, motor vehicles, office equipment, computers and all other fixed assets except premises should be shown under the head 'Other Fixed Assets'.

2.06 The original cost of fixed assets as on 31<sup>st</sup> March of the preceding year, additions thereto and deductions therefrom during the year, and total depreciation written off to date are to be disclosed in the financial statements. The Notes and Instructions for Compilation of Balance Sheet, issued by the RBI, require that where sums have been written-off on reduction of capital or revaluation of assets, every balance sheet after the first balance sheet subsequent to the reduction or revaluation should show the revised figures for a period of five years with the date and amount of revision made.

2.07 No rates of depreciation on fixed assets have been prescribed by the Banking Regulation Act, 1949. The provisions of the Schedule II to the Companies Act, 2013, should, therefore, be kept in mind in this respect especially in so far as the banking companies are concerned. Disclosure is mandatory in respect of the method adopted to compute the revalued amounts, the nature of the indices used, the year of any appraisal made and whether an external valuer was involved in case the assets are stated at revalued amounts. The Banking Regulation Act, 1949 requires that the auditor should examine whether the rates of depreciation are appropriate in the context of the expected useful lives of the respective fixed assets. Depreciation rates must be reconfirmed with the accounting policy of the bank. In respect of computers and

data processing equipment, RBI has directed that depreciation should be provided over three year period. With respect to fixed assets held at foreign offices/branches, depreciation policy should be consistent with that followed by the bank as a whole and to the extent not contradictory with the local laws and regulations. Further, as per note 4 of Schedule II of the Companies Act, 2013, useful life specified in Part C of the Schedule is for whole of the asset. Where cost of a part of the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately, in other words component accounting with respect to fixed assets would be mandatory effective from financial year 2015-16 onwards.

2.08 An immovable property acquired by the bank in satisfaction of debts due should be included under the head 'fixed assets', if it is held by the bank for its own use.

2.09 The Third Schedule to the Banking Regulation Act, 1949, does not specifically deal with disclosure of land. Land is generally shown under the heading 'Premises'.

### **Other Assets**

2.10 The following items broadly are to be disclosed under the head 'Other Assets':

- Inter-office adjustments (net)
- Stationery and stamps
- Interest accrued
- Non-banking assets acquired in satisfaction of claims
- Tax paid in advance/tax deducted at source
- Others

2.11 As per RBI Circular no. DBOD.BP.BC.24/21.04.048 dated March 30, 1999, credit card outstanding is not to be included under 'Other Assets'. Instead, they have to be shown as part of advances.

2.12 As per RBI circular DBOD.BP.BC.83/21.01.002/2000-01 dated February 28, 2001, all loans and advances given to staff, which are non-interest bearing should be included in item 'Others' under 'Other Assets' and should not be reflected as 'Advances'.

## **Audit Approach and Procedures**

### **Fixed Assets**

2.13 In carrying out the audit of fixed assets, the auditor is concerned, primarily, with obtaining evidence about their ownership, existence and

valuation. For this purpose, the auditor should review the system of internal controls relating to fixed assets, particularly the following:

- Control over expenditures incurred on fixed assets acquired or self-constructed;
- Accountability and utilisation controls; and
- Information controls for ensuring availability of reliable information about fixed assets.

2.14 The branch auditor should ascertain whether the accounts in respect of fixed assets are maintained at the branch or centrally. Similarly, the auditor should ascertain the location of documents of title or other documents evidencing ownership of various items of fixed assets. The procedures described in the following paragraphs would be relevant only to the extent the accounts and documents of title, etc., relating to fixed assets are maintained at the branch. Where the acquisition, disposal, etc., of fixed assets take place at branches / other offices, but accounting of fixed assets is done at the head office, the branch auditor should examine whether acquisitions, disposals, etc. effected at the branch during the year have been properly communicated to the head office. In cases where, for any reason acquisition of fixed asset is shown in suspense account then the branch cannot classify the asset in the Balance Sheet under this head unless the asset is put to use or ready for use, as the case may be, and all internal formalities are completed. A long-standing suspense entry of this type should be properly dealt with by the auditor and may need to be escalated to the statutory central auditors if the amount involved is material.

### ***Premises***

2.15 The auditor should verify the opening balance of premises with reference to schedule of fixed assets, ledger or fixed assets register. Acquisition of new premises should be verified with reference to authorisation, title deeds, record of payment, etc. Self-constructed fixed assets should be verified with reference to authorisation from appropriate authority and documents such as, contractors' bills, work order records, record of payments and completion certificate. The auditor should also examine whether the balances as per the fixed assets register reconcile with those as per the ledger and the final statements.

2.16 In the case of leasehold premises, capitalisation and amortisation of lease premium, if any, should be examined. Any improvements to leasehold premises should be amortised over their balance residual life. It would be

appropriate to segregate the cost/value of the land from the building/superstructures to ensure that depreciation/amortisation is appropriately considered in case of leasehold premises.

2.17 In case the title deeds are held at the head office or some other location, the branch auditor should obtain a written representation to this effect from the branch management and should bring this fact to the notice of the statutory central auditor through a suitable mention in his report. This fact should also be brought in the Long Form Audit Report (LFAR).

2.18 Where premises are under construction, it should be seen that they are shown under a separate heading, e.g., 'premises under construction'. Advances to contractors may be shown as a separate item under the head 'fixed assets' or under the head 'Other Assets'. It should be verified that where the branch has obtained the licence to commence business and is ready for use then the same is not shown as "premises under construction". In such cases even if all the bills/ documents from the contractors/suppliers are not received, at the year end, an estimate of the expenditure thereon should be made and capitalised on a provisional basis.

2.19 As per the AS-10 (Revised), Property, Plant & Equipment, the banks can adopt the policy to follow Cost Model or Revaluation Model for Premises or any other class of Property, Plant & Equipment (PPE). The auditor should inquire about the policy followed by the bank and verify the accounting treatment more specifically with reference to revaluation model. The auditor should also check the impairment, if any, by applying the principles laid down in Accounting Standard (AS) 28, "Impairment of Assets".

2.20 The auditor should specifically keep in mind the provisions of section 9 of the Banking Regulation Act, 1949, which prohibit a banking company from holding any immovable property, howsoever acquired (i.e., whether acquired by way of satisfaction of claims or otherwise), for a period exceeding seven years from the date of acquisition, except such as is required for its own use. The auditor should specifically examine that no immovable properties other than those required for the own use of the bank have been included in fixed assets (own use would cover use by employees of the bank, e.g., residential premises provided to employees). The branch auditor should also obtain a written representation to the above effect from the branch management.

### ***Other Fixed Assets***

2.21 The procedures discussed above regarding premises also apply, to the extent relevant, to verification of other fixed assets. In respect of movable fixed assets, the auditor should pay particular attention to the system of

recording the movements as well as other controls over such fixed assets, e.g., their physical verification at periodic intervals by the branch management and/or by inspection/internal/concurrent audit team. The auditor should also examine whether discrepancies have been properly dealt in the books of account and adequate provision in respect of any damaged assets has been made – as per the physical verification of fixed assets reports available on record.

2.22 Banks incur substantial expenditure on computer hardware and software. Computer hardware qualifies the definition of a property, plant and equipment' as given in AS 10 (Revised), "Property, Plant and Equipment". Computer software that is essential for the functioning of the hardware (e.g., operating system) can be considered an integral part of the related hardware. The expenditure incurred on acquisition and installation of the hardware (as also on any systems software considered to be an integral part of the related hardware) should be capitalised in accordance with the principles laid down in AS 10 (Revised) and depreciated over the remaining useful life of the hardware. Hardware and software are susceptible to faster rate of technical obsolescence; hence the auditor must take into consideration this fact while verifying the provision for depreciation on these assets. The same, however, should not be depreciated for a period of more than three years.

2.23 Application software is not an integral part of the related hardware and is treated as an intangible asset. Accordingly, the same should be accounted for as per Accounting Standard (AS 26), "Intangible Assets". The treatment of expenditure on application software, whether acquired from outside or developed in-house, would also be similar. However, in estimating the useful life of application software, the rapid pace of changes in software as also the need for periodic modification/ upgradation of software to cater to changes in nature of transactions, information needs etc. need special consideration. As far as expenditure during the stage of in-house development of software is concerned, the same needs to be accounted for in accordance with AS 26, according to which expenditure incurred during the research phase should not be capitalised as part of cost of intangibles. While capitalising the development phase expenditure, due consideration should be given to Paragraph 44 of the said Standard. Further, due care should be taken in verifying the date of capitalization and date on which asset was put to use/ ready for intended use, particularly in case of implementation of application software and system. While conducting the audit of intangible assets, the auditor should also consider the guidelines issued by RBI by way of Circular No.DBOD.No.BP.BC.82/21.04.018/2003-04, dated April 30, 2004.

2.24 In case of banking companies, the auditor needs to verify that the

requirements of Schedule II to the Companies Act, 2013 are also complied with including identification of components wherever applicable. Banks may acquire software at considerable expenditure. The system of recording this expenditure as part of the fixed assets (so that it may be depreciated) or to defer expenditure (for amortisation over its useful life) may be reviewed. The Bank's Accounting Policy in this regard must be enquired into, and a note kept on record. Non-provision for this intangible asset will not attract the provisions of Section 15 of the Banking Regulation Act, 1949 as per a notification specifically issued by the Government of India.

2.25 At times, though depreciation has been fully provided on certain types of assets, however, they continue to be in use. In such cases the auditor should verify that the bank's policy in this regard has been followed.

2.26 Many a times, fixed assets like furniture, office equipments, etc., are transferred from one branch to another. The auditor should examine whether accumulated depreciation in respect of such assets is also transferred. It may be noted that the consolidated accounts of the bank would not be affected by such transfers. In recent times, the fixed asset management software are in use. The auditor has to examine the reasonableness of the internal controls with respect to recording such inter branch transfer of assets.

2.27 It should be examined whether fixed assets have been properly classified. Fixed assets of similar nature only should be grouped together. For example, items like safe deposit vaults should not be clubbed together with the office equipment or the theft alarm system of the bank.

2.28 In respect of fixed assets sold during the year, a copy of the sale deed, if any, and receipt of the sale value should be examined by the auditor. In such a case, it should also be seen that the original cost and accumulated depreciation on the assets sold have been correctly adjusted. Profit earned or loss incurred on such sales should also be checked.

2.29 In case of sale/disposal/scraping of fixed assets, the auditor should examine whether there is an adequate control system in place and the same has been adhered to. The auditor should also ensure that proper accounting for the same has been done.

2.30 The auditor should examine whether any expenditure incurred on a fixed asset after it has been brought to its working condition for its intended use, has been dealt with properly. According to AS 10 (Revised), "Property, Plant & Equipment", such expenditure should be added to the book value of the fixed asset concerned only if it increases the future benefits from the asset beyond its previously assessed standard of performance.

2.31 The auditor at head office level should examine if the consolidated fixed assets schedule matches in all respect and all the transfers' ins/outs, are tallied. A broad check on the depreciation amount *vis-a-vis* the gross block of assets must be reviewed with special emphasis on the computer hardware/software.

### **Leased Assets**

2.32 RBI's Circular No. DBOD No.FSC.BC.70/24.01.001/99 dated July 17, 1999 deals with accounting and provisioning norms to be followed by banks undertaking leasing activity. The auditor, in respect of leased assets, should also have regard to the requirements of AS 19, "Leases". Assets given on Lease need to be separately shown in the same manner as other assets.

### **Impairment of Assets**

2.33 AS 28, "Impairment of Assets" prescribes the procedures that an enterprise should apply to ensure that its assets are carried at not more than their recoverable amount. An asset is treated as carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and this Standard requires the enterprise to recognise an impairment loss. This Standard also prescribes when an enterprise should reverse an impairment loss and it prescribes certain disclosures for impaired assets. This Standard requires that an enterprise should assess at each balance sheet date whether there is any indication that an asset may be impaired. The impairment loss, if recognised, shall be debited to the profit and loss account provided no revaluation reserve exists at that date in relation to the asset, and if it exists, the loss should first be debited to revaluation reserve. After debiting the revaluation reserve, if still there is impairment loss then the same should be debited to profit and loss account. RBI's circular on compliance with Accounting Standards, issued in April 2004 states as follows in respect of AS 28:

- The Standard would not apply to investments, inventories and financial assets such as loans and advances and may generally be applicable to banks in so far as it relates to fixed assets.
- Banks may also take into account the following specific factors while complying with the Standard:
  - Paragraphs 7 and 8 of the Standard have clearly listed the triggers which may indicate impairment of the value of assets. Hence, banks may be guided by these in determining the circumstances when the Standard is applicable to banks and how frequently the assets covered by the Standard need to be reviewed to measure impairment.

- In addition to the assets of banks which are specifically identified above, viz., financial assets, inventories, investment, loans and advances etc to which the Standard does not apply, the Standard would apply to financial lease assets and non-banking assets acquired in settlement of claims only when the indications of impairment of the entity are evident.

## **Other Assets**

2.34 The branch auditor may carry out the audit of various items appearing under the head 'Other Assets' in the following manner.

### **Inter-Office Adjustments**

2.35 Inter Office Adjustments/Inter Branch Account is dealt separately in Chapter 11 of Part III of Guidance Note on "Inter-office Transactions".

### **Interest Accrued**

2.36 The main components of this item are interest accrued but not due on investments and advances and interest due but not collected on investments. As banks normally debit the borrower's account with interest due on the borrower's repayment cycle date, there would usually be an amount of interest accrued but not due on advances on balance sheet date. On the other hand, interest on government securities, debentures, bonds, etc., which accrues from day to day should be calculated and brought into account, in so far as it has accrued on the date of the balance sheet. The auditor should examine whether the interest has been accrued on the entire loans and advances portfolio of the bank. Special consideration should be given to the overdue bills purchased/discounted. Several times the interest accrued on such advances is manually computed by the Branch and the auditors should check the workings thoroughly so as to avoid any income leakages. As far as possible, the detailed breakup of the loan portfolio and the interest accrual should be obtained and the same should agree with the general ledger balance. This would ensure completeness of the interest accrual of advances. The auditor should also examine the interest accrued on advances by re-computing it on a test check basis by referring to the loan parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc., from the loan agreements. This would ensure the completeness of the interest accrual on advances. In the current banking scenario, the interest accrual setup is automated system driven for most banks and the auditor should verify the in-built logic and controls of the system.

2.37 The auditor should examine whether only such interest as can be realised in the ordinary course of business should be shown under this head.

This is based on the principle, recognised in AS 9, “Revenue Recognition” that revenue cannot be recognised if there is a significant uncertainty about its collectability; as also with instructions given by RBI to the effect that interest be not recorded as income in respect of Non-Performing Assets (NPAs). Interest accrued in the current year in respect of accounts identified as NPAs must be reversed to Income and derecognised and cannot be the subject matter of a provision. Dividends recognised as income but not received may be included in the residuary sub-head of ‘Others’. Dividends and interest on investments would be recognised in the books of the branch only if it is handling the work relating to investments or receipt of income on investments.

### **Tax Paid in Advance/Tax Deducted at Source**

2.38 Generally, this item is dealt at the head office only and would, therefore, not appear in the balance sheet of a branch, except that tax deducted at source on fixed deposits and other products/services if handled at the branch level. The procedures to be followed by the branch auditor for verification of tax deducted at source by the branch would be similar to those in an audit of other types of entities. The branch auditor needs to examine whether the certificates for such tax deducted at source is collected by the branch and the original copy is sent to the Head Office along with the transfer of such Tax Deducted at Source (TDS) amount to Head Office on periodic basis as defined.

2.39 At Head Office, the availability of all the TDS Certificates, submission of the same with Income Tax Department/claim of the same in Income Tax returns filed should be checked to verify the justification of the claim towards such certificates. The auditor should also verify the online tax credit from the Income Tax website with the TDS/advance tax recorded in the books and ask for a reconciliation of the same. Income recognized in the books could also be cross verified by this analysis. If there is any TDS, the auditor needs to enquire as to the income to which it pertains so that the bank claims it in its assessments.

### **Stationery and Stamps**

2.40 Internal controls over stationery of security items (like term deposit receipts, drafts, pay orders, cheque books, traveller’s cheques, gift cheques, etc.) assume special significance in the case of banks as their loss or misuse could eventually lead to misappropriation of the most valuable physical asset of a bank, viz., cash. The branch auditor should study and evaluate the existence, effectiveness and continuity of internal controls over these items in the normal course of his audit. It may be noted that the branch auditor is required to

specifically comment on the adequacy of the relevant internal controls in his LFAR.

2.41 As per RBI instructions, the item “Stationery and Stamps” should include only exceptional items of expenditure on stationery like, bulk purchase of security paper, loose leaf or other ledgers, etc., which are shown as quasi-asset to be written off over a period of time. The valuation of such items is suggested to be at cost without any element of escalation/appreciation. In other words, the normal expenditure on stationery may be treated as an expense in the profit and loss account, while unusually heavy expenditure may be treated as an asset to be written off based on issue/consumption. At the branch level, the expenditure on latter category may not appear since a considerable part of the stationery is supplied to branches by the head office.

2.42 The auditor should physically verify the stationery and stamps on hand as at the year-end, especially stationery of security items. Any shortage should be inquired into as it could expose the bank to a potential loss from misuse. The auditor should examine whether the cost of stationery and stamps consumed during the year has been properly charged to the profit and loss account for the year in the context of the accounting policy/instructions from the head office regarding treatment of cost of stationery and stamps.

### **Non-Banking Assets Acquired in Satisfaction of Claims**

2.43 Under this heading, will be included, those immovable properties/tangible assets, which the bank has acquired in satisfaction of debts due or its other claims and are being held with the intention of being disposed of.

2.44 While examining this item, the auditor should specifically keep in mind the provisions of section 9 of the Banking Regulation Act, 1949, which prohibit a banking company from holding any immovable property, however acquired (i.e. whether acquired by way of satisfaction of claims or otherwise), except such as required for its own use, for any period exceeding seven years from the date of acquisition thereof. During this period, the bank may deal or trade in any such property for the purpose of facilitating the disposal thereof. The RBI has the power to extend the aforesaid period in a particular case up to another five years.

2.45 Except when held for its own use, AS 10 (Revised), “Property, Plant & Equipment”, would not be applicable on those fixed assets which are held with the bank in satisfaction of claim. At the date of acquisition, the assets should be recorded at amount lower of the net book value of the advance or net realisable value of asset acquired. At each balance sheet date, net realisable value of such assets may be re-assessed and necessary adjustments may be made.

2.46 The auditor should verify such assets with reference to the relevant documentary evidence, e.g., terms of settlement with the party, order of the Court or the award of arbitration, etc. The auditor should verify that the ownership of the property is legally vested in the bank's name. If there is any dispute or other claim about the property, the auditor should examine whether the recording of the asset is appropriate or not. In case the dispute arises subsequently, the auditor should examine whether a provision for liability or disclosure of a contingent liability is appropriate, keeping in view the requirements of AS 29 "Provisions, Contingent Liabilities and Contingent Assets".

### **Others**

2.47 This is the residual heading, which will include items not specifically covered under other sub-heads, e.g., claims which have not been received, debit items representing additions to assets or reductions in liabilities which have not been adjusted for technical reasons or want of particulars, etc., receivables on account of government business, prepaid expenses, Accrued income other than interest (e.g., dividend declared but not received) may also be included under this head. The audit procedures relating to some of the major items included under this head are discussed below.

### ***Non-Interest Bearing Staff Advances***

2.48 The auditor should examine non-interest bearing staff advances with reference to the relevant documentation and the bank's policy in this regard. The availability, enforceability and valuation of security, if any, should also be examined. It needs to be examined whether the same relates to employees on the roll of the bank on the date of the preparation of financial statements.

2.49 Banks grant unsecured advances to staff like festival/drought relief/housing advances etc. due to the employer- employee relationship where normally lien is marked on the terminal benefits of the employee; but advances against FDRs and other securities etc. are also given. While distinction needs to be made between advances given by the bank as an "employer" and as "banker", the RBI's latest applicable circular needs to be kept in view as regards disclosure requirement of advances in the latter category i.e. as banker.

### ***Security Deposits***

2.50 Security deposits with various authorities (e.g., on account of telephone, electricity, etc.,) and with others (e.g., deposits in respect of premises taken on rent) should be examined with reference to documents containing relevant terms and conditions, and receipts obtained from the parties concerned. The auditor should verify that the deposits have not become

due as per the terms and conditions. If it is so, then the recoverability of the same needs to be looked into in detail and appropriate provision should be suggested against the amount where recovery is in doubt.

2.51 The auditor, based on the materiality, should send independent balance confirmation for security deposit at period end and should document the reason in the case of any differences. Verification of all security deposits given during the year should be conducted and that of older deposits can be done on a test check basis.

### ***Suspense Account***

2.52 'Suspense' account is another item included under 'other assets'. Ideally, where accounts are maintained properly and on a timely basis, the suspense account may not arise. However, in a practical situation, suspense account is often used to temporarily record certain items such as the following:

- (i) amounts temporarily recorded under this head till determination of the precise nature thereof or pending transfer thereof to the appropriate head of account;
- (ii) debit balances arising from payment of interest warrants/ dividend warrants pending reconciliation of amounts deposited by the company concerned with the bank and the payment made by various branches on this account;
- (iii) amounts of losses on account of frauds awaiting adjustment.

2.53 RBI has also suggested a quick audit of entries in Suspense Account and the status thereof to be reported in terms of its circulars dated 6.7.95/18.8.95 and reference may also to be made to the RBI Circular DBOD.BP.BC.4/21.04.018/2003-04 dated 19.7.03.

2.54 The auditor should pay special attention to any unusual items in suspense account since these are prone to fraud risk. The auditor should obtain the management policy for provision/write off for old outstanding items. He should obtain from the management, details of old outstanding entries/age-wise balances along with narrations in suspense account. The auditor should also verify the reasons for such delay in adjusting the entries. Where the outstanding balances comprised in suspense account require a provision/write-off, the auditor should examine whether the necessary provision has been made/written off. All items of more than 6 months in suspense accounts need special attention of the auditor. The auditor has to certify all the suspense account entries through a separate certificate in the annual closing sets.

***Prepaid Expenses***

2.55 The auditor should verify prepaid expenses in the same manner as in the case of other entities. The auditor should examine whether the basis of allocation of expenditure to different periods is reasonable. The auditor should particularly examine whether the allocation of discounting and rediscounting charges paid by the bank to different accounting periods is in consonance with the accounting policy followed for the bank as a whole.

***Miscellaneous Debit Balances on Government Account***

2.56 Miscellaneous debit balances on government account in respect of pension, public provident funds, compulsory deposit scheme payments, etc., for which the branch obtains reimbursement from the government through a designated branch, are also included under the head 'others'. In many cases, the accounting for this is outside the core banking solution and needs the special attention of the auditor. The auditor should review the ageing statements pertaining to these items. He should particularly examine the recoverability of old outstanding items. The auditor should also examine whether claims for reimbursement have been lodged by the branch in accordance with the relevant guidelines, terms and conditions. The net balances of the amount recoverable at the Head Office level should also be taken along with the age-wise analysis of the same. In case of old outstanding balances without any confirmation or proper justification of the same, should be provided for /written off as the case may be in the accounts.

2.57 The residual item of "Others" in "Other Assets" generally constitutes a significant amount in the Balance Sheet of the bank. The Head Office auditors should obtain the head wise details of the same along with the previous year figures. The age-wise details of the major outstanding should also be obtained. Further, the major variance as compared to the previous year figures should also be enquired into and reasons for the same should be recorded and reviewed. In case any amount seems doubtful of recovery, appropriate provisions against the same should be made.

## **Borrowings and Deposits**

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### **Borrowings**

3.01 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**

3.02 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.

3.03 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.

3.04 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.

3.05 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).

3.06 '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.

3.07 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 "Master Direction on Money Market Instruments: Call/Notice Money Market, Commercial Paper, Certificates of

Deposit and Non-Convertible Debentures (original maturity up to one year)" dated July 7, 2016 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)**

3.08 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.

3.09 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**

3.10 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**

3.11 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**

3.12 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***

3.13 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.

3.14 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**

3.15 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.

3.16 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.

3.17 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***

3.18 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.

3.19 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.

3.20 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.

3.21 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.

3.22 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.

3.23 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.

3.24 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 some time after its maturity, banks generally allow interest from the date of maturity rather than from the date of renewal. In other words, the renewal is given a retrospective effect. In case the deposit is matured and not renewed by the customer, the rate of interest same as saving bank rate is provided on the same as per RBI Guidelines.

3.25 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.

3.26 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.

3.27 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**

3.28 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**

3.29 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**

3.30 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**

3.31 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.

3.32 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**

3.33 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.

3.34 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.

3.35 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 XII** of the Guidance Note.

### **Procedural Aspects**

3.36 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)**

3.37 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**

3.38 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.

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

3.40 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.

3.41 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.

3.42 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.

3.43 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.

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

3.45 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**

3.46 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***

3.47 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.

3.48 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.

3.49 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'.

3.50 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***

3.51 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.

3.52 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.

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

***Term Deposits***

3.54 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.

3.55 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.

3.56 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.

3.57 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.

3.58 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.

3.59 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***

3.60 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***

3.61 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***

3.62 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***

3.63 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.

3.64 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***

3.65 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.

3.66 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**

3.67 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.

## Capital, Reserves and Surplus

### Capital

4.01 The following particulars have to be given in respect of share capital in the balance sheet.

#### (a) For Banks Incorporated in India

Authorised Capital	(shares of Rs. __ each)
Issued Capital	(shares of Rs. __ each)
Subscribed Capital	(shares of Rs. __ each)
Called-up Capital	(shares of Rs. __ each)
Less: Calls unpaid	
Add: Forfeited shares	

(In case of Nationalised Banks capital owned by Central Government as on the date of balance sheet including contribution from Government, if any, for participating in World Bank Projects should be shown separately.)

#### (b) For Banks Incorporated Outside India

- (i) Capital (the amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head).
- (ii) Amount of deposit kept with the RBI under section 11(2) of the Banking Regulation Act, 1949.

4.02 RBI *vide* its circular no. DBOD.BP.BC No.81/ 21.01.002/2009-10 dated March 30, 2010 on "Classification in the Balance Sheet - Capital Instruments" advised that under the Schedule 1 - Capital, Perpetual Non-Cumulative Preference Share (PNCPS) should be sub – classified in the balance sheet from the financial year ending March 31, 2010. If circumstances permit, items which can be combined may be shown under one head, for instance, 'Issued and Subscribed Capital'.

4.03 In case of banking companies incorporated outside India, the amount of deposit kept with the RBI under section 11(2) of the Act has to be shown under this head; the amount, however, should not be extended to the outer column.

4.04 The RBI's Master Circular no. RBI/2015-16/99 DBR.BP.BC No.23/21.04.018/2015-16 dated July 1, 2015 on "Disclosure in Financial Statements – Notes to Accounts" lays down the certain aspects to be disclosed in respect of capital for the current as well as the previous year.

### **Capital Adequacy Measures in India**

4.05 In India, the statutes governing various types of banks lay down the minimum capital requirements for them. Besides, there are also requirements for maintenance of statutory reserves. Considering the variations in minimum capital requirements applicable to different types of banks and taking into account the approach adopted by Basel Committee, the Reserve Bank prescribed, in year 1992, a uniform methodology for determining the capital adequacy of scheduled commercial banks (other than regional rural banks). The Master Circular No. RBI/2015-16/85 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)" provides the guidelines to be followed by banks for capital adequacy. As per RBI circular RBI/2016-17/321 DBR.No.BP.BC.74/21.06.009/2016-17 dated June 13, 2017 Prudential Guidelines on Capital Adequacy and Market Discipline- New Capital Adequacy Framework (NCAF) - Eligible Credit Rating Agencies – INFOMERICS Valuation and Rating Pvt Ltd. (INFOMERICS) - The long term and short term ratings issued by these domestic credit rating agencies have been mapped to the appropriate risk weights applicable as per the Standardised Approach under the Basel II Framework. Some of the important aspects of the circular are covered below.

4.06 The basic approach of capital adequacy framework is that a bank should have sufficient capital to provide a stable resource to absorb any losses arising from the risks in its business. Capital is divided into tiers according to the characteristics/qualities of each qualifying instrument. For supervisory purposes capital is split into two categories: Tier I and Tier II, representing different instruments' quality as capital.

- **Tier I capital** consists mainly of share capital and disclosed reserves and it is a bank's highest quality capital because it is fully available to cover losses. AS per RBI circular RBI/2016-17/222,DBR.BP.BC.No.50/21.06.201/2016-17 dated Feb 2, 2017, Additional Tier 1 capital, the change in coupon discretion needs to be considered.
- **Tier II capital** consists of certain reserves and certain types of subordinated debt. The loss absorption capacity of Tier II capital is lower than that of Tier I capital.

When returns of the investors of the capital issues are counter guaranteed by the bank, such investments will not be considered as Tier I/II regulatory capital for the purpose of capital adequacy.

4.07 The 2015 Master Circular on Prudential Norms on Capital Adequacy and Market Discipline – New Capital Adequacy Framework (NCAF) also covers the concept of ‘Capital Adequacy Requirement for Credit Default Swap (CDS) Positions in the Banking Book’. Readers may refer to the aforesaid Circular for detailed guidelines in this regard.

### **Components of Capital**

4.08 The Master Circular on Capital Adequacy discusses the Capital Funds in two categories – capital funds for Indian banks and capital funds of foreign banks operating in India.

### **Undisclosed Reserves**

4.09 They can be included in capital, if they represent accumulations of post-tax profits and are not encumbered by any known liability and should not be routinely used for absorbing normal loss or operating losses.

### **Re-valuation Reserves**

4.10 It would be prudent to consider re-valuation reserves at a discount of 55 percent while determining their value for inclusion in Tier II capital. Such reserves will have to be reflected on the face of the Balance Sheet as re-valuation reserves.

4.11 However, as per RBI’s circular no. RBI/2015-16/331DBR.No.BP.BC.83/21.06.201/2015-16 dated 1<sup>st</sup> March, 2016, revaluation reserves arising out of change in the carrying amount of a bank’s property consequent upon its revaluation may, at the discretion of banks, be reckoned as Common Equity Tier 1 (CET1) capital at a discount of 55%, instead of as Tier 2 capital under extant regulations, subject to meeting the following conditions:

- bank is able to sell the property readily at its own will and there is no legal impediment in selling the property;
- the revaluation reserves are shown under Schedule 2: Reserves & Surplus in the Balance Sheet of the bank;
- revaluations are realistic, in accordance with Indian Accounting Standards;
- valuations are obtained, from two independent valuers, at least once in every 3 years; where the value of the property has been substantially impaired by any event, these are to be immediately revalued and appropriately factored into capital adequacy computations;

- the external auditors of the bank have not expressed a qualified opinion on the revaluation of the property;
- the instructions on valuation of properties and other specific requirements as mentioned in the RBI's circular no. RBI No.2006-2007/224 DBOD.BP.BC No. 50 / 21.04.018/ 2006-07 dated 4th January, 2007 on 'Valuation of Properties - Empanelment of Valuers' are strictly adhered to.

**Foreign Currency Translation Reserve (FCTR)**

4.12 As stated in RBI's circular no. RBI/2015-16/331 DBR.No.BP.BC.83/21.06.201/2015-16 dated 01st March, 2016, Banks may, at their discretion, reckon foreign currency translation reserve arising due to translation of financial statements of their foreign operations in terms of Accounting Standard (AS) 11 as CET1 capital at a discount of 25% subject to meeting the following conditions:

- the FCTR are shown under Schedule 2: Reserves & Surplus in the Balance Sheet of the bank;
- the external auditors of the bank have not expressed a qualified opinion on the FCTR.

4.13 **Deferred Tax Asset (DTA)** – As per RBI's circular no. RBI/2015-16/331DBR.No.BP.BC.83/21.06.201/2015-16 dated 01st March, 2016:

- (i) Deferred tax assets (DTAs) associated with accumulated losses and other such assets should be deducted in full from CET1 capital.
- (ii) DTAs which relate to timing differences (other than those related to accumulated losses) may, instead of full deduction from CET1 capital, be recognised in the CET1 capital up to 10% of a bank's CET1 capital, at the discretion of banks [after the application of all regulatory adjustments].
- (iii) The amount of DTAs which are to be deducted from CET1 capital may be netted with associated deferred tax liabilities (DTLs) provided that:
  - both the DTAs and DTLs relate to taxes levied by the same taxation authority and offsetting is permitted by the relevant taxation authority;
  - the DTLs permitted to be netted against DTAs must exclude amounts that have been netted against the deduction of goodwill, intangibles and defined benefit pension assets; and
  - the DTLs must be allocated on a pro rata basis between DTAs subject to deduction from CET1 capital as at (i) and (ii) above.

**General Provisions and Loss Reserves**

4.14 Such reserves can be included in Tier II capital if they are not

attributable to the actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses. Adequate care must be taken to see that sufficient provisions have been made to meet all known losses and foreseeable potential losses before considering general provisions and loss reserves to be part of Tier II capital. General provisions/loss reserves will be admitted up to a maximum of 1.25 percent of total risk weighted assets. 'Floating Provisions' held by the banks, which is general in nature and not made against any identified assets, may be treated as a part of Tier II capital within the overall ceiling of 1.25 percent of total risk weighted assets. Excess provisions which arise on sale of NPAs would be eligible Tier II capital subject to the overall ceiling of 1.25% of total Risk Weighted Assets.

### **Hybrid Debt Capital Instruments**

4.15 Those instruments which have close similarities to equity, in particular when they are able to support losses on an ongoing basis without triggering liquidation, they may be included in Tier II capital. At present following instruments have been recognised and placed under this category.

- i. • Perpetual Cumulative Preference Shares (PCPS)/ Redeemable Non-Cumulative Preference Shares (RNCPS)/ Redeemable Cumulative Preference shares (RCPS) as part of upper Tier II capital.
- ii. • Debt capital instruments eligible for inclusion as Upper Tier II capital.

The guidelines governing the instruments at (i) and (ii) above, indicating the minimum regulatory requirements are furnished in Annexure 4 and Annexure 3 respectively to the Master Circular on Prudential Guidelines on Capital Adequacy and Market Discipline-New Capital Adequacy Framework (NCAF).

4.16 As per RBI's circular no. RBI/2015-16/428 DBR.BP.BC.No.105/21.06.001/2015-16 dated 23<sup>rd</sup> June, 2016, the extant instructions have been reviewed and it has been decided that banks need not submit a copy of the offer document with respect to any debt/capital raised as above, to Reserve Bank of India. Banks shall however, report to the Principal Chief General Manager, Department of Banking Regulation, Reserve Bank of India, Mumbai, the details of the debt raised as per the format prescribed in this circular duly certified by the compliance officer of the bank. The compliance with the Basel III Capital regulations will continue to be examined by RBI's Department of Banking Supervision, in course of the supervisory evaluation.

4.17 Banks shall however, continue to obtain and keep on their records a certificate from statutory auditors and an external legal opinion in terms of Annex 16 of the Master Circular on Basel III Capital Regulations dated 01<sup>st</sup> July, 2015.

### ***Subordinated Debt***

4.18 Banks can raise, with the approval of their Boards, rupee-subordinated debt as Tier II capital, subject to the terms and conditions given in the Annexure 5 to the Master Circular on Prudential Guidelines on Capital Adequacy and Market Discipline-New Capital Adequacy Framework (NCAF).

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

4.19 In the event of provisions created on account of depreciation in the 'Available for Sale' or 'Held for Trading' categories being found to be in excess of the required amount in any year, the excess should be credited to the Profit & Loss account and an equivalent amount (net of taxes, if any and net of transfer to Statutory Reserves as applicable to such excess provision) should be appropriated to an Investment Reserve Account in Schedule 2 – "Reserves & Surplus" under the head "Revenue and other Reserves" and would be eligible for inclusion under Tier II within the overall ceiling of 1.25 per cent of total Risk Weighted Assets prescribed for General Provisions/ Loss Reserves.

4.20 Banks are allowed to include the 'General Provisions on Standard Assets' and 'Provisions held for Country Exposures' in Tier II capital. However, the provisions on 'standard assets' together with other 'general provisions/ loss reserves' and 'provisions held for country exposures' will be admitted as Tier II capital up to a maximum of 1.25 per cent of the total risk-weighted assets.

## **Reserves and Surplus**

### **Balance Sheet Disclosure**

4.21 The following are required to be disclosed in the balance sheet under the head 'Reserves and Surplus'.

- I. • Statutory Reserves.
- II. • Capital Reserves.
- III. • Share Premium.
- IV. • Revenue and Other Reserves including Investment Reserve Account.  
(In respect of items I–IV above, opening balance, additions during the year and deductions during the year are to be shown separately in respect of each item)
- V. Balance in Profit and Loss Account.

## **Statutory Reserves**

4.22 Under sub-section (1) of section 17 of the Banking Regulation Act, 1949, every banking company incorporated in India has to transfer 20% of its profits to its reserve fund each year before declaring dividends. The transfer to reserve as above and any other reserve created in pursuance of any section of the Act has also to be disclosed under the aforesaid head. Section 17(2) of the Act provides that where a banking company appropriates any sum or sums from the reserve fund or the share premium account, it shall, within twenty-one days from the date of such appropriation, report the fact to the RBI, explaining the circumstances relating to such appropriation.

4.23 All scheduled commercial banks, including foreign banks operating in India, (except RRBs/LABs) have been instructed to transfer not less than 25% of the 'net profit' (before appropriations) to the Reserve Fund with effect from the year ending 31<sup>st</sup> March, 2001. Such transfer to reserves may be made "after adjustment / provision towards bonus to staff".

## **Capital Reserves**

4.24 The expression 'capital reserves' does not include any amount regarded as free for distribution through the profit and loss account. According to the Notes and Instructions for Compilation of Balance Sheet, issued by the RBI, surplus on re-valuation or sale of fixed assets is to be treated as capital reserve. As per RBI master circular No DBR No BP.BC.6/21.04.141/2015-16 dated July 1, 2015 - 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'. It is clarified that the amount so appropriated would be net of taxes and amount required to be transferred to Statutory Reserves. Loss on sale will be recognised in the Profit & Loss Account.

4.25 As per RBI circular No.DBR.No.BP.BC.102/21.04.048/2017-18 Dated April 2, 2018 on Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks – Spreading of MTM losses and creation of Investment Fluctuation Reserve (IFR) all banks are advised to create an Investment Fluctuation Reserve (IFR) with effect from the year 2018-19 with a view to building up of adequate reserves to protect against increase in yields in future, as under:

An amount not less than the lower of the following:

- (a)• net profit on sale of investments during the year
- (b)• net profit for the year less mandatory appropriations

shall be transferred to the IFR, until the amount of IFR is at least 2 percent of the HFT and AFS portfolio, on a continuing basis. Where feasible, this should be achieved within a period of 3 years.

### **Securities Premium Account**

4.26 According to sub-section (1) of section 52 of the Companies Act, 2013, where a company issues shares at a premium, the amount of premium should be transferred to a separate account to be called 'the securities premium account'. The provisions of this Act regarding reduction of capital also apply to securities premium account. As per sub-section (2) of section 52 of Companies Act, 2013, the securities premium may be applied for the following purposes:

- (a)• issuing fully paid bonus securities;
- (b)• writing off the preliminary expenses;
- (c)• writing off the expenses of, or the commission paid or discount allowed on, any issue of securities or debentures;
- (d)• providing for the premium payable on the redemption of any redeemable preference securities or debentures; or
- (e)• for the purchases of its own shares or other securities under section 68 of Companies Act, 2013.

4.27 As per sub-section (3) of section 52, the security premium account may be applied by such company, as may be prescribed and whose financial statement comply with the accounting standards prescribed for such class of companies under section 133 of the Companies Act, 2013.

- (a)• in paying up unissued equity shares of the company to be issued to members of the company as fully paid bonus shares; or
- (b)• in writing off the expenses of or the commission paid or discount allowed on any issue of equity shares of the company; or
- (c)• for the purchases of its own shares or other securities under section 68.

4.28 A banking company has to report to the RBI any appropriations made from the securities premium account. Such an appropriation can be made only for the purposes described above or in accordance with the provisions governing reduction of share capital by a company.

### **Revenue and Other Reserves**

4.29 According to the Notes and Instructions for Compilation of Balance

Sheet and Profit and Loss Account, issued by the RBI, the expression 'Revenue Reserve' shall mean any reserve other than capital reserve.

4.30 All reserves, other than those separately classified (*viz.*, statutory reserves, capital reserves and share premium) will be shown under this head. The expression 'reserve' shall not include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability. In terms of RBI guidelines, the 'Investment Reserve Account' representing write back of excess provision on investments has to be treated as revenue reserve.

### **Balance in Profit and Loss Account**

4.31 This item includes balance of profit after appropriations. According to the Notes and Instructions for compilation of balance sheet and profit and loss account, issued by the RBI, in case of loss, the balance may be shown as a deduction. Though it is not mentioned whether the loss is to be deducted from the aggregate of 'reserves' or from 'revenue and other reserves' only, it is obvious on a consideration of legal requirements and sound accounting principles that the loss should be deducted only from revenue reserves.

4.32 Further, as prescribed by RBI's circular no. DBOD.BP.BC.31/21.04.018/2006-07 dated September 20, 2006, the banks need to obtain prior approval of the Reserve Bank of India before any appropriation is made from the statutory reserve or any other reserve.

4.33 The said circular also requires that:

- (i) All expenses including provisions and write offs recognised in a period, whether mandatory or prudential, should be reflected in the Profit and Loss Account for the period as an 'above the line' item (i.e., before arriving at the net profit);
- (ii) Wherever draw down from reserves takes place with the prior approval of Reserve Bank, it should be effected only "below the line", (i.e., after arriving at the profit/loss for the period); and
- (iii) Suitable disclosures should be made of such draw down of reserves in the 'Notes on Accounts' to the Balance Sheet.

## **Audit Approach and Procedures**

### **Capital**

4.34 The auditor should verify the opening balance of capital with reference to the audited balance sheet of the previous year. In case there

has been an increase in capital during the year, the auditor should examine the relevant documents supporting the increase. For example, in case of an increase in the authorised capital of a banking company, the auditor should examine the special resolution of shareholders and the memorandum of association. An increase in subscribed and paid-up capital of a banking company, on the other hand, should be verified with reference to prospectus/other offer document, reports received from registrars to the issue, bank statement, etc. Compliance with section 14 of the Banking Regulation Act, 1949, should also be examined. In case of increase in capital of a nationalised bank through fresh contributions by the government, the auditor should examine correspondence/government notification or order, bank statement, etc.

4.35 In the case of newly formed banking companies/places of business established in India for the first time by a banking company incorporated outside India, the auditor should also examine compliance with the provisions of sections 11 and 12 of the Banking Regulation Act, 1949.

4.36 The auditor should also check the compliance with capital adequacy requirements for banks.

4.37 The auditor should verify the compliance with the RBI reporting and other requirements issued from time to time.

4.38 In case there has been an increase in Share Capital during the year/period under audit, the auditor should verify the effect of such increase on the disclosures in respect of Earnings per Share (EPS) as well as the percentage of promoter holding.

4.39 In case of issuance of new share capital by bank, the auditor should examine the compliance with section 13 of the Banking Regulation Act, 1949 in respect of restriction on commission, brokerage, discount etc. on sale of shares.

### **Reserves and Surplus**

4.40 The auditor should verify the opening balances of various reserves with reference to the audited balance sheet of the previous year. Additions to or deductions from reserves should also be verified in the usual manner, e.g., with reference to board resolution. In the case of statutory reserves and securities premium account, compliance with legal requirements should also be examined. Thus, the auditor should specifically examine whether the requirements of the governing legislation regarding transfer of the prescribed percentage of profits to reserve fund have been complied with. In case the bank has been granted exemption from such transfer, the auditor should examine the relevant documents granting such exemption. Similarly, the

auditor should examine whether the appropriations from securities premium account conform to the relevant legal requirements.

4.41 Where the local laws or regulations governing overseas branches require creation of certain reserves, the auditor should examine compliance with the relevant requirements concerning the quantum and manner of disclosure of such reserves. The auditor should also ascertain that whenever necessary to secure compliance with the local laws of the respective foreign countries, separate identity of such reserves has been maintained in the balance sheet of the bank as a whole. The auditor should also ascertain that all provisions regarding eligibility criteria and quantum of dividend have been fulfilled in respect of dividend paid by the bank, if any, during the year.

4.42 The auditor should examine the nature of various accounts included under this head to examine that only accounts in the nature of reserves are included. The auditor should verify whether the utilisations of reserves are in accordance with regulatory and statutory requirements and whether the reporting requirements have been complied with in terms of the requirements of Banking Regulation Act, 1949 and the Guidelines of the RBI, issued from time to time.

# III-5

## Other Liabilities and Provisions

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### Balance Sheet Disclosure

5.01 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

5.02 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

5.03 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 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

5.04 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)

5.05 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.

5.06 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.

5.07 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**

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

### **Bills Payable**

5.09 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>3</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 frequent cancellation and re-issuance of demand drafts, pay orders, etc., should be carefully looked into by a responsible official.

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<sup>3</sup> Telegrams has been discontinued since 15<sup>th</sup> July, 2013 and this is now just for academic purposes.

5.10 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)**

5.11 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

6.01 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>4</sup>

6.02 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 - Bank Branch Audit other than Foreign Exchange Transactions.

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<sup>4</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**

6.03 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**

6.04 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**

6.05 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**

6.06 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).

6.07 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***

6.08 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.

6.09 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**

6.10 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.

6.11 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.

6.12 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.

6.13 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".

6.14 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.

6.15 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.

6.16 **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**

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

6.18 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.

6.19 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.

6.20 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.

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

6.22 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**

6.23 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**

6.24 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>5</sup>. The period of guarantees is co-terminus with the period of credit reckoned from the date of shipment.

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<sup>5</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.

## **Contingent Liabilities and Bills for Collection**

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- (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.

6.25 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***

6.26 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***

6.27 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.

6.28 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***

6.29 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.

6.30 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.

6.31 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.

6.32 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".

6.33 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***

6.34 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.

6.35 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***

6.36 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.

6.37 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*

6.38 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.

6.39 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***

6.40 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.

6.41 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.

6.42 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.

6.43 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.

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

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

### **Bills for Collection**

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

6.47 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.

6.48 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.

6.49 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.

6.50 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**

6.51 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**

6.52 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.*

## **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/Discount on Advances/Bills*: This includes interest and discount on all types of loans and advances like cash credit, overdrafts, demand loans, term loans, export loans, domestic and foreign bills purchased and discounted (including those rediscounted), overdue and penal interest and interest subsidy, if any, relating to such advances/bills. The amount to be included under this head is net of the share of participating banks under inter-bank participation schemes on risk-sharing basis. In modern day banking, the entries for interest income on advances are automatically generated through a batch process in the CBS system.
- (b) *Interest Income on Investments*: This will be generally dealt by treasury so branch will not have any income under such head.
- (c) *Interest on Balances with RBI and Other Inter-bank Funds*: This will be generally dealt by treasury so branch will not have any income under such head.
- (d) *Others*: This includes any other interest/discount income not included in the above heads. Interest on advances given by the bank to staff member in its capacity as employer rather than as banker should be included under this head.

### **Income from Investments**

7.06 Interest and dividend on investments is usually accounted for at the Treasury Branch of the bank. Thus, a branch will not have any income under such head.

### **Other Income**

7.07 The following items are included under this head:

- (i) *Commission, Exchange and Brokerage*: This item comprises of the following:
  - (a) Commission on bills for collection.
  - (b) Commission/exchange on remittances and transfers, e.g. demand drafts, NEFT, RTGS, etc.
  - (c) Commission on letters of credit and guarantees, letter of comforts.

- (d) Loan processing, arranger and syndication fees.
  - (e) Mobile banking fees.
  - (f) Credit/Debit card fee income including annual fee income, merchant acquiring income, interchange fees, etc.
  - (g) Rent from letting out of lockers.<sup>6</sup>
  - (h) Commission on Government business.
  - (i) Commission on other permitted agency business including consultancy and other services.
  - (j) Brokerage on securities.
  - (k) Fee on insurance referral.
  - (l) Commission on referral of mutual fund clients.
  - (m) Service/transaction banking charges including charges levied for transaction at other branches.
  - (n) Income from rendering other services like custodian, demat, investment advisory, cash management and other fee based services.
- (ii) *Profit on sale of Land, Buildings and Other Assets:* This item includes profit (net of any loss) on sale of land, buildings, furniture, motor vehicles, gold, silver, etc.
- (iii) *Profit on exchange transactions:* This includes revaluation gains/losses on forward exchange contracts and other derivative contracts, premium income/expenses on options, etc.
- (iv) Income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India.
- (v) Miscellaneous income.

***Profit/Loss on Revaluation of Property, Plant & Equipment (PPE)***

7.08 According to the Notes and Instructions for compilation of profit and loss account, issued by the RBI, the net profit/loss on revaluation of the aforesaid assets may also be shown under this item. In this regard, the requirements of AS 10 (Revised), *Property, Plant & Equipment*, relating to revaluation of fixed assets assume significance. According to the AS 10 (Revised), when a PPE is revalued in financial statements, the entire class of assets should be revalued, or the selection of assets for revaluation should be made on a systematic basis. It is also provided that an increase in net book

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<sup>6</sup> As per the Notes and Instructions for compilation of the profit and loss account, issued by the Reserve Bank, this item should come under this head. There is, however, a contrary view in some quarters that locker rent should be included in miscellaneous income. The latter view seems more plausible.

value arising on revaluation of fixed assets should be credited directly to owners' interests under the head of revaluation reserve. However, if such increase is related to and not greater than a decrease arising on revaluation which was previously recorded as a charge to the profit and loss account, it may be credited to the profit and loss account. On the other hand, any decrease in net book value arising on revaluation of fixed assets should be charged directly to the profit and loss account except that to the extent that such a decrease is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it may be charged directly to revaluation reserve account.

7.09 From the above, it can be seen that as per AS 10 (Revised), surplus on revaluation of a fixed asset cannot be credited to the profit and loss account except to the extent that such surplus represents a reversal of a related previous revaluation decrease that was charged to the profit and loss account.

### ***Profit on Exchange Transactions***

7.10 This item includes profit (net of loss) on dealings in foreign exchange and will be applicable at treasury or selected foreign designated branches.

### ***Income Earned by Way of Dividends, etc. from Subsidiaries and Joint Ventures abroad/in India***

7.11 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***

7.12 This head generally includes following items of income:

- (a) Recovery in Written off Accounts;
- (b) Rental income from bank's properties;
- (c) Security charges;
- (d) Insurance charges recoverable from customers;
- (e) Other income from carrying out other services like selling of gold coins etc.

7.13 The Notes and Instructions for compilation of profit and loss account, issued by the Reserve Bank, require that in case any item under this head exceeds one per cent of the total income, particulars thereof may be given in the notes.

## Expenses

7.14 Expenditure is to be shown under three broad heads: interest expended; operating expenses; and provisions and contingencies.

### Interest Expended

7.15 The following items are included under this head:

- (a) *Interest on Deposits:* This includes interest paid/ payable on all types of deposits including deposits from banks and other institutions. Usually, the rates of term deposits of banks are amended from time to time by the ALCO or the Board.
- (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.

7.16 The RBI has issued Interest Rate on Deposits Directions, 2016 on March 03, 2016 which contains 'Interest Rate Framework'.

The RBI has deregulated the savings bank deposit interest rate. In other words, the banks are free to determine their savings bank deposit interest rate. The auditor should verify that prior approval of the Board/Asset Liability Management Committee (if powers are delegated by the Board) has been obtained by a bank while fixing interest rates on such deposits.

7.17 The RBI has also deregulated the interest rates on Non Resident (External) Rupee Deposits and Ordinary Non-Resident (NRO) Accounts as follows:

- Banks are free to determine their interest rates on both savings deposits and term deposits of maturity of one year and above under Non-Resident (External) Rupee (NRE) Deposit accounts and savings deposits under Ordinary Non-Resident (NRO) Accounts. However, interest rates offered by banks on NRE and NRO deposits cannot be higher than those offered by them on comparable domestic rupee deposits.
- Prior approval of the Board/Asset Liability Management Committee (if powers are delegated by the Board) needs to be obtained by a bank while fixing interest rates on such deposits. At any point of time, individual banks need to offer uniform rates at all their branches.

- The revised deposit rates apply only to fresh deposits and on renewal of maturing deposits.
- Banks also need to closely monitor their external liability arising on account of such deregulation and ensure asset-liability compatibility from systemic risk point of view.

7.18 The RBI has consolidated instructions pertaining to FCNR(B) deposits by Banks. Specific consideration should be given to the ceiling on interest rates, 360 days to a year basis for interest payment, rounding off of interest etc. Recurring Deposits should not be accepted under the FCNR (B) Scheme. The interest on FCNR (B) deposits should be calculated and paid at intervals of 180 days each and thereafter for the remaining actual number of days. However, the depositor will have the option to receive the interest on maturity with compounding effect.

Auditor should verify concurrent or internal audit reports for revenue leakages detected but not rectified till date. Appropriate entries if necessary could be passed.

### Operating Expenses

7.19 The following items are included under this head:

- 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.
- 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>7</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.

Some banks follow the policy of providing for the promotional points earned by the customers on the use of Debit/Credit cards on actuarial basis. These provisions could be shown under this head.

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**

7.20 This item represents the aggregate of the provisions made in respect of the following:

- (a) Non-performing assets.
- (b) Taxation.
- (c) Diminution in the value of investments.
- (d) Provisions for contingencies.

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<sup>7</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.

Provisioning norms for NPA are given in circular RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 dated 1<sup>st</sup> July 2015. Interest reversal in case of advances which have become NPA to be specifically checked. The most important item included in this head is the provision in respect of non-performing assets. The other provisions are usually made at the head office level.

### **Deferred Tax Liability on Special Reserve created under Section 36(1)(viii) of the Income Tax Act, 1961**

7.21 RBI *vide* its Circular No. DBOD.No.BP.BC.77/21.04.018/2013-14 on “Deferred Tax Liability on Special Reserve created under Section 36(1)(viii) of the Income Tax Act, 1961” dated December 20, 2013 advised banks, that as a matter of prudence, DTL should be created on Special Reserve.

7.22 For this purpose, banks may take the following course of action:

- a) If the expenditure due to the creation of DTL on Special Reserve as at March 31, 2013 has not been fully charged to the Profit and Loss account, banks may adjust the same directly from Reserves. The amount so adjusted may be appropriately disclosed in the Notes to Accounts of the financial statements for the financial year 2013-14.
- b) DTL for amounts transferred to Special Reserve from the year ending March 31, 2014 onwards should be charged to the Profit and Loss Account of that year.

In view of the requirement to create DTL on Special Reserve, banks may reckon the entire Special Reserve for the purpose of computing Tier-I Capital. Reference in this regard is also drawn to the Announcement “Manner of Reporting by the Auditors In Respect of RBI’s Circular on Deferred Tax Liability on Special Reserve created under Section 36(1) (viii) of the Income Tax Act, 1961” dated April 30, 2014 issued by the Auditing and Assurance Standard Board of the Institute of Chartered Accountants of India.

### **Appropriations**

7.23 Under this head, the net profit/ loss for the year as well as profit/ loss brought forward have to be shown. The appropriations of the aggregate thereof are to be shown under the following heads:

- (a) Transfer to Statutory Reserves.
- (b) Transfer to Capital Reserves.
- (c) Transfer to Investment Fluctuation Reserve.
- (d) Transfer to Debenture Redemption Reserve.
- (e) Transfer to Other Reserves.

- (f) Transfer to Government/ Proposed Dividend.
- (g) Transfer to Tax on Dividend.

7.24 The appropriations of profits are decided at the head office level. This item would not therefore appear in the profit and loss account at the branch level. The central statutory auditor should therefore verify compliance with the statutory requirement regarding transfers to reserve accounts and the other appropriation as applicable will have to be taken into consideration while verifying these. According to RBI circular RBI/2006-07/132 DBOD.BP.BC No. 31 / 21.04.018/2006-07 dated 20<sup>th</sup> September 2006 all expenses including provisions and write-offs recognized in a period, whether mandatory or prudential, should be reflected in the profit and loss account for the period as an 'above the line' item (i.e. before arriving at the net profit).

## **Audit Approach and Procedures**

### **Income**

7.25 In carrying out an audit of income, the auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transactions, which took place during the relevant period and pertain to the bank, that there is no unrecorded income, and that income is recorded in proper amounts and is allocated to the proper period. In view of the mandatory requirement of recognition of income, the recognition of revenue will have to be subjected to examination *vis-à-vis* the guidelines. *Vide* circular DBOD.No.BP. BC. 89 /21.04.018/2002-03 dated 29<sup>th</sup> March 2003, RBI has advised that in respect of any income which exceeds one percent of the total income of the bank if the income is reckoned on a gross basis or one percent of the net profit before taxes if the income is reckoned net of costs, should be considered on accrual as per AS-9. If any item of income is not considered to be material as per the above norms, it may be recognised when received and the auditors need not qualify the statements in that situation. As per AS-9 Revenue Recognition, revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognised when no significant uncertainty as to measurability or collectability exists. If revenue recognition is postponed, as per AS 9, an enterprise should also disclose the circumstances in which the revenue recognition has been postponed pending the resolution of significant uncertainties.

7.26 Since the entire accounting in banks is done on the CBS, the auditor should plan the audit procedures based on controls testing. If he is not satisfied with the controls in place for accounting and recording of items of

income and expenses correctly, he should resort to more of substantive checking of documents and records.

In case the auditor decides to adopt the control reliance strategy, the auditor should perform test of controls which mitigate the risk of what could go wrong.

### ***Interest Income***

7.27 As a measure of control and also to ensure that the legal remedies against defaulting borrowers are not adversely affected, banks commonly follow the procedure of recording interest on non-performing advances in a separate account styled as 'Interest Suspense' or other similar account. Amounts lying in Interest Suspense Account do not represent income of the bank and have also to be deducted from the relevant advances. The auditor should also check whether, in terms of the income recognition guidelines issued by the RBI, the bank has either reversed or made provision in respect of interest accrued and credited to income account, in respect of an advance (including bills purchased and discounted) that becomes NPA as at the close of any year. Income in case of NPA account should be recognised only on realisation on cash basis as per circular RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/ 2015-16 dated 01/07/2015. These norms are also applicable to Government Guaranteed Advances.

7.28 In case of accounts under Corporate Debt Restructuring (CDR) scheme, the auditor should see whether the income on projects under implementation which have been classified as standard has been accounted for on accrual basis pursuant to the RBI's income recognition norms. Banks are not permitted to recognize income on accrual basis from projects under implementation which have been classified as 'sub-standard' asset. Bank may recognize income in such accounts only on realisation on cash basis. Income in respect of Funded Interest and where loans are converted into equity, debentures or any other instrument is to be recognized on the same basis as in the case of restructuring and re-scheduling of loans.

7.29 The said norms also require that the banks should not recognise income from those projects under implementation which have been classified as sub-standard and it should be recognised only on cash basis. The auditor should also, accordingly, see whether any interest on such projects which has been recognised as income in the past is either reversed or a provision for an equivalent amount is made in the accounts.

7.30 The auditor may assess the overall reasonableness of the figure of interest earned by working out the ratio of interest earned on different types of assets to the average quantum of the respective assets during the year.

The auditor should obtain an in-depth understanding as to how the bank's management monitor their business, analyse its credit portfolio and the interest income thereon.

7.31 For example, the auditor may obtain from the bank an analysis of sector-wise and segment-wise deployment of credit, including the lending rates of advances in various sectors and figures of advances outstanding at the end of each month/quarter. From such information, the auditor may work out a weighted average lending rate. This analysis can be done for corporate and retail loan portfolio separately. In case of retail loans, the portfolio can be further bifurcated into home loans, auto loans, personal loans, jewel loans, etc. Further, the auditor should understand the process of computation of the average balance and re-compute the average balance on sample basis.

7.32 The auditor should set the expectation for the movement in yield based on the discussion and inquiries made with the management; rate movement observed in the industry, etc., and should obtain explanations for major variances in the yield on month basis or quarterly basis.

7.33 To ascertain completeness of interest income in the analysis, the auditor should obtain general ledger break-up for the interest income earned during the respective months/quarter and examine whether the aggregation of the same agrees with the interest income considered for the yield analysis. The auditor should analyze monthly/quarterly yields and document the reasons for the variances as per the expectation set. The auditor may also compare the average yield on advances with the corresponding figures for the previous years and analyse any material differences. The auditor may also compare the reported market yield in percentage terms with market rates, RBI rates, advertised rates and rates across various products of the bank. Interest Income includes interest accrued but not due on investments.

7.34 The auditor should, on a test check basis, verify the rates of interest as per terms of sanction in the CBS as well as the calculation of interest through product rate sheets generated by CBS to satisfy himself that –

- (a) Interest has been charged on all the performing accounts upto the date of the balance sheet;
- (b) Interest rates charged are in accordance with the bank's internal regulations, directives of the RBI and agreements with the respective borrowers. The scrutiny of interest rates charged is particularly important in the case of advances made on floating interest rate basis;
- (c) Discount on bills outstanding on the date of the balance sheet has

been properly apportioned between the current year and the following year;

- (d) Interest on inter-branch balances has been provided at the rates prescribed by the head office; and
- (e) Any interest subsidy received (or receivable) from RBI in respect of advances made at concessional rates of interest is correctly computed.

7.35 The auditor should also understand the process of accrual of interest income on credit card portfolio. Credit card account will be treated as an NPA if the minimum amount due as stated in statement is not fully paid within 90 days from the date of next statement. The auditor should understand the assumption taken for accrual of interest income such as revolving portfolio, standard assets etc. and independently assess the reasonableness of these assumptions.

7.36 The auditor should also satisfy himself that interest on non-performing assets has not been recognised unless realised.

7.37 As per AS 9, "*Revenue Recognition*", dividends should be recognised when the right to receive payment is established, i.e. dividend has been declared by the corporate body at its Annual General Meeting and the owner's right to receive payment is established. The auditor should test certain samples of the dividend income booked during the period by obtaining the counterfoils of dividend warrants and the amount credited in the bank account.

7.38 In the case of bill discounting, interest income is received in advance hence, the auditor should examine whether the interest income for the period has been accounted for properly and the balance is treated as other liabilities. In CBS, the interest on bill discounted is system driven and the auditor should verify the in-built logic of the system. For the sample cases, the auditor should verify the interest income on bill discounted by obtaining the underlying documents like purchase order, letter of credit, etc.

7.39 The auditor should also understand the process of increase or decrease in Marginal Cost of funds based Lending Rate (MCLR) and process of updating in the system. The auditor should also ascertain compliance with RBI guideline in respect of increase in tenor of retail loan due to increase in MCLR. The auditor should also verify on sample basis as to whether the increase/decrease in base rate are effected in the system on the effective date.

7.40 Interest income includes interest accrued but not due on assets. However, as banks normally debit the borrower's account with interest due on the month end, at balance sheet date there would not usually be any amount of interest accrued but not due on advances on balance sheet date. Auditor should verify the same.

7.41 The auditor should examine the completeness of accrual of the interest by obtaining a detailed break-up of the loan portfolio (scheme wise or segment wise) and the interest accrual on the same. The aggregation of loan portfolio should be agreed to the general ledger.

7.42 The auditor should examine whether interest has been accrued on the entire investment and money market lending portfolio by obtaining the detailed break-up of the investment and money market lending portfolio along with the interest accrued thereon and agree the same with the general ledger. The auditor should re-compute the interest accrual on sample basis considering parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc., from the term sheet, deal ticket, agreements, etc.

7.43 In determining the extent of sample checking, the auditor should take into account, *inter alia*, the results of the analytical procedures and the reports, if any, on income and expenditure/ revenue audit as well as other internal and RBI inspection reports. The auditor's assessment of the effectiveness of concurrent audit would also affect the extent of his detailed checking of interest earned. In determining the extent of sample checking, the auditor may place greater emphasis on examining interest on large advances.

### **Commission Income**

7.44 Auditor may check the items of commission, exchange and brokerage on a test check basis. Such examination can be done for commission earned on bills sent for collection, commission on letters of credit, guarantees and letter of comforts. The auditor should examine whether the commission on non-funded business (e.g., letters of credit, guarantees and bills for collection) has been properly apportioned between the current year and the following year.

7.45 The auditor should obtain details of loans sanctioned and disbursed during the period as well as verify the policy of the bank for booking the processing fee income on such loans. For corporate loans, the processing fee income for the material loans sanctioned and disbursed should be re-computed and verified on test check basis by obtaining the loan agreements, sanction letter, etc. Further, for loans sanctioned but not disbursed wherein the processing fee income has been booked on accrual basis, the auditor should verify the subsequent receipt of the same and enquire for subsequent reversals. For retail loans, the auditor should perform analytical procedures for computing the processing fee percentage for different ticket size loans.

7.46 The auditor should obtain an understanding of the various types of fee income earned on credit cards and debit cards. Further, the auditor should obtain

the rate matrix for various fees charged to the customer. On a sample basis, the auditor should verify whether the fees charged and accounted is as per the rate matrix. Interchange fees is earned from service providers namely Visa, Master card, Amex proportionate to the transactions entered by the customer. On a sample basis, the auditor should verify whether the interchange fees have been received and accounted as per the agreement. Merchant acquiring income is earned on the transactions entered by the customers of other banks on the bank's terminal. The auditor should perform analytical procedures for such income and obtain the explanation for the variances, if any.

7.47 The auditor should understand how management monitors non-funded business and use their analysis for analytical procedures. The auditor should understand the relation with fee income with the business. For example, month on month /quarter loan processing fees with sanction value to arrive at average processing fees on monthly/quarterly basis. The auditor should analyse monthly/quarterly fee percentage and document the reasons for the variances as per the expectation set. Similarly auditor can perform analysis of other fee income by doing monthly/quarterly guarantee fees with average monthly/quarterly guarantee amount, interchange credit card fees *vis a vis* inter charge transactions etc.

7.48 The auditor may also compare the average fee income with the corresponding figures for the previous years and analyse any material differences.

7.49 The auditor should also check whether any fees or commission earned by the banks as a result of renegotiations or rescheduling of outstanding debts has, in terms of the income recognition guidelines issued by the RBI, have been recognised on an accrual basis over the period of time covered by the renegotiated or rescheduled extension of credit.

7.50 According to the guidelines for income recognition, asset classification, etc., issued by the RBI, if interest income from assets in respect of a borrower becomes subject to non-accrual, fees, commission and similar income with respect to same borrower that have been accrued should cease to accrue for the current period and should be reversed or provided for with respect to past periods, if uncollected. The auditor should examine whether the bank has accordingly made suitable adjustments for de-recognition/ reversal of uncollected commission, etc.

7.51 Fee on insurance referral is fast emerging as a major source of income for banks. In terms of the RBI Master Circular No. DBR.No.FSD.BC 19/24.01.001/2015-16 dated July 1, 2015 on "Para Banking Activities", banks

are permitted to undertake insurance business as agents of insurance companies on fee basis or referral arrangement without any risk participation subject to the conditions prescribed under the Master Circular. The auditor should carefully examine the agreement entered into by the bank and the concerned insurance company to see the basis for calculation of the said fee, time when the referral fees becomes due to the bank. Normally, as an industry practice, such agency arrangements also contain clauses known as “claw back” of agency fee, whereby if the client referred to the insurance company by the bank fails to pay the insurance premium for a stipulated amount of time, the agency fees paid or due to the bank becomes recoverable from the bank or is frozen. Such clauses have a direct impact on the recognition of income from the agency fees in terms of Accounting Standard 9, Revenue Recognition and may, therefore, require creation of a corresponding provision in the accounts.

7.52 *Profit on sale of Land, Buildings and Other Assets:* This item includes profit (net of any loss) on sale of land, buildings, furniture, motor vehicles, gold, silver, etc.

7.53 The auditor can check authority for disposal of:

- fixed assets, if any, sold during the year under audit; and
- non-banking assets acquired in satisfaction of claims.

The auditor should also vouch transactions in evidence of profit/ loss recorded by the Branch in respect of assets, as aforesaid.

***Profit/ Loss on Revaluation of PPE***

7.54 The auditor should satisfy himself about the appropriateness and proper application of the basis of revaluation of PPE adopted by the bank. Where revaluation is based on an appraisal/report/certificate by approved valuers, the auditor should examine the appraisals to the extent possible and satisfy him about their adequacy for audit purposes.

7.55 The revaluation of PPE can be done on the basis of appraisals by competent valuers such as engineers or architects, or on the basis of indexation of historical cost, or with reference to current prices. The auditor should satisfy himself about the appropriateness and proper application of the basis of valuation adopted by the bank. Where revaluation is based on an appraisal by valuers, the auditor should examine the appraisals to the extent possible and satisfy himself about their adequacy for audit purposes.

7.56 The auditor should also examine that the bank has complied with the provisions of AS 28, Impairment of Assets. In terms of paragraph 58 of AS 28, an

impairment loss should be immediately recognised as an expense in the Profit and Loss Account, unless the asset is carried at revalued amount in accordance with AS 10 (Revised). In such a case, any impairment loss of a revalued asset should be treated as a revaluation decrease under AS 10 (Revised). The Notes and Instructions for compilation of profit and loss account, issued by the Reserve Bank, require that in case any item under this head exceeds one per cent of the total income, particulars thereof may be given in the notes.

### ***Interest on Deposits***

7.57 The auditor may assess the overall reasonableness of the amount of interest expense in accordance with Master Direction DBR.Dir. No.84/13.03.00/2015-16 dated March 03, 2016 “Reserve Bank of India (Interest Rate on Deposits) Directions, 2016” by analysing ratios of interest paid on different types of deposits and borrowings to the average quantum of the respective liabilities during the year. For example, the auditor may obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material. The auditor may also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences. The auditor should obtain general ledger break-up for the interest expense incurred on deposits (savings and term deposits) and borrowing each month/quarter. The auditor should analyse month on month (or quarter) cost analysis and document the reasons for the variances as per the benchmark stated. He should examine whether the interest expense considered in the cost analysis agrees with the general ledger. The auditor should understand the process of computation of the average balance and re-compute the same on sample basis.

7.58 The auditor should, on a test check basis, verify the calculation of interest. He should satisfy himself that:

- (a) Interest has been provided on all deposits and borrowings upto the date of the balance sheet; and verify whether there is any excess or short credit of material amount.
- (b) Interest rates are in accordance with the bank's internal regulations, the RBI directives, and agreements with the respective depositors.
- (c) In case of Fixed Deposits it should be examined whether the Interest Rate (as applicable) in the accounting system are in accordance with the

- Interest Rate mentioned in the Fixed Deposit Receipt/Certificate.
- (d) Interest on Savings Accounts should be checked on a test check basis in accordance with the rules framed by the bank in this behalf.
  - (e) Discount on bills outstanding on the date of the balance sheet has been properly apportioned between the current year and the following year.
  - (f) Payment of brokerage is properly authorized.
  - (g) Interest on inter-branch balances has been provided at the rates prescribed by the head office.
  - (h) Interest on overdue/ matured term deposits should be estimated and provided for.

7.59 The auditor should ascertain whether there are any changes in interest rate on saving deposits and term deposits during the period. The auditor should obtain the interest rate card for various types of term deposits and analyse the interest cost for the period. The auditor should examine the completeness that there has been interest accrued on the entire borrowing portfolio by obtaining the detailed breakup of the money market borrowing portfolio and the interest accrued and the same should agree with the GL code wise break up. The auditor should re-compute the interest accrual on sample basis i.e., by referring to the parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc from the term sheet, deal ticket, agreements, etc.

## **Expenditure**

### ***Operating Expenses***

7.60 Generally the audit procedures followed by auditors in any entity are to be followed.

### ***Payments to and Provisions for Employees***

7.61 The auditor should ascertain the procedure followed by the bank in this regard while verifying this item. The auditor should obtain the human resource policy and identify the benefits available to employees. Auditor should understand the compensation structure and process of payment of salary, benefits like employee stock options, car assistance, leave encashment, asset assistance, etc. to the various grades of employees. He should obtain the standard compensation structure for each grade of employee. In case, where payment is made on production of evidence or incurrence by employee, auditor should ascertain whether provision for the same has been made in the books.

7.62 The auditor should perform an overall analytical review for the payments and provisions for employees by month on month grade-wise analysis of the

employees cost and number of employee in that grade to identify per employee cost month on month and enquire about the variances, if any. The auditor should examine whether all the benefits for all the employees have been appropriately accounted for.

7.63 The auditor should also check the calculation of salaries and allowances, etc. on a test check basis with reference to appointment/awards/offer letters. He may also assess the reasonableness of expenditure on salaries, allowances, etc. by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.

7.64 Auditor should also obtain an understanding of the provision for payment of bonus and other incentive and ascertain adequacy of the amount recorded by the bank. Further, the auditor should verify whether the bank has made adequate provisions for employee benefits and has complied with the recognition, measurement and disclosure requirements of AS 15.

#### *Rent, Taxes and Lighting*

7.65 The auditor may check the following on a test check basis:

- Rent paid and verify whether adjustments have been made for the full year on account of rent at the rates as applicable and as per agreement in force.
- Rent does not include House Rent Allowance to employees.
- Whether municipal rates/ taxes are duly paid/ adjusted for the year under audit.
- Enquire whether any disputed liability exists on this account upto the year-end.
- Further, the auditor should obtain the listing of the premises which have been obtained on lease. If the lease agreements have escalation clause, lease equalization should be done in accordance with AS-19 unless the terms and conditions of the lease indicate otherwise.
- In addition, the auditor should perform month on month rent analysis and verify major variance in the average rent per month per branch. The auditor should also verify the provision made for the expired lease rent agreements.

#### *Printing and Stationery*

7.66 The auditor should verify this item with reference to documents evidencing purchase/debit note received.

*Advertisement and Publicity*

7.67 Expenditure incurred by the bank for advertisement and publicity, including printing charges of publicity material is verified with the documents.

*Repair and Maintenance Expenses*

7.68 The auditor should verify the Annual Maintenance Contract (AMC) at the Branch and should verify the provisioning and prepaid accounting of these contracts.

*Depreciation on Bank's Property*

7.69 The auditor should ascertain the procedure followed by the bank while verifying this item. 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 either be centralised at the head office level or decentralised.

7.70 The auditor should check head office instructions as regards adjustments of depreciation on the fixed assets of the Branch. The auditor should also check whether depreciation on fixed assets has been adjusted at the rates and in the manner required by head office.

7.71 The auditor may also report unadjusted depreciation on assets acquired but not capitalised. The auditor should re-compute the depreciation for the period, perform depreciation rationalisation and agree the amount with the general ledger. The auditor may also verify and obtain explanation for the unadjusted depreciation on assets acquired but not capitalised.

**Provisions and Contingencies**

7.72 The auditor should ascertain compliance with the various regulatory requirements for provisioning as contained in the various circulars.

7.73 The auditor should obtain an understanding as to how the Bank computes provision on standard assets and non-performing assets. It will primarily include the basis of the classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets. For verification of provision on standard assets, the auditor should verify the loan classification on a sample basis. The auditor should obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balance with the general ledger. The auditor should examine whether by performing re-computation the provisions in respect of standard loans, NPA and NPI comply with the regulatory requirements.

7.74 The auditor should obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation. The auditor should re-compute the provision for tax by applying the applicable tax rate after considering the allowances and disallowances as per Income Tax Act, 1961 and as per Income Computation and Disclosure Standards (ICDS). The other provisions for expenditure should be examined *vis a vis* the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

## III-8

# Disclosure Requirements in Financial Statements•

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8.01 Sub-sections (1) and (2) of section 29 of the Banking Regulation Act, 1949 deal with form and content of financial statements of a banking company. Sub-section (1) of section 29 requires every banking company to prepare a balance sheet and a profit and loss account in the forms set out in the Third Schedule to the Banking Regulations Act, 1949 (hereinafter referred to as 'the Act'). Form A of the Third Schedule to the Act contains the form of balance sheet and Form B contains the form of profit and loss account.

8.02 The disclosure requirements for disclosure in the financial statements can be broadly classified in the following four categories:

- (i)• Prescribed by Reserve Bank of India.
- (ii)• Prescribed by Accounting Standards and other pronouncements.
- (iii)• Requirement emanating from Statues.
- (iv)• Requirement emanating from Listing.

8.03 *Disclosures Prescribed by RBI:* In addition to the disclosures to be made in the balance sheet and profit and loss account in pursuance of the requirements of the Third Schedule to the Act, the RBI has, *vide* its Master Circular no. DBR.BP.BC No. 23/21.04.018/2015-/16 dated July 1, 2015 on "Disclosure in Financial Statements - Notes to Accounts", prescribed disclosures to be made in the Notes to Accounts in respect of certain significant aspects of the items of financial statements of banks. Banks should, at a minimum, disclose the items listed in the circular in the 'Notes to Accounts'. However, banks should also make more comprehensive disclosures than the minimum required under the circular if they become significant and aid in the understanding of the financial position and performance of the bank. The disclosure listed is intended only to supplement, and not to replace, other disclosure requirements under relevant legislation or accounting and financial reporting standards. Where relevant, a bank should comply with such other disclosure requirements as applicable.

8.04 *Disclosures Required Under Accounting Standards:* The disclosure requirements under the various notified Accounting Standards, prescribed under section 133 of the Companies Act, 2013 read with Rule 7 of the Companies (Accounts) Rules, 2014 and various applicable pronouncements of the ICAI.

8.05 *Requirements of Statutes:* The requirements of the Companies Act, 2013 relating to the balance sheet and profit and loss account of a company, in so far as they are not inconsistent with the Banking Regulation Act, 1949 also apply to the balance sheet or profit and loss account of a banking company [sub-section (3) of section 29 of the Act]. It may be noted that this provision applies only to those banks, which have been incorporated as companies.

8.06 *Requirements of Listing:* Banks listed on a stock exchange have to also comply with the requirements for listing as amended from time to time.

## **Disclosure of Summary of the Significant Accounting Policies**

8.07 Banks should disclose the accounting policies regarding key areas of operations at one place, i.e., under Schedule 17, along with notes to accounts in their financial statements. This may include disclosure, such as, Basis of Accounting, Transactions involving foreign exchange, Investments – classification, valuation, etc, Derivative Transactions, Advances and Provisions thereon, Fixed Assets and Depreciation, Revenue Recognition (including strategic Debt Restructuring), Employee Benefits, Provision for Taxation, etc.

8.08 The Form A and B of the Third Schedule contains 16 schedules, which is to be uniformly used by all the banks. In addition to the 16 detailed prescribed schedules, banks are required to furnish the 'Summary of Significant Accounting Policies' and 'Notes to Accounts' under Schedule 17 and Schedule 18 respectively, to maintain uniformity. This Chapter deals with disclosure requirements in Notes to Accounts as laid down in the respective RBI circular. The disclosures requirement contained in the Master Circular are minimum disclosure requirements. The banks may consider disclosing significant additional information for enhancing the understanding of the users of the financial statements.

8.09 The previous year's comparatives should also be disclosed along with the disclosures for the current year.

## Audit Approach

8.10 The auditor's primary objective in audit of disclosures made in the notes to accounts is to satisfy himself that such disclosures are free from material misstatement. Examination of compliance with statutory, regulatory and accounting standards requirements is also an important objective in as much as non-compliance may have a direct and material impact in understanding the financial statements. The auditor should keep this in view while designing audit procedures relating to disclosures. The auditor could have a checklist of all the prescribed disclosure requirements which should include a column of the manner in which the data is extracted by the bank and the manner of auditor's verification of the same. This will ensure completeness and accuracy of the various disclosures. Care needs to be taken that the qualitative disclosures emanate from various policies, procedures and practices of the bank and represent the manner in which the bank conducts its activities referred to in the disclosures. The auditor needs to be satisfied that the quantitative disclosures originate from the books of account and other related records. The auditor should be satisfied with regard to the procedure of the bank to extract the relevant information. In case the process of extraction is automated the auditor can focus on the concerned systems controls too. In case the process is manual then more rigorous verification is necessary. Some of the disclosures could emanate from software and management information systems that are not seamlessly linked to the core banking software or any accounting software. In such cases the auditor should obtain audit evidence as to the robustness of the process followed by the bank to arrive at the data / information that is eventually disclosed in the financial statements.

8.11 The following paragraphs list the various requirements of disclosures. The audit approach for verification of these disclosures is detailed in the respective chapters of this Guidance Note.

## Disclosures Prescribed by RBI<sup>8</sup>

8.12 Banks are also required to comply with AS 1 on "Disclosure of Accounting Policies" issued by ICAI. In addition to the 16 detailed prescribed schedules to the balance sheet, banks are required to furnish the information as discussed in the following paragraphs in the "Notes to Accounts".

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<sup>8</sup>The RBI *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 the disclosures to be made by the banks in the notes to accounts.

### **8.13 Capital<sup>9</sup>**

- (i)• The Capital to Risk-weighted Assets Ratio (CRAR) as assessed by the Bank on the basis of the guidelines issued by the RBI for implementation of the Capital Adequacy Framework should be computed and disclosed in Notes to accounts.
- (ii)• CRAR should be computed on over all basis (i.e. Total Capital) and also for Tier I and Tier II capital.
- (iii)• Amount of equity capital raised.
- (iv)• Amount of Additional Tier 1 capital raised; of which
  - a.• Perpetual Non cumulative Preference Shares (PNCPS).
  - b.• Perpetual Debt Instrument (PDI).
- (v)• Amount of Tier 2 capital raised; of which
  - a.• Debt capital instrument.
  - b.• Preference Share Capital Instrument. [Perpetual Cumulative Preference Shares (PCPC)/Redeemable Non-Cumulative Preference Shares (RNCPS)/ Redeemable Cumulative Preference Shares (RCPS)]
- (vi)• For nationalized banks percentage of the shareholding of the Government of India should also be disclosed.

### **8.14 Investments**

- (i) The details of investments and the movement of provisions held towards depreciation of investments of the bank should be stated under following heads:
  - (a)• gross value of investments in India and outside India;
  - (b)• aggregate of provisions for depreciation, separately on investments in India and outside India;
  - (c)• net value of investments in India and outside India; and
  - (d)• Movement of provision held towards depreciation on investment stating opening balance, provisions made during the year, appropriation/transfer, if any, from Investment Fluctuation reserve, write-off/ write back of excess provisions and closing balance.
- (ii) The gross value of investments and provisions need not, however, be shown against each of the categories specified in the Schedule. The

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<sup>9</sup>For the format of disclosures please refer to the relevant paragraphs of “Master Circular-Disclosure in Financial Statements-Notes to Accounts”.

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.

### **Repo Transactions**

8.15 The details of Securities sold under repo and Securities purchased under reverse repo for Government and Corporate debt securities during the year should be disclosed stating minimum and maximum outstanding balance daily average outstanding balance of securities and Outstanding as on March 31.

### **8.16 Non-SLR Investment Portfolio**

- (i)• The composition of issuer of Non SLR investments should be disclosed in notes to account categorizing the issuer into PSUs, FIs, Banks, Private Corporates, Subsidiaries/Joint Ventures and Others.
- (ii)• The Grand total of the issuer wise details of Non-SLR investment should tally with the total of Investments included under the following categories in Schedule 8 to the balance sheet:
  - a.• Shares;
  - b.• Debentures & Bonds;
  - c.• Subsidiaries/joint ventures;
  - d.• Others.
- (iii)• The investments held with each category of issuer should be classified into extent of private placement, below investment grade security, unrated securities and unlisted securities. Amounts reported under the above classification may not be mutually exclusive.
- (iv)• Provision held towards depreciation of investments should be shown separately.
- (v)• The movement in gross non-performing Non-SLR investments (i.e. securities other than government and other approved securities) should also be disclosed separately along with total provision thereof.

### **Sale and transfers to/from HTM Category**

8.17 If the value of sales and transfers of securities to / from HTM category exceeds 5 per cent of the book value of investments held in HTM category at the beginning of the year, the bank should disclose the market value of the investments held in the HTM category and indicate the excess of book value over market value for which provision is not made. This disclosure is required to be made in 'Notes to Accounts' in the bank's audited Annual Financial Statements. The 5 per cent threshold referred to above will exclude the one -

time transfer of securities to / from HTM category with the approval of Board of Directors permitted to be undertaken by banks at the beginning of the accounting year and sales to the Reserve Bank of India under pre-announced OMO auctions.

## **8.18 Derivatives**

- (i)• **Forward Rate Agreement/ Interest Rate Swap:** Following details are required to be disclosed with respect to Forward Rate Agreement/Interest Rate Swap:
  - a)• Notional principal of swap agreements<sup>10</sup>;
  - b)• Losses which would be incurred if counterparties failed to fulfill their obligations under the agreements;
  - c)• Collateral required by the bank upon entering into swaps<sup>11</sup>;
  - d)• Concentration of credit risk arising from the swaps (for e.g. exposures to particular industries or swaps with highly geared companies); and
  - e)• Fair value of the swap book<sup>12</sup>.
- (ii)• **Exchange Traded Interest Rate Derivatives:** With respect to Exchange Traded Interest Rate Derivatives instrument-wise disclosure of Notional principal amount of Exchange Traded Interest Rate Derivatives undertaken during the year, derivatives outstanding as on March 31, derivatives outstanding and not "highly effective" should be disclosed. Mark-to-market value of exchange traded interest rate derivatives outstanding and not "highly effective instrument-wise should also be disclosed.
- iii) Disclosures on risk exposure in derivatives**
  - (i)• **Qualitative Disclosure:** Banks should discuss their risk management policies pertaining to derivatives with particular reference to the extent to which derivatives are used, the associated risks and business purposes served. The discussion shall also include:
    - a)• the structure and organisation for management of risk in derivatives trading;

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<sup>10</sup> Nature and terms of the swaps including information on credit and market risk and the accounting policies adopted for recording the swaps should be disclosed.

<sup>11</sup>Examples of concentration could be exposures to particular industries or swaps with highly geared companies.

<sup>12</sup>If the swaps are linked to specific assets, liabilities, or commitments, the fair value would be the estimated amount that the bank would receive or pay to terminate the swap agreements as on the balance sheet date. For a trading swap the fair value would be its mark to market value.

- b)• the scope and nature of risk measurement, risk reporting and risk monitoring systems;
  - c)• policies for hedging and/or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges/mitigants; and
  - d)• accounting policy for recording hedge and non-hedge transactions; recognition of income, premiums and discounts; valuation of outstanding contracts; provisioning, collateral and credit risk mitigation.
- (ii)• *Quantitative Disclosure*: Quantitative disclosure with regard to currency and interest rate derivatives should be disclosed in notes to accounts stating:
- a)• The notional principal amount of derivatives both for hedging and trading.
  - b)• Mark to market position separately for positive and negative marked to market position.
  - c)• Credit Exposure.
  - d)• Likely impact of one percentage change in interest rate on hedging and trading derivatives and maximum and minimum change in interest rate observed during the year.

### **8.19 Asset Quality**

- (i) ***Non-performing assets***: Banks are required to disclose Net NPA as percentage to net advances and the details of movement of gross NPAs, net NPAs and provisions during the year.
- (ii) Following details are to be disclosed in respect of Loan Assets subjected to restructuring:
- i. details of accounts restructured on a cumulative basis excluding the standard restructured accounts which cease to attract higher provision and risk weight (if applicable);
  - ii. provisions made on restructured accounts under various categories; and
  - iii. details of movement of restructured accounts.

Above details are classified under different categories as under:

- Type of restructuring- Under CDR Mechanism, Under SME Debt Restructuring Mechanism and Others;

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

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- Asset Classification of restructured accounts- Standard, Sub-standard, Doubtful and Loss assets;
- Movement under each of the above disclosing No. of borrowers, Amount outstanding and Provision thereon.

These details are to be disclosed in a tabular format as given in the Master Circular on Disclosure in Financial Statements - Notes to Accounts dated July 1, 2015.

RBI vide its circular no. DBR.No.BP.BC.33/21.04.132/2016-17 dated 10.11.2016 requires banks to make certain disclosures in their annual financial statements on application of the Scheme for Sustainable Structuring of Financial Assets:

Banks should also disclose investment in equity shares under strategic Debt Restructuring.

Banks must disclose the total amount outstanding in all the accounts/facilities of borrowers whose accounts have been restructured along with the restructured part or facility. This means even if only one of the facilities/accounts of a borrower have been restructured, the bank should also disclose the entire outstanding amount pertaining to all the facilities/accounts of that particular borrower.

Further Divergence in respect of Gross NPA, Net NPA, Provisions and Net profit after Tax as mandated in circular No.DBR.BP.BC.No.63/21.04.018/2016-17 dated 18th April 2017 issued by RBI shall be disclosed in the notes to accounts in the below format:-

(Rs in _____)		
Sr.	Particulars	Amount
1.	Gross NPAs as on March 31, 20XX* as reported by the bank	
2.	Gross NPAs as on March 31, 20XX as assessed by RBI	
3.	Divergence in Gross NPAs (2-1)	
4.	Net NPAs as on March 31, 20XX as reported by the bank	
5.	Net NPAs as on March 31, 20XX as assessed by RBI	
6.	Divergence in Net NPAs (5-4)	

## Disclosure Requirements in Financial Statements

7.	Provisions for NPAs as on March 31, 20XX as reported by the bank	
8.	Provisions for NPAs as on March 31, 20XX as assessed by RBI	
9.	Divergence in provisioning (8-7)	
10.	Reported Net Profit after Tax (PAT) for the year ended March 31, 20XX	
11.	Adjusted (notional) Net Profit after Tax (PAT) for the year ended March 31, 20XX after taking into account the divergence in provisioning	
* March 31, 20XX is the close of the reference period in respect of which divergences were assessed		

- (iii) • **Financial assets transferred during the year to securitisation company (SC)/reconstruction company (RC)** - With regards to financial assets transferred by the bank to securitisation/reconstruction company, the bank is required to disclose the number of accounts transferred, aggregate value (net of provisions) of accounts sold to SC/RC, aggregate consideration and additional consideration realized in respect of accounts transferred in earlier years. Aggregate gain/loss over net book value is also required to be computed and disclosed.

Excess Provision reversed to Profit & Loss Account on account of Sale of NPAs to Securitisation Company (SC) / Reconstruction Company (RC) shall be disclosed in the notes.

*To enhance transparency additional disclosure for investment in Security Receipts (SRs) is required as follows:-*

Particulars	SRs Issued within Past 5 Years	SRs issued more than 5 years ago but within past 8 Years	SRs issued more than 8 Years ago	Total
(i) Book value of SRs Backed by NPAs sold by the bank as underlying. Provision held against (i)				
(ii) Book value of SRs Backed by NPAs sold by Other banks / financial institutions / nonbanking Financial companies as Underlying Provision held against (ii)				
<b>Total (i) + (ii)</b>				

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

As per RBI circular DBR.No.BP.BC.9/21.04.048/2016-17 dated September 1, 2016 banks should make sure that sale of stressed assets by banks actually result in 'true sale' of assets and to create a vibrant stressed assets market, RBI has decided to progressively restrict banks' investment in SRs backed by their own stressed assets.

- i. With effect from April 1, 2017, where the investment by a bank in SRs backed by stressed assets sold by it, under an asset securitisation, is more than 50 percent of SRs backed by its sold assets and issued under that securitisation, the provisions held in respect of these SRs will be subject to a floor; this floor shall be progressive provisioning as per extant asset classification and provisioning norms, notionally treating book value of these SRs as the corresponding stressed loans, assuming these had remained, without recovery of principal, on the bank's books. In effect, provisioning requirement on SRs will be higher of the:
  - a) provisioning rate required in terms of net asset value declared by the SCs/RCS; and
  - b) provisioning rate as applicable to the underlying loans, assuming that the loans notionally continued in the books of the bank;
- ii. With effect from April 1, 2018, the above threshold of 50 percent will stand reduced to 10 percent.

Disclosures on the Scheme for Sustainable Structuring of Stressed Assets (S4A), as on March 31 (INR Crore)				
No. of accounts where S4A has been applied	Aggregate amount outstanding	Amount outstanding		Provision Held
		In Part A	In Part B	
Classified as Standard				
Classified as NPA				

Additional disclosures are required to be made in respect of Flexible Structuring of existing loans, Accounts still under the stand-still period under SDR scheme, Change in Ownership outside SDR scheme, Change in Ownership of projects under Implementation, as per format in the Appendix to RBI Circular RBI/2016-17/122 DBR. No. BP.BC.34/21.04.132/2017-17 dated November 10, 2016.

- (iv) **Details of non-performing financial assets purchased/sold** - Banks which purchased/ sold non-performing financial assets from/to other banks shall be required to make the following disclosures in the Notes on Accounts to their Balance sheets:
- A. Details of non-performing financial assets purchased:
- (a)• No. of accounts purchased during the year;
  - (b)• Aggregate outstanding:
    - Of these, number of accounts restructured during the year;
    - Aggregate outstanding.
- B. Details of non-performing financial assets sold:
- (a)• No. of accounts sold during the year;
  - (b)• Aggregate outstanding;
  - (c)• Aggregate consideration received.
- (v) **Provisions on Standard Asset:** Provisions made towards Standard Assets should be disclosed separately in notes to account. It may be noted that the amount need not be netted off from gross advances but shown separately as 'Provisions against Standard Assets', under 'Other Liabilities and Provisions - Others' in Schedule No. 5 of the balance sheet.

## **Business Ratios**

8.20 RBI has prescribed following ratios to be computed by the bank to be disclosed in the notes forming part of the balance sheet:

- (i) *Interest Income as a percentage to Working Funds*- Working funds is to be reckoned as average of total assets (excluding accumulated losses, if any) as reported to RBI in Form X under Section 27 of the Banking Regulation Act, 1949, during the 12 months of the financial year.
- (ii) *Non-interest income as a percentage to Working Funds*- Non-interest income is to be reckoned as income reported under Schedule 14.
- (iii) *Operating Profit as a percentage to Working Funds*- Operating Profit is to be reckoned as profit before making provisions, i.e., Total income as per Schedule 13 and Schedule 14 less Total expenditure as per Schedule 15 and Schedule 16.
- (iv) *Return on Assets (it should be with reference to average working funds i.e., total of assets excluding accumulated losses, if any)*: The return is to be reckoned as the net profit for the year after making all the provisions.
- (v) *Business (Deposits plus advances) per employee (inter- bank deposits*

*may be excluded*): This ratio may be computed based on the average business and average no. of employees during the year.

- (vi) *Profit per employee*: This ratio may be computed based on the average no. of employees during the year.

### **Asset Liability Management**

8.21 Banks are required to disclose the maturity pattern of Deposits, Advances, Investments, Borrowings, Foreign Currency assets, Foreign Currency liabilities as on balance sheet date. The maturity pattern needs to be disclosed in following time buckets-

- (i)• Day 1
- (ii)• 2 to 7 days
- (iii)• 8 to 14 days
- (iv)• 15 to 28 days
- (v)• 29 days to 3 months
- (vi)• Over 3 months & upto 6 months
- (vii)• Over 6 months & upto 1 year
- (viii)• Over 1 year & upto 3 years
- (ix)• Over 3 years & upto 5 years
- (x)• Over 5 years

The maturity pattern of demand deposits and demand loans (including in foreign currency) is to be based on empirical study carried by the bank. Based on such study, such deposits and loans should be classified under different buckets. Auditor will also have to verify the accuracy of the maturity pattern generated by the system at Branch level and also at controlling office level to ensure the accuracy of disclosure made under this paragraph.

### **Exposures**

8.22 The RBI vide its Master Circular DBR.No.Dir.BC. 12/13.03.00/2015-16 dated July 1, 2015 on “Exposure Norms” provides requirements in respect of exposure limits for banks. Under the master circular on Disclosure in Financial Statements – Notes to Accounts, the RBI has prescribed the details which need to be disclosed with respect to Banks exposure to real estate sector and capital market:

- (A) **Exposure to Real Estate Sector**- Banks are required to disclose direct and indirect exposure to real estate sector in the below mentioned format:
- a)( *Direct exposure*

- (i)• Residential Mortgages: Includes lending fully secured by mortgages on residential property that is or will be occupied by the borrower or that is rented; (Individual housing loans eligible for inclusion in priority sector advances may be shown separately)
  - (ii)• *Commercial Real Estate*- Both fund and non-fund based lending secured by mortgages of commercial real estate; (office buildings, retail space, multi-purpose commercial premises, multi-family residential buildings, multi-tenanted commercial premises, industrial or warehouse space, hotels, land acquisition, development and construction, etc.).
  - (iii)• Investments in Mortgage Backed Securities (MBS) and other securitised exposures-
    - a. Residential;
    - b. Commercial Real Estate.
  - b)• *Indirect Exposure*: Fund based and non-fund based exposures on National Housing Bank (NHB) and Housing Finance Companies (HFCs).
- (B) **Exposure to Capital Market**- Banks are required to disclose the total exposure to capital market under the following heads:
- a.• direct investment in equity shares, convertible bonds, convertible debentures and units of equity-oriented mutual funds the corpus of which is not exclusively invested in corporate debt;
  - b.• advances against shares/bonds/debentures or other securities or on clean basis to individuals for investment in shares (including IPOs/ESOPs), convertible bonds, convertible debentures, and units of equity-oriented mutual funds;
  - c.( advances for any other purposes where shares or convertible bonds or convertible debentures or units of equity oriented mutual funds are taken as primary security;
  - d.• advances for any other purposes to the extent secured by the collateral security of shares or convertible bonds or convertible debentures or units of equity oriented mutual funds i.e. where the primary security other than shares/convertible bonds/convertible debentures/units of equity oriented mutual funds does not fully cover the advances;

- e. secured and unsecured advances to stockbrokers and guarantees issued on behalf of stockbrokers and market makers;
- f. loans sanctioned to corporates against the security of shares / bonds/ debentures or other securities or on clean basis for meeting promoter's contribution to the equity of new companies in anticipation of raising resources;
- g. bridge loans to companies against expected equity flows/issues;
- h. underwriting commitments taken up by the banks in respect of primary issue of shares or convertible bonds or convertible debentures or units of equity oriented mutual funds. However, RBI, *vide* its Master Circular No. DBR.No.Dir.BC. 12/13.03.00/2015-16 dated July 1, 2015 on "Exposure Norms" has clarified that with effect from April 16, 2008, banks may exclude their own underwriting commitments, as also the underwriting commitments of their subsidiaries, through the book running process for the purpose of arriving at the capital market exposure of the solo bank as well as the consolidated bank;
- i. financing to stockbrokers for margin trading;
- j. all exposures to Venture Capital Funds (both registered and unregistered).

The exposure is to be reckoned with reference to higher of outstanding and sanctioned limit. Exposure to the sensitive sector would include lending which is primarily secured against such sensitive sector.

(C) **Risk category-wise country-wise exposure:** As per the extant RBI guidelines, the country wise net exposure of the Bank and the provision held thereof is categorized into various risk categories listed below:

- (i) Insignificant
- (ii) Low
- (iii) Moderate
- (iv) High
- (v) Very High
- (vi) Restricted
- (vii) Off-credit
- (viii) Total

8.23 Till the banks move over to own internal rating systems, they may use the seven category classification followed by Export Credit Guarantee Corporation of India Ltd. (ECGC) for the purpose of classification and making

provisions for country risk exposures. ECGC shall provide to banks, on request, quarterly updates of their country classifications and shall also inform all banks in case of any sudden major changes in country classification in the interim period.

(D) **Details of Single Borrower Limit (SGL), Group Borrower Limit (GBL) exceeded by the bank:** The bank should make appropriate disclosure in respect of cases where it had exceeded the prudential exposure limits during the year. The sanctioned limit or entire outstanding, whichever is high, shall be reckoned for arriving at exposure limit and for disclosure purpose. The same needs to be verified from the minutes of Board meeting of the bank. If there is no such disclosure, auditor may take representation from bank in this regard.

Following disclosure need to be made:

- i. The number and amount of exposures in excess of the prudential exposure limit during the year.
  - ii. Credit exposure as percentage to capital funds and as a percentage to total assets, in respect of:
    - the largest single borrower.
    - the largest borrower group.
    - the 20 largest single borrowers.
    - the 20 largest borrower groups.
  - iii. Credit exposure to the five largest industrial sectors (if applicable) as percentage to total loan assets.
  - iv. Total amount of advances for which intangible securities such as charge over the rights, licenses, authority, etc. have been taken as also the estimated value of such intangible collateral. The disclosure shall be made under a separate head to differentiate such loans from other entirely unsecured loans.
  - v. Factoring exposures.
  - vi. Exposures where the Bank had exceeded the Prudential Exposure Limits during the year.
- (E) **Unsecured Advances** - To ensure correct reflection of the unsecured advances in Schedule 9 of the banks' balance sheet, the banks are required to follow the norms as under:

- For determining the amount of unsecured advances for reflecting in Schedule 9 of the published balance sheet, the rights, licenses, authorizations, etc., charged to the banks as collateral in respect of projects (including infrastructure projects) financed by them, should not be reckoned as tangible security. Hence such advances shall be reckoned as unsecured.
- Banks should also disclose the total amount of advances for which intangible securities such as charge over the rights, licenses, authority, etc. has been taken as also the estimated value of such intangible collateral. The disclosure may be made under a separate head in "Notes to Accounts". This would differentiate such loans from other entirely unsecured loans.

### **Disclosure of Penalties imposed by RBI**

8.24 At present, Reserve Bank is empowered to impose penalties on a commercial bank under the provision of Section 46(4) of the Banking Regulation Act, 1949, for contraventions of any of the provisions of the Act or non-compliance with any other requirements of the Banking Regulation Act, 1949; order, rule or condition specified by Reserve Bank under the Act. The penalty also is required to be disclosed in the "Notes on Accounts" to the Balance Sheet.

### **Provisions and Contingencies**

8.25 To facilitate easy reading of the financial statements and to make the information on all Provisions and Contingencies available at one place, banks are required to disclose in the 'Notes to Accounts' the following information:

- (i)• Provisions for depreciation on Investment.
- (ii)• Provision towards NPA.
- (iii)• Provision towards Standard Asset.
- (iv)• Provision made towards Income tax.
- (v)• Other Provision and Contingencies (with details).

### **Floating Provisions**

8.26 Banks are required to make comprehensive disclosures on the movement of floating provisions in the "notes to accounts" to the balance sheet as follows:

- Opening balance in the floating provisions account.
- The quantum of floating provisions made in the accounting year.

- Amount of draw down made during the accounting year.
- Closing balance in the floating provisions account.

For draw down of provision during the year, purpose of draw down is required to be mentioned.

### **Draw Down from Reserves**

8.27 Suitable disclosures should be made regarding any draw down of reserves.

### **Disclosure of complaints**

8.28 Banks are also required to disclose the following brief details along with their financial results:

(i)• *Customer Complaints*

- (a)• No. of complaints pending at the beginning of the year.
- (b)• No. of complaints received during the year.
- (c)• No. of complaints redressed during the year.
- (d)• No. of complaints pending at the end of the year.

(ii)• *Awards passed by the Banking Ombudsman*

- (a)• No. of unimplemented Awards at the beginning of the year.
- (b)• No. of Awards passed by the Banking Ombudsmen during the year.
- (c)• No. of Awards implemented during the year.
- (d)• No. of unimplemented Awards at the end of the year.

### **Disclosure of Letter of Comforts (LoCs) / Letter of Undertakings (LoUs) issued by banks**

8.29 The banks are required to disclose full particulars of all the Letter of Comforts (LoCs) / Letter of Undertakings (LoUs) issued during the year, including their assessed financial impact, as also their assessed cumulative financial obligations under the LoCs issued by them in the past and outstanding at the end of current year. Auditor would be required to verify the accuracy of system generated data in respect of this disclosure and verify that disclosure is correctly made.

### **Provisioning Coverage Ratio (PCR)**

8.30 The PCR (ratio of provisioning to gross non-performing assets) should be disclosed in the Notes to Accounts to the Balance Sheet.

### **Bancassurance Business**

8.31 The details of fees / brokerage earned in respect of insurance broking, agency and bancassurance business undertaken by bank is required to be disclosed in the 'Notes to Accounts' to the Balance Sheet.

### **Concentration of Deposits**

8.32 Total Deposits of twenty largest depositors and Percentage of Deposits of twenty largest depositors to Total Deposits of the bank should be disclosed by the bank in the notes to accounts.

### **Concentration of Advances**

8.33 Total Advances of twenty largest borrowers and Percentage of Advances to twenty largest borrowers to Total Advances of the bank should be disclosed by the bank in the notes to accounts. Advances should be computed as per definition of Credit Exposure including derivatives furnished in the Master Circular on Exposure Norms.

### **Concentration of Exposures**

8.34 Total Exposure to twenty largest borrowers/customers and Percentage of Exposures to twenty largest borrowers/customers to Total Exposure of the bank on borrowers/customers should be disclosed by the bank in the notes to accounts. Exposures should be computed based on credit and investment exposure as prescribed in the Master Circular on Exposure Norms.

### **Concentration of NPAs**

8.35 Total Exposure to top four NPA accounts should be disclosed by the bank in the notes to accounts.

### **Sector-wise NPAs**

8.36 Percentage of NPAs to Total Advances in the sectors, such as, Agriculture & allied activities, Industry (Micro & small, Medium and Large), Services, Personal Loans, should be disclosed by the bank in the notes to accounts.

### **Movement of NPAs**

8.37 Movement in NPAs during the year including opening balance, additions during the year, less upgradations, recoveries(excluding recoveries made from upgraded accounts) and write off during the year, should be disclosed by the bank in the notes to accounts.

## Disclosure Requirements in Financial Statements

Further, banks should disclose the stock of technical write offs and the recoveries made thereon as per the format below:

<b>Particulars</b>	<b>Current year</b>	<b>Previous year</b>
Opening balance of Technical / Prudential written off accounts as at April 1		
<b>Add</b> : Technical / Prudential write offs during the year		
<b>Subtotal (A)</b>		
<b>Less</b> : Recoveries made from previously technical / prudential written off accounts during the year (B)		
<b>Closing balance as at March 31 (A-B)</b>		

8.38 **Overseas Total Assets, Total NPAs and Total Revenue** should be disclosed by the bank in the notes to accounts.

8.39 **Off-balance Sheet SPVs** sponsored (which are required to be consolidated as per accounting norms) both domestic and overseas should be disclosed by the bank in the notes to accounts.

### **Unamortized Pension and Gratuity Liabilities**

8.40 Appropriate disclosures of the accounting policy followed in regard to amortization of pension and gratuity expenditure may be made in the Notes to Accounts to the financial statements.

### **Disclosures on Remuneration**

8.41 Private sector banks and foreign banks (to the extent applicable) are advised to disclose remuneration as specified in the Master Circular on "Disclosures in Financial Statements- Notes to Accounts".

### **Disclosures relating to Securitisation**

8.42 The Notes to Accounts of the originating banks should indicate the outstanding amount of securitized assets as per books of the SPV sponsored by the bank and total amount of exposures retained by the bank as on the date of balance sheet to comply with the Minimum Retention Requirement (MRR). These figures should be based on the information duly certified by the SPV's auditors obtained by the originating bank from the SPV.

### **Credit Default Swaps**

8.43 Banks using a proprietary model for pricing CDS, shall disclose both the proprietary model price and the standard model price in terms of extant

guidelines in the Notes to the Accounts and should also include an explanation of the rationale behind using a particular model over another.

### **Intra Group Exposure**

8.44 With the developments of financial markets in India, banks have increasingly expanded their presence in permitted financial activities through entities that are owned by them fully or partly. As a result, banks' exposure to the group entities has increased and may rise further going forward. In order to ensure transparency in their dealings with group entities, banks should make the following disclosures for the current year with comparatives for the previous year: (a) Total amount of intra group exposures (b) Total amount of top 20 intra group exposures (c) Percentage of intra group exposures to total exposure of the bank on borrowers / customers (d) Details of breach of limits on intra group exposures and regulatory action thereon, if any.

The details may be verified by the auditor from investment details of Bank and other relevant information available with Bank.

### **Transfer to Depositor Education and Awareness Fund (DEAF)**

8.45 Unclaimed liabilities where amount due has been transferred to DEAF is required to 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 'Notes to Accounts' as per the format given below.

(Amount in Rs. crore)

<b>Particulars</b>	<b>Current Year</b>	<b>Previous Year</b>
Opening balance of amounts transferred to DEAF		
Add: Amounts Transferred to DEAF during the year		
Less: Amounts reimbursed by DEAF towards claim		
Closing balance of amounts transferred to DEAF		

### **Unhedged Foreign Currency Exposure**

8.46 Banks are required to disclose-

- i. their policy on managing credit risk arising out of unhedged foreign currency risk of the Borrowers.

- ii. • Incremental provision and additional capital held by the Bank for unhedged foreign currency exposure of their borrowers.

The auditor needs to understand the policy of the bank for unhedged foreign currency exposure and verify that it is appropriately disclosed. As also incremental provision and additional capital held.

#### 8.47 **Liquidity Coverage Ratio (LCR)**

- i. Banks are required to disclose information on their Liquidity Coverage Ratio (LCR) in their annual financial statements under 'Notes to Accounts', for which the LCR related information needs to be disclosed in the elaborate format as given in the Master Circular.

LCR is a ratio of two factors, viz, the stock of High Quality Liquid Assets and the Net Cash Outflows over the next 30 calendar days.

The LCR requirement would be binding on banks from January 1, 2015; with a view to provide a transition time for banks, the requirement would be minimum 60% for the calendar year 2015 i.e. with effect from January 1, 2015, and rise in equal steps to reach the minimum required level of 100% on January 1, 2019, as per the time-line given below:

	January 01, 2017	January 01, 2018	January 01, 2019
Minimum LCR	80%	90%	100%

- ii. Besides above, banks are also required to provide qualitative discussion around the LCR to facilitate understanding of the data provided, for example:
  - (a) the main drivers of their LCR results and the evolution of the contribution of inputs to the LCR's calculation over time;
  - (b) intra period changes as well as changes over time;
  - (c) the composition of HQLA;
  - (d) concentration of funding sources;
  - (e) derivative exposures and potential collateral calls;
  - (f) currency mismatch in the LCR;
  - (g) a description of the degree of centralisation of liquidity management and interaction between the group's units; and

- (h) other inflows and outflows in the LCR calculation that are not captured in the LCR common template but which the institution considers to be relevant for its liquidity profile.
- iii. The relevant RBI circular reference no. DBOD.BP.BC.No.120 / 21.04.098/2013-14 dated June 9, 2014 read with subsequent updated upto RBI/2018-19/62 DBR.BP.BC.No.05/21.04.098/2018-19 dated October 19, 2018 can be referred for further details.

### **Fraud Reporting**

8.48 As per RBI circular DBR.No.BP.BC.92/21.04.048/2015-16 dated April 01, 2016 on Provisions pertaining to Frauds, Bank should make suitable disclosure regarding

- i. No. of Frauds reported;
- ii. Amount involved in such frauds;
- iii. Quantum of Provisions during the year;
- iv. Quantum of unamortized Provision debited to other reserves.

### **Disclosures prescribed by Accounting Standards**

8.49 This Guidance Note deals with only those disclosure requirements where RBI has issued guidelines in respect of disclosure as per Accounting Standards.

1. As the format of the profit and loss account of banks prescribed in Form B under Third Schedule to the Banking Regulation Act 1949 does not specifically provide for disclosure of the impact of prior period items on the current year's profit and loss, such disclosures, wherever warranted, may be made in the Notes on Accounts of banks. (AS-5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies")
2. Disclosure with regards to the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties. (AS-9, "Revenue Recognition")
3. Banks may follow the disclosure requirements prescribed under AS 15 (revised), 'Employees Benefits' issued by ICAI.
4. While complying with AS-17, "Segment Reporting", banks are required to adopt the following:
  - i) The business segment should ordinarily be considered as the primary reporting format and geographical segment would be the secondary reporting format.

- ii)• Reported business segments should be 'Treasury', 'Corporate/Wholesale Banking', 'Retail Banking' and 'Other banking operations'.
- iii)• 'Domestic' and 'International' segments will be the geographic segments for disclosure.
- iv)• Banks may adopt their own methods, on a reasonable and consistent basis, for allocation of expenditure among the segments.

For the formats relating to the segment reporting disclosures, readers may refer to the above Master Circular.

5. *Related Parties:* Related parties for a bank are its parent, subsidiary(ies), associates/joint ventures, Key Management Personnel (KMP) and relatives of KMP. KMP are the whole time directors for an Indian bank and the chief executive officer for a foreign bank having branches in India. Banks need to report related party relationships and transactions between a reporting enterprise and its related parties. No disclosure is required in respect of related parties, which are "State-controlled Enterprises" as per paragraph 9 of Accounting Standard (AS) 18. Further, in terms of paragraph 5 of AS 18, transactions in the nature of Banker-customer relationship are not required to be disclosed in respect of Key Management Personnel and relatives of Key Management Personnel. Further, where there is only one entity in any category of related party, banks need not disclose any details pertaining to that related party other than the relationship with that related party. RBI has modified illustrative disclosure format recommended by the ICAI to suit banks. (AS-18, "Related Party Disclosures").

6. As regards disclosures in the 'Notes on Accounts' to the Consolidated Financial Statements (AS-21, "Consolidated Financial Statements"), banks may follow the general clarifications issued by Institute of Chartered Accountants of India from time to time. A parent company, presenting the CFS, should consolidate the financial statements of all subsidiaries - domestic as well as foreign, except those specifically permitted to be excluded under the AS-21. The reasons for not consolidating a subsidiary in CFS should be disclosed in the CFS. The responsibility of determining whether a particular entity should be included or not for consolidation would be that of the Management of the parent entity. In case, its Statutory Auditors are of the opinion that an entity, which ought to have been consolidated, has been omitted, they should incorporate their comments in this regard in the "Auditors Report".

7. Adoption of AS 22, "Accounting for Taxes on Income", may give rise to creation of either a deferred tax asset (DTA) or a deferred tax liability (DTL) in

the books of accounts of banks. This would give rise to certain issues, which have a bearing on the computation of capital adequacy ratio and banks' ability to declare dividends. In this regard RBI has clarified as under:

- (i)• DTL created by debit to opening balance of Revenue Reserves on the first day of application of the Accounting Standards 22 or to Profit and Loss account for the current year should be included under item (vi) 'others (including provisions)' of Schedule 5 - 'Other Liabilities and Provisions' in the balance sheet. The balance in DTL account will not be eligible for inclusion in Tier I or Tier II capital for capital adequacy purpose as it is not an eligible item of capital.
- (ii)• DTA created by credit to opening balance of Revenue Reserves on the first day of application of Accounting Standards 22 or to Profit and Loss account for the current year should be included under item (vi) 'others' of Schedule 11 'Other Assets' in the balance sheet.
- (iii)• The DTA computed as under should be deducted from Tier I capital:
  - DTA associated with accumulated losses; and
  - The DTA (excluding DTA associated with accumulated losses), net of DTL. Where DTL is in excess of the DTA (excluding DTA associated with accumulated losses), the excess shall neither be adjusted against item (i) nor added to Tier I capital.

8. A bank may acquire more than 20% of voting power in the borrower entity in satisfaction of its advances and it may be able to demonstrate that it does not have the power to exercise significant influence since the rights exercised by it are protective in nature and not participative. In such a circumstance, such investment may not be treated as investment in associate under AS 23, "Accounting for Investments in Associates in Consolidated Financial Statements". Hence the test should not be merely the proportion of investment but the intention to acquire the power to exercise significant influence.

9. Merger/ closure of branches of banks by transferring the assets/liabilities to the other branches of the same bank may not be deemed as a discontinuing operation and hence AS 24, "Discontinuing Operations", will not be applicable to merger / closure of branches of banks by transferring the assets/ liabilities to the other branches of the same bank. Disclosures would be required under the Standard only when:

- (i)• discontinuing of the operation has resulted in shedding of liability and realization of the assets by the bank or decision to discontinue an

operation which will have the above effect has been finalized by the bank;  
and

(ii)• the discontinued operation is substantial in its entirety.

10. With regards to Accounting Standard (AS) 25, "Interim Financial Reporting", the half yearly review prescribed by RBI for public sector banks, in consultation with SEBI, *vide* circular DBS. ARS. No. BC 13/ 08.91.001/ 2000-01 dated 17<sup>th</sup> May 2001 is extended to all banks (both listed and unlisted) with a view to ensure uniformity in disclosures. Banks may also refer to circulars DBS.ARS.No.BC.4/08.91.001/2001-02 dated October 25, 2001 and DBS.ARS.No.BC.17/08.91.001/2002-03 dated June 5, 2003 and adopt the format prescribed by the RBI for the purpose.

11. Other Accounting Standards - Banks are required to comply with the disclosure norms stipulated under the various Accounting Standards issued by the Institute of Chartered Accountants of India.

### 8.50 Other Disclosures:

- Disclosure as required under the Micro, Small and Medium Enterprises Development Act, 2006 (MSMED).
- The disclosure requirements in Section 22 of the MSMED Act requires any buyer, whose annual accounts are audited under any law for the time being in force, to furnish the following additional information in his annual statement of accounts.

8.51 The following details relating to Micro, Small and Medium Enterprises shall be disclosed in the notes:-

1. The principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year;
2. The amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year;
3. The amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006;

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

4. The amount of interest accrued and remaining unpaid at the end of each accounting year; and
5. The amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

### Corporate Social Responsibility (CSR)

8.52 As per Section 135 of the Companies Act, 2013, a CSR committee has been formed by the Company. The funds are utilized throughout the year on the activities which are specified in Schedule VII of the aforesaid Act. Gross Amount required to be spent by the company during the year – XX crores.

The areas of CSR activities and contributions made thereto are as follows –

Particulars	In cash	Yet to be paid in Cash	Total
Amount spent during the year on – 1)• Construction/ Acquisition of any assets 2)• For purposes other than (1) above: (Specify)			

For detail guidance, refer “Guidance Note on Accounting for Expenditure on Corporate Social Responsibility Activities”, issued by ICAI in May, 2015.

### Priority Sector Lending Certificate (PSLC)

8.53 Bank shall report the amount of PSLCs (category-wise) sold and purchased during the year in the ‘Note to Accounts’ as mandated by the RBI in circular RBI/2015-16/366 FIDD.CO.Plan.BC.23/04.09.01/2015-16 as follows:-

S.No.	Type of PSLCs	Representing	Counting for
1.	PSLC Agriculture	- All eligible Agriculture loans except loans to SF/MF for which separate certificates are available	Achievement of agriculture target and overall PSL target

## Disclosure Requirements in Financial Statements

2.	PSLC - SF/MF	All eligible loans to small/marginal farmers	Achievement of SF/MF sub-target, agriculture target and overall PSL target
3.	PSLC - Micro Enterprises	All PSL Loans to Micro Enterprises	Achievement of micro-enterprise sub-target and overall PSL target
4.	PSLC - General	The residual priority sector loans i.e. other than loans to agriculture and micro enterprises for which separate certificates are available	Achievement of overall PSL target

### Contingent liabilities

8.54 Movement of provisions against contingent liabilities:

Particulars	Current Year	Previous Year
Opening Balance		
Additions during the year		
Amount utilised during the year		
Unused amount reversed during the year		
Closing balance		

### Inter Office Accounts

8.55 Status of reconciliation of Inter Office Accounts between branches, controlling offices, zones and head office should be commented in "Notes to Accounts" and material effect if any on the profit and loss account.

### Counter Cyclical Provisioning Buffer (CCPB)

8.56 Banks should disclose in its "Notes to Accounts" any Utilisation of Floating Provisions/Counter cyclical Provisioning Buffer as per RBI circular No. DBR.No.BP.BC.79/21.04.048/2014-15 dated March 30, 2015 on 'Utilisation of Floating Provisions/Counter Cyclical Provisioning Buffer' has allowed the banks, to utilise up to 50 per cent of CCPB held by them as on December 31, 2014, for

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

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making specific provisions for Non-Performing Assets (NPAs) as per the policy approved by the Bank's Board of Directors.

**Movement of Reward Points**

<b>Particulars</b>	<b>Reward points on Debit Card</b>	<b>Reward points on Credit Card</b>	<b>Total</b>
Opening Balance			
Add: Reward points accrued during the Year by Customers			
Less: Reward Points availed by customers			
Less: Reward Points Expired			
Closing balance			

# III-9

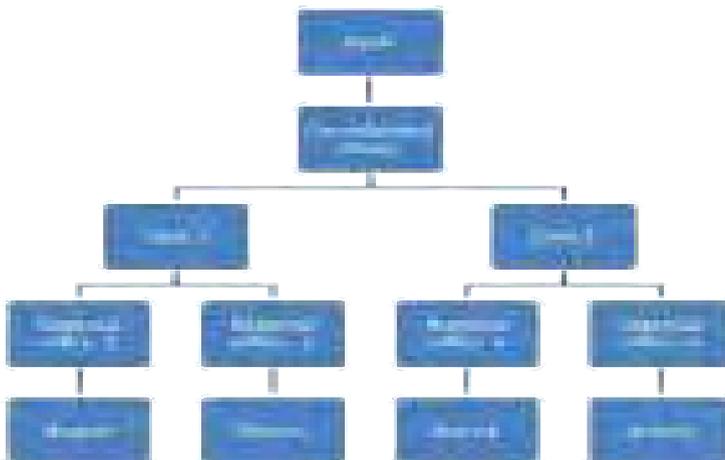
## Consolidation of Branch Accounts•

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9.01 Consolidation of branch accounts (audited and unaudited) is one of the important and sensitive aspect of the financial statements of a bank. Preparation of the consolidated financial statements of the bank as a whole (after consolidation of accounts of branches) is the responsibility of the bank's management. RBI *vide* its Circular No DBOD.No.BP.BC.72/21.04.018/2001-02 dated February 25, 2003 has issued guidelines to banks on consolidated accounting and other quantitative methods. The following documents are consolidated:

- Balance Sheets;
- Profit and Loss Accounts;
- LFAR (Long Form Audit Report);
- Ghosh Committee compliance checklists;
- Jilani Committee compliance checklists;
- Tax Audit reports;
- Other various reports like Assets classification, fixed assets, bills payable, sundries, credit subventions, etc.

### Process of consolidation



9.02 The consolidation process starts from the Branch level and the accounts of branches get consolidated at the respective regional office and all regional offices get consolidated at respective Zonal office and all zonal offices get consolidated at Head Office. The procedures regarding consolidation of accounts vary from bank to bank, in some banks mostly in a private sector the entire consolidation work gets done at the head office.

Bank managements generally follow the below mentioned process for the purpose of consolidation:

### **Step 1**

#### ***Back up of the Financial Statements as on 31<sup>st</sup> March***

9.03 At the year-end i.e., 31<sup>st</sup> March, the bank takes the backup of financial data and keeps the same on different software. This data is given for audit purpose to the statutory auditor.

### **Step 2**

#### ***Effect of Memorandum of Changes (MOC)***

9.04 There are two types of financial statements, Pre-MOC, i.e., the original data and Post-MOC, i.e., after giving the effect of accounting entries suggested by the central statutory auditor (which is known as MOC). The MOC are not fed in the live data but are recorded on a different software (e.g., ROSS, ADF) at all levels like Branches, Region, zone and Head office. All the banks have different mechanism of posting the effects of the MOC's in the financials statement. Like for e.g. in few banks all MOC suggested at branches get consolidated and recorded at Controlling Offices (Regional / Zonal / Circle offices) and MOC of Controlling Offices gets consolidated at the Head Office.

In this way, the effect of MOC at all levels of bank gets recorded in the parallel software e.g. ROSS, ADF. For making any changes in the financial statement there has to be an MOC approved by the SBA/ACA. Therefore, there will be an MOC for difference between Pre-MOC financial statements and Post-MOC financial statements.

#### ***Accounting of MOC effect in live data***

9.05 After the financial statements get approved and signed with all changes the MOCs gets accounted in live data. For example, the financial statements for the financial year 2017-18 gets approved and signed on 30<sup>th</sup> April, 2018, then on that day or on any other day with value date of 30<sup>th</sup> April, 2018, all MOCs will be accounted in the live data in CBS. Thus, if an account is marked as NPA by way

of MoC during the audit, the same would be effected as NPA in the system from that day with date of NPA being the one suggested as per MoC.

### **Step 3:**

#### **Controlling Office (CO)**

9.06 *Process:*

1. Branches depending on the limits prescribed can be either audited branches or unaudited branches.
2. At the branch level the audited financial statements as well as unaudited financial statements signed by Bank manager is uploaded in the system and consolidated data is generated at regional office level.
3. Controlling office accounts get consolidated and also adjustments if any are made at regional level. The Controlling Office is a cost centre and the auditor has to certify the financial statements of the Controlling Office in addition to the consolidation of the Branches under the relevant Controlling Office.

#### **Audit Approach:**

1. Statutory Central Auditor (SCA) for a CO must verify the completeness of the data uploaded by the branches into the system.
2. SCA on sample basis must also verify the completeness of the data.
3. SCA should obtain reasonable assurance and sufficient appropriate audit evidence of the adjustments made if any at the Controlling office level.
4. SCA should also check the arithmetic accuracy of the number of financial statements to be uploaded at Controlling office level.
5. SCA may communicate to the SBAs, the requirements regarding process of consolidation for the current year, about the significant observations from the previous year's audit, quarterly reviews and additional precautions, modifications in Audit Program required considering the recent RBI Circulars. This communication can be circulated along with the closing instructions to SBAs.
6. SCA should ensure on sample basis if all the documents as required by the respective banks have been taken at each level of consolidation i.e. appropriate flow of data along with the required documents.

#### **Head Office**

9.07 *Process:*

At Head Office level all the Controlling office data is consolidated and further adjustments if any is made, ensuring the accuracy of the data uploaded at each stage of hierarchy.

***Audit Approach to be followed by Bank Consolidating Auditor:***

1. The consolidating Auditor must ensure the completeness as well as accuracy of the data at the bank as a whole.
2. Auditor should obtain reasonable assurance and sufficient appropriate audit evidence of the adjustments made if any at the Bank level.

9.08 The SCA should also examine the following key additional aspects;

- a. Reversal of interest on inter-branch balances and other similar items.
- b. Cancellation of transfers of assets among branches.
- c. Review of observations made by the SBAs in audit report and LFAR.
- d. Review of the various audited and unaudited returns.
- e. Effect of Memorandum of Changes (MOC).

Review of MOCs so as to ascertain whether there are systemic issues or deficiencies which need to be addressed by the management.

***IT Controls***

9.09 There is a significant and voluminous data involved during this whole process of consolidation. Consolidation being a system oriented process, auditor must verify if the IT controls of the bank are effective.

***Consolidation of Overseas Branches***

9.10 While consolidating the overseas branches the auditor should examine the following aspects:

- a. The various reports of the overseas branches would be received in the local currencies of the reporting countries which need to be converted into the Indian currency.
- b. The effect of reinstatement of assets and liability which is given in Accounting standard 11, The Effects of Changes in Foreign Exchange Rates. RBI has also issued a circular for compliance of AS 11. DBOD.BP.BC.No.76/21.04.018/2005-06) dated April 5, 2006.
- c. Foreign exchange gain and loss.

- d. • As per AS 11 (revised 2003), the method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise. For this purpose, foreign operations are classified as either "integral foreign operations" or "non-integral foreign operations".
- e. • In terms of its circular no DBOD.BP.BC.76/ 21.04.018/2004-05 dated March 15, 2005, the RBI has prescribed that with the issuance of the said circular, there should normally be no need for any statutory auditor for qualifying financial statements of a bank for non-compliance with Accounting Standard 11 (revised 2003). Whenever specific difference in opinion arises among the auditors, the statutory central auditors would take a final view. Continuing difference, if any, could be sorted out in prior consultation with RBI, if necessary.
- f. • The auditor may also review the compliance with the applicable local laws and regulations of the concerned country by the overseas branches.
- g. • As advised by ICAI, statutory auditor has to give the total number and amount of debits/ credits arising pursuant to the Memorandum of changes submitted by them in their audit reports under the "Other Matters Paragraph".

9.11 The auditor should furnish the statement of Adjustments for non-uniform accounting policies.

# III-10

## Consolidation of Financial Statements

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10.01 The RBI, in its requirement of disclosures in Financial Statements has included AS 21: Consolidated Financial Statements (CFS) that includes consolidated Balance Sheet, consolidated Profit and Loss Account & notes, explanatory material that form an integral part thereof and also consolidated cash flow statements.

10.02 Consolidated Financial Statements are presented for a group of entities under the control of a parent. A parent is an entity that has one or more subsidiaries. For the purpose of CFS it may be noted that if a parent does not have subsidiary but has investment in associates and joint ventures, it will be required to prepare CFS. However, for the purpose of quarterly reporting under SEBI guidelines, CFS will not be necessary if the parent does not have subsidiary but has investments in associates and joint ventures. For the purpose of this guidance a parent would mean a Consolidating Bank.

### Responsibility of a Bank

10.03 The responsibility for preparation and presentation of CFS is that of the Bank. This responsibility, *inter alia*, includes:

1. Identifying components including financial information.
2. Identifying reportable segments.
3. Identifying related party transactions.

### Responsibility of the Statutory Central Auditor

10.04 It is necessary for the auditor to take into consideration the accounting standards relevant for the purpose of CFS. They are AS 21: Consolidated Financial Statements, AS 23: Accounting for Investments in Associates in Consolidated Financial Statements and AS 27: Financial Reporting of Interests in Joint Ventures. Further, careful consideration should be given by the auditor of CFS to Other Matters paragraph, Emphasis of Matter paragraph, Modified Opinion in the report issued by the component auditors.

In addition to the Accounting Standards, it is pertinent for an auditor to consider the relevant accounting and auditing Guidance Notes.

10.05 When the parent's auditor decides to make a reference to the auditor's report of the other auditors in the auditor's report on CFS, the latter should disclose clearly the magnitude of the portion of the financial statements audited by the other auditor(s). This may be done by stating the rupee amounts or percentages of total assets and total revenue of subsidiary(ies) included in CFS not audited by the parent's auditor. However, reference in the report of the auditor of CFS to the fact that part of the audit of the group was made by other auditor(s) is not to be construed as a modification of the opinion. The auditor should also consider implications on reporting if some of the components are unaudited<sup>13</sup>.

10.06 Generally, while conducting audit of a bank, SCA has a practice of issuing general instructions for the SBAs to facilitate easy consolidation of branch accounts. It would be appropriate to have a similar approach with respect to auditors of components, if the component auditors are different from the group auditor. This is especially important in case of "the other financial information" which is necessary for the purpose of consolidation and preparation of notes. It is advisable to make sufficient arrangements for co-ordination and efforts at the planning stage.

### **Audit of CFS**

10.07 Audit of CFS needs to be planned properly with regards to following aspects:

1. Accounting policies of Bank and its various components. It is very much probable that the policies of the components may differ from each other depending upon the respective business lines.
2. Auditor should obtain list of all the subsidiaries, associates and joint ventures of Bank, whether to be included under CFS or not. Any entity that has been kept outside CFS should be carefully examined for its exclusion with respect to the relevant statute. At this stage it is important to note that the ownership of the voting rights does not necessarily qualify for the purpose of CFS. It would be necessary to understand the concept of the control of the enterprise. If the auditor establishes that the bank exercises control over the entity in spite of minor shareholding by virtue of control over the composition of board of directors/governing body, such enterprise would qualify for CFS. There would be many other ways to exercise the control.

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<sup>13</sup> Attention in this regard is drawn to the Announcement on "Manner of Disclosure in the Auditor's Report of the Fact of Inclusion of Unaudited Financial Statements/ Information of Component/s in the Financial Statements Audited by the Principal Auditor(s)" issued by ICAI in February, 2014.

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

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To verify the same, it is advisable that the auditor verifies the board minutes, shareholder agreements entered into by the bank with the other entities, the various business agreements such as technology and knowhow supply, or enforcement of statute as the case may be. The auditor would need to exercise professional judgment to determine the control in such cases.

3. The auditor should identify the changes in the shareholding that might have taken place since the last audit.
4. Following transactions require attention for current period consolidation adjustments:
  - a) Intra group interest/management fees paid and received.
  - b) Unrealized intra group profits on assets acquired within the components.
  - c) Intra group indebtedness, including non-fund based exposures.
  - d) Adjustments relating to harmonizing different accounting policies within the group.
  - e) Adjustments made for the effects of the significant transaction or event that occur between the date of financial statement of the bank and one or more of the components, if they follow different financial reporting dates.
  - f) Determination of movement of equity attributable to minority since the date of subsidiary.
  - g) In case of step acquisition, appropriate adjustments need to be carefully audited.
  - h) Further due care be taken in respect of impairment of goodwill in addition to review of net worth and profit reconciliation to ensure completeness of consolidation exercise.
5. As far as possible the formats of the financial statements and cash flows used for the purpose of bank's individual financial reporting should be used for the CFS. In case the subsidiaries/joint venture accounts are prepared as per different regulation such as IRDA etc., the auditor should be careful while converting the same in format prescribed by Banking Regulation Act. The auditor, wherever possible should obtain the certified "Fit-for-consolidation" financial statements duly certified by the respective Statutory Auditors of Subsidiaries/Joint Venture.
6. The auditor should examine that the financial statements used in the consolidation are drawn up as of the same reporting date. If that is not

possible, AS 21 allows adoption of six month old balance sheet of subsidiaries and prescribes that adjustments shall be made for the effects of significant transactions or other events that have occurred during the intervening period. In case that the balance sheet dates of parent and subsidiaries are different, inter-group netting shall be done as on the balance sheet date of the parent entity. The bank shall ensure completion of statutory audit of the accounts of such subsidiaries before consolidation with the parent's accounts.

7. The SCAs should examine that the CFS is prepared using uniform accounting policies for like transactions and other events in similar circumstances. If it is not practicable to do so, that fact shall be disclosed together with the proportions of the items in the CFS to which the different accounting policies have been applied. For the purpose of preparing the CFS using uniform accounting policies, the banks shall rely on a Statement of Adjustments for non-uniform accounting policies, furnished by the Statutory Auditors of the subsidiaries.
8. In cases where different entities in a group are governed by different accounting norms laid down by the concerned regulator for different businesses, the bank shall use for consolidation purposes the rules and regulatory requirements applicable to the banks in respect of like transactions and other events in similar circumstances. In situations where regulatory norms have not been prescribed by RBI, the norms as applicable according to the accounting standards may be followed.
9. For the purpose of valuation, the investments in associates (other than those specifically excluded under AS 23) shall be accounted for under the "Equity Method" of accounting in accordance with AS 23 which shall be examined by the auditor.
10. The valuation of investments in subsidiaries which are not consolidated and associates which are excluded under AS 23, shall be as per the relevant valuation norms issued by the Reserve Bank of India. The valuation of investments in joint ventures shall be accounted for under the 'proportionate consolidation' method as per AS 27. The banks may take into account the provisions of the accounting standards relating to the exclusion of subsidiaries, associates or joint ventures from consolidation under specific circumstances. This aspect shall be examined by the auditor.

## Management Representations

10.08 SA 580, "Written Representations" requires the auditor to obtain written representations from management and where appropriate those charged with

governance. Such representations would include:

- a)• Completeness of components included in the CFS.
- b)• Identification of reportable segments for segment reporting.
- c)• Identification of related parties and related party transactions for reporting.
- d)• Appropriateness and completeness of consolidation adjustments, including the elimination of intra-group transactions.

# III-11

## Inter-Office Transactions•

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11.01 Inter-office transactions mostly take place at branches. The balances can be debit balance or credit balances in Balance Sheet of the branches. Branches have number of transactions amounting to large sums with the other branches and controlling office, hence it becomes very important to monitor the same. It is the responsibility of the bank to reconcile their transactions on a daily basis and keep a track on un-reconciled transactions.

11.02 Followings are the major transactions which occur between branches and Head office.

- a. • Issue of remittance instruments like drafts/TTs/MTs on other branches.
- b. • Payment of remittance instruments like drafts/TTs/MTs drawn by other branches.
- c. • Payment to / receipts from other branches of the proceeds of instruments received/sent for collection /realization/clearing.
- d. • Payments made under LCs of other branches.
- e. • Cash sent to/received from other branches.
- f. • Payment of instruments like gift cheques/ banker's cheques/ interest warrants/ dividend warrants/repurchase warrants/refund warrants / travelers cheques, etc. which are paid by the branch on behalf of other branches which have received the amount for payment of these instruments from the customers concerned.
- g. • Head office interest receivable and payable by the branches.
- h. • Profit/loss transferred by the branch to head office.
- i. • Government receipts and payments handled by the branch either as the nodal branch or as an agent of the nodal branch.
- j. • Operations by the authorised branches on the bank's NOSTRO accounts.
- k. • Foreign exchange transactions entered into by the branch for which it has to deal with the nodal forex department of the bank for exchange of rupees with foreign currency.
- l. • Deposits into and withdrawal of money, by branches into currency chest maintained by another branch.
- m. • Gold Banking Transactions at the branch on behalf of nodal branches.

- n. Transactions through NEFT, RTGS, NACH, UPI, etc.
- o. ATM transactions of the customer either at ATM linked with other branches or with merchant establishments.
- p. Internet based transactions other than inter-account transfers with the same branch.
- q. Credit card related transactions of the customers.
- r. Control Accounts of Indian Branches maintained with Overseas Branches of the bank.
- s. Capital Funds with the Overseas Branches.
- t. Head Office balances with the overseas branches including subordinated debt lent to the overseas branches.
- u. Service Tax transactions advises to Nodal branches where Service Tax remittance is made where Service Tax is remitted on behalf of other branches within their fold.

11.03 Following are the most common types of errors observed in inter branch transactions.

- Wrong identification of the nature of transaction.
- Recording of particulars in incorrect fields.
- Wrong accounting of bank charges, commission, etc.
- Errors in writing the amounts.
- Incorrect branch code numbers.
- Incorrect schedule numbers.
- Recording the same transaction twice.
- Difference between the closing and opening balances in successive daily statements.
- Squaring off the transaction by same amount without checking the transactions.
- Forced matched transactions

11.04 Banks generally have a separate department to deal with the process of reconciliation of inter branch transactions. Following is the generally followed reconciliation process.

- Each branch submits the transaction statement (can be also generated through CBS System) in the prescribed format. RBI has advised the banks (vide its circular dated April 28, 1993) to segregate inter-branch

transactions relating to demand drafts from other inter-branch transactions. Further, vide its circular no. DBS.CO.SMC.BC No. 28/22.09.001 dated 20<sup>th</sup> August, 1998, RBI has directed the banks to introduce the system of segregating DD/TT/MT transactions, with reconciliation at weekly intervals and close monitoring of large amounts.

- On receipt of the statement, reconciliation department scrutinizes the data like opening balance, account heads etc. and rectify the same for any error in data.
- After rectifying the error, the same are fed into the system.
- As and when the other branch settles the funds transfer transaction in its books (by way of payment of draft/traveller's cheques, etc. or by acting on the advices received under the inter-branch account mechanism), it advises the details of these transactions like the netting reference number, account currency, foreign currency amount, local currency amount, event, reporting branch code no., date of transaction at the reporting branch, type of transaction, draft no., etc., to the reconciliation department.
- Some of the transactions do not reconcile due to incorrect data entry or non-accounting of transactions by other branch, which might indicate fraud if debit transaction in one branch does not have corresponding credit effect in other branch.

The total number of inter-branch transactions makes their reconciliation a tedious task. Lack of reconciliation causes this account to be susceptible to frauds. Recognizing this, RBI has taken a number of measures to achieve an expeditious reconciliation of these transactions by the banks concerned. Non-reconciliation results in a 'fraud risk factor' as defined in SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements". This Standard further provides that in such situation, the auditor needs to modify his audit procedures to reduce the effect of the constituents of fraud risk.

In all inter-office transactions, one branch originates a transaction (called the 'reporting branch' or the 'originating branch') and the other branch (called the 'responding branch') settles the transactions at its end.

11.05 Many Banks have the concept of 'Service Branches' for such inter branch transactions. These Service Branches exclusively provide the following services:

- a. They act as agents for the other branches of the bank for collection of instruments drawn on local branches of other banks (Clearing).
- b. To centralise the payment of drafts drawn by other outside branches.

## **Audit Approach**

11.06 Inter branch account has been very sensitive area and can prove to be problematic or prone to errors and frauds. The Auditor should review the system of operation for such sensitive account. Several times it has been observed that there are old entries in such accounts due to migration issues. The auditor should check thoroughly the details of such entries with their ageing and also the improvement in settlement of the entries on a periodic basis by the Bank including its reporting to the appropriate higher authorities at regular intervals. Such old entries have been noticed between the Treasury Branch and other Branches/ Head Office.

- Every bank has its own procedures and methodology for inter branch transactions hence it is very important for the auditor to understand the procedure followed by the bank for recording inter-branch transactions. The procedure followed by the bank for maintaining inter-branch transactions should be as per the RBI requirements.
- RBI has directed banks to introduce the system of segregating DD/TT/MT transactions, with reconciliation at weekly intervals and close monitoring of large amounts vide its circular no. DBS.CO.SMC.BC No. 28/22.09.001 dated 20th August, 1998.
- Banks have to provide 100% provision against the net debit balance arising out of the un-reconciled entries outstanding for more than 6 months in the inter-branch account, from the year ending March 31<sup>st</sup>, 2004 vide RBI circular no. DBOD No. BP.BC. 73 /21.04.018/2002-03 dated 26<sup>th</sup> February, 2003.
- As per RBI Circular from 1<sup>st</sup> April 1999, banks should maintain category wise/Head wise accounts of various types of transactions under inter branch accounts and the netting off the transactions should be done on category wise, hence the net debit in one category is not to be set-off against net credit in another category.
- Banks have been advised by RBI to segregate the credit entries outstanding for more than five years in inter-branch accounts and transfer them to a separate Blocked Account which should be shown in the balance sheet under the head 'Other liabilities and provisions–Others' (Schedule 5). While arriving at the net amount of inter-branch transactions for inclusion in the balance sheet, the aggregate amount of Blocked Account should be excluded and only the amount representing the remaining credit entries

should be netted against debit entries. Banks have been advised that any adjustment from the Blocked Account should be permitted only with the authorisation of two officials, one of whom should be from outside the branch concerned, preferably from the controlling/head office if the amount exceeds Rs.1 lakh.

- There are some transactions like dividend warrant, interest warrant, refund order etc. which required special attention because in the recent past number of transactions has been reported by the bank in these groups. In these transactions the funds are deposited at one branch and payments take place at many branches. Hence to prevent the frauds the outstanding balances of these accounts should be checked with professional skepticism.
- Auditor should review all material transactions accounted in inter-branch account just before the year end and where required, request the bank management to rectify the same by accounting in the correct account head.
- The auditor should cautiously review all material transactions outstanding in inter branch account even if it is outstanding for more than 6 months for which 100% provision is made.
- The auditor should check all adjustments in the account and ensure that the adjustments are done properly and supported by adequate documentary evidence as to its validity. Auditor should also verify that the reversal entries are made under proper authority and after due explanation and evidence.
- The account should be adjusted only on the basis of advices and not on the strength of entries found in the statement of account received from other branches.
- Prompt action should be taken preferably by central authority, if any entries particularly debit entries are not responded to any branch within a reasonable time.
- The auditor should report on the year end status of inter branch accounts indicating the dates upto which all or any segments of accounts have been reconciled. The auditor should also indicate the number and amount of outstanding entries in the inter branch accounts, giving the relevant information separately for debit and credit entries. The auditor can obtain the relevant information primarily from branch audit reports.

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

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- Normally Inter-branch accounts are reconciled at HO and unreconciled entries are sent to originating branches for their response. Branch auditor is expected to check whether such responses are sent promptly. The branch auditors are also expected to certify the amount pending under such accounts as part of the year end closing.
- Branches must ensure to respond the entries in Inter Branch Transaction System (IBTS) at the earliest. Items of revenue nature such as travelling expenses bills, and any other expense/income item should not be allowed to float in Inter Branch Transaction System (IBTS) for a longer period.
- Nostro Accounts at branch - Branches should also prepare reconciliation statement (REC) relating to those accounts for each of the Foreign Offices or Foreign Correspondents, as the case may be for examination by SBAs.

# **PART - IV**

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# IV-1

## Long Form Audit Report in Case of Banks

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1.01 The statutory auditors should address their Long Form Audit Report ('LFAR') to the Chairman of the bank concerned and also a copy thereof should be forwarded to the designated office of the RBI. Many of the matters to be dealt with by the statutory auditors in their LFARs are, normally, based on the LFARs received from the branch auditors. In dealing with such matters, the statutory auditors are expected to make their observations on the basis of review of branch auditors' LFARs.

1.02 Where any of the comments made by the auditor in his LFAR is adverse, the auditor should consider whether a qualification in the main report is necessary. It should not, however, be assumed that every adverse comment in the LFAR would necessarily result in a qualification in the main audit report. In deciding whether a qualification in the main report is necessary, the auditor should use his professional judgement having regard to the facts and circumstances of each case.

1.03 Where the auditors have any reservation or adverse remarks with regard to any of the matters to be dealt with in their LFARs, they should give the reasons for the same.

1.04 The matters to be dealt with by the statutory auditors in their LFARs are discussed in the following paragraphs.

### I. Advances

1.05 Lending activities constitute an important part of a bank's operations. The statutory auditors are expected to offer their comments on various aspects of lending activities in their LFARs. The format of LFAR requires the statutory auditors to offer their comments on the following aspects:

a., Credit policy	e., Review / Monitoring / Supervision
b., Credit appraisal	f., Recovery Policy in respect of Bad / Doubtful Debts/NPAs
c., Sanctioning / Disbursement	g., Large advances
d., Documentation	

1.06 The statutory auditors are expected to offer their comments on the adequacy and effectiveness of the internal control systems relating to the above aspects of credit administration. In order to form an opinion on these matters, the statutory auditors would also need to consider the branch auditors' LFARs. In cases where sanctions are accorded otherwise than at the branch level (i.e., by higher / Controlling Authorities), the auditors should carry out, on a selective basis, an examination of the specified matters at the head office and / or other controlling offices of the bank.

1.07 Every bank usually has a written manual of instructions which describes in detail the procedures to be followed for executing various types of transactions and also lays down limits on delegated powers in respect of various operations of the bank. The auditor should examine such manual of instructions and report his views as to the adequacy of the relevant instructions in the LFAR. Further every bank will have its own limits above which the instances of observations be attached to LFAR comments. It would be prerogative of the auditors to revise these limits in consultation with the Management.

1.08 Further, as per the "Master Circular – Loans and Advances – Statutory and Other Restrictions" dated July 1, 2015, DBR.No.Dir.BC.10/13.03.00/2015-16 issued by the RBI, all banks are required to frame "Fair Practices Code for Lenders" based on the Guidelines contained in this Master Circular. The Fair Practices Code Covers areas, such as, applications for loans and their processing, loan appraisal and terms / conditions, disbursement of loans including changes in terms and conditions, post disbursement supervision, general aspects, etc. Further, RBI *vide* its circular no. DBOD. Leg. BC. 61 /09.07.005/2010-11 dated November 12, 2010 on "Guidelines on Fair Practices Code for Lenders – Disclosing all information relating to processing fees / charges" requires the banks to disclose 'all in cost' inclusive of all such charges involved in processing / sanction of loan application in a transparent manner to enable the customer to compare the rates / charges with other sources of finance. It should also be ensured that such charges / fees are non-discriminatory.

### **Credit Policy**

1.09 In respect of loan policy, the auditor is expected to give his observations on –

- , *Existence of Loan Policy – specifying the prudential exposure norms, industry-wise exposures, regular updation of the policy, system of monitoring and adherence thereto.*

1.10 Each bank has its own policy for sanctioning, disbursing, supervising and renewing loans. The policy usually includes the terms and conditions for granting loans, limits upto which loans may be disbursed to individual clients, industry wise exposure, i.e., different exposure limits for different industries, etc. The policy should specifically include the prudential norms given by the RBI. The auditor should report whether the policy is in existence and the same is regularly updated depending on the guidelines issued by the RBI. The Master Circular on “Loans and Advances – Statutory and other Restrictions”, DBR.No.Dir.BC.10/13.03.00/2015-16 dated July 1, 2015, provides a framework of the rules / regulations / instructions issued to Banks on statutory and other restrictions on loans and advances. The Master Directions on “Lending to Micro, Small & Medium Enterprises (MSME) Sector”\_RBI/FIDD/2017-2018/56 Master Direction FIDD.MSME & NFS.12/06.02.31/2017-18, July 24, 2017 (updated as on April 25, 2018), contains guidelines / instructions / directives issued by the RBI to banks in regard to matters relating to lending to Micro, Small & Medium Enterprises sector. The auditor should also enquire whether there is any system followed by the bank for regularly monitoring the policy laid down by the bank.

### **Credit Appraisal**

1.11 In respect of credit appraisal, the auditor is expected to give his observations on –

- , *Existence of a well-laid system of appraisal of loans / credit proposals, including adequacy of information for appraising the creditworthiness of the applicant, and adherence thereto.*

1.12 Credit appraisals require a detailed analysis of the borrower's or, counterparties financial position and debt-servicing ability, a thorough understanding of their background and the purpose of the credit and an evaluation of the collateral pledged, if any. The auditor should review the system of credit appraisal followed by the bank. The auditor should examine whether the system facilitates a proper evaluation of the credit risk. In order to facilitate collection and analysis of all the relevant data for evaluating creditworthiness of a prospective borrower, banks generally use standardised loan application forms. The factors considered in evaluating loan applications normally include the purpose of loan, prospects of the business, the sources and period of repayment (in case of term loans), the borrower's stake and

security, etc. Further, information in the form of financial statements, costing analyses, market information, External Rating, tax status, project reports (in case of new projects), etc., is also usually obtained from prospective borrowers and analysed.

1.13 The auditor should also satisfy himself that the system of credit appraisal is actually in force. For this purpose, the auditor should review the relevant observations of the bank's branch auditors contained in their LFARs. Where the auditor has serious reservations about the quality of credit appraisal, he may also give his observations in this regard. The auditor may specify:

- (i) instances of quick mortality vis-à-vis comments related with the credit appraisal process or on stand-alone basis;
- (ii) instances of frequent short reviews / adhoc and ToD limits sanctioned including roll-overs of short term advances.

### **Sanctioning/Disbursement**

1.14 In respect of sanctioning / disbursement of advances, the auditor is expected to comment on –

- , *Delegation of powers / authority at various levels; adherence to authorised limits; whether limits are disbursed after complying with the terms and conditions of sanction.*

1.15 The auditor should familiarise himself with the system of sanctioning and disbursement of advances. He should also familiarise himself with the relevant directives of RBI. Normally, the system in a bank provides for limits on the sanctioning powers of authorities at various levels. The auditor should examine the documents prescribing such limits, e.g., operation manual, circulars from head office, etc. Where the branch auditors' reports indicate cases of credit facilities sanctioned beyond the aforesaid limits, the auditor should draw attention to this fact in his LFAR. The auditor should also examine the branch auditors' report to ascertain whether such cases have been promptly reported to higher authorities as per the procedure laid down in this regard. If not, the auditor should report the fact, giving illustrations of non-compliance with the laid down procedure in his LFAR.

1.16 The auditor should also review the sanctions made at different levels. For this purpose, the auditor should randomly select a sample of sanctions made at various levels and review whether the procedure laid down for the

concerned level has been followed. Where the auditor has serious reservations about any of the aspects thereof, he should give his observations in this regard in his LFAR. Where the branch auditors' reports indicate cases where limits have been disbursed without complying with the terms and conditions of the relevant sanctions or cases of frequent overdrawing beyond sanctioned limits, the auditor should state this fact in his LFAR, giving illustrations.

### Documentation

1.17 The auditor is expected to comment on the following aspects of documentation in respect of advances:

- , *System of ensuring that documents are executed as per the terms of sanction.*
- , *Nature of documentation defects observed during audit and suggestions to avoid such defects.*
- , *System of documentation in respect of joint/consortium advances.*
- , *Renewal of documents.*

1.18 Generally, the system of a bank prescribes the specific documents to be executed in respect of various types of credit facilities, including special documentation required in cases of consortium advances, advances to companies, statutory corporations and government undertakings, etc. It may be noted that in case of consortium advances, original documents are held by the lead bank, however, copies of such documents are available with each of the participating banks. Banks also usually have a system of renewal of documents and of periodically obtaining confirmation of balances to ensure that the documents do not become time-barred.

1.19 The auditor should review the system of obtaining the loan documents, including renewal thereof. He should examine whether the system provides for obtaining all such loan documents which are required to protect the interests of the bank.

1.20 Where the branch auditors' reports indicate cases of credit facilities accorded without proper documentation, the auditor should state this fact in his report, giving illustrations.

1.21 The auditor is also required to comment on the nature of documentation defects observed during the audit and to make suggestions to avoid such defects. The auditor can obtain the relevant information substantially from the branch audit reports and from records maintained at the head office / regional or zonal offices of the bank.

## **Review/ Monitoring/ Supervision**

1.22 In respect of review, monitoring and supervision of advances, the auditor is required to comment on the following aspects:

- , Periodic balance confirmation / acknowledgement of debts.
- , Receiving regular information, Stock / Book Debt statements, Balance Sheet, etc.
- , System of calculation of drawing power in adherence with RBI guidelines.
- , System of inter-changeability of limits with special attention to instances wherein the same is warranted due to devolvement of LC / BG.
- , System of revision of rate of interest whenever there is a change in base rate.
- , Receiving audited accounts in case of (non-corporate) borrowers with sanctioned limits beyond limits set by the bank in this regard.
- , System of scrutiny of the above information and follow-up by the bank.
- , System of periodic physical verification or inspection of stocks, equipment and machineries and other securities.
- , System of identification of substantial deterioration in value of security. (primary as well as collateral)
- , System and periodicity of stock audits.
- , System of obtaining of Diligence Report.
- , Inspection reports and their follow-up.
- , Norms and awarding of Credit Rating.
- , Review / renewal of advances including enhancement of limits.
- , Monitoring and follow-up of overdues arising out of other businesses such as leasing, hire purchase, credit cards, etc.
- , Overall monitoring of advances through maturity/ aging analyses; Industry-wise exposures and adherence to the Loan Policy.
- , System of monitoring of off-balance sheet exposures including periodic reviews of:
  - (a) claims against the bank not acknowledged as debts.
  - (b) letters of credit.

- (c) guarantees.
- (d) ready forward transactions.
- (e) co-acceptances.
- (f) swaps, etc.
- , The auditor should examine whether the internal credit rating system has linkage with pricing of advances with various products.
- , System of monitoring of unhedged foreign currency exposure and adequacy of provisioning thereof.
- , System of classification, monitoring, reporting and provisioning, if required of loan accounts in 3 categories as special mention accounts and reporting thereof to CRILC.
- , Manual intervention, if any, in automated system of identification and classification of advances.
- , System of upgradation of accounts.

1.23 Generally, banks have a system of periodic review of each advance. The primary purpose of such a review is to ensure that the assumptions on the basis of which the loan had been sanctioned continues to hold good; the loan is used for the purpose for which it was sanctioned and in case of deviation in respect of any aspect of the sanction, approval of appropriate authority has been obtained; the project has been implemented as per the approved lines; there are no unexplained overruns in cost of the project; the borrowing unit is functioning properly; the stipulated instalments/interest are being paid regularly and promptly and, in case of default or delay in payment, the reasons are looked into; the terms and conditions of the loan, particularly restrictive covenants, are being duly complied with; the required margins have been maintained in the account at all times; the properties mortgaged/hypothecated/pledged are maintained in good order by the borrower and adequately insured, etc. The auditor should examine whether the system of periodic review is functioning effectively. He should review the LFARs given by the branch auditors to identify any weaknesses in the design of the system and in its implementation.

1.24 The auditor should examine whether there is an effective system of obtaining confirmations / acknowledgement of debts periodically. For this purpose, the auditors should also review the branch audit reports.

1.25 The RBI has issued a circular (dated October 21, 2002) advising all scheduled banks to have the Board fix a suitable cut-off limit with reference to

the borrower's overall exposure to banking system, over which the accounts of borrower would be required to be audited by chartered accountants in the prescribed manner. The auditor is expected to report on compliance with this requirement in case of sanction or renewal of limits, primarily on the basis of a review of branch audit reports. The auditor should report the number of branches and the total number of accounts in respect of which audited accounts have not been placed on record.

1.26 The auditor is also expected to comment on the effectiveness of system of physical verification or inspection of stocks, machineries and such other securities which have been charged to the bank. The auditor's comments will be based primarily on a review of branch audit reports.

1.27 In 1985, the RBI advised banks to introduce a comprehensive and uniform Health Code System indicating the quality or health of individual advances. At present the health code system is not in operation.

1.28 However, in the wake of the introduction of guidelines for income recognition, assets classification and provisioning vide RBI's Circular No. DBOD.BP.BC.129/ 21.04.043-92 dated April 27, 1992, the RBI reviewed the need to continue to require the classification of advances as per the Health Code System. Based on the review, the RBI made the continuance of the Health Code System discretionary for banks. In case a bank uses this tool, auditors may peruse the information from an audit perspective.

1.29 The auditor may review the statistical and analytical reports on advances which are often placed for information before the Board of Directors or submitted to the RBI. Based on this data, the Board assesses the bank's exposure to various industries. The auditor is expected to comment on the effectiveness of such reporting system in vogue in the bank.

1.30 Generally, banks have a system of periodic review of credit rating awarded to various clients. The purpose is to review whether the rating which had been awarded to a particular client continues to hold good as per the norms or whether a review of the credit rating was required.

1.31 The auditor should examine whether the system of periodic review is functioning effectively as per the norms fixed by the bank. He should review the LFARs given by the branch auditors to identify whether the norms for credit rating are being followed consistently. Where the branch auditors have pointed out any weaknesses in the review / monitoring / supervision of such norms, the auditor should, if the weaknesses are material, comment and find out the impact.

1.32 Apart from conducting the normal banking business, banks also undertake other activities like, leasing, hire purchase, etc. The auditor should examine whether the bank has a system for monitoring the overdue arising out of this business. The auditor should also examine whether for the purpose of overdue, regular follow-up is done with the customers from which the funds are due.

1.33 The RBI vide its circular DBR.BP.BC.No.65/21.04.103/2016-17 dated April 27, 2017 advised the Banks to lay down a Board-approved policy clearly defining the role and responsibilities of the Chief Risk Officer (CRO). The auditor should examine the board policy and the go through the minutes of Risk Management Committee. Also banks have established the compliance department who evaluates the compliance risk in each business line at periodical intervals and put up the results to the Board/Management Committee. The same should be examined by the auditors.

### **Recovery Policy in Respect of Bad/Doubtful Debts/ NPAs**

1.34 The auditor is expected to report on the following aspects of the recovery period:

- , *Existence of a recovery policy; regular updation thereof; monitoring and adherence thereto; compliance with the RBI guidelines.*
- , *System of monitoring of recovery from credit card dues in respect of credit cards issued.*
- , *Effectiveness of the system for compiling data relating to the bad and doubtful debts and the provision in respect thereof.*
- , *System for identification, quantification and adequacy of provision (including that at foreign branches).*
- , *System for suspension of charging of interest and adherence thereto.*
- , *Ascertaining the realisable value of securities (including valuation of fixed assets) and the possible realisation from guarantors including DICGCI/ ECGC/CGST.*
- , *Assessment of the efficacy of rehabilitation programmes.*
- , *Method of appropriation of recoveries against principal, interest, etc.*
- , *System of compromise/ settlement. Review such cases and cases of recovery of over Rs.1.00 crore and also the cases wherein limit of sacrifices laid down in the Recovery Policy is exceeded. Compliance with RBI guidelines.*
- , *Provision/write-offs under proper authority.*

- , *Recovery procedures including those relating to suit filed and decreed accounts along with its age-wise analysis.*
- , *System of identifying and reporting of willful defaulters.*
- , *Borrowers against whom IBC process is mandated but not initiated by the branch.*
- , *Borrowers against whom IBC process is initiated by its creditors including bank.*

1.35 The Bank should have a policy for recovery of the bad and doubtful debts and NPAs. The auditor should examine whether the policy framed complies with the RBI guidelines and also that the same policy is followed by the bank. The policy should be regularly monitored and updated keeping in view the RBI guidelines where the bank gives credit to its customers by way of credit card also, the auditor should examine whether proper procedure is adopted to recover the credit card dues. The RBI has issued a Master Circular on “Credit Card, Debit card and Rupee Denominated Cobranded Prepaid Card Operations of banks” (RBI/2015-16/31 DBR.No.FSD.BC. 18/ 24.01.009/ 2015-16) dated July 1, 2015. The circular provides general guidelines to banks on their credit card operations, and the systems and control expected of them in managing their credit card business.

1.36 The RBI has issued detailed guidelines for income recognition, asset classification, provisioning and other related matters *vide* Master Circular on “Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances” (DBR.No.BP.BC.2/21.04.048/2015-16) dated July 1, 2015. Under the guidelines, the quantum of provision as also the charging of interest is dependent upon the classification of advances into performing or non-performing. The non-performing advances are required to be further classified into sub-standard, doubtful and loss assets. The auditor should satisfy himself that there exists a system of ensuring correct classification of advances as per the RBI guidelines. For this purpose, the auditor should review the adequacy and appropriateness of the instructions issued to the branches.

1.37 According to the aforesaid guidelines, income from Non-performing Advances (NPAs) is not recognised on accrual basis but is booked as income only when it is actually received. However, interest on advances against term deposits, NSCs, IVPs, KVPs and life policies may be taken to income account on the due date, provided adequate margin is available in the accounts. As a measure of control and also to ensure that the legal remedies against defaulting borrowers are not adversely affected, banks normally follow the procedure of recording interest on non-performing advances in a separate

account styled as 'Interest Suspense' or maintaining only a record of such interest in proforma accounts. It may be noted that the amounts held in Interest Suspense Account (or other similar account) cannot be reckoned as part of provision in respect of non-performing advances. Amounts lying in Interest Suspense Account are to be deducted from the relevant advances, and provisions (as required by the RBI norms) are to be made on the balances after such deduction.

1.38 The auditor should enquire into the procedure followed by the bank for recording interest on non-performing advances. Any departures from the laid down procedure which comes to the auditor's attention should be reported. The auditor should also comment on the increase/ decrease during the year in the aggregate balance held in Interest Suspense Account.

1.39 Realisable value of securities is relevant in determining provisioning against doubtful debts. Therefore, the auditor should examine whether there is a system of having realistic estimates of the value of security available, such as immovable properties, plant and machinery and stocks. The availability of security or net worth of borrower/guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise, as income recognition is based on record of recovery.

1.40 Every bank usually has a procedure for the write-off of bad debts, including the limits on authority to deal with/approve such write-offs. These limits are normally sanctioned by the Board of Directors or other similar authority. The auditor should examine the relevant procedure as also whether the provisions/write-off confirm to the laid down procedures.

1.41 At times, the Management may opt for one-time settlement or an out-of-court settlement with the defaulting borrowers on agreed stipulations as to down payment and installment over a period. The auditor should verify the authority for write-off, if any, arising out of such settlement and the system for proper accounting thereof.

1.42 As regards advances to sick units which are under rehabilitation programmes, the auditor should examine whether the bank has adhered to the broad parameters for grant of relief / concessions as per the RBI guidelines. The auditor should examine the efficacy of rehabilitation programs by comparing the actual performance with the estimates contained in the rehabilitation programme. On the basis of such assessment, the auditor should examine whether any further provision is required in respect of the units concerned. In this regard, it may be pointed out that the guidelines require that provision should continue to be made in respect of the dues to a bank in respect of existing credit facilities sanctioned to a unit under rehabilitation, as per their classification as sub-

standard or doubtful asset. As regards the additional facilities sanctioned as per package finalised by BIFR and/or term lending institutions, provision on additional facilities sanctioned need not be made for a period of one year from the date of disbursement. Further, in respect of additional credit facilities granted to SSI units which are identified as sick and where rehabilitation packages/nursing programs have been drawn by the bank themselves or under consortium arrangements, no provision need to be made for a period of one year.

1.43 The auditor is also expected to comment on the efficacy of the procedure for recovery of bad/doubtful advances, including that relating to suit-filed and decreed accounts. The auditor can get the relevant information from the branch audit reports and from the records maintained at head office/regional or zonal offices. The auditor should particularly review the efficacy of procedure for recovery in cases where decrees have been obtained in favour of the bank. Where there are significant doubts about the execution of the decrees, the auditor should take this fact into account in determining the adequacy of the provision.

### Large Advances

1.44 In respect of large advances, the auditor's responsibility is as under:

- , *Comments on adverse features considered significant and which need Management's attention.*

1.45 In the normal course of audit, the auditor would obtain from the Management a list of problem accounts and discuss the same to determine whether any such account is doubtful of recovery. On the basis of information and explanations provided by the Management, the auditor may be satisfied that certain problem accounts need not be considered doubtful of recovery and, therefore, not be provided for beyond the provision required under the guidelines for provisioning issued by the RBI. In respect of such major accounts, the auditor should give relevant details in the LFAR. The details to be given in respect of each such account should include the name of the borrower, the amount outstanding and a brief history and statement of facts. It would be desirable for the auditor to obtain the relevant explanations from the Management in writing.

1.46 As regards adverse features in large accounts, the auditor can obtain relevant information substantially from the branch LFARs and from records maintained at the head office/regional or zonal offices. Banks usually have a system of reporting to the Board on large accounts (e.g., accounts where the borrowings are of Rs 2 crores or 5% of aggregate year-end advances of the branch whichever is lower) where the adverse features have been observed, including accounts which require a review or close monitoring to ensure that they do not become sub-standard or doubtful at a later stage. Unhealthy features in such accounts include frequent over-drawing beyond sanctioned

limits, non-furnishing of data relating to security, defaults in furnishing of the information relating to the security charged to the bank, non-registration of charge in the case of companies, default in the matter of various stipulations for borrowings (for example, keeping the security uninsured, accumulation of old/obsolete stocks, etc.), non-renewal of documents, defaults in complying with the repayment schedules, frequent returning of bills in bill-discounting facility, and non-observance of the covenants between the bank and the borrower which may have a significant impact on the realisability of the advance or which may cause detriment to the security charged. The auditor should review the relevant reports submitted to the Board, where available.

1.47 The auditor should indicate the name of the branch, the name of the borrower, the balance as at the year-end and the general nature of adverse features noticed during the year. In case the adverse features have been persistent over a period of time and adverse comments have been made by the previous auditor(s) on these accounts, the same should also be reported.

1.48 In case the auditor notices a trend of the adverse observations then he may suitably report them in a summarised manner. In case this adverse trend is of a significant nature the auditor will need to consider the same while reporting on the effectiveness of internal financial controls, if such reporting is applicable to the bank.

## **II. Liquidity and Funds Management**

### **Investments**

1.49 The auditor is expected to comment on the following aspects of investments:

- , *Existence of investment policy and adherence thereto; compliance with RBI guidelines.*
- , *System of purchase and sale of investments; delegation of powers; reporting system; segregation of back office function, etc.*
- , *Controls over investments, including periodic verification/ reconciliation of investments with book records.*
- , *Valuation mode; changes in mode of valuation compared to previous year; shortfall and provision thereof.*
- , *Investments held at foreign branches; valuation mode; regulatory reserve requirements; liquidity.*
- , *Composition of investment portfolio as per RBI guidelines and the depreciation and diminution in the value of investments, if any, not provided for.*

- , *System relating to unquoted investments in the portfolio and the liquidity of such investments.*
- , *System relating to SGL/BRs; control over SGL/BRs outstanding at the year end and their subsequent clearance.*
- , *System and periodicity of concurrent and internal audit/ inspection of investment activities; follow up on such reports.*
- , *System of recording and accounting of income from investments.*
- , *System of monitoring of income accrued and due but not received.*
- , *System of monitoring matured investments and their timely encashment.*
- , *Average yield on investments.*
- , *System related to Repos.*

1.50 The auditor is required to comment whether there exists any investment policy in accordance with RBI guidelines and whether the same has been properly implemented. For that purpose, the auditor should not only familiarise himself with the investment policy of the bank, including broad investment objectives, authorities competent to make investments, procedure to be followed to put through deals, procedure to be followed for obtaining sanction of the appropriate authority, prescribed exposure limits and the system of reporting but also report whether the same is in existence in accordance with the RBI Guidelines and whether the same is being properly implemented. The RBI has issued detailed guidelines concerning investment portfolio of banks (Master Circular on “Prudential Norms for Classification, Valuation and Operation of Investment portfolio by Banks” DBR No BP.BC.6 /21.04.141/2015-16 dated July 1, 2015). These guidelines include instructions in respect of ready forward or buy-back deals, transactions in government securities for which Subsidiary General Ledger (SGL) facility is available, issue of bank receipts (BRs) and related records, internal control system for buying and selling securities, dealings through brokers and uniform accounting for Repo/Non-Repo transactions. The RBI has also issued detailed guidelines in respect of accounting of investments, including their classification under permanent and current categories. The auditor should familiarise himself with these guidelines and examine whether the bank has complied with them.

1.51 The auditor should examine the efficacy of various controls over investments, including the functional separation of various operations, custody of investment scrips, periodic physical verification of investments and reconciliation with book records. Any shortcomings in the prescribed system or non-compliance with the prescribed system should be reported.

1.52 The auditor should enquire into the mode of valuation of investments

and ascertain whether the mode of valuation followed during the year is same as that followed in the previous year. The auditor's reporting requirements include: (a) the mode of valuation of year-end investments, and (b) any change in the mode of valuation of investments as compared to that of the previous year.

1.53 The auditor should ascertain the method followed for recording of the shortfall (depreciation) in the value of investments which is arrived at by comparing the market value of Investments with their book value as at the year end. If bank has not provided for depreciation on investments then the auditor should state the fact.

1.54 While reporting on the shortfall in value as at the year-end, the auditor may give the relevant information separately in respect of various kinds of investments (e.g., government securities, other approved securities, etc.). The manner of arriving at the shortfall in the value of securities should be indicated particularly in the case of non-traded or unquoted securities. Further, the auditor should also verify entries made in "Investment Reserve Account" and proper utilisation of the same, if any.

1.55 The auditor should carefully scrutinize the entire investment portfolio keeping in mind the RBI guidelines and comment whether investment portfolio is as per the RBI guidelines. The auditor should also verify that the accounting methodology for Repo/ Reverse Repo transactions is appropriate and uniform throughout the year. For this purpose, the auditor should thoroughly familiarise himself with the RBI guidelines. A brief discussion of RBI guidelines is already given in earlier chapters.

1.56 In case of unquoted investments, reporting requirements of the auditor include:

- , *Whether appropriate system is followed for valuation of the unquoted investment in the portfolio. The basis of valuation is different depending on the type of investment.*
- , *Whether the unquoted investments are liquid in nature, i.e., they are easily saleable in the open market. This depends on the trend of the sale price, net-worth of the enterprise, the market condition, etc.*

1.57 Amongst internal audit of various areas and departments, internal audit of investment activities is one of the important requirements. While not only the scope and frequency of various types of internal audits in different banks varies, their form also varies, one of which is concurrent audit. Concurrent audit is to be regarded as bank's early-warning system to ensure timely detection of irregularities and lapses which helps in preventing fraudulent transactions. It also refers to examination of the transactions by an

independent person not involved in its documentation. The emphasis is in favour of substantive checking in key areas rather than test checking.

1.58 Auditor is expected to report whether the bank has a proper system of conducting concurrent and internal audit of investment activities either through its own staff or external auditors. The option to consider bank's own staff or external auditors is at the discretion of the individual banks. The auditor is expected to comment on the system in existence. The auditor should also enquire whether the bank has appropriate system for carrying out the inspection of investment activities on a regular basis. The auditor should report whether the bank has undertaken a follow up of the report and implemented relevant suggestions.

1.59 Income from investments includes all income derived from the investment portfolio by way of interest and dividend etc., from subsidiaries and joint ventures abroad / in India. The bank should have an appropriate system of recording income so that all the incomes which arose from the transaction which took place during the relevant period and pertain to the bank are actually recorded. The auditor should report whether there are no unrecorded incomes and that income is recorded in proper amounts and that it is allocated to the proper period.

1.60 The auditor should report whether there is a proper system for monitoring income accrued and due but not received and whether appropriate steps have been taken by the bank to recover the same.

1.61 The bank should have a system of keeping a track of investments which would mature in the near future so that its encashment can be done as soon as they mature. The auditor is required to report whether investments are encashed on time. The auditor should also report whether the bank has a system of monitoring the matured investment, i.e, the matured investments and depending on the requirement for funds, reinvestment of the same. The funds should be reinvested taking into consideration the risk-return analysis.

1.62 In case of investments held at foreign branches, the auditor should satisfy himself for existence of such investments. The auditor should examine that such investments are as per the rules and regulations set out by the bank and the RBI. Valuation policy of such investment should be on same line as of investments held in India. Such investment should be critically examined from the point of view of their liquidity.

1.63 Auditor should find out average yield on investments made by the bank. Such yield should be compared with the previous year as well as with industry norms. In case of investment where average yield is not adequate, such investment should be scrutinized for their continuity.

### SLR/CRR Requirements-System of Ensuring Compliance

1.64 The auditor is expected to comment on the following aspects of the system for ensuring compliance with the SLR/CRR requirements:

- , *System of compiling weekly DTL position from branches.*
- , *Records maintained for the above purpose.*

1.65 Section 24 of the Banking Regulation Act, 1949, requires that every scheduled commercial bank shall maintain, in India, in cash, gold or unencumbered approved securities, an amount, the value of which shall not, at the close of business on any day, be less than such percentage as may be specified, 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 referred to as 'Statutory Liquidity Ratio' (SLR).

1.66 The schedule of changes relevant to period in the SLR prescription has been detailed in the table below:

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

1.67 Section 18 of the Act requires that every banking company, not being a scheduled bank, shall maintain in India by way of cash reserve with itself, or by way of balance in a current account with the RBI, or by way of net balance in current accounts, or in one or more of the aforesaid ways, a sum equivalent to at least 4.00 per cent of the total of its demand and time liabilities in India as on the last Friday of the second preceding fortnight. Every scheduled bank is similarly required, by virtue of the provisions of section 42(1) of the Reserve Bank of India Act, 1934, to maintain with the RBI an average daily balance the amount of which

<sup>14</sup> Vide RBI notification no. RBI/2018-19/86/DBR.No.Ret.BC.10/12.02.001 dated 05.12.2018.

shall not be less than 4.00 per cent of the total of its demand and time liabilities in India. The said rate may, however, be increased by the RBI by notification up to 20% of the total of demand and time liabilities in India. Consequent upon the amendment to sub-section (1) of Section 42 of the RBI Act, 1934, effective from June 22, 2006, the RBI having regard to the needs of securing monetary stability in the country, can prescribe the Cash Reserve Ratio (CRR) for Scheduled Commercial Banks without any floor rate or ceiling rate. The RBI, from time to time, reviews the evolving liquidity situation and accordingly decides the rate of CRR required to be maintained by Scheduled Commercial Banks.

1.68 These requirements seek to ensure that banking institutions maintain adequate liquid assets in an unencumbered form so as to safeguard the interests of depositors.

1.69 To comply with these requirements, banks have evolved systems whereby all branches send their weekly trial balance as on every Friday and these are consolidated at the head office. Based on this consolidation, the total demand and time liabilities (DTL) is determined for every alternate Friday (normally called 'the reporting Friday'). Banks have to maintain cash or other eligible assets on the basis of the DTL position during the following fortnight.

1.70 The auditor should examine the system for compilation of DTL position, including verification of returns and their consolidation by the bank. The auditor should request the Management to provide him a compilation of all the circulars / instructions of the RBI regarding composition of items of DTL. The auditor should review their compliance by the bank. Any weaknesses in the system of compilation of DTL and its reporting to the RBI in the prescribed form should be reported by the auditor, along with the suggestions, if any, to overcome such weaknesses.

1.71 The auditor may examine compliance with SLR/CRR requirements with reference to the eligible assets maintained by the bank.

1.72 It may be noted that the RBI, vide its Master Circular No. RBI/2015-16/98 DBR. No. Ret. BC.24/12.01.001/2015-16 dated July 1, 2015 on "Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)" requires that the statutory auditors should verify and certify that all items of outside liabilities, as per the bank's books had been duly compiled by the bank and correctly reflected under DTL/NDTL in the fortnightly/monthly statutory returns submitted to RBI for the financial year.

## **Cash**

1.73 The auditor is required to comment on cash operations as under:

- , *System of monitoring of cash at branches; and Management of cash through currency chest operations.*
- , *Insurance cover (including insurance for cash in transit).*
- , *System and procedure for physical custody of cash.*

1.74 The cash is normally maintained under joint custody of the branch manager and the cashier. The main key to the safe is with the branch manager while the second and the third keys are with the accountant and/ or cashier. Each branch should maintain the records showing the details of keys and key-holders. Further, the bank should have a system of verifying whether the instructions of the bank in this regard have been complied with consistently throughout the year.

1.75 In the normal course, cash balances are expected to be verified on a daily basis and recorded in the cash book under the signature of the branch manager and another authorised signatory, since cash is under dual charge at the branch level. The auditor should ensure whether the bank has a system for verifying the same. The system should include general scrutiny of the cash book to ascertain whether it is in accordance with the instructions given by the bank, physical verification of cash and agreeing the same with the books maintained, with due authentication of such balances by the authorised signatories. For this purpose, the auditor should review the LFARs of the branches.

1.76 The auditor should ensure whether the bank has the system of checking the cash balance at the branches at periodic intervals by the authorised officials of the bank.

1.77 The auditor is also supposed to comment whether the system relating to Management of the cash through currency chest operations is appropriate. The currency chest operations are those where the bank holds cash as an agent of RBI. The auditor should report whether the bank has a system of regularly monitoring the currency chest operations. The balances in the chest should be periodically verified by the bank officials.

1.78 The auditor should examine and report on the adequacy of the insurance cover for cash with reference to the cash balance generally carried by the bank. He should also examine whether the insurance policy is in force. The auditor should ensure and comment whether the bank has obtained a global insurance policy in respect of cash at all the branches. The auditor is also supposed to report whether the insurance obtained includes the insurance for cash-in-transit.

1.79 The auditor should ensure about the system followed for the physical custody of cash. The system may include as to maintenance of cash will be in joint custody of which two or more officials, verification of the cash balance on daily basis and tallying the same with the books maintained, etc. The system should also include the names of the person who will have the custody of the keys. The auditor should properly examine the system and procedure and report whether the same is appropriate or there are any loopholes.

### **Call Money Operations**

1.80 The auditor is required to make comments on system relating to call money operations as under:

- , *System related to inter-bank call money.*

1.81 The auditor should verify that aspects relating to call money operations, viz., prudential limits in respect of outstanding borrowing and lending transactions, reporting requirement, documentation, etc., are adhered to in accordance with the guidelines of RBI Master Directions NO. RBI/FMRD/2016-17/32 FMRD. Master Direction No. 2/2016-17 dated July 7, 2016 “Master Direction on Money Market Instruments: Call/Notice Money Market, Commercial Paper, Certificates of Deposit and Non-Convertible Debentures (original maturity up to one year)”. Any changes made to the rules and regulation during the year should be scrutinised. Auditor should check that all the above changes are promptly and correctly conveyed to all the branches and whether any branch LFAR contains any negative remarks for the above system.

### **Asset Liability Management**

1.82 Regarding asset liability Management, the auditor is expected to make comment on the following aspects:

- , *Existence of Policy on Asset – Liability Management and monitoring thereof; compliance with the RBI guidelines.*

#### **Functioning of Asset-Liability Management Committee**

1.83 RBI has issued guidelines on ALM system vide circular no BP.BC.8/21.04.098/99 dated February 10, 1999 advising banks to give adequate attention to put in place an effective ALM system. Bank should set up an internal Asset-Liability Committee, headed by CEO/CMD or ED. The Management Committee or any specific Committee of the Board should oversee the implementation of the system and review its functioning periodically. The auditor should ensure whether the bank has a policy on Asset-Liability Management and whether the same complies with the RBI guidelines. As per the RBI guidelines the ALM process rests on three pillars:

- , *ALM Information Systems*
  - , Management Information Systems
  - , Information availability, accuracy, adequacy and expediency
- , *ALM Organisation*
  - , Structure and responsibilities
  - , Level of top Management involvement
- , *ALM Process*
  - , Risk parameters
  - , Risk identification
  - , Risk measurement
  - , Risk Management
  - , Risk policies and tolerance level

The auditor should also report whether the ALM policy is regularly monitored.

1.84 As per the circular No.BP.BC.8/21.04.098/99 dated February 10, 1999 Asset Liability Management Committee consists of the bank's senior Management including CEO. This committee should be responsible for ensuring adherence to the limits set by the Board as well as deciding the business strategy of the bank (on the asset-liability sides) in line with the bank's budget and decided risks, Management objectives. As per the circular, each bank is supposed to decide on the role of its Asset Liability Committee, its responsibility as also the decisions to be taken by it. The auditor should ensure and report whether the committee is functioning as per the decisions formed by the bank. The functioning of the committee should be useful and helpful to the Bank.

### ***Liquidity Risk Management by Banks***

1.85 The final guidelines issued in circular no RBI No 2012-13/285 DBOD.BP.No. 56/ 21.04.098/ 2012-13 November 7, 2012. The guidelines consolidate the various instructions/guidance on liquidity risk management that the Reserve Bank has issued from time to time in the past, and where appropriate, harmonise and enhance this instructions / guidance in line with the BCBS's Principles for Sound Liquidity Risk Management and Supervision. They include enhanced guidance on liquidity risk governance, measurement, monitoring and the reporting to the Reserve Bank on liquidity positions. The enhanced liquidity risk management measures are required to be implemented by banks immediately.

### ***Reporting to the Reserve Bank of India***

1.86 The existing liquidity reporting requirements have been reviewed. Banks will have to submit the revised liquidity return to the Chief General Manager-in-

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

Charge, Department of Banking Supervision, Reserve Bank of India, Central Office, World Trade Centre, Mumbai as detailed below.

### **Statement of Structural Liquidity**

1.87 At present banks are furnishing statement of structural liquidity for domestic currency at fortnightly interval and statement of structural liquidity for overseas operations at quarterly interval. In addition, statement for structural liquidity for the consolidated bank under consolidated prudential returns (CPR) is prescribed at half yearly intervals. However, under the revised requirements, this statement is required to be reported in five parts viz. (i) 'for domestic currency, Indian operations'; (ii) 'for foreign currency, Indian operations'; (iii) 'for combined Indian operations'; (iv) 'for overseas operations' and for (v) 'consolidated bank operations'. While statements at (i) to (iii) are required to be submitted fortnightly, statements at (iv) and (v) are required to be submitted at monthly and quarterly intervals, respectively. The Maturity and Position statement (MAP) submitted by the banks at monthly intervals is discontinued as the same is now addressed by statement for foreign currency, Indian operations. The periodicity in respect of each part of the return is given in the Table below:

Sl. No.	Name of the Liquidity Return (LR)	Periodicity	Time period by which required to be reported
	Structural Liquidity Statement		
(i)	Part A1 - Statement of Structural Liquidity – Domestic Currency, Indian Operations	Fortnightly*	within a week from the reporting date
(ii)	Part A2 – Statement of Structural Liquidity – Foreign Currency, Indian Operations	do	do
(iii)	Part A3 – Statement of Structural Liquidity – Combined Indian Operations	do	do
(iv)	Part B – Statement of Structural Liquidity for Overseas Operations	Monthly#	within 15 days from the reporting date
(v)	Part C – Statement of Structural Liquidity – For Consolidated Bank Operations	Quarterly#	within a month from the reporting date
* Reporting dates will be 15th and last date of the month – in case these dates			

are holidays, the reporting dates will be the previous working day.  
# Reporting date will be the last working day of the month / quarter.

### III. Internal Control

1.88 The auditor is expected to comment on the following aspects of internal control:

- , *Written guidelines/instructions/manual for accounting aspects.*
- , *Balancing of Books/Reconciliation of control and subsidiary records.*
- , *Inter-branch Reconciliation.*
- , *Branch Inspections.*
- , *Concurrent Audit.*
- , *Dealing Room Operations.*
- , *RBI Inspection.*
- , *Frauds/Vigilance.*
- , *Suspense Accounts, Sundry Deposits, etc.*

#### **Written Guidelines/Instructions/Manual for Accounting Aspects**

1.89 Generally, every bank has a written guidelines/manual/ instructions, which describes in detail, the procedures to be followed for executing various types of transactions. The manual normally also includes guidelines for accounting of various types of transactions. The auditor should examine whether there exists a written manual or other compilation in relation to various accounting aspects in the bank. The auditor should also examine whether there is a system of updating the manual or other compilation periodically. He should particularly enquire whether the directions/ instructions of the RBI relating to accounting aspects are incorporated in the manual promptly. The auditor should also examine the system of communicating any changes in the manual to the branches.

#### **Balancing of Books/Reconciliation of control and subsidiary records**

1.90 These are:

- , *System of monitoring the position of balancing of books/ reconciliation of control and subsidiary records.*
- , *Usage of software which are not part of CBS.*
- , *Follow-up action.*

1.91 The auditor's comments would cover the head office/regional or zonal

offices as well as the branches. The auditor can get the requisite information in respect of branches substantially from the LFARs pertaining to branches. The auditor is also expected to comment on the balancing of the books of account, e.g., whether the primary books of account have been tallied and the general ledger balanced. The auditor should examine the position relating to balancing of books which form the basis of the financial statements. The status as at the year-end relating to books not balanced should be clearly indicated by stating the relevant particulars and indicating the extent to which these remain to be balanced.

1.92 The auditor should state the number of branches in respect of which the control and subsidiary records have not been reconciled. Where such records have been reconciled after the year-end, the auditor should exercise his judgment as to whether such cases need to be reported.

1.93 In so far as the head office is concerned, the auditor should give his observations on the unreconciled balances between the control and subsidiary records. It is suggested that, in respect of the relevant heads of account, the report should show the amount appearing in the general ledger, the aggregate amount appearing in the subsidiary records, and the difference between the two. The observations of the auditor would cover non-balancing of subsidiary records at the head office and persistent defaults observed in reconciliation of control and subsidiary records.

1.94 The auditor should critically examine the system for reporting the status of balancing/reconciliation by branches and offer his comments and suggestions, if any.

### **Inter-branch Reconciliation**

1.95 These are:

- , *Comments on the system/ procedure and records maintained.*
- , *Test check for any unusual entries put through inter-branch/ head office accounts.*
- , *Position of outstanding entries; system for locating long outstanding items of high value.*
- , *Steps taken or proposed to be taken for bringing the reconciliation up-to-date.*
- , *Compliance with the RBI guidelines with respect to provisioning for old outstanding entries.*

1.96 Inter-branch accounts are normally reconciled by each bank at the central level. While practices with various banks may differ, the inter-branch accounts are normally sub-divided into segments or specific areas, e.g., 'Drafts paid/ payable', 'inter-branch remittances', 'H.O. A/c', etc. The auditor should report on the year-end status of inter-branch accounts indicating the dates up to which all or any segments of the accounts have been reconciled. The auditor should also indicate the number and amount of outstanding entries in the inter-branch accounts, giving the relevant information separately for debit and credit entries. The auditor can obtain the relevant information primarily from branch audit reports. Where, in the course of audit, the auditor comes across any unusual items in inter-branch/head office accounts, he should report the details of such items, indicating the nature and the amounts involved. The auditor should examine the procedure for identifying the high-value items remaining outstanding in inter-branch reconciliation. He should review the steps taken or proposed to be taken by the Management for clearing the outstanding entries in inter-branch accounts, particularly the high-value items. If he has any specific suggestions for expeditious reconciliation of inter-branch accounts including any improvements in the systems to achieve this objective, the same may be incorporated in the report. In the new CBS environment the branch reconciliation is done of IT department at H.O. in most of the banks.

1.97 Considering the extent of arrears in inter-branch accounts, the RBI, vide its circular no. DBOD No. BP.BC. 73 /21.04.018/2002-03 dated February 26, 2003 has advised banks to arrive at the category-wise position of unreconciled entries outstanding in the inter-branch accounts for more than six months as on March 31, 2004 and make provision equivalent to 100 percent of the aggregate net debit under all categories. While doing so, it may be ensured that:

- (i) The credit balance in the Blocked Account created in terms of instructions contained in circular DBOD No. BP.BC.73/21.04.018/98 dated July 27, 1998 is also taken into account; and
- (ii) The net debit in one category is not set-off against net credit in another category.

1.98 After introduction of digital banking, there is an increase in transactions through RTGS/NEFT/IMPS and also various other modes like Rupay, VISA, Master, AMEX etc. Banks should have control mechanism in place to ensure these accounts are duly reconciled. Auditors to review that these reconciliations are in order.

## **Branch Inspections**

1.99 These are:

- , *System of branch inspections: frequency; scope/ coverage of inspection/ internal audit, concurrent audit or revenue audit; reporting.*
- , *System of follow-up of these reports; position of compliance.*

1.100 The auditor should acquaint himself with the scheme of various internal inspections existing in the bank, viz., internal audit, concurrent audit, revenue audit, etc. He should consider whether the frequency and coverage of various types of audit are adequate having regard to the size of the bank. He should also examine the system of follow-up and compliance with reports of various auditors.

## **Dealing Room Operations**

1.101 The auditor should obtain and comment on the observations forming part of the System Audit Report of Dealing Room required to be conducted in terms of RBI guidelines.

## **RBI Inspection**

1.102 The auditor should obtain and comment on the observations forming part of Annual Financial Inspection u/s 35 of the Banking Regulation Act, 1949 conducted by RBI.

## **Frauds/Vigilance**

1.103 These are:

- , *Observations on major frauds discovered during the year under audit.*
- , *System of follow-up of frauds/ vigilance cases. (Reported to RBI in FMR1.)*

1.104 The auditor is expected to give his observations on major frauds discovered during the year under audit. He is also expected to comment on the efficacy of the system of follow-up on vigilance reports.

1.105 Banks normally maintain a record, usually in separate register, of the frauds that have taken place at any branch or other office which have been brought to the notice of the head office/Controlling Authority of the bank. A brief history of each of the frauds discovered is also available to the statutory auditor, through reports by the Management to the Board of directors as also to the RBI. The RBI has issued Master Directions on "Frauds-Classification and Reporting" (RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016 - 17) dated July 1, 2016 (updated July 03, 2017). The directions / circulars

require the banks to report to RBI complete information about frauds and the follow-up action taken thereon.

1.106 The auditor should look into the cases of major frauds which have been discovered and recorded including those which have been reported after the year-end. He should report on major frauds discovered and recorded by the bank. He should also examine the quarterly and annual review of frauds done by the bank and ascertain the number of frauds where final action has been taken by the banks and cases disposed of.

1.107 In case the auditor observes weaknesses in the internal control system which has resulted in frauds, or where the *modus operandi* is common, he may give his suggestions for overcoming such weaknesses by taking preventive steps to reduce/minimise incidence of frauds.

### **Suspense Accounts, Sundry Deposits etc.**

1.108 These are:

- , *System for clearance of items debited/credited to these accounts.*

1.109 The auditor should look into the procedure of the bank to determine whether entries raised in nominal heads of account including 'Suspense Accounts' and 'Sundry Deposits' or 'Sundries Account' are cleared expeditiously.

1.110 In the course of audit, the auditor would have examined large items and also old outstanding entries included in the year-end balances in such accounts. It is possible that whereas a debit entry has been raised to 'Suspense Account', the corresponding credit may be lying in 'Sundry Deposits'; or other similar account and an exercise may not have been carried out by the bank to adjust these transactions on matching, after proper scrutiny thereof. In his report, the auditor should bring out large and old outstanding entries which deserve the attention of the Management for expeditious clearance. He may also make his suggestions to the Management for expeditious clearance of these entries by adjustment thereof after making a thorough scrutiny of the transitions. The auditor may also point out any adjustments of large outstanding in these accounts which have not been specifically explained to him in the course of his audit, for example, for want of relevant documents/evidence or vouchers, etc., and where he is not satisfied with the nature of adjustments made.

1.111 Where, in the course of audit, the auditor comes across any unusual items in 'Suspense' or 'Sundry Deposits Account', he should report the details of such items, indicating the nature and the amounts involved. The relevant

information will be available to the auditor primarily from the branch audit reports.

#### **IV. Capital Adequacy**

1.112 The auditors are required to:

- , *Enclose a copy of the capital adequacy certificate.*
- , *The auditors should bring out their observations on the systems and processes being followed by the Bank for compilation of capital adequacy returns as well as on the efficacy of the internal control system over the computation of the Risk Weighted Assets.*

#### **V. Automation and Computerisation**

1.113 Computerisation results in changes in the processing and storage of information and affects the organisation and procedures employed by the entity to achieve adequate internal control. The auditor should ensure whether there exists any policy for computerisation and automation. The auditor is also required to comment whether any progress has been made during the period under review. Progress may be in the nature of conversion of partially computerised bank into fully computerised, or increasing the level of computerisation and thereby making the work simpler.

1.114 Pursuant to circular DBS.CO.PP.BC.11/11.01.005/2001-2002 dated 17 April 2002, 'Long Form Audit Report to the Management by Central Statutory Auditors of Banks', the Central Statutory Auditors should address their Long Form Audit Report to the Chairman of the Bank concerned and a copy thereof should be forwarded to the designated office of the Reserve Bank of India. Some of the key aspects as regards to automation and computerisation which should be covered are as follows. Regarding computerisation, the auditors are required to comment on the following aspects:

- , *Existence of Computerisation and Automation Policy; progress made during the year under review.*
- , *Critical areas of operations not covered by automation.*
- , *Number of branches covered by computerisation and the extent of computerisation.*
- , *Procedures for back-ups, off-site storage, contingency and disaster recovery and adherence thereto.*
- , *Existence of Systems/ EDP audit; coverage of such audit.*

- , *Electronic Banking; existence of systems and procedures; monitoring; regular updation of technology; method of review and audit of procedures.*
- , *Suggestions, if any, with regard to computerisation and automation.*

1.115 The central statutory auditor may in addition to performing specific work to comment on the above points may also review the adequacy and appropriateness of the Information Security Policy and report any shortcomings or suggestions for improvement in the computerisation and automation in the LFAR based on the discussions with the Management and IT personnel and leveraging on the work performed whilst undertaking audit procedures. The auditor may also report in his LFAR whether the approved Information Technology Security Policy is in place and communicated to all the branches for implementation.

1.116 The auditor is also required to comment whether the critical areas are covered by automation and the application used therein together with the fact as to whether the systems are developed in-house or acquired from external vendors. Generally, critical areas like treasury and loans are supported by sub-systems which are interfaced to the General Ledger. The auditor needs to make sure that there is a formal process of reconciliation of these sub-systems with the GL on a periodical basis. Further, the relevant application and access controls as prevalent to the CBS should also be followed for these sub-systems.

1.117 The auditor should also report the number of branches covered by computerisation and the extent of computerisation. The extent of computerisation may include inquiring whether the branch is fully or partially computerised. For this purpose auditor will have to go through the LFARs of the branches. In case of private sector banks and foreign branches, the central statutory auditor may inquire and verify about the level of branch automation when he conducts branch visits.

1.118 The bank should have a documented procedure for off-site backup. The auditor should enquire about the adequacy of the procedures followed for the recovery of data in case of contingency and disaster including details of the data backup policies for its systems and data, disaster recovery plans, periodicity of backups and details of offsite locations.

1.119 The auditor should report whether the bank has the system of conducting Systems audits periodically to assess the effectiveness of the software, hardware and operations to identify any changes required therein. The auditor also needs to review these reports to assess the impact of IT issues, if any, on the audit of the bank and his scope of work.

## **Reconciliation of Control and Subsidiary Records**

1.120 Have the figures, as at the year end, in the control and subsidiary records been reconciled? If not, the last date upto which such figures have been reconciled should be given under the respective heads, preferably in the following format:

<b>Account</b>	<b>Date</b>	<b>General Ledger Balance (Rs.)</b>	<b>Subsidiary Balance (Rs.)</b>	<b>Last Date on which balanced</b>

## **VI. Profitability**

1.121 The auditor is required to comment on the profitability aspects as under:

- , *Analysis of variation in major items of income and expenditure compared to previous year.*
- , *Important ratios such as ROA, ROE etc; comparison and analysis in relation to previous year.*
- , *Policy relating to general provisions/ reserves.*

1.122 The auditor is expected to present an analysis of variations in major items of income and expenditure compared to previous year, along with important ratios. This information is normally compiled by banks as per the requirements of the RBI. Wherever feasible, the auditor may also comment on the extent of income generated through non-traditional and specialized activities, such as, merchant banking, consumer banking, etc., as also on any unusual items of income and expenditure which may have had a significant impact on the profit/loss for the year.

1.123 The effects of any changes in accounting policies on the profit/loss for the year should be reported by the auditor.

## **VII. Systems and Controls**

1.124 The auditor is required to comment on systems and controls as under:

- , *Existence of systems and procedures for concurrent and internal audits, inspections, EDP audit of computer systems/software, etc.; monitoring and follow - up on such reports.*

1.125 Internal audit is an important constituent of the system of internal

control in banks. Banks should generally have well organised system of internal audit. The internal audit is carried out either by separate departments within the bank or by firms of chartered accountants. The scope and frequency as also the form of various types of internal audits in different banks varies, and one of which is concurrent audit.

1.126 A system of concurrent audit at large and other selected branches has been in vogue in most banks for quite long. Recognising the importance the concurrent audit in the banking sector, the RBI, vide its circular no BC.182/16.13.108/93-94 dated October 11,1993 addressed to all scheduled commercial banks (except regional rural banks) formally advised such banks to institute an appropriate system of concurrent audit. It may be also noted that the RBI vide its circular no RBI/2015-16/133 DBS.CO.ARS.No. BC. 2/08.91.021/2015-16 dated July 16, 2015 has incorporated new guidelines for concurrent audit system in commercial banks. The system includes scope of concurrent audit, coverage of business/branches, types of activities covered, appointment of auditors, facilities for effective concurrent audit, remuneration and the reporting systems. Concurrent audit is regarded as bank's early-warning system to ensure timely detection of irregularities and lapses which helps in preventing fraudulent transactions. It also refers to examination of the transactions by an independent person not involved in its documentation. The emphasis is in favour of substantive checking in key areas rather than test checking.

1.127 The auditor should enquire whether the bank has a system of conducting concurrent and internal audit, inspections of various departments inside the bank, etc. either through its own staff or external auditors. The option to consider bank's own staff or external auditors to undertake audit is at the discretion of the individual banks. The auditor is required to comment on the system in existence. The auditor should report whether the follow-up of the reports of internal and concurrent audits, etc. is carried out and relevant suggestions implemented timely.

1.128 Auditor should report whether there is a system of conducting Risk based audits – Auditor should comment on the system in place for closure of audit issue and to ensure that there are no repeat observations or there is a significant reduction in repeat audit issues. Auditor should examine whether there is a mechanism to remedy the underlying process gap by conducting Root- Cause analysis by testing the Control Process.

- , *Existence of Management Information System; method of compilation and accuracy of information.*
- , *Reliability of regulatory reporting under the Off Site Surveillance System of the RBI.*

1.129 The Management of banks requires database information for taking policy decisions as well as for taking other corrective measures. Banks operate their business through network of their branches spread over a vast geographical area. Thus, auditor should check that an effective Management information system exists which generates timely, accurate, reliable, relevant and complete information.

## **VIII. Other Matters**

1.130 Besides the above matters, the auditor is also expected to comment on the following:

- , *Comments on accounting policies, if any, including comments on changes in accounting policies made during the period.*
- , *Policies and systems for monitoring activities such as underwriting, derivatives, etc.*
- , *Adequacy of provisions made for statutory liabilities such as Income Tax, Interest Tax, Gratuity, Pension, Provident Fund, etc.*
- , *Adequacy of provisions made for off-balance sheet exposures and other claims against the bank.*
- , *Any major observations on branch returns and process of their consolidation in final statement of accounts.*
- , *Balances with other banks - observations on outstanding items in reconciliation statements.*
- , *Procedure for revaluation of NOSTRO accounts and outstanding forward exchange contracts.*
- , *Observations on the working of subsidiaries of the bank:*
  - (a) *reporting system to the holding bank and*
  - (b) *major losses of the subsidiary, if any.*
- , *Any other matter, which the auditor considers should be brought to the notice of the Management.*

1.131 The Long Form Audit Report (LFAR) issued by the RBI clarifies that

the matters required to be reported by the auditor therein are illustrative and not exhaustive. Therefore, if it is felt that if there is any other important matter which deserves to be included in the LFAR the statutory auditor may do so. The LFAR format was drafted in 2003. There have been significant changes in the banking Industry ever since. As a result certain additional areas which have not been considered in any of the above paragraphs can also be considered. The following is an illustrative list of few such matters:

<ul style="list-style-type: none"><li>•, Corporate Governance</li><li>•, Borrowings</li><li>•, Premises</li><li>•, Stationery department</li><li>•, Jilani and Ghosh Committee Compliances</li><li>•, Implementation of recommendation of Mitra Committee</li><li>•, GST Vigilance</li></ul>	<ul style="list-style-type: none"><li>•, Legal departments (Details relating to suit filed and decreed accounts)</li><li>•, Merchant banking activity</li><li>•, Inter Office adjustments</li><li>•, Planning department</li><li>•, Raj Bhasha</li><li>•, Voluntary retirement scheme</li><li>•, Demat accounts and Loan against Shares</li><li>•, Legal Compliance Certificate</li><li>•, Stress Testing</li></ul>
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1.132 The auditor should examine whether the Income Tax liability is computed as per the provisions of the Income Tax Act, 1961. Apart from that the auditor should review the appellate orders received during the year and consider the need for any additional provision/ reversal. If there is no requirement to retain a provision, it can be reversed.

1.133 Provisions for certain employee costs, such as, bonus, ex-gratia in lieu of bonus, and gratuity, pension and other retirement benefits are usually made at the head office level. The auditor should examine whether the liability for bonus is provided for in accordance with the Payment of Bonus Act, 1965 and/or agreement with the employees or an award of a competent authority.

1.134 The auditor should examine whether provisions in respect of termination benefits; retirement benefits such as gratuity, pension, post-employment life insurance and post-employment medical care; and other long

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

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term employee benefits like, long-service leave, bonuses, deferred compensation, etc., are made in accordance with the requirements of Accounting Standard (AS) 15, "Employee Benefits". The auditor should examine the adequacy of the provisions made with reference of such documentary evidence as reports of actuaries or certificates from the LIC, as appropriate under the facts and circumstances of the case.

1.135 Auditor should reassess all off-balance sheet exposures and other claims against the bank for its contingency and chances of accrual. Auditor can go through the relevant files, papers and documents related to legal case.

# **PART - V**

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# V-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

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

(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>15</sup>	Interest free funds from Head Office <sup>16</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	Revaluation reserves with discount of 55% (till 29 <sup>th</sup> February

<sup>15</sup> Refer Annexure 1 to Master Circular on Basel III Capital Regulations for criteria.

<sup>16</sup> Refer Annexure 2 to Master Circular on Basel III Capital Regulations for criteria.

	from 1 <sup>st</sup> March 2015), subject to meeting conditions prescribed in RBI circular dated 1 <sup>st</sup> March 2016	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 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 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

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

<b>Additional Tier I (AT 1)</b>	Perpetual non-cumulative preference shares <sup>17</sup>	Head office borrowings in foreign currency by foreign banks operating in India as per criteria <sup>18</sup>
	Share premium on instruments included in AT 1 capital	
	Debt Capital instruments including Perpetual Debt instruments <sup>19</sup>	
	Any other instrument notified by RBI from time to time	Any other instrument notified by RBI from time to time
	Less: Regulatory adjustments / deductions applied in the calculation of Additional Tier 1 capital	Less: Regulatory adjustments / deductions applied in the calculation of Additional Tier 1 capital
<b>Tier II Capital</b>	Revaluation reserves with discount of 55% (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>20</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>21</sup>	Perpetual Cumulative Preference Shares (PCPS)/ Redeemable Non- Cumulative Preference Shares (RNCPS)/ Redeemable cumulative preference shares (RCPS) <sup>22</sup>
	Premium on instruments included in Tier 2	

<sup>17</sup> Refer Annexure 3 to Master Circular on Basel III Capital Regulations for criteria.

<sup>18</sup> Refer Annexure 4 to Master Circular on Basel III Capital Regulations for criteria.

<sup>19</sup> Refer Annexure 4 to Master Circular on Basel III Capital Regulations for criteria.

<sup>20</sup> Refer Annexure 5 to Master Circular on Basel III Capital Regulations for criteria.

<sup>21</sup> Refer Annexure 6 to Master Circular on Basel III Capital Regulations for criteria.

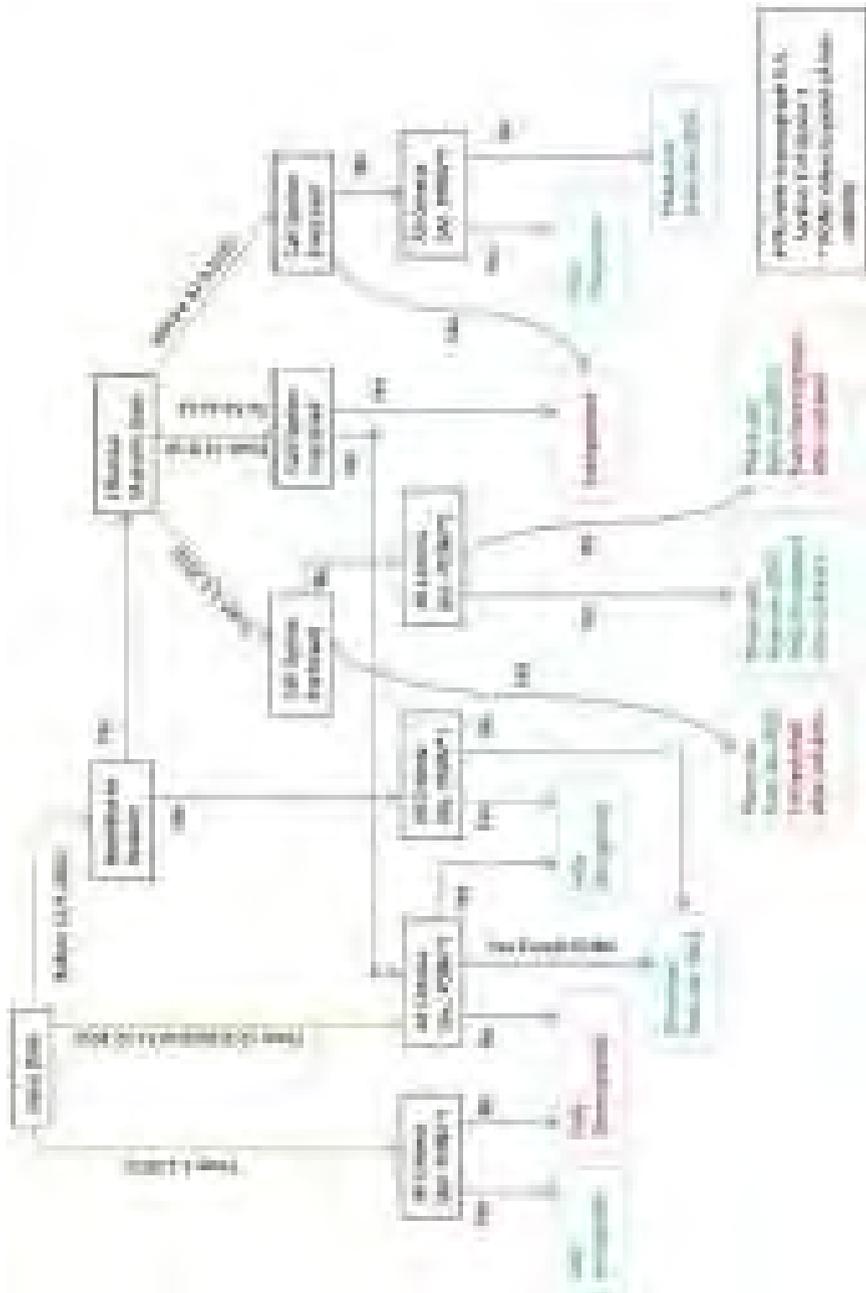
<sup>22</sup> Refer Annexure 6 to Master Circular on Basel III Capital Regulations for criteria.

	Less: Regulatory adjustments / deductions applied in the calculation of Tier 2 capital	Less: Regulatory adjustments / deductions applied in the calculation of Tier 2 capital
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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:

**TRANSITIONAL ARRANGEMENTS FOR NON-EQUITY REGULATORY CAPITAL INSTRUMENTS**



## 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		

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

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

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 XIII** of the Guidance Note.

## 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.

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

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- , 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.
- , 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.

## 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 III on “Fixed Assets and Other Assets” at the branch level, except that the central auditor may request the respective branch auditors to examine the evidence of physical existence of fixed assets that, as per the records, are located at the branch or have been provided to employees for use (such as residential premises).

### **Provisions for Certain Employee Costs**

4.16 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".

<b>ICDS No.</b>	<b>Name</b>
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 (viiia) 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)(viiia). According to section 36(1)(viiia), 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)(viiia). 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.

4.40 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.

4.41 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.

digital signature of the 'Designated Director' by either uploading the Form 61B or 'NIL' report.

4.53 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.

4.54 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.

4.55 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.

4.56 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***

4.57 Readers may refer publication of ICAI related with compliances of GST.

# **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

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. Niranjana Joshi, CA. Ashutosh Pednekar, CA. Dhananjay Gokhale, CA. Manish Sampat, CA. G. N. Sampath, CA. Shivratana 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.

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

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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 Premeekh Chhaged 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

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. Sripriya, CA. M P Vijay Kumar, CA. Ranjeet Kumar Agarwal, CA.

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

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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

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 Premasukh 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

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

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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.

Mukesh Singh Kushwah, CA. Sanjiv Kumar Chaudhary, CA. Atul Kumar Gupta, Shri P Sesh Kumar, Shri Bhaskar Chatterjee, CA. Sanjay Kumar Jain, CA. Sunil Ramakant Bhumralkar, CA. K. Sai Ram, CA. Navin Tilakraj Gupta, CA. Ravi Prasad, CA. Uttam P. Agarwal, Shri R Kesavan, RBI, Shri Anindya K Das, SEBI, CA. Vijay Sachdeva, ASSOCHAM, CA. Sanjay Vasudeva and CA Amit Roy, CII without whose support, the Guidance Note would not have been possible.

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.

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

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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

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# 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 Niranjana Joshi, CA Sandeep Welling, CA Shivratna Agarwal, CA Ulhas Chitale, CA Gautam Shah, CA Neville M. Daruwalla and CA Ashwin Suvarna for squeezing time out of their pressing professional and personal commitments to work on the 2013 edition of the Guidance Note on Audit of Banks and finalise it in a short time.

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

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

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

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.

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

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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, convener 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

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

# 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

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

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

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

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

# 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

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:
    - a. Minimum Net Owned Funds of Rs. 1,000 crore.
    - b. Minimum CRAR of 9%.
    - c. Net NPAs of less than 3% and a profit making record for the last three years.
  - B) Indian banks which are undertaking PD business through a partly or wholly owned subsidiary and wish to undertake PD business departmentally by merging/taking over PD business from their partly/wholly owned subsidiary subject to fulfilling the criteria mentioned in A (a) to (c) above.
  - 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 net worth 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

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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>.

latter's functioning (this period can, however, be extended by the Central Government).

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'

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.

66. 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.

67. 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**

68. 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.

69. 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.

70. 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.

71. 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.

72. 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***

73. 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.

74. 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.

75. 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**

76. 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.

77. 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.

78. 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.

79. 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.

80. 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.

81. 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.

82. 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**

83. The Union Government is also initiating various measures from time to time in order to strengthen the Banking Sector in India.

84. 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.

85. The seven shades of Indradhanush mission include appointments, de-stressing PSBs, capitalisation, empowerment, framework of accountability Bank Board Bureau and governance reforms.

86. It seeks to achieve the objective of economic growth revival through improving credit and minimising the political interference in the functioning of PSBs.

87. 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.

88. 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).

89. BBB has suggested compensation reforms in PSBs so that best practices can be introduced 'on the lines already prevalent in CPSEs.

90. 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**

91. 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.

92. 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.

93. 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**

94. 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.

95. 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.

96. 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.

97. 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.

### **98. 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.

99. 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.

100. 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.

101. 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**

102. 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.

103. 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.

104. It amended the Banking Regulation Act, 1949 by adding provisions for handling cases related to stressed assets or non-performing assets (NPAs) of banks.

105. 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.

106. 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).