

Chapter - 10 "Audit of Banks"

Topics Covered:

- I. Banking operations :
- II. Auditing framework :
- III. Types and Classification of Advances :
- IV. Computation of DP
- V. Verification (Audit) of Advances :

(A) Audit approach: Auditor is primarily concerned with Obtaining Evidences as to:

- (i) Amount shown in B/s are O/s as on B/s date. (Existence)
- (ii) Advances represent amt. due to bank. (Right)
- (iii) Advances are supported by loan documents. (Validity & Accuracy)
- (iv) No unrecorded advances. (Completeness)
- (v) Basis of valuation is appropriate and applied properly and recoverability recognised in valuation. (Valuation)
- (vi) Disclosure, classification is as per recognised accounting policies and statutory requirements. (Presentation, disclosure, and Classification)
- (vii) Provisions made as per RBI Norms, ASs and GAAPs.

(B) How to obtain audit Evidences :

- (i) By Study and Evaluation of Internal Controls relating to advances;
- (ii) By Examining
 - Validity of recorded amount;
 - Loan documentation; (Inspection)
 - Existence, Enforceability and Valuation of securities
- (iii) By reviewing the operations of accounts.
- (iv) By checking compliance with RBI Norms.
- (v) By Carrying out appropriate APs.

(5) Evaluation of Internal Control:

(Learning + Noting) - Any 6 points

(vi) Audit of Revenue Items:

(A) Income

(B) Expenses

(a) Interest Earned: Advances [CIC, O/D, TIL, BP, BD, etc.]

Investments

Balance with RBI

Inter-Bank loans, etc.

(a) Interest Expense:

- Deposits (SB, FD, R.D.)

- Borrowings from RBI

- Inter-Bank Borrowings

(b) Other Income: - Commission, Brokerage, Exchange

- Profit on sale / revaluation of Investments / Fixed assets.

- Dividend Income

- Others

(b) Operating Expenses:

- Payments to Employees

- Rent, Taxes, Lighting

- Printing Stationery, Telephone

- Repair, Maintenance, Insurance

Advt, marketing, audit fee.

etc.

Provision and Contingencies

✓ Audit of Revenue Items (Incomes):

(i) Audit Approach and Procedures ✓

(ii) Reversal of Income ✓

(iii) Partial recoveries in NPA ✓

(iv) Take-out Finance

Audit of Revenue Items (Expenses):

(i) Verification of Interest Expense

(ii) " " Operating "

(iii) " " Provision and

Contingencies

Verification of Interest Expense:

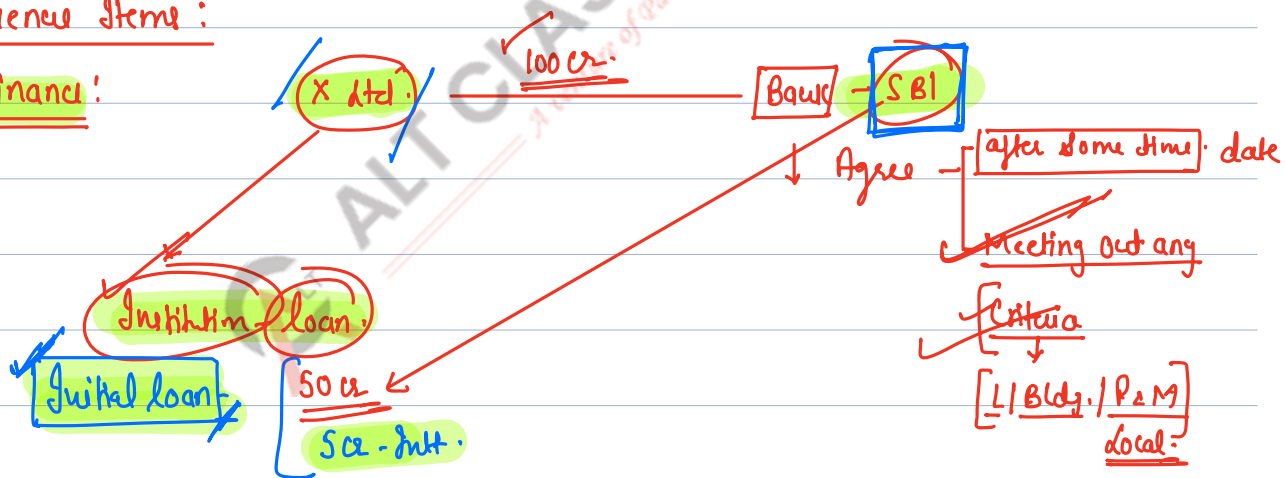
- (i) Compute Weighted average interest rate based on analysis of types of deposits outstanding at End of each quarter.
Rate so Computed shall be compared with actual average rate for CY and inquire for the differences.
- (ii) Compare average rate of interest with that of PY and inquire for the differences.
- (iii) Ascertain changes in Interest rates on saving deposits and term deposits during the year.
- (iv) Check calculation of interest and ensure the following:
- | | | | |
|--|--------|--------|--------|
| | 21-22 | 22-23 | 23-24 |
| | (4-5%) | (5-7%) | (5-7%) |
- (a) Interest provided upto B1s date
- (b) " rates are as per bank regulations, RBI directives and agreement with depositors.
- (c) Interest on Inter bank balances has been provided at the rates prescribed by H.O.
- (d) Interest rates on saving deposits are in accordance with the Rules framed by the bank.

- ## Verification of Operating expenses:
- (a) Evaluate IC system including Authorisation procedure, do as determine NTF of Sub. procedures.
- (b) Examine significant deviations in respect of any major expenditure.
- (c) Perform Analytical reviews for payments
- (d) Examine supporting documents of payments.
- (e) Check calculations of payments made.

- Imp - Verification of Provisions and Contingencies:
- Ascertain compliance with regulatory requirements as contained in RBI Circulars.
 - Obtain understanding as to how bank computes provisions on NPA and Standard Assets.
 - Examine Basis of classification of advances into Std, Sub-Standard, doubtful and loss assets.
 - Examine whether O/S Balance of Advances matches with GL.
 - Obtain Stn. of Computation of tax provision and verify nature of items debited and credited in P&L A/c.
 - Examine other provisions for expenditure as to Circumstances requiring provisioning and adequacy of same.

Audit of Revenue Items:

Take-out financing:



- Method of financing whereby a loan that is procured later will be used to replace the initial loan. In such financing, lender promises to provide funds at a particular date or when particular criteria for completion of projects are met. (Initial loan)
- Account is classified by lending bank as NPA, based on record of recovery;
- Income of such financing should not be recognised unless realised from borrower or taking over institution.

Chapter-12 "Audit of Banks" (Lecture No.3)

(IV.) Audit of Revenue Items (Incomes):

- (i) Composition of Income:
- | | |
|---------------------|-----------------------|
| (A) Interest Earned | - reading from book - |
| (B) Other Incomes | |

(ii) Audit Approach and Procedures:

(a) Auditor's concern: To obtain reasonable assurance that:

(i) recorded income arises from transactions taking place in the relevant period, pertains to the bank. [Occurrence]

(ii) there is no unrecorded income. [Completeness]

(iii) Income is recorded at appropriate amount. [Measurement]

(b) RBI's directions: Income should be recognised on accrual basis as per AS-9, if that income exceeds:

✓ Gross Commission = 2 Cr. [$< 1\%$ of Total Income]

Total Income = 180 Cr.

Net Commission = 1.2 Cr. [$> 1\%$ of Net Profit]

Net Profit before tax = 100 Cr.

1% of Total Income
of bank computed on
Gross Basis

1% of Net Profit before taxes
Computed on net of costs.

Note: If any item of income is not considered material as per the above norms, it may be recognised when received and in such case, auditor need not to qualify their report.

Example: (A) Gross Commission = 2 Cr. Total Income 180 Cr.

As Gross Commission is $< 1\%$ of Total Income, bank may recognise this income on Cash basis.

(B) Net Commission = 1.2 Cr. Profit before taxes 100 Cr.

As net Commission is $> 1\%$ of Net Profit before taxes, bank should recognise this income on accrual basis.

(c) Revenue certainty: If no uncertainty exist as to ultimate collection of revenue, banks should recognise revenue income on accrual basis i.e. as it is earned.

(d) Revenue uncertainty: In case of significant uncertainty, regarding ultimate collection of income arising in respect of NPA, RBI guidelines requires that banks should not recognise income on NPA until it is actually realised.

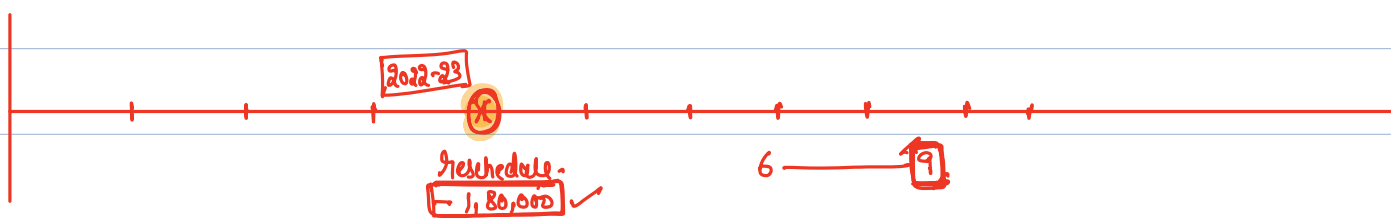
(e) Advances against securities: Interest on advances against fixed deposits, NSCs, KVP, IVP and Life insurance policies, may be recognised on due dates, provided adequate margin are available.

(f) Bills Purchased | — Self Study —

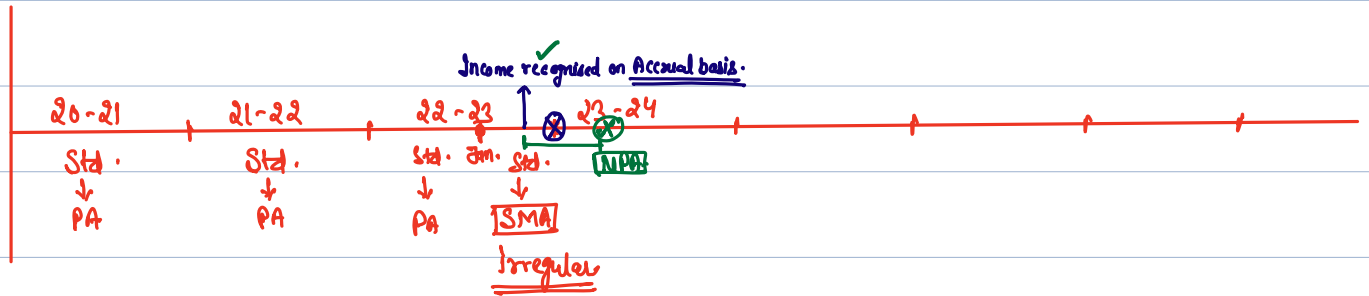
(g) Bills for collection

(h) Renegotiation:

- Fees/Commission earned by a bank as a result of renegotiation or rescheduling of outstanding debts should be recognised on accrual basis over the time covered by the re-negotiated period.
- Test check the Interest earned by the banks from the selected samples.
- Test check the fees and commission earned by the banks.



(iii) Reversal of Income:



- If any advance becomes NPA as at close of any year, entire **interest accrued** and credited to income account in the past periods, should be reversed, if the same is not realised.
- This requirement will apply for Govt. Guaranteed Advances also.
- In respect of NPA's, any **fees, commission etc.** that have accrued should cease to accrue in current period and should also be **reversed, if uncollected.**
- In case of banks which have wrongly recognised income in the past should reverse the interest, or make a provision for an equivalent amount.

(iv) Partial Recoveries in NPA:

- In the absence of a clear agreement between bank and borrower for the purpose of appropriation of recoveries in NPA, banks are required to adopt an accounting policy and appropriate the recovery amount in a uniform manner.
- Appropriate policy to be followed is to recognise income as per AS-9 when certainty attaches to realisation and accordingly amount reversed or not recognised in the past should be accounted for.
- Interest partly or fully realised in NPA, to be considered as Income.

(v) Income on Investments: - Self Study -