Chapter – 10 "Audit of Banks"

Topics Covered:

I. Banking operations

II. Auditing Framework

III. Types and classification of Advances

IV. Computation of Drawing Power:

Example: ABC Ltd. ⟶ ICICI Bank.

Working Capital limit = 6 Cr.

↓

Security → Current Assets – Stock + Debtor
– Current liabilities – Creditor

Sanctioned limit = $\boxed{6\text{ Cr}}$

↓ Condition → Drawing Power – Quarterly Statement

↓

Computation = [Stock – damaged stock – unpaid stock (Creditor) – stock > 3 M old] $\boxed{75\%}$ 25%

\+

[Debtor – > 3 Month old] × 60% $\boxed{40\%}$

Eligible Amount (cannot Exceed sanctioned limit)

CARO – Para 3(ii)

> 5 Cr.

↓

Auditor → $\boxed{\text{Quarterly statements}}$

↓

agree with books of Accounts

(i) Concept of Drawing Power: – FROM Book –

(A) Meaning of D.P.

(B) Sanctioned Limit vs D.P

(C) Bank's Duties

(D) Auditor's Concern

(E) Computation

(F) Stock Audit

Learning + Noting

V. Audit of Advances : (a) Audit approach.
(b) How to Collect Evidences
(c) Evaluation of Internal Control

(A) Audit approach!

Auditor is primarily concerned with obtaining evidences as to :

i) Amount shown in B/s are o/s as at B/s date. [Existence]
ii) Advances represent amount due to the bank. [Right of the bank]
iii) " are supported by loan documents. [Validity of Advances]
iv) No unrecorded advances. [Completeness]
v) Basis of Valuation is appropriate and properly applied. [Valuation]
vi) Disclosure, classification and description is in accordance with recognised A/c'ing Policies and Statutory requirements.
vii) Provisions are made as per RBI Norms, Accounting Standards and GAAPs.

(B) How to Collect Audit Evidences :

i) By Study and Evaluation of Internal Controls related to advances.
ii) By examining – (a) loan documentation
(Inspection) (b) Validity of amount recorded; and
(c) Existence, valuation and enforceability of securities.
iii) By Reviewing the Operation of controls.
iv) " performing appropriate analytical procedures.
v) " checking compliance with RBI Norms including classification and Provisioning.

(C) Internal control over advances : (Learning and Noting – Any six points)

VI. Audit of Revenue Items:

(A) Composition of Income:

- (a) Interest Income: (including discount)
  - Interest on Advances
  - " " Balances with RBI
  - " " Inter-Bank loan
  - Discount " Bills Discounted, etc.
- (b) Other Income:
  - Commission, Exchange, Brokerage
  - Profit on sale of Investments
  - " " " " L&B, Other Assets
  - " " Revaluation of Investments
  - " " " " L&B
  - Dividend on Investments, etc

(B) Audit Approach and Procedures:

(I.) Auditor's Concern: To obtain reasonable assurance that:

(i) Recorded income arises from transactions taking place in the relevant period and pertains to the bank. (i.e. Occurrence)

(ii) there is no unrecorded income. (i.e. completeness)

(iii) income is recorded at appropriate amount. (i.e. Measurement)

II. RBI Directions for Revenue recognition:

Income should be recognised on accrual basis as per AS-9, if that income exceeds: 1% of total Income (If income computed on Gross basis)

OR

1% of Net Profit Before Taxes (If income computed net of costs)

Example: Total Income = 150 Cr.

Gross Commission = 1.8 Cr. – (To be recognised on Accrual basis)

" " = 1.45 Cr – (May be recognised on Cash basis)

Example: Profit before taxes = 100 Cr.

Net Commission = 1.05 Cr (To be recognised on Accrual)

= 0.95 Cr (May be recognised on Cash basis)

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

III Revenue Certainity: Revenue income like interest, commission, fees, etc. to be recognised on Accrual Basis (i.e. at the time when it is earned), provided it should not be unreasonable to expect its ultimate collection (i.e. no uncertainity as to collection)

IV. Revenue uncertainity: In case of significant uncertainity arising in respect of NPAs, regarding ultimate collection of Income, RBI Guidelines requires that banks should not recognise income on NPA until it is actually realised.

Note: Reversal of Income: If any credit facility is classified as NPA for the first time, any interest accrued and credited in the income account, which has not been realised should be reversed or provided for.

Note: Policy for Revenue recognition should be objective and based on record of recovery rather than on any subjective consideration.

V. Advance against Securities

VI. Bills Purchased

VII. Bills for Collection

VIII. Renegotiation

From Book (Reading Purpose)

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V. Audit of Advances

(VI). Audit of Revenue Items (Income):

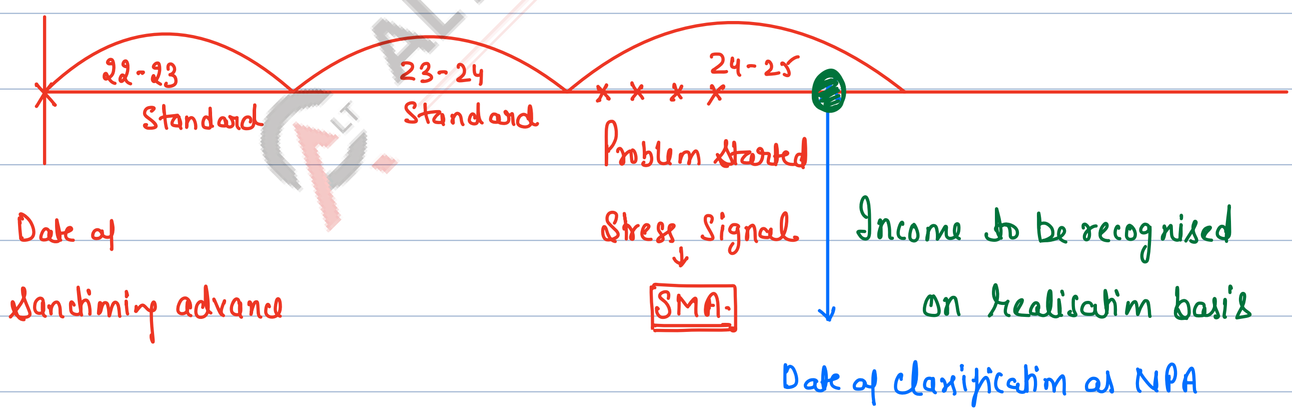
(A) Composition of Income

(B) Audit Approach and Procedures

(C) Miscellaneous Topics: — (a) Reversal of Income ~~(c)~~ Partial Recoveries in NPA

(b) Take out finance ~~(d)~~ Income on Investments

(i) Reversal of Income:



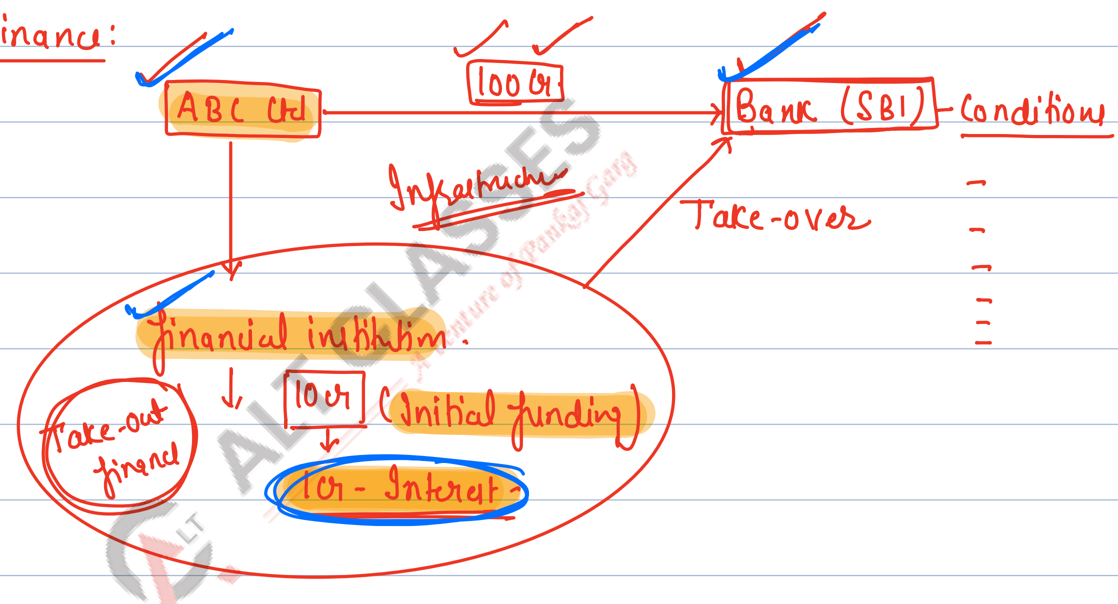
Interest Income → $\boxed{\text{Accrual}}$ (AS-9)

Collected | $\boxed{\text{Uncollected}}$ → Reversed | provision

- 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 amount is not realised.
- This requirement will apply for Govt Guaranteed Advances also.

- In respect of NPAs, any fees, commission or similar income that have accrued should cease to accrue in current period and should be reversed, if uncollected.
- Auditor should inquire, if there are any large debits in interest income account that have not been explained.
- In case of banks, which have wrongly recognised income in the past period should reverse the income or make a provision for an equivalent amount.

(ii) Take out finance:



- It is a method of financing whereby a loan that is procured later will be used to replace the initial loan.
- In such arrangements, lender promises to provide funds at a particular date or when particular criteria for completion of project are met.
- If, based on record of recovery, account is classified as NPA by lending bank, interest income should not be recognised unless realised from the borrower/ taking over institution.
- Objectives of take-out finance: (a) To expand sources of finance;
  (b) To address sectoral exposure issues; and
  (c) To boost availability of longer tenor debt finance.

(iii) Partial Recoveries in NPAs :

- In absence of clear agreement between bank and borrower as to appropriation of recovery in NPA, banks are required to adopt an appropriate Aling Policy.
- Appropriation should be done in a uniform and consistent manner.
- Policy to be followed need to be as per AS-9.
- Income that is reversed or not recognised in past should be accounted for.
- Interest partly / fully realised in NPAs, to be considered as Income.

(iv) Income on Investments :

(a) Interest Income: includes income derived from Govt. securities, bonds and debentures of corporates and other Investments in the form of Interest and dividend.

(b) Profit on sale of Investments: to be taken to P&L A/c.

(c) Profit / Loss on revaluation of Investments: to be taken to P&L A/c.

(VII) Audit of Revenue Items (Expenses):

(A) Composition of Revenue Expenses:

(a) Interest Expense

↓ on

- deposits
- RBI Borrowings
- Inter-Bank loans
- Others

(b) Operating Expense

↓

- Payment to Employees
- Rent, Rates and Taxes
- Printing and Stationery
- Repair, Maintenance, Insurance, advertisement, audit fees.
- Other Expenditures.

(c) Provisions & Contingencies

↓

- NPA
- Taxation
- Diminution in value of Investments
- 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 current year and inquire for the difference.

(ii) Compare average rate of interest with that of previous year and inquire for the difference.

(iii) Ascertain changes in interest rates on saving and term deposits during the year.

(iv) Check calculation of interest and ensure the following:

(a) Interest provided upto Balance Sheet date.

(b) Interest 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:

(i) Evaluate Internal control system related to payment of expenses, including authorisation procedure so as to determine Nature, Timing and Extent of Substantive Audit Procedures.

(ii) Examine divergent trends / significant deviations in respect of any major expenditure.

(iii) Perform analytical procedures for payments on monthly basis.

(iv) Examine supporting documents of payments.

(v) Check calculations of payments made, wherever needed.

Verification of Provisions and Contingencies:

(i) Ascertain compliance with regulatory requirements as contained in RBI circulars.

(ii) Obtain understanding as to how bank computes provision on standard assets and NPAs.

(iii) Examine basis of classification of advances into Std, Sub-Std, doubtful and loss assets.

(iv) Examine whether o/s Balances of advances agree with General ledger.

(v) Obtain Statement of computation of tax provision and verify nature of items debited and Credited in Profit and loss Account.

(vi) Examine other provision for expenditure, circumstances warranting provisions and adequacy of same by discussing with the management of the Bank.

Test Schedule.	21.07	Ch-1, 11
	28.07	Ch-2, 3
	04.08	Ch-4, 6
	11.08	Ch-5
	18.08	Ch-7, 8
	25.08	Ch. 9 $\boxed{10}$