Chapter - 10 "Audit of Banks"

Topics Covered:

I. Banking operations

II. Auditing Framework

(A) Auditor

(B) Types of Audit Reports

(C) Bank Audit Approach

(D) Conducting an Audit:

(i) Initial Considerations

(ii) Understanding of bank and its Environment

(iii) Identifying and assessing ROMM

Imp: (iv) Understanding of Risk Mngt. Process

(v) Engagement Team Discussion

(vi) Establishing Overall audit Strategy

(vii) Developing audit plan

(viii) Other Considerations

(ix) Stress Testing

(x) BASEL III Framework

(xi) Reliance and Review on Other Reports

Requirements of an Effective Risk Management System in a Bank:

(a) Involvement of TCWG: TCWG shall approve the Risk Management policies of Bank.

While approving such policies, ensure that policies are consistent with:

(a) Bank Business objectives and strategies

(b) Capital Strength;

(c) Management Expertise;

(d) Regulatory Requirements;

(e) Acceptable Risk.

(b) Identification, Measurement and Monitoring the risk: Risk that may effect the achievement of Goals and objectives of the bank should be Identified, Measured, and Monitored.

(c) Control Activities: Banks must exercise controls to manage the risks, including:

(i) Segregation of duties;

(ii) Verification and Approval of transactions;

(iii) Setting of limits;

(iv) Reporting and approval of exceptions.

(d) Monitoring the risk: Independent Risk Management unit should be set-up which regularly assess the Risk Management Models; Methodologies and Assumptions used to measure and manage the risk.

(e) Reliable Info. System: Banks must have a reliable info. system that provide financial, operational and compliance information to mngt. and TCWG on a timely and consistent basis.

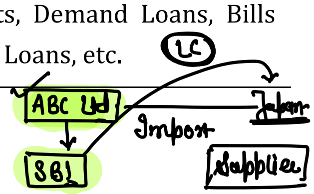
Imp:-

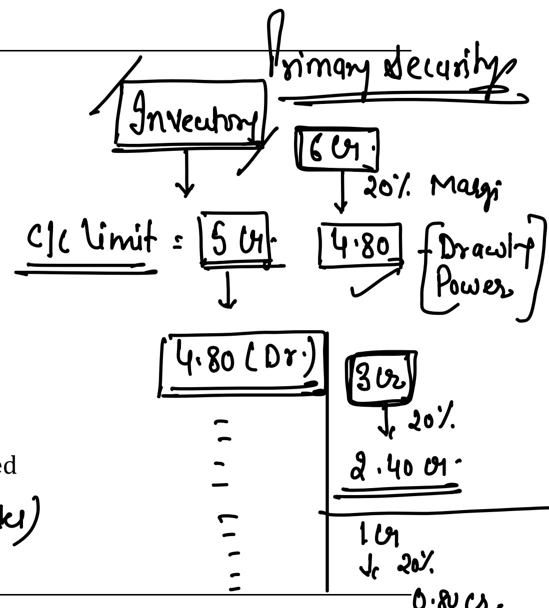
(f) Assessing Risk of fraud:

- As per SA 240, auditors objective is to identify and assess RoMM in the f.s. due to fraud and to obtain SAAE on identified misstatements and to respond appropriately to assessed risk.
- To recognise the possibility of misstatements due to fraud, auditor should maintain an attitude of Professional skepticism.
- RBI has also issued guidelines that deals with prevention of money laundering and KYC Norms. These guidelines requires the banks to establish policies, procedures and controls to deter and to recognise and report money laundering activities.

Assessing Risk of Fraud	• As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor's objective is to identify and assess the risks of material misstatement in the financial statements due to fraud, to obtain sufficient appropriate audit evidence on those identified misstatements and to respond appropriately. • The attitude of professional skepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud. • 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 ("KYC Guidelines – Anti Money Laundering Standards"), requiring banks to establish policies, procedures and controls to deter and to recognise and report money laundering activities.

10.3 – Types and Classification of Advances		
Types of Advances	**Funded loans**	• Loans where there is an actual transfer of funds from the bank to the borrower. • **Examples**: Term loans, Cash credits, Overdrafts, Demand Loans, Bills Discounted and Purchased, Interest-bearing Staff Loans, etc.
	Non-funded facilities	• Facilities which do not involve transfer of funds. • Examples: Letters of credit, Bank guarantees, etc.
Disclosure Requirements	**Nature wise**	(i) Bills purchased and discounted (ii) Cash credits, Overdrafts and loans repayable on demand (iii) Term Loans
	Security wise	(i) Secured by tangible assets (ii) Covered by Bank/Government guarantees (iii) Unsecured
	Location wise	I. Advances in India (i) Priority sectors (ii) Public sector (iii) Banks (iv) Others II. Advances outside India: (i) Due from Banks (ii) Due from Others: (a) Bills Purchased and discounted (b) Syndicated loans (foreign stake) (c) Others
Creation of Security	**Primary security**	Security offered by the borrower for bank finance or the one against which credit has been extended by the bank.





	Collateral security	It is an additional security and can be in any form i.e. tangible or intangible asset, movable or immovable asset.
	Examples of Securities	(a) Personal Security of Guarantor (b) Goods/Stocks/Debtors/Trade Receivables (c) Gold Ornaments and Bullion (d) Immovable Property (e) Plantations (For Agricultural Advances) (f) Third Party Guarantees (g) Banker's General (h) Lien Life Insurance Policies (i) Stock Exchange Securities and Other Instruments
	Mode of Creation of Security	
	Security may be created by different modes like Mortgage, Pledge, Hypothecation, Lien, Assignment.	
	Mortgage	• Registered Mortgage can be affected by a 'Mortgage Deed' signed by the mortgagor. • Equitable mortgage, is affected by a mere delivery of title deeds or other documents of title with intent to create security thereof.
	Pledge	• It involves physical delivery of goods by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance. • Legal ownership of the goods remains with the pledger while the lending banker gets certain defined interests in the goods.
	Hypothecation	• Hypothecation is the creation of an equitable charge, which is created in favour of the lending bank by execution of hypothecation agreement in respect of the movable securities belonging to the borrower. • Borrower holds the physical possession of the goods. Neither ownership nor possession are transferred to the bank. • Borrower periodically submits statements regarding quantity and value of hypothecated assets (like stocks, debtors, etc.) to the bank on the basis of which the drawing power of the borrower is fixed.
	Lien	Lien is creation of a legal charge with consent of the owner, which gives lender a legal right to seize and dispose/liquidate the asset under lien.
	Assignment	• It is a transfer of an existing or future debt, right or property belonging to a person in favour of another person. • Only actionable claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of movable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment.

	Set-Off		• Set-off is a statutory right of a creditor to adjust, wholly or partly, the debit balance in the debtor's account against any credit balance lying in another account of the debtor. • Right of set-off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and same right. • For this purpose, all branches of a bank are treated as one single entity. Right of set-off can be exercised in respect of time-barred debts also.
Prudential Norms Overdue >90 Non-performing Performing Std. SMA Stress SS 12M >12M Doubtful Loss	**Non – Performing Advances**		An Advance will be classified as NPA if: (a) It ceases to generate income for a bank. (b) interest and/or installment of principal remain **overdue** for a period of more than 90 days in respect of a term loan; (c) account remains '**out of order**' in respect of an Overdraft/Cash Credit (OD/ CC); (d) the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.
		Overdue	Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.
		Out of Order	An account should be treated as 'out of order' if: • outstanding balance remains continuously in excess of the sanctioned limit/drawing power or • if there are no credits continuously for 90 days as on the date of Balance Sheet; or credits are not enough to cover the interest debited during the same period.
PA. Std. - No risk - Normal risk. SMA - Sign-Stress - 0: -30, 1: 31-60, 2: 61-90 Sub Std - >90 days overdue Doubtful - >12 Months SS. Loss - declared - Auditor. NPA.	**Special Mention accounts**		Special Mention accounts (SMA) are those accounts which are resulting signs of incipient stress leading to the possibility that borrowers may default on debt obligations. SMA 0 – Accounts showing stress signals SMA 1 – Overdue between 31 to 60 days SMA 2 – Overdue between 61 to 90 days Such a classification is significant as early recognition of such accounts enables banks to initiate timely remedial actions to prevent potential slippages of such accounts into NPAs.
	Classification as per prudential norms	**Standard assets**	Assets which do not disclose any problem and does not carry more than normal risk.
		Sub-standard assets	Asset which has remained NPA for a period less than or equal to 12 months.
		Doubtful assets	Asset which has remained in the substandard category for a period of 12 months.

		Loss assets	Asset in respect of which loss has been identified by the bank or internal auditors or the RBI inspection, but the amount has not been written off, wholly.	
	Provisioning Requirements	**Standard assets**	0.40%	
		Sub-standard assets	15%	
		Doubtful assets	**Unsecured portion**	100%
			Secured portion	25% to 100% depending upon the period for which advance has remained doubtful. • Upto one year - 25% • More than one year but upto 3 years - 40% • Above three years - 100%
		Loss assets	100%	
Special cases w.r.t. NPA Classification	Classification as NPA should be based on record of recovery. Availability of security or net worth of borrower/guarantor is not to be considered for purpose of treating an advance as NPA.			
	Asset Classification borrower-wise	Asset classification would be borrower-wise and not facility-wise. All facilities including investments in securities would be termed as NPA.		
	Accounts regularised near B/S date	• Where it appears that an account has inherent weakness and few credits near the balance sheet tries to make it regular, the account should be classified as NPA. • Auditor should check for sample transactions immediately before and after closing of financial year to get a knowledge of objective behind the transactions if they have any relation to each other which might show an arrangement to prevent Borrower account(s) from slipping into NPA category.		
	Govt. guaranteed advances	• Credit facilities backed by C.G. guarantee, though overdue will be classified as NPA only when govt. repudiates its guarantee when invoked. This exemption is only for asset classification and provisioning and not for the purpose of recognition of income. Interest on such advances should not be taken to income account unless it has been realized. • Credit facilities backed by S.G. guarantee should be classified as NPA in normal way.		
	Advances under Consortium	• Consortium advances mean advancing loans to a borrower by two or more Banks jointly by forming a Consortium. Joint appraisal, control and monitoring will facilitate for exchange of valuable information among the Banks. Usually, a Bank with a higher share will lead the consortium.		

	• Classification of Consortium advances should be based on the record of recovery of respective individual member banks and other aspects having a bearing on the recoverability of the advances. • Where the remittances by borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, account should be treated as not serviced in the books of the other member banks and therefore, an NPA. • Banks participating in consortium, need to arrange to get their share of recovery transferred from the lead bank or to get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.
Erosion in Value of Securities	In case there arise erosion in value of security or any fraud is committed by Borrowers, banks can directly classify these accounts as Doubtful or Loss Assets, irrespective of the period for which the account has remained NPA. (i) Erosion in value of securities by more than 50% of value assessed by the bank or accepted by RBI inspection team at time of last inspection, would be considered as "significant", requiring the asset to be classified as doubtful straightaway and provided for adequately. (ii) If realisable value of security as assessed by bank/approved valuers/ RBI is less than 10% of outstanding in borrowal accounts, existence of security should be ignored and the asset should be classified as loss asset. In such cases asset should either be written off or fully provided for.
Advances Against Term Deposits, NSCs KVPs/IVPs, etc.	Advances against Term Deposits, NSCs eligible for surrender, KVP/IVP and life policies need $\boxed{\text{not be}}$ treated as NPAs, provided $\boxed{\textbf{adequate margin}}$ is available in the accounts. 100000 → 70000 — $\boxed{\text{Qtr. 2100}}$ +2100 +2100 +2100 1% p.m.
Agricultural Advances affected by Natural Calamities	Where, in the wake of natural calamities, short-term agricultural loans are converted into term loans or there is rescheduling of repayment period or fresh short-term loans are sanctioned, the term loan as well as fresh short-term loan may be treated as current dues and need not be classified as NPA.
Advances to Staff loan - Principal - Interest	• Interest-bearing staff advances should be included as part of advances portfolio of bank. In case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards. • Such loans/advances should be classified as NPA only when there is a default in repayment of installment of principal or payment of interest on respective due dates.

due - $\boxed{\text{30.06.2023}}$

30.09.2023

09.11.2023

9%

Staff - fee loan

$\boxed{\text{Subsidised rate}}$

9% - 2% = $\boxed{7\%}$

Principal - due

Interest - overdue

1%

$\boxed{1000000}$	20000	10000
9,80,000	20000	9800
9,60,000	20000	9400

9200

4,90,200 - 2000

	Agricultural Advances/ Loans	Interest and/or Instalment of principal is **overdue** for – • two crop seasons, in case loans granted for Short Duration crops, • one crop season, in case loans granted for Long Duration crops (i.e. more than 1 year)
		Points to Remember • Long duration crops mean the crops with crop season longer than one year. • Short Duration Crops means the crops, other than long duration crops. • Crop season means the period up to harvesting of the crops, as determined by the State Level Bankers' Committee in each State.

10.4 - Computation of Drawing Power (DP)

Meaning of DP	• DP is an important concept for Cash Credit (CC) facility availed from banks and financial institutions. • It may be defined as the limit up to which a firm or company can withdraw from the working capital limit sanctioned.
Sanctioned Limit vs. DP	• Sanctioned limit is the total exposure that a bank can take on a particular client for facilities like cash credit, overdraft, export packing credit, non-funded exposures etc. • On the other hand, DP refers to the amount calculated based on primary security less margin as on a particular date.
Considerations	• All accounts should be kept within both DP and sanctioned limit at all times. • Accounts which exceed the sanctioned limit or DP or are against unapproved securities or are otherwise irregular should be brought to the notice of the Management/Head Office regularly.
Bank's Duties	• Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets. • DP is required to be arrived at based on current stock statement. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. • Outstanding in the account based on DP calculated from stock statements older than 3 months is deemed as irregular.
Auditor's Concern	• Stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinized in detail. Audited Annual Report submitted should be scrutinized properly. • Monthly stock statement of the month for which the audited accounts are prepared and submitted should be compared and the reasons for deviations, if any, should be ascertained.
Computation of DP	• Ensure that DP is calculated as per extant guidelines formulated by the BoD of respective bank and agreed upon by concerned statutory auditors.