

# Guidance Note on Audit of Banks (2020 Edition)

## Attention

Members' attention is invited to relevant directions/circulars issued by the Reserve Bank of India up to January 1, 2020 available at ICAI website 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, 2020.



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

© The Institute of Chartered Accountants of India

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form, or by any means, electronic, mechanical, photocopying, recording, or otherwise, without prior permission, in writing, from the publisher.

First Edition : November, 1994  
Second Edition : March, 2001  
Third Edition : March, 2005  
Fourth Edition : March, 2006  
Fifth Edition : February, 2008  
Sixth Edition : February, 2009  
Seventh Edition : March, 2011  
Eighth Edition : March, 2013  
Ninth Edition : February, 2014  
Tenth Edition : February, 2015  
Eleventh Edition : January, 2016  
Twelfth Edition : February, 2017  
Thirteenth Edition : March, 2018  
Fourteenth Edition : February, 2019  
Fifteenth Edition : March, 2020

Committee/  
Department : Auditing and Assurance Standards Board

Website : [www.icaai.org](http://www.icaai.org)  
E-mail : [aasb@icaai.in](mailto:aasb@icaai.in)

Price : Rs. 700/-)

ISBN : 978-81-8441-690-9

Published by : The Publication Department on behalf of the  
Institute of Chartered Accountants of India, ICAI  
Bhawan, Post Box No. 7100, Indraprastha Marg,  
New Delhi – 110 002.

Printed by : Sahitya Bhawan Publications, Hospital Road, Agra  
282 003.  
March /2020/ (Revised)

## Foreword

---

Banking industry in India has scaled newer heights with the changing times. The increased use of technology and digitalization has brought a revolution in the working style of banks. Nevertheless, the core fundamental aspects of banking i.e. trust and confidence of the people on the banking system remain same. The changing dynamics of banking industry brings new kind of risk exposures for banks making statutory audit of banks a major ingredient to bridge off the risk exposures.

The statutory audit of banks forms an integral and important part of control mechanism of the banking sector. It enhances the stakeholders' confidence in the credibility of financial information provided by banks at year end. It is essential that the statutory auditors are well equipped in terms of their knowledge of the banking industry to conduct effective and efficient bank audits.

The Guidance Note on Audit of Banks brought out by the Institute of Chartered Accountants of India under the aegis of Auditing and Assurance Standards Board (AASB) 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 revised 2020 edition of the "Guidance Note on Audit of Banks" for the benefit of the members and stakeholders at large. I am happy to see that the Guidance Note is comprehensive and self-contained reference document.

I compliment CA. G. Sekar, Chairman, CA. Debashis Mitra, Vice-Chairman and other members of the Auditing and Assurance Standards Board for bringing out this revised Guidance Note to assist the members in maintaining quality in bank audits. I also acknowledge the contribution of CA. Shrinivas Y. Joshi, Convenor of the Study Group in revising this Guidance Note.

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

New Delhi  
March 2, 2020

**CA. Atul Kumar Gupta**  
President, ICAI



## Preface

---

The depth and spread of the banking sector in any country is a major indicator of the economic strength of the country. It is, therefore, very essential to ensure that the banking sector remains healthy and robust. For healthy and robust banking sector, one of the most important factors is reliable financial information supported by audits performed in accordance with the established performance benchmarks.

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" to provide detailed guidance to the members who undertake audits of banks and bank branches. The Guidance Note is updated every year to incorporate the impact of developments that have taken place in the banking sector which require attention of statutory auditors, such as, master directions/circulars of RBI, other relevant circulars issued by RBI, relevant pronouncements of ICAI having bearing on bank audits, amendments/changes in applicable laws or regulations. 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.

We are happy to place in your hands this revised 2020 edition of the Guidance Note on Audit of Banks. The Guidance given in the Guidance Note is broadly bifurcated into two Sections i.e. Section A - Statutory Central Audit, Section B - Bank Branch Audit. Department wise guidance is given in Section A - Statutory Central Audit viz. Personal Banking and Operations, Retail Banking and Marketing, Wealth Management and Third Party Products, Credit Monitoring and Restructuring, Treasury Operations, Audit of Information Technology and Digital Banking, Long Form Audit Reports Consolidation, etc.

For benefit of the members, the Guidance Note also contains various Appendices like Illustrative formats of engagement letter, illustrative formats of auditor's report both in case of nationalized banks and banking companies, illustrative formats of management representation letter, the text of master directions, master circulars and other relevant circulars issued by RBI.

At this juncture, we wish to place on record our gratitude to CA. Shrinivas Y. Joshi, Central Council Member and Convenor of the Study Group, who is a subject matter expert and possess vast practical experience in Bank Audit, for revising the Guidance Note and his team.

We wish to express our sincere thanks to CA. Atul Kumar Gupta, Honourable President, ICAI and, CA. Nihar Niranjan Jambusaria, Honourable Vice-President, ICAI for their guidance and support to the activities of the Board.

We are thankful to all our Central Council colleagues for their guidance and support to the activities of the Board. We also express our gratitude to all the members of AASB for their guidance and support in finalizing this Guidance Note. We also thank CA. Megha Saxena, Secretary, AASB, CA. Rajnish Aggarwal, Assistant Director, CA. Nitish Kumar, Executive Officer and other staff of AASB for their hard work in giving the Guidance Note its final shape.

We are sure that the members would find the Guidance Note useful while conducting audits of banks and bank branches.

**CA. (Dr.) Debashis Mitra**  
Vice Chairman  
Auditing and Assurance Standards Board

**CA. G. Sekar**  
Chairman  
Auditing and Assurance Standards Board

## Acknowledgement

---

The Board acknowledges the contribution made by the following members of the Study Group constituted for the purpose of revising the Guidance Note on Audit of Banks and we place on record our gratitude for their contribution in enrichment of knowledge of the members:

CA. Abhijit Sanzgiri, CA. Sandeep D. Welling, CA. Dhananjay J. Gokhale, CA. Niranjan Joshi, CA. Atul Bheda, CA. Abhay V. Kamat, CA. Ashutosh Pednekar, CA. Sanjay Khemani, CA. Vikas Kumar, CA. Gautam V. Shah, CA. Nilesh Joshi, CA. Parag Hangekar, CA. Shivratn Agarwal, CA. (Dr.) Yogesh Satpute, CA. Kuntal P. Shah, CA. Ketan Jogalekar, CA. Nachiket Deo, CA. Parag V. Kulkarni, CA. Nitesh Shetty, CA. Ketan Saiya, CA. Pankaj Tiwari, CA. Prashant Tidke, CA. Ashutosh Joshi, CA. Bhakti Dalbhide, CA. Swapnil Ghate, CA. Milind Bhave, and CA. Mukund K. Bhave.

**CA. (Dr.) Debashis Mitra**  
Vice Chairman  
Auditing and Assurance Standards Board

**CA. G. Sekar**  
Chairman  
Auditing and Assurance Standards Board





# Contents

---

*Foreword*

*Preface*

**Section A – Statutory Central Audit ..... 1-214**

Chapter 1: Personal Banking and Operations Department .....	1-3
Chapter 2: Retail Banking and Marketing Department.....	4-10
Chapter 3: Wealth Management and Third Party Products .....	11-14
Chapter 4: International Banking Division .....	15-16
Chapter 5: Treasury Operations .....	17-111
Chapter 6: Audit of Information Technology and Digital Banking Division.....	112-139
Chapter 7: Human Resources Department.....	140-142
Chapter 8: Large Corporate and Loan Syndication .....	143-144
Chapter 9: Micro, Small and Medium Enterprises Department.....	145-146
Chapter 10: Rural and Agricultural Business Department.....	147-148
Chapter 11: Law Department .....	149-151
Chapter 12: Credit Recovery Department.....	152-153
Chapter 13: Risk Management Department.....	154-167
Chapter 14: Central Audit and Inspection Department .....	168-170
Chapter 15: Credit Monitoring and Restructuring Department .....	171-175
Chapter 16: Consolidation and Balance Sheet Preparation .....	176-199
Chapter 17: Government Business Department.....	200-205
Chapter 18: Consolidation of LFARs for the Bank.....	206-209
Chapter 19: Certification .....	210-214

**Section B – Bank Branch Audit ..... 215-718**

Chapter 1: Practical Guide for Statutory Branch Auditors performing Bank Branch Audit for first time .....	217-223
Chapter 2: Bank Branch Audit Planning.....	224-225
Chapter 3: Audit Documentation in Bank Branch Audit.....	226-227
Chapter 4: Overview of Standards on Auditing.....	228-248
Chapter 5: Special Considerations in a CBS Environment.....	249-256
Chapter 6: Cash .....	257-259
Chapter 7: Balances with Reserve Bank of India, State Bank of India and Other Banks.....	260-261
Chapter 8: Money at Call and Short Notice (For Branches Outside India) .....	262
Chapter 9: Investments.....	263
Chapter 10: Advances-Agriculture.....	264-293
Chapter 11: Reporting for Advances .....	294-471
Chapter 12: Fixed Assets and Other Assets .....	472-486
Chapter 13: Borrowings and Deposits .....	487-499
Chapter 14: Other Liabilities .....	500-503
Chapter 15: Contingent Liabilities and Bills for Collection.....	504-515
Chapter 16: Profit and Loss Account .....	516-536
Chapter 17: Audit Reports and Certificates.....	537-566
Chapter 18: Gold/Bullion.....	567
Chapter 19: Books and Records .....	568-570
Chapter 20: Inter Branch/Office Accounts.....	571-577
Chapter 21: Fraud .....	578-583
Chapter 22: Miscellaneous.....	584-585
Chapter 23: Audit of Foreign Exchange Business .....	586-618
Chapter 24: Clearing House Operations by Service Branches.....	619-622
Chapter 25: Recovery of Non-Performing Assets by Asset Recovery Branches.....	623-632
Chapter 26: Bank Branch Audit and GST Compliance .....	633-718

## **Contents available at ICAI website**

- A. Forward and Preface of Past Years
- B. Text of Guidance Note on Audit of Banks, 2020 edition
- C. Appendices of Guidance Note on Audit of Banks, 2020 edition
  - Appendices of Section A - Statutory Central Audit of Guidance Note on Audit of Banks, 2020 edition
    - Appendix I : Illustrative Format of Report of the Auditor of a Nationalised Bank
    - Appendix II : Illustrative Format of Report of the Auditor on the Standalone Financial Statements of Banking Company
    - Appendix III : Illustrative Format of Engagement Letter in case of a Nationalised Bank
    - Appendix IV : Illustrative Format of Engagement Letter to be sent to the Appointing Authority of the Banking Company
    - Appendix V : 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)
    - Appendix VI : Illustrative Format of Management Representation Letter to be obtained from Bank Management in case of Statutory Central Audit
    - Appendix VII : Illustrative Format of Management Representation Letter to be obtained from Bank Management in connection with the Limited Review
    - Appendix VIII : Illustrative List of Special Purpose / Exception Reports in CBS
    - Appendix IX : Illustrative Audit Checklist for Capital Adequacy
    - Appendix X : Illustrative Checklist for the Verification of the Aspects of the Treasury/Investments of the Bank in Statutory Audit

- Appendices of Section B – Bank Branch Audit of Guidance Note on Audit of Banks, 2020 edition
  - Appendix I : Text of Section 6 of the Banking Regulation Act, 1949
  - Appendix II : The Third Schedule to the Banking Regulation Act, 1949
  - Appendix III : Illustrative Format of Report of the Branch Auditor of a Nationalised Bank
  - Appendix IV : Illustrative Format of Report of the Branch Auditor of a Banking Company
  - Appendix V : Illustrative Format of Engagement Letter to be sent to the Appointing Authority of the Nationalised Bank by Branch Auditor
  - Appendix VI : Illustrative Format of Written Representation Letter to be obtained from the Branch Management
  - Appendix VII : Features of the gold monetization scheme
  - Appendix VIII : Suggested Abbreviations used in the Banking Industry
  - Appendix IX : Illustrative list for Basis of Selection of Advance Accounts in case of Bank Branch Audit
  - Appendix X : Illustrative Bank Branch Audit Programme for the Year ended March 31, 2020

D. Text of Relevant Master Circulars Issued by RBI

E. Text of Relevant Master Directions issued by RBI

F. Text of Relevant Notifications, FAQs and General Circulars

**Section A –  
Statutory Central Audit**



# Personal Banking and Operations Department

---

## Introduction

1.01 The area of operation / function of the Personal Banking and Operations Department is typically confined to the Resource Mobilization, i.e., source of funds (for the bank) in the form of CASA Deposits, Term Deposits and customer service and operations. The department is responsible for monitoring of the deposit portion which is major contributor for the bank as resource of funds.

1.02 In today's new age banking, there are various innovative products which are launched by every bank which has its own unique characteristics and customisation based on the need of funds and customer portfolio of the bank. For example, the bank may have deposit products as well as products / services linked with categorisation of customers based on predefined criteria offering privileged banking services to certain section of customers. In the era of liberalisation of rate of interest, every bank is expected to be proactive in terms of decision making for rate of interest. Further, the banks do have specified policies w.r.t. bulk deposits and the bank may offer special rates on such deposits on need-based basis.

## Preparation / Planning

1.03 The Statutory Central Auditor (SCA) should obtain deposit policy of the bank and rules and regulation related to deposits as framed by the bank. Further, the auditor should get himself acquainted with the various deposit products of the bank along with rules related thereto. The bank may have various methodologies adopted for interest payment wherein the deposits can be non-cumulative, cumulative deposits and in certain cases, bank may launch schemes wherein there is a bullet payment of interest at the end of tenure of deposits without compounding of interest.

## Conduct / Execution

1.04 Verify the application of rate of interest vis-à-vis interest table to every product of deposits by taking sample accounts of each type of deposit product including instances of premature withdrawal of deposits, retrospective renewal of deposits.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

- Verify whether the accounting effects of interest payable in the form of interest accrued but not due and interest accrued and due are correctly given and compliance of TDS thereon.
- Verify the compliance of internal circulars of the bank in terms of categorisation of customers and application of the said terms in the master data of such deposit holders.
- Verify the compliance with the rules and regulations formulated by the bank related with the deposit products based on sample check.
- Verify the complaints lodged w.r.t. the customer services and contingent liability / liability arising thereon.
- Verify the special rate deposits (those deposits wherein rate of interest is deviated as compared to the interest table) as regards the eligibility and approval of the same as per internal policy of the bank.

### **Reporting / Conclusion**

1.05 Check whether the appropriate presentation of deposits is made in financials of the bank with reference to the type of product, interest accrued thereon and also verify the requirement for disclosure of contingent liability, if any, arising out of consumer court and other cases, related with deposits. Based on audit issue, appropriate reporting of adversities observed in the Deposit section and customer services.

1.06 Readers may note that for the reference and benefit of the members various illustrative formats for Auditor's Report, Engagement Letter, Management Representation Letter, Exception Reports in CBS, Checklist for Capital Adequacy, and Checklist for the verification of the aspects of the Treasury/Investments are given in the appendices of Section A (Available on ICAI website) of the Guidance Note as follows:

- Appendix I** – Illustrative Format of Report of the Auditor of a Nationalised Bank Independent Auditor's Report
- Appendix II** – Illustrative Format of Report of the Auditor on the Standalone Financial Statements of Banking Company
- Appendix III** – Illustrative Format of Engagement Letter in case of a Nationalised Bank
- Appendix IV** – Illustrative Format of Engagement Letter to be sent to the Appointing Authority of the Banking Company



- Appendix V** – 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)
- Appendix VI** – Illustrative Format of Management Representation Letter to be obtained from Bank Management in case of Statutory Central Audit
- Appendix VII** – Illustrative Format of Management Representation Letter to be obtained from Bank Management in connection with the Limited Review
- Appendix VIII** – Illustrative List of Special Purpose / Exception Reports in CBS
- Appendix IX** – Illustrative Audit Checklist for Capital Adequacy
- Appendix X** – Illustrative Checklist for the Verification of the Aspects of the Treasury/Investments of the Bank in Statutory Audit

# 2

## Retail Banking and Marketing Department

---

### Introduction & Bank's process

2.01 The banks generally provide various retail advances namely:

- Home loans and loans against property
- Vehicle/Automobile loans
- Personal loan
- Consumer durable loans
- Credit cards
- Micro finance loans
- Jewel loans

2.02 Generally, loans are either sourced through direct selling agents or through bank's own branches. The bank has a credit policy which defines process to be followed for sanction and disbursement of loan and the various documents required. Sanction for retail loans and management of retail loans cannot be outsourced.

2.03 Recently, the Reserve Bank of India (RBI) has prohibited banks from deploying direct selling agents (DSAs) to sell retail loans and verifying borrowers' documents. KYC procedures, involving verifying borrowers' original documents should be performed by bank officials and cannot be outsourced.

2.04 Generally, the credit assessment process is not as detailed as followed in case of the corporate loans. The bank generally collects following documents:

- Completely filled Loan Application Form with customers' signature.
- Income proof like Salary slip, financial statements, Income tax returns, Bank statement.
- Photograph.
- Business continuity proof. (e.g. Form D of Maharashtra Shops and Establishment Act, Any other govt. certificate for doing business).
- Residence proof.

- Identification proof.
- Contact Point – Mobile No of applicants is mandatory.
- Age proof.
- PAN Card.

### **Credit Due Diligence for Retail Financing**

2.05 Credit due diligence for a retail financing is different from the wholesale financing since the quantum of loan and the complexity of transaction is different. Retail finance credit due diligence is parameterised / score card driven wherein if the borrower fits into a pre-defined credit matrix / parameters and gets a score which is above the threshold, loan is approved / sanctioned. The scorecard parameter would be suitably deliberated and considered based on historical experience and keeping in view the dynamic environment like minimum income criteria, employment details, age, telephone etc. Once the score is generated the bank would also run CIBIL score and if CIBIL score is above specific score than the bank considers for further sanction. The scorecard based approved portfolio is closely monitored at regular frequency and the parameters are suitably modified based on portfolio's performance.

2.06 For e.g. For Farm / tractor loan, parameters / factors like soil fertility, area under cultivation, produce per acre, rainfall / reservoirs levels, make model of the tractor, geography are pre-defined and weightages are assigned to each parameter depending on the criticality which will throw up a score for each borrower. These models/ score cards are embedded in the loan management system of the banks which result into auto approval of the loan. While the quantum of the loan is small, number of retail borrowers is significantly large and therefore it is time consuming for banks to evaluate credit for each borrower. Hence credit loan approval for retail financing is primarily score card driven. Parameters could be qualitative and quantitative in nature.

2.07 The banks generally have a system in which various information collected are keyed into the system. The system generally automatically runs a credit filter report. The credit Filter report is based on pre-defined criteria as per the credit policy like minimum income criteria, employment details, age, telephone etc. and the score are generated from the system.

2.08 As a part of sanction process of the loan, the bank also runs CIBIL score and if CIBIL score is above specific score than the bank considers for further sanction.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

2.09 The bank also conducts field investigations on the proposed customer which generally involve residential and office visits. Few banks also have the process of Fraud Containment Unit (FCU) screening of selected sample of file. At the FCU, the FCU officer screens through the genuineness and authenticity of the documents from the perspective of any traces of a fraud.

2.10 Post the above verification by FCU, the bank also initiates the Positive De dupe check for positive database, wherein if the customer is existing customer of the bank, the system gets the popup of such links on his screen.

2.11 The credit officer initiates the negative de dupe check on the negative database through system, Negative De dupe check against the RBI defaulter list, Terrorist list and declined applications. Such list is uploaded in the system by Central team of the bank. If the customer is traced under such negative listing then loan application is rejected by the credit officer in the system. Once, all the processes are completed and based on the results, the bank sanctions the loan.

### **Post Disbursement Monitoring**

2.12 Once the funds are disbursed, periodic reviews on the portfolio/borrowers/assets are conducted by the relevant Business and Credit Departments. Notwithstanding sound appraisal processes and risk management, some portfolios / accounts may develop weakness on account of changes in internal or external conditions. Mechanisms for monitoring and identifying early warning signals (EWS) should be in place to review the portfolio and identify such weak accounts before they turn NPA. These monitoring mechanisms will help take remedial measures and limit losses. Such monitoring can be undertaken through the following:

#### *Retail Financing*

Roll forward / roll back rates – (deterioration on days past due / improvement in days past due).

Infant / Early delinquencies – non payment of first EMI / instalments.

Performance review across at branch / scheme / program / Relationship Manager etc, Scorecard parameter reviews.

### **Credit Risk Rating Process**

2.13 The rating provides a consistent and common scale for measurement of credit risk of a loan asset in terms of Probability of Default (PD) across products and sectors. Coupled with estimation of Loss Given Default (LGD), it enables the organisation to make an estimate of credit cost for the loan assets and thus, helps to differentiate among loan assets as objectively as possible.

PD is measured by the internal rating assigned to the Borrower and assesses the likelihood that the Borrower will default on its debt obligations. LGD is measured by the value of the security/ collateral / cash flow cover (project finance)/ DSRA/other credit enhancements for the particular facility provided by the Borrower, after applying haircut to each assets sub class, which will form a cover for the outstanding facility, once a default has occurred. Each loan is then assessed for rating migration (upward or downward movement) throughout the loan life cycle. There are 3 integral components (known as **risk components**) that are required to be estimated for credit risk quantification.

**Probability of Default (PD):** It refers to the probability / risk / chance of a borrower defaulting\* on the payment of the credit obligations, within a given time horizon, usually one year.

**Loss Given Default (LGD):** It refers to the loss likely to be suffered in the event of a default occurring in an exposure. It takes into account the amount of recoveries likely to be made post default

**Exposure at Default (EAD):** It refers to the amount that is exposed to the default risk. It is usually the amount outstanding as well as undrawn commitment that is expected to be drawn by the time of default.

### **Audit approach, procedures including regulatory considerations**

#### **2.14**

##### **A. Preliminary Check**

The banks should do a preliminary check of all the accounts before considering the proposed loan. An auditor should look at the following documents for checking the bank preliminary process:

- i. Prescribed Application form.
- ii. CIBIL Check of borrower and guarantor.
- iii. KYC Compliance.
- iv. Income proof like Salary slip, financial statement, Income tax returns, Bank statement.
- v. Property Valuation Report.
- vi. NOC stating that the property is not mortgaged at any other bank.
- vii. Technical Review.
- viii. In case of Vehicle Loans, copy of original invoices, copy of RC and

## **Guidance Note on Audit of Banks (Revised 2020)**

---

insurance policy of vehicle with bank clause should be obtained.

- ix. In case of Education loans, document for the studies in affiliated universities/colleges, prospectus and fees details should be obtained.
- x. Whether the Bank has complied with the particulars given in the documentation manual.
- xi. If the loan is taken over from another Bank, satisfactory performance report from that Bank to be collected.
- xii. If any additional limit is granted, ensure the security and eligibility is being considered.
- xiii. Whether the Bank has obtained legal security report addition to valuation report.
- xiv. Whether all registers required by the Bank/Branch is kept updated.

### **B. Disbursement**

The auditor should check that the disbursement should happen only if all the terms and conditions of the sanction letter have been fulfilled and an acceptance letter for the same have been acquired.

Also check whether processing charges, inspection charges, mortgage charges and documentation charges have been collected by the bank.

### **C. Post Disbursement Inspection**

The bank should have a proper check on the active accounts. The important elements that a statutory auditor can check are as follows:

- i. There should be an acceptance letter duly acknowledged by the borrowers for all the loan accounts.
- ii. Execution of the loan documents should be as per the terms and conditions of the sanction letter.
- iii. All the original documents are held in the safe custody in fire resistance safe.
- iv. Confidential Report and NOC from the existing bankers.
- v. CIBIL Report and score. The bank should check for any adverse comments.
- vi. Valuation of Securities.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

- vii. External & Internal Credit Rating.
- viii. Due Diligence Certificate.
- ix. Verify the payment schedule as per the sanction letter is implemented. If any, check the approval document for the same.
- x. Perform ledger scrutiny.
- xi. Whether the interest and principal repayment are received in timely manner in accordance with the repayment schedule as mentioned in the loan agreement/term sheet.
- xii. Whether the SMAs/EWS are reported to the management on regular intervals and what course of action is taken to mitigate the same.
- xiii. Verify whether the group exposure and industry exposure is within the prescribed limits.
- xiv. 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.
- xv. The auditor should perform analytical procedures for computing the processing fee percentage for different ticket size loans.

The auditor should check for any Non-Performing Asset (NPA). All accounts which are overdue or stops generating income for the banks continuously for 90 days, then it has to be treated as NPA and provision should be made as per extant guidelines of RBI.

### **Other Aspects**

2.15 RBI Circular RBI/2019-20/53 DBR.DIR.BC.No.14/13.03.00/2019-20 (September 04, 2019), it has now been decided to link all new floating rate personal or retail loans (housing, auto, etc.) and floating rate loans to Micro and Small Enterprises extended by banks with effect from October 01, 2019 to external benchmarks.

- (a) All new floating rate personal or retail loans (housing, auto, etc.) and floating rate loans to Micro and Small Enterprises extended by banks from October 01, 2019 shall be benchmarked to one of the following: -
  - Reserve Bank of India policy repo rate
  - Government of India 3-Months Treasury Bill yield published by the Financial Benchmarks India Private Ltd (FBIL)

#### **Guidance Note on Audit of Banks (Revised 2020)**

---

- Government of India 6-Months Treasury Bill yield published by the FBIL
  - Any other benchmark market interest rate published by the FBIL.
- (b) Banks are free to offer such external benchmark linked loans to other types of borrowers as well.

#### **Direct Marketing Expenses**

2.16 These are the expenses incurred majorly for sourcing of retail loans/credit cards and collection of retail overdue loans. RBI circular RBI/2006/167/DBOD.NO.BP.40/21.04.158/2006-07 dated 3rd 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.



# 3

## Wealth Management and Third Party Products

---

### Introduction

#### Wealth management

3.01 Wealth management involves advice and execution of investments on behalf of high net worth banking individuals. Each bank will have its own criteria for defining High Net Worth Individuals based on the relationship with the bank and the amount of assets kept by the customers. The focus is on the asset allocation of the client considering his financial goals and plans and his risk comfort or risk aversion.

3.02 Banks have dedicated staff called as Wealth Managers or Relationship Managers who look after the needs and requirements of their customers. These are a single point of contact for dealing with and through the Bank. The staff has the necessary training, qualifications and the expertise to handle these services.

3.03 Wealth Management is also synonymously used with Private Banking. However wealth management is a broader concept. Private Banking teams may not render investment services or restrict themselves to their own products. However mostly the functions and roles overlap in many Banks.

3.04 These specifically designated individuals help the customer with either a tailor made portfolio or also suggest alternate investments either in Real-Estate, Debt, Mutual Funds, Equity, Art, Private Equity, Structured Products etc. Banks also help with tax advice.

3.05 Optimal asset allocation after a prudent risk analysis is done for the customer to design a tailor made, customized portfolio to balance the risk reward ratio. This portfolio is continuously monitored to ensure the Bank customer earns a healthy return on his investments. A detailed customer risk appetite study is done before designing the asset allocation. These services are generally provided for a fee.

#### Third party products

3.06 Banks not only have their own products in terms of Deposits, Loans, Remittances, Lockers, Credit Cards etc. but also offer a variety of third party products. Third party products are those financial products that are sold by a

### **Guidance Note on Audit of Banks (Revised 2020)**

---

Bank for some other Institutions. Bank only distribute or sale these products on fee basis. These products are not created by the Bank. These products not come under the Balance sheet of the Bank as Deposit or Loans and Advances. Bank also do not have any requirement to allocate Capital for these products, hence these are not a part of Bank's CRAR calculations. Bank can act as a Broker permitting them to sell insurance policies of different insurance companies.

3.07 A third party is an individual or entity that is involved in a transaction but is not one of the principal and has a lesser interest.

3.08 Few Examples of Third Party Products:

- Insurance Product
- Gold Coins
- Mutual Funds
- Collection of utility bills and taxes
- Investment Advisory Services
- Mobile Recharge
- Government Bonds/Securities
- Demat Accounts
- Portfolio Management Services
- Referral Services
- Equipment Leasing and Hire Purchase Business
- Sponsoring Infrastructure Debt
- Factoring Services
- Underwriting Activities
- Primary Dealership Business
- Pension Fund Management

3.09 Banks can undertake certain eligible financial services or para-banking activities either departmentally or by setting up subsidiaries. Banks may form a subsidiary company for undertaking the types of businesses which a banking company is otherwise permitted to undertake, with prior approval of Reserve Bank of India. The instructions issued by Reserve Bank of India to Banks for undertaking various financial services are stated in RBI Master Direction DBR.FSD.No.101/24.01.041/2015-16 May 26, 2016 (Updated as on September 25, 2017).

### **Guidance Note on Audit of Banks (Revised 2020)**

---

3.10 A Bank can undertake business permitted under Section 6(1) of Banking Regulation Act 1949 provided -

- There shall be a Board approved policy for the activity that shall comprehensively cover the said activity including the various risks associated with it and suitable risk mitigation measures.
- The instructions/ guidelines on KYC/AML/CFT applicable to Banks, issued by RBI from time to time, shall be complied with.
- The general principles as enunciated in the Charter of Customer Rights issued by RBI shall be adhered to.
- Specific conditions of IRDA, SEBI, PFRDA, Accounting Standards issued by ICAI need to be complied.
- No Bank shall engage in a financial Activity without prior approval of RBI other than approved activities.
- A Bank that is a trading/clearing member shall keep its and its clients' position distinct from one another.
- Professional Clearing Member of the commodity derivatives segment of SEBI recognised exchanges need to satisfy the prudential criteria.
- Bank shall take exposure on its trading members as per the policy approved by its board.
- Bank shall ensure strict compliance with various margin requirements as may be prescribed by the Bank's board or the Commodity Exchanges as also the extant RBI guidelines regarding guarantees issued on behalf of commodity brokers.
- Banks may invest in other equipment leasing/ hire purchase/factoring companies within the limits specified in Section 19(2) of Banking Regulation Act, 1949, with the Reserve Bank's prior approval but they shall not act as promoters of such companies.

3.11 Banks earn revenue on Sale of different products. Low-cost of operations and NIL capital requirements makes it viable for Banks to sell third party products. Banks get good commission income by cross selling multiple products to existing customers.

3.12 Auditor should note the following –

- 1) Agreements are entered into with reputed third party product manufacturers. Due diligence on the financial credentials and the reputation of the third party is comprehensively done before the tie-up. Detailed diligence testing and validation documents should be in place.

#### **Guidance Note on Audit of Banks (Revised 2020)**

---

- 2) There is a policy in place detailing the products and the manner in which they can be and are sold. The policy should be in conformity with extant RBI guidelines. Adherence to the policy should be strictly ensured.
- 3) Whether there is a policy in place for identifying vulnerable customers; if any and the adequacy of governance and oversight process right from product launch to ongoing monitoring.
- 4) Bank's staff who are designated to sell these products have the necessary prescribed qualifications and training. The sale should be done by the designated employees only. The suitability and appropriateness of the product to the customer to whom it is sold must be ensured.
- 5) Revenue earned on sale of these products is properly accounted and received as per the contractual rates as per the agreement entered into between these parties. These rates could change from time to time. Correct applicable rates should be accounted. The point of accounting of Income is critical and it should be consistently applied.
- 6) The original agreements must be on record, properly filed and stored. Compliance to the terms and conditions of the agreement from both parties must be ensured. Timely renewal of these agreements should be ensured.
- 7) Complaints if any on mis-selling of these products or deficiency in service should be looked into for proper redressal and closure. These complaints may pose both a regulatory and a reputational risk to the Bank. Necessary disciplinary action against the concerned staff should be initiated as per bank's internal policy.
- 8) For any outstanding receivables from these third parties, balance confirmations should be called for and be on record. Any old outstanding should be verified for disputes, appropriate provisioning or write-off.
- 9) General IT controls and controls over Management Information.

# 4

## **International Banking Division**

---

### **Functions of International Banking Division includes:**

#### 4.01

- Monitoring Overseas Branches
- Sanction of Loans of Overseas Branches
- Monitoring of advances accounts of Foreign branches
- Appointment of Statutory Auditors for these branches
- Obtaining Audit Reports of Overseas Branches
- Annual Budgeting of Overseas Branches
- Sanctioning of Expenses of Overseas Branches
- Review of policies for foreign branches such as ORM Policy, IBO Policy, Premises Policy
- Compilation of Unhedged Foreign Currency Exposure
- Conversion of the Branch Balance Sheet for consolidation into Bank Balance Sheet
- ECGC Claims
- Return Filing
- Investments held by Foreign Branches - Monitoring the limits set by Treasury
- GST compliances
- Cash management, fund and wire transfers

4.02 The auditor should firstly understand the organization structure and the functionalities of the specialized centralized division. If, there is a manual of operations in place, then he should obtain the latest updated version. The auditor should also obtain copies of inspection or other internal audit reports of this division which covers the efficiency of various functional operations. The audit scope, frequency of audit and the accuracy of MIS generated and communicated

## **Guidance Note on Audit of Banks (Revised 2020)**

---

should be looked in to. Any open issues should be followed up for closure and also understanding the reasons why these issues were not addressed till date.

4.03 Appointment of competent staff to handle overseas operations, appointment of overseas statutory auditors, sanction of expenses, obtaining timely audit reports in compliance with local laws, MIS, ensuring integration of these accounts with local accounts are key functions and the Statutory Central Auditor (SCA) who is allocated this responsibility should ensure that these are conducted as per due laid down process in accordance with regulations.

4.04 The auditor should understand the process of preparation of the Trial Balance, Profit and Loss account, Balance Sheet and the internal financial controls therein. Generally, this division would operate as a cost centre.

4.05 There may be cases where local branches would have given Guarantees for overseas borrowers in foreign Branches which is a funded liability in Foreign Books in which case, care need to be taken that these are netted off at the consolidation level and a funded / non funded liability is not shown for the same borrower in consolidated accounts.

4.06 Where the borrower is an NPA in India but is either standard or credit impaired overseas, the amount of provision held overseas should also be synced to higher as per local laws.

4.07 Any significant or material amounts also having a bearing on consolidated operations need to be disclosed separately or appropriately disclosed as policies / notes on accounts at the consolidated level.

4.08 Any deviations or discrepancies noted should be appropriately reported in The Long Form Audit Report.

## Treasury Operations

---

### (A) Introduction and Bank's Process

5.01 Treasury operations is one of the most important function of a bank, responsible for the processing of all financial market transactions and usually much more, including a crucial role in managing risk. Treasury comprises two main components – Investments (comprising transactions related to domestic investments and money market operations) and Forex & Derivatives. In a well-functioning risk management system, banks broadly position their balance sheet into Trading and Investment or Banking Books. While the assets in the trading book are held primarily for generating profit on short-term differences in prices/yields, the banking book comprises assets and liabilities, which are contracted basically on account of relationship or for steady income and statutory obligations and are generally held till maturity. Thus, while the price risk is the prime concern of banks in trading book, the earnings or economic value changes are the main focus of banking book.

### Core functions of Treasury Operations in Bank

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

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

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

#### Front Office (Dealing Room)

- Money and fixed income dealings
- Forex & Derivatives
- Treasury Sales
- Equities

- Primary Dealers
- Debt Sales
- Credit Default Swaps

**Mid Office (Risk)**

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

**Back Office**

- Settlement and follow up
- Reconciliations
- Accounting
- Valuation

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

**Front office Operations**

5.05 The front office operations consist of dealing room operations wherein the dealers transact deals with the various approved counterparties. Deals are transacted by dealers on various anonymous order matching platforms such as NDS-OM, CROMS, NDS-CALL, FX-CLEAR, FX-SWAP, E-Kuber and over communication platform such as Reuters', Bloomberg, telephonic conversation with counter party or through empaneled brokers.

5.06 The dealers are primarily responsible to check for counterparty exposure limits, eligibility, and other requirements of the Bank before initiating any deal with the counter-party. Dealers must ensure that all risk/credit limits are available before transacting a deal. Also, the deal must not contravene the current regulations regarding dealing in INR with overseas banks/counterparties. All counterparties are required to execute the International Swaps and Derivatives Association ('ISDA') agreement as well as pass a board resolution allowing it to enter into derivative contract. As soon as the deal is struck with counterparty, the deal details are noted in a dealers' deal pad and thereafter captured in front office system of the Bank which gets queued in for authorization by back office.



### **Middle office Operations**

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

- Limit setting and monitoring exposures in relation to limits;
- Assessing likely impact of market movements based on internal assessments and external /Internal research;
- Evolving hedging strategies for assets and liabilities;
- Interacting with the bank's Risk Management Department on liquidity and market risk;
- Monitoring open currency positions;
- Calculating and reporting VAR;
- Stress testing and back testing of investment and trading portfolios;
- Risk-return analysis; and
- Marking open positions to market to assess unrealized gain and losses.

### **Back office Operations**

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

5.09 An important development in the back office has been the advent of straight-through processing (STP), also called 'hands-off' processing. This has been made possible through enhancement of computer system to real time online input in the trading platform, which in turn has meant that the back office can authorise/confirm deals pending for authorisation in the trading platform. In practice this is done automatically by matching incoming data from counterparties and thereby focussing on investigating exceptions. With the introduction of online trading systems, the deal is 'confirmed' as it is done, allowing the back office to concentrate principally on handling exceptions, settlement and monitoring and risk control. This is a completely different approach than the earlier system of input and checking of written paper-based deals that represented only a dealer's version of what the deal was before external verification could even commence.

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

### **Functions of Back Office**

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

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

#### ***Counterparty confirmation***

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

5.13 Deals done with customers (non-banks) will normally be confirmed by e-mail, with instructions swapped on the telephone, depending on the

arrangements. Increasingly, however, corporate customers are using automatic confirmation-matching services. It is essential that the deal is confirmed independently of the trader before any kind of value is given or payment is made.

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

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

**Settlement**

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

**Reconciliation**

5.16 Operations areas are typically involved in a number of reconciliation processes, including the reconciliation of dealers' overnight positions, NOSTRO accounts and brokerage payments. This can also mean reconciling positions for margin calls in futures trading or reconciling custody accounts to the underlying securities in securities trading. However, the basic reconciliation function is to agree or reconcile the entries that have passed over an account with correspondent bank against those that have been passed internally in the books of the bank to a NOSTRO account. After reconciliation, the unmatched items in both accounts then represent those that have not been responded to in either the books of the bank or its correspondent and should therefore requires to be investigated.

**Important Terms**

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

**Approved Securities**

5.18 Section 5(a) of the Banking Regulation Act, 1949 defines 'approved securities' to mean securities in which a trustee may invest money under clauses (a) to (d) and (f) of section 20 of the Indian Trusts Act, 1882. Approved

## **Guidance Note on Audit of Banks (Revised 2020)**

---

securities comprise primarily the securities issued or guaranteed by the Central or State Government, or any other security expressly authorised by the Central Government by notification in the official gazette.

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

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

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

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

5.21 The RBI has issued 'Repo in Corporate Debt Securities (Reserve Bank) Directions, 2015' on 3<sup>rd</sup> February 2015 and allowed banks to undertake repo transactions in corporate debt securities. Further, the RBI *vide* its circular no. RBI/2015-2016/403 FMRD.DIRD. 10 /14.03.002/2015-16 dated 19<sup>th</sup> May, 2016 on "Repo/Reverse Repo Transactions with RBI" (effective from 3<sup>rd</sup> October 2016) has decided to: (a) align the accounting norms to be followed by market participants for repo/reverse repo transactions under LAF and the Marginal Standing Facility (MSF) of RBI with the accounting guidelines prescribed for market repo transactions. Accordingly, all repo/ reverse repo transactions are required to be accounted as lending and borrowing transactions with effect from 3<sup>rd</sup> October 2016.

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

5.23 RBI *vide* notification RBI/2016-2017/156 FMOD.MAOG No. 117/01.01.001/2016-17 dated November 25, 2016 has decided that the Oil

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

### **Short Sale**

5.24 Short Sale is defined as sale of securities which one does not own, i.e., selling of a security without possessing stock of such securities. A bank can also undertake 'notional short sale' wherein it can sell a security short from HFT even though the stock of said security is held under HFT / AFS / HTM category. Thus, short sales include actual as well as 'notional' short sale. A short sale can be undertaken by the bank subject to certain conditions as stipulated by RBI and within specified limits. Securities which are sold short are invariably required to be delivered on the settlement. A bank may meet the delivery obligation for a security sold short, by utilising the securities acquired under 'reverse repo' mechanism (except under RBI's Liquidity Adjustment Facility). However, as announced in paragraph 13 of the Statement on Developmental and Regulatory Policies, of the fourth Bi-monthly Monetary Policy Statement for 2017-18 dated October 04, 2017, it has been decided that market participants undertaking 'notional' short sale need not compulsorily borrow securities in the repo market. While the short selling entity may ordinarily borrow securities from the repo market, in exceptional situations of market stress (e.g. short squeeze), it may deliver securities from its own HTM/AFS/HFT portfolios. If securities are delivered out of its own portfolio, it must be accounted for appropriately and reflect the transactions as internal borrowing. All 'notional' short sales must be closed by an outright purchase in the market. It may be ensured that the securities so borrowed are brought back to the same portfolio, without any change in book value. The short selling entity must adhere to the extant regulations and accounting norms governing sale or valuation of securities in its portfolios. The bank may frame a Board approved policy for this purpose. Even though reverse repos can be rolled over, short sale position needs to be covered within a maximum period of three months including day of trade.

### **STRIPS**

5.25 STRIPS stand for Separate Trading of Registered Interest and Principal Securities. Stripping is a process of converting periodic coupon payments of an existing Government Security into tradable zero-coupon securities, which will

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

***When Issued Securities***

5.26 'When, as and if issued' (commonly known as 'when-issued' (WI)) security refers to a security that has been authorized for issuance but not yet actually issued. 'WI' trading takes place between the time a new issue is announced and the time it is actually issued. All 'when issued' transactions are on an 'if' basis, to be settled if and when the actual security is issued. The NDS-OM members have been permitted to transact on 'When Issued' basis in Central Government dated securities, subject to the guidelines of RBI.

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

5.27 It is a negotiable money market instrument and issued in dematerialized form or as a Usance Promissory Note against funds deposit at a bank or eligible Financial Institution for a specified time period. CDs can be issued by a bank with a maturity period which is not less than 7 days and not more than one year, from the date of issue and should have a minimum deposit size from a single subscriber not less than Rs. 1 lakh. CDs may be issued at a discount to face value or at a fixed / floating coupon rate.

5.28 Banks have to maintain appropriate reserve requirements, i.e., CRR and SLR, on the issue price of the CDs. There is no lock-in period for the CDs. Though, NRIs may also subscribe to CDs (but only on non-repatriable basis), such CDs cannot be endorsed to another NRI in the secondary market. Banks/FIs may account the issue price under the Head "CDs issued" and show it under deposits. Accounting entries towards discount will be made as in the case of "Cash Certificates".

***Commercial Paper (CP)***

5.29 It is an unsecured money market instrument issued in the form of a promissory note by Corporates, PDs, FIs subject to compliance with the guidelines issued by RBI vide Master Direction on Money Market Instrument:

Call/Notice Money Market, Commercial Paper, Certificate of Deposit and Non Convertible Debentures dated July 7, 2016. The tenure of CP should not be less than 7 days and not more than one year, from the date of issue.

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

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

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

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

***REITs & InvITs***

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

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

Investment Portfolio, Basel III Capital requirements for Commercial Real Estate Exposures and Large Exposure Framework, as applicable.

### **State Development Loans**

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

### **Treps**

5.36 In terms of the Repurchase Transactions (Repo) (Reserve Bank) Directions, 2018 dated 24th July, 2018 "Tri-party repo" means a repo contract where a third entity (apart from the borrower and lender), called a Tri-Party Agent, acts as an intermediary between the two parties to the repo to facilitate services like collateral selection, payment and settlement, custody and management during the life of the transaction.

5.37 Triparty Repo i.e. TREPS facilitates borrowing and lending of funds, in Triparty Repo arrangement. CCIL is the Central Counterparty to all trades from Tri Party Repo Dealing System (TREPS) and also performs the role and responsibilities of Triparty Repo Agent, in terms of Repurchase Transactions (Repo) (Reserve Bank) Directions, 2018 as amended from time to time.

5.38 TREPS Dealing System is an anonymous order matching System provided by Clearcorp Dealing Systems (India) Ltd (CCDS) to enable Members to borrow and lend funds. It also disseminates online information regarding deals concluded, volumes, rate etc., and such other notifications as relevant to borrowing and lending under Triparty Repo by the members.

5.39 The eligible securities deposited by a member as collateral towards borrowing limit as Triparty Repo Collateral are subjected to a valuation exercise at the end of each business day. The valuation is carried out using CCIL's mark-to-mark price for such securities. Aggregate value of securities contributed by a member, net of haircut, rounded downwards to the nearest rupee is set as permissible borrowing limit for such member. Any security deposited during the day as collateral towards borrowing limit is also revalued at last available MTM price of the security and such a value, net of haircut, is made available as Borrowing Limit. Value of any security withdrawn during the day is reduced from the available borrowing limit. Apart from the end of the day valuation, CCIL undertakes such valuation on multiple times during the day also.



5.40 RBI has made the reserve requirements for Triparty Repo borrowing similar to borrowing in market repo and no CRR is required to be maintained for Triparty Repo borrowings outstanding in the books of Member/s. (RBI Notification RBI/2018-19/24 – FMRD.DIRD.01/14.03.038/2018-19 DATED July 24, 2018)

**(B) Audit Approach, Procedures including regulatory requirements/ restrictions & updates**

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

5.42 The latter aspect assumes special significance in the case of banks where investment transactions have to be carried out within the numerous parameters laid down by the relevant legislation and directions of the RBI. The auditors should keep this in view while designing their audit procedures relating to investments.

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

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

5.44 In today's scenario, most of the treasury functions of banks are performed in an automated environment (for example, trade booking, settlement and accounting). In such a situation, it becomes imperative for the auditors to test the general information technology controls and system application controls around the functioning of the systems involved and also the interfaces between various systems.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

5.45 Some of the typical audit procedures include:

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

### **Substantive Audit Procedures**

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

### **Examination of Reconciliation**

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

5.48 Some typical audit procedures would include:

- perusing the process, frequency of reconciliation and controls over same.
- perusing the reconciliation (period end as well as interim) and examining whether proper impact has been given for reconciling items.
- obtaining direct balance confirmations.

### **Inspection of Documents**

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

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

5.51 Some typical audit procedures would include:

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

### **Examination of Existence of Investments**

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

5.53 The auditor should verify the investments held with PDO, custodians and the depository, at the close of business on the date of the balance sheet with the statement of holdings. The auditor should circulate and maintain control over independent investments' balance confirmation requests to the custodian and other constituents (for example, RBI for SGL and CSGL balances) in accordance with SA 505, "External Confirmations" issued by ICAI.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

Furthermore, the auditor should design sufficient alternative audit procedures in situations where the independent confirmations are not received back (after reasonable follow up procedures) before the auditor signs off on the bank's financial statements. These alternative procedures should also be designed in such a way that independent data points are used for corroborating investment balances. (e.g.: the auditor gets the bank personnel download the investment statement in his own presence e.g. from E-Kuber for Government Securities, DP's website for Shares and Bonds etc.)

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

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

5.56 The auditor may specifically request the Statutory Branch Auditors to examine and report any cases of non-receipt of income against investments for a long period or of scrips being held without being redeemed long after the redemption date, as these situations might be indicative of the scrips being forged or otherwise unrealisable. In case the investment scrips are held at an unaudited branch, the auditor should request the management to obtain the scrips at the head office for his examination.

### **Cut-off Procedures**

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

5.58 Some typical audit procedures would include:

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

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

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

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

5.61 The auditor should examine whether the shifting of the investments to/from HTM category is carried out only once during a financial year and at the beginning of the financial year unless otherwise stipulated by RBI under special dispensation. Such shifting is required to be duly approved by the Board of Directors of the bank. As regards the shifting of investments from AFS to HFT, the auditor should verify the same as having been duly approved by the Board of Directors / ALCO / Investment Committee. In case of exigencies, the shifting from AFS to HFT may be done with the approval of the Chief

## **Guidance Note on Audit of Banks (Revised 2020)**

---

Executive of the Bank/ Head of ALCO, but should be ratified by the Board of Directors later. Shifting of investments from HFT to AFS is generally not allowed. However, it will be permitted only under exceptional circumstances like not being able to sell the security within 90 days due to tight liquidity conditions, or extreme volatility, or market becoming unidirectional. Such transfer is permitted only with the approval of the Board of Directors/ ALCO/ Investment Committee.

5.62 Transfer of scrips from AFS / HFT category to HTM category should be made at the lower of book value or market value. In other words, in cases where the market value is higher than the book value at the time of transfer, the appreciation should be ignored and the security should be transferred at the book value. In cases where the market value is less than the book value, the provision against depreciation held against this security (including the additional provision, if any, required based on valuation done on the date of transfer) should be adjusted to reduce the book value to the market value and the security should be transferred at the market value. Auditors should examine memo (or internal note) on the periodic reviews of SLR / Non-SLR investments carried out and reported to the Board, as specified in para 1.1.8 read with para 1.2 of the master circular on investments.

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

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

5.64 It is to be noted that in case if the bank is following 'Weighted Average Method', the cost of acquisition of the security is not relevant and instead book value (which would be weighted average value) needs to be considered for the purpose of above mentioned both clauses.

5.65 If the value of sale or transfer (excluding one-time shifting and additional shifting explicitly permitted by RBI), exceeds 5% of the book value of HTM investments as at the beginning of the year, the bank should disclose

market value of the investments under HTM category along with disclosure of excess of book value over market value for which provision is not made.

5.66 The audit procedures in this regard would include:

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

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

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

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

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

5.70 RBI guidelines require that individual scrip in the available-for-sale ('AFS') category should be marked to market at quarterly or more frequent intervals. It is further required that net depreciation in respect of each of the categories in which investments are presented in the balance sheet should be provided for and net appreciation should be ignored. As regards the scrips in Held for Trading (HFT) category, the same should be marked to market at

## **Guidance Note on Audit of Banks (Revised 2020)**

---

monthly or at more frequent intervals in the similar manner, except in the following cases:

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

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

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

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

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

5.74 The auditor should examine the process of valuation followed by the Bank and perform checks to examine that the market rates taken by the bank for valuation of investment securities are in accordance with the RBI guidelines. The auditor should also examine the accounting entries passed for marked to market depreciation, to ascertain, whether RBI guidelines pertaining to inter-category netting off are followed. Further, the auditor should include investment from each class of investment in his sampling technique in accordance with SA 530 "Audit Sampling" so as to ensure that the valuation policy of all classes of investments gets validated. Audit sampling can be applied using either statistical or non-statistical sampling approach which is a matter of auditor's judgment. Particular focus should be on investments which involve management judgment or are not simple rule based valuations (preference shares and pass through certificates). While the auditor checks the valuation of investment securities across products



### **Guidance Note on Audit of Banks (Revised 2020)**

---

in line with RBI prescribed methodology, he should also carefully focus on assessing the appropriateness of inputs used in various valuation models/formulae. This would include a check of:

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

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

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

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

5.78 The classification of investments into held-to-maturity, held-for-trading and available-for-sale categories is based on the intention with which the respective investments have been acquired by the bank. The auditor should examine whether the investments have been properly classified into the three categories at the time of acquisition based on such intention as evidenced by dealers' pad or equivalent, along with reference to the decision of the competent authority such as Board of directors, ALCO or Investment Committee.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

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

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

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

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

5.83 Some of the typical audit procedures would include:

- obtaining list of investment as at reporting period from Bank and ascertaining completeness of the same by reconciliation process as highlighted above.
- checking the carrying amount of investments and ensuring that same is calculated on consistent basis. This is normally calculated by system, hence auditor needs to check IT controls and calculation on sample basis for ensuring accuracy.
- In case quotes are available, checking source of capturing market price/ fair value as at reporting date.

**Guidance Note on Audit of Banks (Revised 2020)**

- In case quotes are not available, checking calculation for fair value as at reporting date to ensure compliance with RBI guidelines.
- checking calculation of Marked to Market Gain/ loss and accounting for same in compliance with RBI guidelines.

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

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

**Guidance Note on Audit of Banks (Revised 2020)**

Type of Investment	Basis of Valuation
	to an upper cap of redemption value of preference shares
Equity Shares	Valued at break-up value without considering 'revaluation reserves', if any
Units of Mutual Funds	Latest Re-purchase price or NAV and if NAV is not available, at cost
Commercial Papers	Carrying Cost (acquisition cost plus discount accrued)
Investments in RRBs	Carrying Cost (i.e., at book value)
Securities issued by Securitisation Company (SC) / Reconstruction Company (RC)	Lower of redemption Value or Net Book Value (NBV)
Venture Capital Funds (VCFs)	For first three years, VCFs may be classified under HTM and subsequently under AFS and valued for Units / Equity / Bonds as per specified norms

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

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

5.85 Banks had been given the option to spread provisioning for their mark to market (MTM) losses on all investments held in AFS and HFT for the quarter ended Dec. 31, 2017 and March 31, 2018 equally over up to four quarters, commencing with the quarter in which the loss is incurred. Banks that have utilised the above option shall make suitable disclosures in their notes to accounts/ quarterly results providing details of -

- (a) the provisions made for depreciation of investment portfolio for the quarters ended Dec., 2017 and March, 2018 made during the quarter/ year and
- (b) the balance provisions required to be made in the remaining quarters.
- (c) creation of IFR

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

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

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

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

## **Guidance Note on Audit of Banks (Revised 2020)**

---

- (vi) In case of conversion of principal and / or interest into equity, debentures, bonds, etc., such instruments should be treated as NPA *ab initio* in the same asset classification category as the loan if the loan's classification is substandard or doubtful on implementation of the restructuring package and provision should be made as per the norms. Further movement in the asset classification of these instruments would also be determined based on the subsequent asset classification of the restructured advance.
- (vii) In respect of an account that is classified as NPA as on the reference date, the Part B instruments shall continue to be classified as NPI and provided for as per the extant prudential norms, as long as such instruments remain in Part B. The sustainable portion (Part A) may optionally be treated as 'Standard' upon implementation of the resolution plan by all banks, subject to provisions made upfront by the lenders being at least the higher of 50 percent of the amount held in Part B or 25 percent of the aggregate outstanding (sum of Part A and Part B). For this purpose, the provisions already held in the account can be reckoned. As per para (iv) of the circular DBR. No. BP. BC. 33/21.04.132/2016-17 dated November 10, 2016 "In call cases, lenders may upgrade Part B to standard category and reverse the associated enhanced provisions after one year of satisfactory performance of Part A loans. In case of any pre-existing moratorium in the account, this upgrade will be permitted one year after completion of the longest such moratorium, subject to satisfactory performance of Part A debt during this period. However, in all cases, the required MTM provisions on Part B instruments must be maintained at all times.

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

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

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

5.90 The audit procedures would include:

- Identifying Non Performing Investments based on RBI guidelines as defined above. In case advances given to a party is classified as NPA, investment in securities issued by same party also needs to be classified as NPI and *vice-versa* except in case of preference shares, wherein if a preference share is classified as NPI, the performing securities and performing credit facilities granted to the said party need not be treated as NPI / NPA.
- Ascertaining whether the bank has made appropriate provision for the depreciation in the value of the NPI.
- Ensuring that the banks have not off-set the depreciation on NPI against the appreciation in respect of other performing securities.
- Obtaining separate list of investments as a result of conversion of interest/ principal. These investments need to be classified as NPI *ab initio*, if the loan's classification is NPA on implementation of the restructuring package.

### **Special Aspects**

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

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

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

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

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

***Investment Fluctuation Reserve***

- (i) Banks were advised to build reserves towards investment fluctuation, of a minimum 5% of the investment portfolio within 5 years period.
- (ii) To ensure smooth transition to Basel II norms, banks had been advised to build adequate reserve towards capital charge for market risks in a phased manner over a two year period as follows:
  - (a) In respect of securities included in the HFT category, open gold position limit, open foreign exchange position limit, trading positions in derivatives and derivatives entered into for hedging trading book exposures by March 31, 2005; and
  - (b) In respect of securities included in the AFS category by March 31, 2006.
- (iii) As advised by RBI in October, 2005, Banks maintaining capital of at least 9 per cent of the risk weighted assets for both credit risk and market risks for both HFT (of items - open gold position limit, open foreign exchange position limit, trading positions in derivatives and derivatives entered into for hedging trading book exposures) and AFS category as on March 31, 2006 were permitted to treat the entire balance of IFR as Tier I capital, transfer the balance in the IFR 'below the line' in the Profit & Loss Appropriation account to statutory reserve, general reserve or balance of Profit and Loss Account.

***Investment Reserve Account***

- (i) Provisions created for depreciation on investments in the AFS and HFT categories if found excessive should be credited to the Profit & Loss Account and equivalent amount (net of taxes, if any and net of transfer to Statutory Reserve as applicable to such excess provision) should be appropriated to an Investment Reserve Account in Schedule 2 – “Reserves and Surplus” under the head “Revenue and Other Reserves” and would be eligible for inclusion under Tier II capital within the overall ceiling of 1.25% of total risk weighted assets prescribed for general provisions/ Loss Reserves.
- (ii) The Investment Reserve Account can be utilised in the prescribed manner.
- (iii) The amounts debited to the Profit & Loss Account for provision should be debited under the head "Expenditure - Provisions & Contingencies". The amount transferred from the Investment Reserve Account to the Profit & Loss Account should be shown as "below the line" item in the Profit and



Loss Appropriation Account after determining the profit for the year. Provision towards any erosion in the value of an asset is an item of charge on the profit and loss account and hence should appear in that account before arriving at the profit for the accounting period. Adoption of the following would not only be adoption of a wrong accounting principle but would, also result in a wrong statement of the profit for the accounting period:

- (a) the provision is allowed to be adjusted directly against an item of reserve without being shown in the profit and loss account; or
- (b) a bank is allowed to draw down from the Investment Reserve Account before arriving at the profit for the accounting period (i.e., above the line); or
- (c) a bank is allowed to make provisions for depreciation on investment as a below the line item, after arriving at the profit for the period.

Hence none of the above options are permissible.

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

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

5.96 Investments should not normally be held by any other person. If any investments are so held, proper enquiry should be made to ensure that there is some justification for it, e.g., shares may be held by brokers for the purpose of transfer or splitting-up etc. Shares may also be lodged with the companies concerned for transfer etc. When investments are held by any other person on

behalf of the bank, the auditor should obtain a certificate from him. The certificate should state the reason for holding the investment (e.g., in safe custody or as security). The receipt originally issued by such person while taking delivery of the investment is not adequate for audit purposes. In the case of inscribed stock also, a certificate should be obtained which should certify the holding of the bank as at the date of the balance sheet.

5.97 Where securities lodged for transfer have not been received back within a reasonable period, or where share certificates, etc., have not been received within a reasonable period of the lodging of the allotment advice, the auditor should examine whether adequate follow-up action has been taken. He may, in appropriate cases, also enquire from the issuers, or their registrars, about the reasons for the delay. In cases where the issuer/Registrar has refused to register the transfer of securities in the name of the bank, the auditor should examine the validity of the title of the bank over such securities.

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

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

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

#### **Income from investments**

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

5.102 Some of the typical audit procedures would include:

- Re-computation of amortisation of premium / discount on investment securities.
- Re-performance of profit / loss on sale of investments keeping into consideration the method of allocating cost to securities (FIFO or weighted average).
- Assessing the dividend recognition policy of bank considering revenue recognition principles of Accounting Standard 9, Revenue Recognition.
- Re-computation of interest income on investments and checking the treatment of broken period interest, including ensuring proper cut-offs at reporting period ends.
- Checking of proper recognition of investment valuation loss as at reporting date
- Checking of interest accrual in respect of interest-bearing investment outstanding at reporting date.

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

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

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

#### **Legal Requirements**

5.106 For the purposes of section 24 of the Banking Regulation Act, 1949, the valuation of securities is to be done with reference to the cost price, market

## **Guidance Note on Audit of Banks (Revised 2020)**

---

price, carrying cost or face value, or a combination of these methods, as may be specified by the RBI from time to time.

5.107 Section 19 of the Act places restrictions on overall holding of investments by banks in the shares of companies (except in the shares of subsidiary company. As per Section 19(2) of the Act, no banking company shall hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding thirty per cent of the paid-up share capital of that company or thirty per cent of its own paid up share capital and reserves, whichever is less.

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

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

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

- (a) Shares in a subsidiary may be held in the name(s) of the company's nominee(s) to the extent necessary to ensure the minimum number of members as required by law.
- (b) Investments may be deposited with the bankers of the company for collection of dividend or interest.
- (c) Investments may be deposited with, or transferred to, or held in the name of, the State Bank of India or a scheduled bank to facilitate transfer thereof, subject to the conditions laid down in this behalf.

- (d) Investments may be deposited with, or transferred to, any person by way of security for repayment of a loan or performance of an obligation undertaken by the company.
- (e) Investments in the form of securities may be held in the name of a depository.

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

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

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

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

#### **Classification of Investments**

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

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

## **Guidance Note on Audit of Banks (Revised 2020)**

---

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

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

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

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

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

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

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

5.116 The banks will have the freedom to decide on the extent of holdings under HFT and AFS. This will be decided by them after considering various aspects such as basis of intent, trading strategies, risk management capabilities, tax planning, manpower skills, capital position. RBI vide its circular dated 16th July 2015 decided that for accounting periods commencing on or after April 1, 2015, deposits placed with NABARD/ SIDBI/ NHB on account of

shortfall in priority sector targets should be included under Schedule 11- 'Other Assets' under the subhead 'Others' of the Balance Sheet instead of disclosing under Schedule 8 "Investments".

### **Exposure Limits**

5.117 The RBI, *vide* its Master Circular dated July 1, 2015 on "Exposure Norms" provides requirements in respect of exposure limits for banks. Further, the Reserve Bank of India *vide* Notification No. RBI/2018-19 /196 DBR.No.BP. BC.43/21.01.003/2018-19 dated June 03, 2019 has issued guidelines on Large Exposure Framework (LEF). These guidelines shall come into effect with effect from April 1, 2019.

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

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

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

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

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

## **Guidance Note on Audit of Banks (Revised 2020)**

---

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

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

### **(D) Accounting Aspects**

#### **Disclosure Requirements**

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

- (i) Governments Securities;
- (ii) Other Approved Securities;
- (iii) Shares (both equity as well as preference);
- (iv) Debentures and Bonds;
- (v) Subsidiaries/ Joint Ventures/ Associates;
- (vi) Other investments, such as, Commercial Papers, Certificate of Deposits, Security Receipts (SR), Pass Through Certificates (PTC), Units of Mutual Funds, Venture Capital Funds, Real Estate Funds, Real Estate Investment Trust (REITs), Infrastructure Investment Trust (InvITs) etc.

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

#### **Balance Sheet Presentation**

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

- I. *Investments in India in:*



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

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

- (a) gross value of investments in India and outside India;
- (b) aggregate of provisions for depreciation, separately on investments in India and outside India;
- (c) net value of investments in India and outside India; and
- (d) movement of provisions held towards depreciation on investments including opening balance by adding provisions made during the year and after deducting write-off/ write-back of excess provisions during the year.

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

### **(E) Internal Financial Controls Over Financial Reporting including IT Controls**

5.125 The auditors should familiarise themselves with the instructions/directions issued by the RBI regarding transactions in investment securities. The Banks should frame Internal Investment Policy Guidelines and obtain the Board's approval. The investment policy may be suitably framed / amended to include Primary Dealer (PD) activities also. Further, the Reserve Bank of India has issued Master Directions on Operational Guidelines for Primary Dealers

## **Guidance Note on Audit of Banks (Revised 2020)**

---

dated July 1, 2016 (updated November 22, 2018), which should be complied by Banks. The auditor should review the investment policy of the bank to ascertain that the policy conforms, in all material respects, to the RBI's guidelines as well as to any statutory provisions applicable to the bank.

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

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

5.128 Some of the typical audit procedures would include:

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

audit report, if any and follow-up action taken by the management thereon.

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

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

5.129 Apart from making investments on its account, a bank may also deal in securities on behalf of its customers only with the prior approval from RBI. These activities of banks are in the nature of trust or fiduciary activities. The accounting implications of the trust activities of banks may be noted. Banks commonly act as trustees and in other fiduciary capacities that result in holding or placing of assets on behalf of individuals, trusts, retirement benefit plans and other institutions. Provided the trustee or similar relationship is legally supported, these assets are not assets of the bank and, therefore, are not included in its balance sheet. If the bank is engaged in significant trust activities, disclosure of that fact and indication of the extent of those activities is made in its financial statements because of the potential liability if it fails in its fiduciary duties. For this purpose, trust activities do not encompass safe custody functions.

5.130 The auditor should examine whether bank's income from such activities has been recorded and is fairly stated in the bank's financial statements. The auditor also needs to consider whether the bank has any material undisclosed liability from a breach of its fiduciary duties, including the safekeeping of assets. The auditor also needs to give certificate for reconciliation of securities held by the bank as custodian.

## **(F) Compliance with CRR and SLR requirements**

### **Introduction**

5.131 Due to the nature of their operations, banks need to maintain sufficient liquid assets in the normal course of their business. The failure of a bank to meet its liabilities to depositors, as and when called upon to do so, undermines the confidence of the depositors not in the particular bank alone but in the entire banking system. While ensuring some liquid money against deposits is the primary purpose of CRR, its secondary purpose is to allow the RBI to control liquidity and interest rates in the economy. In the short term,

interest rates swing up or down depending on how much liquidity is available for lending. Too much money leads to a collapse in rates, and too little, a spike.

### **Regulatory Requirements**

5.132 Recognising the need to safeguard the interests of depositors by ensuring that banks do not over-extend their resources and thereby to maintain the confidence of the public in the banking system, Section 24(2A) of the Banking Regulation Act, 1949 requires that a scheduled bank shall maintain in India, in addition to the average daily balance which it is, or may be, required to maintain under Section 42 of the RBI Act, 1934, and every other banking company, in addition to the cash reserve which it is required to maintain under section 18 of the Banking Regulation Act, 1949, assets the value of which shall not be less than such percentage not exceeding forty per cent of the total of its demand and time liabilities (DTL) in India as on the last Friday of the second preceding fortnight in such form and manner as the RBI may by notification in the official gazette, specify from time to time. This is referred to as 'Statutory Liquidity Ratio' (SLR). The Friday with reference to which the amount of liquid assets has to be maintained during a fortnight is determined is commonly, referred to as the 'reporting Friday'. The prescribed percentage of liquid assets has to be maintained as at the close of business on every day. It may be noted that the statutory liquidity ratio is to be maintained with reference to the bank as a whole, and not for individual branches.

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

5.134 Further, Reserve Bank has specified *vide* notification RBI/2016-17/83 DBR.No.Ret.BC.15/12.02.001/2016-17 dated October 13, 2016 that every Scheduled Commercial Bank shall continue to maintain in India assets as detailed below, the value of which shall not, at the close of business on any day, be less than 20.75 per cent from October 1, 2016, 20.50 per cent from January

### **Guidance Note on Audit of Banks (Revised 2020)**

7, 2017, 20 per cent from June 24, 2017 and 19.5 per cent from October 14, 2017 on the total net demand and time liabilities (NDTL) as on the last Friday of the second preceding fortnight valued in accordance with the method of valuation specified by the Reserve Bank of India from time to time:

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

This is now amended by RBI notification on Section 24 and Section 56 of the Banking Regulation Act, 1949 - Maintenance of Statutory Liquidity Ratio (SLR) dated December 5, 2018, which has reduced the SLR by 0.25% in a phased manner beginning from 5.1.2019 till it reaches 18% by 11.4.2020 as follows –

Effective date (from the fortnight beginning)	SLR on net demand and time liabilities (per cent)
October 14, 2017	19.50
05.01.2019 <sup>1</sup>	19.25
13.04.2019 <sup>1</sup>	19.00
06.07.2019 <sup>1</sup>	18.75

<sup>1</sup> Vide RBI notification no. RBI/2018-19/86/DBR.No.Ret.BC.10/12.02.001 dated 05.12.2018.

**Guidance Note on Audit of Banks (Revised 2020)**

---

12.10.2019 <sup>1</sup>	18.50
04.01.2020 <sup>1</sup>	18.25
11.04.2020 <sup>1</sup>	18.00

5.135 Provided that the instruments referred to in items (i) to (iii) above that have been acquired under reverse repo with Reserve Bank of India, shall not be included as SLR securities for the purpose of maintenance of SLR assets up to October 2, 2016. From October 3, 2016 such securities acquired from Reserve Bank shall be considered as eligible assets for SLR maintenance.

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

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

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

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

end of the month to which it relates. The banks should also submit a statement as annexure to the form VIII giving daily position of –

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

As per Circular RBI/2016-17/302 Ref: DBR.CO.No.Ret.BC/66/12.07.144/2016-17 dated May 11, 2017, the reporting of SLR has been moved from PCRPCD to XBRL (Extensible Business Reporting Language) platform from April 2017 onwards.

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

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

### **Computation of CRR**

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

### **Computation of SLR**

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

### **Audit Approach and Procedures**

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

## **Guidance Note on Audit of Banks (Revised 2020)**

---

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

5.145 The Statutory Central Auditor should acquaint himself with the circulars/ instructions of the RBI regarding composition of items of DTL. For this purpose, he may request the management to provide him a copy of the relevant circulars/instructions. He should keep these circulars/instructions in mind while examining compliance with the SLR requirements.

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

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

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

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

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



**Guidance Note on Audit of Banks (Revised 2020)**

---

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

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

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

- (a) Net credit balance in Branch Adjustment Accounts. The credit entries in branch adjustment account which are outstanding for more than 5 years are required to be considered at gross;
- (b) Interest accrued on deposits should be calculated on each reporting

## **Guidance Note on Audit of Banks (Revised 2020)**

---

fortnight (as per the interest calculation methods applicable to various types of accounts), whether or not such interest is accounted for in books of accounts, so that the bank's liability in this regard is fairly reflected in the total NDTL of the same fortnightly return.

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

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

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

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

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

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

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

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

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

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

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

### **Treasury Operations-Foreign Exchange and Derivative Transactions**

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

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

5.163 Foreign exchange transactions, to be distinguished from transactions in foreign currencies, consist of contracts in which each party is committed to

deliver one currency while, at the same time, receive another. Until the time of delivery, when settlement is to be made on the contract, the contract represents a future commitment of the Bank's resources. Thus, the maturity of a contract culminates in the realisation of the transaction envisaged in the contract, at which time the counterparties are given value for the currencies the contract says they are to receive.

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

### **Derivatives**

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

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

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

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

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

## Guidance Note on Audit of Banks (Revised 2020)

- IDMC.MSRD.4801/06.01.03 dated June 3, 2003 on Exchange-Traded Interest Rate Derivatives.
- IDMD.PDRD.No. 1056/03.64.00/2009-10 dated September 1, 2009 on Guidelines on Exchange Traded Interest Rate Derivatives.
- RBI/2010-11/147 A.P. (DIR Series) Circular No. 05 dated July 30, 2010 on “Guidelines on trading of Currency Options on Recognised Stock /New Exchanges.
- DBOD.No.BP.BC.51 / 21.06.101 / 2010-11 dated October 28, 2010 on Introduction of Exchange Traded Currency Options – Permitting Banks to Participate in Currency Options on Recognized Stock / New Exchanges.
- DBOD.No.BP.BC. 44/21.04.157/2011-12 dated 2 November 2011 modifying the 20 April 2007 circular.
- DBOD.BP.BC.No. 61/21.06.203/2011-12 of 30th November 2011 regarding credit default swaps.
- RBI/2016-17/199 FMRD.DIRD.12/14.01.011/2016-17, December 29, 2016 on Introduction of Interest Rate Options in India, detailed directions of which are given in Notification No. FMRD-DIRD.11/2016 dated December 28,2016.

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

### Derivatives Markets

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

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

RBI vide its circular RBI/2017-18/134 A. P. (DIR Series) Circular No. 18 dated February 26, 2018 permit persons resident in India and FPIs to take positions (long or short), without having to establish existence of underlying exposure, upto

## Guidance Note on Audit of Banks (Revised 2020)

---

a single limit of USD 100 million equivalent across all currency pairs involving INR, put together, and combined across all exchanges.

### Participants

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

- User: A user participates in the derivatives market to manage an underlying risk.
- Market-maker: A market-maker provides bid and offer prices to users and other market-makers. A market-maker need not have an underlying risk.

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

### Purpose

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

Objectives/Purpose	Reasons
Balance Sheet Management	<ul style="list-style-type: none"><li>• Use of derivatives by the Bank to manage its balance sheet exposures.</li><li>• The Bank will use derivatives as a means for managing the interest rate, liquidity and foreign exchange risks arising from its banking operations.</li></ul>
Client servicing	<ul style="list-style-type: none"><li>• Offering derivative products to existing and new clients as an additional product from the Bank.</li><li>• The Bank will offer derivative products to enhance product offerings to its existing clients as well as to build new client relations.</li></ul>
Proprietary Trading	<ul style="list-style-type: none"><li>• The Bank will undertake derivative transactions to earn trading profits.</li><li>• The Bank's treasury may take view-based transactions as well as offer two-way quotes on</li></ul>

### Guidance Note on Audit of Banks (Revised 2020)

	derivatives within the limits prescribed by this policy.
Hedging On-Balance sheet transactions	<ul style="list-style-type: none"><li>• Banks are exposed to interest-rate risk from their on-balance-sheet activities when their assets do not reprice at the same time as their liabilities. So, banks undertake derivatives transactions to hedge their Balance sheets transactions such as banks may use swaps to hedge on-balance-sheet interest-rate risk.</li></ul>

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

5.172 The major requirements for undertaking any derivative transaction include:

- In addition to generic derivative products, market-makers may also offer structured derivative products to users as long as they do not contain any derivative instrument as underlying and have been specifically permitted by RBI in its Master Direction No. 1/2016-17 dated July 5, 2016 (updated January 07, 2020) on 'Risk Management and Inter-Bank Dealings' and guidelines contained in RBI's Circular DBOD.No.BP.BC.86/21.04.157/2006-07 dated 20 April 2007 on Comprehensive Guidelines on Derivatives and further amendments issued vide circulars DBOD.No.BP.BC. 27 / 21.04.157/2011-12 dated 2 August 2011 and DBOD.BP.BC.44/21.04.157/2011-12 dated 2 November 2011 on 'the Comprehensive Guidelines on derivatives'.
  - a. The following derivative instruments used to hedge an existing interest rate and forex exposure, on a standalone basis, may be treated as generic derivative products:
    - Forex Forward Contracts
    - Forward Rate Agreements
    - Interest rate caps and floors (plain vanilla only)
    - Plain Vanilla Options (call option and put option)
    - Interest Rate Swaps
    - Currency Swaps including Cross-Currency Swaps
    - Exchange traded Currency Futures
    - Exchange traded currency options
    - Interest Rate Options.

## Guidance Note on Audit of Banks (Revised 2020)

---

- b. The following derivative products may be treated as structured derivative products:
  - Instruments which are combination of either cash instrument and one or more generic derivative products.
  - Instruments which are combination of two or more generic derivative products.

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

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

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

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



These include:

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

### **Suitability and Appropriateness**

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

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

5.176 Before offering any derivative product to a client:

- (a) Obtain Board resolution from the corporate which contains the details specified in the Comprehensive Guidelines on derivatives. Identify whether the proposed transaction is consistent with the user's policies and procedures with respect to derivatives transactions, as they are known to the market-maker.

#### **Guidance Note on Audit of Banks (Revised 2020)**

---

- (b) Ensure that the terms of the contract are clear and assess whether the user is capable of understanding the terms of the contract and of fulfilling its obligations under the contract.
- (c) inform the customer of its opinion, where the market-maker considers that a proposed derivatives transaction is inappropriate for a customer. If the customer nonetheless wishes to proceed, the market-maker should document its analysis and its discussions with the customer in its files to lessen the chances of litigation in case the transaction proves unprofitable to the customer. The approval for such transactions should be escalated to next higher level of authority at the market-maker as also for the user.
- (d) ensure the terms of the contract are properly documented, disclosing the inherent risks in the proposed transaction to the customer in the form of a Risk Disclosure Statement which should include a detailed scenario analysis (both positive and negative) and pay outs in quantitative terms under different combination of underlying market variables such as interest rates and currency rates, etc., assumptions made for the scenario analysis and obtaining a written acknowledgement from the counterparty for having read and understood the Risk Disclosure Statement.
- (e) guard against the possibility of misunderstandings all significant communications between the market-maker and user should be in writing/email or recorded in meeting notes.
- (f) ensure to undertake transactions at prevailing market rates and to avoid transactions that could result in acceleration/deferment of gains or losses.
- (g) should establish internal procedures for handling customer disputes and complaints. They should be investigated thoroughly and handled fairly and promptly. Senior management and the Compliance Department/Officer should be informed of all customer disputes and complaints at a regular interval.
- (h) The market-makers should carry out proper due diligence regarding 'user appropriateness' and 'suitability' of products before offering derivative products to users. Each market-maker should adopt a Board-approved 'Customer Appropriateness & Suitability Policy' for derivatives business.

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

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

and appropriateness' norms, and the regulatory requirements will be at par with forex forward contracts.

## **Documentation**

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

5.179 The comprehensive guidelines on derivatives circular require the market participants to ensure that documentation requirements in respect of derivative contracts are complete in all respects. The following instructions in this regard may, therefore, be strictly adhered to:

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

## Identification and Management of Risk

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

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

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

### Risk limits

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

### Independent Risk control

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

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

### Operational Controls

5.184 Operational risk arises as a result of inadequate internal controls, human error or management failure. This risk in derivatives activities is

particularly important, because of the complexity and rapidly evolving nature of some of the products. The nature of the controls in place to manage operational risk must be commensurate with the scale and complexity of the derivatives activity being undertaken. The operational controls could in addition to segregation of duties, cover aspects such as:

- trade entry and transaction documentation
- confirmation of trades
- settlement and disbursement
- reconciliations
- revaluation
- exception reports
- accounting treatment
- audit trail

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

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

#### **Asset Classification of Derivatives**

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

- i. The overdue receivables representing positive mark-to-market value of a derivative contract will be treated as a non-performing asset, if these

## **Guidance Note on Audit of Banks (Revised 2020)**

---

- remain unpaid for a period of 90 days from the specified due date for payment.
- ii. In case the overdues arising from forward contracts and plain vanilla swaps and options become NPAs, all other funded facilities granted to the client shall also be classified as non-performing asset following the principle of borrower-wise classification as per the existing asset classification norms.
  - iii. However, any amount, representing positive mark-to-market value of the foreign exchange derivative contracts (other than forward contract and plain vanilla swaps and options) that were entered into during the period April 2007 to June 2008, which has already crystallised or might crystallise in future and is / becomes receivable from the client, should be parked in a separate account maintained in the name of the client /counterparty. This amount, even if overdue for a period of 90 days or more, will not make other funded facilities provided to the client, NPA on account of the principle of borrower-wise asset classification, though such receivable overdue for 90 days or more shall itself be classified as NPA, as per the extant IRAC norms. The classification of all other assets of such clients will, however, continue to be governed by the extant IRAC norms.
  - iv. If the client concerned is also a borrower of the bank enjoying a Cash Credit or Overdraft facility from the bank, the receivables mentioned at item (i) above may be debited to that account on due date and the impact of its non-payment would be reflected in the cash credit/overdraft facility account. The principle of borrower-wise asset classification would be applicable here also, as per extant norms.
  - v. In cases where the contract provides for settlement of the current mark-to market value of a derivative contract before its maturity, only the current credit exposure (not the potential future exposure) will be classified as a non-performing asset after an overdue period of 90 days.
  - vi. As the overdue receivables mentioned above would represent unrealised income already booked by the bank on accrual basis, after 90 days of overdue period, the amount already taken to 'Profit and Loss a/c' should be reversed.

5.187 RBI vide its Circular No. DBOD.No.BP.BC.48 / 21.06.001/2010-11 dated October 1, 2010 on "Prudential Norms for Off-Balance Sheet Exposures of Banks - Bilateral netting of counterparty credit exposures" has decided that since the legal position regarding bilateral netting is not unambiguously clear, bilateral netting of mark-to-market (MTM) values arising on account of such

derivative contracts cannot be permitted. Accordingly, banks should count their gross positive MTM value of such contracts for the purposes of capital adequacy as well as for exposure norms.

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

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

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

## Guidance Note on Audit of Banks (Revised 2020)

---

clear, receivables and payables from/to the same counterparty including that relating to a single derivative contract should not be netted.

- Similarly, in case a fund-based credit facility extended to a borrower is classified as NPA, the MTMs of all the derivative exposures should also be classified as NPA.
- These guidelines are applicable to both outstanding derivatives contracts and the derivatives transactions undertaken from the date of the circular.

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

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

- i. Banks should have a Board approved policy in this regard.
- ii. Banks should permit repayment in instalments only if there is a reasonable certainty of repayment by the client.
- iii. The repayment period should not extend beyond the maturity date of the contract.
- iv. The repayment instalments for the crystallized MTM should be uniformly received over the remaining maturity of the contract and its periodicity should be at least once in a quarter.
- v. If the client is permitted to pay the crystallized MTM in instalments and
  - a. if the amount becomes overdue for 90 days from the date of partial / full termination of the derivative contract, the receivable should be classified as NPA.
  - b. if the amount becomes overdue for 90 days from the due date of payment of subsequent instalments, the receivable should be classified as NPA.
- vi. Banks should reverse the entire MTM which has been taken to Profit and



Loss account on accrual basis in case of (v) (a) and (v) (b) above. For the accounting of reversed MTM in these cases, banks should follow an approach similar to the one stipulated in circulars DBOD.No.BP.BC.57/21.04.157/2008-09 dated October 13, 2008 and DBOD.No.BP.BC.28/21.04.157/2011-12 dated August 11, 2011 on 'Prudential Norms for Off-balance Sheet Exposures of Banks'. Accordingly, the crystallized MTM of these derivative contracts should be reversed from Profit and Loss account and credited to another suspense account styled as '*Suspense Account - Crystallised Receivables*'.

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

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

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

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

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

##### **Purpose**

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

### **Products**

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

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

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

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

5.198 The RBI vide its circular No. DBOD.No.BP.BC.89 /21.04.141/2008-09 dated December 1, 2008 on "Operations of foreign branches and subsidiaries of the Indian banks – Compliance with statutory/regulatory/administrative prohibitions/ restrictions" provides that transactions by the foreign branches / foreign subsidiaries, in financial products which are not available in the Indian market and on which no specific prohibition has been currently placed by the RBI, no prior approval of the RBI would be required for the purpose provided these are merely plain-vanilla financial products. Banks should, however, ensure that their foreign branches / subsidiaries, dealing with such products in foreign jurisdictions, have adequate knowledge, understanding, and risk management capability for handling such products. Such products should also be appropriately captured and reported in the extant off-site returns furnished to the RBI. These products would also attract the prudential norms such as capital adequacy, credit exposure, periodical valuation, and all other applicable norms. In case the current RBI norms do not specify prudential treatment of such financial products, it would be incumbent upon the banks to seek specific RBI guidance in the matter. RBI vide Notification No./2013-14/588 DBOD.No.BP. BC.111/21.04.157/2013-14 May 12, 2014 permitted that if foreign branches / subsidiaries of Indian banks propose to offer structured financial and derivative products that are not specifically permitted by the Reserve Bank in the domestic market, they may do so only at the established financial centers outside India like New York, London, Singapore, Hong Kong, Frankfurt, Dubai, etc. subject to compliance with the conditions stipulated therein.

### **Risk management**

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

5.200 This is a function that can sit well in the middle office provided it is properly staffed by officers who understand fully the business and risks involved

– which usually means ex-market practitioners. It can range from agreeing overnight cash positions for the trading room through to full-risk modeling associated with derivatives trading and hedging. In between can come monitoring of counterparty, country, dealer and market-related limits that have been set and approved in other areas of the bank such as the credit department. Bank shall comply with guidelines issued by RBI with regard to Internal Controls vide circular FE.CO.FMD. No. 18380 /02.03.137/2010-11 February 3, 2011.

## **Risk Identification Process**

### **Price or Rate Risk**

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

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

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

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

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

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

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

### **Timing Risk**

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

### **Credit Risk**

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

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

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

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

### **Settlement Risk**

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

### **Market risk**

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

### **Liquidity Risk**

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

### **Market Liquidity Risk**

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

### **Funding Liquidity Risk**

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

### **Sovereign Risk or Cross Border Risk**

5.214 This is the risk that the Government of a particular country may interfere with a payment due to the Bank from a client resident in that country and

preclude the client from converting and/or transferring the funds. In such cases, bank's obligor may be economically sound and capable of repaying its obligation, but its country's Government may place an embargo on remittances for political/economic reasons.

### **Operations Risk**

5.215 Basel I defined operational risk as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events". Basel II, however, defined operational risk as, "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events". As per RBI Guidelines on Basel III Capital Regulations, Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk. Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements. For emergence of such a risk four causes have been mentioned and they are people, process, systems and external factors.

- (a) **People risk** – Lack of key personnel, lack of adequate training/experience of dealer (measured in terms of opportunity cost/employee turnover), unauthorised access to the dealing room, tampering voice recorders, nexus between the front and back offices, etc.
- (b) **Process risk** - Wrong reporting of important market developments to the management resulting in faulty decision making, errors in entry of data in deal slips, non-monitoring of exposure in positions, loss of interest owing to the liquidity beyond prescribed limits, non-revision of card rates in cases of volatility, non-monitoring of closing and opening positions, wrong funding of accounts (wrong currency, wrong way swap), lack of policies, particularly in respect of new products.
- (c) **Systems** - Losses due to systems failure, hardware and software failures, telecommunication problems, and utility outages such as CCIL- not maintaining secrecy of system passwords, failure of dealing platforms, valuation engines, system issues with deal blotters interrupting deal flows to back-office etc.
- (d) **Legal and regulatory risk** - Treasury activities should comply with the regulatory and statutory obligation. As per RBI Guidelines, Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.

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

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

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

5.217 NOOPL may be fixed by the boards of the respective banks and communicated to the Reserve Bank immediately. However, such limits should not exceed 25 percent of the total capital (Tier I and Tier II capital) of a bank, refer RBI Master Directions – Risk Management and Inter Bank Dealings dated July 5, 2016 (updated as on January 07, 2020). This limits the maximum allowable excess of assets plus exchange bought contracts over liabilities plus exchange sold contracts ("overbought" position) and the reverse ("oversold" position) that may be carried overnight in foreign currencies.

### **Daylight Limit**

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

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

5.219 These limits are designed to restrict the amount of potential loss from certain types of derivatives products or the whole trading book to levels (or percentages of capital or earnings) approved by the board and senior management. To monitor compliance with the limits, management calculates the current market value of positions and then uses statistical modelling techniques to assess the probable loss (within a certain level of confidence) given historical changes in market factors.

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

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

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

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

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

5.224 The Banks are also required to compute VAR on a daily basis as per the RBI model on the overall bank gap. The bank has to maintain a separate VAR limit for derivative transactions as mentioned in the RBI Circular No. MPD.BC.187/07.01.279 dated July 7, 1999. As of the last reporting Friday of every month, treasury operations has to prepare the GAP report in prescribed format as given by the RBI for the overall gap position of the Bank.

### **Aggregate Contract Limit**

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

### **Options Limit**

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

- Delta is a measure of the amount an option's price would be expected to change for a unit change in the price of the underlying instrument.
- Gamma is a measure of the amount delta would be expected to change in response to a unit change in the price of the underlying instrument.



- Vega is a measure of the amount an option's price would be expected to change in response to a unit change in the price volatility of the underlying instrument.
- Theta is a measure of the amount an option's price would be expected to change in response to changes in the options time to expiration.
- Rho is a measure of the amount an option's price would be expected to change in response to changes in interest rates.
- Auditor should check the limit setting and its monitoring process along with exception handling measures.

The auditor is expected to make efforts and be aware of these concepts

### **Stop Loss Limit**

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

5.228 Some institutions also establish management action trigger (MAT) limits in addition to stop loss limits. These are for early warning purposes. For example, management may establish a MAT limit at 75 per cent of the stop loss limit. When the unrealized loss reaches 75 per cent of the stop loss limit, management will be alerted of the position and may trigger certain management actions, such as close monitoring of the position, reducing or early closing out the position before it reaches the stop loss limits. The above loss triggers complement other limits, but they are generally not sufficient by themselves. They are not anticipatory; they are based on unrealized losses to date and do not measure the potential earnings at risk based on market characteristics. They will not prevent losses larger than the stop loss limits if it becomes impossible to close out positions, e.g., because of market illiquidity.

### **Limit Exceptions**

5.229 A limit exception is a trade or position specific authorization to exceed a limit for a defined period of time. All limit exceptions must be approved in advance of establishing a position that would exceed a limit. Normally Market Risk Management is responsible for maintaining all documentation of the excess including the agreed upon corrective action and the resolution date and is responsible for the ongoing monitoring of the excess to ensure the corrective action is carried out. Auditor should check whether all exceptions along with the reasons are reported to senior management and approvals (Limit Breach Ratifications) were taken for the same.

### **Regulatory Reporting Requirements**

5.230 Derivatives are governed by the Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000. Derivatives are allowed only under the provisions of these regulations and amendments since, or with the prior permission of the Reserve Bank of India. The reporting requirements under RBI Master Direction No. RBI/FMRD/2016-17/31 FMRD master direction no. 1/2016-17 dated July 5, 2016 (updated as on January 07, 2020) on 'Risk Management and Inter-Bank Dealings' and RBI Circular No. DBOD. No. BP.BC.86/21.04.157/2006-07 dated April 20, 2007 on "Comprehensive Guidelines on Derivatives" should be adhered to.

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

- i) Daily statements of Foreign Exchange Turnover in Form FTD and Gaps, Position and Cash Balances in Form GPB.
- ii) Statement of Nostro / Vostro Account balances.
- iii) Consolidated data on cross currency derivative transactions undertaken by residents on half yearly basis.
- iv) Details of exposures in foreign exchange as at the end of every quarter as per those details of exposures of all corporate clients who meet the prescribed criteria have to be included in the report. The AD banks should submit this report based on bank's books and not based on corporate returns.
- v) Details of option transactions (FCY-INR) undertaken on a weekly basis.
- vi) Total outstanding foreign currency borrowings under all categories as on the last Friday of every month.
- vii) Monthly report (as on the last Friday of every month) on the limits granted and utilized by their constituents under the facility of booking forward contracts on past performance basis.
- viii) Statement in form BAL giving details of their holdings of all foreign currencies on fortnightly basis through Online Returns Filing System (ORFS).
- ix) A monthly statement, in respect of cover taken by FIIs, indicating the name of the FII / fund, the eligible amount of cover, the actual cover taken, etc.
- x) List (in triplicate) of all bank's offices/branches, which are maintaining Rupee accounts of non-resident banks as at the end of December every year.

#### **Guidance Note on Audit of Banks (Revised 2020)**

---

- x) Quarterly report on the forward contracts booked and cancelled by SMEs and Resident Individuals.
- xii) Consolidated data on the transactions undertaken by non-residents under the scheme.
- xiii) Doubtful transactions involving frequent cancellation of hedge transactions and / or the underlying trade transactions by non-residents under the scheme.
- xiv) Report of Commodity Hedging in Overseas Market on Quarterly basis.

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

5.233 Moreover, ADs have to provide forms A2 for all interbank cross-currency deals done with overseas banks maturing during a fortnight to the RBI through the R-Return which is submitted on a fortnightly basis. ADs also have to submit a report (MAP/ SIR) in the format as prescribed by the RBI. This is required to be prepared for 4 major currencies (i.e. US\$, GBP, YEN and CHF). MAP will be prepared for the last reporting Friday of each month.

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

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

## **Guidance Note on Audit of Banks (Revised 2020)**

---

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

### **Accounting**

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

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

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

5.239 It also enables treasury operations staff to understand the accounting that is peculiar to treasury, such as the 'trading account' and 'base currency' concepts. This is vital as most of the accounting is 'hidden' by being automatically systems generated as a result of deal input of various types. Indeed, this problem is self-perpetuating as the more complex the deals become the more likely a bank will be to automate to prevent errors. Also accounting framework for option contracts will be as per FEDAI circular No.SPL-24/FC-Rupee Options/2003 dated May 29, 2003.

### **Rate Reasonability**

5.240 The bank's risk department will perform the rate reasonability process as per the Price Verification Policy of the bank and for any transaction that falls outside the band specified, the same should be enquired into for reasons. This process is also known as 'Rate Scan' or 'Market Conformity Check'.

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

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

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

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

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

5.244 The valuation models used for these financial instruments are sophisticated and involve complex algorithms. Generally, inputs into these models are sourced from market available data points. Given the enormous "leverage" provided by various derivative financial instruments and the track record of significant losses reported in the industry, the valuation of these instruments will generally have a high inherent risk.

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

### **Audit Approach**

5.246 While innovative products and ways of trading create new possibilities for earnings for the bank, they also introduce novel and sometimes unfamiliar risks that must be identified and managed. Failure to do so can result losses

## **Guidance Note on Audit of Banks (Revised 2020)**

---

entailing financial and reputational consequences that linger long after the loss has been recognized in financial statements. Hence, auditor should assess controls as part of audit work.

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

### **Audit Programming and Procedures**

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

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

### **Product Program and Policy**

5.250 The auditor should obtain the approved product policy and procedures of the Bank relating to foreign exchange and derivative business and review them for adequacy and coverage and check whether the policy is commensurate with the nature of operations and adequately covers all the activities of the Bank.

Further, in accordance with the Comprehensive Guidelines on derivatives, the auditor should obtain and verify full particulars of the model used for valuation and the documented algorithms used by the Bank through its Valuation Policy and operating procedure manual for valuations.

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

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

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

### **Credit limits**

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

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

### **Deal Initiation and Recording**

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

### **Guidance Note on Audit of Banks (Revised 2020)**

---

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

### **Deal Authorisation**

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

- Check the process flow of authorizations of deals in the system and check areas of manual intervention in the system.
- Check whether proper authorization levels are set for treasury operations and observe and verify whether the prescribed procedure is followed.
- For the selected samples, check whether deals entered in front office system are authorised by the back office team after verifying the deal details with external evidences like Reuters' conversation, telephonic conversation with customers' back office, etc.



- Examine the selected deals from the front office and establish that they are confirmed by the back office operations.
- Check that all sampled deals are authorised at the proper levels of authority against the deal slip.
- Check whether alterations and cancellations on deal slips are duly authorised.
- Check whether bank is preparing trade amendments sheets and whether the reasons for such amendments are mentioned in the sheet.
- Check whether any exceptional reports are being generated.

### **Segregation of Duties**

5.256 For this aspect, the audit procedure may include:

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

### **Counterparty confirmations**

5.257 For this aspect, the auditor would inter alia:

- Understand the process of sending and tracking the confirmations including follow – up procedures.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

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

### **Customer Complaints**

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

### **Underlying document**

5.259 The audit procedures for this aspect include:

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

### **Guidance Note on Audit of Banks (Revised 2020)**

---

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

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

5.260 The audit procedures for this aspect include:

- Checking whether there is a direct hands-off between front end system and the accounting system for passing accounting entries in the general ledger.
- Checking whether correct accounting entries are recorded in the general ledger and the back office regularly reviews the accounting entries passed in the general ledger.
- Checking whether the treasury department generates a daily P&L (desk-

## **Guidance Note on Audit of Banks (Revised 2020)**

---

wise) and same has been reviewed and compared to the general ledger to identify any mismatches.

- Understand the accounting scheme for the various products. Further, inquire about the routine and non – routine accounting entries with the bank.
- Check whether any exceptional reports are being generated by the system.
- For the selected samples, verify the accounting entries passed.

### **Position Reconciliation**

5.261 The audit procedures include:

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

### **Deal Settlements**

5.262 The audit procedures include:

- Checking whether there exists effective mechanism for settlement of deals on due date and whether deals due for settlement are generated on a daily basis by back office.
- Examining whether customer intimations are sent across as soon as the deal is settled and the respective customer accounts are debited / credited.
- Check whether separate responsibilities are in place between authorization and release of settlement.
- Examining whether the Settlement desk ensures proper settlement of funds through CCIL/RTGS/SWIFT networks. Any deal rejected by CCIL should be examined and settlement through any other means should be taken up only after thoroughly examining the deal/deal confirmation as in most of the cases the rejection is on account of improper deal entry.
- Examining whether deal is settled / cancelled in case no confirmation is received from customers till expiry dates.
- Check whether any settlements defaults were made.

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

5.263 The audit procedures include:

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

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

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

- For spot and tom contracts checking whether correct FEDAI rates are used by the Bank for marking them to market. In case of automatic feed of FEDAI rates, verifying whether the rates are correctly uploaded into the system. At the end of the reporting period, sight the process and verify the process of downloading rates from external source and the process of uploading of rates in the system by the middle/back office for all FX contracts and derivatives.
- Process of computation of net present value of rates.
- Re-performing and checking on a sample basis the accuracy of the MTM gain / loss booked by the bank on the outstanding forex contract.

5.265 In case of valuations of swaps, options and other derivative products most of the banks have proprietary valuation models developed by them or

## Guidance Note on Audit of Banks (Revised 2020)

---

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

### Guidance for Arriving at Fair / Market Value

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

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

5.268 In case of infrequently traded instruments/non-traded OTC derivatives, various techniques are used to determine the best estimate of market price. This synthetic market price may be derived through use of market data (such as interest/ exchange rates) in appropriate models/systems designed for this purpose.

5.269 In case of the following instruments, fair value can be arrived at using the market data as mentioned there against:

FX spot / forwards	Prices as published by Foreign Exchange Dealers Association of India ('FEDAI'). With effect from 31 December 2014, these are further required to be adjusted for arriving net present value.
Exchange traded interest rate	Prices quoted on the relevant exchange.

**Guidance Note on Audit of Banks (Revised 2020)**

futures	
Commodity futures	Prices quoted on the relevant exchange.
OTC derivatives:	
Options	Black Scholes Merton Method.
Swaps / Forward Rate Agreements	Discounted cash flows using the applicable Interest Curves (ROI can be taken from FIMMDA / NSE / Reuters' site based on the nature and currency of the product).

5.270 The valuation of derivatives is based on exchange rate and the swap rate prevailing on the valuation date. Various banks use different in-house/ vendor developed model for valuation of their derivative products. However, the general benchmarks used for valuation are OIS/MIBOR, MIFOR, MITOR, LIBOR and INBMK as per the end of the day quotes appearing on the Bloomberg or Reuters page.

5.271 In case of hedge swaps, the income/ expense is accounted for on an accrual basis except the swap designated with an asset or liability that is marked to market or lower of cost or market value in the financial statements. In that case, the swap should be marked to market with the resulting gain or loss recorded as an adjustment to the market value of designated asset or liability. Whereas, the trading swaps are marked to market as per the instructions contained in the RBI circular NO. MPD. BC. 187/07.01.279/1999-2000 dated July 7, 1999.

5.272 The marked to market gain/ loss on forward financial derivatives contract is derived from the difference between the agreed-upon contract price of an underlying item and the current market price (or market price expected to prevail) of that item, times the notional amount, approximately discounted. The notional amounts, sometimes described as the nominal amount, is the amount underlying a financial derivatives contract that is necessary for calculating payments or receipts on the contract. This amount may or may not be exchanged.

5.273 In the specific case of a swap contract, the market value is derived from the difference between the expected gross receipts and gross payments, appropriately discounted; that is, its net present value.

5.274 The market value for a forward contract can therefore be calculated using available information – market and contract prices for the underlying item, time to maturity of the contract, the notional value, and market interest rates.

From the viewpoint of the counter parties, the value of a forward contract may become negative (liability) or positive (asset) and may change both in magnitude and direction over time, depending on the movement in the market price for the underlying item. Forward contract settled on a daily basis, such as those traded on organized exchanges - and known as futures - have a market value, but because of daily settlement it is likely to be zero value at each end-period.

5.275 The price of an option depends on the potential price volatility of the price of the underlying item, the time to maturity, interest rates, and the difference between the contract price and the market price of the underlying item.

5.276 For traded options, whether they are traded on an exchange or not, the valuation should be based on the observable price. At inception the market value of a non-traded option is the amount of the premium paid or received. Subsequently, non-traded options can be valued with the use of mathematical models, such as the Black-Scholes formulae, that take account of the factors mentioned above that determine option prices. In the absence of a pricing model, the price reported for accounting or regulatory purposes might be used. Unlike forwards, options cannot switch from negative to positive value, or vice versa, but they remain an asset for the owner and a liability for the writer of the option.

5.277 It may be mentioned that counter party wise netting is only allowed where specific legally enforceable bilateral netting arrangement such as International Swaps and Derivative Association (ISDA) master agreement, etc., exists.

### **Examples for the Calculation of Market or Fair Values of Derivative Contracts**

5.278 The following examples indicate how to calculate the market or fair value of various derivative contracts.

5.279 For a forward, a contract to purchase USD against EUR at a forward rate of say, 1.00 when initiated has a positive market value if the EUR/ USD forward rate at net present value at the time of reporting for the same settlement date is lower than 1.00. It has a negative market value if the forward rate at net present value at the time of reporting is higher than 1.00, and it has a zero market value if the forward rate at the time of reporting is equal to 1.00.

5.280 For swaps, which involve multiple (and sometimes two-way) payments, the market or fair value is the net present value of the payments to be exchanged between the counter parties between the reporting date and the contracts maturity, where the discount factor to be applied would normally reflect the



market interest rate for the period of the contract's remaining maturity. Thus, a fixed/floating swap which at the interest rates prevailing at the reporting date involves net annual receipts by the reporter of say, 2% of the notional principal amount for the next three years has a positive marked to market (or replacement) value equal to the sum of three net payments (each 2% of the notional amount), discounted by the market interest rate prevailing at the reporting date. If the contract is not in the reporter's favour (i.e., the reporter would have to make net annual payments), the contract has a negative net present value.

5.281 Unlike forwards or swaps, OTC options have a market or fair value at initiation which is equal to the premium paid to the writer of the option.

5.282 Throughout their life, option contracts can only have a positive market or fair value for the buyer and a negative market or fair value for the seller. If a quoted market price is available for a contract, the market value to be reported for that contract is the product of the number of trading units of the contract multiplied by that market price. If a quoted market price is not available, the market or fair value of an outstanding option contract at the time of reporting can be determined on the basis of secondary market prices for options with the same strike prices and remaining maturities as the options being valued, or by using option pricing models.

5.283 In an option pricing model, current quotes of forward prices for the underlying (spot prices for American options) and the implied volatility and market interest rate relevant to the option's maturity would normally be used to calculate the market values. Options sold and purchased with the same counter party should not be netted against each other, nor should offsetting bought and sold options on the same underlying. RBI vide its Circular DBOD. No.BP.BC.76/21.04.157/2013-14 dated December 09, 2013 has issued operational Guidelines on "Novation of OTC Derivative Contracts".

### **Rate Scan**

5.284 The audit procedures for this would include:

- Checking whether for the selected deals, the rates taken are the prevailing rates in the market at the time of striking the deal. In doing so the auditor needs to assess the process of advising card rates to customers, through its branches or relevant operating departments.
- Checking whether in outright deals the back office checks the rate scans for the veracity of the rate at which the dealer has struck the deal. Any deviation should be enquired into compliance with AS 11.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

- Check whether any exceptional reports are being generated in this respect.
- In case of deviations, reasons should be obtained and check whether the same have been reported to the senior management.

### **Margins held with exchanges / margins held under Credit Support Annex ('CSA')**

5.285 The forward contracts in banks are now a days increasingly being collateralized using Customer Support Annex (CSA) margins which form part of the ISDA agreement. The audit procedures for this would include:

- Sending independent third party confirmations to confirm the balances held as at the reporting date.
- Agreeing the balances to underlying supporting such as margin statements.

Check whether margin statements are being sent to the clients and check the correctness of the same.

### **Assessment of controls**

5.286 The audit procedure may include verifying and assessing controls including:

- Existence of comprehensive treasury policy and operating procedures manual (SOP).
- Review of the policies and procedures document and assess comprehensiveness of the same.
- Determining whether the above document addresses, in granular detail, the framework within which the treasury business and operations have to be conducted.
- Inquiring on the procedures the bank has when there is a change over or new appointment to a 'review' role within the treasury function.
- Check whether proper system of rotation of dealer is in place.
- Understanding the level of detail in which the process of handover of responsibilities operates.
- Check whether mandatory leave policy is being compiled in the bank.
- Inquiring whether there has been any change in responsibilities in the current period and in case there are changes, verifying whether there is an appropriate training mechanism and whether signoffs have been regularized after the new superior has taken over the responsibilities.

### **Guidance Note on Audit of Banks (Revised 2020)**

---

- On a test check basis, verifying whether the review process and controls were working effectively during the transition period.
- Obtaining and reviewing on test check basis, the daily Profit and Loss prepared for MIS purpose and assessing the granularity and exhaustiveness of the same.
- Assessing whether such Profit and Loss is granular enough to provide desk wise, product wise and various price component wise Profit and Loss.
- Assessing whether gross position reviews are undertaken and also whether such Profit and Loss are prepared and reviewed at a gross trade level.
- Reviewing the Bank's policy on valuation. On a test check basis, verifying whether the material valuation adjustments are reviewed, authorized and are appropriate.
- Verifying whether these valuation adjustments are disclosed / visible in the reconciliation.
- Assessing whether there is an independent 'Valuation Control' team.
- Checking whether dealers have access to adjust or modify trade values.
- Checking whether the reconciliations are prepared on a timely basis and the un-reconciled items are independently inquired by the back office.
- Reviewing the ageing and quantum of the un-reconciled items and inquire for the high value and long outstanding reconciling items.
- Assessing whether the escalations are done in a timely manner for the large / unusual / recurring reconciliation items.

#### **Market Risk System**

- Reviewing the key market risk reports generated and verifying that these reports are in sync with risk attributes of the products being traded and convey the risk positions appropriately.

#### **Cancelled / amended / late (C/A/L) booking of futures trades into the Front Office risk system**

- Reviewing the policy of the bank as regards the cancelled / amended / late booked trades and whether there is a clear policy describing the Front office supervisor's responsibility in respect of reviewing and signing off on these instances.
- Reviewing whether these instances are reported to the senior management as per the policy and are ratified.
- Verifying whether the system is capable to capture the C/A/L and obtaining a complete inventory of these instances.

### **Guidance Note on Audit of Banks (Revised 2020)**

---

- Reviewing the frequency of such instances during the period and verifying on a test check basis whether there is a justification of such cancellations / amendments / delays.
- Checking the process relating to late trades – how does these get captured in risk reporting's (if there is a time cut off when such reports are generated).
- Check the approval and control process of the said transactions.
- Sample check of the same can be done by putting dummy entries for verification purpose.

Fictitious trades with deferred settlement dates and/or at off-market prices and subsequent amendments

- Reviewing the controls over cancellation of trades before reaching settlement dates and checking whether these are ratified by the authorized personnel with appropriate justifications.
- Reviewing the "Rate scan" process performed by mid-office and whether the exceptions noted in the rate scan are inquired and reasons are obtained for the same.
- Reviewing the Day 1 Profit or Loss assessment process and verify whether the Day-1 Profit or Loss is sufficiently assessed and explained.
- Verifying whether the change in pricing / other criterion is approved and confirmed with the counterparty.

Breaches of the Net Delta Limits

- Verifying whether the breaches of the delta limits set by the Bank are monitored on a frequent basis and whether the breaches (if any) are ratified by the authorized personnel and the reason is recorded for such breaches.

Failure to identify and escalate risk issues

- Verifying whether a process is in place to educate employees about escalation mechanism to report any events that represent a risk to the institution and is embedded in the code of conduct. This may include directly reporting the incidences to the highest authorities on a no name basis, hotline numbers etc.

Quality of supervision

- Assessing and determining the nature of comments and queries that are posed by the reviewer on any reconciliation breaks, long unexplained balances, exceptional trades, follow up on responses, etc.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

- Determining and assessing whether the review function is not a mere sign off and it is conducted with appropriate supervisory intent.
- Verification of training sessions conducted by the bank.

### Temporary discontinuance of a process or control

- Verifying that the controls identified and tested have been operational throughout the period and where there has been a temporary discontinuance (for any reason) verify whether there were alternative controls.

### Rewards and recognition policy not in sync with ideal 'risk and control' culture

- Reviewing the remuneration policy and independently assess how and to what degree it addresses matters relating to risk and compliance with control policies as part of the employee remuneration for treasury staff members.

### Outsourced/Hubbed process

- Reviewing the Service Level Agreements (SLAs) and agreements with such agencies and verify the robustness of the controls that reside in house in the bank to review and understand the work undertaken at outsourced / hub locations.
- Reviewing and verifying the documentary evidence of the communication the bank has with these agencies on a regular basis. The forward contracts in banks are now a days increasingly being collateralized and using Customer Support Annex (CSA) margins, which form part of the ISDA agreement. The auditor should devise audit procedures required to be performed for verification of these margin balances as per the underlying agreements.

## **NOSTRO and VOSTRO Accounts**

5.287 A fundamental feature of foreign exchange transactions is that the useful possession of any currency can be had only in the country in which it is a legal tender or countries in which it is circulated. (e.g., US Dollar is widely circulated in Russia, CIS countries). Therefore, in order to be able to put through foreign exchange transactions, banks normally maintain stocks of foreign currencies in the form of bank accounts (usually current accounts) with their overseas branches/correspondents. Such a foreign currency account maintained by a bank at an overseas centre is usually designated by it as 'NOSTRO Account' (i.e. "Our account with you"). Thus, banks in India may maintain a pound-sterling account with its London office/correspondent; such

account would be called by it as NOSTRO Account. Conversely, if a foreign bank is to deal in a local currency of another country, it would maintain a 'VOSTRO Account' (i.e. 'your account with us') with the local bank, e.g. a bank in England may maintain a 'VOSTRO Account' in Indian Rupee with a correspondent bank in India. A VOSTRO account is in substance no different from any other account in the local currency.

### **NOSTRO / VOSTRO Reconciliation**

5.288 In respect of old unreconciled entries in NOSTRO Accounts, the RBI vide its Circular DBOD No.BP.BC.67/21.04.048/99 dated July 1, 1999 has allowed, as a onetime measure, a netting off procedure.

5.289 The auditor may consider the following aspects in respect of NOSTRO reconciliation:

- Whether a system of periodical reconciliation is in place and is upto date.
- Whether the reconciliation process followed ensures matching of each item and not for overall matching of total amount.
- Whether logs are generated for any change made in entry and whether maker checker is implemented for authorising changes made in entry, if any, for reconciliation.
- Whether confirmations from the foreign banks are obtained on a periodic basis. This may be either through physical confirmations, swift messages, emails, etc.
- Whether Information to the controlling office is sent on a timely basis.
- Whether long outstanding are taken up and cleared.
- Random check of the method of reconciliation.
- Debits outstanding in the NOSTRO accounts are to be verified and recommended for provision wherever necessary.
- Set off the credit against debits only at the permission of the head office for long outstanding entries.
- Whether payments are promptly advised and effected and receipts are suitably recorded in the "Nostró" account.
- Whether large balance has been held in an inoperative account, for a long period and if so, the reasons thereof.
- Whether bank has been submitting the BAL Statements periodically to RBI.

### **Guidance Note on Audit of Banks (Revised 2020)**

---

5.290 RBI's circular no. DBOD.BP.BC.16/21.04.018/2001-02 dated August 24, 2001 has also clarified that the balances carried in "Sundry Debtors/ Unclaimed Deposits Accounts" under NOSTRO Accounts, represent unreconciled entries which may be large in a few cases and hence susceptible to frauds. Accordingly, the banks should transfer the following balances in the "Sundry Debtors/ Unclaimed Deposits Accounts" appearing in the books of the bank as on September 30, 2001 to distinct "Blocked Accounts" and shown under "Other Liabilities and Provisions" (item no. iv of Schedule 5) in the balance sheet:

- (i) the net credit balance arising out of the netting of entries pertaining to the period prior to April, 1996; and
- (ii) credit entries originated on or after April 1, 1996 and remaining unreconciled in NOSTRO/ mirror accounts for more than three years.

Further, the balances in the Blocked Accounts will be reckoned for the purposes of maintenance of CRR/ SLR.

Any adjustment from the Blocked Accounts should be permitted with the authorisation of the two officials, one of whom should be from outside the branch concerned, preferably from the Controlling branch/ head office if the amount exceeds Rs. one lakh.

5.291 The audit considerations for this aspect include:

- Examining whether currency wise NOSTRO reconciliation is performed on a day-to-day basis and check for long outstanding items.
- Checking whether there exists a policy of following up for outstanding reconciliation items with the counterparties or with the respective banks.
- Outstanding debit items over 90 days attract provisioning under RBI provisioning norms.
- Examining whether the statement of account is sent to the Vostro account holder and periodic confirmation is obtained and discrepancies, if any, is properly dealt in the books of accounts.
- To verify the bank submitted statement of Nostro / Vostro account balances on monthly basis to RBI.
- Verify if reconciliation is done by separate department and not by treasury department who operates Nostro accounts.
- Check for write off any un-reconciled item / number / amount and see if details are sent to RBI for approval.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

- Whether MIS of unreconciled entries of NOSTRO account is being sent to senior management periodically and does the senior management review the same

### **Evaluation of Internal Audit/Concurrent Audit**

5.292 The audit considerations for this aspect include:

- Examining whether treasury transactions are separately subjected to concurrent audit by internal auditors / external auditors and monthly reports containing their findings are submitted to the management for corrective action.
- Obtaining the monthly concurrent audit reports of the treasury operations and check whether deficiencies if any, mentioned in the report are rectified or noted for corrective action by the management.
- In internal audit reports, examining whether major control weaknesses are highlighted and a management action plan to remedy the weaknesses are agreed with a timeframe.
- Check whether any persisting irregularities are being highlighted in the audit reports.

Management should periodically monitor newly implemented systems and controls to ensure they are working appropriately. Failure of management to implement recommendations within an agreed timeframe should be reported to the Audit Committee.

### **Risk Management**

5.293 The audit considerations for this aspect include:

- Checking whether the bank has adequate risk management process, sound risk measurement procedures, sound information systems, continuous risk monitoring and frequent management reporting for treasury operations.
- Examining whether the mid-office monitors the exchange and gap positions for cut loss limits, overnight limits, daylight limit, liquidity, counterparty exposure limit and aggregate gap limit fixed in the banks trading policy/ guidelines.
- Reviewing the adequacy and effectiveness of the overall risk management system, including compliance with policies, and procedures.
- Investigating unusual occurrences such as significant breaches of limits, unauthorized trades and unreconciled valuation or accounting differences.



### **Guidance Note on Audit of Banks (Revised 2020)**

---

- Inquiring whether there is a 'New Product Approval' process prior to undertaking transactions in new or structured derivative products and verifying whether the 'New Product Paper' for all new derivative products is approved and signed-off by the Chief Compliance Officer of the bank.
- Obtaining the 'Risk Management Policy' of the bank and verifying whether risk management pertaining to derivative transactions is an integral part of the policy.
- Verify whether the Policy is updated on a periodic basis in line with the dynamic market and regulatory changes.
- The Board should have overall responsibility for management of risks and should decide the risk management policy of the bank and set limits for liquidity, interest rate, foreign exchange and equity price risks and verifying that the policy inter alia covers the following aspects:
  - i. Defines the approved derivative products and the authorized derivative activities;
  - ii. Details requirements for the evaluation and approval of new products or activities;
  - iii. Ensures appropriate structure and staffing for the key risk control functions, including internal audit;
  - iv. Establishes management responsibilities;
  - v. Identifies the various types of risks faced by the bank and establishes a clear and comprehensive set of limits to control these;
  - vi. Establishes risk measurement methodologies which are consistent with the nature and scale of the derivative activities;
  - vii. Requires stress testing of risk positions;
  - viii. Details the type and frequency of reports for monitoring risks which are submitted to the Board (or committees of the Board);
  - ix. Typical risks and commonly used risk limits in respect of derivative transactions;
  - x. It is essential that banks have interest rate risk measurement systems that capture all material sources of interest rate risk and that assess the effect of interest rate changes in ways that are consistent with the scope of their activities. The assumptions underlying the system should be clearly understood by risk managers and bank management.

### **Information Technology ('IT') Controls**

5.294 The audit considerations for this aspect include:

- Check controls over creation of all masters, eg. counterparty, broker, limit, dealer, etc.
- Check the integration of various treasury application with Core Banking Application.
- Check interface controls between various applications used in treasury department (viz. SWIFT and CBS, Finacle Treasury and Finacle core, etc.)
- To verify the integration of CBS, including Trade Finance and/or aligned software/modules, with SWIFT system and status of automation thereon.
- The auditor should specifically verify whether any special privileges or rights are given for operating SWIFT system allowing direct initiation of transactions through SWIFT without initiating the transactions through CBS. And whether such transactions are reflected correctly in CBS?
- Obtain IT related information from the bank for treasury operations and review, as appropriate, minutes of any committees responsible for overseeing and coordinating IT resources and activities to determine user involvement and organizational priorities.
- Check functional separation in the system.
- Verification of limit system and determination and reconciliation of positions and results.
- Check whether there were any changes in EDP systems.
- Review organizational charts, job descriptions, and training programs to ascertain that the bank has sufficient number of technology personnel and that these personnel have the expertise the bank requires.
- Review MIS reports for significant IT systems and activities to ascertain that risk identification, measurement, control, and monitoring are commensurate with the complexity of the bank's technology and operating environment.
- Evaluate the separation of duties and responsibilities in the operation and data processing of treasury functions.
- Evaluate the adequacy of input/output controls and reconciliation procedures for batch capture and image capture systems.
- Review controls and audit trails over master file change requests (such as address changes, due dates, commission / interest rates, and service

charge indicator) and also consider individuals authorized to make changes and potential conflicting job responsibilities and documentation/audit trail of authorized changes and procedures used to verify the accuracy of master file changes.

- Assess adequacy of controls over changes to systems, programs, data files, and PC-based applications and consider procedures for implementing program updates, releases, and changes.
- Check if controls are in place to restrict and monitor use of data-altering utilities and adequate process management to select system and program security settings (i.e., whether the settings were made based on using sound technical advice or were simply default settings).
- Check whether controls are established to prevent unauthorized changes to system and programs security settings.
- Evaluate the effectiveness of password administration for employee and customer passwords considering the complexity of the processing environment and type of information accessed and consider confidentiality of passwords - (whether only known to the employee/customer), procedures to reset passwords to ensure confidentiality is maintained, frequency of required changes in passwords, password design (number and type of characters), security of passwords while stored in computer files, during transmission, and on printed activity logs and reports.
- Check whether any system audit has been conducted by the bank.
- Determine whether the bank has removed/reset default profiles and passwords from new systems and equipment and determine whether access to system administrator level is adequately controlled.
- Check whether the data hands off process from one product processor to another or to any other system is conducted under a secure environment and without or with least but controlled manual intervention.
- Check whether proper backup of records is being maintained.
- Whether any dealer/employee has accessed the dealing room on holidays. If yes, verify the reasons and approvals for the same.
- Check mandatory leave policy has been adhered to.
- Check BCP details of the bank in relation to Treasury activities.
- Check whether the voice recording systems are periodically tested by the operations team and process to tag trades and corresponding unique voice records. Concurrent auditors are also required to verify this at periodic intervals.

- Check compliance with Internal Control Guidelines issued by RBI vide FE.CO.FMD. No. 18380 /02.03.137/2010-11 February 3, 2011.

### **Asset Liability Management (ALM)**

5.295 The Management of banks has to base their business decisions on a dynamic and integrated risk management system and process, driven by corporate strategy. Banks are exposed to several major risks in the course of their business - credit risk, interest rate risk, foreign exchange risk, equity / commodity price risk, liquidity risk and operational risk. It is, therefore, important that banks introduce effective risk management systems that address the issues related to interest rate, currency and liquidity risks. Banks need to address these risks in a structured manner by upgrading their risk management and adopting more comprehensive Asset-Liability Management (ALM) practices than has been done hitherto. ALM, among other functions, is also concerned with risk management and provides a comprehensive and dynamic framework for measuring, monitoring and managing liquidity, interest rate, foreign exchange and equity and commodity price risks of a bank that needs to be closely integrated with the banks' business strategy. It involves assessment of various types of risks and altering the asset-liability portfolio in a dynamic way in order to manage risks.

5.296 Banks should give adequate attention to putting in place an effective ALM System. Banks should set up an internal Asset-Liability Committee (ALCO), headed by the CEO/CMD or the ED. The Management Committee or any specific Committee of the Board should oversee the implementation of the system and review its functioning periodically.

5.297 In order to capture the maturity structure of the cash inflows and outflows, the Statement of Structural Liquidity should be prepared, Also, in order to enable the banks to monitor their liquidity on a dynamic basis the statement of Short-term Dynamic Liquidity should be prepared.

5.298 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 levels.

5.299 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 several time buckets.

5.300 Measuring and managing liquidity needs are vital for effective operation of commercial banks. By assuring a bank's ability to meet its liabilities as they become due, liquidity management can reduce the probability of an adverse situation developing. The importance of liquidity transcends individual institutions, as liquidity shortfall in one institution can have repercussions on the entire system. Banks management should measure not only the liquidity positions of banks on an ongoing basis but also examine how liquidity requirements are likely to evolve under different assumptions. Experience shows that assets commonly considered as liquid like Government securities and other money market instruments could also become illiquid when the market and players are unidirectional. Therefore liquidity has to be tracked through maturity or cash flow mismatches. For measuring and managing net funding requirements, the use of a maturity ladder and calculation of cumulative surplus or deficit of funds at selected maturity dates is adopted as a standard tool.

### **Auditors Approach**

#### **5.301**

- Auditors should obtain the Board approved policies for Asset Liabilities Management (ALM), Liquidity Risk Management and Liquidity Coverage Ratio (LCR).
- Auditors should examine the process manuals across risk management units and ALM/ALCO functionaries.
- Auditors should carry out complete process walkthrough.

Auditors should obtain and examine all the key ALM, ALCO and Risk Management Committee meeting details and analyze the minutes of meetings.

# 6

## Audit of Information Technology and Digital Banking Division

---

### Introduction

6.01 Over the past decade, the financial services industry has changed considerably, as constantly-evolving Information Technology (IT) has had a huge impact on the industry, creating numerous new opportunities, but also bringing challenges. The technology driven changes coupled with regulatory and demographic factors are cutting through the entire value chain of the banking system resulting in a constant state of flux. Therefore, it is important for banks to adapt to new technologies trending around the world.

6.02 Risks arising from the use of Information Technology can affect banks at strategic, tactical and operational level. Technology risk is pervasive and continually changing. As we know, Information Systems (IS) increasingly underpin a bank's financial and operational processes. Under these circumstances, effectively controlling IT/ IS risks has become important for sound financial and operational processes.

6.03 These risks are on account of threats and vulnerabilities ranging from hacking, viruses, obsolescence, unpatched systems, unavailability of talent, loss of key skills, inadequate control implementation, lack of monitoring, natural disasters and frauds. The targeted cyber-attacks on banks like SWIFT incidents, data theft/ loss, Distributed Denial of Service (DDoS), etc. have led to greater regulatory focus and demand for robust cyber security readiness.

6.04 Hence, banks must build capabilities to assess important Information Technology risks, to mitigate these and demonstrate the same to all stakeholders. The banks must keep abreast, and wherever possible anticipate, fast-moving developments in Information Technology.

6.05 In the context of above, IT audit needs to continually evolve to effectively cover the relevant Information Technology risks. The IT audit also require professionals to have appropriate technical skills and experience to meet the demands of a complex and constantly changing IT environment and compliance with evolving legislation and regulations.

6.06 IT audit may, but not limited to, cover following aspects:

- Entity level IT Controls

- IT Governance and Organization
  - IT Policies and Standards
  - IT Procedures and Guidelines
  - IT Strategy and Plan
  - Business Process and Automated Controls
  - Access Controls
  - Change Management Controls
  - IT Asset Management
  - System Acquisitions/Development and/or Migration Controls
  - IT Services Management Controls
    - Incident Management
    - IT Capacity and Performance Management
  - Backup Management
  - RBI Cyber Security Controls (including Physical, Network, Application and Database Security)
  - Payment Systems (including SWIFT) Controls
- Other Areas to be covered:
- Digital Banking - Key considerations
  - Cryptography Key Management Controls
  - Consumer Identity and Access Management
  - Data Protection/ Privacy
  - Outsourcing Risks
  - RPA and AI
  - Aadhaar Controls
  - Blockchain

## **Scope**

6.07 Range of the activities that are to be subjected to an IT audit are mentioned below, but not limited to the following:

### **Business process controls**

6.08 Applications and systems such as ERP (Enterprise Resource Planning) solutions, core banking applications, treasury systems, investment management, core insurance, CRM (Customer Relationship Management) and other custom

systems shall be identified to audit processes w.r.t Banking: Retail, Corporate and Investment Banking; Treasury, Insurance: New Business, Claims processing; Billing, Purchase to Pay, Order to Cash, Record to Report, Customer Relationship: Lead, Relationship, service management, Finance and Accounts: General Ledger, Accounts Payable/Receivable, Fixed Assets, HR Processes: Hire to Retire. It shall also include the test of the adequacy of: system configuration controls, process controls, maker checker controls, master data controls, reporting controls, data upload/ interface controls, Information produced by the Entity (IPE) controls, controls around end user computing sheets and information security controls.

### **User Access Management**

6.09 User Access management controls are put in place to protect organization's internal and client confidential information by controlling who has the rights to use or access information resources as per permissible responsibilities/roles matrix.

#### **Policies and procedures for user access management**

6.10 Robust policies and procedures shall be framed for the user access management which will provide guidelines for the user access provisioning, user access deprovisioning, user access review, generic user ids and authentication controls.

#### **User access creation including administrative and vendor IDs**

6.11 Access to information resources are granted based on least user privilege and on a 'need to know' principle. Individuals should be granted access to systems and/or data aligned to their job responsibilities.

Administrative accounts are accounts with access rights that may override controls that exist at the assertion level, database level and at the application level (e.g., system administrators, security administrators, database administrators).

- Administrative access should be restricted to a small group of individuals and to personnel/teams who require the administrative access as a part of their job responsibilities.
- Activities performed by users having administrative access should be monitored and reviewed for appropriateness.

User access provisioning should be done based on the organization's access control policy.



### **User access modification including administrative and vendor IDs**

6.12 The transition of a user to a new role/department/location must be agreed with the users existing reporting manager and with the new reporting manager (if there are any changes) for the following points:

- A review of the existing permission should be performed to check what access permissions are needed to be preserved during transition period and when these permissions must be removed (if applicable).
- New permissions required by the user as per his/her job responsibilities in their new role.

### **User access revocation including administrative and vendor IDs**

6.13 When an individual/group of individuals leave the organization due to termination, resignation, retirement, absconding etc., their system accounts (including Active Directory access) should be disabled within a stipulated time period to avoid unauthorized access to the systems and data.

### **Review of role – right matrix**

6.14 Access rights should be reviewed periodically to determine deviations from role baselines and to validate rights in alignment to the job responsibilities.

### **Segregation of Duties/Conflicting Access**

6.15 Segregation of duties (SOD) is the concept of having more than one person required to complete a task end to end. In business, the separation by sharing of more than one individual in one single task is an internal control intended to prevent fraud and error. SOD and critical access review shall be performed on a periodic basis along with the assessment of the appropriateness of access to critical transactions. Core application transactions shall be reviewed along with the master data to determine instances of SOD violation and related risk amounts.

### **Change Management**

6.16 Change Management is the process of planning, documenting, coordinating, approving, implementing and monitoring changes affecting the Development, Quality Assurance, Staging and Production platform within organization environments.

The objectives of the Change Management processes are to:

#### **Guidance Note on Audit of Banks (Revised 2020)**

---

- Ensure that changes are implemented with minimum disruption to the services IT has committed to its users
- Support the efficient and prompt handling of all changes
- Provide accurate and timely information about all changes
- Ensure all changes are consistent with business and technical plans and strategies
- Ensure that a consistent approach is used
- Provide additional functionality and performance enhancements to systems while maintaining an acceptable level of user services
- Reduce the ratio of changes that need to be backed out of the system due to inadequate preparation
- Ensure that the required level of technical and management accountability is maintained for every change
- Monitor the number, reason, type, and associated risk of the changes

6.17 Activities of the Change Management Process should include the below but not limited to:

- Receiving change requests from requesters
- Assigning the change to resources within organization for solution
- identification, sizing and risk analysis
- Accepting or rejecting the requested change
- Assigning the change to solution development resources
- Segregation between the production and test environment
- Reviewing the solution prior to implementation
- Scheduling the change
- Coordinating the change activities, including:
  - Planning the change
  - Documenting the change
  - Developing back out plan
  - Acquiring change approvals
  - Change Implementation

- Post Implementation Testing
- Communicating change status as required to all concerned parties
- Closing the change

6.18 Change management policies and procedures shall be framed along with the change requisition procedures where any change will involve requirement analysis, change authorization and development, testing of changes in User Acceptance Testing environment (UAT), segregation of the UAT and production environment, change approval and migration controls, monitoring of changes post implementation and segregation of duties for the changes. Procedures shall also be defined for emergency changes highlighting implementation and approval mechanism which shall be followed for the same.

### **IT Service management**

6.19 IT service management involves effective management of the following areas where the organization should design, build, implement, operate and manage these processes effectively:

#### **Incident Management**

6.20 Policies, procedures and guidelines for incident management shall be defined and all the incidents should be classified, managed, monitored and tracked to closure as per the defined guidelines.

#### **System acquisition, development and maintenance**

6.21 System requirements analysis and specification guidelines shall be documented along with system change control procedures. Security during the development and support processes needs to be maintained along with correct processing techniques such as input data validation, control of internal processing, output data validation and securing application services on public networks. Also, technical review of application shall be conducted after operating platform changes.

#### **Information security risk management**

6.22 Risk management program shall be documented along with the information security risk assessment policy and procedures. Information security risk assessments should be performed on a periodic basis which would include remediation of the identified gaps as well. Review of the business continuity preparedness, business continuity policy and awareness and disaster recovery framework shall also be performed as a part of the risk management program.

### **Capacity Management**

6.23 Policy and procedures around capacity and performance monitoring shall be framed along with the threshold metrics for capacity management. Management shall define frequency to review the capacity management reports and controls to address any deviation from the defined metrics.

### **Backup Management**

6.24 Policy and procedures around backup management, backup failures, offsite backup management and degaussing mechanism shall be framed along with the implementation of technical controls around backup solution, secure backup solution configuration, encryption and access restriction of the management console.

### **Information asset management**

6.25 A repository of all assets shall be maintained, and the process shall be documented and followed for assigning an ownership to all assets, asset return, information erasure in case of user termination, information classification/labelling and secure media disposal among other areas.

### **Information and Cyber security review**

6.26 Security controls are safeguards or countermeasures to avoid, detect, counteract, or minimize security risks to physical property, information, computer systems, or other assets. There are various guidelines, circulars and mandates released by RBI and other regulatory bodies for information technology, cyber security and information security. E.g. RBI vide circular number RBI/2015-16/418 DBS.CO/CSITE/BC.11/ 33.01.001/ 2015-16 dated June 2, 2016 on Cyber Security Framework in Banks provides as follows:

- Review of cyber security policy.
- Cyber crisis management plan (CCMP) - CCMP should address the following four aspects: (i) Detection (ii) Response (iii) Recovery and (iv) Containment. Banks need to take effective measures to prevent cyber-attacks and to promptly detect any cyber-intrusions so as to respond / recover / contain the fall out.
- Cyber security preparedness indicators - The adequacy of and adherence to cyber resilience framework should be assessed and measured through development of indicators to assess the level of risk/preparedness. These indicators should be used for comprehensive testing through independent compliance checks and audits carried out by qualified and competent professionals.

- Vulnerability assessment.
- Information sharing initiatives - banks need to report all unusual cyber security incidents (whether they were successful or were attempts which did not fructify) to the Reserve Bank. Banks are also encouraged to actively participate in the activities of their CISOs' (Chief Information Security Officer) Forum coordinated by IDRBT and promptly report the incidents to Indian Banks – Center for Analysis of Risks and Threats (IB-CART) set up by IDRBT (Institute for Development and Research in Banking Technology).
- Baseline Cyber Security and Resilience Requirements - An indicative but not exhaustive list of requirements to be put in place by banks to achieve baseline cyber-security/resilience is given. This may be evaluated periodically to integrate risks that arise due to newer threats, products or processes. To ensure adequate cyber-security preparedness among banks on a continuous basis and to enhance the resilience of the banking system following shall be followed but not limited to, putting in place an adaptive incident response, management and recovery framework to deal with adverse incidents/disruptions, preventing execution of unauthorized software, environmental controls, network management and security, application security life cycle, secure configuration, vendor risk management, removable media, data leakage prevention strategy, maintenance, monitoring, and analysis of audit logs, advanced real time threat defense and management and user/employee/management awareness.
- Organizational arrangements - Banks shall review the organizational arrangements so that the security concerns are appreciated, receive adequate attention and get escalated to appropriate levels in the hierarchy to enable quick action.
- Cyber-security awareness among stakeholders / Top Management / Board – As management of the cyber risk requires the commitment of the entire organization to create a cyber-safe environment, a high level of awareness among staff at all levels shall be ensured. Top Management and Board shall also have a fair degree of awareness of the fine nuances of the threats and appropriate familiarization may be organized. Banks shall proactively promote, among their customers, vendors, service providers and other relevant stakeholders an understanding of the bank's cyber resilience objectives and ensure appropriate action to support their synchronized implementation and testing. It is well recognized that stakeholders' (including customers, employees, partners and vendors) awareness about the potential impact of cyber-attacks helps in cyber-security preparedness of banks. Banks are required to take suitable steps in building this awareness.

## **RBI Cyber Security engagements for banks**

6.27 Bank's Statutory Central Auditor (SCA) were required to certify that whether bank has attended to/not attended to/ or partially attended (as applicable) to all the Circulars. It was advised that SCAs may assess the level of compliance by banks in this regard through the following methodology:

- Discussion and process understanding with the bank
- Review of notes/reports/documents submitted to various committees (Board, Board level and Executive level) of the bank
- Review of the audit reports – external as well as internal and their compliance level as submitted to the Audit Committee (Board/Executive)
- Review of returns submitted by the bank to RBI (CSITE Cell, Department of Banking Supervision (DBS))
- List of circulars and advisories issued by RBI (CSITE Cell, DBS) to banks to be referred for comments on the compliance including outstanding observations and reviewing bank's response/actions taken to the advisories/alerts/circulars
- Review of the organization structure for assuring the implementation of controls or measures suggested as part of circulars/advisories/alerts
- Reviewing third party assurance report
- Reviewing the notes put up to Information Security Committee, ITSC (Information Technology Sub Committee) on major issues – committee minutes and actions
- Review of the steps taken for assuring that controls gaps- identified, critical or reoccurring gaps are reported to appropriate top committees and controls are sustained
- Review whether bank has conducted audit of Third-party vendors (outsourcing)
- Review the role of CISO
- Check for the incidents reported by the bank to RBI (CSITE Cell) and its status of closure at their end – reporting to customers, regulator, Root Cause Analysis (RCA), Forensics etc.

## **Application Security**

6.28 Application security mechanisms such as structural analysis, input

validation, application and user control, data transaction analysis along with review of password policy controls, user access management, root/admin access controls, SOD matrices, system administration and change management process shall be taken into consideration for an application security review. Also, review of pre-production application security testing mechanism, Security measures considered / taken in System Development Life Cycle (Requirements gathering to UAT (User acceptance testing) signoff), IT DR (Disaster Recovery) capabilities for the applications, approved documentation (application Standard operating procedure, user Manual and training material).

### **Enterprise security**

6.29 Policy and standards, strategy and governance framework shall be framed as a part of enterprise security. Roles and responsibilities of the CISO, board, head of functional departments, Technology/Operations/Admin/HR/ functional teams, business owners, senior Management, information users, internal audit and functional technology teams along with the conduction of the information security training and awareness.

### **Physical and Environmental security**

6.30 Secure physical access procedures shall be framed and implemented which includes physical security, clear desk policy, cabling security, secure disposal or re-use of equipment, security of equipment off-premises, physical security, securing offices, room and facility, environmental controls such as mock drills and security of the equipment off-premises.

### **Human resource security**

6.31 Human resource security shall include defined activities, processes and checks for the different phases - pre-employment, during employment and termination of employment which would include background checks, terms and conditions of employment to be agreed upon, defining the roles and responsibilities of the personnel and management and return of assets and removal of access rights post leaving the organization.

### **Platform/ Infrastructure Security and Network Security**

6.32 Secure configuration documents for operating system, web server, application server, database server and network components shall be framed and implemented along with a periodic review of these documents. Regular scheduled assessments such as vulnerability scans, hardening checks and secure configuration review shall be performed, and exception approval process needs to be in place for exceptions in configuration.

## **Cryptography and Key Management**

6.33 Policy on use of cryptographic controls shall be framed along with implementation of processes around accountability for management of master keys, security of master keys, key management process, key backup, retention of keys and verification of digital certificates.

## **Aadhaar Guidelines review for banks based on AADHAAR ACT 2016**

6.34 Evaluate the applicability of the AADHAAR considering the Supreme Court Judgment on usage of AADHAAR

- Review of the IT Landscape based on the following applicable guidelines of UIDAI (Unique Identification Authority of India) for AUA's
- AADHAAR ACT
- AADHAAR (Authentication) Regulations, 2016
- AADHAAR (Data Security) Regulations, 2016
- AADHAAR (Sharing of Information) Regulations, 2016
- Updated UIDAI Information Security Policy in respect of AUA (Authentication User agency)/ KUA (KYC User Agency) for circulation
- Instruction for providing Authentication or eKYC Services by AUA KUA to Sub-AUA
- Circular for AADHAAR Data Vault
- Procurement of Registered Devices for AADHAAR Authentication
- Registered Device Certification of Biometric Devices along with STQC (Standardization Testing and Quality Certification) certificate
- Circular for Registered Devices (Implementation Timelines)
- Circular for AUA/KUA and ASA (Authentication Service Agency) Agreements V 4.0.
- Delta Certification process of Biometric Devices for Registered Devices.
- Implementation of HSM (Hardware-based security module) by AUA/KUA/ASA

## **SWIFT review (vide RBI press release 2017-2018/2249)**

6.35 RBI, as part of its ongoing efforts for strengthening of the supervisory framework in the country, has been issuing necessary instructions to banks from time to time on a variety of issues of prudential supervisory concern, including the management of operational risks inherent in the functioning of banks. The



risks arising from the potential malicious use of the SWIFT infrastructure, created by banks for their genuine business needs, has always been a component of their operational risk profile. RBI had, therefore, confidentially cautioned and alerted banks of such possible misuse, advising them to implement the safeguards detailed in the RBI's communications, for pre-empting such occurrences.

6.36 In the wake of SWIFT-related fraud involving significant amount, reported recently by Punjab National Bank, RBI has reiterated its confidential instructions and mandated the banks to implement, within the stipulated deadlines, the prescribed measures for strengthening the SWIFT operating environment in banks.

SWIFT review primarily includes –

- SWIFT process-based reviews based on the RBI mandate
- Review of pre and post transmission of SWIFT messages
- Review of logging and session controls
- Review of network controls in place to support the application

### **Audit Approach**

6.37 This section provides description of the audit approach that will be adopted to perform the IT audit for the applications having an impact on the statutory financial statements of a bank and for the support applications (such as change management tool, incident management tool, user access management tool, ticketing tool) that aid to assist the IT processes for such financial statements impacting applications or the overall bank security processes. During audit planning and risk assessment stage, audit engagement teams are required to determine the scope and extent of audit procedures for their IT audit based on the following set of illustrative factors:

- Whether the IT application system is used in the financial statements preparation or passing accounting entry- such as CBS, NPA (Non-Performing Asset) module, Loan and Treasury systems etc.
- Whether the IT application system directly or indirectly assists the processes which are relevant in the preparation of financial statements or for ensuring adequate control framework and governance over the financial statements preparation and reporting process e.g. transaction processing systems, Reconciliation systems etc.
- Whether IT application system is used for generation of reports or data elements which will be used as audit evidence for the financial statements.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

The may also include reports which are used by management for the purpose of passing an accounting entry or for making a decision having impact on financial statements e.g. applications systems used for preparation of disclosures in the financial statements etc.

- IT systems not having direct impact on financial statements but necessary for overall bank security posture of the Bank e.g. applications systems used for compliance with RBI requirements around cyber security where auditor also needs to provide a certificate etc.
- Any other IT application system or IT processes which the auditor believes is relevant for audit.

A summary of the activities that will follow are outlined in this section:

### **Strategic anchoring**

6.38

- Identify key stakeholders responsible and accountable for the audit
- Perform interviews with process owner, stakeholders & various other functional teams
- Understand the bank's strategic goals, their competitors and identify what is considered the major business risks within the bank
- Walkthrough the internal and external service catalogue and map services to strategic goals
- Walkthrough of the operating model for different functions and validate with leadership.
- Define capability characteristics and agree a desired target operating model.
- Understand if the current set-up is capable of achieving the desired state

### **Functional review**

6.39

- The functional review will predominately cover processes and procedures for the management and administration of the security architecture, implantation of security solution controls in place to protect data, network and systems against any kind of attack, the monitoring and incident response efforts to ensure continuous compliance to security requirements
- Interviews will be followed by document review and sample-based testing

- The security capability model will be used leveraging the technical security domain to assess operating models while the detailed Control Security methodology will be used to assess content and detailed operational processes

## **Report and roadmap**

### 6.40

- Define findings to close the identified gaps by -
  - Reviewing current capabilities and desired operating model
  - Following factors need to be considered when assessing the risk of failure:
    - Nature and materiality of the misstatements which the control is designed to prevent or detect;
    - Inherent risk of error associated with relevant significant account and assertions addressed by the control;
    - Competence of the personnel who perform the control or monitor its performance and whether there have been changes in the personnel;
    - Nature of the control and frequency with which it operates;
    - Whether the related significant account has a history of errors;
    - Degree to which the control relies on the effectiveness of other controls.
  - Hold workshops with key stakeholders identified in the earlier phases to:
    - Walkthrough the findings ensuring input and insights from within the bank;
    - Validate results and incorporate insights.
- Basis the risk of the identified gaps e.g.- low risk finding (control failed to discover an error, the amount of the error is likely to be only a portion of the total amount of the transaction being controlled) or a high risk finding (control failed to detect or prevent an error, there is a greater likelihood that the amount of the error could be the total transaction amount, or, in case of the completeness assertion, greater than the transaction amount), adequate impact analysis will be performed.

## Reporting

### Long form Audit report (LFAR)

6.41 Below is the general flow and critical sections covered as a part of the Long form Audit report –

- Systems and Controls
  - IT organization and management
  - Documentation of the organization's different IT teams and groups along with their functions and responsibilities
- IT strategy and planning

*Representation of the functions of the IT strategy and IT steering committee*

- Information Technology applications and infrastructure

*Documentation of the list of all the applications and devices used as a part of infrastructure and perimeter security*

- Information System audit (IS)

*IS audit provides independent, objective assurance on the effectiveness of internal controls, risk management and corporate governance and suggests improvements. Objective, scope, frequency and reporting of the audit is part of this section.*

- IT controls environment

*Documentation of the broad constituents of the bank's IT control environment which shall include Information security, logical access controls, physical access controls, backup and offsite storage, security monitoring, Business continuity plan and Disaster Recovery and cyber security.*

- IT observations

*Documentation of the significant observations noted as a part of the statutory audit*

## Outsourcing

6.42 Technology Outsourcing framework of the bank should be documented which must include IT related outsourcing process. This process should be formulated after considering all the guidance and circulars issued by regulatory authorities such as RBI circular on information security, electronic banking, technology risk management and cyber fraud ref. RBI/2010-11/494

DBS.CO.ITC.BC.No.6/31.02.008/2010-11 dated 29 April 2011. Key areas to be covered as per the framework are (but not limited to):

- Broad category of IT activities outsourced by the Bank
- Governance structure for IT Outsourcing e.g. role of the Board and IT Steering Committee
- Audit coverage and annual compliance certificate
- Assessment of outsourced IT activities i.e. materiality, risks & controls and data sensitivity assessments
- Periodic review of service providers
- Business continuity and agreement covering legal obligations

## **Other aspects**

### **6.43 Digital banking - Key considerations**

- Digital Banking has completely changed the way bank functions in today's times. With Digital Banking, Customer can transact with higher speed, ease and convenience. By definition, the Digital Banking is banking done through the digital platform, doing away with all the paperwork like cheques, pay-in slips, Demand Drafts, and so on. It means availability of all banking activities online. The first phase of the Digital Banking revolution was through the internet. The second phase of Digital Banking involves mobile phone platforms. After smartphones came into the market, Digital Banking has taken off in a big way.
- Bank offers various services such as Internet banking, Mobile banking, Credit Card/Debit Card, IMPS, RTGS, NEFT, ATM, Aadhar based payment and Prepaid Instruments. Digital banking involves high levels of process automation, web-based services and may include APIs enabling cross institutional services, use of payment gateway. Seamless flow of transaction within fraction of second supported by integration of various applications is possible only with the help of third-party service providers.

6.44 Auditor should get understanding of

1. List of digital products offered by banks
2. Involvement of third-party service providers, NPCI, VISA, Master, aggregator, payment gateways, debit card/ credit card manufacturing company
3. Flow of transactions of each product

## **Guidance Note on Audit of Banks (Revised 2020)**

---

4. Security of transaction flow, data confidentiality,
5. customer on-boarding process, authentication and OTP generation
6. daily reports generated from bank's own system and received from vendors
7. the Bank's mechanism of monitoring vendors
8. RBI guidelines on digital products and for third party service providers

6.45 The dependence of banks on third party service providers may expose bank's data in public domain and cyber risks. At the same time, data entered in CBS for digital mode transactions are also generated from third party service providers system. In this case Bank need to have strong mechanism to verify internal controls and cyber security controls at service providers.

6.46 Even though the bank is providing services through digital mode can not absolve them from regulatory compliance such as KYC, Anti Money Laundering (AML), Combating the financing of terrorism (CFT). The bank shall file suspicious transactions report (STR) to Financial Intelligent unit (FIU-IND) for mobile banking and internet banking transactions.

6.47 Customer Protection rights are also applicable to mobile and internet banking services. Liability arising out of cyber events, insuring events from third party should be considered while executing agreement between payee and payee's bank, the participating banks and service provider.

### **i. Role of NPCI in Digital Payment**

6.48 NPCI provides NFS platforms to route all transactions. NFS is shared ATM network that interconnects NFS members and ATM switches. It also supports card plus PIN transactions on Micro ATMs. NPCI provides services such as networking of ATMs, switching of ATM transactions and settlement of transactions and charges. In return of such services, card issuing banks pay transaction fees to NPCI and interchange fees to card acquiring members.

### **ii. Settlement process**

6.49 NPCI maintains settlement account for all members participating in NFS network. This account is the current account/RTGS settlement account maintained by all members with RBI through which the inter-bank transactions are routed in the day-to-day banking activity. NPCI carry out settlement pertaining to NFS transactions and send daily reports to all member banks for reconciliation and adjustments for discrepant transactions.

In this context, auditor should examine control over

- Settlement accounts, suspense or office accounts maintained for such

transactions

- Daily reconciliation process, three-way matching of data from ATM switch files, CBS files and NFS files
- Chargeback, dispute resolution procedure

**iii. Third part service provider**

6.50 As already mentioned, Banks are heavily dependent upon third party application service providers for shared services such as

- ATM switch applications,
- Credit/ debit card printing and issuance,
- ATM switch monitoring, Uptime monitoring
- ATM daily reconciliation

6.51 These service providers have exposure to the payment system landscape therefore, they become exposed to the associated cyber threats. Hence, the agreement between banks and third-party application service providers should cover necessary cyber security controls. In case of outsourcing of digital payment transaction processing and reconciliation, then income and expenses recordings are also based on the reports submitted by third party vendors. In this situation, internal controls at service providers locations is important. At the same time, Bank's verification mechanism of vendor supplied reports and control over suspense, sundry deposits accounts are critical.

Audit should consider

- Bank's mechanism of monitoring service providers
- Audit reports (Internal and External) to check compliance with relevant controls
- Third party service provider's compliance with relevant standards- PCI DSS, ISO 27001, PA-DSS
- Confirmation on various RBI requirements
- Third Party assurance report

**Consumer identity and access management**

6.52 As organizations conduct more business online, they need to provide customers with a personalized experience. This means recognizing, storing and utilizing customer information. With consumer Identity & Access Management (IAM), people are associated with information, facilitating rich digital relationships between providers and consumers.

Important aspects of Consumer IAM:

- Promoting access to products and services
- 'Know Your Customer', personalization, preferences and privacy (consent)
- Customer experience and ease of use
- Access anywhere, anytime, on any device
- Omni-channel relationships including real-world and digital services
- Advanced authentication including multifactor, biometrics and behavioral

6.53 Consumer IAM provides a platform that leverages identity information to enhance a customers' experience, while building loyalty, trust and business. This platform must be agile and able to continuously adapt to changes in consumer expectations – and risks – while supporting new capabilities such as adaptive authentication.

6.54 By associating multi-sourced data about a customer with a digital identity – often aided by data analytics – organizations can mirror the sort of customer insight they enjoy in the physical world. In return, they can delight customers with contextually relevant services, offers and personalization, and even to how an individual's landing page is populated. Because the experience is consistent across all channels, your systems can add value anywhere, anytime, from any device.

6.55 Review of controls around, but not limited to privacy, customer identification programs (CIP), information security and access management, Know Your Customer (KYC), segregation of duties, role/attribute-based controls, access governance, privileged access and data access governance shall be conducted for evaluation of this area.

## **Secure by Design**

6.56 The demand for accessing digital payment channels has increased significantly post the demonetization drive in the country. While this provides an opportunity to service providers, the demand of solution led to design and launch of multiple products during short period, which may lead to security controls not being designed comprehensively.

6.57 Digital Payment: Digital payment ecosystem is evolving at a rapid pace as India is embracing digital and technological advancement. The value of entire chain of entire ecosystem is large and growing, which exposes it to cyber security risks. The key variables include:

- Data interface across the products: Products are required to have multiple



interface with other services/application and most of the product have multiple Application Program Interface (APIs) for this purpose. There is high possibility that these API may be exposed to untested/untrusted interfaces which may lead to compromise of security measures.

- Third Party service provider: There is lot of information exchange that happens with third parties, and overall security levels are based on the weakest link in the chain. Incident related to debit card security compromise were attributed to security attack on third party service provider.
- Lack of perimeter: The ecosystem being large with multiple data interfaces, devices and system, has led to undefined perimeter for the environment. Enforcing adequate security control in such an environment causes its own challenges.

6.58 Review of control measures around security specifications, risk assessment activities, security designs, system security classification, minimizing the attack surface area, establishing secure defaults, evaluating the default services, review of source code, penetration testing, application security testing, system security acceptance testing, and audit and continuous monitoring shall be performed to conduct evaluation of this domain.

## **Device Security**

6.59

- Smartphones have emerged as a preferred mode of carrying out the digital payment since it enables communication anytime, anywhere, provide application for ease of access. While doing transaction/business is more convenient using mobile devices, it also exposes individuals and organization to cyber security risks such as online fraud, information theft, and malware or virus attack.
- Adequate security measures on device: Smart phones with internet access are more exposed to vulnerabilities and cyber-attacks however these devices can be secured by security tools such as antivirus, anti-spam, etc. or banks should create their own Mobile Device Management (MDM) container in device to make it secure.
- Cracked application installed on device: user should avoid using any cracked application on device as this may have access to information across the device. These applications potentially access financially sensitive information and pass on to attackers.
- Avoid use of vulnerable/unpatched operating system or products for which vendor has stopped support.

6.60 Policies and procedures shall be defined for the device security management along with an inventory of all such mobile devices. Network access controls shall be implemented to connect such devices to the organization's network. Mobile device management (MDM) solutions shall be used to manage security on mobile devices along with other secure configurations such as remote block, remote wipe, encryption, preventing cloud upload, strong authentication measures. Any kind of security incident w.r.t the devices shall follow an incident management process.

### **Secure Transaction**

6.61 While real-time payments and open banking are opportunities for financial services companies and their partners, there is also a growing threat of cyber-attacks, data breaches, and fraudulent activity, often outpacing and outsmarting today's existing security capabilities.

6.62 Companies that handle payments are becoming more aware – sometimes after experiencing their own breach – of the serious consequences of not offering better protection, especially on any open commerce platform. The risk is not just the data breach itself but also the potential loss of trust among customers – regardless of whether they were directly affected. Customers increasingly expect companies they interact with to do everything in their power to safeguard their data.

6.63 There are opportunities for financial services companies amid the growing threat of cyber-attacks, which can benefit them and their customers. More data traveling with the payment can provide more assurance for managing risk and more insight for identifying fraud, especially as new technologies rise to meet the challenge such as Artificial Intelligence (AI). There is also a first-mover advantage for companies that work to commercialize protection systems and software, while also adhering to the increasingly strict regulatory requirements put in place to keep data secure.

6.64 To help serve and protect their customers, players in the payments industry are expected to make significant investments in data security in the coming years. Their goal is not only avoid falling victim but staying one step ahead of cyber criminals. It is about giving customers the protection they want and building a solid reputation for doing it.

6.65 Review of business application controls around application operations handling critical transactions, along with log monitoring and review where at minimum following should be logged –

- timestamp

- event, status, and/or error codes
- service/command/application name
- user or system account associated with an event
- Device used (e.g. source and destination IPs, terminal session ID, web browser, etc.)

Audit trail activities shall be closely monitored for critical applications by integrating the audit logs with SIEM (Security Information and Event Management) tool to create and trigger alerts in case of any suspicious activity.

## **Privacy**

6.66 Based on existing regulations and recognizing that most intelligent authentication processes do not collect personally identifiable information, many suggest that privacy is of little concern here. However, given that cultural and social expectations around data privacy are only now forming, banks would be wise to come to an understanding with customers about their use of intelligent authentication.

6.67 Review of the following shall be conducted at minimum to evaluate the effectiveness of controls in this domain -

- Identify which regulation applies to the organization – GDPR (General Data Protection Regulation, CCPA (California consumer privacy act), PDPB (Personal data protection bill)
- Review privacy governance framework
- Review existing data privacy policies, procedures, guidelines and templates
- Review data privacy organization structure
- Review legal contracts on a sample basis
- Review technology projects post the implementation of any regulation
- Review insurance requirements
- Review privacy aspects in the risk management plan
- Review training and awareness on data privacy
- Review existing GDPR operational plan and annual audit plan with respect to GDPR requirements
- Review coverage of privacy impact assessment carried at the time of implementation

## RPA (Robotics Process Automation) Assessment

6.68 RPA is the simplest form of digital labour. Its significance is that it enables data to be collected, analyzed or calculated at a speed and scale far greater than a human or team of humans could manage. RPA has enormous implications for the audit — and is already bringing huge benefits.

6.69 In the analogue world where accounting was done with manual tools like physical ledgers, the auditor would validate processes and transactions using statistically valid sampling or similar techniques. In today's digital world, where data is proliferating across digital networks and systems, we are bringing new capabilities to mine the mountain of data to identify audit risk, highlight anomalies and outliers, and perform further analysis. Already, new technology is dramatically enhancing the analytical power of our audits. Using RPA, we can analyze 100% of certain datasets through various audit lenses. This means that we can quickly identify the outliers that need further examination. Areas such as audit confirmations, reconciliations, generation of emails, automated emails, both internally and with the organization's data, can all be facilitated with RPA.

6.70 A key use of RPA is to gather audit evidence by collecting information where there is data in different organizations' systems that are not integrated. This information can then be subjected to data analytics to inform the auditor to enhance risk assessment procedures or provide audit evidence. RPA is not in itself 'intelligent' but is a vital part of the process of gathering information that can then be intelligently analyzed. RPA helps with collecting data, combining data from different sources and applying a basic order to the data. The auditor may consider SA 620, "Using the Work of an Auditor's Expert" to arrive at necessary comfort in this regard.

6.71 Review of following controls shall be covered to evaluate the effectiveness of controls in this domain –

- Entity Level controls
  - RPA program governance and assurance
  - RPA policies and procedures
  - RPA ownership and responsibilities
- Technology risk controls
  - Bot access management
  - Bot process changes management
  - Bot logging and monitoring

- Bot logic and functionality
  - Security by design
  - Privacy by design
  - Algorithm and logic review
  - Secure code review
  - Vulnerability assessment
  - Bot process documentation and user stories

## **Blockchain**

6.72 In the current digital era, businesses across the world are running transactions of humongous volumes. Blockchain technology is a step towards modernization of digital infrastructure and allows the reorganization of data and assets. Blockchain solutions across industries are helping solve complex problems with use of its platform and technology qualities, yet it remains a question whether we are ready to handle the risks that these solutions can bring in. Traditional models of audit fail to take into consideration many of the risks associated with blockchain-enabled processes, and hence there is a need to understand the specific set of risks and develop an evolved auditing approach for blockchain based solutions.

6.73 Auditing block chain solutions has been developed keeping in mind specific risks that block chain models entail. Following are the key areas which can be covered as part of the audit:

- Interoperability and integration - Consistent communication between multiple blockchain platforms and integration with organizations' enterprise and legacy systems.
- Consensus mechanism - Blocks in the chain are validated by nodes to maintain a single version of the truth to keep adversaries from derailing the system and forking the chain.
- Heterogeneous regulatory compliance - Compliance with laws and regulations across various country and state legislations that will govern information and transactions processed.
- Key Ownership and management - Secure storage, maintenance, review and governance of cryptographic private keys used for authentication and validation by nodes.
- Network and nodes governance - Monitoring of network for information compliance and node reputation checks to handle and resolve disputes.
- Infrastructure and application management - Secure software development

practices and testing of blockchain applications, platform, infrastructure and communication interfaces.

- Access and permissions management - Permissions configured for defined roles for access, validation and authorization of blockchain transactions by internal and external participants.

## **Annexure on IT Fraud**

6.74 Banking sector has grown by leaps and bound in last few years, and this has also increased the need for more governance, accountability and transparency. The pace of changes puts great challenges for banks to grapple with multiple fraud related challenges, and to develop comprehensive fraud risk management controls that will help in prevention as well as detection of fraud as soon as they occur. E-banking, internet banking and internet fraud are the top fraud risks that are currently posing highest concern for the banks.

### **Types of frauds possible in banks**

6.75

- Frauds in banks – Cash lending during working hours, Missing notes in bundles, use of same note bundles by two branches, Posting in wrong accounts, Misuse of sensitive stationery, etc. These frauds are made by Bank's Staff.
- Frauds on banks – Includes Technology related frauds, Deposit related frauds, and Advances portfolio frauds.

6.76 Technology related frauds - The fraudsters employ hostile software programs or malware attacks, phishing (mails), vishing (voice-mail), Smising (Text messages), whaling (Targeted phishing on high net worth individuals), Card duplication Techniques apart from stealing confidential data to perpetrate Frauds.

6.77 Deposit related frauds - Lack of compliance with KYC Guidelines, misuse of inoperative accounts, Non-reconciliation of Suspense and Sundry accounts and lack of control over transactions, in these accounts, result in frauds.

6.78 Advances portfolio frauds - Majority of credit related frauds are on account of deficient appraisal system, Poor post- disbursement supervision and inadequate follow-up. Most of the frauds relating to advances come to light only during the recovery process initiated after the accounts have been classified as NPA. Fabricated/fudged Financial Statements, inflated security valuation report, defective search report for title deeds of mortgaged property are commonly discovered.

### Fraud risks involving Digital Banking

6.79 Information Technology (IT) plays a significant role in development of Digital banking to make the banking fast, effective and efficient. Use of IT in banking system made banking more customer oriented, quality driven and easy to use by both bank and customer. Various initiatives have been taken by the banks to converge their self from traditional banking to Digital banking. The initiatives took by the banks are as follows:

- Core Banking Systems (CBS)
- Digital Payment System
- Credit / Debit Cards
- ATMs/ POS Terminals/CDMs
- Internet Banking like NEFT/RTGS
- Mobile Banking
- Branchless Banking
- Digital Wallet

6.80 The following are one of the most common ways in which exploitation of IT is being done on the most popular initiatives-

- **Fraud Risk on CBS:** When the letter of understanding (LOU) issued, message for the credit transfer conveyed to the overseas banks through SWIFT (Society for Worldwide Interbank Financial Telecommunication) system by the sending bank and this message through SWIFT is termed as sending bank's consent and guarantee to the overseas bank. The sending bank official must log into its CBS system to route the transaction on SWIFT. The fraud on CBS occurs when SWIFT is not integrated with CBS and a perpetrator can easily sends LOUs to overseas bank simply bypassing the CBS
- **Fraud Risk on Digital Payment System:** Digital payment system spread across globe due to its scalability and acceptability by all class of users. Handling of account by a user either through online or through mobile is increasing day by day and hence they are the common target for the perpetrator. The perpetrator may deploy different techniques to make fraud happen.

Some techniques are explained as follows-

**Phishing:** Perpetrator use to send emails to lure users, that he has won the lottery, or some money needs to be deposited in his account and then requesting user to provide the details of his bank account.

**Device Compromise:** Device through which bank customer is operating his account either through online or through mobile usually prone to be compromised by perpetrator for execution of the fraud. Compromising the Operating system of the smart phone or any other status change like firewall setting etc. may lead to fraud.

**Man in the Middle Attack:** Perpetrator, in this case, altering the communication between the two legitimate parties and execute the fraud. The legitimate parties think that they are communicating with one another but in real scenario their communication is received and altered by the perpetrator.

**Spoofing Attack:** This attack is used to disguise the user by sending fraudulent communication from the fraud site as legitimate site. For example, instead of sbionline.com perpetrator may use sblonline.com for the user and force the user to enter the credentials in the fraudulent site.

**APT Attacks:** Advance persistence threat used for the infiltration of credentials of the customers of a bank. Perpetrator generally used botnets (malicious software) to infect the computers in the bank network for the infiltration of the credentials.

**Location Manipulation:** Perpetrator generally manipulating the actual location of the device for the outstation account fraud.

- **Credit / Debit Cards:** There are two types of Credit / Debit Cards frauds as detailed below:

**Card physically Not Present Fraud:** This type of Credit / Debit Cards fraud prepared by perpetrator by sending phishing emails to the card holder and lure him to enter the card information in the email or disguised portal directed by the link in the email. When all the information is available related to the Credit / Debit Card the perpetrator used to do illegal transaction online without having the physical possession of the card.

**Card physically present Fraud:** This type of Credit / Debit Cards fraud prepared by perpetrator by using some device either at swiping machine at sales counter or parallel reader in an ATM machine. Skimming money from the Credit / Debit card in the later stages would follow the departure of the Credit / Debit Card holder.

- **Internet Banking Fraud:** Internet banking used by the bank customer to do the transaction to purchase from the E-Commerce websites, transfer the money from his account to other accounts, to submit the EMI for loans to the lending banks, instalments of PPF, RD etc. Bank customer login into



the bank portal by providing the credentials to open his account page. Perpetrator try to crack the credentials of the users by different tricks which are explained as follows:

**Social Engineering:** Perpetrator pertained to be the person which he is not, to get the credentials of the user. Perpetrator uses the emotions and traits of the human like fear, greed, curiosity etc. as his tools to force the user to utter his credentials.

**Shoulder Surfing:** Shoulder surfing happen when a perpetrator tries to look over other person in hope to see his credential at the time when the said person was about to place his credentials in the bank portal. Once the perpetrator is able to see the credentials, he will use the same to divert the money from the user account.

**Key Logger:** Key logger is surveillance software installed by the perpetrator in such a way that every keystroke by the user (including credentials) in his computer is captured in an encrypted file. Perpetrator using other means collect this file and figure out the credentials in the long text.

**Spoofing Attack:** As discussed above used to obtain the credentials of the user.

**APT Attacks:** As explained above, Advance persistence threat used for the infiltration of the credentials of the customers of a bank.

These are the most common frauds that occur in Digital banking, although banks are taking lot of efforts to decrease the number of frauds by putting proper controls, customers trainings and sending alerts but it is also the responsibility of the customer to follow the guidelines issued by the bank from time to time.

# 7

## **Human Resources Department**

---

7.01 Human Resources (HR) is one of the most important department of the Bank in recent times. HR plays a variety of roles foremost is setting up an HR policy for the Bank & getting it approved by the Management or select portions by the Nomination & Remuneration committee of the Board as applicable & as the case may be.

7.02 The HR policy would normally contain the following issues -

- 1) Organizational functional structure & chart including reporting obligations
- 2) Background screen checks – health checks – fixing turn round times for various activities
- 3) Interviews, Selection & Recruitment
- 4) Issuance of Appointment Letters – fixing job roles, responsibilities & designations
- 5) Induction, awareness, sensitization & training
- 6) Salary Fixation, structure & payment, TDS calculations, deductions & payment, Issuance of Form 16, Salary slips, Profession tax payments, fixing perks & privileges including insurance entitlements
- 7) Provident Fund recoveries & contributions
- 8) Grant of Loans & Advance, interest rates thereon & recoveries
- 9) Stating Holidays, Leave & attendance record management
- 10) Staff productivity & engagement
- 11) Performance appraisal & promotions
- 12) Skill set gap assessment & development
- 13) Succession planning
- 14) Disciplinary mechanism in case of any wrongdoings including issuance of warnings & show cause notices
- 15) Complaint Resolution
- 16) Conflicts of interest & bribery

- 17) Investigation mechanism for determining staff accountability in case of frauds
- 18) Handling employee resignations, retrenchments, terminations
- 19) Full & Final settlements, Exit interviews
- 20) Handling deviations from policy & ratifications, escalations thereof
- 21) MIS – generation, circulation list & frequency

7.03 HR department will also be responsible for the following issues for which there would be specific policies -

- a) Code of Conduct – Ethics
- b) Dispute resolution mechanism
- c) Whistle blower policy & hotlines
- d) Prevention of Sexual Harassment Policy

7.04 Each Bank may have its own organization structure. While the policy framing, sign off & periodical reviews would happen centrally, monitoring & implementation could be decentralized at the Zonal, Regional or cluster level as the case may be which will also depend on the size of the Bank in terms of number of employees, branches & geographical spread.

7.05 HR department is generally headed by a Chief Human Resource Officer who would also be designated separately. He could be assisted by functional experts who would be individually & separately responsible for

- 1) Recruitment
- 2) Training
- 3) Payment
- 4) Compliance

7.06 Each of these functional heads would have individual teams centrally & at zonal, regional or cluster levels as may vary from Bank to Bank. These functional heads would be responsible for executing & enforcing various activities as stated in the Bank HR policy.

7.07 The auditor will have to ensure –

- 1) There is a comprehensive HR policy in place encompassing in detail all the issues mentioned above & it is duly updated & signed-off. Policy is periodically updated, reviewed & signed-off.

#### **Guidance Note on Audit of Banks (Revised 2020)**

---

- 2) Policy is not in violation of existing applicable laws especially labour laws.
- 3) The policy has been adhered to and this is monitored / validated independently either internally by a distinct HR team or by internal audit or internal audit conduct by external professionals.
- 4) Parameters are set to generate Exception reports to capture deviations. These Exception Reports are generated, monitored & reviewed for closure / resolution at defined intervals normally daily.
- 5) Any deviations or non-adherence to the policy are appropriately approved, addressed & closed. Ageing of open deviations is duly monitored. Classification of deviations is done risk wise into High - Medium & Low categories as per pre-defined classification norms. High risk deviations are stringently monitored for closure & open items duly escalated.
- 6) Proper Documentation is in place, stored & retained.
- 7) Tax calculations are done as per current tax laws, salary payments are in adherence to labour laws & internal policy, issuance of appropriate tax forms – Loan recoveries, interest charge is in order.
- 8) Process of Appointment – Induction – Performance & appraisal reviews, Trainings, Complaints etc is in order.
- 9) Impact on account of cash outflow is accrued / reflected in appropriate heads.
- 10) Specific adherence to Code of Ethics, Whistle Blower Policy, Prevention of Sexual Harassment is in place.
- 11) Actuarial valuation of Gratuity, Leave Encashment (generally obtained by HR) has been duly obtained on record.

7.08 While most of the issues stated above will not have a direct quantitative impact, indirectly they play a big impact on the employee motivation, engagement, performance & productivity & hence it is imperative that the auditor reviews the process end to end. Any issues noted therein should be appropriately discussed for resolution, necessary reporting of the same should be made in the LFAR.

7.09 Profit per employee / Business per employee figures need to be stated in the Notes to Accounts by Banks. The Employee number & the methodology for arriving this number will have to be certified by the HR department.

# 8

## Large Corporate and Loan Syndication

---

### Introduction

8.01 All corporate need large requirements of funds by way of debt and equity for timely financial closure of their projects. Loan syndication most often occurs when a borrower requires an amount too large for a single lender to provide or when the loan is outside the scope of a lender's risk-exposure levels. Thus, multiple lenders form a syndicate to provide the borrower with the requested capital. The Bank which spear head the process is called as Lead Bank. The lead Bank carries out most of the due diligence. The Lead Bank in most of the cases is responsible for the initial transaction, fees, documentation, compliance reports and repayments throughout the duration of the loan, loan monitoring, and overall reporting for all lending parties. Hence, the lead bank has more responsibility as compared to other members of syndication. Any laxity in any stage of the loan i.e. Sanctioning, Documentation, Disbursement, Monitoring by lead bank may increase the Risk associated with the Borrower for all syndicate members. Normally in Loan Syndication one agreement is entered between all members of Syndicate and Borrower. Though the Lead Banker is single point for correspondence, other Banks / lenders have right in proportion to their share in Loan. The Lead Bank charges fees for the syndication arrangement which are normally higher than normal loan processing fees.

8.02 Auditor of Lead Banker in case of Loan Syndication should verify

- Whether the Bank has Board Approved Policy for business of Loan Syndication?
- Whether the Bank has put processes in place for loan syndication business?
- Whether the Bank has underwritten any loan which it has syndicated, if yes whether the same has been considered as Contingent Liability?
- Whether the Bank has collected fees in all cases of syndication?
- Whether Loan Syndication Department is adequately staffed having different skill sets as required to carry out due diligence?

**Guidance Note on Audit of Banks (Revised 2020)**

---

8.03 Auditor of Other Bank (Member) should verify

- Whether the Bank has a Board Approved policy for participation in a Syndicate?
- Whether the Bank has carried out its own due diligence on information provided by the Lead Bank and raise queries, if any to the Lead Bank and whether the same are resolved satisfactorily?
- Whether share of the Bank is clearly mentioned in correspondence with Lead bank and other syndicate members?
- Whether the Bank has put in place for loan system for Delivery of Bank Credit.

## Micro, Small and Medium Enterprises Department

---

### Introduction

9.01 Advances to MSME Sector are categorised as Priority Sector Advances as per existing guidelines issued by RBI. Target for MSME Sector advances is 7.5% of ANBC or credit equivalent amount of Off Balance Sheet exposure, whichever is higher.

9.02 Determination of MSME based on limits of investment in plant and machinery and equipment, *vide* Notification S.O.1642(E) dated September 9, 2006, is as under:

<b>Manufacturing Sector Enterprises</b>	<b>Investment in Plant &amp; Machinery</b>
Micro Enterprises	Does not exceed twenty five lakh rupees
Small Enterprises	More than twenty five lakh rupees but does not exceed five crore rupees
Medium Enterprises	More than five crore rupees but does not exceed ten crore rupees
<b>Service Sector Enterprises</b>	<b>Investment in Equipment</b>
Micro Enterprises	Does not exceed ten lakh rupees
Small Enterprises	More than ten lakh rupees but does not exceed two crore rupees
Medium Enterprises	More than two crore rupees but does not exceed five crore rupees

9.03 RBI issued circular on MSME Sector – Restructuring of Advances - RBI Circular No. RBI/2018-19/100 DBR.No.BP.BC.18/ 21.04.048/ 2018-19 dated January 1, 2019. One time relaxation given for Restructuring of MSME Standard Accounts without downgrading, subject to compliance of following conditions:

1. Aggregate exposure (Fund Based/Non-Fund Based) of Banks and NBFCs should not exceed Rs. 25 Crores as on 01.01.2019.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

2. Borrower Account should be a Standard Asset as on 01.01.2019 and till date of implementation of restructuring.
3. Borrower entity should be registered under GST on the date of implementation of restructuring, unless exempted.
4. Restructuring of borrower accounts to be implemented on or before 31.03.2020 subject to fulfilment of certain conditions.
5. Additional Provision of 5% to be made and retained till end of specified period or account demonstrating satisfactory performance.
6. Post restructuring usual NPA norms to be applied.
7. Disclosure in Notes to Accounts required for MSME Restructured Accounts specifying number of accounts and amount.
8. If restructured account is downgraded as NPA as per IRAC norms, the same would be eligible for upgradation only if it demonstrates satisfactory performance (Not overdue for more than 30 days) during the specified period (1 year).

### **Preparation / Planning**

9.04 Obtain the revised, updated MSME Policy of Bank. Discuss the process of collecting information from MSME customers and recording the same in Account Master of CBS. How is this process internally validated?

### **Conduct / Execution**

9.05 Verify whether the process for identification of MSME account has been followed at branches / Controlling offices / CBS

- Check the Internal Controls for recognition of MSME accounts
- check 2% interest subvention to all GST Registered MSME Accounts
- Check for Restructured MSME Accounts Additional 5% provision (over and above provisions already held) is made at reporting date.
- Check for Restructured MSME Accounts Disclosure required in financial statements for Number of accounts restructured and amount
- What is the process for arriving at deviations & correction of the same, if any.

### **Reporting / Conclusion**

9.06 Based on audit issue appropriate certificate, report on compliance for MSME Advances in the Long Form Audit Report. Check whether appropriate disclosures are being made in the notes to accounts in the financial statements.



# 10

## Rural and Agricultural Business Department

---

### Introduction

10.01 Rural & Agricultural business department focuses on the lending under agriculture. The department function revolves around Supervision, Policy & Strategy formulation for lending under priority sector with a focus of agriculture and other government schemes relating to farmers & weaker sections.

10.02 The department is generally responsible for allocation, monitoring & compliances relating to priority or Agricultural business across various sectors/ subsectors.

### Audit Approach

1	Comparative Statement	I) Prepare a comparative chart of Expenses as per Profit & Loss Account of Current year & Previous year and check in depth wherever variance is much higher than last year. Variance needs to be addressed II) Verify to see that all records are upto date
2	Expenses & Provisions Verification	Verification of Expenses and Provisions made thereof
3	New Sanctions during the audit period	Verification of New Sanctions during the audit period
4	Scrutiny of Office Accounts	Verification of Office accounts - Scrutinizing Long Outstanding entries in office accounts
5	Closure of Previous Auditor's Report	Ensure adherence to the previous audit points, and MOC effects have been given
6	Verification of Interest Subvention process	Verification of Interest Subvention process - Submission to RBI, Booking in Finacle, Receipts from RBI and distribution to branches
7	Interest Subvention Certificate	Verification of accuracy of Interest Subvention Certificate

**Guidance Note on Audit of Banks (Revised 2020)**

---

8	Maturity Pattern of IBPC Borrowings as on the cut off date	I) Check the Maturity Pattern of Borrowings from the System Generated figure and also check where this figure is appearing in the Bank Balance Sheet II) Checking of Terms and Conditions of the Borrowings III) Obtaining Balance Confirmation Certificate from the Respective Banks IV) Verification of Interest on Borrowings V) Check the Guideline prescribed by the RBI that 18% of the total net bank credit should go to the Agricultural Advance has been maintained
9	Directions from Regulatory Authorities and charged with Governance	To check various RBI and Government guidelines and actions taken by bank upon the same. Relevant board notes also to be checked
10	Review Concurrent Audit Report	Review of Concurrent Audit Report

## Law Department

---

11.01 One of the key risks faced by banks is the legal risk. Banks issue loans & advances to its customers & enter into agreements to record the transaction. Besides various securities hypothecated or pledged to the bank in connection with the advance are documented by legally enforceable agreements. The responsibility of ensuring these documents are valid, enforceable in court of law & properly stamped & executed rests with the Bank's legal team or the law department.

11.02 Besides for various Deposit & Demat accounts, the Bank obtains Account opening forms duly executed. The same holds good for Locker arrangements, Lease agreements, Borrowings, Remittances, Trade Finance transactions, Guarantees issued, Forward Contracts, Interest rate or Currency Swaps where various documents are obtained by banks to legally validate the transaction & protect the Bank's interest. The Bank's legal department located centrally ensures pre-vetting of all documents used by the Bank in discharge of its various income – expense bearing activities.

11.03 The key document is the Bank's legal policy. The legal policy contains a detailed write-up on the roles, responsibilities & also the manner of execution / implementation. The legal policy contains or refers to various documentation to be obtained / executed for various funded and non-funded facilities sanctioned by the Bank & the custody, storage of the same as well as the stamping requirements which could vary from state to state. Important documents are scanned & movements of original loan papers need to be tracked.

11.04 The legal policy is subject to periodic review. The legal department headed by the Chief Legal Officer is the original compiler & custodian of this policy. The legal team is assisted by various staff centrally as well as at decentralized zonal, regional or cluster levels. Banks have to ensure the legal team is adequately staffed & vacancies if any, are promptly filled in by inducting competent resources.

11.05 One of the key functions of the legal team is to have a legal audit conducted for advances over a particular threshold. The threshold varies from Bank to Bank. This audit is done either pre-sanction or pre-disbursement of the loan amount.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

11.06 The risk policy of the Bank talks of legal risks & the primary role of de-risking the Bank from any legal risks rests with the legal department. The legal team works in co-ordination with the risk department in this regard.

11.07 Various legal compliances like reporting to CIBIL / CRILC needs to be done within deadlines. These are handled either at the Branch level & also monitored in parallel with the compliance team.

11.08 At times during the credit sanction process, various legal issues crop up & the legal team is responsible for issuing opinions in that connection.

11.09 Banks have set processes wherein certain disbursements over a threshold cannot be made unless there is a legal clearance certificate.

11.10 The legal department conducts the title search of the mortgaged premises & ensures that the original title deeds are in order on record. The work is also outsourced to panel advocates. The empanelment of advocates for conducting outsourced work, the detailed due diligence to be done prior to empanelment is all conducted by the legal team. The legal team is also responsible for framing & monitoring the legal outsourcing policy.

11.11 Banks have cases of credit defaults & at various occasions, legal action needs to be initiated against the borrowers for recovery. All legal cases of the Bank are handled & co-ordinated by the Bank's legal team either internally or through support of the panel advocates.

11.12 Issuance of loan recall, recovery & securitization notices, newspaper advertisements in this connection, obtaining symbolic- physical possession, filing cases in Debt Recovery Tribunals or Initiating insolvency proceedings in tribunal is handled either by the Bank's recovery department, in case the bank has a separate department, but in which case the recovery department closely liaisons with & obtains guidance & support of the legal department wherever needed.

11.13 The legal team maintains a tracker of all legal cases court wise – date wise which is constantly updated post each case hearing. These updates have to be timely. As best practice some Banks have an online legal tracker updated close to real time. Timelines are also prescribed for updating the case status post the case date.

11.14 Bank should have a full-fledged legal department headed & manned by an experienced, expert legal resource. The entire team has to be comprised of legal professionals who should be periodically trained & fully equipped to handle all legal challenges.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

11.15 While the tracker for time barred debts is monitored at individual branches & also at cluster / regional / zonal level, in certain Banks, the legal team also monitors this tracker in parallel.

11.16 The auditor needs to liaison with the legal team to get an updated status on all pending cases, filed by the Bank or against the Bank. This position has to be obtained with the amount in litigation & also whether the cases have been won or lost in earlier courts & appealed subsequently. Whether a lost case, needs to be appealed further & ensuring the appeal timelines are met is also the role of the legal team. The key discussion with the legal team is to quantify the amount of contingent liability & arrive at the provisioning requirement if any, thereon. The provisioning of the fees payable to advocates will also have to be arrived based on the agreements entered with the respective advocates & discussions with the legal team.

11.17 Banks also have a panel of valuers for conducting valuation of securities sanctioned / mortgaged to the Bank. The responsibility of appointment of valuers, fixing their appointment terms & conditions is also co-ordinated by the Bank's legal team.

11.18 The legal team is responsible for conducting a performance review of the efficiency & effectiveness of the empanelled advocates work. At times, services of empanelled advocates are discontinued due to work quality & in all these decisions, the legal department is the key co-ordinator. The legal team is also subject to an internal audit review for efficiency & effectiveness.

11.19 The auditor should ensure –

- 1) The Bank has an updated legal policy in place.
- 2) Due diligence for empanelment of panel advocates is done.
- 3) Documentation requirements for each loan facility is established.
- 4) Tracker of legal cases is maintained court wise, amount wise, stage wise.
- 5) Arrival of Contingent Liabilities for court cases, provisioning for legal liability & Debits to profit and loss for legal fees is correctly done.
- 6) Adverse issues noted in legal audit conducted, if any are properly addressed.
- 7) Deviations if any from the legal policy are duly escalated, authorized & properly addressed.
- 8) Filing & custody of loan documents is in order.
- 9) Systematic track of legal opinions issued is maintained.
- 10) Legal risks are identified & gaps therein especially high risks are noted for remediation.

## Credit Recovery Department

---

### Introduction

12.01 The area of operation / function of the Credit Recovery Department is typically confined to the monitoring of the ARBs (Asset Recovery Branches) with major thrust on the areas related to recovery of credit portfolio of the bank. The scope of the department may also include handling of recovery through various other mechanisms like NBAs (Non-Banking Assets, Selling of Assets to Asset Recovery Companies(ARCs) whereby upfront cash is realised or Security Receipts (SRs) may be received, Cases under Insolvency and Bankruptcy Code (IBC), One Time Settlement (OTS), upgradation of accounts, etc. The auditor needs to be critical in income recognition policies of the bank as regards the order of recovery and income recognition especially with respect to cases wherein the recovery is made in the form of Non-Banking Assets and sale of assets to ARCs.

### Preparation / Planning

12.02 The auditor should get acquainted himself with the Recovery Policy of the bank and the guidelines of Reserve Bank of India as regards the accounting and income recognition thereto. The auditor needs to take into consideration the extent of automation of process related with accounting of recovery of credit portfolio of the bank while audit planning.

### Conduct / Execution

12.03

- Verify the returns / data from Asset Recovery Branches (ARBs) under reporting of the departments.
- Verify the consistency in income recognition process as regards order of recovery and whether the same is in sync with the internal policy of the bank and is appropriately disclosed in notes on accounts.
- Verify whether the income recognition is in compliance with extant RBI guidelines related to income recognition.
- Verify whether the non-performing accounts upgraded during the period under audit are upgraded in compliance with the extant RBI guidelines in this regard.

### **Guidance Note on Audit of Banks (Revised 2020)**

---

- Verify whether the income is recognised against recovery especially through NBAs and SRs only to the extent of cash realisation and not to the extent of fair market value of NBAs / SRs as the same is yet to be realised.
- Review and verify as regards the possibility of the devaluation in the value of NBAs and / or requirement of provision for diminishing in the value of NBAs and the policy of the bank in this regard and the disclosure of the same in notes on accounts.
- Verify the accounts upgraded (from NPA to PA) during the period under audit with thrust on the source of funds and the compliance of upgradation norms as per the extant RBI guidelines.
- Verify the compliance with Insolvency and Bankruptcy Code w.r.t. the accounts under recovery under IBC mechanism.

#### **Reporting / Conclusion**

12.04 Check whether the appropriate disclosure of policy related to recovery especially in terms of order of recovery and NBAs / SRs is made in notes on accounts.

12.05 Based on adverse audit observations, appropriate reporting is to be ensured in LFAR and / or Audit Report.

## **Risk Management Department**

---

13.01 Risk is a key function in a Bank. Banks face various risks in their conduct of business. The Basel framework capital adequacy ratio mandates banks to maintain minimum capital as per its risk weighted assets. Risk calculation is a key Banking activity. Some risks which the Bank faces are -

- 1) Operational risks
- 2) Credit risks
- 3) Liquidity risks
- 4) Market risks
- 5) Investment risk
- 6) Interest rate risk
- 7) Legal risk
- 8) Regulatory risk
- 9) Reputational risk
- 10) Financial risk
- 11) Money laundering risk
- 12) Technology risk
- 13) Product risk
- 14) Concentration risk

13.02 Banks have a risk department which is responsible for framing a risk policy. The risk policy contains detailed risk guidance on –

- 1) Risk identification – various risk scenarios, existing or emerging which the bank could be exposed on an end to end activity, sub-activity basis.
- 2) Risk assessment – classification of identified risks based on their probability or likelihood & significance or impact into High, Medium or Low. Methodology for risk classification has to be objectively quantified. Alternate risks can also be classified into risk types.



### **Guidance Note on Audit of Banks (Revised 2020)**

---

- 3) Risk evaluation – mapping assessed risks based on current controls designed & in place to mitigate / remediate the risks
- 4) Risk monitoring – periodically reviewing the evaluated risks based on operating effectiveness of the controls to actually identify the status of residual risks or gaps. Auditor to ensure controls are automated & proactive. Reactive & manual controls should be pointed out for upgradation or stringent maker -checker.
- 5) Risk response – post risk evaluation, noting whether overall risks are within risk appetite & transaction wise within defined risk tolerances. If risks are beyond risk appetite, ensuring that they are appropriately responded by strengthening controls to minimize impact to below risk tolerance / appetite acceptable levels. Alternate bank could decide whether to avoid such transactions or get them insured or budget losses appropriately.
- 6) Risk communication – Banks have to ensure that activities have to be done right first time. Hence, they need to sensitize their employees & make them risk aware & risk ready by proper training.

13.03 The risk policy of the Bank will have to be comprehensively compiled & periodically updated. Banks have a risk department headed by a Chief Risk Officer whose main responsibility is to ensure adherence to the risk policy in terms of identification, assessment, evaluation, response & communication. Banks have a risk review committee where key existing & emerging risks discussed & brainstormed from control perspective.

13.04 The Risk department is generally centralized with various support decentralized functionaries located zone, region or cluster wise as the case may be. The key aspect is that risk is treated as close to the scene of origination especially credit & money laundering risk.

13.05 Auditor has to primarily ensure that the Bank has a formal risk structure in place with a formally approved comprehensive risk policy. Auditor should ensure that the Bank is in adherence to the policy. Any deviations to the policy are duly monitored & captured for appropriate addressal.

13.06 RBI *vide* its circulars have mandated risk based audit in Banks. Auditor should focus on high risk areas. Audit plan should be based on due risk classification & audit time spent should be commensurate with the risk involved. Auditor should ensure that there is a risk-based audit structure formally in place.

13.07 Auditor has to ensure –

- 1) Bank has a formally defined risk appetite & risk tolerance levels are fixed transaction wise.

### **Guidance Note on Audit of Banks (Revised 2020)**

---

- 2) Risk identification based on what can go wrong on an end to end activity wise basis is conducted considering the organization structure, functions & responsibilities. The bank is maintaining a Risk Register for the same.
- 3) Risk identification is an ongoing, periodic activity.
- 4) Risk assessment or classification of risks into risk types or High-Medium-Low is comprehensively done.
- 5) Existing Controls are mapped to risks.
- 6) Trainings on risk awareness is conducted amongst employees.
- 7) Gaps which are beyond risk appetite / risk tolerance are addressed. Timelines & the manner of addressal along with the risk owner is identified. Open risk items should be duly tracked. Proper escalation mechanisms should be in place to highlight open items.
- 8) Risk policy is periodically updated & reviewed.
- 9) Minutes of Risk Committee Meetings are duly recorded on a timely manner.
- 10) Effectiveness of IT system/IT infrastructure including Management Information Systems.

13.08 Any risk deviations noted are to be appropriately discussed with the management or appropriate risk committee members and duly reported in the Long Form Audit Report as the case may be.

### **Frauds**

13.09 While the primary responsibility for preventing frauds lies with banks themselves, the Reserve Bank of India (RBI) has been advising banks from time to time about the major fraud prone areas and the safeguards necessary for prevention of frauds. Banks are required to introduce necessary safeguards / preventive measures by way of appropriate procedures and internal checks so as to prevent/minimize occurrence of frauds and resultant financial loss to the banks.

13.10 The CEOs of the banks are supposed to provide singular focus on the "Fraud Prevention and Management Function" to enable, among others, effective investigation in fraud cases and prompt as well as accurate reporting of fraud cases to appropriate regulatory and law enforcement authorities including RBI. Banks are required to frame their internal policy for fraud risk management and fraud investigation function with the approval of their respective Boards. The

auditor should refer SA 240, "The Auditor Responsibilities relating to Fraud in an Audit of Financial Statements" in this regard.

### **Classification**

13.11 Frauds are classified, mainly on the basis of the provisions of Indian Penal Code (IPC), as under:-

- a) Misappropriation and criminal breach of trust.
- b) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
- c) Unauthorized credit facilities extended for reward or for illegal gratification.
- d) Negligence and cash shortages.
- e) Cheating and forgery.
- f) Irregularities in foreign exchange transactions.
- g) Any other type of fraud not coming under the specific heads as above.

13.12 Cases of 'negligence and cash shortages' and 'irregularities in foreign exchange transactions' (d & f) are to be reported as fraud if the intention to cheat/defraud is suspected/ proved. However, the following cases where fraudulent intention is not suspected/proved at the time of detection will be treated as fraud and reported accordingly:

Cases such as:-

- a) Cases of cash shortage more than Rs. 10,000/-, and
- b) Cases of cash shortage more than Rs.5,000/- if detected by management / auditor/ inspecting officer and not reported on the day of occurrence by the persons handling cash.
- c) Frauds involving forged instruments have to be reported only by the paying banker whereas collection of a genuine instrument fraudulently by a person who is not the true owner, the collecting bank, which is defrauded, will have to file fraud report with the RBI.
- d) Collection of an instrument where the amount has been credited before realization and subsequently the instrument is found to be fake/forged and returned by the paying bank, the collecting bank is required to report the transaction as fraud with the RBI as they are at loss by parting the amount.
- e) Collection of an altered/fake cheque involving two or more branches of the same bank, the branch where the altered/fake cheque has been encashed

is required to report the fraud to its H.O. for further reporting to RBI by the H.O.

- f) An altered/fake cheque having been paid/encashed involving two or more branches of a bank under Core Banking Solution (CBS), the branch which released the payment is required to report the fraud to its H.O. for further reporting to RBI.
- g) Cases of theft, burglary, dacoity and robbery are not treated as fraud.
- h) Banks (other than foreign banks) having overseas branches/offices are required to report all frauds perpetrated at such branches/offices to RBI.

## **Reporting**

### **Reporting of Frauds to RBI (FMR -1)**

#### **13.13 Frauds involving Rs. 1 lakh and above**

- Fraud including in the subsidiaries and affiliates/joint ventures of the Banks perpetrated through misrepresentation, breach of trust, manipulation of books of account, fraudulent encashment of instruments like cheques, drafts and bills of exchange, unauthorised handling of securities charged to the bank, misfeasance, embezzlement, misappropriation of funds, conversion of property, cheating, shortages, irregularities, etc.
  - Cases under criminal proceedings initiated by central investigating agencies *suo motto* and/or where RBI has directed to treat as frauds.
  - For frauds involving Rs. 5 Lakh and above, banks are required to send Soft copy of the reports (FMR-1/B) to the Central Office of the Department of Banking Supervision (DBS) within three weeks of detection of fraud, etc.
- a) Frauds committed by unscrupulous borrowers.** Such frauds include:-
- Fraudulent discount of instruments or kite flying in clearing effects.
  - Fraudulent removal of pledged stocks/disposing of hypothecated stocks without the bank's knowledge/inflating the value of stocks in the stock statements and drawing excess bank finance.
  - Diversion of funds outside the borrowing units, lack of interest or criminal neglect on the part of borrowers, their partners, etc. leading to the unit becoming sick as also due to laxity in effective supervision over the operations in borrowal accounts on the part of the bank functionaries rendering the advance difficult to recover.

Banks are supposed to exercise due diligence while appraising the credit needs of unscrupulous borrowers, borrower companies, partnership/

proprietorship concerns and their directors, partners and proprietors, etc. as also their associates who have defrauded the banks. Besides the borrower fraudsters, other third parties such as builders, vehicle/tractor dealers, warehouse/cold storage owners, etc. and professionals are also to be held accountable if they have played a vital role in credit sanction/disbursement or facilitated the perpetration of frauds. Banks are required to report to Indian Banks Association (IBA) the details of such third parties involved in frauds.

**b) Frauds in borrowal accounts having multiple banking arrangements (MBA)**

- All banks under MBA arrangement are required to evolve a system of exchanging information on fraud committed by the borrower so as to take appropriate action including criminal action against the borrower.
- Banks are required to evolve an operating framework for tracking frauds and dealing with them.

**13.14 Frauds involving Rs. 100.00 lakh and above**

- Banks are required to report frauds involving Rs. 100 Lakh and above to Central Office, RBI, by way of D.O. letter giving the details such as amount involved, nature of fraud, modus operandi in brief, name of the branch/office, parties involved, etc. within a week of notice of the fraud at the bank's H.O. duly marking copy to R.O., RBI under whose jurisdiction the bank's branch, where the fraud has been perpetrated, is functioning.

**13.15 Cases of attempted fraud**

- Banks are required to report the cases of attempted fraud involving likely loss which would have been Rs. 1.00 crore or more had the fraud taken place to the Central Office, RBI giving the full details including the modus operandi within 2 weeks of the bank coming to know that the attempt to fraud has failed or foiled.

**Quarterly Returns**

**13.16 Report on frauds outstanding**

- Banks are required to submit its Quarterly Report (FMR-2) on frauds outstanding to Central Office, RBI, within 15 days of the end of the quarter to which it relates (soft copy).
- The Report is to be accompanied by a certificate to the effect that all individual fraud cases of Rs.1 Lakh and above reported to the RBI (FMR-1)

## **Guidance Note on Audit of Banks (Revised 2020)**

---

during the quarter have also been put up to the bank's Board and have been incorporated in the Report.

### ***Closure of fraud cases***

13.17 Fraud cases closed during the quarter are required to be reported by banks in quarterly return (FMR 3) to the Central Office, RBI, and R.O., RBI, along with reasons for the closure where no further action was called for. Fraud cases closed during the quarter are required to be reported in quarterly return FMR 3 and cross checked with relevant column in FMR-2 return before sending to RBI.

13.18 Banks should report only such cases as closed where the actions as stated below are complete:

- a) CBI/Police/Court have finally disposed of;
- b) Staff accountability has been examined/ completed;
- c) The amount of fraud has been recovered or written off.
- d) Insurance claim wherever applicable has been settled.
- e) Bank has reviewed the systems and procedures taken steps to avoid recurrence;
- f) Banks should also pursue vigorously with CBI for final disposal of pending fraud cases especially where the banks have completed staff side action, etc.

### ***Progress Reports on Frauds (FMR-3)***

13.19 Banks are required to submit case-wise quarterly progress reports on frauds involving Rs. 1.00 lakh and above (including cases where there are no developments) in the format given in FMR - 3 to the Central Office of RBI, as well as the concerned Regional Office of the RBI within 15 days of the end of the quarter to which they relate.

## **Reports to the Board**

### ***Reporting of fraud***

13.20 Banks need to ensure that all frauds of Rs. 1.00 lakh and above are reported to their Boards promptly on their detection. Such reports should, among others, contain the failure on the part of the concerned branch officials and controlling authorities and consider initiation of appropriate action against the officials responsible for the fraud.

### ***Quarterly Review of Frauds***

13.21 Information relating to frauds are to be placed before the Audit Committee of the Board of Directors on quarterly basis ending March, June and

September with statistical analysis. The auditor is supposed to read the minutes of all such meetings and ensure the appropriate accounting and disclosure in the financial statements.

13.22 Banks are required to constitute a Special Committee consisting of CMD of public sector banks and MD in respect of SBI/its associates for monitoring and follow up of cases of frauds involving amounts of Rs. 1.00 crore and above exclusively. The main function of the committee would be to monitor and review all the frauds of Rs. 1.00 crore and above and to put in place, among others, measures as may be considered to prevent recurrence of frauds such as strengthening of internal controls etc.

#### **Annual Review of Frauds**

13.23 Banks are required to conduct an annual review of the frauds and place a note before the Board of Directors/Local Advisory Board for information. The review would take into account, among others, whether the systems in the bank are adequate to detect frauds once they have taken place within the shortest possible time.

#### **Guidelines for Reporting Frauds to Police/CBI**

##### **13.24 Private Sector Banks/Foreign banks (operating in India)**

- While reporting the frauds, banks are required to ensure that, besides the necessity of recovering the amount expeditiously, the guilty persons do not get unpunished.
- Cases that are required to be referred to State Police include:
  - a) Cases of fraud involving an amount of Rs. 1.00 lakh and above committed by outsiders on their own and/or with the connivance of bank staff/officers.
  - b) Cases of fraud involving amount exceeding Rs. 10,000/-committed by bank employees.
  - c) Fraud cases involving amounts of Rs 1.00 crore and above should also be reported to the Serious Fraud Investigation Office (SFIO), GOI, in FMR-1.

#### **Public Sector Banks**

##### **13.25 Cases to be referred to CBI**

- a) Cases of fraud involving amount of Rs. 1.00 crore and above upto Rs. 7.50 crore:
  - Where staff involvement is prima facie evident - CBI (Anti Corruption Branch).

### Guidance Note on Audit of Banks (Revised 2020)

- Where staff involvement is prima facie not evident- CBI (Economic Offences Wing)
- b) All cases involving amount more than Rs.7.50 crore - Banking Security and Fraud Cell of the respective centres, which is specialized cell of the Economic Offences Wing of the CBI for major bank fraud cases.

#### 13.26 Cases to be referred to Local Police

Fraud involving Rs. 1.00 Lakh and above involving outsiders (Private parties and bank staff)	Compliant to be filed with Regional Head of the bank to State CID/Economic Offences Wing of State concerned
Below Rs. 1.00 Lakh but above Rs. 10,000/-	Local Police Station by the branch
Below Rs. 10,000/- involving bank officials	Reported to Regional Head of the bank to decide on further course of action.
Frauds involving forged instruments	Paying banker to Local Police
Fraudulent encashment of DD/TTs/Pay orders/ Cheques/ DWs, etc.	Local Police concerned
Collection of genuine instrument, but collected frequently by a person who is not the owner	Collecting bank to Local Police concerned
Payment of uncleared instrument which found to be fake/forged and returned by the paying bank	Collecting Bank to Local Police
Collection/payment of altered/fake cheque involving 2 or more branches of the same bank	Branch where the cheque was encashed to the Local Police

#### Reporting Cases of Theft, Burglary, Dacoity and Bank Robberies

##### 13.27

- Occurrence of any bank robberies, dacoities, thefts and burglaries are required to be reported immediately by Fax/e-mail to RBI, Department of Banking Supervision, Central Office and Regional Office, Security Adviser,



Central Security Cell, RBI and Ministry of Finance, Department of Financial Services, GOI with details of modus operandi and other information as required in FMR-4. Banks are also required to submit a quarterly consolidated statement (FMR-4) to RBI Central Office/RO within 15 days of the end of the quarter it relates.

- Various reporting formats (FMR-1, 2, 3, 4) are provided in the RBI Direction on Fraud by way of Annexure.

13.28 The auditor has to check the above and confirm whether the bank has complied with the above provisions.

### **Audit Methodology**

13.29 Auditor has to ensure:

- 1) That there is a Fraud Policy in place which is reviewed and updated at periodic intervals. This Fraud policy has been circulated on the bank Intranet & employees are sensitized of the fraud policy.
- 2) Periodic anti-fraud training & awareness sessions are in place.
- 3) Whistle Blower hotlines are in place.
- 4) Fraud risk scenarios are identified & current anti- fraud controls noted and mapped to fraud risks. Measures are put in place to prevent significant gaps.
- 5) The bank Zero tolerance policy for fraud or ethical violations is made aware to all employees.
- 6) Swift dismissal / termination of employees found guilty of fraud is in place.
- 7) Mechanisms of early detection and reporting of fraud incidents is in place.
- 8) Back ground screening checks for employee joining is in place.
- 9) Periodic anti-fraud communication and care to be taken to prevent frauds / money laundering is in place.
- 10) Auditor to examine robustness of anti-fraud controls, staff accountability is in place.
- 11) Reporting mechanisms to RBI is effectively in place.
- 12) Definition of Fraud is clearly identified. Policies for reporting on fund diversions, siphoning of funds and wilful defaults is in place.

If the auditor notes adverse issues, the same have to be discussed at appropriate levels of the management. Necessary reporting will have to be done in the Long Form Audit Report or the main audit reports as the case may be.

## **Vigilance**

13.30 The Chief Vigilance Officers in the Banks have been authorised to decide upon the existence of a vigilance angle in a particular case, at the time of registration of the complaint. Once a complaint has been registered as a vigilance case, it will have to be treated as such till its conclusion, irrespective of the outcome of the investigation. Although formulation of a precise definition is not possible, generally such an angle could be perceptible in cases characterised by:

- (i) commission of criminal offences like demand and acceptance of illegal gratification, possession of disproportionate assets, forgery, cheating, abuse of official position with a view to obtaining pecuniary advantage for self or for any other person; or
- (ii) irregularities reflecting adversely on the integrity of the public servant; or
- (iii) lapses involving any of the following;
  - (a) gross or wilful negligence;
  - (b) recklessness;
  - (c) failure to report to competent authorities, exercise of discretion without or in excess of powers/jurisdiction;
  - (d) cause of undue loss or a concomitant gain to an individual or a set of individuals/a party or parties; and
  - (e) flagrant violation of systems and procedures.

13.31 In banking institutions risk-taking forms an integral part of business. Once a vigilance angle is evident, it becomes necessary to determine through an impartial investigation as to what went wrong and who is accountable for the same.

13.32 Information about corruption, malpractices or misconduct on the part of public servants may come to the CVO's notice through various sources, such as,

- (i) the complaints received from the public, or through the administrative Ministry, CBI and the CVC;
- (ii) departmental inspection reports and stock verification surveys;
- (iii) scrutiny of property returns and the transactions reported by the concerned employee under the Conduct Rules;
- (iv) audit reports;

- (v) press reports;
- (vi) reports of parliamentary committees etc. Information received verbally should be reduced to writing and dealt with similarly.

13.33 The vigilance department acts upon all such kind of complaints and conducts a detailed investigation. Periodic meetings are held with the respective committees and cases are discussed with the top Management of the Bank. The SCA is expected to read the minutes of the meetings and understand the complaints and the actions taken upon them by the CVC department. The details of the individual cases should be ascertained and the same can be discussed with the CVO and his department by the SCA. It is essential that the SCA arrives at a proper judgement over the cases and concludes its proper accounting/disclosure in the financial statements.

### **Risk management limits & monitoring**

13.34 Risk is a function of probability and impact. Risk department is an important function in Banks. Banks have a separate risk management department and a committee. The department is responsible for identifying key risks, assessing, evaluating, monitoring and responding to risks. The risk committee ensures that the risk oversight is adequate and effective. Design of automated Controls and its effective and efficient implementation and execution to pro-actively remediate and mitigate the risks is monitored on an ongoing manner.

13.35 One of the key aspects in risk monitoring is setting up limits and ensuring that these are not breached. These are tolerance levels within which the activities have to be conducted. Limits ensure control. Any Breach in the limits needs to be escalated, ratified and approved at appropriate levels. The limits are duly framed in respective policies and reviewed from time to time. Some limits are framed by the RBI itself while some limits are set up by Banks internally.

13.36 Limits are also in place for reporting purposes as transactions over a particular threshold need to be reported to either RBI – FIU – Income Tax authorities.

13.37 Banks have limits in place for various activities namely:

- 1) Advances – Single Borrower and Group Borrower exposure details – Priority Sector lending – Unsecured Advances – Minimum Provisioning – conduct of stock audits – obtaining end use and other certifications – obtaining 2<sup>nd</sup> valuations.

#### **Guidance Note on Audit of Banks (Revised 2020)**

---

- 2) Investments – Held to maturity Securities / Non SLR Securities – Creation of Investment Fluctuation / Depreciation Reserve.
- 3) Borrowing Limits.
- 4) Transfers to Statutory and other mandatory Reserves.
- 5) Cash Reserve Ratio – Statutory Liquidity ratio Limits.
- 6) Overseas Foreign Currency borrowing Limits including overdrafts in Nostro accounts adjusted in 5 days.
- 7) Limits under various AP-DIR circulars - Reporting in XOS- BEF statements.
- 8) Treasury – Open limits, Aggregate Gap Limits, Individual gap limits, Counterparty limits, Settlement limits, Currency Limits.
- 9) Obtaining PAN for cash transactions over a determined threshold.
- 10) Remittances under Liberalized Remittance scheme (LRS).
- 11) Legal audit and verification of title deeds for loans over Rs 5 Crores – conducting due diligence reporting.
- 12) RTGS transactions – Minimum amount should be over Rs 2 lakhs.
- 13) NEFT transactions has no limits. Earlier Banks had certain time restrictions but now RBI has instructed that these facilities be available 24 hours.
- 14) Parameters are in place for automated transaction monitoring and breach of these limits throws system alerts which are white washed or validated. Exceptions are reported in the Suspicious Transactions Report, Banks also have to report transactions in Cash transaction reports, Cross Border Wire Transfer Report, Counterfeit Currency reports, Non-Profit organization transaction reports.
- 15) Banks also have internal monitoring thresholds and any breach of these parameters are reported as Exceptional transactions in Exception reports which are generated and monitored daily.
- 16) Cash retention Limits - Limits on amount of cash withdrawals at other than Home Branch with / without charges – Cash deposits other than home branches – ATM amount withdrawn per day.
- 17) Reporting under FATCA- CRS.
- 18) Limits for Fraud reporting.
- 19) Annual Information Reporting.
- 20) Reporting to Credit information Companies.

**Guidance Note on Audit of Banks (Revised 2020)**

---

21) Reporting to Central Repository of Information on Large Credits.

13.38 This list is not exhaustive and the auditor should look up various RBI – FEMA - CBDT Circulars / Bank Internal policies for the list of limits to be monitored and reported.

13.39 Auditor should primarily obtain a listing of all limits which the Bank is monitoring for internal control purposes or reporting purposes authority wise.

13.40 In the absence of such a list, the auditor will have to primarily report the non- existence of such a list as an issue.

13.41 Auditor should examine the process for compilation of this list and how these limits are monitored. An automated system should ideally be in place. Where the monitoring is done manually, stringent maker checker process controls should be in place which should operate effectively and efficiently at all times.

13.42 Any deviations or discrepancies noted should be reported appropriately in the Long Form Audit Report or duly qualified in the accounts if necessary, as the case maybe.

# 14

## Central Audit and Inspection Department

---

### Introduction

14.01 Audit Department in Banks is a combination of Centralized function with some level of decentralization at the Cluster, Regional or Zonal level. The structure may vary from Bank to Bank. Banks have an audit manual, Audit policy or audit charter. The Audit department is usually headed by a Chief Audit Executive or Head Audit. Designations would vary from Bank to Bank. The primary function is to ensure that the audit function is handled smoothly, effectively & efficiently.

14.02 The functions are as under:

- 1) Scoping the audit – deciding who does what, how and when – maintaining an audit calendar – ensuring that the audit calendar is maintained as scheduled.
- 2) Ensuring the audit committee agenda is properly framed. Presentations to be made if any are prepared. Minutes of the audit committee record the proceeding details correctly.
- 3) Ensuring that audit follows a Risk based approach in accordance with RBI guidelines.
- 4) Closure of open audit issues. Tracking audit issues for closure.
- 5) Placing audit reports before the Audit committee / Management committees, as the case may be. Ensuring any actions suggested by the audit committee are duly followed and closed.
- 6) Appointment of concurrent auditors, deciding their scope, meeting the concurrent auditors, discussing their issues, conducting trainings if needed, review of work of concurrent auditors. Ensuring that RBI guidelines on Concurrent audit are adhered.
- 7) Closely interacting with other departments like risk – compliance to ensure these functions are effectively conducting their duties.
- 8) Following up closures of stock audit issues.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

- 9) Conducting some audits internally – Branch audits, functional audits like Human Resources, Information Technology, review of risks and compliance functions for effectiveness & efficiency, MIS reviews etc.
- 10) Ensuring the internal audit team is well equipped and trained.
- 11) Co-ordinating with RBI Inspectors or Statutory auditors whenever needed. At times they are one of the main co-ordinators for RBI audit
- 12) Ensuring audit function is automated & adopts the latest techniques & procedures
- 13) Co-ordinating with the Fraud department for de-risking
- 14) Laying down parameters for risk-based audit. Deciding risk classification in co-ordination with Risk / Business
- 15) Laying internal metrics for evaluating efficiency & effectiveness of audit function. Being validated externally – internally.
- 16) Close Co-ordination with the Chairman of audit Committee or similar position for ensuring effective audit oversight.
- 17) Ensuring that other audits like revenue audits, Legal audits, Information Security audits, Cyber Security audits are duly conducted and process gaps noted therein are resolved.
- 18) Ensuring that the audit policy, audit manual or audit charter is duly reviewed on an annual basis.

14.03 Audit has moved from the traditional transaction verification to the process driven risk-based audit. The focus is on doing things right first time. The key is to ensure that there are no gaps and gaps if any are closed within acceptable time frames.

### **Audit approach**

14.04 The Statutory Central Auditor should ensure that the audit function is effectively discharging its duties & functions enumerated above. He needs to co-ordinate with the audit head & validate the audit process. The validation could be done by a combination of transaction and system-process checks. It is the statutory auditor validating the internal audit function for efficiency and effectiveness. Any shortcomings or gaps noted have to be effectively escalated to the audit committee and reported appropriately in the LFAR.

14.05 The statutory auditor will also go through the reports of Concurrent auditors of key branches, functions. He will also have to scrutinize the system audit reports, revenue audit reports, stock audit reports, internal inspection

### **Guidance Note on Audit of Banks (Revised 2020)**

---

reports. The scoping, frequency and quality will have to be looked into in depth and commented.

14.06 The statutory auditor also goes through the RBI Inspection reports. These are sensitive, confidential reports for internal consumption and auditor should ensure these findings are noted for adherence.

14.07 The focus is on systems, processes and a root cause analysis to find out what went wrong and what could be done that the error does not recur again.

14.08 The statutory auditor could attend audit committee meetings to get real-time grasp of how the meetings are held, issues discussed and resolved.



# 15

## Credit Monitoring and Restructuring Department

---

### Introduction

15.01 Credit Monitoring & Restructuring department (CMRD), as the name suggests is a credit monitoring hub of the entire bank. Like many other departments at HO, CMRD too does not carry any financial activity. The sanctioning and operations of credit takes place with respective branches and departments designated. This department is expected to keep close watch over the health of the credit portfolio.

15.02 As a result, the overdue statements generated by the bank are closely monitored and necessarily followed up to the concerned department/ Branch or officer is done through this department.

15.03 Further in some banks, this department may be responsible for sanctioning of restructure of advances. Although, the restructure of advances is no longer beneficial to the bank and is rarely done, the earlier restructured portfolio is controlled and monitored through this department. As a result, calculations of the provision required for the restructured portfolio is done here.

### Audit Approach

15.04 It may be observed that all the activities of the department are controlling and compliance in nature. Hence the transactions take place at respective branches. However, the controlling authority is exercised through this department. Hence the trial balance of the department may show just expenses incurred in the department. However, it is necessary that the auditor carefully looks into the functions of the department.

### Credit Monitoring

15.05 The department is responsible to monitor the credit portfolio independently and interact with the Zones/ Regions and Branches for the follow up. The overall overdue statement generated by the bank above certain limits is closely monitored.

15.06 The auditors at respective branch, though take care of the credit portfolio, the department auditor may undertake certain tests independently at this department with a different perspective keeping in mind the overall

## **Guidance Note on Audit of Banks (Revised 2020)**

---

materiality. Keeping in view the significance from the regulator perspective following transactions may be selected for checking at the HO level.

1. Any account in the bank having exposure (funded and non-funded) which is more than 2000 crores across banking sectors.
2. Accounts against whom NCLT proceedings are initiated either by Bank, any other financial creditors or the operational creditors.
3. List of SMA accounts having exposure above 50 crore and above.
4. Red Flagged Accounts refer RBI circular dated May 7, 2015.
5. Cases under investigation for fraud. These are typically the ones not reported as fraud and hence not available with Fraud monitoring department.
6. List of upgraded accounts in the branch above ₹ 1 Crore.
7. Test checking of CRILC reported accounts for its classification with other banks.

At this juncture, it is necessary to keep following developments in mind while conducting CMRD audit:

### **Market mechanism for Large Borrowers**

#### 15.07

- Guidelines issued on August 25, 2016, Effective from April 1, 2017
- Build-up of high concentration of credit risk at the systemic level in the banking sector. While single and group exposure norms put a ceiling on the amount an entity can borrow from a single bank, there is no ceiling on total bank borrowing by a corporate entity. This has resulted in banks collectively having very large exposures to some of the large corporates in India, particularly in the power/ infrastructure, housing finance and steel sectors/ industries. As observed from the analysis, many large corporates are excessively leveraged and banking sector's aggregate exposure towards such companies is also excessively high. This poses a collective concentration risk to the banking sector, even when the single and group borrower exposures for each bank remain well within the prescribed exposure limits.
- Framework mitigates the risk posed to the banking system on account of large aggregate lending by the banking system to a single corporate as the single borrower exposure limit linked to a bank's Tier 1 capital may not by itself be sufficient to contain the risk the banking system is exposed to.

**Key Aspects of this mechanism:**

15.08

- **Aggregate Sanctioned Credit Limit (ASCL)** - The aggregate of the fund based credit limits sanctioned or outstanding, whichever is higher, to a borrower by the banking system. ASCL would also include unlisted privately placed debt with the banking system.
- **Specified Borrower:** A borrower having an ASCL of more than
- **Reference Date:** The date on which a borrower becomes a 'specified borrower'.
- **Normally permitted lending limit (NPLL):** 50 percent of the incremental funds raised by the specified borrower over and above its ASCL as on the reference date, in the financial years (FYs) succeeding the FY in which the reference date falls. For this purpose, any funds raised by way of equity shall be deemed to be part of incremental funds raised by the specified borrower (from outside the banking system) in the given year.
  - Rs.25,000 crore at any time during FY 2017-18.
  - Rs.15,000 crore at any time during FY 2018-19.
  - Rs.10,000 crore at any time from April 1, 2019 onwards.

**Prudential Measures for NPLL**

15.09

- From 2017-18 onwards, incremental exposure of the banking system to a specified borrower beyond NPLL shall be deemed to carry higher risk which shall be recognised by way of additional provisioning and higher risk weights as under:
  - Additional provisions of 3 percentage points over and above the applicable provision on the incremental exposure of the banking system in excess of NPLL, which shall be distributed in proportion to each bank's funded exposure to the specified borrower.
  - Additional Risk weight of 75 percentage points over and above the applicable risk weight for the exposure to the specified borrower. The resultant additional risk weighted exposure, in terms of risk weighted assets (RWA), shall be distributed in proportion to each bank's funded exposure to the specified borrower.

**Mandatory Loan System for Delivery of Bank Credit**

15.10

- Draft Guidelines issued on June 11, 2018. Final Guidelines issued on December 5, 2018.

## Guidance Note on Audit of Banks (Revised 2020)

---

- Effective from April 1, 2019.
- Banks provide working capital finance by way of cash credit/overdraft, working capital demand loan, purchase/discount of bills, bank guarantee, letter of credit, factoring, etc. Cash credit (CC) is by far the most popular mode of working capital financing.
- While CC has its benefits, it also poses several regulatory challenges such as perpetual roll overs, transmission of liquidity management from the borrowers to banks/RBI, hampering of smooth transmission of monetary policy, etc.

### 15.11 Key Aspects of the draft:

- **Minimum level of 'loan component' and Effective date:** In respect of borrowers having aggregate fund based working capital limit of Rs.1500 million and above from the banking system, a minimum level of 'loan component' of 40 percent shall be effective from April 1, 2019. Accordingly, for such borrowers, the outstanding 'loan component' (Working Capital Loan) must be equal to at least 40 percent of the sanctioned fund based working capital limit, including ad hoc limits and TODs.
- **Sharing of Working Capital Finance:** All lenders in the consortium shall be individually and jointly responsible to make sure that at the aggregate level, the 'loan component' meets the above-mentioned requirements. Under Multiple Banking Arrangements (MBAs), each bank shall ensure adherence to these guidelines at individual bank level.
- **Amount and tenor of the loan:** The amount and tenor of the loan component may be fixed by banks in consultation with the borrowers, subject to the tenor being not less than seven days. Banks may decide to split the loan component into WCLs with different maturity periods as per the needs of the borrowers.
- **Repayment/Renewal/Rollover of Loan Component:** Banks/consortia/syndicates will have the discretion to stipulate repayment of the WCLs in instalments or by way of a "bullet" repayment, subject to IRAC norms. Banks may consider rollover of the WCLs at the request of the borrower, subject to compliance with the extant IRAC norms.
- **Risk weights for undrawn portion of cash credit limits:** Effective from April 1, 2019, the undrawn portion of cash credit/ overdraft limits sanctioned to the aforesaid large borrowers, irrespective of whether unconditionally cancellable or not, shall attract a credit conversion factor of 20 percent.

- The guidelines will be effective from April 1, 2019 covering both existing as well as new relationships. The 40 percent loan component will be revised to 60 percent, with effect from July 1, 2019.

### **Restructure Portfolio**

15.12 As mentioned earlier, the banks are not restructuring anymore due to provisioning requirement. However, the erstwhile portfolio is maintained.

- Sacrifice calculations at the end of the period
- Additional provisioning of the overall restructured portfolio

These two calculations and working are integral part of the department audit. Care may be taken to ensure that the provisions sometimes exceed 100% as the account may have been fully provided as per IRAC and additional provision of 5% continues in CMRD books.

### **Other aspects**

15.13 The auditor should also obtain copies of inspection or other internal audit reports of this division which covers the efficiency of various functional operations.

15.14 Any deviations or discrepancies noted should be appropriately reported in The Long Form Audit Report.

# 16

## Consolidation and Balance Sheet Preparation

---

16.01 The preparation of the financial statements in case of a bank is significantly different as compared to preparation of the financial statement of the companies. The Third Schedule to the Banking Regulation Act, 1949 has prescribed the Form A -format of Balance Sheet and Form B- Format of Profit and Loss Account. These formats for the Balance Sheet and Profit & Loss account are prescribed as per Section 29 of the Banking Regulation Act, 1949.

16.02 The process of preparation of the financial statements is divided into following phases:

- A. Preparation of Standalone Financial Statements including consolidation of the Branch Accounts. (Role of SBA & SCA)
- B. Preparation of the Consolidated Financial Statements. (including subsidiary, associates, joint venture) (Role of SCA)

### **A. Standalone Financial Statements including Branch Consolidation:**

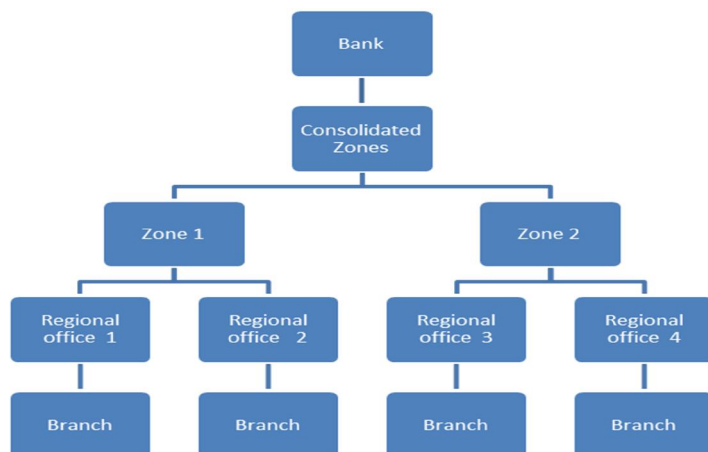
16.03 The preparation of the Standalone Financials of the Bank is primarily the consolidation of branch accounts and incorporation of various verticals/departments at the bank. The consolidation of branch accounts (audited and unaudited) is one of the important and sensitive aspect of the financial statements 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.

16.04 The following documents which are audited by the Statutory Branch Auditor are consolidated at the Bank level:

- 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



16.05 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 case of private Banks, the consolidation process is centralized at the Head office since there is no such concept of mandatory branch audit by the Reserve bank of India.

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

### Step 1

#### ***Data for the Financial Statements as on 31<sup>st</sup> March***

16.07 At the year-end i.e., 31<sup>st</sup> March, the bank provides the financial data to the statutory auditor in the form of various returns, Branch Balance Sheet, Profit and Loss Account for the purpose of the audit.

### Step 2

#### ***Audit Adjustments through Memorandum of Changes (MOC)***

16.08 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

## **Guidance Note on Audit of Banks (Revised 2020)**

---

by the Statutory Central Auditor (which is known as MOC). The effect of these MOC are not fed in the live data but are recorded on a different software (e.g., ROSS, ADF) at appropriate consolidation level and are considered for the purpose of giving the financial impact in the closing financials.

16.09 All the banks have different mechanism of posting the effects of the MOC's in the financial statements. 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.

16.10 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 statements 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***

16.11 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 2019-20 gets approved and signed on 30<sup>th</sup> April, 2020, then on that day or on any other day with value date of 30<sup>th</sup> April, 2020, 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 date as per the MOC suggested by the Auditor.

### **Step 3:**

#### ***Consolidation at Controlling Office (CO)-Regional Office/Zonal Office:***

16.12 *Process:*

1. Branches can be either audited branches or unaudited branches depending on the limits prescribed.
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 financial statements/returns are generated at regional office level/Zonal Office level.
3. These 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. However, this consolidation process is automated at most of the banks and the auditor should verify the various controls adopted by the controlling office management to ensure the completeness.
2. SCA should obtain reasonable assurance and sufficient appropriate audit evidence of the adjustments made if any at the Controlling office level for the accounts which are audited by the Statutory Branch Auditor.
3. SCA should also reconcile and verify the effect of the Branch MOC's which are consolidated and effected at the CO office;
4. 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.
5. 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.
6. SCA are also required to verify the consolidation of various certificates/returns which are audited by the SBAs, the SCA should clearly bring out his/her responsibility while issuing the report at the CO level;

***Consolidation Process at Head Office:***

*16.13 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. Further, at the Head office the financial information from various other departments are also consolidated and incorporated in the Financial Statements like for e.g. Gratuity, Pension, Leave encashment, etc. are audited by the vertical auditor and are consolidated while preparing the financial statements.

Further, various provisions such as Provision on Standard Assets, Restructured accounts, Stress sector provision are computed and provided at the Head office level.

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

16.14

1. The consolidating auditor should understand the various process and systems used by the bank for preparation and presentation of the financial statements;
2. The Consolidating auditor should also verify the various checks and controls placed by the bank to identify any unusual entries or any other differences;
3. The consolidating Auditor must ensure the completeness as well as accuracy of the data at the bank as a whole. However, the responsibility of the consolidating auditor is to verify the accuracy of the data consolidated from the various returns/financial information which are audited by the auditor of various departments/verticals;
4. Auditor should obtain reasonable assurance and sufficient appropriate audit evidence of the adjustments made if any at the Bank level.

16.15 The Consolidating Auditor 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, however such review is done by the respective auditors of controlling office.
- d. Effect of Memorandum of Changes (MOC) if any passed at Head office.
- e. Provision on Standard Assets, Fraud Provision and Other Provision.
- f. Review of MOCs so as to ascertain whether there are systemic issues or deficiencies which need to be addressed by the management.

***IT Controls***

16.16 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. The auditor should also review the system audit report available with the Bank with respect to the system used for the purpose of preparation of the financial statement.

***Consolidation of Overseas Branches:***

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

### **Guidance Note on Audit of Banks (Revised 2020)**

---

- 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 and RBI/2016-17/281 DBR.BP.BC.No.61/ 21.04.018/2016-17 on Guidelines on compliance with Accounting Standard (AS) 11 [The Effects of Changes in Foreign Exchange Rates] by banks – Clarification dated April 18, 2017.
- c. 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".
- d. 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.
- e. The auditor may also review the compliance with the applicable local laws and regulations of the concerned country by the overseas branches. The auditor should also review the report given by the Overseas branch auditor to identify the areas of concerns.
- f. The auditor should also verify the process of translation from the foreign currency to the presentation currency and ensure that the consistent process have been followed by the bank over a period.
- g. The asset classification and provisioning on the loans are done as per the local laws of those respective branches, however the auditor should ensure that the stricter norms has been followed by the bank at the time of consolidation.
- h. The auditor should also roll-out a reporting package to be submitted by the Overseas Branch auditor for various compliances/control at the respective branches.

***Disclosure in Standalone Financial Statements:***

16.18 The Consolidating Auditor is also required to verify various disclosures made in the Financial Statements as required under Master Circular no. RBI/2015-16/99 DBR.BP.BC No.23/21.04.018/2015-16 dated July 1, 2015 “Disclosure in Financial Statements - Notes to Accounts”. The circular requires the bank to give various disclosures in Annual Accounts, some of these disclosures are audited and certified by the auditor of various department/verticals. However, generally there are certain disclosures which are prepared and to be verified by the consolidating auditor e.g. Segment Reporting as per RBI Circular and Accounting Standard 17 and Earning Per Share as per Accounting Standard 20. The consolidating auditor should carefully review these disclosures and ensure the compliance as per the Master Circular or other circulars/notification issued from time to time. Further, the auditor should carefully review the disclosure made for Divergence in the asset classification and provisioning as required by RBI Circular no. RBI/2016-17/283 DBR.BP.BC.No.63/21.04.018/2016-17 dated April 18, 2017.

**B. Consolidated Financial Statement (including Subsidiary, Associates and Joint venture)**

16.19 The PSB's and PVB's in India are listed on recognised stock exchange and are required to comply with the SEBI Regulations including Listing Obligations and Disclosure Requirements (LODR) as issued and amended on time to time basis.

16.20 As per Regulation 33 of SEBI LODR Regulations, the listed entities are required to prepare the standalone financial results and consolidated financial results shall be prepared as per Generally Accepted Accounting Principles in India. Further, new sub-regulation was inserted under Regulation 33 of the SEBI LODR Regulations, which will come into effect from April 01, 2019 which require the entities to prepare consolidated financial statements on quarterly basis. .

16.21 Consolidated Financial Statements (CFS) 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

16.22 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

16.23 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. The auditor should also refer Guidance Note on Audit of Consolidated Financial Statements (Revised 2016) issued by ICAI for the guidance while auditing the CFS.

16.24 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) in "Other Matter" paragraph. 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.

16.25 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. In light of the SEBI Circular no. CIR/CFD/CMD1/44/ 2019 dated March 29, 2019; the auditor should also consider implications on reporting if some of the components are unaudited<sup>2</sup>.

16.26 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

---

<sup>2</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.

advisable to make sufficient arrangements for co-ordination and efforts at the planning stage

### **Audit of Consolidated Financial Statements**

16.27 The auditor should carefully review the following while auditing the consolidated Financial Statements:

- Accounting policy of the bank and its various components;
- any subsidiaries, associates and joint ventures of Bank not consolidated under CFS;
- changes in the shareholding that might have taken place since the last audit.

16.28 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 Ventures.

16.29 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.

16.30 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.

16.31 Audit Standard, "Written Representations" requires the auditor to obtain written representations from management and where appropriate those charged with governance. Such representations would include:

- Completeness of components included in the CFS.
- Identification of reportable segments for segment reporting.
- Identification of related parties and related party transactions for reporting.

Appropriateness and completeness of consolidation adjustments, including the elimination of intra-group transactions.

16.32 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.

## **Other Aspects**

### **Head Office**

16.33 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
- It shall be checked by the statutory auditors of public sector banks (PSBs) that, the conditions attached to capital infusion by the Government have been complied with by the respective PSBs. In case of any non-compliance, the same may be suitably highlighted by the Statutory Auditors of PSBs in their Audit Report.
- Dividends.

### Provisioning for Non-performing Assets

16.34 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, *read with* updates thereafter. 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.

16.35 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.

16.36 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 Statutory Central Auditor examines prima facie the correctness of the classification as a part of his examination of consolidation of branch returns. The Statutory 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.

16.37 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 Statutory 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.

16.38 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.

16.39 The RBI has specified that advances against book debts may be included under the head 'secured by tangible assets'.

## **Other Provisions at central office**

### **1. Non-Performing Investments:**

#### **Meaning of NPI**

16.40 In respect of securities included in HTM/AFS/HFT Category where interest/ principal is in arrears:

- (i) Interest/ instalment (including maturity proceeds) is due and remains unpaid for more than 90 days.
- (ii) In case of preference shares where the fixed Dividend/ Maturity Proceeds is not paid and remains outstanding for more than 90 days.
- (iii) In the case of equity shares, in the event the investment in the shares of any company is valued at Re.1 per company on account of the non-availability of the latest balance sheet those equity shares would also be reckoned as NPI.
- (iv) If any credit facility availed by the issuer is NPA in the books of the bank, investment in any of the securities issued by the same issuer would also be treated as NPI and vice versa.
- (v) The investments in debentures / bonds, which are deemed to be in the nature of advance would also be subjected to NPI norms as applicable to investments.

#### **Treatment of NPI**

##### **16.41**

1. The banks should not reckon income on the such securities to the income.
2. Should make provisions for the depreciation in the value of the investment i.e. Carrying Value of the investment minus the mark to market price.
3. The banks should not set-off the depreciation requirement in respect of these non-performing securities against the appreciation in respect of other performing securities.

(Refer RBI Master Circular – Prudential norms for classification, valuation and operation of investment portfolio by banks.)

### **2. Impairment of Investments**

#### **Meaning of Impairment of Investments**

16.42 Impairment loss is a decrease in net carrying value, the acquisition cost minus depreciation, of an asset that is greater than the future undisclosed cash flow of the same asset.

### **Testing of Impairment**

16.43 In case of HTM/ AFS Securities, The need to determine whether impairment has occurred is a continuous process and the need for such determination will arise in the following circumstances:

- (a) On the happening of an event which suggests that impairment has occurred.

This would include:

- (i) the company has defaulted in repayment of its debt obligations.
  - (ii) the loan amount of the company with any bank has been restructured.
  - (iii) the credit rating of the company has been downgraded to below investment grade.
- (b) When the company has incurred losses for a continuous period of three years and the net worth has consequently been reduced by 25% or more.
  - (c) In the case of new company or a new project when the originally projected date of achieving the breakeven point has been extended i.e., the company or the project has not achieved break-even within the gestation period as originally envisaged.

When the need to determine whether impairment has occurred arises in respect of a subsidiary, joint venture or a material investment, the bank should obtain a valuation of the investment by a reputed/qualified valuer and make provision for the impairment, if any.

### **Treatment of Impairment Loss**

#### **16.44**

Impaired Loss is calculated as the reduction in the net carrying value.

Subtract the future value or present value of any future net cash flows from the book value of the asset to find impairment loss, then write the asset down to the fair market value.

### **3. Convergence of Foreign Subsidiaries/Branches Balance Sheet**

16.45 The Balance Sheets of the respective branches and subsidiaries are drawn in the respective currencies hence for the purpose of the consolidation the same needs to be converted to the INR.

Therefore in compliance with AS 11 (Revised),

The Balance sheet items are converted to INR at the Closing Rates published by FEDAI.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

The Profit and Loss account is converted on incremental basis for every quarter based on the average rate of the quarter published by FEDAI.

For eg:

If the expense for the period of June 2019 is 100\$, then the same needs to be converted at average rate for the quarter ended June 2019.

If the same expense for the period of September 2019 is 300\$, then the incremental 200\$ gets converted at average rate for the quarter ended September 2019.

### **Recognition of Certain Expenses**

16.46 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***

16.47 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.

16.48 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***

16.49 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.

16.50 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.

16.51 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***

16.52 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**

16.53 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 Statutory 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 12, "Fixed Assets and Other Assets" of Section B of the Guidance Note at the branch level, except that the Statutory 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**

16.54 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.

16.55 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.

16.56 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.

16.57 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**

16.58 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***

16.59 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.

16.60 The Statutory Auditor should consider impact of Income Computation and Disclosure Standards (ICDS) issued vide notification issued 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".

#### ***Bad Debts and Provision for Bad and Doubtful Debts***

16.61 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

### **Guidance Note on Audit of Banks (Revised 2020)**

---

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 not 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 (vii) 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.

16.62 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)(vii). According to section 36(1)(vii), 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.

16.63 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)(vii). However, for the purpose of claiming this deduction, it is

## **Guidance Note on Audit of Banks (Revised 2020)**

---

necessary that such income should be disclosed in the return of income under the head 'Profit and gains of business or profession'.

16.64 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**

16.65 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)**

16.66 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***

16.67 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.

16.68 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.

16.69 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***

16.70 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.

16.71 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.

16.72 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.

16.73 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***

16.74 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.

16.75 It is not prudent to recognise interest on possible refund which is not determined by any order from tax authorities.

***Pending Proceedings***

16.76 The auditor should review the appellate orders received during the year and consider the need for any additional provision/reversal.

***Method of Accounting***

16.77 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***

16.78 It is possible that subsequent judicial pronouncements/ appellate orders may make the provisions of earlier years excessive.

16.79 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.

16.80 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.

16.81 On the above considerations, if there is no requirement to retain a provision, it can be reversed and the amount of liability is included in contingent liability. A suitable note on the following lines is recommended:

- (a) Provision for Income Tax is arrived at after due consideration of decisions of the Appellate authorities and advice of counsels; and
- (b) No provision is made for the disputed demands of Income tax keeping in view the judicial pronouncements and/or legal counsels' opinion.

### **Items Requiring Special Consideration**

#### ***Tax Implications of Valuation of Investments***

16.82 The RBI has issued various circulars on valuation of investments, according to which the difference between the market value/value as per yield to maturity method (YTM) will have to be provided in the books of accounts for certain types of investments. The various judicial decisions on the allow ability of depreciation in valuation of investments, including implication of ICDS VIII, should be considered while provisioning.

#### ***Notional Gain/Loss on Foreign Exchange Translations***

16.83 Banks are required to translate their foreign exchange balances / obligations in foreign currency as per FEDAI Guidelines. While recognising gains or loss for tax purposes the following decisions may be considered by the auditor along with FEDAI Guidelines:

- The Madras High Court in the case of *Indian Overseas Bank Vs. Commissioner of Income-tax (1990) 183 ITR 200* has held that notional profits on translation of foreign exchange forward contracts is not taxable.
- The Madras High Court in the case of *Commissioner of Income-tax Vs. Indian Overseas Bank (1985) 151 ITR 446* has held that notional loss on translations of foreign exchange contracts is not tax deductible.

***Carry forward of unabsorbed business loss and depreciation on amalgamation of a banking company with a banking institution***

16.84 Section 72AA of the Income Tax Act, 1961 deals with Provisions relating to carry forward and set-off of accumulated loss and unabsorbed depreciation allowance in Scheme of amalgamation of banking company in certain cases.

***FATCA /CRS***

16.85 Foreign Account Tax Compliance Act (known in short as FATCA) is a legislation to counter tax evasion in the United States of America (USA). FATCA was introduced by US Dept of Treasury (Treasury) and US Internal Revenue Service (IRS) to encourage better tax compliance by preventing US persons from using banks and other financial organisations to avoid US taxation on their income and assets.

16.86 India and the USA have signed the reciprocal version of model 1 IGA for FATCA on 9th July 2015. India signed the OECD's CRS (Common Reporting Standards) on 3rd June 2015. The IGA has 2 models – India has signed Model 1 IGA wherein banks will have to report information to the prescribed authority who in turn will submit information to the IRS.

16.87 In Model 1 IGA, the Foreign Financial Institution (FFI) has to report all FATCA related information to their governmental agencies, which would then report the FATCA related information to the IRS. Some Model 1 IGAs are reciprocal, requiring the US to provide certain information about residents of the Model 1 country to the Model 1 country in exchange for the information that country provides to the USA. An FFI covered by a Model 1 IGA will not need to sign an FFI agreement but needs to register on the IRS's FATCA Registration Portal or file Form 8957.

16.88 Like FATCA, Common Reporting Standard (CRS) is a reciprocal exchange of information on financial accounts on an automatic basis with other countries/ non-sovereign territories so as to combat the menace of offshore tax evasion and avoidance and stashing of unaccounted money abroad.

16.89 India would be obligated to get its financial institutions to share financial account information of accountholders who are tax residents in any of these countries. Likewise, India would also get similar information through financial institutions of such treaty countries.

16.90 CBDT has notified Rule 114H for Due Diligence Requirement under FATCA, major requirements for the Bank as under:

## **Guidance Note on Audit of Banks (Revised 2020)**

---

All the concerned financial institutions should register on the related e-filing portal of Income Tax Department as Reporting Financial Institution by submitting the requisite details. Thereafter, the reports can be submitted online by using the digital signature of the 'Designated Director' by either uploading the Form 61B or 'NIL' report.

16.91 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.

16.92 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.

16.93 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.

16.94 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.

## **Government Business Department**

---

### **Introduction**

17.01 Basic scope of work of Government Business carried out by banks is given in RBI Master Circular on Conduct of Government Business by Agency Banks – Payment of Agency Commission RBI/2015-16/81 DGBA.GAD.No.2 / 31.12.010 / 2015-16 dated July 1, 2015 (Updated as on January 21, 2016).

### **Government transactions eligible for agency commission**

17.02 Transactions relating to the following government business undertaken by agency banks are eligible for agency commission:

- a. Revenue receipts and payments on behalf of the Central/State Government
- b. Pension payments in respect of Central / State Governments
- c. Special Deposit Scheme (SDS) 1975
- d. Public Provident Fund (PPF) Scheme, 1968
- e. Senior Citizen Savings Scheme (SCSS), 2004
- f. Kisan Vikas Patra, 2014 and Sukanya Samridhi Account
- g. Any other item of work specifically advised by Reserve Bank as eligible for agency commission (viz. Relief Bonds/ Savings Bonds etc. transactions)

17.03 Short term/long term borrowings of State Governments raised directly from financial institutions and banks are not eligible for agency commission as these transactions are not considered to be in the nature of general banking business. Reserve Bank pays the agency banks separate remuneration as agreed upon for acting as agents for management of public debt. Transactions arising out of Letters of Credit opened by banks on behalf of Ministries/Departments etc. do not qualify for agency commission.

17.04 Whenever agency banks collect stamp duty through physical mode or e-mode (challan based), they are eligible for payment of agency commission, provided the agency banks do not collect any charges from the members of public or receive remuneration from the State Government for doing this work.

17.05 If the agency bank is engaged by the State Government as Franking Vendor and it collects stamp duty from the public for franking the documents, it

## **Guidance Note on Audit of Banks (Revised 2020)**

will not be eligible for agency commission since the State Government is paying commission to it as Franking Vendor. However, the agency bank which collects the stamp duty paid by the Franking Vendor for credit to the Treasury through challan in physical or e-mode for purchase of the franking bar, would be eligible for agency commission since it is a regular payment of Stamp Duty as stated above.

17.06 All agency banks while claiming Turnover Commission (ToC) should certify that no claim of ToC is made on ineligible transactions.

17.07 Agency banks paying their own tax liabilities through their own branches or through authorised branches of State Bank of India or offices of Reserve Bank of India wherever they do not have their own authorised direct tax collection branch should indicate the same separately in the scroll. Such transactions will not be eligible for payment of agency commission. Banks should furnish a certificate to the effect that own tax liabilities (TDS, Corporation Tax, etc.) paid by them have been excluded while claiming agency commission.

### **Rates for agency commission**

17.08 As per paragraph 5 of the agency bank agreement, RBI pays agency commission at rates determined by it. The rates applicable with effect from July 1, 2019 are as under:

<b>Sr. No.</b>	<b>Type of Transaction</b>	<b>Unit</b>	<b>Revised Rate</b>
a. (i)	Receipts - Physical mode	Per transaction	Rs. 40/-
(ii)	Receipts - e-mode	Per transaction	Rs. 9/-
b.	Pension Payments	Per transaction	Rs. 75/-
c.	Payments other than Pension	Per Rs. 100 turnover	6.5 paise

In this context, the 'Receipts-e-mode transactions' indicated against Sr. No. a.(ii) in the above table refer to those transactions involving remittance of funds from the remitter's bank account through internet banking as well as such transactions which do not involve physical receipt of cash /instruments.

17.09 Agency banks would be eligible to claim agency commission for pension transactions at the rate of Rs. 65/- per transaction only when the entire work relating to disbursement of pension including pension calculation is attended to by them. If the work relating to pension calculations, etc., is attended to by the concerned Government Department / Treasury and the bank branches

## **Guidance Note on Audit of Banks (Revised 2020)**

---

are required only to credit the amount of pension to the pensioners' accounts maintained with them by a single debit to Government Account, such transaction is to be categorised under 'other than pension payment' and would be eligible for payment of agency commission @ 5.5 paise per Rs.100/- turnover w.e.f. July 1, 2012.

17.10 Turnover commission is payable to an agency bank at the full rate provided the transactions are handled by the bank at all stages. Where, however, the work is shared between two banks, the turnover commission is shared between the banks in the proportion of 75:25. Thus, broadly, the turnover commission is payable to the agency banks as detailed below:

- a. At the full rate, in cases where the transactions are handled by the bank at all stages, i.e., up to the stage of dispatch of scrolls and challans / cheques to the Pay and Accounts Offices, and treasuries/sub-treasuries.
- b. At 75% of the applicable rate, where the dealing branch is required to account for the transaction by passing on the scrolls and documents to the local/nearest branch of Reserve Bank of India or any agency bank conducting government business.
- c. At 25% of the applicable rate, in the case of agency branch which received the scrolls and documents from dealing branches of other banks and is responsible for the account of these transactions and dispatching of the scrolls and documents to the Pay and Accounts Offices, Treasuries, etc.

17.11 The number of transactions eligible for payment of agency commission should not exceed 14 per pensioner per year. This includes one monthly credit for payment of net pension and a maximum of two per year for payment of arrears on account of increase in dearness relief, if applicable. Cases involving payment of arrears on account of late start/restart of pension qualifies as a single transaction for claiming of agency commission. In other words, any payment of arrears on account of late start/restart of pension should be treated as a single credit transaction and not as separate monthly credits.

### **Claiming agency commission**

17.12 Agency banks are required to submit their claims for agency commission in the prescribed format to Central Accounts Section (CAS) Nagpur in respect of Central government transactions and the respective Regional Office of Reserve Bank of India for State government transactions. The revised formats for claiming agency commission claims for all agency banks and separate and distinctive set of certificates to be signed by the branch officials and Chartered Accountants are given in Annex-2 of RBI Master Circular on Conduct of Government Business by Agency Banks – Payment of Agency Commission



## **Guidance Note on Audit of Banks (Revised 2020)**

---

RBI/2015-16/81 DGBA.GAD.No.2 / 31.12.010 / 2015-16 dated July 1, 2015 (Updated as on January 21, 2016). These certificates would be in addition to the usual Certificate from ED / CGM (in charge of government business) to the effect that there are no pension arrears to be credited / delays in crediting regular pension / arrears thereof.

17.13 Where the External Auditor is also the Concurrent Auditor / Statutory Auditor, claims can be certified by such Concurrent Auditor / Statutory Auditor. The auditor's certificate should, inter-alia, state that:

- a. 'receipt' and 'pension payment transactions' as also the agency commission claims for 'payments other than pension payments' indicated in the agency commission claim application submitted to the RBI are tallied with the records maintained at the concerned branch/es of the agency bank; and
- b. the agency commission claims made in respect of volume (number) based transactions viz. 'receipt' and 'pension payment transactions' have been claimed only once and the same stands excluded while arriving at value based transactions in respect of 'payments other than pension payments'.

17.14 In addition to this, agency banks are required to ensure that the agency bank's internal inspectors / auditors verify the agency commission claims submitted by their branches and confirm their accuracy during the course of their inspection / audit.

17.15 Agency banks are required to ensure that agency commission claims submitted to the Regional Offices of Reserve Bank of India / Central Accounts Section, Nagpur in the prescribed format are accurate. Agency banks may also alert their branches concerned to ensure that agency commission claims submitted to our Regional Offices are accurate. Such erroneous claims, if certified by the Internal / Concurrent Auditors, will defeat the very purpose of making such requirement an essential condition for making quarterly claims.

### **Deduction of TDS on Agency Commission**

17.16 Central Board of Direct Taxes (CBDT) has clarified that 'tax would not be required to be deducted by RBI on the turnover commission paid or credited by it to agency banks for transacting general banking business of the Central Government and State Governments'. However, agency commission would be taxable in the accounts of banks concerned as it is part of the bank's income.

### **Penal interest for wrong claims**

17.17 Agency banks will be liable to pay penal interest at Bank Rate as notified by Reserve Bank of India plus 2% for any wrong claims of agency commission settled.

**Preparation / Planning**

- Obtain Government Business Policy of the Bank
- Check Accounting policy whether it is on accrual or cash basis and accordingly plan the work

17.18 Discuss the process of execution of Government Business through authorised branches, recording of transactions in CBS system, reconciliation with respective Government Departments for various schemes. Some examples listed below:

Government Deposit Scheme	E-Kisan Vikas Patra Scheme, 2014 Sovereign Gold Bonds Public Provident Fund (PPF) Senior Citizen Savings Scheme 2004 Sukanya Samridhhi Accounts 2014 RBI Bonds
Taxes	Collection of Direct taxes (CBDT) Goods and Services Tax Collection of State Taxes
Pension Payments to Government / Ministries / Departments / others	Central/Civil Freedom Fighters Pension Railway Telecom & Postal Defence
Other Schemes	Pension Payment to State Governments National Pension System (NPS) Treasury/Sub Treasury Business e-Stamping e-Biz Services to Civil/Non-Civil Ministries Atal Pension Yojana

**Guidance Note on Audit of Banks (Revised 2020)**

---

	EPFO Collection ESIC Collection PFMS-Public Fund Management System NTRP (Non-Tax Receipt Portal) Gold Monetization Scheme, 2015
--	---

**Conduct / Execution**

17.19

- Verify whether Income from Government Business is accounted properly
- Check Income Reconciliation, follow up for recovery
- Check Tax Collection and Payment to Government Treasury in timely manner
- Check the Internal Controls for receipt / payments

**Reporting / Conclusion**

17.20 Based on audit issue appropriate certificate, report on compliance for Government Business. Check whether appropriate disclosures are being made in financial statements.

## **Consolidation of LFARs for the Bank**

---

### **Introduction**

18.01 The financial statements of the banks generally signed within 45 days of the year end. However, RBI has given time up to June 30 for the submission of LFAR. Hence formal consolidation process starts after the Financial statements of the Bank are signed and delivered.

18.02 The consolidation takes place based on Long Form Audit Reports submitted by the Statutory Branch Auditors in respect of branches/offices and the information / explanations and other data provided by the management, for Audited/Un-audited branches and departments. Hence the analyzing of the data is required at the time of conducting the Financial audit at the zonal/ regional level audit and not just during LFAR consolidation process. It is often noted that branch LFAR may have given certain comments on the borrower account or some process in the Branch that may need attention in the main audit report issued by the auditors during financial audit. If analysis of branch LFAR is deferred, there may be a probability of missing on such comments.

18.03 It is the responsibility of the consolidating auditor to highlight the significant observations therein and summarise the issues after considering the information provided by the Bank, wherever required. All statistical data needs to be incorporated as provided by the Bank. Further auditor is expected to consider the compliance report of the Bank on LFAR for the previous year.

18.04 At the start of the audit of the Financial Statements, the Statutory Central Auditors need to communicate to Branch auditors and Departmental Auditors specifically to provide the data in structured format for the purpose of consolidation. The consolidated LFAR need not give the entire details reported under these annexure. The auditor may determine the materiality of the amounts to be reported in LFAR. However, the said data is required to be compiled bank-wide and submitted to the management.

### **Setting Reporting Materiality**

18.05 The overall objective is to design and carry out our audit procedures in order to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether due to fraud or error.

Materiality is set for the financial statements should represent the maximum

cumulative numerical misstatement in an account balance, class of transactions or other disclosure that the auditor would regard as not influencing the decisions of users of those financial statements. The materiality for reporting may be categorised into 2 types:

### **Specific Transaction Materiality**

18.06 These transactions are selected for reporting irrespective of the materiality due to their sensitive nature such as:

1. Any standard account in the branch having exposure (funded and non-funded) which is more than 50 crore across bank.
2. Accounts against whom NCLT proceedings are initiated either by Bank, any other financial creditors or the operational creditors
3. SMA accounts above 5 crore
4. Red Flagged Accounts.

The list above is indicative.

### **The overall materiality limits**

18.07 Having determined specific materiality it is necessary to determine a level of overall materiality which will be used when assessing the risk of reporting. The use of overall materiality is intended to reduce the risk of inappropriate audit report.

18.08 Unlike financial statement materiality (which is dependent on the perceptions of users) this materiality is affected by risk of misreporting.

18.09 Hence as a part of setting up of overall materiality limits, any uncorrected observations affecting the financial statement above certain amount, that may be decided by the Statutory Central Auditors (all observations put together by individual auditor at unit level). The together impact needs to be assessed and reported in LFAR.

### **The Reporting**

18.10 The RBI has specified the reporting format of the consolidated LFAR. The existing format is in vogue for considerable long period of time and requires certain data or information that may not be required through Audit Report. The ICAI has initiated the new LFAR format to suit the current day working. The same shall be applicable after RBI approves and notifies for the purpose of reporting.

18.11 The compilation of the questions is done on the basis of information provided by the Statutory Branch Auditors. However, as mentioned above, the

### **Guidance Note on Audit of Banks (Revised 2020)**

---

specific information or the annexures that may be required by the consolidating auditor to ensure the adequacy of reporting, will have to be decided and called for during communicating to the Statutory Branch Auditors as required by SA 600. The illustrative list of annexures that may be required could be as under:

- i. Accounts where excess over sanctioned limits are allowed
- ii. Branches where limits were disbursed without complying with the terms and conditions of sanction
- iii. Branches with deficiencies in documentation/inadequate insurance cover
- iv. Branches where periodic balance confirmation / acknowledgement of debt not obtained
- v. Branches having accounts where review / renewal is pending
- vi. Branches where stock / book debt statements and other periodical operational & financial statements not obtained
- vii. Branches where audited accounts not on record for advances to non-corporate with limit over Rs. 10 lakh
- viii. Branches where stock audit report is not obtained at prescribed interval
- ix. Short reviewed for period beyond six months
- x. Accounts where credit card dues are not recovered promptly
- xi. Comments on major accounts (standard accounts having outstanding exceeding Rs. 5 crore)
- xii. Quarterly/half yearly statements not obtained
- xiii. Break up of outstanding entries in Nostro reconciliation as of 31.03.2018
- xiv. Rate of interest charged less than prescribed rate decided by the bank
- xv. Deficiencies noticed in appraisal, monitoring and supervision
- xvi. Details of accounts where the relevant controlling authority of the bank has authorised legal action for recovery of advances
- xvii. List of overdue / matured term deposits
- xviii. Major / adverse comments / issues not addressed by the branch arising out reports from previous auditors, concurrent auditors, stock or internal auditors or special audit or inspection report of RBI

**Guidance Note on Audit of Banks (Revised 2020)**

---

- xix. Whether identification and classification of advances as standard/sub-standard/doubtful/ loss assets is as per RBI circular and instructions as per CO. If not, then details of accounts where there are deviations.
- xx. Guarantees involved / expired but not adjusted / reversed
- xxi. Outstanding amount of letter of credit / buyers credit
- xxii. Cash holding/ cash held exceeds retention limit
- xxiii. Details of cases where physical verification of securities not done as per laid down procedure
- xxiv. Details of NPA accounts where valuation report is not obtained
- xxv. Detail of items for more than three years in bills payable / sundry deposit etc.
- xxvi. List of the accounts (with outstanding in excess of Rs. 1.00 crore), which have been downgraded regarding their classification as non-performing asset or standard asset during the year
- xxvii. List of the accounts (with outstanding in excess of Rs. 1.00 crore), which have been upgraded regarding their classification as non-performing asset or standard asset during the year
- xxviii. List of recoveries and their appropriation against interest and principal accounts settled/ written off/ closed during the year
- xxix. List of new borrower accounts transferred to the branch during the year.

# 19

## Certification

---

### Introduction

19.01 The SCAs have to issue various Special Purpose Reports and Certificates at Head Office level. The Appointment letter normally contains the exhaustive list of all such Reports and Certificates which are required to be certified by the SCA's. These are to be verified and certified by the SCAs to ensure its correctness and accuracy. Most of these certificates are prepared by consolidating the certificates issued by SBAs for the respective branches and SCAs for the respective head office departments allocated at the time of appointment.

### Regulatory Requirements

19.02 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.

19.03 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

19.04 At the time of accepting the Audit, issuing engagement letter, preparing audit program, maintaining adequate working papers, the SCAs should appropriately comply with the requirements of Guidance Note on Reports or Certificates for Special Purposes (Revised 2016) issued by the Institute of Chartered Accountants of India (ICAI). Readers may also refer covering report for certificates as prescribed in Annexure A "Illustrative Format of Covering Report for various Certificates issued by SBAs" of the Chapter.



19.05 The SCAs may verify the process for consolidation of certificates received from various branches and head office departments with respect to the contents of consolidated certificates to be issued at head office level. All the Returns submitted by unaudited branches to various higher authorities shall be verified.

19.06 Where ever possible SCAs should reconcile or tally the closing balance of the return / certificate with the General Ledger Heads in the Trial Balance of the Bank as at the year end. This will be important for semi-automatic or manual returns. For system generated returns without manual intervention, it should still be ensured that they tally with the year-end figures, though detailed verification may not be warranted.

### **Responsibility of the Management**

19.07 It is clear that the correctness in preparation of various certificates is the responsibility of the management of the banks. The responsibility of the SCAs is to verify and report on the status of correctness of the same through the necessary checks carried out during the audit. The results of the verification carried out by the SCAs on test check basis and their comments thereon would be given in a separate report.

### **Audit Approach and Procedures**

19.08 The format of certificates required to be issued by the SBAs and SCAs are devised by the Bank, RBI and other authorities who are the users of these certificates. Thee prescribed formats are required to be filled in by the banks for reporting on compliance.

19.09 The SCA shall obtain a confirmation from the management whether it has received the various reports / certificates 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 compliance.

19.10 The SCA should maintain proper documentation about the information received, audit process carried out, extent of checking, observations and findings.

19.11 The SCA should obtain and review a copy of these reports / certificates so prepared / compiled and submitted to them by the bank. Such a review would help the auditors identify areas which are susceptible to fraud/ malpractices. The results of such a review / checking may also require the

**Guidance Note on Audit of Banks (Revised 2020)**

---

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.

19.12 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.

## ***Annexure A***

### **Illustrative Format of Covering Report for various Certificates issued by SCAs**

**Independent Auditor's Certificate for various certificates issued during the Statutory Audit of [Name of the Bank] for the Financial year 2019 – 2020.**

1. This Certificate is issued in accordance with the terms of our agreement dated [date of Engagement Letter].
2. The accompanying Statement contains various certificates issued by us during the Statutory Audit of [Name of the Bank] for the Financial year 2019 – 2020, listed in Annexure [Name], which we have initialed for identification purposes only.

#### **Managements' Responsibility for the Statement**

3. The preparation of the accompanying Statement is the responsibility of the Management of the Bank. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and presentation of the Statement, and applying an appropriate basis of preparation; and making estimates that are reasonable in the circumstances.
4. The Management is also responsible for ensuring that the Bank complies with the requirements of the Equity Listing Agreement and for providing all relevant information to the Securities and Exchange Board of India.

#### **Auditor's Responsibility**

5. Pursuant to the requirements of the various RBI guidelines, our responsibility is to express reasonable assurance in the form of an opinion based on our audit and examination of books and records on test check basis, as to whether the [Name of the Bank] has undertaken only those activities that have been specifically permitted by the RBI and has complied with the specified terms and conditions.
6. We audited the financial statements of [Name of the Bank] for the Financial year 2019 – 2020, on which we issued an unmodified audit opinion vide our reports dated [date of Audit Report]. Our audit of these financial statements was conducted in accordance with the Standards on Auditing and other applicable authoritative pronouncements issued by the Institute of Chartered Accountants of India. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

7. We conducted our examination of the Statements/Certificates given in Annexure [Name], in accordance with the Guidance Note on Reports or Certificates for Special Purposes issued by the Institute of Chartered Accountants of India. The Guidance Note requires that we comply with the ethical requirements of the Code of Ethics issued by the Institute of Chartered Accountants of India.

8. We have complied with the relevant applicable requirements of the Standard on Quality Control (SQC) 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

### **Opinion**

9. Based on our examination as above, and the information and explanations given to us, we report that the Statement in Annexure [Name] is in agreement with the books of account and other records of [Name of the Bank] for the Financial year 2019 – 2020 as produced to us for our examination, and the information thereof is prepared, in all material respects, in accordance with the applicable criteria.

### **Restriction on Use**

10. This certificate has been prepared at the request of the [Name of the Bank] solely with reference to our appointment letter, for the purpose of onward compilation of various certificates and disclosure requirements for [Name of the Bank] as a whole. It should not be used by any other person or for any other purpose. Accordingly, we do not accept or assume any liability or any duty of care or for any other purpose or to any other party to whom it is shown or into whose hands it may come without our prior consent in writing.

For  
Chartered Accountants  
Firm's Registration Number:

Partner / Proprietor  
Membership Number  
UDIN

Place:

Date:

**Section B –  
Bank Branch Audit**



## Practical Guide for Statutory Branch Auditors performing Bank Branch Audit for first time

---

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 of the Banking Regulation Act, 1949 has been reproduced in **Appendix I** of Section B (Available on ICAI website) of the Guidance Note. Of these banks, commercial banks are the most wide spread banking institutions in India. Commercial banks provide a number of products and services to general public and other segments of economy. Two of the main functions of commercial banks are (1) accepting deposits and (2) granting advances. In addition to their main banking activities, commercial banks also undertake certain eligible Para Banking activities which are governed by the RBI guidelines on Para Banking activities.

1.03 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

## **Guidance Note on Audit of Banks (Revised 2020)**

---

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.

1.04 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 Section B (Available on ICAI website) of 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). 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.

### **Pre-Commencement of Audit:**

#### **Co-ordination with Branch Management**

1.05 Now a days typically, Statutory Branch Auditor (SBA), are given limited time within which they have to undertake the audit of branches allotted to them. Co-ordination between the auditor and the branch management is essential for an effective audit, timely completion with the highest audit quality. NOC from the previous auditor should be obtained and kept on record by SBA. It is advisable that immediately after accepting the appointment, the SBA should send a formal communication to the branch management/HO accepting his appointment and other declarations and undertakings so required. Further, the SBA should also specify the books, records, and other information that he would require in the course of his audit. Such a communication would enable the branch management to keep the requisite documents, information, etc., ready.



1.06 SBA needs to plan the work properly prior to commencement of audit. SBA needs to issue the audit engagement letter in accordance with Standard on Auditing (SA) 210, "Agreeing the Terms of Audit Engagements" and the requirement letter which will contain the details or information needed to conduct the audit. SBA needs to obtain basic information about the size of the branch and nature of the activities carried out at the branch, to find out about whether the branch is a normal branch or specialised branch such as forex or service branch. If the branch is a normal branch, then based on size of the branch, SBA should organise his audit team and make audit plan. If it is specialised branch, composition of persons in the audit team should be thoroughly acquainted with the rules and regulations governing such specialised branch. The audit team needs to have basic knowledge about Reserve Bank of India's regulations, circulars governing the specialized branch and it is advisable to complete the entire non-financial verification (like documentation, sanctioning terms, review of the supervision and monitoring terms, review of the concurrent/internal audit and inspection reports before the year-end.

### **Engagement and Quality Control Standards**

1.07 The auditor/audit firm should establish a system of quality control designed to provide reasonable assurance that the auditor/firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm or engagement partner(s) are appropriate in the circumstances and will survive the test of any regulatory, legal or other action that may arise in future. This system of quality control should consist of policies designed to achieve its objectives and the procedures necessary to implement and monitor compliance with those policies. The nature of the policies and procedures developed by individual or firms to comply with SQC 1 will greatly depend on various factors such as the size, maturity, geographical location, type of work handled and other operating characteristics.

1.08 The ICAI has issued various Engagement and Quality Control Standards applicable to an audit of financial statements which are mandatorily to be followed by all practitioners. Understanding of the concepts in these Engagement Standards would help the SBA in discharging his duties in a diligent way.

1.09 In the present scenario of Statutory Bank Branch Audit, the most important aspect is proper planning. As they say, well begun is half-done. Documentation of the audit Plan is a must. SBA must have sound and complete knowledge of the business of the Bank.

1.10 Auditor needs to study:

## **Guidance Note on Audit of Banks (Revised 2020)**

---

**1. Appointment Letter** – It is necessary to read the appointment Letter carefully and duly consider all the terms and conditions mentioned therein, that are required to be followed during the process of the audit. The letter of appointment sent by banks to Statutory Branch Auditors typically contains the following:

- Appointment under the Banking Regulation Act, 1949, and the underlying duties and responsibilities of the SBA.
  - Particulars of branch(s) to be audited and of the region/zone to which the branch reports.
  - Particulars of Statutory Central Auditors (SCAs).
  - Particulars of previous auditors.
  - Guidelines for conducting audit of Branches, completion of audit, eligible audit fees and reimbursement of expenses etc.
  - Procedural requirements to be complied with in accepting the assignment, e.g., letter of acceptance, declaration of indebtedness, declaration of fidelity and secrecy, other undertaking by the firm/SBA, specimen signatures, etc.
  - Scope of work - Besides the statutory audit under the provisions of the Banking Regulation Act, 1949, SBA is also required to verify certain other areas and issue various report and certificates like LFAR, Tax Audit Report, certificates for cash verification on odd dates, Ghosh & Jilani reports etc.
  - SBA need to note compliance with relevant and applicable Engagement and Quality Control Standards issued by the ICAI.
- 2. RBI Guidelines and Circulars** – SBA must read and study RBI Circulars, master directions, notifications and the Banking Regulation Act, 1949.
- 3. Bank's Closing Circular** – With appointment letter, Banks also issue closing guidelines. This Circular covers the process and policies followed by Bank. Basic understanding of these circulars is necessary.
- 4.** SBA also needs to have basic knowledge of allied applicable laws to carry out effective audit. For example, Indian Contract Act 1872, The Bombay Stamp Act 1958, Negotiable Instruments Act 1881 etc.

### **Steps for audit of advances and NPA related matters**

1.11 SBA should document the criteria for test check which he has chosen for verification of advances. SBA should prepare / suitably create check-list to verify advances which are selected for verification. Based on RBI guidelines auditor should see that Sanctioning, Review / renewal, monitoring of advances is

being done properly. If there are deviations, auditor should report the same. Auditor should select appropriate sample from all categories of advances so that they truly represent the entire population and carry out appropriate test checks.

1.12 SBA should study the latest Income Recognition and Asset classification (IRAC) guidelines of RBI. Auditor should also check whether the Bank has correctly classified the advances into performing and non-performing categories. Appropriate test checks should be carried out regarding classification of advances. Auditor should appropriately deal with the deviations in classification and accordingly Memorandum of changes should be issued if required. SBA should report all deficiencies noted by him in Long Form Audit Report.

#### **Steps for audit related to Cash and Housekeeping Matters**

1.13 SBA should check internal controls on custody of cash and see that the cash management policy of the bank is duly followed. SBA should physically check cash at the branch and at the ATM attached to branch. SBA should examine rotation of duties of key management at branch for effective operations. SBA should examine limit for cash holding and what is cash actually hold by branch throughout the year.

#### **Steps for audit related to Financial Statements**

1.14 SBA should apply basic audit principles and carry out the checking of the Financial Statements. SBA may apply analytical procedures such as ratio analysis, comparative analysis to find out material misstatements, if any in the financial statements. Based on the audit process carried out by audit team and after examination of the final financial statements, the auditor should frame his audit opinion.

#### **Steps for compiling the Main report & LFAR etc.**

1.15 The SBA 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". Based on the audit process carried out auditor should report his findings in the Audit Reports. The illustrative formats of auditor's report are given in **Appendices III and IV** of Section B (Available on ICAI website) of the Guidance Note as follows:

## **Guidance Note on Audit of Banks (Revised 2020)**

---

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

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

1.16 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) to the management. While planning the audit, auditor must cover all aspects on which reporting is to be done in his main report and also in the LFAR. The matters to be dealt with by auditors in LFAR have been specified by the RBI. For matters which are reported in Main Report and LFAR, auditor should have necessary and appropriate audit documentation to evidence the findings made. If the auditor intends to issue modified opinion, reasons for such modified opinion need to be mentioned. For the reference and benefit of the members various illustrative Formats for Engagement Letter, Written Representation Letter, Broad Features of the Gold Monetization Scheme, Abbreviations used in the Banking Industry, Illustrative list for Basis of Selection of Advance Accounts, and Illustrative Bank Branch Audit Programme for the Year ended March 31, 2020 are given in Appendices V to X of Section B (Available on ICAI website) of the Guidance Note as follows:

**Appendix V** - Illustrative Format of Engagement Letter to be sent to the Appointing Authority of the Nationalised Bank by Branch Auditor;

**Appendix VI** - Illustrative Format of Written Representation Letter to be obtained from the Branch Management;

**Appendix VII** - The Broad features of the Gold Monetization Scheme;

**Appendix VIII** - Suggested Abbreviations used in the Banking Industry;

**Appendix IX** - Illustrative list for Basis of Selection of Advance Accounts in case of Bank Branch Audit;

**Appendix X** - Illustrative Bank Branch Audit Programme for the Year ended March 31, 2020.

### **Special Audit Considerations in Foreign Banks**

1.17 Audit of foreign banks operating in India, poses unique challenges compared to local banks in India. Foreign banks have different operating models

compared to local banks, and, to a limited extent, they also operate in a different regulatory environment.

1.18 Foreign banks operate in India through branches and do not have a separate legal entity existence in India. However, for all practical purposes, the RBI regulates their functioning in India, with regards to scale and nature of business they undertake in India.

1.19 Auditors of foreign bank will have to modify their audit procedures so as to take care of the operational structure and operations of these banks. Some of the important elements related to foreign banks which may have a bearing on the audit plan and procedure are listed below:-

- Management structure.
- More centralised operational functions.
- Core banking software used globally.
- Requirement for compliance with foreign legal and regulatory requirements.
- Cross border flow and processing of data.
- Complex treasury operations and cross border forex deals.
- Operational processes.

## **Bank Branch Audit Planning**

---

### **Appointment of Auditors**

2.01 The ICAI invites applications from CAs to be empanelled for carrying out the Bank / Bank branch audit for nationalised banks. After due verification of details submitted, approved list of CAs is submitted to Reserve Bank of India (RBI). RBI circulates this list to banks for appointment of their auditors. Banks confirm with CA firms about their willingness and confirm their appointments. Once the appointment of statutory auditors is done, the final list is submitted with RBI by all the nationalised banks.

### **Understanding Business of Bank**

2.02 Auditor should understand the nature of activities carried out at branch. Auditor should consider requirements of SA 315 "Identifying and assessing the risks of Material Misstatement through understanding the entity and its environment". Newer Banking products are being periodically introduced by the Banking industry; Auditor should have complete knowledge about these products. Auditor should study the financial implication of these products. Types of facilities provided to Borrowers and the Standard Operating Procedures (SOP) should be studied. Authority levels should be understood. Based on features of the products, Auditor should draw up a suitable audit plan to verify the transactions of the activities being provided by the Bank. Risk Assessment is to be carried out based on clear understanding of business profile of the Bank.

2.03 Auditor should find out the role and responsibilities of branch officials and the internal controls in operation. Most of the Banks have converted their branches as Customer facing point of Contact and Sales and almost all processing / decision making is centralised. Depending on the functions being carried out at the branch, the auditor should design his audit plans.

### **Audit Planning**

2.04 Auditor should plan the audit keeping requirements of SA 300 "Planning an Audit of Financial Statements" in mind. Auditor should document the audit plan prepared. Auditor should conduct preliminary enquiry to know nature, size of bank branch to be audited. Auditor should make overall audit strategy for execution of audit.

2.05 Auditor needs to assess the risk involved in branch being audited. Depending on nature of transactions executed at branch, audit plan should be designed. General branches will have one set of audit plan and specialised branches will have different audit plan based on nature of transactions executed at branch, such as treasury branches, forex branches, service / clearing branches.

2.06 Auditor should assess resource requirements for audit to be completed in stipulated timelines. Based on volume, nature of transactions executed at branch staff will be deployed. Audit team needs to be updated with banking law and regulations and RBI Guidelines.

2.07 Detailed requirement letter seeking information regarding branch should be sent by auditor to branch management so that necessary information is received during the planning stage and accordingly proper audit plans can be made. Auditor should call previous year's important reports so that before hand auditor is aware about past key issues reported by previous statutory auditor.

2.08 Auditor should document in Audit plan Direction, Supervision and review strategies.

**Audit procedures /understanding forms and content of financial statements/reporting**

2.09 Auditor should carry out analytical and substantive audit procedures to verify True & fair view of the financial statements. Due to stringent timelines set by the Bank, along with appropriate test checks carried out, analytical procedures will be useful tools to find material misstatement, if any, in the financial statements. Auditor should set materiality level in accordance with SA 320, "Materiality in Planning and Performing an Audit" and carry out substantive audit procedures for all material transactions.

2.10 Various closing forms and certificates are to be certified by statutory auditors. Understanding objective of such forms and certificates is very essential. Auditor should read relevant RBI circulars and guidelines before verifying the forms and certificates. Auditor should understand the process followed in making such forms / certificates

2.11 Final auditor's report and Long form Audit Report are two documents that are issued by statutory auditor to the bank management. During the course of audit, auditor should note down observations which have come across which requires attention of the management and various points need to be reported in Long Form Audit Report. While carrying out audit of each area simultaneously auditor should make replies for questions in Long Form Audit Report.

# 3

## Audit Documentation in Bank Branch Audit

---

### Audit Documentation in Bank Branch Audit

3.01 SA 230, Audit Documentation requires the auditor to duly prepare and maintain audit documentation for an audit of financial statements. Bank Audit is no exception and auditors need to collect all the documentary evidences while carrying out an audit. The nature and purpose of audit documentation has been well explained in SA 230.

3.02 Various SAs state the documentation that should be maintained by an auditor which should be ensured.

3.03 Auditor should prepare the audit plans and make a note of the extent of checks that will be carried out by him during the audit process. He should note the queries raised by him and how the same have been resolved, nature of issues that have arisen and the documents obtained for the same, significant matters which have come across.

3.04 Audit documentation may be recorded on paper or on electronic or other media. Examples of audit documentation include: Audit programs, Analysis, Issue-Memorandum, Summaries of significant matters, Letters of confirmations and representations, Checklists, Correspondences (including e-mail) concerning significant matters.

3.05 For Bank audit, auditor should collect following documents; an illustrative list is given below-

- Latest RBI Master Directions / Circulars, other material for conducting the audit.
- Closing Guidelines / Circular issued by the Bank.
- Powers & Responsibilities at various levels.
- Policies, Processes and procedures followed.
- Financial Statements of the previous year and current year.
- Trial Balance for the year.



#### **Guidance Note on Audit of Banks (Revised 2020)**

---

- Various Audit reports such as internal inspection report, concurrent audit reports, previous year statutory audit report.
- Statement of advances with classification along with various fields duly filled such as security, sanction limits, date of sanction / renewal, outstanding balance etc.
- Copies of supporting documents that are verified during the audit.
- Old outstanding items of assets / liabilities.
- Other Bank / RBI balance confirmation.
- Management Representation Letter.
- Various other Audit documents / evidence considered in audit process.

# 4

## Overview of Standards on Auditing

4.01 Effective implementation of Standards on Auditing (SAs) is essential to ensure quality in bank branch audit like in case of any other audit engagement. While it is true that the degree of depth in application of SAs to various size of the branch will vary materially, it is necessary that the auditor must have on its records the evidence that he has carried the audit as per the applicable SAs.

4.02 In order to facilitate compliance of these SAs, every audit file must contain the list of these SAs and remarks of signatory against each whether the standard is applied. This will inculcate the necessary discipline among the staff members and even the signatories of the audit statements.

4.03 Let us first understand the overall structure of the standards on auditing. The entire structure of SAs is divided as under:

SAs are applicable to all audit engagements. SAs are categorised as under:

1. General principles & Responsibilities SA 200 to SA 299
2. Risk assessment & Response to the assessed risks SA 300 to SA 499
3. Audit Evidence SA 500 to SA 599
4. Using work of others SA 600 to SA 699
5. Audit conclusions & Reporting SA 700 to SA 799
6. Specialised Areas SA 800 to SA 899

4.04 Finally, it is necessary to keep a list of SAs in our audit documentation file to ensure its compliance. The brief on each SAs is given below which can be utilised as a reference checklist for each audit/ assignment undertaken.

SA - No.	Name of Standard on Auditing	Scope and Objective of Standard	Remark of Auditor
SA-200	Overall Objectives of the Independent Auditor and the Conduct of an	This SA establishes the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with SAs. Specifically, it sets out the overall objectives of the independent auditor,	

**Guidance Note on Audit of Banks (Revised 2020)**

	<p>Audit in Accordance with Standards on Auditing</p>	<p>and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority and structure of the SAs, and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the SAs.</p> <p>In conducting an audit of financial statements, the overall objectives of the auditor are:</p> <p>(a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and</p> <p>(b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.</p>	
<p><b>SA-210</b></p>	<p>Agreeing the Terms of Audit Engagements</p>	<p>This SA deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance. This includes establishing that certain preconditions for an audit, responsibility for which rests with management and, where appropriate, those charged with governance, are present.</p> <p>The objective of the auditor is to accept</p>	

**Guidance Note on Audit of Banks (Revised 2020)**

		<p>or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:</p> <p>(a) Establishing whether the preconditions for an audit are present; and</p> <p>(b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.</p>	
<b>SA-220</b>	Quality Control for an Audit of Financial Statements	<p>This SA deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements. It also addresses, where applicable, the responsibilities of the engagement quality control reviewer.</p> <p>The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:</p> <p>(a) The audit complies with professional standards and regulatory and legal requirements; and</p> <p>(b) The auditor's report issued is appropriate in the circumstances.</p>	
<b>SA-230</b>	Audit Documentation	<p>This SA deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements.</p> <p>The objective of the auditor is to prepare documentation that provides:</p> <p>(a) A sufficient and appropriate record of the basis for the auditor's report;</p>	

**Guidance Note on Audit of Banks (Revised 2020)**

		<p>and</p> <p>(b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.</p>	
<b>SA-240</b>	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements	<p>This SA deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Specifically, it expands on how SA 315 and SA 330 are to be applied in relation to risks of material misstatement due to fraud.</p> <p>The objectives of the auditor are:</p> <p>(a) To identify and assess the risks of material misstatement in the financial statements due to fraud;</p> <p>(b) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and</p> <p>(c) To respond appropriately to identified or suspected fraud.</p>	
<b>SA-250</b>	Consideration of Laws and Regulations in an Audit of Financial Statements	<p>This SA deals with the auditor's responsibility to consider laws and regulations when performing an audit of financial statements.</p> <p>The objectives of the auditor are:</p> <p>(a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and</p>	

**Guidance Note on Audit of Banks (Revised 2020)**

		<p>disclosures in the financial statements;</p> <p>(b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and</p> <p>(c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.</p>	
<b>SA-260 (Revise d)</b>	Communication with Those Charged with Governance	<p>This SA deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements.</p> <p>The objectives of the auditor are:</p> <p>(a) To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;</p> <p>(b) To obtain from those charged with governance information relevant to the audit;</p> <p>(c) To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and</p> <p>(d) To promote effective two-way communication between the auditor and those charged with governance.</p>	

**Guidance Note on Audit of Banks (Revised 2020)**

<b>SA-265</b>	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	<p>This SA deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements.</p> <p>The objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.</p>	
<b>SA-299 (Revised)</b>	Joint Audit of Financial Statements	<p>This SA lays down the principles for effective conduct of joint audit to achieve the overall objectives of the auditor as laid down in SA 200. This SA deals with the special considerations in carrying out audit by joint auditors. Accordingly, in addition to the requirements enunciated in this Standard, the joint auditors also need to comply with all the relevant requirements of other applicable SAs.</p> <p>The objectives of this Standard are:</p> <ul style="list-style-type: none"> <li>(a) To lay down broad principles for the joint auditors in conducting the joint audit.</li> <li>(b) To provide a uniform approach to the process of joint audit.</li> <li>(c) To identify the distinct areas of work and coverage thereof by each joint auditor.</li> <li>(d) To identify individual responsibility and joint responsibility of the joint auditors in relation to audit.</li> </ul>	

**Guidance Note on Audit of Banks (Revised 2020)**

<b>SA-300</b>	Planning an Audit of Financial Statements	<p>This SA deals with the auditor's responsibility to plan an audit of financial statements. This SA is framed in the context of recurring audits. Additional considerations in initial audit engagements are separately identified.</p> <p>The objective of the auditor is to plan the audit so that it will be performed in an effective manner.</p>	
<b>SA-315</b>	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment	<p>This SA deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control.</p> <p>The objective of the auditor 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.</p>	
<b>SA-320</b>	Materiality in Planning and Performing an Audit	<p>This SA deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements.</p> <p>The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.</p>	
<b>SA-330</b>	The Auditor's Responses to	This SA deals with the auditor's responsibility to design and implement	



**Guidance Note on Audit of Banks (Revised 2020)**

	Assessed Risks	<p>responses to the risks of material misstatement identified and assessed by the auditor in accordance with SA 315.</p> <p>The objective of the auditor is to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.</p>	
<b>SA-402</b>	Audit Considerations Relating to an Entity Using a Service Organization	<p>This SA deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations.</p> <p>The objectives of the user auditor, when the user entity uses the services of a service organisation, are:</p> <ul style="list-style-type: none"> <li>• To obtain an understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement; and</li> <li>• To design and perform audit procedures responsive to those risks.</li> </ul>	
<b>SA-450</b>	Evaluation of Misstatements Identified during the Audit	<p>This SA deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.</p> <p>The objective of the auditor is to evaluate:</p> <p>(a) The effect of identified misstatements on the audit; and</p>	

**Guidance Note on Audit of Banks (Revised 2020)**

		(b) The effect of uncorrected misstatements, if any, on the financial statements.	
<b>SA-500</b>	Audit Evidence	<p>This SA explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.</p> <p>The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.</p>	
<b>SA-501</b>	Audit Evidence-Specific Considerations for Selected Items	<p>This SA deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence in accordance with SA 330, SA 500 and other relevant SAs, w.r.t. certain aspects of inventory, litigation and claims involving the entity, and segment information in an audit of financial statements.</p> <p>The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the:</p> <ul style="list-style-type: none"> <li>(a) Existence and condition of inventory;</li> <li>(b) Completeness of litigation and claims involving the entity; and</li> <li>(c) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.</li> </ul>	

**Guidance Note on Audit of Banks (Revised 2020)**

<b>SA-505</b>	External Confirmations	<p>This SA deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 330 and SA 500.</p> <p>The objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence.</p>	
<b>SA-510</b>	Initial Audit Engagements- Opening Balances	<p>This SA deals with the auditor's responsibilities relating to opening balances when conducting an initial audit engagement.</p> <p>In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:</p> <ul style="list-style-type: none"> <li>(a) Opening balances contain misstatements that materially affect the current period's financial statements; and</li> <li>(b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.</li> </ul>	
<b>SA-520</b>	Analytical Procedures	<p>This SA deals with the auditor's use of analytical procedures as substantive procedures, and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.</p>	

**Guidance Note on Audit of Banks (Revised 2020)**

		<p>The objectives of the auditor are:</p> <p>(a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and</p> <p>(b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.</p>	
<b>SA-530</b>	Audit Sampling	<p>This SA applies when the auditor has decided to use audit sampling in performing audit procedures. It deals with the auditor's use of statistical and non-statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from the sample.</p> <p>The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.</p>	
<b>SA-540</b>	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	<p>This SA deals with the auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how SA 315, SA 330 and other relevant SAs are to be applied in relation to accounting estimates.</p> <p>The objective of the auditor is to obtain sufficient appropriate audit evidence whether in the context of the applicable</p>	

**Guidance Note on Audit of Banks (Revised 2020)**

		<p>financial reporting framework:</p> <p>(a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable; and</p> <p>(b) related disclosures in the financial statements are adequate.</p>	
<b>SA-550</b>	Related Parties	<p>This SA deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements. Specifically, it expands on how SA 315, SA 330 and SA 240 are to be applied in relation to risks of material misstatement associated with related party relationships and transactions.</p> <p>The objectives of the auditor are:</p> <p>(a) Irrespective of whether the applicable financial reporting framework establishes related party requirements, to obtain an understanding of related party relationships and transactions sufficient to be able:</p> <p>(i) To recognise fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and</p> <p>(ii) To conclude whether the financial statements, insofar as they are affected by those relationships and transactions:</p>	

**Guidance Note on Audit of Banks (Revised 2020)**

		<ul style="list-style-type: none"> <li>a. Achieve a true and fair presentation (for fair presentation frameworks); or</li> <li>b. Are not misleading (for compliance frameworks); and</li> </ul> <p>(b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.</p>	
<b>SA-560</b>	Subsequent Events	<p>This SA deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements.</p> <p>The objectives of the auditor are to:</p> <ul style="list-style-type: none"> <li>(a) Obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements; and</li> <li>(b) Respond appropriately to facts that become known to the auditor after the date of the auditor's report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.</li> </ul>	

**Guidance Note on Audit of Banks (Revised 2020)**

<p><b>SA-570 (Revised)</b></p>	<p>Going Concern</p>	<p>This SA deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report.</p> <p>The objectives of the auditor are:</p> <ul style="list-style-type: none"> <li>(a) To obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements;</li> <li>(b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and</li> <li>(c) To report in accordance with this SA.</li> </ul>	
<p><b>SA-580</b></p>	<p>Written Representations</p>	<p>This SA deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance.</p> <p>The objectives of the auditor are:</p> <ul style="list-style-type: none"> <li>(a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;</li> <li>(b) To support other audit evidence</li> </ul>	

**Guidance Note on Audit of Banks (Revised 2020)**

		<p>relevant to the financial statements or specific assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and</p> <p>(c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.</p>	
<b>SA-600</b>	Using the Work of Another Auditor	This SA establishes standards to be applied in situations where the principal auditor, reporting on the financial information of an entity, uses the work of other auditor w.r.t. financial information of components included in the financial information of the entity.	
<b>SA-610 (Revised)</b>	Using the Work of Internal Auditors	<p>This SA deals with the external auditor's responsibilities if using the work of internal auditors. This includes (a) using the work of the internal audit function in obtaining audit evidence and (b) using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor.</p> <p>The objectives of the external auditor, where the entity has an internal audit function and the external auditor expects to use the work of the function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external</p>	



**Guidance Note on Audit of Banks (Revised 2020)**

		<p>auditor, or to use internal auditors to provide direct assistance, are:</p> <p>(a) To determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent;</p> <p>and having made that determination:</p> <p>(b) If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit; and</p> <p>(c) If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.</p>	
<b>SA-620</b>	Using the Work of an Auditor's Expert	<p>This SA deals with the auditor's responsibilities regarding the use of an individual or organisation's work in a field of expertise other than accounting or auditing, when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence.</p> <p>The objectives of the auditor are:</p> <p>(a) To determine whether to use the work of an auditor's expert; and</p> <p>(b) If using the work of an auditor's expert, to determine whether that work is adequate for the auditor's purposes.</p>	
<b>SA-700 (Revised)</b>	Forming an Opinion and Reporting on Financial Statements	<p>This SA deals with the auditor's responsibility to form an opinion on the financial statements. It also deals with the form and content of the auditor's report issued as a result of an audit of financial statements.</p>	

**Guidance Note on Audit of Banks (Revised 2020)**

		<p>The objectives of the auditor are:</p> <p>(a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and</p> <p>(b) To express clearly that opinion through a written report.</p>	
<b>SA - 701</b>	Communicating Key Audit matters in the Independent Auditor's report	<p>This SA deals with the auditor's responsibility to communicate key audit matters in the auditor's report. It is intended to address both the auditor's judgment as to what to communicate in the auditor's report and the form and content of such communication.</p> <p>The objectives of the auditor are to determine key audit matters and, having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report.</p>	
<b>SA-705 (Revised)</b>	Modifications to the Opinion in the Independent Auditor's Report	<p>This SA deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700(Revised), the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary. This SA also deals with how the form and content of the auditor's report is affected when the auditor expresses a modified opinion.</p> <p>The objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that is necessary when:</p> <p>(a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material</p>	

**Guidance Note on Audit of Banks (Revised 2020)**

		<p>misstatement; or</p> <p>(b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.</p>	
<b>SA-706 (Revised)</b>	<p>Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report</p>	<p>This SA deals with additional communication in the auditor's report when the auditor considers it necessary to:</p> <p>(a) Draw users' attention to a matter or matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements; or</p> <p>(b) Draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.</p> <p>The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:</p> <p>(a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or</p>	

**Guidance Note on Audit of Banks (Revised 2020)**

		(b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.	
<b>SA-710</b>	Comparative Information- Corresponding Figures and Comparative Financial Statements	<p>This SA deals with the auditor's responsibilities regarding comparative information in an audit of financial statements.</p> <p>The objectives of the auditor are:</p> <p>(a) To obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and</p> <p>(b) To report in accordance with the auditor's reporting responsibilities.</p>	
<b>SA-720 (Revised)</b>	The Auditor's Responsibilities Relating to Other Information	<p>This SA deals with the auditor's responsibilities relating to other information, whether financial or non-financial information (other than financial statements and the auditor's report thereon), included in an entity's annual report.</p> <p>The objectives of the auditor, having read the other information, are:</p> <p>(a) To consider whether there is a material inconsistency between the other information and the financial statements;</p> <p>(b) To consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit;</p>	

**Guidance Note on Audit of Banks (Revised 2020)**

		<p>(c) To respond appropriately when the auditor identifies that such material inconsistencies appear to exist, or when the auditor otherwise becomes aware that other information appears to be materially misstated; and</p> <p>(d) To report in accordance with this SA.</p>	
<b>SA-800</b>	Special Considerations-Audit of Financial Statements Prepared in Accordance with Special Purpose Frameworks	<p>This SA deals with special considerations in the application of SAs in the 100-700 series to an audit of financial statements prepared in accordance with a special purpose framework.</p> <p>The objective of the auditor, when applying SAs in an audit of financial statements prepared in accordance with a special purpose framework, is to address appropriately the special considerations that are relevant to:</p> <p>(a) The acceptance of the engagement;</p> <p>(b) The planning and performance of that engagement; and</p> <p>(c) Forming an opinion and reporting on the financial statements but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.</p>	
<b>SA-805</b>	Special Considerations-Audit of Single Financial Statements and specific Elements, Accounts or Items of a	<p>This SA deals with special considerations in the application of SAs in the 100-700 series to an audit of a single financial statement or of a specific element, account or item of a financial statement.</p> <p>The objective of the auditor, when applying SAs in an audit of a single</p>	

**Guidance Note on Audit of Banks (Revised 2020)**

	Financial Statement	<p>financial statement or of a specific element, account or item of a financial statement, is to address appropriately the special considerations that are relevant to:</p> <ul style="list-style-type: none"> <li>(a) The acceptance of the engagement;</li> <li>(b) The planning and performance of that engagement; and</li> <li>(c) Forming an opinion and reporting on the single financial statement or on the specific element, account or item of a financial statement but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.</li> </ul>	
<b>SA-810</b>	Engagements to report on Summary Financial Statements	<p>This SA deals with the auditor's responsibilities when undertaking an engagement to report on summary financial statements derived from financial statements audited in accordance with SAs by that same auditor.</p> <p>The objectives of the auditor are to:</p> <ul style="list-style-type: none"> <li>(a) Determine whether it is appropriate to accept the engagement to report on summary financial statements;</li> <li>(b) Form an opinion on the summary financial statements based on an evaluation of the conclusions drawn from the evidence obtained; and</li> <li>(c) Express clearly that opinion through a written report that also describes the basis for that opinion.</li> </ul>	

In the end, it is concluded that compliance with the SAs should be taken care of, while executing the audit as well as reporting.

# 5

## Special Considerations in a CBS Environment

---

### Introduction

5.01 The face of Banking Industry is changing rapidly. What Banking is today is quite different from what it was in the years gone by. Rapid strides in technological advancements, different payment systems, integration of AADHAR for Card Less transactions are changing the way of banking. However, in recent times there have been few instances of manipulating the banking system for unlawful gains and frauds.

### Responsibilities of Branch Auditors

5.02 Generally, the branch auditors do not have access to the overall IT policy, processes, controls and accounting procedures implemented by the bank. Moreover, the branch auditors confront following practical issues at fully computerised branches:

- Accounting manual, entries, calculations and framework is built in computerised accounting systems.
- Critical IT and manual controls are centralised at HO level.
- Limited access to periodical MIS and exception reports generated by the system.
- Documentation of critical processes performed for accounting and book keeping (IT and Manual).
- Access to primary records and entry level transactions.
- Audit sampling.
- Hard copies of transactions.
- Independent IT Audit at branches, etc.

5.03 The overall review of IT environment and of the computerised accounting system has to be taken up at central level. The management plays a more proactive role to ensure that the computerised accounting systems are working properly and effectively. It is for the Statutory Central Auditor to review

whether the management is performing this role effectively. The roles and responsibilities of bank, and the branch auditors are enumerated below -.

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

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

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



auditors, RBI inspection and internal inspection, etc., related to computerised accounting and overall IT systems.

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

***Role and responsibilities of branch auditors***

5.05 Based on the guidance and information received from the Statutory Central Auditor / Bank, the branch auditors need to ensure that:

- Their roles and responsibilities are clearly understood and implemented.
- To the extent possible, data analysis tools are used for better and effective audit.
- Test of controls and substantive checking of sample transactions is carried out at the branch level and, where considered necessary, the results are shared with the Statutory Central Auditors.
- Data review and analysis through CBS is carried out.
- Significant observations having bearing on the true and fair view are reported to the Statutory Central Auditors.
- Any other limitations on audit which are required to be reported to the Statutory Central Auditors are reported in a timely manner.

---

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

## Audit in a CIS environment

### Assessment of Inherent and Control Risks

5.06 The nature of banking operations is such that the auditors may not be able to reduce audit risk to an acceptably low level by the performance of substantive procedures alone. It may be not on account of following factors:

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

5.07 In most situations, the auditors' ability to reduce audit risk to an acceptably low level would be affected by the internal control systems established by the management that allow the auditors to be able to assess the level of inherent and control risks as less than high. The auditors obtain sufficient appropriate audit evidence to assess the level of inherent and control risks.

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

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

- A. *Deterrent controls* - Deterrent Controls are designed to deter people, internal as well as external, from doing undesirable activities. For example, written policies including the punitive measures may deter people from doing undesired activities.
- B. *Preventive Controls* - Preventive Controls prevent the cause of exposure from occurring or at least minimise the probability of unlawful event taking place. For example, security controls at various levels like hardware, software, application software, database, network, etc.
- C. *Detective Controls* - When a cause of exposure has occurred, detective controls report its existence in an effort to arrest the damage further or

minimise the extent of the damage. Thus, detective controls limit the losses if an unlawful event has occurred.

- D. *Corrective Controls* - Corrective Controls are designed to recover from a loss situation. For example, Business Continuity Planning is a corrective control. Without corrective controls in place, the bank has risk of loss of business and other losses due to its inability to recover essential IT based services, information and other resources after the disaster has taken place.

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

### **Security Control Aspects**

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

- Ensure that authorised, accurate and complete data is made available for processing.
- Ensure that in case of interruption due to power, mechanical or processing failures, the system restarts without distorting the completion of the entries and records.
- Verify whether “access controls” assigned to the staff-working match with the responsibilities as per manual. It is important for the auditor to ensure that access and authorisation rights given to employees are appropriate.
- Verify that segregation of duties is ensured while granting system access to users and that the user activities are monitored by performing an activities log review.
- Verify that changes made in the parameters or user levels are authenticated.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

- Verify that charges calculated manually for accounts when function is not regulated through parameters are properly accounted for and authorised.
- Verify that exceptional transaction reports are being authorised and verified on a daily basis by the concerned officials. It is important for auditor to understand the nature of exception and its impact on financials.
- Verify that the account master and balance cannot be modified / amended / altered except by the authorised personnel.
- Verify that all the general ledger accounts codes authorised by Head Office are in existence in the system.
- Verify that balance in general ledger tallies with the balance in subsidiary book.

### *Credit Risk*

5.11 Generally, the bank's credit risk is not increased by the mere fact that a loan is originated through an e-banking channel. However, the bank should ensure that additional precautions are in place when originating and approving loans electronically including assuring management information systems effectiveness by preparing a track of the performance of portfolios originated through e-banking channels. The following aspects of on-line loan origination and approval tend to make risk management of the lending process more challenging:

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

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

### *Compliance/ Legal Risk*

5.12 Compliance and legal issues arise out of the rapid growth in usage of e-banking services and the differences between the electronic and paper-based processes. E-banking is a new delivery channel where the laws and rules

governing the electronic delivery of certain financial products or services may be ambiguous or still evolving. Specific regulatory and legal challenges include:

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

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

#### *Reputational Risk*

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

#### **Audit through CBS**

5.15 With the adoption of CBS by banks, realignment in the conventional audit methodology has also become inevitable.

What is CBS?

5.16 The core banking system is the set of basic software components that manage the services provided by a bank to its customers through its branches (branch network). The bank's customers can make their transactions from any branch, ATM, Service Outlets, Internet, Phone at their disposal. The CBS is based on Service Oriented Architecture (SOA). It helps banks to reduce risk that can result from manual data entry and out of date information. It also helps banks

#### **Guidance Note on Audit of Banks (Revised 2020)**

---

to improve Service Delivery quality and time to its customer. The software is accessed from different branches of bank via communication lines like telephones, satellite, internet etc.

5.17 Core Banking Solution [CBS] works on a concept of Centralized Database and Processing. Transactions take place at various geographical locations which get recorded and processed at a Centralized Server. Updating of Database is on Real Time Basis. Due to the Centralization of Transaction Processing, issue of Out of Date Information is eliminated. All the users connected to CBS will be able to get upto date information. CBS also enhances quality of Reporting and strengthens Access Control.

5.18 Under CBS data is stored in centralized servers at Data Centre. This effectively means that all operations at the connected branches, back offices are carried out through servers at Data Centre including transactions through other delivery channels like ATMs, Internet Banking, Phone Banking.

5.19 Under CBS, the branches, back offices are defined as SOL (i.e. Service Outlets) where each SOL functions as a service window. The CBS is capable of processing any transaction from any branch location connected to CBS. It can be equated with single window operations at airline counters or railway reservation counters wherein all the services can be obtained at one place. Hence, under CBS customer is now a customer of the bank and not merely a customer of a branch of the Bank. This has facilitated Any-where, Anytime Banking convenience for the customer.

5.20 From Bank's perspective, control over the application and processes has been entrusted at Data Center Level. In addition to it CBS also makes available effective MIS on real-time basis. It enables generation of all periodical returns centrally.

5.21 There are various CBS developed by various software companies are available in the market. Few widely used CBS are a) FINACLE, b) BaNCS and c) FlexCube.

# 6

## Cash

---

6.01 The primary check for cash is to 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.

6.02 The physical verification should be evidenced through working paper indicating the denominations & number of currency notes. The counting sheet should be counter signed by the Cashier and the Branch manager.

6.03 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 should 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.

6.04 Besides the physical verification, if there are specific instructions or certifications specific to the bank, the same needs to be complied with. Following specific questions w.r.t. cash also need to be addressed in LFAR.

- a) Does the branch generally carry cash balances, which vary significantly from the limits fixed by the controlling authorities of the bank? Whether excess balances have been reported to the controlling authorities of the bank?
- A letter received from controlling office to be perused to ascertain the cash retention limit allotted to the branch (including foreign currencies).
  - The limits as above to be verified with the daily closing cash balance (including foreign currency) of the Branch.
  - Any exceptions may be reported as under:
    - i. We have been informed that Controlling Office had fixed Cash Retention Limit of Rs. ----vide letter no..... dated---

**Guidance Note on Audit of Banks (Revised 2020)**

---

- ii. During the year under audit the cash balance was in excess of Retention Limit on many / few occasion. The instances are as under: -

<b>Date</b>	<b>Balance in Rs.</b>

The above data can be obtained from system generated report. If the instances are voluminous then the auditor may mention the number of days and disclose the peak levels of excesses observed during the year.

- b) Does the branch hold adequate insurance cover for cash-in-hand and cash-in-transit? -
- Generally, the Branch cash balance has been covered under the Bankers' Indemnity Policy. Hence no action is required at the branch level.
  - A copy of the policy to be obtained from Branch. In case the insurance is taken by Head Office / Controlling Office, a copy of policy or any correspondence from Head Office / Controlling Office in this regard to be perused.
- c) Is cash maintained in effective joint custody of two or more officials, as per the instructions of the controlling authorities of the bank?
- Joint custody of cash and its evidencing at the branch is very crucial. Many times, documentary evidence shows that the keys are controlled by minimum two officers. However, during the audit, even for the sake of convenience, if auditor observes the custody is not shared, it should trigger the further audit check on the part of the auditor.
  - Obtain the instructions in this regard and peruse the compliance thereof.
- d) Have the cash balances at the branch been checked at periodic intervals as per the procedure prescribed by the controlling authorities of the bank?



#### **Guidance Note on Audit of Banks (Revised 2020)**

---

- Obtain the copy of the procedure prescribed by the Controlling Authorities and examine the compliance thereof. Ensure that the branch manager has signed the verification reports along with the stamping of dates.
  - In addition, ascertain, whether the branch is under Concurrent Audit. Generally, the Concurrent Auditors do the Cash verification every month.
- e) Does the figure of the balance in the branch books in respect of cash with its ATM(s) tally with the amounts of balances with the respective ATMs, based on the year end scrolls generated by the ATMs? If there is any difference, same should be reported.
- 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.
  - 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.

# 7

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

---

7.01 In most of the branches, there will be no bank account. Hence this section does not require any reporting. However, in case there is a bank account balance, following steps need to be undertaken for the audit.

- (i) 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.
- (ii) 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.
- (iii) Examine that all bills or outstanding cheques sent for collection and outstanding as on the closing date have been credited subsequently.
- (iv) 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.
- (v) In respect of balances in deposit accounts, original deposit receipts should be examined in addition to confirmation certificates obtained from banks in respect of outstanding deposits. Balances in deposit accounts are usually (though not necessarily) in round figures. Where such balances are in odd figures, the auditor should enquire whether the account concerned is actually of the nature of a deposit account. The auditor should also ensure that interest on such deposits has been recorded on time proportion basis and interest has been recorded till the closing day.
- (vi) 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.

**Guidance Note on Audit of Banks (Revised 2020)**

---

(vii) 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.

7.02 Besides the requisite audit checks as specified above, in respect of branches where bank balances are maintained, following LFAR issues need to be addressed:

- a) Were balance confirmation certificates obtained in respect of outstanding balances as at the year-end and whether the aforesaid balances have been reconciled? The nature and extent of differences should be reported.
  - Balance confirmation certificates obtained in respect of outstanding balances as at the year end.
  - Obtain the Bank Reconciliation Statement.
  - If the reconciliation is not carried out or carried out incorrectly the same to be reported.
  - If any difference is observed, then report the amount, nature of difference and period since lying in the reconciliation statement.
- b) Auditor's observations on the reconciliation statements may be reported in the following manner:
  - (i) Cash transactions remaining un-responded (give details)
  - (ii) Revenue items requiring adjustments/write-off (give details)
  - (iii) Old outstanding balances remaining unexplained/ unadjusted. Give details for:
    - Outstanding between six months and one year; and
    - One year and above
  - (iv) Other Credit and debit entries originated in the statements provided by RBI/other banks, remaining un-responded for more than 15 days.
  - (v) Where the branch maintains an account with the RBI, the following additional matter may be reported:

Entries originated prior to, but communicated/recorded after, the year end in relation to currency chest operations at the branch/other link branches, involving deposits into/withdrawals from the currency chest attached to such branches.

# 8

## **Money at Call and Short Notice (For Branches Outside India)**

---

8.01 Generally, this is looked after by Treasury Department, hence, such types of transactions generally do not appear in Branch Books. However, the auditor should confirm that no such transactions are appearing in the Branch Trial Balance. The RBI statement provided to the Treasury Branch mentions the branch code against each of the entries and in turn the treasury department provides the same to the branch and asks the branch to respond for passing the appropriate accounting entry in the books of accounts. The auditor should check the communication between the branch and the Treasury branch and ascertain that any entry pertaining to the branch is appropriately identified and passed in the books of accounts.

8.02 If there are such types of transactions, obtain the instructions / guidelines laid down by the Controlling Authorities of the bank and examine the compliance thereof.

# 9

## Investments

---

9.01 This is looked after by Treasury Department; hence, such types of transactions do not appear in Branch Books. However, the auditor should confirm that no Investments are appearing in the Branch Trial Balance.

9.02 If Investments are appearing in the Branch Trial Balance physical verification and reconciliation with the books should be conducted and reported accordingly. Also verify investment balance confirmation of counter party (Investee) with balance appearing in Branch Books.

For Branches in India

- a) Are there any investments held by branches on behalf of Head Office/other offices of the bank? If so, whether these have been made available for physical verification or evidences have been produced with regard to the same where these are not in possession of the branch?
- b) Whether any amounts received as income on such investments have been reported to the Head Office?
- c) In respect of investments held by branches on behalf of Head Office/other offices of the bank whether any income is accrued/ received and recognized as income of the branch contrary to the instructions of the controlling authorities of the bank?
- d) Whether there are any matured or overdue investments which have not been encashed. If so, give details?
- e) Whether the Guidelines of the RBI regarding Transactions in Securities have been complied with.
- f) Whether Guidelines of the RBI regarding Valuation of Investments have been complied with.

9.03 The questions in LFAR are self-explanatory and no specific guidance is provided here as it is expected that such a situation for the branch audit would not arise. However, should there be any balance reported in the branch books, the auditor may refer to the Chapter 5 "Treasury Operations" given in the Section A "Statutory Central Audit" of Guidance Note on Audit of Banks, 2020 edition.

**Introduction**

10.01 Indian Agriculture has always been the backbone of Indian economy despite sustained progress in industrial and service(s) sector. It still contributes around 14% of the GVA (Gross Value Added) and provides employment opportunities to around 42% of the population (Source: National Council of Applied Economic Research, Delhi). Indian agriculture has been source of raw materials to many of our leading industries like cotton, jute textile industries, sugar, flour mills, vanaspati, oil mills etc. Besides, many industries like handloom weaving, rice-dehusking etc. depend indirectly on the agriculture.

10.02 Agricultural credit is considered as one of the most basic input for conducting all agricultural development programmes. In India there is an immense need for proper agricultural credit as the economic condition of Indian farmers generally is of subsistence.

10.03 With a view to ensure wider spread of agricultural credit, the Government adopted the institutional credit approach through various agencies like co-operatives, commercial banks, regional rural banks etc. to provide adequate credit to farmers, at a cheaper rate of interest. The long term and short term credit needs of these institutions are also being met by National Bank for Agriculture and Rural Development (NABARD). It has the objective of promoting the health and the strength of the credit institutions which are in the forefront of the delivery system namely, cooperatives, commercial banks and regional rural banks. It is, in brief, an institution for the purpose of refinance; with the complementary work of directing, inspecting and supervising the credit- flows for agricultural and rural development.

10.04 The evolution of institutional credit to agriculture could be broadly classified into four distinct phases –

- i. 1904-1969 (predominance of co-operatives and setting up of RBI);
- ii. 1969-1975 [nationalization of commercial banks and setting up of Regional Rural Banks (RRBs)];
- iii. 1975 - 1990 (setting up of NABARD); and
- iv. From 1991 onwards (financial sector reforms): The genesis of institutional involvement in the sphere of agricultural credit could be traced back to the

enactment of the Cooperative Societies Act in 1904. The establishment of the RBI in 1935 reinforced the process of institutional development for agricultural credit.

10.05 Government has increasingly begun to tap institutional finance from banks and other term lending institutions for financing various developmental programmes in view of the need to supplement plan financing. Banks have also played a pivotal role in this regard. However, credit should be utilized in prudent manner to maximize returns and spread the benefit over wider sections of the population. Successful implementation of socioeconomic developmental programmes calls for effective co-ordination between financial agencies and government departments. It also helps in improvising efficiency of resource allocation & identifying infrastructural gaps.

10.06 The State Level Bankers' Committee ('SLBC'), constituted by the Reserve Bank of India under the Lead Bank Scheme periodically takes up the review performance and monitors progress under special schemes. At the district level the District Consultative Committee with the Chief Executive Officer of Zilla Panchayat as chairperson and representatives of financial institutions and Heads of Government departments at the district level as members' monitors the implementation of government sponsored schemes & Service Area Credit Plans. At the block level, Block Level Bankers' Committee chaired by Lead District Manager with bank managers and departmental heads of government at block level as members periodically reviews the implementation of government sponsored schemes & Service Area Credit Plans and sorts out problems encountered in the implementation of various programmes. In order to select & prioritise the works for loan assistance from NABARD under Rural Infrastructure Development Fund (RIDF) Scheme, launched in 1995-96, a Cabinet Sub-Committee on RIDF has been constituted under the chairmanship of the Minister for Public Works. There is also a High Power Committee chaired by the Additional Chief Secretary and Development Commissioner for reviewing the implementation of RIDF projects. These policy measures have resulted in the increase in the share of institutional credit of the rural households.

### **Priority Sector Lending (PSL)**

10.07 The RBI has classified lending to the Agriculture and allied activities under Priority Sector Lending. Commercial banks are guided by priority sector lending policy of providing credit to various deserving sectors/sections including agriculture and allied activities.

10.08 With a view to regulate and encourage the flow of agricultural credit by all scheduled Commercial Banks, the RBI from time to time, issues a number of guidelines /instructions/directives to banks on Priority Sector Lending.

10.09 Priority Sector Lending programme has been an integral part of the banking policy in India. It is a major public policy intervention through which credit is directed to the sectors of national priorities critical for both employment and equity. The Priority Sector Lending programme of India is one among the longest serving direct lending programmes in the world. This scheme is intended to give loans to the important sectors of the economy (agriculture, small scale industries etc.) in such a way to ensure maximum credit flow to the last man in the last village of the country through a strong banking network. The origin of the PSL programme can be traced back to the Credit Policy for 1967-68, when banks were advised to increase their involvement in financing of certain sectors identified as priority sectors in line with the national economic policy. Priority sector lending in its present form was introduced in 1980, when it was also made applicable to private sector banks and a sub-target was stipulated for lending to the “weaker” sections of the society within the priority sector.

**Meaning – Priority Sector & Priority sector advances**

10.10 Priority sector refers to those sectors of the economy which may not get timely and adequate credit in the absence of this special dispensation. Priority sector advances are small value loans to farmers for agriculture and allied activities, micro and small enterprises, poor people for housing, students for education and other low income groups and weaker sections.

10.11 In terms of RBI Master Direction- RBI/FIDD/2019-20/70 Master Direction FIDD.CO.Plan.BC No.08/04.09.01/2019-20 “Master Direction-Priority Sector Lending - Small Finance Banks-Targets and Classification” dated July 29, 2019 the categories under priority sector are as follows:

- (i) Agriculture
- (ii) Micro, Small and Medium Enterprises
- (iii) Export Credit
- (iv) Education
- (v) Housing
- (vi) Social Infrastructure
- (vii) Renewable Energy
- (viii) Others

10.12 The targets and sub-targets for agriculture set under priority sector lending for all scheduled commercial banks operating in India are furnished below for domestic scheduled commercial banks and foreign banks with 20 branches and above:



**Guidance Note on Audit of Banks (Revised 2020)**

<b>Agriculture</b>	<p>18 percent of Adjusted Net Bank Credit (ANBC) or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher.</p> <p>Within the 18 percent target for agriculture, a target of 8 percent of ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher is prescribed for Small and Marginal Farmers. Additionally, domestic banks are directed to ensure that the overall lending to non-corporate farmers does not fall below the system-wide average of the last three years achievement. All efforts should be maintained to reach the level of 13.5 percent direct lending to the beneficiaries who earlier constituted the direct agriculture sector. The applicable system wide average figure for computing achievement under priority sector lending will be notified every year. For FY 2018-19, the applicable system wide average figure is 11.99 percent.</p> <p>Foreign banks with less than 20 branches have to achieve the Agriculture Target of 40% in phased wise manner by 2019-20 and the target for FY: 2018-19 is 38%.</p> <p>Guidelines issued by RBI for Priority Sector lending by Small Finance Banks are different and these should be noted separately.</p>
--------------------	--

**Computation of Adjusted Net Bank Credit (ANBC)**

10.13

Bank Credit in India [As prescribed in item No.VI of Form 'A' under Section 42 (2) of the RBI Act, 1934].	I
Bills Rediscounted with RBI and other approved Financial Institutions	II
Net Bank Credit (NBC)*	III (I - II)
Bonds/debentures in Non-SLR categories under HTM category + other investments eligible to be treated as priority sector + Outstanding Deposits under RIDF and other eligible funds with NABARD, NHB, SIDBI and MUDRA Ltd. on account of priority sector shortfall + outstanding PSLCs	IV

**Guidance Note on Audit of Banks (Revised 2020)**

Eligible amount for exemptions on issuance of long-term bonds for infrastructure and affordable housing as per circular DBOD.BP.BC.No.25/08.12.014/2014-15 dated July 15, 2014.	V
Eligible advances extended in India against the incremental FCNR (B)/NRE deposits, qualifying for exemption from CRR/SLR requirements.	VI
ANBC	III+IV-V-VI
<p>* For the purpose of priority sector computation only. Banks should not deduct / net any amount like provisions, accrued interest, etc. from NBC</p> <p>A. The computation of priority sector targets/sub-targets achievement will be based on the ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposures, whichever is higher, as on the corresponding date of the preceding year.</p> <p>B. For the purpose of priority sector lending, ANBC denotes the outstanding Bank Credit in India [As prescribed in item No.VI of Form 'A' under Section 42(2) of the RBI Act, 1934] minus bills rediscounted with RBI and other approved Financial Institutions plus permitted non SLR bonds/debentures under Held to Maturity (HTM) category plus other investments eligible to be treated as part of priority sector lending (e.g. investments in securitised assets).</p> <p>C. The outstanding deposits under RIDF and other funds with NABARD, NHB, SIDBI and MUDRA Ltd. in lieu of non-achievement of priority sector lending targets/sub-targets will form part of ANBC.</p> <p>D. Advances extended in India against the incremental FCNR (B)/NRE deposits, qualifying for exemption from CRR/SLR requirements, as per the Reserve Bank's circulars DBOD.No.Ret.BC.36/12.01.001/2013-14 dated August 14, 2013 read with DBOD.No.Ret.BC.93/12.01.001/2013-14 dated January 31, 2014 and DBOD mailbox clarification issued on February 6, 2014 will be excluded from the ANBC for computation of priority sector lending targets, till their repayment.</p> <p>E. The eligible amount for exemption on account of issuance of long-term bonds for infrastructure and affordable housing as per Reserve Bank's circular DBOD.BP.BC.No.25/08.12.014/2014-15 dated July 15, 2014 will also be excluded from the ANBC for computation of priority sector lending targets.</p> <p>F. For the purpose of calculation of Credit Equivalent Amount of Off-Balance Sheet Exposures, banks may be guided by the Master Circular on Exposure</p>	

Norms issued by the Department of Banking Regulation.

- G. If a bank opts to subtract prudential write off at Corporate/Head Office level while reporting Bank Credit as above, bank credit to priority sector and all other sub-sectors so written off should also be subtracted category wise from priority sector and sub-target achievement.

### **Agriculture Credit**

10.14 Hitherto the agriculture advances were bifurcated into direct / indirect agriculture advances, however, in terms of revised guidelines issued by Reserve Bank of India (RBI-2014-15/573 FIDD.CO.Plan.BC.54/04.09.01/2014-15 dated April 23, 2015), the present distinction has been dispensed with and the lending to agriculture sector has been defined to include:

- (i) Farm Credit (which will include short-term crop loans and medium/long-term credit to farmers)
- (ii) Agriculture Infrastructure and
- (iii) Ancillary Activities.

10.15 A list of eligible activities under the three sub-categories is indicated below:

#### **(i) Farm Credit**

- A. Loans to individual farmers [including Self Help Groups (SHGs) or Joint Liability Groups (JLGs), i.e. groups of individual farmers, provided banks maintain disaggregated data of such loans] and Proprietorship firms of farmers, directly engaged in Agriculture and Allied Activities, viz., dairy, fishery, animal husbandry, poultry, bee-keeping and sericulture. This will include:
- a. Crop loans to farmers, which will include traditional/non-traditional plantations and horticulture, and, loans for allied activities.
  - b. Medium and long-term loans to farmers for agriculture and allied activities. (e.g. purchase of agricultural implements and machinery, loans for irrigation and other developmental activities undertaken in the farm, and developmental loans for allied activities.)
  - c. Loans to farmers for pre and post-harvest activities, viz., spraying, weeding, harvesting, sorting, grading and transporting of their own farm produce.

### **Guidance Note on Audit of Banks (Revised 2020)**

---

- d. Loans to farmers up to Rs. 50 lakh against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months.
  - e. Loans to distressed farmers indebted to non-institutional lenders.
  - f. Loans to farmers under the Kisan Credit Card Scheme.
  - g. Loans to small and marginal farmers for purchase of land for agricultural purposes.
- B. Loans to corporate farmers, farmers' producer organizations/companies of individual farmers, partnership firms and co-operatives of farmers directly engaged in Agriculture and Allied Activities, viz., dairy, fishery, animal husbandry, poultry, bee-keeping and sericulture up to an aggregate limit of Rs. 2 crore per borrower.

This will include:

- a. Crop loans to farmers which will include traditional/non-traditional plantations and horticulture, and, loans for allied activities.
- b. Medium and long-term loans to farmers for agriculture and allied activities. (e.g. purchase of agricultural implements and machinery, loans for irrigation and other developmental activities undertaken in the farm, and developmental loans for allied activities.)
- c. Loans to farmers for pre and post-harvest activities, viz., spraying, weeding, harvesting, sorting, grading and transporting of their own farm produce.
- d. Loans up to Rs. 50 lakh against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months.

#### **(ii) Agriculture Infrastructure**

- a. Loans for construction of storage facilities (warehouses, market yards, godowns and silos) including cold storage units/ cold storage chains designed to store agriculture produce/products, irrespective of their location.
- b. Soil conservation and watershed development.
- c. Plant tissue culture and agri-biotechnology, seed production, production of bio-pesticides, bio-fertilizer, and vermicomposting.

For the above loans, an aggregate sanctioned limit of Rs. 100 crore per borrower from the banking system, will apply.

**(iii) Ancillary activities**

- a. Loans up to Rs. 5 crore to co-operative societies of farmers for disposing of the produce of members.
- b. Loans for setting up of Agri clinics and Agribusiness Centres.
- c. Loans for Food and Agro-processing up to an aggregate sanctioned limit of Rs. 100 crore per borrower from the banking system.
- d. Loans to Custom Service Units managed by individuals, institutions or organizations who maintain a fleet of tractors, bulldozers, well-boring equipment, threshers, combines, etc., and undertake the farm work for farmers on contract basis.
- e. Outstanding deposits under RIDF and other eligible funds with NABARD on account of priority sector shortfall.

10.16 For the purpose of computation of achievement of the sub-target, Small & Marginal Farmers will include the following:-

- a. Farmers with landholding of up to 1 hectare (Marginal Farmers). Farmers with a landholding of more than 1 hectare and up to 2 hectares (Small Farmers).
- b. Landless agricultural labourers, tenant farmers, oral lessees and share-croppers, whose share of landholding is within the limits prescribed for small and marginal farmers.
- c. Loans to Self Help Groups (SHGs) or Joint Liability Groups (JLGs), i.e. groups of individuals Small and Marginal farmers directly engaged in Agriculture and Allied Activities, provided banks maintain disaggregated data of such loans.
- d. Loans to farmers' producer companies of individual farmers, and co-operatives of farmers directly engaged in Agriculture and Allied Activities, where the membership of Small and Marginal Farmers is not less than 75 percent by number and whose land-holding share is also not less than 75 percent of the total land-holding.

**10.17 Kisan Credit Card (KCC)**

- a. In terms of RBI Circular No. RPCD:F.S.D. BC No. 77/05/09/2011-12 dated 11<sup>th</sup> May, 2012 revised scheme for issue of Kisan Credit card was introduced by RBI, which was subsequently modified vide various circulars. Latest Master Circular No. RBI/2018-19/10 FIDD.CO.FSD.BC. No. 6/05.05.010/2018-19 dated July 04, 2018.

### Guidance Note on Audit of Banks (Revised 2020)

---

- b. The scheme was simple and hassle free for both the farmers and bankers. The scheme was aimed at providing adequate & timely credit support under single window to the farmers for their cultivation and other needs as indicated below:
- Short term credit limits.
    - i. To meet the short-term credit requirement for cultivation of crops.
    - ii. Post-harvest expenses.
    - iii. Produce marketing loan.
    - iv. Consumption requirement of farmer household.
    - v. Working capital for maintenance of farm assets & activities allied to agriculture like dairy, inland fishery etc.
  - Long term Credit Limit:
    - i. Investment credit requirement for agriculture & allied activities.
- c. It may be noted that KCC is not a type of loan, but is a channel for granting either short term or long term agricultural finance.
- d. The Limits are required to be renewed every year. In case of non-renewal higher rate of interest is applicable.
- e. Vide RBI Circular No. RBI/2018-19/112 FIDD.CO.FSD.BC.12/05.05.010/2018-19 dated 4<sup>th</sup> February 2019, it has been decided to extend KCC facility to Animal Husbandry farmers and Fisheries for their working capital requirements.
- f. The master circular No. RBI/2018-19/10 FIDD.CO.FSD.BC. No. 6/05.05.010/ 2018-19 dated July 04, 2018, throws more light on the following macro topics:
- i. Eligibility for KCC
  - ii. Fixation of credit limit / Loan amount for :
    - All farmers other than marginal farmers
    - For Marginal Farmers
  - iii. How Disbursement takes place
  - iv. Issue of Electronic Kisan Credit Cards
  - v. Validity/Renewal
  - vi. Rate of Interest (ROI)

- vii. Repayment Period
- viii. Margin
- ix. Security
- x. Other features like :
  - Interest subvention
  - Payment of insurance through KCC
  - Simple documentation
- xi. Classification of account as NPA
- xii. Delivery Channels - Technical features :
  - Issue of cards
  - Type of Card
  - Delivery Channels
  - Mobile Banking / Other Channels

**10.18 Interest Application**

- a. Unlike normal loans, the interest on agricultural advances is not charged at monthly rests but is charged normally at half yearly or annual rests.
- b. Compounding of Interest is generally not permitted in respect of an Agricultural advance, unless it turns out to be a non-performing advance.
- c. The RBI *vide* its circular no. DBOD No. Dir. BC. 25/13.03.00/2002-03 dated September 19, 2002 had advised the banks that instructions regarding charging of interest on monthly rests shall not be applicable to agricultural advances and banks shall continue to follow the existing practice of charging/compounding of interest on agricultural advances linked to crop seasons.

Examples of Interest application according to crop seasons and for other activities:

<b>Crop Season</b>	<b>Kharif</b>	<b>Rabi</b>	<b>Horticulture</b>
Disbursement Period	April 01 to Sept 30	Oct 01 to March 31	
Interest Application	Annual	Annual	Annual
Interest Application date	31st March	30th June	31st March

**Guidance Note on Audit of Banks (Revised 2020)**

Compounding	Annual	Annual	Annual
Due Date	31st March	30th June	One year after first disbursement every year.
Compounding from date	After 31st March	After 30th June	After end of year (to be calculated from date of first disbursement every year)
Penal Interest	If overdue, after 31st March	If overdue, after 30th June	If overdue, from the due date

	Allied Activities	
	Dairy, Poultry	Goat Rearing, Piggery
Repayment	Quarterly	Half Yearly / Yearly
Interest Application	Quarterly	Half Yearly / Yearly
Interest application date	Quarter end	Half Year end / Year end
Compounding Frequency	Quarterly	Half Yearly / Yearly
Compounding from date	After Quarter end	After Half Year end / Year end
Penal Interest	If overdue, after Quarter end	If overdue after half year /year end.

**Interest Subvention**

10.19 Public / Private Sector Scheduled Commercial Banks (in respect of loans given by the rural and semi urban branches) are eligible under the scheme. On a loan given at 9% interest, subvention of 2% p.a. is allowed on their own funds used for short term crop loans upto Rs.3.00 lakh per farmer. Short term credit, thus made available at 7% p.a. to farmers, is considered for interest subvention. This is calculated on the crop loan amount from the date of its disbursement/ drawal up to the date of actual repayment of the crop loan by the farmer or up to the due date of the loan fixed by the banks, whichever is earlier, subject to a maximum period of one year.

10.20 From 2011-12, additional interest subvention of 3% to those farmers, who repay their short term crop loans promptly and on or before the due date, thus making total interest subvention @ 2%+3% i.e. 5%. Farmers, who promptly



repay their crop loans as per the repayment schedule fixed by the banks, are offered loans at an effective interest rate of 9% - 5% i.e. 4% p.a.

10.21 The RBI vide its circular no. RBI/2017-18/190 FIDD.CO.FSD.BC.No.21/05.04.001/2017-18 dated June 07, 2018 has specified continuation of the interest subvention scheme for 2018-19 on the terms and conditions approved for the scheme for 2017-18.

10.22 The RBI vide Circular No. RBI/2019-20/48 FIDD. CO. FSD. BC. No. 10/05.02.001/ 2019-20 dated 26<sup>th</sup> August 2019, has decided to extend interest subvention for KCC facility to Animal Husbandry farmers and Fisheries for two years 2019-20 and 2020-21 on specified stipulations.

**10.23 Additional subvention to short term crop loans also affected by natural calamity.** Further, As notified by the Government of India (Subject to inclusion in the Interest Subvention Scheme on short term crop loans) from time to time, to provide relief to farmers availing short term crop loans and affected by a natural calamity, an interest subvention of 2 percent per annum shall be made available to banks for the first year on the restructured loan amount. Such restructured loans shall attract normal rate of interest from the second year onwards.

#### **Interest subvention scheme to post harvest loans**

10.24 Scheme extended to small and marginal farmers (having Kisan Credit Card) for a further period upto six months, post-harvest, against negotiable warehouse receipt for keeping their produce in warehouses. To discourage distress sale by farmers and to encourage them to store their produce in warehouses against warehouse receipts.

10.25 Auditors have to submit certificate of Interest Subvention alongwith annual accounts of the branch audited by them.

10.26 To ensure hassle-free benefits to farmers under Interest Subvention Scheme, banks are advised to make Aadhar linkage mandatory for availing short-term crop loans in 2018-19 and 2019-20.

10.27 Further, all short term crop loans processed in 2018-19 are required to be brought on ISS portal / DBT platform. Banks are advised to capture and submit category wise data of beneficiaries under the scheme and report the same on ISS portal individual farmer wise once it is launched to settle the claims arising from 2018-19 onwards.

***Audit Procedure***

1. Obtain written representation from the management about the scheme and its applicability.
2. For details of short term crop loans qualifying for subvention, obtain information in Format I and Format II submitted by the Branch to HO or submitted by Bank to RBI. (Refer to annexure 1 and annexure 2 )
3. Obtain list of eligible borrowers with outstanding balance.
4. Interest on the loan account has been properly charged. Ensure that the interest is first credited to the account and then a claim is made for reimbursement.
5. The subvention is computed properly for the eligible year and credited in respective borrower account.
6. Inquire about any rejection made in earlier year's claims and reasons thereof.

As per RBI circular, the auditor needs to certify the correctness of the claim, so the substantive testing needs to be carried out for examinations.

**Non-achievement of priority sector targets**

10.28 Scheduled Commercial Banks having any shortfall in lending to priority sector shall be allocated amounts for contribution to the Rural Infrastructure Development Fund (RIDF) established with NABARD and other Funds with NABARD/NHB/SIDBI/ MUDRA Ltd., as decided by the Reserve Bank from time to time. The achievement will be arrived at the end of financial year based on the average of priority sector target /sub-target achievement as at the end of each quarter.

10.29 While computing priority sector target achievement, shortfall / excess lending for each quarter will be monitored separately. A simple average of all quarters will be arrived at and considered for computation of overall shortfall / excess at the end of the year. The same method will be followed for calculating the achievement of priority sector sub-targets. An Illustrative example is given in Annex of Master Directions No. RBI/FIDD/2016-17/33 FIDD.CO.Plan.1/04.09.01/2016-17 dated July 07, 2016 (Updated as on December 05, 2019) "Priority Sector lending – Target and Classification".

10.30 The interest rates on banks' contribution to RIDF or any other Funds, tenure of deposits, etc. shall be fixed by RBI from time to time. The misclassifications reported by the Reserve Bank's Department of Banking Supervision would be adjusted/ reduced from the achievement of that year, to

which the amount of declassification/ misclassification pertains, for allocation to various funds in subsequent years. Non-achievement of priority sector targets and sub-targets will be taken into account while granting regulatory clearances/approvals for various purposes.

### **Categories of Agriculture Credit**

10.31 The credit needs of cultivators fall into three broad categories:

#### **I Farm Credit**

- A. Loans to individual farmers [including Self Help Groups (SHGs) or Joint Liability Groups (JLGs), i.e. groups of individual farmers, provided banks maintain disaggregated data of such loans] and Proprietorship firms of farmers, directly engaged in Agriculture and Allied Activities, viz., dairy, fishery, animal husbandry, poultry, bee-keeping and sericulture. This will include:
- (i) Crop loans to farmers, which will include traditional/non-traditional plantations and horticulture, and, loans for allied activities.
  - (ii) Medium and long-term loans to farmers for agriculture and allied activities (e.g. purchase of agricultural implements and machinery, loans for irrigation and other developmental activities undertaken in the farm, and developmental loans for allied activities.)
  - (iii) Loans to farmers for pre and post-harvest activities, viz., spraying, weeding, harvesting, sorting, grading and transporting of their own farm produce.
  - (iv) Loans to farmers up to ₹50 lakh against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months.
  - (v) Loans to distressed farmers indebted to non-institutional lenders.
  - (vi) Loans to farmers under the Kisan Credit Card Scheme.
  - (vii) Loans to small and marginal farmers for purchase of land for agricultural purposes.
- B. Loans to corporate farmers, farmers' producer organizations/companies of individual farmers, partnership firms and co-operatives of farmers directly engaged in Agriculture and Allied Activities, viz. dairy, fishery, animal husbandry, poultry, bee-keeping and sericulture up to an aggregate limit of ₹2 crore per borrower. This will include:

## **Guidance Note on Audit of Banks (Revised 2020)**

---

- (i) Crop loans to farmers which will include traditional/non-traditional plantations and horticulture, and, loans for allied activities.
- (ii) Medium and long-term loans to farmers for agriculture and allied activities (e.g. purchase of agricultural implements and machinery, loans for irrigation and other developmental activities undertaken in the farm, and developmental loans for allied activities.)
- (iii) Loans to farmers for pre and post-harvest activities, viz., spraying, weeding, harvesting, sorting, grading and transporting of their own farm produce.
- (iv) Loans up to ₹50 lakh against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months.

### **II. Agricultural Infrastructure**

- i) Loans for construction of storage facilities (warehouse, market yards, godowns and silos) including cold storage units/cold storage chains designed to store agriculture produce/products, irrespective of their location.
- ii) Soil conservation and watershed development
- iii) Plant tissue culture and agri-biotechnology, seed production, production of bio-pesticides, bio-fertilizer, and vermi composting.

For the above loans, an aggregate sanctioned limit of ₹100 crore per borrower from the banking system, will apply

### **III. Ancillary Activities**

- (i) Loans up to ₹5 crore to co-operative societies of farmers for disposing of the produce of members.
- (ii) Loans for setting up of Agriclincs and Agribusiness Centres.
- (iii) Loans for Food and Agro-processing up to an aggregate sanctioned limit of ₹100 crore per borrower from the banking system.
- (iv) Loans to Custom Service Units managed by individuals, institutions or organizations who maintain a fleet of tractors, bulldozers, well-boring equipment, threshers, combines, etc., and undertake farm work for farmers on contract basis.
- (v) Bank loans to Primary Agricultural Credit Societies (PACS), Farmers' Service Societies (FSS) and Large-sized Adivasi Multi-Purpose Societies (LAMPS) for on-lending to agriculture.

- (vi) Loans sanctioned by banks to MFIs for on-lending to agriculture sector as per the conditions specified in paragraph 19 of the Master Direction on Priority sector lending-targets and classification.
- (vii) Loans sanctioned by banks to registered NBFCs (other than MFIs) as per conditions specified in paragraph 21 of the Master Direction on Priority Sector Lending-Targets and Classification.
- (viii) Outstanding deposits under RIDF and other eligible funds with NABARD on account of priority sector shortfall.

As per the extant RBI guidelines, “long duration” crops would be crops with crop season longer than one year and crops, which are not “long duration” crops would be treated as “short duration” crops. The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Banker’s Committee in each State depending upon the duration of crops raised by an agriculturist.

### **State Level Banker’s Committee (SLBC)**

10.32 The Agriculture finance is supervised and monitored by State Level Banker’s Committee (‘SLBC’) and its decisions are implemented by all banking sector having branches in the state. Every state has its own SLBC and guidelines have been issued to banks to develop agricultural finance.

10.33 The SLBC is an inter-institutional forum for co-ordination and joint implementation of development programmes and policies by all the financial institutions operating in a state. Although SLBC is envisaged as a bankers’ forum, Government officials are also included. The Lead Bank is designated as ‘Convener Bank’. The State Level Banker’s Committee meets once a quarter.

10.34 The SLBC of the respective state decides the crop season for each crop, which effectively means the period upto harvesting of the crop raised and the banks of the respective state have to adhere with the crop season as decided by the SLBC of that respective state. Hence, practically it may occur that same crop may have different harvesting season in different states as decided by the respective SLBC of those states. In these cases, the auditor needs to verify whether the Banks have the requisite mechanism to map the crop season(s) vis-à-vis the crop season(s) as defined by the SLBC of each state as any discrepancies may have a direct impact on identification of NPAs. Auditors are advised to refer to the guidelines issued by SLBC of the state wherein the branch under the audit is located. An example of Harvesting Season as defined by SLBC in Maharashtra state in various years is as follows:

**Maharashtra SLBC**

10.35 Based on the resolution and minutes of 71<sup>st</sup> steering committee meeting of SLBC held on September 6, 2004 following guidelines have been framed for identification of NPA's in respect of Farm credit (erstwhile Direct Agricultural Advances) and come into effect from September 30, 2004.

It was decided that in Maharashtra State except sugarcane and banana, all other crops would be reckoned as Short duration crops.

**A. Short Duration Crops:**

1. Kharif / Rabi crops: A loan granted for Kharif / Rabi crop will be treated as NPA if the instalment of principal or interest thereon remains overdue for a period of 21 months from repayment due date.
2. Horticulture Crops: A loan granted for Horticultural crop will be treated as NPA if the instalment of principal or interest thereon remains overdue for a period of 24 months from repayment due date.

**B. Long Duration Crops:**

1. Perennial Crop Sugarcane (Adsali): A loan granted for sugarcane (Adsali) will be treated as NPA if the instalment of principal or interest remains overdue for a period of 18 months from repayment due date.
2. Perennial Crop Banana (Mrig Bahar): A loan granted for banana crop will be treated as NPA if the instalment of principal or interest remains overdue for a period of 21 months from repayment due date.
3. Repayment due date means the date fixed at the time of sanction of loan for repayment of crop loan or instalments/interest of term loan.

**C. Agricultural term Loan:**

Depending upon the duration of crops raised (e.g., short duration, long duration or both), by an agriculturalist, respective overdue period as applicable to the crops mentioned above in (A) and (B) will be applicable for identification of NPAs in agricultural term loans availed by the borrower.

**10.36 While identifying NPAs following points may be noted:**

- a. Term loan/s availed with crop loan/s: Where an agriculturist has availed loans both for short duration as well as long duration crops along with Term loan/s, such term loan/s will be classified as NPA if either of the loans for short duration or long duration crops is classified as NPA.

Example 1: An agriculturist avails following loans

**Guidance Note on Audit of Banks (Revised 2020)**

---

- i) Crop loan for kharif crop (a short duration crop) is availed on 1.6.2016 for which repayment due date prescribed is 31.03.2017.
- ii) Crop loan for Adsali sugarcane (a long duration crop) is availed on 1.7.2016 for which repayment due date prescribed is 30.06.2018.
- iii) A term loan for deepening of well is availed on 01.05.2016 for which first repayment instalment is due on 30.06.2018.

If crop loan for Kharif crop remains overdue up to 31.12.2018 (i.e. overdue for 21 months after repayment due date of 31.03.2017) this crop loan along with the crop loan for sugarcane and term loan for deepening of well, will be classified as NPA with effect from 31.12.2018.

- b. Term loan/s availed without crop loan: where an agriculturist has availed only Agricultural Term Loan without availing any crop loan, details of crops grown (i.e. whether kharif / Rabi, horticulture, sugarcane or banana) are required to be obtained, verified and recorded. Based on the duration of these crops, overdue period for each crop as stated in (A) or (B) above will be identified and recorded. If the term loan remains overdue for the period identified as above, the same will be classified as NPA.

Example 2: In the example 1 referred to above, if only term loan is availed without availing crop loan for kharif crop & sugarcane, which are actually grown by the borrower, overdue period will be identified as 21 months for kharif crop and 18 months for sugarcane crop as mentioned in above paragraphs. The term loan will become NPA if its instalment of principal or interest remains overdue for 18 months from repayment due date i.e., from 30.06.2018 (overdue period applicable will be the lower of 18 or 21 months as applicable for crops grown by the borrower). Thus the loan for deepening of well will become NPA on 31.12.2019.

***RBI Clarification received by Maharashtra SLBC***

10.37 Loan may be treated as NPA immediately on completion of two crop seasons / one crop season (as the case may be, depending on the duration of the crops) after the repayment due date. Two crop seasons after the due date should refer to only those two consecutive crop seasons in which the farmer usually undertakes crop production.

10.38 The crop season for each crop, means the period up to harvesting of the crops raised. The asset classification norms assume that there is normal crop yield during the season for which credit is extended. Hence, immediately after consecutive two harvest seasons (as per the cultivation pattern followed by the farmer borrower) from repayment due date, the account is to be identified as

NPA as per the revised guidelines. In case the yield is affected by natural calamities as declared by the State Government, the loan accounts should be restructured / rescheduled.

### **Example of NPA identification**

#### 10.39 NPA in Agricultural advances

- i. A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons. A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season. For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops, would be treated as "short duration" crops. The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made applicable to agricultural term loans availed of by him.

The above norms should be made applicable only to Farm Credit extended to agricultural activities as listed at paragraph III (1) of the Circular No. FIDD.CO.Plan. BC.54/04.09.01/ 2014-15 dated April 23, 2015 "Priority Sector Lending – Targets and Classification". An extract of the list of these items is furnished in the Annex - 2 of the Circular. In respect of agricultural loans, other than those specified in the Annex - 2 of the Circular and term loans given to non-agriculturists, identification of NPAs would be done on the same basis as non-agricultural advances, which, at present, is the 90 days delinquency norm.

- ii. Where natural calamities impair the repaying capacity of agricultural borrowers for the purposes specified in Annex - 2 of the circular, banks may decide on their own as a relief measure conversion of the short-term production loan into a term loan or re-schedulement of the repayment period; and the sanctioning of fresh short-term loan, subject to guidelines contained in RBI circular no. FIDD.No.FSD.BC.52/ 05.10.001/2014-15 dated March 25, 2015 "Guidelines for Relief Measures by Banks in Areas Affected by Natural Calamities".
- iii. In such cases of conversion or re-schedulement, the term loan as well as fresh short-term loan may be treated as current dues and need not be classified as NPA. The asset classification of these loans would thereafter be governed by the revised terms & conditions and would be treated as



**Guidance Note on Audit of Banks (Revised 2020)**

NPA if interest and/or instalment of principal remains overdue for two crop seasons for short duration crops and for one crop season for long duration crops. For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" would be treated as "short duration" crops.

- iv. While fixing the repayment schedule in case of rural housing advances granted to agriculturists under Indira Awas Yojana and Golden Jubilee Rural Housing Finance Scheme, banks should ensure that the interest/instalment payable on such advances are linked to crop cycles.

10.40 Example of NPA identification for various types of Crop loans is given as follows.

<b>Particulars</b>	<b>Rabi Season</b>	<b>Kharif Season</b>	<b>Rabi Season</b>	<b>Sugarcane</b>	<b>Banana</b>
Year of Finance	2017-18	2018	2018-19	October	July
Date of Finance	From 1/10/2017	From 1/4/2018	From 1/10/2018	From 1/10/2017	From 1/7/2017
Season starts	Oct. 2017	May/June 2018	Oct. 2018	Oct-Nov.17	July-Oct.17
Harvesting Time	March / April 2018	Nov. 2018	March/ April 2019	Oct/Dec.18	Sept.18- Dec.18
Repayment Due date	Up to 30/9/2018	Up to 31/3/2019	Up to 30/9/2019	Up to 31/12/2018	Up to 31/12/2018
<b>First Crop Season after due date:</b> (For Dual Crop Farmer i.e. he is growing Rabi and Kharif Crop both in a year)					
Season starts	May/June 18	Oct., 2018	June 19	1/10/2018	1/7/2018
Harvesting Time	Nov. 2018	March/ April 19	Nov. 2019	Oct./Nov.19	Sept.19- Dec.19
<b>Second Crop Season after due date:</b> (For Dual Crop Farmer i.e. he is growing Rabi and Kharif Crop both in a year)					
Season starts	Oct/Nov 18	May/June 2019	Oct./Nov 19		

**Guidance Note on Audit of Banks (Revised 2020)**

Harvesting Time	March/ April 2019	Nov. 19	March 2020		
NPA Date	30/6/2019	31/12/19	30/6/2020	31/12/2019	31/12/2019
<b>First Crop Season after due date:</b> (For Mono Crop Farmer i.e. he is growing only one crop in a year.)					
Season starts	Oct/Nov 18	May/June 2019	Oct./Nov 19		
Harvesting Time	March/ April 2019	Nov. 19	March 2020		
<b>Second Crop Season after due date:</b> (For Mono Crop Farmer i.e. he is growing only one crop in a year.)					
Season starts	Oct/Nov 19	May/June 2020	Oct./Nov 20		
Harvesting Time	March/ April 2020	Nov. 20	March 2021		
NPA Date	30/6/2020	31/12/20	30/6/2021		

<b>Allied Activity (Instalment)</b>				
<b>Type</b>	<b>Dairy</b>	<b>Goat Rearing</b>	<b>Piggery</b>	<b>Poultry</b>
	(equated quarterly instalment with moratorium period, first instalment is due on Sept 30, 2018)	(equated half yearly / yearly instalment considering moratorium period of six months first instalment is due on June 30, 2019)	(equated half yearly / yearly instalment considering moratorium period of six months first instalment is due on June 30, 2019)	(equated quarterly instalment with moratorium period, first instalment is due on Sept 30, 2018)
<b>Loan Disbursed</b>	1-Jun-18	1-Jul-18	1-Jul-18	1-Jun-18
<b>Due Date</b>	30-Sep-18	30-Jun-19	30-Jun-19	30-Sep-18
<b>Overdue Date</b>	1-Oct-18	1-Jul-19	1-Jul-19	1-Oct-18

**Guidance Note on Audit of Banks (Revised 2020)**

<b>Compounding</b>	1-Oct-18	1-Jul-19	1-Jul-19	1-Oct-18
<b>NPA turning date</b>	31-Dec-18	30-Sep-19	30-Sep-19	31-Dec-18
<b>Remark</b>	After 90 days overdue	After 90 days overdue	After 90 days overdue	After 90 days overdue

<b>Investment Credit (Instalment)</b>	
Type	Investment Credit - Minor Irrigation system to a farmer cultivating cotton
Loan Disbursed	1-Jun-18
Due Date	31-Mar-19
Overdue Date	1-Apr-19
Compounding	1-Apr-19
NPA turning date	31-Mar-19
Remark	After two crop season. First crop season will end at March 2019 and other will end at March 2020

**Some of the Key Points while Auditing Agriculture Advances**

10.41 The audit approach for agriculture advances has to be on the similar lines as that of other advances. The following is a summary of few Key aspects in the audit of Agricultural Advances:

- a. Sanctioned amount of Agriculture Loans should be as per scale of finance applicable to the land under cultivation and the crop being cultivated. Further, appropriate security should be obtained as per the guidelines framed by the bank.
- b. Auditors should verify that the agricultural credit is extended only after obtaining 'No dues/ No objection certificates' from the existing credit agencies in the area of finance.
- c. Disbursement of agricultural finance is required to be carried out in various 'stages' based on the requirements of farming activity. This needs to be ensured strictly. In some cases, the expenditure is incurred by farmer from his/her own sources or by raising loans from non-institutional lenders and subsequently banks are requested to reimburse the same. In such cases, auditors have to carefully verify the facts from the documents/evidences

### **Guidance Note on Audit of Banks (Revised 2020)**

---

available on record. Under all situations, auditors should verify that the bank holds documents evidencing the utilisation of loans for agricultural activities.

- d. For crop loans, primary security is normally the standing crops under cultivation, as such pre and post sanction visits by the officers of bank, who are experts in Agriculture finance and adequate documentation of visit report is a key control.
- e. While verifying the security offered for agricultural loans, it is to be confirmed that the security is legally enforceable. Standing crops and agricultural machinery and implements are secured by a hypothecation charge, while the agricultural land is secured by a mortgage charge. Auditors have to ensure that amongst others, the following has been duly taken on record by the banks:
  - Copy of the land revenue extracts, with banks charges recorded.
  - Land Tax Assessment and payment receipt.
  - Copy of record with sub registrar. (wherever applicable)
  - Original copies of the title deeds.
  - Search of title deeds and Legal opinion from the advocate on the Bank's approved panel.
  - Valuation of land from a valuer on the Bank's approved panel.
- f. Loans granted to farmers against the security of NSC, KVP or Fixed Deposits of Banks, which has been utilised for agricultural purposes, is allowed to be classified under the category of finance to agriculture under priority sector in schedule 9. However, auditors should carefully verify the loan documents and other supporting documents to ensure that non-agricultural loans are not classified as Agricultural Finance.
- g. Agricultural Advances are required to be serviced through realisation of sale proceeds of crop. Auditors should be skeptical about the nature and timing of credits coming in to service the agricultural loans and ensure that they are from genuine sources.
- h. Auditor should ensure that the Asset Classification criteria (NPA) of two crop season for short duration crop and one crop season for long duration crop are applied only to agriculture advances in the nature of Farm Credit extended to agricultural activities listed in Annex 2 of Circular on Priority Sector Lending RBI Circular No. FIDD.CO.Plan.BC.54/04.09.01/2014-15 dated April 23, 2015. All other agricultural loans other than listed in Annex 2 of the Circular, shall be treated as non agricultural loans.

## **Agricultural Advances Affected by Natural Calamities**

10.42 Paragraph 4.2.13 of the Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated July 1, 2015 deals elaborately with the classification and income recognition issues due to impairment caused by natural calamities. Banks may decide on their own relief measures, viz., conversion of the short term production loan into a term loan or re-schedulement of the repayment period and the sanctioning of fresh short-term loan, subject to the guidelines contained in RBI Master Circular No. RBI/15-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 dated July 1, 2015 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances" and directions contained in RBI Master Direction no. RBI/FIDD/2018-19/64 FIDD.CO.FSD.BC No.9/05.10.001/2018-19 dated October 17, 2018 on "Reserve Bank of India (Relief Measures by Banks in Areas Affected by Natural Calamities) Directions, 2018". In such cases the NPA classification would be governed by such rescheduled terms. Asset classification of remaining amount (if any), not restructured, continue to be governed by original terms & conditions.

10.43 Additional finance granted due to natural calamities treated as standard assets, and will be governed by the terms & conditions of its sanction. Different dues from the borrower (e.g. current dues, dues which are not restructured etc.) will be classified under different asset classification norms. This is accepted departure from the basic principle of IRAC norms, i.e. NPA should be borrower-wise and not facility-wise.

10.44 In such cases of conversion or re-schedulement, the term loan as well as fresh short-term loan may be treated as current dues and need not be classified as NPA. The said benefit of restructuring of assets would not be available for Short-term Crop Loans if the said loan was overdue at the time of occurrence of natural calamity and for Long-term Credits if the borrower has wilfully defaulted in repayment of loan in earlier years. The asset classification of these loans would thereafter be governed by the revised terms & conditions and would be treated as NPA if interest and/or instalment of principal remain overdue for two crop seasons for short duration crops and for one crop season for long duration crops. For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" would be treated as "short duration" crops.

10.45 In case of receipt of claim of crop insurance, the insurance proceeds shall ideally compensate the losses. Under the Prime Minister Fasal Bima Yojana (PMFBY), all Seasonal Agricultural Operations (SAO) loans for notified

crops in notified areas are to be compulsorily provided insurance cover for all stages of the crop cycle including post-harvest risks in specified instances. There are further ancillary measures prescribed by RBI for providing relief in terms of relaxation on KYC norms, providing access to banking services, etc.

### **Collateral Free Agricultural Loans**

10.46 RBI vide notification No FIDD.CO.FSD.BC.No.13/05.05.010/2018-19 dated February 7, 2019 has increased the collateral free limit for Agricultural Loans from Rs.1 Lac to Rs.1.60 Lac. (Refer earlier circular RPCD.PLFS.BC.No 85/05.04.02/2009-10 dated June 18, 2010).

### **Agricultural Debt Relief / Waiver Schemes**

10.47 There are various state and central government debt waiver / relief schemes which are implemented for providing relief to the affected agriculture borrowers. An auditor is advised to go through the schemes so declared and implemented by state / central government for providing agricultural debt relief / waiver as the case may be and consider the same in terms of eligible loans under the scheme, amount of relief / waiver provided, asset classification norms and accounting.

#### ***Audit Procedure***

1. Obtain the copy of relevant schemes and bank's circular in this regard.
2. Obtain list of eligible borrowers with outstanding balance.
3. Check the claim amount statement submitted to RO/ZO for claiming the same.
4. Check the accounting entries passed for the credit of eligible amount in the account of the borrower.
5. Verify the accounting of interest and other charges to be borne by the lending institution as per the scheme.
6. Ensure reporting requirement as per closing instructions of the bank.
7. Obtain written representation from the management about the scheme and its applicability including cutoff amount and period of loan disbursed.

#### **Important points**

- i) Here Land holding being the deciding criterion for an Agricultural Loan to an individual farmer, a company though the objects are farming etc., if it is not a farm producer Company and none of its directors hold land, it shall not qualify for Agri Loans in that category.

**Guidance Note on Audit of Banks (Revised 2020)**

---

- ii) Loans given for the purchase of some vehicles like Balero, Maruti VAN, Bikes and some other two wheelers and Four wheelers shall come under commercial vehicle Loan category. For purchase of Tractors loan can be given as Agri Term Loan.
- iii) Loans to fishermen for purchase of trawlers/ Boats etc. can be considered.
- iv) SHG and JLGs where farmers are members of the Group, qualify to take Agricultural Loans. Further Loans are categorised according to the activities carried out by the Groups and purpose for which the loans are taken.
- v) If the term deposits are given by farmers to the Primary Agricultural Societies which are deposited in Banks, the Societies qualify for Loans against the deposits. The primary Agriculture Society can back to back, give loans to its member farmers.

**Annexure 1**

**Format I**

Claim for 2% Interest Subvention on Short-term Crop Loans/ Post-harvest credit against negotiable warehouse receipts/ Loans restructured due to NC/ Loans restructured due to Severe NC, up to Rs. 3 lakh for the year 2018-19 / 2019-20

Name of the Bank: \_\_\_\_\_

Statement for the half year / year ended on

September 20 / March 20 \_ / Additional Claim

	*Total short term production credit at 7% p.a		Amount of total subvention claimed (Rs. in actuals)
	No. of accounts (in thousands)	Amount Disbursed / drawn (Rs. lakh)	
Loans up to Rs.3 lakh			

Category-wise claim for 2% Interest Subvention for 2018-19 / 2019-20 for All India except North East region

	*Total short term production credit at 7% p.a. for All India except North East region								
	General			SC			ST		
	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. In actual)	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. In actual)	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. In actual)
Loans up to Rs.3 lakh									



**Guidance Note on Audit of Banks (Revised 2020)**

Category-wise claim for 2% Interest Subvention for 2018-19 /  
2019-20 for North East region

	<b>*Total short term production credit at 7% p.a. for North East region</b>								
	<b>General</b>			<b>SC</b>			<b>ST</b>		
	<b>No. of accounts (in thousand)</b>	<b>Amount Disbursed/ drawn (Rs. lakh)</b>	<b>Amount of subvention claimed (Rs. in actuals)</b>	<b>No. of accounts (in thousand)</b>	<b>Amount Disbursed/ drawn (Rs. lakh)</b>	<b>Amount of subvention claimed (Rs. In actuals)</b>	<b>No. of accounts (in thousand)</b>	<b>Amount Disbursed/ drawn (Rs. lakh)</b>	<b>Amount of subvention claimed (Rs. in actuals)</b>
Loans up to Rs.3 lakh									

- i) We certify having disbursed the above loans at 7% p.a. up to Rs. 3 lakh by way of short-term production credit to the farmers during the year 2018-19 / 2019-20.

Sd/-

Authorised Signatory of the Bank

- ii) (Statutory auditor certifying the correctness of the subvention claim) Sd/

Seal and Signature of Auditor

Date:

(This claim format needs to be duly certified by Statutory Auditors with the Firm Registration Number and Membership Number of all Signatories)

\*May be modified suitably for post-harvest credit against negotiable warehouse receipts/ Loans restructured due to NC/ Loans restructured due to severe NC

**Annexure 2**

**Format II**

One - time Claim for Additional 3 per cent Subvention for timely repayment of Short-term Crop Loans / Loans restructured due to Severe NC, up to Rs.3 lakh disbursed in 2018-19 / 2019-20

Name of the Bank: \_\_\_\_\_

	*Total short term production credit at 7% p.a		*Total short term production credit which were repaid in time		Amount of additional subvention claimed @ 3% (Rs. in actuals)
	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	No. of accounts (in thousands)	Amount disbursed drawn (Rs.lakh)	
Loans up to Rs.3 lakh					

Category-wise one-time claim for additional 3% Subvention for 2018-19 / 2019-20 for All India except North East region

	*Total short term production credit which were repaid in time for All India except North East region								
	Geneal			SC			ST		
	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. in actuals)	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. in actuals)	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. in actuals)
Loans up to Rs.3 lakh									

**Guidance Note on Audit of Banks (Revised 2020)**

Category-wise one-time claim for additional 3% Subvention for 2018-19 / 2019-20 for North East region

	<b>*Total short term production credit which were repaid in time for North East region</b>								
	<b>General</b>			<b>SC</b>			<b>ST</b>		
	<b>No. of accounts (in thousands)</b>	<b>Amount Disbursed/ drawn (Rs. lakh)</b>	<b>Amount of subvention claimed (Rs. in actuals)</b>	<b>No. of accounts (in thousands)</b>	<b>Amount Disbursed/ drawn (Rs. lakh)</b>	<b>Amount of subvention claimed (Rs. in actuals)</b>	<b>No. of accounts (in thousands)</b>	<b>Amount Disbursed/ drawn (Rs. lakh)</b>	<b>Amount of subvention claimed (Rs. in actuals)</b>
Loans up to Rs.3 lakh									

- i) We certify that the above loans for which the claim is being made were repaid in time and the benefit of additional 3 percent incentive subvention has already been passed on to the account holders, thereby bringing down the interest rate for such farmers to 4 per cent per annum for short term production credit / Loans restructured due to Severe NC, up to Rs. 3 lakh disbursed during 2018-19 / 2019-20 for these farmers.

Sd/-

Authorised Signatory of the Bank

- ii) (Statutory Auditor certifying the correctness of the subvention claim) Sd/- Seal and Signature of Auditor Date:

(This claim format needs to be duly certified by Statutory Auditors with the Firm Registration Number and Membership Number of all Signatories)

\*May be modified suitably for Loans restructured due to severe NC.

## Reporting for Advances

---

### Introduction

11.01 Lending constitutes a major activity of a bank besides the investment function. The core business of banks is accepting deposits for onward lending. Advances, generally, constitute the largest item on the assets side of the balance sheet of a bank and are major source of its income.

11.02 Audit of advances is one of the most important areas covered by auditors in bank audit. It is necessary that auditors have adequate knowledge of the banking industry and its regulations. Auditors must be aware of various functional areas of the bank/branches, its processes, procedures, systems and prevailing internal controls with regard to advances.

11.03 Advances generally comprise of:

- a) Money lent by bank to its customers including interest accrued & due;
- b) Debit balances in depositor accounts;
- c) Inter-Bank Participation Certificates.

11.04 Every bank has its credit policy approved by its board of director which is updated at regular intervals. The credit policy is in line with applicable RBI guidelines, relevant laws and regulations. Auditors must acquaint themselves with the credit policy of the bank and the advances portfolio composition.

### Type of Advances and Nature of Security

#### Types of Advances

##### Fund Based and Non-Fund Based Credit Facilities

11.05 In Fund based credit facilities, there is an actual outflow of funds from the bank to the borrower, whereas non-fund based facilities, do not involve outflow of bank's funds. Typical fund based facilities are term loans, cash credits and overdrafts while non-fund based facilities are letters of credit, bank guarantees, letter of comfort/undertaking, etc. Non-fund based facility may turn into a fund based facility on due date, if not paid by the borrower, for e.g. devolvement of bills under LC, invocation of Bank Guarantee, etc.

## **Fund Based Facilities**

### ***Cash Credit***

11.06 Cash credit facility is provided to entities (borrowers) engaged in manufacturing and / or trading activities to enable them meet the gap in their working capital requirements. This facility is repayable on demand. The cash credit facility is generally granted against security of stocks of goods (net of trade creditors), standing crops, bills / book debts representing genuine sales (restricted to pre-defined age of such book debts).

11.07 A cheque book is issued to the borrower for withdrawal of money against the limit sanctioned. The withdrawals are permitted to the extent, lower of drawing power or sanctioned limit. This is a revolving facility and is, generally, reviewed and renewed annually or on other intervals as per Bank policy. The Bank performs a periodical review of the borrower based on his credit assessment.

11.08 Cash credit advances are generally on 'floating' interest rate basis. The rate is reset periodically, depending upon changes in the bank's base rate (MCLR – Marginal Cost of fund based Lending Rate) / spread in relation to the borrower class and his risk perception.

### ***Working Capital Demand Loan (WCDL)***

11.09 WCDL is granted for a fixed period on expiry of which it has to be liquidated, renewed or rolled over. WCDL is generally granted to meet the working capital requirement gap and is considered as a part of working capital facility. Depending on the sanction terms, repayment of WCDL can either be in the form of instalments spread over the loan tenure or an end of tenure bullet payment. It has to be ensured that there is actual repayment at the end of the loan tenure by fund flows and not just a renewal by roll-over which could tantamount to ever-greening.

### ***Term Loans***

11.10 Term loans are generally extended for the following purposes:

- setting up of plants, acquisition of fixed assets like land and building, plant and machinery, furniture, vehicles, implements, houses, consumer durables, etc.
- meeting expenses on education/medical treatment of self/dependants.
- meeting other personal expenses.
- Travel – Vehicle - Housing purchase and renovation.
- meeting deficit in net working capital requirements as assessed by the bank.(WCTL)
- Marketing / Launching / Branding etc.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

11.11 Banks may give general purpose loans also i.e. without stipulating any end-use of funds, on the strength of a suitable security, or even without security based on the borrower's credit worthiness. Bank's policy provides guidance and documentation to be obtained for end use of funds in such cases which has to be ensured.

11.12 Term loans are repayable in instalments spread over a period of time excluding the moratorium period, if granted. The moratorium period is assessed by the lender based on future cash flows and borrower requirements. If the borrower defaults in compliance with terms and conditions, the bank has the right to demand repayment of the entire loan outstanding, before due date. In few cases, there are terms for increase in interest rate as stipulated in sanction terms and conditions. The amount, periodicity of repayment, last draw down date and other terms and conditions are fixed at the time of sanction and duly recorded in the loan documents. The amount and periodicity may be uniform throughout the life of the loan, or either or both of them may differ from instalment to instalment. Besides, repayment schedule may either be drawn only for the principal amount in which case periodic interest has to be paid by the borrower separately as and when due, or a schedule may be fixed with 'equated monthly instalments' which also includes amount of interest likely to be applied to the account during its entire tenure at the rate of interest applicable at the time of sanction/documentation/first disbursement. The disbursal may happen in one tranche or more than one tranche as per the borrower requirements.

11.13 The interest rate for loans may be on 'fixed' terms' in which event, the rate contracted originally holds good during the entire loan currency, or it may be on 'variable' terms; where the rate may undergo changes at unspecified periods on happening of certain events as outlined in the loan agreement. This aspect is a subject matter of negotiation between the bank and the borrower. Interest is charged on reducing balance method at monthly rests.

### **Foreign Currency Loans (FCL)**

11.14 Banks are authorised to lend in foreign currency. These loans are sanctioned as per the EXIM Policy and guidelines issued by RBI from time to time. (FCL) may be in nature of Term loans or Working Capital loans. These loans may be issued independently or through conversion of rupee term/working capital loan to (FCL) for a stipulated period as per RBI guidelines.

### **Overdrafts**

11.15 The overdraft facility may be either secured or clean (i.e., without security) and does not generally carry a fix repayment schedule. The most

common form of security for an overdraft arrangement is term deposit receipts. Overdrafts may also be granted against other securities like immovable properties, life insurance policies, shares, bonds, NSCs, Kisan Vikas Patra, Indira Vikas Patra, etc. In case of term deposit receipts, care is taken to lien mark the deposit in the system and also on physical fixed deposit receipt (not on fixed deposit advice). Fixed deposits are generally for specific period and need to be renewed on maturity. Care should be taken to ensure that interest rate spread between overdraft and fixed deposit is maintained. The bank has to update lien mark on the new fixed deposit. The bank has to ensure that proper margin i.e. security value and loan amount is kept while sanctioning the overdraft and at all times during the loan pendency.

### **Bills**

11.16 Finance against bills is meant to finance the actual sale transactions and can be in any of the below mentioned form:

- Purchase of bills if these are payable 'on demand'.
- Discounting of bills if these are usance (or time) bills.
- Advance against bills under collection from the drawee, whether sent for realisation through the bank or sent directly by the drawer to the drawees.

11.17 Bills may be either 'documentary', i.e., accompanied by original documents of title to goods, or 'clean', i.e., without original documents of title to goods. In case of documentary bills, Bank releases documents of title to the drawee only against payment (in case of demand bills purchased) or against acceptance (in case of usance bills discounted). On release of documents of title after acceptance of usance bills, these assume the nature of clean bills. The bills may be domestic (denominated in rupee for domestic trade) or foreign (denominated in foreign currency for import/export).

11.18 A unique facility under this head is advances against bills drawn on public sector undertakings / government departments which do not accept bills. In such cases, pre-receipted challans are submitted by the borrower to the bank as an evidence for availing finance there against (a pre-receipted challan establishes genuine movement of goods and ensures usage of bank funds for sanctioned purposes only). This facility is commonly known in the banking sector as 'government bills facility' or 'supply bills facility'. The purchase / discounting of bills may be either under or without a letter of credit. In case of dishonour of bills, banks have the right to recover the amount from the drawer with penalty, additional interest, etc.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

11.19 RBI has issued guidelines for regulation of discounting and rediscounting of bills (Ref. Master Circular No. DBR.No.Dir.BC.10/13.03.00/2015-16, dated July 01, 2015, "Loans and Advances-Statutory and other Restrictions").

### **Export**

#### *Export Credit*

11.20 Exporters are granted facilities in form of cash credit and bills only. These facilities are in form of 'pre-shipment credit' and 'post-shipment credit'. All type of advances sanctioned to finance the production cycle – i.e. from procurement of raw materials to bringing them to the port for despatch fall under 'pre-shipment credit' category. It also includes financing of working capital expenses towards rendering of services. The advance is given based on individual order obtained, or sanctioned as an Export Packing Credit (EPC) limit and amounts disbursed on submission of individual orders; in the latter case, EPC becomes a running account. The exporter usually adjusts the account by drawing bills of exchange on the foreign buyer, which are discounted by the bank under the letter of credit and the proceeds collected from the foreign bank. The post-shipment credit relates to financing of bills raised on the overseas buyer upon shipment of goods/ services. The export credit advance may be granted in Indian Rupees or a designated foreign currency. In the latter case, the loan is disbursed in a foreign currency. The export credit is granted at concessional rates of interest. The pre-shipment credit has to be liquidated out of export proceeds only and cannot be adjusted out of rupee funds (except where raw materials required for processing exceed the FOB contract value, in which case the excess advance has to be repaid maximum within 30 days from the date of advance). Export proceeds have normally to be received within 9 months from the shipment date. This period can be extended in genuine cases, with the bank's approval (within discretion available to it under the relevant regulations in force) or RBI approval, as permitted by the Exchange Control Manual and operating instructions issued by the RBI from time to time. The bills representing the export proceeds can be handled only by branches permitted to act as authorised foreign exchange dealers as they involve handling transactions in a foreign currency and reporting to Reserve Bank.

11.21 Pre-shipment credit granted in a foreign currency is called 'Packing Credit in Foreign Currency' (PCFC) advance and has to be repaid out of export bills discounted under the Export Bills Rediscounting (EBR) scheme or out of export proceeds. Each bank designates a few select branches to handle PCFC and EBR transactions. The Rupee Export credit is also allowed to be shared between export order holders and manufacturer of the goods to be exported.



Similarly, bank may extend PCFC to the manufacturer basis of disclaimer from the export order holder through his bank. PCFC granted to the manufacturer can be repaid by transfer of foreign currency from the export order holder by availing of PCFC or by discounting of bills. It should be ensured that no double financing is involved in the transaction and total period of packing credit is limited to actual cycle of production of exported goods. (Ref. Para 5.12 of the Master Circular No. DBR No.DIR.BC.14/04.02.002/2015-16 dated July 1, 2015, "Rupee/Foreign Currency Export Credit & Customer Service to Exporter"). PCFC may be made available to both the supplier of EOU/EPZ/SEZ unit and the receiver of EOU / EPZ / SEZ unit and PCFC for supplier EOU / EPZ / SEZ unit will be for supply of raw material/components of goods which will be further processed and finally exported by receiver EOU / EPZ / SEZ unit. The PCFC extended to the supplier EOU/EPZ/SEZ unit will have to be liquidated by receipt of foreign exchange from the receiver EOU/EPZ/SEZ unit, for which purpose, the receiver EOU/EPZ/SEZ unit may avail of PCFC. The stipulation regarding liquidation of PCFC by payment in foreign exchange will be met in such cases not by negotiation of export documents but by transfer of foreign exchange from the banker of the receiver EOU/EPZ/SEZ unit to the banker of supplier EOU/EPZ/SEZ unit. Thus, there will not normally be any post-shipment credit in the transaction from the supplier EOU/EPZ/ SEZ unit's point of view. In all such cases, it has to be ensured by banks that there is no double financing for the same transaction. The PCFC to receiver EOU/EPZ/SEZ unit will be liquidated by discounting of export bills or by receipt of export proceeds as per Master Circular DBR No.DIR.BC.14/04.02.002/2015-16 dated July 01, 2015, on "Rupee/Foreign Currency Export Credit & Customer Service to Exporter". In this context, attention is invited to RBI's Circular No. DBOD.Dir.BC.NO.57/04.02.001/2013-14 on "Export Credit in Foreign Currency" dated September 25, 2013.

### ***Import***

#### ***Trade Credit – Buyer's Credit***

11.22 This facility is provided by overseas banks / foreign branches of Indian banks to importers of capital goods and raw material through Indian Banks to its customers (importers) towards payment of imports in India. The overseas bank either (i) credits the amount of Buyer's credit in the NOSTRO account of the Indian bank and the Indian bank remits funds to the importer's overseas supplier for payment of import bill or (ii) remits funds to importer's overseas supplier for payment of import bill.

Typical flow of Buyer's Credit transaction (with underlying import through LC transaction) is as follows:

### **Guidance Note on Audit of Banks (Revised 2020)**

---

- 1) The borrower imports goods from foreign supplier against Foreign Letter of Credit (FLC) drawn in favour of foreign supplier;
- 2) The borrower either through its Indian bank or on its own approaches foreign bank (or overseas / foreign branches / offices of Indian banks) for availing Buyer's Credit for payment to be made to foreign supplier;
- 3) The borrower's bank arranges the credit and provides a quote with details of tenure, rate of interest applicable (including margin) and foreign currency conversion rate;
- 4) Letter of Comfort is issued by Indian bank to the foreign bank on approval of terms and conditions through SWIFT message for the proposed Buyer's Credit;
- 5) The foreign Bank remits funds to the NOSTRO Account of Indian bank which is handling import transaction, on the strength of the Letter of Comfort (LoC)/ Letter of Undertaking (LoU) which is issued by the Indian bank in its favour;
- 6) The Indian bank remits funds to foreign supplier through its NOSTRO Accounts;
- 7) The Indian bank subsequently retires and reverses the Letter of Credit in its book and passes another entry for creation of a non-fund based (contingent) liability of Letter of Comfort;
- 8) On the due date of Buyer's Credit, the Indian bank remits the funds (inclusive of interest) to the overseas bank and recovers similar amount from its customer;
- 9) The liability towards Letter of Comfort, is accounted as "Contingent Liability".

Entries of inward and outward remittances (specified in steps 4 and 5) are to be recorded in the books of accounts (NOSTRO Mirror Account) of the Indian bank.

### **Nature of Security**

11.23 Types of securities commonly accepted by banks for granting different kinds of credit facilities are examined in greater detail in this section. Security can be in any form i.e. tangible or intangible, movable or immovable. Further, same is classified into 2 types being, primary and collateral securities.

### **Primary and Collateral Securities**

11.24 'Primary Security' refers to the security offered by the borrower for bank finance or the one against which credit is extended by the bank. Primary

security is the principal security for an advance. A collateral security is an additional security.

### **Mode of Creation of Security**

11.25 Depending on the nature of the advance, creation of security may be in form of a mortgage, pledge, hypothecation, assignment, set-off, or lien.

#### ***Mortgage***

11.26 Mortgage is defined under section 58 of the Transfer of Property Act, 1882, as “the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to a pecuniary liability”.

11.27 Mortgages are of several kinds but the most important are the Registered Mortgage and the Equitable Mortgage. A Registered Mortgage is effected by a registered instrument called the ‘Mortgage Deed’ signed by the mortgagor. It registers the property to the mortgagee as a security. Equitable mortgage, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof. The government mandates registration of all types of mortgages with Central Registry of Securitisation Asset Reconstruction and Security Interest of India (CERSAI) which should be strictly followed by banks.

#### ***Pledge***

11.28 A pledge is defined under section 172 of the Indian Contract Act, 1872, as “the bailment of goods as security for payment of a debt or performance of a promise.” A pledge involves bailment or delivery of goods by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance. The legal ownership of the goods remains with the pledger while the lending banker gets certain defined interest in the goods. The pledge of goods constitutes a specific (or fixed) charge. In a pledge, the bank has all the liabilities and responsibilities of a bailee of goods. The bank may be held responsible for not carrying out their obligations as bailee.

#### ***Hypothecation***

11.29 The term ‘hypothecation’ in commercial parlance refers to the creation of an equitable charge (i.e., a charge created not by an express enactment but by equity and reason), in favour of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower. Neither ownership nor possession is transferred to the bank. However, the borrower holds the physical possession of the goods as an

agent/trustee of the bank. The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker based on which the drawing power of the borrower is fixed.

**Assignment**

11.30 Assignment represents 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 moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment. An assignment gives the assignee absolute right over the moneys/debts assigned to him. The transfer of debt, right or property is subject to all the liabilities and equity to which the transferor was subject on the date of transfer. In other words, the assignee cannot get a better title than that of the assignor.

**Set-off**

11.31 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. A lending bank has the right of set-off in the absence of an agreement, express or implied, to the contrary with the borrower. The 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 in the same right (i.e., the capacity of the account holder in both the accounts should be the same). For purposes of set-off, all bank branches are treated as one single entity. The right of set-off can also be exercised in respect of time-barred debts.

**Lien**

11.32 Lien is creation of a legal charge with the owner's consent, which gives lender a legal right to seize and dispose / liquidate the asset under lien.

**Types of Securities**

11.33 The characteristics of a good security from the view point of the lending bank are marketability; easy ascertain ability and stability of value, clean title, realisability and transferability/transportability.

11.34 The most common types of securities accepted by banks are the following.

**Fixed and Floating Charges**

11.35 A fixed charge (also called 'specific charge') is a charge on some specific and ascertained assets. The creator of the charge (i.e., the borrower)

cannot deal with the asset without the specific consent of the holder of the charge (i.e., the lender). A floating charge, is an equitable charge on the assets, present and future. A floating charge attaches to assets whose condition varies from time to time in the ordinary course of business (e.g., work-in-process). A floating charge crystallises (i.e., becomes a fixed charge) when money becomes repayable and the holder of the charge (i.e., lender) takes necessary steps for enforcement of the security.

***Personal Security of Guarantor***

11.36 The personal security of guarantor comprises a third party guarantee for payment of loan outstanding, in the event of borrower's default. No charge is created on the guarantor's movable or immovable assets.

***Margin***

11.37 Margin on Loans is upfront payment by the borrower towards the purpose of sanctioned loan. Banks provide finance after keeping suitable margin, depending on its risk perception. Margin is deducted from asset value to take care of any downward fluctuations in the asset market value. Generally, margin is prescribed in every sanction letter in terms of percentage of security value, as per bank's credit policy. For certain loans such as advances against gold ornaments and jewellery, RBI has defined limits on the loan to value.

***Stock Exchange Securities and Other Instruments***

11.38 Stock exchange securities include shares, debentures and bonds which are traded on stock exchanges. These securities are easily marketable; the market value is readily ascertainable; it is easy to ascertain the title of the depositor; and they are easy to pledge. Banks have policy for shares against which they provide loans and periodically re-assess the eligible share as security for lending. Banks also advance against instruments as gilt-edged securities, National Savings Certificates, Kisan Vikas Patras, Indira Vikas Patras, Gold Bonds, etc. Banks are not allowed to provide loans to companies for buy back of shares / securities. Banks are also not allowed to provide loans against security of its own shares.

11.39 These securities are usually in the possession of the bank. Wherever the shares are held as security by a bank (as primary or collateral security), banks are required to have them transferred in their own names if the loan amount exceeds the RBI prescribed ceiling). The ceiling is different for shares in dematerialised form and in physical form. In other cases, (i.e., where the loan amount does not exceed the prescribed ceiling), banks accept the aforesaid securities subject to following conditions:

- (a) in the case of physical shares, they are accompanied by blank transfer

## **Guidance Note on Audit of Banks (Revised 2020)**

---

deeds duly signed by the person in whose name they are registered; in case of shares held in dematerialised form, authorisation slips should be obtained from the borrower and passed on to relevant depository participant who immediately marks those shares as pledged; or

- (b) the bank holds a general power of attorney from the person in whose name they are registered.

11.40 If the person in whose name the securities are registered is other than the borrower, the bank has to particularly satisfy itself that the person has a good title to the security. The bank also obtains a letter of renunciation from the person in whose name the securities are registered.

11.41 In the case of advances against bearer securities (Kisan Vikas Patras/ Indira Vikas Patras), banks obtain independent/direct confirmation of the genuineness of the certificates from issuing authorities. After obtaining such confirmation, bank possession is sufficient.

11.42 In case of government paper and inscribed stock, banks should get them registered in their own name while accepting them as security.

11.43 Before accepting shares as security, the lending bank has to ensure that provisions of section 19 of the Banking Regulation Act, 1949 are not contravened except otherwise specifically permitted by RBI regulations. This section prohibits a banking company from holding shares in any company, whether as pledge, mortgagee or absolute owner, of an amount exceeding thirty per cent of the paid up share capital of that company or thirty per cent of its own paid-up share capital and reserves, whichever is less.

### **Goods**

11.44 Goods constitute a significant proportion of the securities taken by banks. They are either stock-in-trade of its trading customers or finished products of manufacturers. Raw materials, work-in-process, etc., are also accepted as security. Banks should have a system in place to ensure that the security in terms of stock offered by borrower is as per bank policy.

11.45 Goods may be either hypothecated to, or pledged with, the bank. As mentioned earlier, in case of hypothecation of goods, banks obtain periodic statements from the borrowers (monthly/quarterly), declaring quantity and value of the goods basis which the borrowers drawing power is fixed. The officers of the lending bank pay regular visits to borrower godowns or factories to inspect and check the correctness of records maintained by the borrowers basis which, the periodic statements are prepared by them. They also check value of the goods in stock with reference to sale bills, market quotations, etc. In case of large advances, inventory is subject to inspection and verification

(stock audit) by external agency at stipulated intervals. The auditor may go through the same for determining existence and adequacy of security and also to determine irregularity in the account, if any.

11.46 Stock registers are maintained by godown keepers of the lending bank in respect of goods pledged with the bank. Godowns are regularly inspected by the inspectors and other bank officers. When goods are brought into the godown, the godown keeper has to satisfy himself, by appropriate test checks, regarding the quantity and quality of goods. Banks have to exercise care to ensure that frauds are not perpetrated against them by pledging packages not containing the specified goods and later on holding them responsible for the goods supposed to have been pledged as per the documents.

11.47 The goods are insured against fire and other risks involved and the insurance policies are either in the name of, or endorsed in favour of, the bank. In case the borrower is a company, the bank has to ensure registration of charge with the Registrar of Companies.

#### ***Documents of Title to Goods***

11.48 A document of title to goods is a negotiable or quasi-negotiable instrument. According to section 2(4) of the Sale of Goods Act, 1930, a document of title is any document used in the ordinary course of business as proof of the possession or control of goods, or authorising or purporting to authorise, either by endorsement or by delivery, the possessor of the document to transfer or receive the goods represented thereby.

Documents of title include:

- Bill of lading
- Railway receipt
- Transporter's receipt
- Dock warrant
- Warehouse-keeper's certificate
- Wharfinger's receipt
- Warrant or order for delivery of goods

Before being pledged with the bank, these documents have to be appropriately endorsed in bank's favour.

#### ***Gold Ornaments and Bullion***

11.49 Gold ornaments are accepted by banks as security on the basis of assessor's certificate regarding the content, purity, weight of gold and value

## **Guidance Note on Audit of Banks (Revised 2020)**

---

thereof. Valuation, keeps on changing as a result of market fluctuations. Loans are given only on basis of gold content of ornaments, without considering gold making charges. RBI, vide Master Circular No. DBR.No.Dir.BC.10/13.03.00/2015-16 on Loans and Advances-Statutory and Other Restrictions dated July 1, 2015, directed banks to give preference to hallmarked jewellery for granting advances. RBI vide Circular No. DBOD.BP.BC.No.86/21.01.023/2013-14 on "Lending against Gold Jewellery" dated January 20, 2014, issued guidance in respect of Advances against Gold Ornaments and Jewellery for purpose of Medical Expenses and Meeting Unforeseen Liabilities". In this context, attention is invited to RBI's Circular No. DBOD.No.BP.79/21.04.048/2013-14 on "Non-Agriculture Loans against Gold Ornaments and Jewellery" dated December 30, 2013 containing guidelines on bullet repayment of loans extended against pledge of gold ornaments and jewellery for other than agricultural purposes.

### ***Life Insurance Policies***

11.50 Life insurance policies have to be assigned in bank's favour and such assignment has to be registered with the insurer. The surrender value of the policies is the basis of valuation.

### ***Plantations***

11.51 Advances are made to agriculturists such as tea gardeners to finance their growing crops. When the produce is harvested, processed and sold, the money is repaid to the bank.

11.52 The basis of calculating amount of the advance is the estimated crop of the season. This depends upon the area under cultivation, expected yield, etc. Separate advances are made for each season's crop.

11.53 The crop to be produced is hypothecated to the bank. Generally, fixed assets of the plantation are also mortgaged with the bank as collateral security. Finance is taken from the bank to incur expenditure on the crop. The amount of the advance increases as the crop grows.

### ***Immovable Property***

11.54 Before advancing money on mortgage of immovable property, the lending bank has to satisfy itself that the borrower has a clear and unencumbered title to the property that is marketable and adequately insured. Banks ascertain whether the property in question has already been mortgaged to any other financial institution and if so, details of charges already created on the property. In respect of advances to public companies against mortgage of a block of assets, it is essential that provisions of section 180(1)(a) of the Companies Act, 2013 are duly considered.



***Third Party Guarantees***

11.55 Advances covered by third party personal guarantees (except banks and government) in addition to borrower's personal security are not classified as 'secured' advances and are classified as 'unsecured' advances.

11.56 The guarantee bond executed by the guarantor in favour of the bank may be in bank's own prescribed form or otherwise. Such bonds are generally executed by holding companies, overseas customers, overseas principals, insurance companies, etc. A letter of continuity is also obtained from the guarantor.

***Banker's General Lien***

11.57 A lending bank also has a general lien under law. A lien represents the right of retaining the goods/securities unless a debt due by a debtor is paid to the creditor (retainer), provided there is no agreement, express or implied, to the contrary. A lien is a statutory right, which does not require any separate agreement. Under section 171 of the Indian Contract Act, 1872, a banker may, in the absence of an agreement to the contrary, retain as security for a general balance of account, any goods and securities bailed to him. This is called banker's general lien.

11.58 Two conditions necessary for creating such lien are:

- (a) Securities must be placed in a banker's hand by his customers; and
- (b) Securities are not specifically appropriated.

11.59 Securities over which a banker has general lien are credit balance in any other account, bonds and coupons deposited for collection, securities allowed to remain in banker's hands after repayment of a secured advance, etc.

11.60 Securities on which a banker does not have a general lien are securities deposited for safe custody, money deposited or earmarked for a specific purpose, documents executed for a special purpose, etc. Lien is applicable even in respect of the borrower's obligations as a surety. The banker's right of general lien over the security is not barred by the law of limitation and can be exercised in case of unenforceable or time-barred debts also.

11.61 'Negative lien' refers to an undertaking given by the borrower to the bank that no charge such as lien, pledge, hypothecation, or mortgage, over his immovable and moveable properties and assets including uncalled capital will be created without bank's prior permission. Negative lien relates to goods, securities, etc., not in Bank's possession. Negative lien does not require registration with Registrar of Companies or similar authorities.

## **Statutory Restrictions**

### ***Advances against Bank's own Shares***

11.62 In terms of Section 20(1) of the Banking Regulation Act 1949, a bank cannot grant any loan or advance against the security of its own shares.

### ***Advances to Bank's Directors***

11.63 Section 20(1) of Banking Regulation Act, 1949 lays down restrictions on loans and advances to directors and firms in which they hold substantial interest.

11.64 Banks are prohibited from entering into any commitment for granting any loans or advances to or on behalf of any of its directors, or any firm in which any of its directors is interested as partner, manager, employee or guarantor, or any company (not being a subsidiary of the banking company or a company registered under Section 8 of the Companies Act, 2013 or a Government company) of which, or the subsidiary or the holding company of which any of the directors of the bank is a director, managing agent, manager, employee or guarantor or in which he holds substantial interest, or any individual in respect of whom any of its directors is a partner or guarantor. Certain exemptions are given in the aforesaid Master Circular in this regard.

11.65 For the above purpose, the term 'loans and advances' shall not include:

- (a) Loans or advances against Government securities, life insurance policies or fixed deposit;
- (b) Loans or advances to Agricultural Finance Corporation Ltd;
- (c) such loans or advances as can be made by a banking company to any of its directors (who immediately prior to becoming a director, was an employee of the banking company) in his capacity as an employee of that banking company and on terms and conditions as would have been applicable to him as an employee of that banking company, if he had not become a director of the banking company. Banking company includes every bank to which provisions of Section 20 of Banking Regulation Act, 1949 apply;
- (d) such loans or advances granted by the banking company to its Chairman and Chief Executive Officer, who was not an employee of the banking company immediately prior to his appointment as Chairman/Managing Director/CEO, for the purpose of purchasing a car, personal computer, furniture or constructing/ acquiring a house for his personal use and festival advance, with prior approval of RBI and on such stipulated terms and conditions;

- (e) such loans or advances granted by a banking company to its whole time director for the purpose of purchasing furniture, car, Personal Computer or constructing/acquiring house for personal use, festival advance with RBI prior approval and on such stipulated terms & conditions;
- (f) Call loans made by banking companies to one another;
- (g) Facilities like bills purchased/discounted (whether documentary or clean and sight or usance and whether on D/A basis or D/P basis), purchase of cheques, other non-fund based facilities like acceptance/co-acceptance of bills, opening of L/Cs and issue of guarantees, purchase of debentures from third parties, etc.;
- (h) Line of credit/overdraft facility extended by settlement bankers to National Securities Clearing Corporation Ltd.(NSCCL) / Clearing Corporation of India Ltd. (CCIL) to facilitate smooth settlement; and
- (i) Credit limit granted under credit card facility provided by a bank to its directors to the extent the credit limit so granted is determined applying the same criteria as applied by it in normal conduct of credit card business.

11.66 Purchase of or discount of bills from directors and their concerns, which is in the nature of clean accommodation, is reckoned as 'loans and advances' for purposes of Section 20 of the Banking Regulation Act, 1949.

***Restrictions on Power to Remit Debts***

11.67 Section 20A of the Banking Regulation Act, 1949 stipulates that notwithstanding anything to the contrary contained in Section 180 of the Companies Act, 2013, a banking company shall not, except with RBI prior approval, remit in whole or in part any debt due to it by -

- any of its directors, or
- any firm or company in which any of its directors is interested as director, partner, managing agent or guarantor, or
- any individual, if any of its directors is his partner or guarantor.

Any remission made contravening provisions stated above shall be void and have no effect.

***Restriction on Holding Shares in Companies***

11.68 As per Section 19(2) of Banking Regulation Act, 1949, banks should not hold shares in any company except as provided in sub-section (1) whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30 percent of

## **Guidance Note on Audit of Banks (Revised 2020)**

---

the paid-up share capital of that company or 30 percent of its own paid-up share capital and reserves, whichever is less, except otherwise specifically permitted by RBI regulations.

11.69 In terms of Section 19(3) of the Banking Regulation Act, 1949, banks should not hold shares whether as pledgee, mortgagee or absolute owner, in any company in the management of which any managing director or manager of the bank is in any manner concerned or interested.

11.70 While granting loans and advances against shares, statutory provisions of Sections 19(2) and 19(3) should be strictly observed, except otherwise specifically permitted by RBI regulations.

### ***Restrictions on Credit to Companies for Buy-back of their Securities***

11.71 As per Section 68 of the Companies Act, 2013, companies are permitted to purchase their own shares or other specified securities out of their:

- Free reserves;
- Securities premium account; or
- Proceeds of any shares or other specified securities.

subject to compliance of various conditions specified in sub-section (2) of section 68 of Companies Act, 2013. Therefore, banks should not provide loans to companies for buy-back of shares/securities.

## **Regulatory Restrictions**

### ***Granting Loans and Advances to relatives of Directors***

11.72 Without prior approval of the Board or without the Board's knowledge, no loans and advances should be granted to relatives of bank's Chairman/Managing Director or other Directors, Directors (including Chairman/Managing Director) of other banks and their relatives, Directors of Scheduled Co-operative Banks and their relatives, Directors of Subsidiaries/Trustees of Mutual Funds/Venture Capital Funds set up by the financing banks or other banks. However, banks may grant loan or advance to or on behalf of spouses of their Directors in cases where the spouse has his/her own independent source of income arising out of his/her employment or profession and the facility so granted is based on standard procedures and norms for assessing the borrower creditworthiness. Such facility should be extended on commercial terms. Accordingly, Banks should not grant loans and advances without approval of Board of Directors/Management Committee aggregating Rupees twenty five lakhs and above to –

#### **Guidance Note on Audit of Banks (Revised 2020)**

---

- a. directors (including the Chairman/Managing Director) of other banks;
- b. any firm in which any of the directors of other banks is interested as a partner or guarantor;
- c. any company in which any of the directors of other banks holds substantial interest or is interested as a director or as a guarantor;
- d. any relative other than spouse and minor/dependent children of their own Chairmen/Managing Directors or other Directors;
- e. any relative other than spouse and minor/dependent children of the Chairman/Managing Director or other directors of other banks;
- f. any firm in which any of the relatives other than spouse and minor/dependent children as mentioned in (d) & (e) above is interested as a partner or guarantor;
- g. any company in which any of the relatives other than spouse and minor / dependent children as mentioned in (d) & (e) above hold substantial interest or is interested as a director or as a guarantor.

#### ***Restrictions on Grant of Loans and Advances to Officers and the Relatives of Senior Officers of Banks***

11.73 No officer or any Committee comprising, *inter alia*, an officer as member, shall, while exercising powers of sanction of any credit facility, sanction any credit facility to his/her relative. Such a facility shall ordinarily be sanctioned only by the next higher sanctioning authority. Credit facilities sanctioned to senior officers of the financing bank should be reported to the Board. Loans and advances and award of contracts to relatives of senior officers of the bank or proposals for credit facilities to the relatives of senior officers of the bank sanctioned by the appropriate authority should be reported to the Board. Further, when a credit facility is sanctioned by an authority, other than the Board, to -

- any firm in which any of the relatives of any senior officer of the financing bank holds substantial interest, or is interested as a partner or guarantor; or
- any company in which any of the relatives of any senior officer of the financing bank holds substantial interest, or is interested as a director or as a guarantor, such transaction should also be reported to the Board.

Credit facility will not include loans and advances such as housing loans, car advances, consumption loans, etc., granted to an officer of the bank under any scheme applicable generally to bank employees.

***Restriction on Advances against Sensitive Commodities under Selective Credit Control (SCC)***

11.74 To prevent speculative holding of essential commodities with the help of bank credit and the resultant rise in their prices, in exercise of powers conferred by Section 21 & 35A of the Banking Regulation Act, 1949, RBI, issues, from time to time, directives to all commercial banks, stipulating specific restrictions on bank advances against specified sensitive commodities.

The auditor should be updated on which commodities are under selection credit control during the audit period under review.

***Restriction on payment of commission to staff members including officers***

11.75 Section 10(1)(b)(ii) of Banking Regulation Act, 1934, stipulates that a banking company shall not employ or continue employment of any person whose remuneration or part of whose remuneration takes the form of commission or a share in the profits of the company. Clause (b) of Section 10(1)(b)(ii) permits payment of commission to any person who is employed only otherwise than as a regular staff. Therefore, banks should not pay commission to staff members and officers for recovery of loans.

***Restrictions on offering incentives on any banking products***

11.76 Banks are not permitted to offer any banking products, including online remittance schemes etc., with prizes /lottery/free trips (in India and/or abroad), etc. or any other incentives having an element of chance, except inexpensive gifts costing less than Rs. 250/-, as such products involve non-transparency in the pricing mechanism. Such products, if offered, by banks are considered as violation of extant guidelines and banks concerned are liable for penal action.

***Restrictions on Other Loans and Advances***

***Loans and Advances against Shares, Debentures and Bonds***

11.77 Banks are required to strictly observe regulatory restrictions on grant of loans and advances against shares, debentures and bonds as detailed in the July, 2015 Master Circular on Exposure Norms'. The restrictions, *inter alia*, on Loans and Advances – Statutory and Other Restrictions loans and advances against shares and debentures, are:

- (a) No loans to be granted against partly paid shares.
- (b) No loans to be granted to partnership/proprietorship concerns against the primary security of shares and debentures.

11.78 RBI's Master Circular No. RBI/2015-16/95 DBR. No. Dir. BC. 10/13.03.00/2015-16 "Loans and Advances - Statutory and Other Restrictions" contains guidelines for granting Loan and Advances against Shares, Debentures and Bonds as follows:

*Advances to individuals*

11.79 Banks may grant advances against security of shares, debentures or bonds to individuals subject to following conditions:

- (i) **Amount of advance:** Loans against security of shares, debentures and bonds should not exceed Rs. 10 lakhs per individual if securities are held in physical form and Rs. 20 lakhs per individual if securities are held in dematerialised form. Auditors should note updated limits from time to time.
- (ii) **Margin:** Banks should maintain a minimum margin of 50 percent of the market value of equity shares / convertible debentures held in physical form. In case of shares / convertible debentures held in dematerialised form, a minimum margin of 25 percent should be maintained. These are minimum margin stipulations and banks may stipulate higher margins for shares whether held in physical or dematerialized form. Margin requirements for advances against preference shares / nonconvertible debentures and bonds may be determined by banks themselves.
- (iii) **Lending policy:** Each bank should formulate with their Board of Directors, approval, a Loan Policy for grant of advances to individuals against shares / debentures / bonds keeping in view RBI guidelines. Banks should obtain a declaration from the borrower indicating the extent of loans availed of by him from other banks as input for credit evaluation. It would also be necessary to ensure that such accommodation from different banks is not obtained against shares of a single company or a group of companies. As a prudential measure, each bank may also consider laying down appropriate aggregate sub-limits of such advances.

*Advances to Share and Stock Brokers/ Commodity Brokers*

11.80

- (i) Banks and their subsidiaries are not permitted to finance 'Badla' transactions. Banks can grant advances only to SEBI registered share and stock brokers complying with capital adequacy norms prescribed by SEBI / Stock Exchanges. This would be towards need based overdraft facilities / line of credit against shares and debentures held by them as stock in trade. A careful assessment of need based requirements for such finance should be made taking into account the borrower's financial position, operations on

his own account and on behalf of clients, income earned, average turnover period of stocks and shares and the extent to which broker's funds are required to be involved in business operations. Banks may also grant working capital facilities to such stock brokers to meet cash flow gap between delivery and payment for DVP transactions undertaken on behalf of institutional clients viz. FIs, FIs, mutual funds and banks, duration of such a facility will be short and based on an assessment of financing requirements keeping in view cash flow gaps, the broker's funds required to be deployed for the transaction and overall financial position of the broker. Utilization has to be monitored based on individual transactions.

Banks may institute adequate safeguards and monitoring mechanisms. A uniform margin of 50 per cent is required to be applied on all advances/ financing of IPOs/ issue of guarantees on behalf of share and stockbrokers. A minimum cash margin of 25 per cent (within the 50% margin) shall be maintained in respect of guarantees issued by banks for capital market operations. The above minimum margin will also apply to guarantees issued by banks on behalf of commodity brokers in favour of commodity exchanges viz. National Commodity & Derivatives Exchange (NCDEX), Multi Commodity Exchange of India Ltd. (MCX) and National Multi Commodity Exchange of India Ltd. (NMCEIL), in lieu of margin requirements as per commodity exchange regulations. These margin requirements will also be applicable in respect of bank finance to stock brokers by way of temporary overdrafts for DVP transactions. Banks may issue guarantees on behalf of share and stock brokers/commodity brokers in favour of stock exchanges in lieu of security deposit to the extent it is acceptable in form of bank guarantee as laid down by stock exchanges. Banks may also issue guarantees in lieu of margin requirements as per stock exchange regulations.

- (ii) The requirement relating to transfer of shares in bank's name in respect of shares held in physical form mentioned at Sl. No. (ix) of paragraph 2.3.1.14 of Master Circular on Loans and Advances would not apply in respect of advances granted to share and stock brokers provided such shares are held as security for a period not exceeding nine months. In case of dematerialised shares, the depository system provides a facility for pledging and banks may avail this facility. In such cases, there will not be a need to transfer the shares in the bank's name irrespective of the period of holding. The share and stock brokers are free to substitute shares pledged by them as and when necessary. In case of a default in the account, the bank should exercise the option to get the shares transferred in its name.



*Bank finance for market makers*

11.81 Necessary guidelines for the same as stated in the Master Circular to be noted wherever applicable cases exist in the Branch.

*Financing of Initial Public Offerings (IPOs)*

11.82 Banks should ensure that no advances exceed Rs. 10 lakhs to any individual against security of shares, convertible bonds, convertible debentures, units of equity oriented mutual funds and PSU bonds for subscribing to IPOs. Banks should not extend any credit or financing to Corporates for investment in other companies' IPOs and to NBFCs for further lending to individuals for IPOs.

*Bank Finance to assist employees to buy shares of their own companies*

11.83

- (i) Banks may extend finance to employees for purchasing shares of their own companies under Employees Stock Option Plan (ESOP)/ reserved by way of employees' quota under IPO to the extent of 90% of the purchase price of the shares or Rs. 20 Lakhs, whichever is less. Banks are not allowed to extend advances including advances to their employees/ Employees' Trusts set up by them for purposes of purchasing their own banks' share under ESOPs/IPOs or from the secondary market irrespective of whether the advances are secured or unsecured. Follow-on Public Offers (FPOs) will also be included under IPO.
- (ii) Banks should obtain declaration from the borrower indicating details of loan/advances availed against shares and other securities specified above, from any other bank/s to ensure compliance with the prescribed ceilings.

*Advances to other borrowers against shares / debentures / bonds*

11.84

- (i) The question of granting advances against Primary Security of shares and debenture including promoters' shares to industrial, corporate or other borrowers should not normally arise except for secured loans granted towards working capital or for other productive purposes other than NBFCs. In such cases, Banks should accept shares only in dematerialised form. Banks may accept shares of promoters only in dematerialized form wherever demat facility is available.
- (ii) Banks may obtain collateral security of shares and debentures by way of margin for a temporary period of one year from borrowers other than NBFCs in the course of setting up of new projects or expansion of existing business or for purposes of raising additional working capital. Banks have

## **Guidance Note on Audit of Banks (Revised 2020)**

---

to satisfy themselves regarding the capacity of the borrower to raise the required funds and to repay the advance within the stipulated period.

### *Bank Loans for Financing Promoters Contribution*

11.85 The promoters' contribution towards the equity capital of a company should come from their own resources and bank's should not normally grant advances to take up shares of other companies. However, banks are permitted to extend loans to corporate against security of shares (as far as possible in dematerialised form) held by them to meet promoters' contribution to equity of new companies in anticipation of raising resources subject to terms and conditions detailed in the loan policy of the bank, in addition to general guidelines given in para 2.3.1.14 of the Master Circular on Loans and Advances – Statutory and Other restrictions dated July 1, 2015.

- i) Margin and loan repayment period may be determined by the banks.
- ii) Loans sanctioned to a corporate against security of shares (as far as possible, demat shares) for meeting promoters' contribution to the equity of new companies in anticipation of raising resources, should be treated as bank's investments in shares coming under the ceiling of 40 percent of the bank's net worth as on March 31 of the previous year prescribed for the bank's total exposure including both fund and non-fund based exposure to capital market in all forms. These loans will be subject to individual/group of borrowers exposure norms and statutory limit on shareholding in companies, detailed in Master Circular RBI/2015-16/70 DBR.No.Dir.BC.12/13.03.00/2015-16 dated July 1, 2015 on Exposure Norms.
- iii) Banks may extend financial assistance to Indian companies for acquisition of equity in overseas joint ventures / wholly owned subsidiaries or in other overseas companies, new or existing, as strategic investment, in terms of a Board approved policy, duly incorporated in the bank's loan policy. Such policy should include overall limit on such financing, terms and conditions of eligibility of borrowers, security, margin, etc. The finance would be subject to compliance with the statutory requirements under Section 19(2) of the Banking Regulation Act, 1949.
- iv) Restriction on grant of bank advances for financing promoters' contribution towards equity capital would also extend to bank finance to activities related to acquisitions like payment of non-compete fee, etc. These restrictions would also apply to bank finance to such activities by overseas branches / subsidiaries of Indian banks.
- v) With the approval of the Board of Directors, banks should formulate internal guidelines with appropriate safeguards for this purpose.

- vi) Under refinance scheme of Export-Import Bank of India, banks may sanction term loans on merits to eligible Indian promoters for acquisition of equity in overseas joint ventures / wholly owned subsidiaries, provided the term loans are approved by EXIM Bank for refinance.

*Advances against Units of Mutual Funds*

11.86 While granting advances against Units of mutual funds, Banks should adhere to the following guidelines:

- i) Units should be listed in Stock Exchanges or repurchase facility for the Units of mutual fund should be available at the time of lending.
- ii) Units should have completed the minimum lock-in-period stipulated in the relevant scheme.
- iii) Amount of advance should be linked to the Net Asset Value (NAV) / repurchase price or market value, whichever is less and not to face value.
- iv) Advance against units of mutual funds (except units of exclusively debt oriented funds) would attract quantum and margin requirements as applicable to advance against shares and debentures. However, the quantum and margin requirement for loans/ advances to individuals against units of exclusively debt-oriented mutual funds may be decided by individual banks themselves in accordance with their loan policy.
- v) Advances should be purpose oriented, taking into account the credit requirement of the investor. Advances should not be granted for subscribing to or boosting up the sales of another scheme of mutual funds or for purchase of shares/ debentures/ bonds etc.

For exposure norms w.r.t. Advances against Mutual Funds, refer to para 4.6 of the Master Circular No. RBI/2015-16/70 DBR.No.Dir.BC.12/13.03.00/2015-16 dated July 1, 2015 "Exposure Norms".

*Margin Trading*

11.87 Banks may extend finance to stockbrokers for margin trading. The Board of each bank should formulate detailed guidelines for lending for margin trading, subject to the following parameters:

- (a) Finance extended for margin trading should be within the overall ceiling of 40% of net worth prescribed for capital market exposure.
- (b) Minimum margin of 50 per cent to be maintained on the funds lent for margin trading.
- (c) Shares purchased with margin trading to be in dematerialised mode under

## **Guidance Note on Audit of Banks (Revised 2020)**

---

pledge to the lending bank. Bank to put in place an appropriate system for monitoring and maintaining the margin of 50% on an ongoing basis.

- (d) Bank's Board should prescribe necessary safeguards to ensure that no "nexus" develops between inter-connected stock broking entities/ stockbrokers and the bank in respect of margin trading. Margin trading should be spread out by the bank among a reasonable number of stockbrokers and stock broking entities.

11.88 The Audit Committee of the Board should periodically monitor bank's exposure by way of financing for margin trading and ensure that Board guidelines, subject to the above parameters, are complied. Banks should disclose the total finance extended for margin trading in "Notes on Account" to their Balance Sheet.

### *Financing for Acquisition of Equity in Overseas Companies*

11.89 Banks may extend financial assistance to Indian companies for acquisition of equity in overseas joint ventures / wholly owned subsidiaries or in other overseas companies, new or existing, as strategic investment, in terms of a Board approved policy, duly incorporated in the bank's loan policy. Such policy should include overall limit on such financing, terms and conditions of eligibility of borrowers, security, margin, etc. While the Board may frame its own guidelines and safeguards for such lending, such acquisition(s) should be beneficial to the company and the country. The finance would be subject to compliance with the statutory requirements under Section 19(2) of the Banking Regulation Act, 1949.

### *Refinance Scheme of Export Import Bank of India*

11.90 Under the refinance scheme of Export Import Bank of India (EXIM Bank), banks may sanction term loans on merits to eligible Indian promoters for acquisition of equity in overseas joint ventures / wholly owned subsidiaries, provided that term loans are approved by the EXIM Bank for refinance.

### *Arbitrage Operations*

11.91 Banks should not undertake arbitrage operations themselves or extend credit facilities directly or indirectly to stockbrokers for arbitrage operations in Stock Exchanges. While banks are permitted to acquire shares from the secondary market, they should ensure that no sale transaction is undertaken without actually holding the shares in their investment accounts.

### *General guidelines applicable to advances against shares / debentures / bonds*

11.92 Statutory provisions regarding grant of advances against shares contained in Sections 19(2) and (3) and 20(1) (a) of the Banking Regulation Act

### **Guidance Note on Audit of Banks (Revised 2020)**

---

1949 should be strictly observed. Shares held in dematerialised form should also be included for the purpose of determining limits under Section 19(2) and 19(3).

11.93 While considering grant of advances against shares / debentures banks must follow normal procedures for sanction, appraisal and post sanction follow-up.

11.94 Advances against primary security of shares / debentures / bonds should be kept distinct and separate and not combined with any other advance.

11.95 Banks should satisfy themselves about the marketability/ reliability of the shares / debentures and the net worth and working of the company whose shares / debentures / bonds are offered as security.

11.96 Shares/ debentures/ bonds should be valued at prevailing market prices when they are lodged as security for advances.

11.97 Banks should exercise particular care when advances are sought against large blocks of shares by a borrower or a group of borrowers. It should be ensured that advances against shares are not used to enable the borrower to acquire or retain a controlling interest in the company/ companies or to facilitate or retain inter-corporate investments.

11.98 No advance against partly paid shares shall be granted.

11.99 No loans to be granted to partnership/ proprietorship concerns against primary security of shares and debentures.

11.100 Whenever the limit/limits of advances granted to a borrower exceed Rupees Ten lakhs, it should be ensured that the said shares / debentures / bonds are transferred in the bank's name and that the bank has exclusive and unconditional voting rights in respect of such shares. For this purpose the aggregate of limits against shares / debentures / bonds granted by a bank at all its offices to a single borrower should be taken into account. Where securities are held in dematerialised form, the requirement relating to transfer of shares in bank's name will not apply and banks may take their own decision in this regard. Banks should, however, avail of the facility provided in the depository system for pledging securities held in dematerialised form under which the securities pledged by the borrower get blocked in favour of the lending bank. In case of default by the borrower and on the bank exercising the option of invocation of pledge, the shares and debentures get transferred in the bank's name immediately.

11.101 Banks may take their own decision in regard to exercise of voting rights and may prescribe procedures for this purpose.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

11.102 Banks should ensure that the scrip lodged with them as security are not stolen / duplicate / fake / benami. Any irregularities coming to their notice should be immediately reported to RBI.

11.103 Banks operating in India should not be a party to transactions such as making advances or issuing back-up guarantees favouring other banks for extending credit to clients of Indian nationality / origin by some of their overseas branches, to enable borrowers to make investments in shares and debentures / bonds of Indian companies.

11.104 A uniform 50% margin shall apply on all advances against shares/financing of IPOs/issue of Guarantees. A minimum 25% cash margin (within margin of 50%) shall be maintained in respect of guarantees issued by banks for capital market operations. These margin requirements will also apply in respect of bank finance to stock brokers by way of temporary overdrafts for DVP transactions.

### ***Advances against Fixed Deposit Receipts issued by Other Banks***

11.105 Instances have come to light where fake term deposit receipts, purported to have been issued by some banks, were used for obtaining advances from other banks. RBI has hence, advised banks to desist from sanctioning advances against FDRs, or other term deposits of other banks.

### ***Advances to Agents/Intermediaries Based on Consideration of Deposit Mobilisation***

11.106 Banks should desist being part to unethical practices of raising of resources through agents/intermediaries to meet credit needs of existing/prospective borrowers or from granting loans to intermediaries, based on consideration of deposit mobilisation, who may not require funds for genuine business requirements.

### ***Loans Against Certificate of Deposits (CDs)***

11.107 Banks cannot grant loans against CDs. Banks are also not permitted to buy-back their own CDs before maturity. However, these restrictions on lending and buy back in respect of CDs held by mutual funds are relaxed. While granting such loans to mutual funds, banks should keep in view provisions of paragraph 44(2) of the SEBI (Mutual Funds) Regulations, 1996. Further, such finance if extended to equity-oriented mutual funds, will form part of banks' capital market exposure.

***Finance for and Loans/Advances against Indian Depository Receipts (IDRs)***

11.108 Banks are not permitted to grant any loan / advance for subscription to Indian Depository Receipts (IDRs). No loans/ advances can be granted against security / collateral of IDRs issued in India.

***Bank Finance to Non-Banking Financial Companies (NBFCs)***

11.109 RBI, vide Master Circular No. DBR.BP.BC.No.5/21.04.172/ 2015-16 on Bank Finance to Non-Banking Financial Companies (NBFCs) dated July 1, 2015 states:

11.110 Ceiling on bank credit linked to Net Owned Fund (NOF) of NBFCs has been withdrawn in respect of all NBFCs statutorily registered with RBI and engaged in principal business of asset financing, loan, factoring and investment activities. Accordingly, banks may extend need based working capital facilities and term loans to all NBFCs registered with RBI and engaged in infrastructure financing, equipment leasing, hire-purchase, loan, factoring and investment activities.

11.111 Banks may finance NBFCs against second hand assets financed by them.

11.112 Banks may formulate suitable loan policy with the approval of their Boards of Directors within RBI prudential guidelines and exposure norms to extend various kinds of credit facilities to NBFCs subject to the condition that the activities as indicated in the Master Circular are not financed by them.

11.113 In respect of NBFCs not required to be registered with RBI, viz.:

- i) Insurance Companies registered under Section 3 of the Insurance Act, 1938;
- ii) Nidhi Companies notified under Section 406 of the Companies Act, 2013;
- iii) Chit Fund Companies carrying on Chit Fund business as their principal business as per Explanation to Clause (vii) of Section 45-I(bb) of the Reserve Bank of India Act, 1934;
- iv) Stock Broking Companies / Merchant Banking Companies registered under Section 12 of the Securities & Exchange Board of India Act, 1992; and
- v) Housing Finance Companies being regulated by the National Housing Bank (NHB) which have been exempted from the requirement of registration by RBI], banks may take their credit decisions based on usual factors like purpose of credit, nature and quality of underlying assets, repayment capacity of borrowers, risk perception, etc.

### **Guidance Note on Audit of Banks (Revised 2020)**

---

11.114 Banks are prohibited from providing credit for following NBFC activities:

- (i) Bills discounted/rediscouted by NBFCs, except for rediscounting of bills discounted by NBFCs arising from sale of –
  - (a) Commercial vehicles (including light commercial vehicles), and
  - (b) Two-wheeler and Three-wheeler vehicles, subject to following conditions:
    - Bills should have been drawn by the manufacturers on dealers only.
    - Bills should represent genuine sale transactions as may be ascertained from the chassis/engine numbers.
    - Before rediscounting the bills, banks should satisfy themselves about the *bona fides* and track record of the NBFCs discounting the bills.
- (ii) Investments of NBFCs both of current and long term nature, in any company/entity by way of shares, debentures, etc. However, Stock Broking Companies may be provided need-based credit against shares and debentures held by them as stock-in-trade.
- (iii) Unsecured loans/inter-corporate deposits by NBFCs to/in any company.
- (iv) All types of loans/advances by NBFCs to their subsidiaries, group companies/entities.
- (v) Finance to NBFCs for further lending to individuals for subscribing to Initial Public Offerings (IPOs) and for purchase of shares from secondary market.

#### **Bank Finance to Residuary Non-Banking Companies (RNBCs)**

11.115 Residuary Non-Banking Companies (RNBCs) are required to be mandatorily registered with RBI. In respect of such companies, bank finance would be restricted to their Net Owned Fund (NOF). The NOF computation will be as per definition given in explanation to Section 45-IA of RBI Act, 1934.

#### **Other Prohibition on Bank Finance to NBFCs**

##### *Bridge loans / interim finance to NBFCs*

11.116 Banks should not grant bridge loans of any nature, or interim finance against capital / debenture issues and / or in form of loans of a bridging nature pending raising of long-term funds from the market by way of capital, deposits, etc. to all categories of Non-Banking Financial Companies, i.e., equipment leasing and hire-purchase finance companies, loan and investment companies and also Residuary Non-Banking Companies (RNBCs).



11.117 Banks should strictly follow these instructions and ensure that they are not circumvented in any manner whatsoever by purport and / or intent by sanction of credit under a different nomenclature like unsecured negotiable notes, floating rate interest bonds, etc., as also short-term loans, repayment of which is proposed / expected to be made out of funds to be or likely to be mobilised from external / other sources and not out of surplus generated by use of the asset(s).

*Advances against collateral security of shares to NBFCs*

11.118 Shares and debentures cannot be accepted as collateral securities for secured loans granted to NBFCs borrowers for any purpose.

*Restriction on Guarantees for placement of funds with NBFCs*

11.119 Banks should not execute guarantees covering inter-company deposits / loans thereby guaranteeing refund of deposits / loans accepted by NBFCs / firms from other NBFCs / firms. The restriction would cover all types of deposits / loans irrespective of their source, including deposits / loans received by NBFCs from trusts and other institutions. Guarantees should not be issued for purposes of indirectly enabling placement of deposits with NBFCs.

*Bank Finance to Equipment Leasing Companies*

11.120 Banks should not enter into lease agreements departmentally with equipment leasing companies as well as other Non-Banking Financial Companies engaged in equipment leasing.

*Bank Finance to Factoring Companies*

11.121 Necessary guidelines given in the master circular should be noted in applicable cases if any in branches

*Restrictions regarding investments made by banks in securities/ instruments issued by NBFCs*

11.122 Banks should not invest in Zero Coupon Bonds (ZCBs) issued by NBFCs unless the issuer NBFC builds up sinking fund for all accrued interest and keeps it invested in liquid investments / securities (Government bonds).

11.123 Banks are permitted to invest in Non-Convertible Debentures (NCDs) with original or initial maturity up to one year issued by NBFCs. While investing in such instruments banks should be guided by the extant prudential guidelines in force, ensure that the issuer has disclosed the purpose for which the NCDs are being issued in the disclosure document and such purposes are eligible for bank finance.

***Advances Against NR(E) and FCNR(B) Deposits***

11.124 Grant of advance against NR(E) and FCNR(B) deposits would be subject to guidelines issued under Foreign Exchange Management Act, 1999.

***Advances Against Bullion/Primary Gold***

11.125 Banks are prohibited from granting any advance against bullion/primary gold. However, specially minted gold coins sold by banks are not treated as “bullion” or “primary gold” and hence are acceptable as security upto 50 gms per customer. Such loans may be covered under the policy framed by the bank’s Board, in terms of RBI circular DBOD.No. BC. 138/21.01.023/94 dated November 22, 1994. Where advances have been granted against gold coins it should be ensured that end use of funds is for approved, non-speculative purposes. Banks should desist from granting advances to silver bullion dealers which are likely to be utilised for speculative purposes.

***Loans for Acquisition of KVPs***

11.126 Banks should ensure that no loans are sanctioned for acquisition of/investing in Small Savings Instruments including Kisan Vikas Patras.

***Advances against Gold Ornaments & Jewellery***

11.127 RBI vide Master Circular No. RBI/2015-16/95 DBR.No.Dir.BC.10/13.03.00/2015-16 dated July 1, 2015 states that hallmarking of gold jewellery ensures quality of gold used in the jewellery as to carat fineness and purity. Hence, granting of advances against security of such hallmarked jewellery is safer and easier. Preferential treatment is given to loans against hallmarked jewellery as it is also in the long-term interest of consumer, lenders and industry. Based on gold purity and content, bank decides on margin and rates of interest.

***Loan to Value Ratio for Loan against Gold Ornaments & Jewellery***

11.128 RBI vide Master Circular No. RBI/2015-16/95 DBR.No.Dir.BC.10/13.03.00/2015-16 dated July 1, 2015 provides that loans (including bullet repayment loans) sanctioned by banks against pledge of gold ornaments and jewellery for non-agricultural purposes should not exceed 75 per cent of the value of gold ornaments and jewellery.

11.129 In order to standardize the valuation and make it more transparent to the borrower, gold ornaments and jewellery accepted as security / collateral will have to be valued at the average of the closing price of 22 carat gold for the preceding 30 days as quoted by the India Bullion and Jewellers Association Ltd. [Formerly known as the Bombay Bullion Association Ltd. (BBA)]. If the gold is of

purity less than 22 carats, bank should translate the collateral into 22 carat and value the exact grams of the collateral.

11.130 Loans extended against pledge of gold ornaments and jewellery other than agricultural purposes, where both interest and principal are due for payment at maturity of the loan will be subject to following conditions:

- (i) Banks, as per their Board approved policy, may decide upon the ceiling with regard to the quantum of loan that may be granted against pledge of gold jewellery and ornaments for non-agricultural end uses.
- (ii) Period of the loan shall not exceed 12 months from sanction date.
- (iii) Interest will be charged at monthly rests and recognized on accrual basis if the account is a 'standard' account. This will also apply to existing loans.
- (iv) Such loans shall also be governed by other extant norms pertaining to income recognition, asset classification and provisioning which shall be applicable once the principal and interest become overdue.

#### **Gold (Metal) Loans**

11.131 Nominated banks can extend Gold (Metal) Loans to exporters of jewellery who are customers of other scheduled commercial banks, by accepting stand-by letter of credit or bank guarantee issued by their bankers in favour of the nominated banks subject to authorised banks' own norms for lending and other conditions stipulated by RBI. Banks may also extend the facility to domestic jewellery manufacturers, subject to the conditions specified by RBI's Master Circular RBI/2015-16/95 DBR.No.Dir.BC.10/13.03.00/2015-16 dated July 1, 2015 on Loans and Advances - Statutory and Other restrictions.

11.132 Nominated banks may continue to extend Gold (Metal) Loans to jewellery exporters subject to following conditions:

- Exposure assumed by the nominated bank extending the Gold (Metal) Loan against stand-by LC / BG of another bank will be deemed as an exposure on the guaranteeing bank and attract appropriate risk weight as per extant guidelines.
- The transaction should be on back-to-back basis i.e. nominated banks should extend Gold (Metal) Loan directly to the customer of a non-nominated bank, against the stand-by LC / BG issued by the latter.
- Gold (Metal) Loans should not involve any direct or indirect liability of the borrowing entity towards foreign suppliers of gold.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

- Banks may calculate their exposure and compliance with prudential norms daily by converting into Rupee the gold quantity by crossing London AM fixing for Gold / US Dollar rate with the rupee-dollar reference rate announced by RBI.

11.133 Banks should recognise overall risks in extending Gold (Metal) Loans and in extending SBLC / BG. Banks should lay down appropriate risk management / lending policy in this regard and comply with Ghosh committee recommendations and other internal requirements relating to acceptance of guarantees of other banks to obviate possibility of frauds.

11.134 Nominated banks are not permitted to enter into any tie up arrangements for retailing of gold / gold coins with any other entity including non-banking financial companies / co-operative banks / non-nominated banks.

### ***Loans and advances to Micro and Small Enterprises (MSEs)***

11.135 RBI has issued Master Directions on Lending to Micro, Small & Medium Enterprises (MSME) sector vide Master Directions no. FIDD. MSME & NFS.12/ 06.02.31/2017-18 dated July 24, 2017 (updated April 25, 2018), in which definition of MSME and common guidelines/instructions for lending to MSME section are given.

### ***Working Capital Finance to Information Technology and Software Industry***

11.136 Following recommendations of the “National Taskforce on Information Technology and Software Development”, RBI has framed guidelines for extending working capital to the said industry. Banks are free to modify the guidelines based on their own experience without reference to the RBI to achieve the purpose of the guidelines in letter and spirit.

11.137 Salient features of these guidelines are as under:

- (i) Banks may consider sanction of working capital limits based on track record of the promoter’s group affiliation, composition of the management team, their work experience and infrastructure.
- (ii) For borrowers with working capital limits of up to Rs 2 crore, assessment may be made at 20 percent of the projected turnover. In other cases, banks may consider assessment of MPBF based on monthly cash budget system. For borrowers enjoying working capital limits of Rs 10 crore and above from the banking system, guidelines regarding the loan system would be applicable.
- (iii) Banks may obtain collateral security wherever available. First/ second charge on current assets, if available, may be obtained.

- (iv) Rate of interest as prescribed for general category of borrowers may be levied. Concessional rate of interest as applicable to pre-shipment/post-shipment credit may be levied.
- (v) Banks may evolve tailor-made follow up system for such advances. Banks could obtain quarterly statements of cash flows to monitor operations. In case the sanction was not made based on cash budgets, they can devise a reporting system, deemed fit.

***Guidelines for bank finance for PSU disinvestments of Government of India***

11.138 In terms of RBI circular DBOD No. Dir.BC.90/13.07.05/98 dated August 28, 1998, Promoters' contribution towards equity capital of a company should come from their own resources and bank should not normally grant advances to take up shares of other companies. Banks should ensure that advances against shares are not used to enable the borrower to acquire or retain a controlling interest in the company/companies or to facilitate or retain inter-corporate investment.

11.139 Instructions of the 1998 circular would not apply in the case of bank finance to the successful bidders under the PSU disinvestment program of the Government, subject to the following:

- Banks' proposals for financing the successful bidders in PSU disinvestment programme should be approved by their Board of Directors.
- Bank finance should be for acquisition of shares of PSU under a disinvestment programme approved by Government of India, including the secondary stage mandatory open offer, wherever applicable and not for subsequent acquisition of PSU shares. Bank finance should be made available only for prospective disinvestments by Government of India.
- Companies, including promoters, to which bank finance is to be extended, should have adequate net worth and an excellent track record of servicing loans availed from the banking system.
- Amount of bank finance provided should be reasonable with reference to the banks' size, its net worth, business and risk profile.

11.140 In case the advances against PSU disinvestment is secured by shares of the disinvested PSUs or any other shares, banks should follow RBI's extant guidelines on capital market exposures on margin, ceiling on overall exposure to the capital market, risk management and internal control systems, surveillance and monitoring by the Audit Committee of the Board, valuation and disclosure, etc. In this regard, banks may be guided by the Master Circular on Exposure Norms dated July 1, 2015.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

### *Stipulation of lock-in period for shares*

11.141 Banks may extend finance to the successful bidders even though the shares of the disinvested company acquired/ to be acquired by the successful bidder are subjected to a lock-in period/ other such restrictions which affect their liquidity, subject to fulfillment of following conditions:

- (a) Documentation between Government of India and the successful bidder should contain a specific provision permitting the pledgee to liquidate the shares during lock-in period that may be prescribed in respect of such disinvestments, in case of shortfall in margin requirements or default by the borrower.
- (b) If the documentation does not contain such a specific provision, the borrower (successful bidder) should obtain waiver from the Government for disposal of shares acquired under PSU disinvestment program during the lock-in period.

11.142 As per terms and conditions of PSU disinvestments by Government of India, the pledgee bank will not be allowed to invoke the pledge during the first year of lock-in period. During the second and third year of the lock-in period, in case of inability of the borrower to restore the margin prescribed for the purpose by way of additional security or non-performance of the payment obligations as per the repayment schedule agreed upon between the bank and the borrower, the bank would have the right to invoke the pledge. The pledgee bank's right to invoke the pledge during the second and third years of the lock-in period, would be subject to documentation terms and conditions between Government and the successful bidder, which cast certain responsibilities on the pledgee banks.

11.143 RBI has clarified that the concerned bank must make a proper appraisal and exercise due caution about creditworthiness of the borrower and the financial viability of the proposal. Bank must satisfy itself that the proposed documentation, relating to the disposal of shares pledged with the bank, are fully acceptable and do not involve unacceptable risks.

11.144 In terms of IECD Circular No. 10/ 08.12.01/ 2000- 2001 dated 8 January 2001, banks are precluded from financing investments of NBFCs in other companies and inter-corporate loans / deposits to/ in other companies.

11.145 Special Purpose Vehicles (SPVs) which comply with the following conditions would not be treated as investment companies and hence not considered NBFCs:

- a) They function as holding companies, special purpose vehicles, etc., with not less than 90 per cent of their total assets as investment in securities held for the purpose of holding ownership stake;
- b) They do not trade in these securities except for block sale;
- c) They do not undertake any other financial activities; and
- d) They do not hold/accept public deposits.

***Financing Housing Projects***

11.146 Master Circular No.DBR.No.DIR.BC.13/ 08.12.001/2015-16 dated July 1, 2015 on Housing Finance provides guidance in respect of housing finance provided by banks. Banks could deploy funds under housing finance allocation in any of the three categories as per norms provided in the Master Circular, i.e.

- Direct Finance.
- Indirect Finance.
- Investment in Bonds of NHB/HUDCO, or combination thereof.

11.147 The Master Circular contains guidelines, including conditions wherein a bank cannot extend credit for housing purposes. These conditions are as follows:

- (i) In case of *lending to housing intermediary agencies*, banks should ensure compliance with National Housing Board (NHB) guidelines, in terms of which, a housing finance companies' total borrowings, by way of deposits, issue of debentures/ bonds, loans and advances from banks or from financial institutions including any loans obtained from NHB, should not exceed 16 times its net owned funds. (i.e., paid up capital and free reserves less accumulated balance of loss, deferred revenue expenditure and intangible assets.)
- (ii) Banks are not permitted to extend fund and non-fund based facilities to private builders for acquisition of land even as part of a housing project.
- (iii) Banks cannot grant finance for construction of buildings meant purely for Government/Semi-Government offices, including Municipal and Panchayat offices. However, banks may grant loans for activities refinanced by institutions like NABARD.
- (iv) *Projects undertaken by public sector entities* which are not corporate bodies (i.e., public sector undertakings not registered under Companies Act or which are not Corporations established under the relevant statute) cannot be financed by banks.

### Guidance Note on Audit of Banks (Revised 2020)

(v) In terms of Delhi high court orders, banks cannot grant loans in respect of:

- Properties falling under unauthorised colonies unless and until they are regularised and development and other charges paid.
- Properties meant for residential use but which the applicant intends to use commercially and declares so while applying for the loan.

#### *Loan to Value (LTV) ratio*

11.148 To prevent excessive leveraging, LTV ratio and risk weight and standard as set provisioning in respect of individual housing loans have been prescribed. Vide RBI Circular No. RBI/2016-2017/317 DBR.BP.BC.No.72/08.12.015/2016-17 dated June 7, 2017 "Individual Housing Loans: Rationalisation of Risk –Weights and Loan to Value (LTV) Ratios" revised LTV ratio is applicable for all loan sanctioned post June 7, 2017 is as under.

Category of loan	LTV ratio (%)	Risk Weight (%)
Upto Rs. 30 lakh	≤ 80	35
	> 80 and ≤ 90	50
Above Rs. 30 lakh and upto ₹ 75 lakh	≤ 80	35
Above Rs. 75 lakh	≤ 75	50

11.149 LTV ratios, Risk Weights and Standard Asset Provision set out in circular DBR.BP.BC.No.44/08.12.015/ 2015-16 dated October 8, 2015, shall continue to apply to loans sanctioned up to June 6, 2017.

Category of loan	LTV ratio (%)	Risk Weight (%)
Upto Rs. 30 lakh	≤ 80	35
	> 80 and ≤ 90	50
Above Rs. 30 lakh and upto ₹ 75 lakh	≤ 75	35
	> 75 and ≤ 80	50
Above Rs. 75 lakh	≤ 75	75

11.150 LTV ratio should not exceed the prescribed ceiling in all fresh cases of sanction. In case LTV ratio is currently above the ceiling prescribed for any reason, efforts should be made to bring it within limits.



*Waiver of EMI in case of regular payment of home loans*

11.151 Some banks have introduced certain incentive to home loans from regular payment of EMI/dues. As per this feature, borrower gets waiver of some EMI amount either at the end of the loan or on some periodical basis. Auditor needs to ensure that the bank has made sufficient provision for future waiver of EMI in the books in the books.

*Innovative Housing Loan Products – Upfront Disbursal of Housing Loans*

11.152 Some banks have introduced certain innovative Housing Loan Schemes in association with developers / builders, e.g. upfront disbursal of sanctioned individual housing loans to the builders without linking the disbursals to various stages of construction of housing project, interest / EMI on the housing loan availed of by the individual borrower being serviced by the builders during the construction period / specified period, etc. This might include signing of tripartite agreements between the bank, the builder and the buyer of the housing unit.

11.153 These loan products are popularly known by various names like 80:20, 75:25 Schemes. Such housing loan products are likely to expose the banks as well as their home loan borrowers to additional risks e.g. in case of disputes between individual borrowers and developers / builders, default / delayed payment of interest / EMI by the developer / builder during the agreed period on behalf of the borrower, non-completion of the project on time, etc. Further, any delayed payments by developers / builders on behalf of individual borrowers to banks may lead to lower credit rating / scoring of such borrowers by credit information companies (CICs) as information about servicing of loans gets passed on to the CICs on a regular basis. In cases where bank loans are also disbursed upfront on behalf of their individual borrowers in a lump-sum to builders / developers without any linkage to stages of construction, banks run disproportionately higher exposures with concomitant risks of diversion of funds.

11.154 In view of the higher risks associated with such lump-sum disbursal of sanctioned housing loans and customer suitability issues, banks are advised that disbursal of housing loans sanctioned to individuals should be closely linked to the stages of construction of the housing project / houses and upfront disbursal should not be made in cases of incomplete / under-construction / green field housing projects.

11.155 Banks while introducing any kind of product should consider customer suitability and appropriateness issues and also ensure that the borrowers / customers are made fully aware of risks and liabilities under such products.

***Retail loans***

11.156 Banks generally provide other various retail advances namely:

- Home loans and loans against property.
- Vehicle loans.
- Personal loan.
- Consumer durable loans.
- Credit cards.

11.157 Loans are either sourced through direct selling agents or bank's own branches. Bank has a credit policy which defines process to be followed for sanction and disbursement of loan and various documents required.

11.158 The credit assessment process is not as detailed as followed in corporate loans. Bank generally collects following documents:

- Completely filled Loan Application Form with customers' signature.
- Income proof like Salary slip, financial statement, Income tax returns, Bank statement.
- Photograph.
- Business continuity proof. (e.g. Shops and Establishment Act, any other govt. certificate for doing business)
- Residence proof.
- Identification proof.
- Contact Point – Mobile No of applicants is mandatory.
- Age proof.
- PAN Card.

11.159 Banks generally have a system in which various information collected are keyed into the system and the system automatically runs a credit filter report. The credit Filter report is based on pre-defined criteria as per credit policy like minimum income criteria, AADHAR, employment details, age, telephone etc. and the score is system generated.

11.160 As a part of loan sanction process, bank runs CIBIL score and only if CIBIL score is above a specific number, than the bank considers further sanction.

11.161 Bank also conducts field investigations on the proposed customer which generally involve residential and office visits. Few banks also have a process of Fraud Containment Unit (FCU) screening of selected sample files. At the FCU, an official screens through the genuineness and authenticity of the documents for traces of fraud.

11.162 Post the above verification by FCU, bank also initiates a Positive De dupe check for positive database, wherein if the customer is an existing customer of the bank, the system gets the popup of such links on his screen.

11.163 The credit officer initiates a negative de dupe check on the negative database through system, Negative De dupe check is against RBI defaulters list, Terrorist list and declined applications. Such list is uploaded in the system by the bank's central team. If the customer is traced under such negative listing then loan application is rejected by the credit officer. Once, all the processes are completed and based on favorable results, bank sanctions the loan.

***Financing Infrastructure Projects***

11.164 RBI has revised the definition of Infrastructure Lending *vide* Master Circular on Loans and Advances – Statutory and Other Restrictions dated July 1, 2015 read with Circular No. RBI/2012 13/297/DBOD.BP.BC.No 58/08.12.014/2012-13 dated 20/11/2012 on “Second Quarter Review of Monetary Policy 2012-13 - Definition of ‘Infrastructure Lending’”. RBI has periodically added certain sectors as infrastructure lending from time to time.

11.165 The revised definition of ‘infrastructure lending’ is effective from the circular date. Exposure of banks to projects under sub-sectors included under previous definition of infrastructure, but not included in the revised definition, will continue to get benefits under ‘infrastructure lending’ for such exposures till completion of the projects. However, any fresh lending to these sub-sectors from the circular date will not qualify as ‘infrastructure lending’.

11.166 The definition of Infrastructure Lending includes credit facility extended by Lenders (i.e., Banks & Selected AIFs) to a borrower for exposure in various infrastructure sub-sectors as per paragraph 2.3.7.2 of Master Circular on Loans and Advances- Statutory and Other Restrictions dated July 1, 2015, read with Circular No. DBOD.BP.BC.No.66/08.12.2014/2013-14 on “Financing of Infrastructure – Definition of ‘Infrastructure Lending’” dated November 25, 2013.

11.167 Banks/FIs are free to finance technically feasible, financially viable and bankable projects undertaken by public and private sector undertakings subject to following conditions:

- i. Amount sanctioned should be within overall ceiling of prudential exposure

## Guidance Note on Audit of Banks (Revised 2020)

---

- norms prescribed by RBI for infrastructure financing.
- ii. Banks/ FIs should have requisite expertise for appraising technical feasibility, financial viability and bankability of projects, with particular reference to risk and sensitivity analysis.
  - iii. In respect of projects undertaken by public sector units, such term loans should not be in lieu of or to substitute budgetary resources envisaged for the project. The term loan could supplement budgetary resources if such supplementing was contemplated in the project design. Banks/FIs are, advised to follow the above instructions scrupulously, even while making investment in bonds of sick State PSUs as part of rehabilitation effort.
  - iv. Banks may lend to SPVs in the private sector, registered under Companies Act for directly undertaking infrastructure projects which are financially viable and not for acting as mere financial intermediaries. Banks may ensure that bankruptcy or financial difficulties of the parent/ sponsor should not affect the financial health of the SPV.
  - v. In few cases where completion of the project gets delayed, RBI vide its Master Circular No. RBI/2015-16/95 DBR.No.Dir.BC. 2/21.04.048/2015-16 dated July 1, 2015 provides detailed guideline on classification and provision for project loans. RBI *vide* Circular No. RBI/2016-17/122 DBR.No.BP.BC.34 /21.04.132/2016-17 provides guidelines for project companies where change of ownership happen/ are happening after date of commencement of commercial operation ('DCCO').
  - vi. Auditor should obtain a list of all outstanding project loans of the bank. Details should also include information about original DCCO and revision of DCCO, if any. Auditor should verify that the revision of the project DCCO is based on technical and financial study and is approved by competent authority. Auditor should also verify the revision in DCCO, and check whether the same is permissible under extent RBI guidelines. Auditor should apply professional judgment and skepticism while evaluating/ accessing and concluding on compliance of the said guidelines for deferment of DCCO and retaining standard/standard restructured classification. To verify compliance, auditor shall obtain documentary evidences for e.g.: legal documents for Court cases, Lead engineers report/ Review note/ consortium meeting minutes specifying the event that is beyond promoter's control etc., as the case may be.
  - vii. RBI has issued a mail box clarification on assessment and revision in project cost. RBI clarification provides guidance on classification of loan in case revision of project cost is above a certain percentage of original project cost. Auditor should ensure compliance with this clarification.

*Types of Financing by Banks*

11.168

- (i) In order to meet financial requirements of infrastructure projects, banks may extend credit facility by way of working capital finance, term loan, project loan, subscription to bonds and debentures/ preference shares/ equity shares acquired as a part of the project finance package which is treated as "deemed advance" and any other form of funded or non-funded facility.
- (ii) Take-out Financing - Banks may be guided by the instructions regarding take-out finance as per Circular No.DBOD.BP.BC.144/21.04.048/2000 dated February 29, 2000.
- (iii) Inter-institutional Guarantees: Banks are permitted to issue guarantees favouring other lending institutions in respect of infrastructure projects, provided the bank issuing the guarantee takes a funded share in the project at least to the extent of 5 per cent of the project cost and undertakes normal credit appraisal, monitoring and follow-up of the project.
- (iv) Financing promoter's equity: In terms of Circular No.DBOD.Dir.BC.90/13.07.05/98 dated August 28, 1998 - Banks are advised that promoters' contribution towards equity capital of a company should come from their own resources and Banks should not normally grant advances to take up shares of other companies. However, under certain circumstances, an exception may be made to this policy for financing acquisition of promoters' shares in an existing company, engaged in implementing or operating an infrastructure project in India.

Conditions, subject to which an exception may be made, are as follows:

- Bank finance would be only for acquisition of shares of existing companies providing infrastructure facilities. Further, acquisition of such shares should be in respect of companies where existing foreign promoters (and/ or domestic joint promoters) voluntarily propose to disinvest majority shares in compliance with SEBI guidelines, where applicable.
- Companies to which loans are extended should, *inter alia*, have a satisfactory net worth.
- Company financed and promoters/ directors of such companies should not be a defaulter to banks/ FIs.
- Bank finance should be restricted to 50% of the finance required for acquiring promoter's stake in the company being acquired.
- Finance extended should be against security of the assets of the borrowing company or the assets of the company acquired and not

## **Guidance Note on Audit of Banks (Revised 2020)**

---

against the shares of that company or the company being acquired. Shares of the Borrower Company / Company being acquired may be accepted as additional security and not as primary security. Security charged to the banks should be marketable.

- Banks should ensure maintenance of stipulated margins at all times.
- Tenor of the bank loans may not be longer than seven years. However, the Boards of banks can make an exception in specific cases, where necessary, for financial viability of the project.
- Financing to be subject to compliance with statutory requirements under Section 19(2) of the Banking Regulation Act, 1949.
- Financing of acquisition of equity shares by promoters should be within the regulatory ceiling of 40 per cent of their net worth as on March 31 of the previous year for the aggregate exposure of the banks to the capital markets in all forms. (fund and non-fund based)
- Proposal for bank finance should have the approval of the Board.

### **System of Base Rate and Interest Rate/ Marginal Cost of Funds based Lending Rate (MCLR)**

11.169 RBI *vide* Circular No. DBR.No.Dir.BC.9/ 13.03.00/2015-16 dated April 1, 2015 and DBR.No.Dir.BC.67/ 13.03.00/2015-16 dated December 17, 2015 on "Interest Rates on Advances" requires banks to freely determine lending rates on the advances as per their Board approved policy subject to the guidelines contained in the circular. The Base Rate system is aimed at enhancing transparency in lending rates of banks and enabling better assessment of transmission of monetary policy.

- All rupee loans sanctioned and credit limits renewed w.e.f. April 1, 2016 will be priced reference to Marginal Cost of Funds based Lending Rate (MCLR) which will be the internal benchmark for such purposes. Auditor should verify whether new loans sanctioned and credit limits renewed post April 1, 2016 is under the new MCLR regime.
- MCLR will comprise of Marginal cost of funds, Negative carry on account of CRR, Operating costs and Tenor premium.

### **Spread**

11.170

- (i) Banks should have a Board approved policy delineating components of spread charged to a customer. Price differentiation should be consistent with bank's credit pricing policy.

- (ii) Bank's internal pricing policy must spell the rationale for, and range of, the spread in case of a given category of borrower, as also, delegation of powers in respect of loan pricing. Rationale of the policy should be available for supervisory review.
- (iii) The spread charged to an existing borrower should not be increased except on account of deterioration in the credit risk profile of the customer or change in the tenor premium. Any such decision regarding change in spread on account of change in credit risk profile should be supported by a full-fledged risk profile review of the customer. Change in tenor premium should not be borrower specific or loan class specific and should be uniform for all types of loans for a given residual tenor.
- (iv) Guidelines contained in sub-paragraph (iii) above are not applicable to loans under consortium/ multiple banking arrangements.

## **Accounting and Auditing Aspects**

### **Balance Sheet Disclosure**

11.171 The Third Schedule to the Banking Regulation Act, 1949 requires classification of advances made by a bank from three different angles, viz., nature of advance, nature and extent of security, and place of making advance (i.e. whether in India or outside India). Accordingly, advances are classified in Schedule 9 to the balance sheet as follows.

- A. (i) Bills purchased and discounted
  - (ii) Cash Credits, Overdrafts and Loans repayable on demand
  - (iii) Term loans
- B. (i) Secured by tangible assets
  - (ii) Covered by bank/government guarantees
  - (iii) Unsecured
- C. 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
- (iii) Bills purchased and discounted
- (iv) Syndicated loans
- (v) Others

### **Classification Based on Nature of Advance**

11.172 Different classifications are as follows:

- (a) In classification under section 'A', all outstandings – in India as well as outside India – less provisions made, will be classified under three heads.
- (b) Outstandings in credit card operations should be shown as part of advances under the head 'cash credits, overdrafts and loans repayable on demand'.
- (c) Term loans will be loans not repayable on demand and would include overdue instalments.
- (d) All interest bearing loans and advances granted by the bank to its employees should be shown as part of advances.

### **Classification Based on Nature and Extent of Security**

11.173 Different classifications are as follows:

- (a) All advances or part of advances, which are secured<sup>2</sup> by tangible assets, whether in India or outside India, should be shown under the heading 'secured by tangible assets'. Advances against book debts may be included under the head 'Secured by Tangible Assets', and presented in Schedule 9 (Advances) as follows:
  - "B Secured by Tangible Assets" (includes advances against book debt)
- (b) Advances in India and outside India to the extent they are covered by guarantees of Indian and foreign governments and Indian and foreign banks and DICGC and ECGC are to be included under the head 'advances – covered by bank/government guarantees'.
- (c) Unsecured advances will include advances not classified under (i) & (ii) of section B.

---

<sup>2</sup> A 'secured advance', according to section 5(n) of the Banking Regulation Act, 1949 means an advance made on the security of assets the market value of which is not at any time less than the amount of such advance.



### **Classification based on Place of Making Advances**

11.174

- a) Advances to sectors, classified as priority sectors according to the instructions of the RBI, are to be classified under the head 'priority sectors'. Such advances should be excluded from, 'Advances to Public Sector'.
- b) Advances to Central and State Governments and other government undertakings including government companies and corporations which are, according to the statutes, to be treated as public sector companies, are to be included in the category 'Public Sector'.
- c) All advances to the banking sector including co-operative banks will come under the head 'Banks'.
- d) All remaining advances will be included under the residual head 'Others'; typically this category will include non-priority advances to the private, joint and co-operative sectors.

### **Audit Approach and Procedures**

11.175 Advances generally constitute major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. Audit of advances requires major attention from the auditors. In carrying out audit of advances, auditor is primarily concerned with obtaining evidence about the following:

- a) Amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.
- b) Advances represent amount due to the bank.
- c) Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.
- d) There are no unrecorded advances.
- e) The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.
- f) Advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
- g) Appropriate provisions towards advances is made as per the RBI norms, Accounting Standards and Generally Accepted Accounting Practices.

### Guidance Note on Audit of Banks (Revised 2020)

---

11.176 The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

- examining validity of the recorded amounts;
- examining loan documentation and it's vetting by the legal department;
- reviewing the operation of the accounts especially of accounts held and operated with other banks;
- examining the existence, enforceability and valuation of the security from time to time especially for loans given on a standalone basis;
- checking compliance with RBI norms including appropriate classification and provisioning; and
- carrying out appropriate analytical procedures.
- procedure for loan balance confirmations

11.177 In carrying out substantive procedures, auditor should examine all large advances while other advances may be examined on sampling basis. The accounts identified to be problem accounts need to be examined in detail unless the amount involved is insignificant. The auditor should obtain list of SMA 1 and SMA 2 borrowers from the bank and the same should also be considered for selection of problematic accounts. The extent of sample checking would depend on auditor's assessment of efficacy of internal controls. What constitutes a 'large advance' needs to be determined in the context of volume of operations of the branch. As a general rule, an advance may be considered to be a large advance if the year-end balance is in excess of Rs.2 crore or 5% of the aggregate year-end advances of the branch, whichever is less.

11.178 Advances which are sanctioned during the year or which are adversely commented by RBI inspection team, concurrent auditors, bank's internal inspection, etc., should, generally, be included in audit sample. Besides this new advances sanctioned during the year should be included on selective basis in the sample.

11.179 In nutshell, auditor at branch may keep following in mind to plan comprehensive coverage of advances and for selection of sample.

1. **Obtain top 10 exposure accounts:** It may be advisable for a branch auditor to visit the branch and ask the list of top 10 accounts/ exposures along with all the details such as status and security etc. before starting of the audit.

2. **Obtain the list of stressed accounts:** Stressed Accounts includes accounts classified as SMA 1 or SMA 2 of projects where implementation is delayed. The banks monitor stressed accounts on daily basis. Accounts that generally have overdue beyond 60 days or likely to slip to NPA at the quarter end are termed as stressed account (some banks may use different terminology). It is advisable to obtain a list of stressed accounts at least 15 days ahead of the closing date i.e. say stressed account list as on 15<sup>th</sup> March. This will provide the auditor a ready list of such accounts. The auditor then can scrutinize (based on materiality) whether the account has slipped or if not whether has been kept standard by unusual transaction that cannot be termed as business transaction. RBI through its circulars has time and again emphasized that stray credits at the quarter end need not qualify to keep account standard. We need to really assess whether the account is inherently weak. If so the same may have to be downgraded. As regards the partial recovery in overdue account (qualifying the criteria for classification of an account as NPA), such account cannot be upgraded unless overdue portion is recovered in entirety. As regards subsequent credit (after the date of balance sheet), the same will not improvise the classification of an advance.
3. **Obtain list of restructured accounts:** Restructured account portfolio requires separate additional provisioning. It is necessary to obtain the list of such accounts and ensure that the restructure is as per RBI directives.
4. **Obtain list of unsecured exposures above Rs. 1 Cr.:** Unsecured exposure has significant impact on the bank, if it slips to NPA. Many times such accounts are reviewed in the traditional manner. These require close monitoring not only from the perspective of financial parameters of the prudential guidelines but also non-financial parameters that give signals of possible ill health. Banking industry (especially PSUs) has faced severe damages on account non-identification of such non-financial parameters.
5. **Early mortality cases:** Any advance slippage to NPA within 12 months of its sanction is called early mortality case. Early mortality cases invoke penalty to the sanctioning authorities. This will have to be checked to understand the reason for such happening to avoid such cases in future and also to find out whether there are any cases classified as performing on some untenable ground to push it beyond early mortality.
6. List of accounts upgraded during the year or previous years.
7. List of accounts rated adversely as per Bank's internal ratings.
8. List of accounts where adverse issues have been noted in previous audits.

***Evaluation of Internal Controls over Advances***

11.180 Auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, *inter alia*, the following:

- Bank should make an advance only after satisfying itself as to the credit worthiness of the borrower by doing KYC compliance, proper credit appraisal etc. and after obtaining sanction from the appropriate authorities of the bank. The sanction for an advance should specify, among other things, the limit of borrowing, nature of security, margin to be kept, interest, terms of repayment etc. It needs to be ensured that loans sanctioned are as per the Loan Policy of the bank and adhere to regulatory (RBI) norms unless a specific exemption is taken in this regard.
- All necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- Compliance with terms of sanction and end use of funds should be ensured.
- Sufficient margin specified in the sanction letter should be kept against securities taken to cover for any decline in the value thereof. Availability of sufficient margin needs to be ensured at regular intervals.
- Controls over custody and storage of documents and their removal for verification.
- If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and effective control of such securities be retained as a part of documentation.
- All securities requiring registration should be registered in the name of the bank or accompanied by documents sufficient to give clear title to the bank.
- In the case of goods in possession of the bank, contents of the packages should be test checked at the time of receipt. Godown should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.
- Surprise checks should be made in respect of hypothecated goods not in physical possession of the bank.
- Drawing Power Register should be updated every month to record value of securities hypothecated. These entries should be separately checked by an independent officer.

- Accounts should be kept within the drawing power and the sanctioned limit.
- All accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to notice of the controlling authority regularly.
- Operation of each advance account should be reviewed at least once a year, and at more frequent intervals in case of large advances.

***Consideration of Drawing Power/Limits in respect of stocks hypothecated***

11.181 In respect of credit facilities against hypothecation of stocks (inventories) being the primary security, Bank's system of appraisal for determining the maximum permissible finance to borrowers and fixing of limits, *inter alia*, should take into consideration the level of sundry creditors. The sanction is expected to be in tune with the appraisal so made. While sanctioning such credit facility, bank is expected to stipulate in the documents, that for computing the Drawing Power, the value of declared stocks is to be considered only net of the stipulated margin; and that declared stocks shall not cover the borrower's liability outstanding in form of sundry creditors for goods or covered by LCs/ guarantees/ co-acceptances or Buyer's Credit availed for procurement of material. Bank should also insist on such information from borrowers. In case of consortium accounts, drawing power calculation and allocation made by the Lead Bank is binding on all Member Banks.

11.182 RBI has issued guidelines on treatment of unpaid stocks while arriving at the drawing power available in borrower accounts. The thrust of the guidelines is avoidance of double financing on unpaid stocks, if such stocks are taken as eligible for computation of drawing power.

11.183 The matter having been re-examined by RBI vide directive No. IECD.No.32/08.10.01/92-93 dated 28th April, 1993, banks were advised as regards the treatment of unpaid stocks while arriving at the drawing power available in the borrower accounts, wherein the thrust is avoidance of the double finance on the unpaid stock, if such stocks are taken as eligible for computation of drawing power. Thus, it would be unrealistic to assume that the composition of the stock items, the level of stock held and the portion of unpaid stock considered at the time of appraisal would be static and should be presumed to be at the same level for subsequent period. For the said reason, the drawing power needs to be recomputed based on variations, not only in composition and level of stock but also in the unpaid portion of stocks before the stipulated margin is applied as per the sanction terms of working capital finance.

11.184 Auditor should review the bank policy for any inherent weakness in the credit system, where the stringency in appraisal, is relaxed while sanctioning the

## **Guidance Note on Audit of Banks (Revised 2020)**

---

advances, having consequential effect on monitoring and supervision, and may have effect on the classification status of the Borrower, where the drawing power falls short of the outstanding.

11.185 Banks usually consider credit facilities by way of Hypothecation of stocks and a charge on the sundry debtors. The Drawing Power is required to be computed net of the stipulated margin, based on and applied to the total eligible current assets comprising:

- Net Value of Stock as stated above, and
- Net Value of Debtors (i.e., eligible Trade Debtors Less Bills Discounted with Bank). The bank usually prescribes conditions as to what comprise eligible trade debtors, and stipulates the period for debts being considered as current and good on which the margin is computed.

11.186 For purposes of classification of advances, computation of drawing power based on realistic value of hypothecated stocks (net of unpaid for stocks, whether covered by Buyer's Credit, LCs/ Guarantees/ Co-acceptances or otherwise) and margin as stipulated, is vital, particularly in cases of default, and in border-line cases where health status of borrowers may be in question, to gauge slippages.

11.187 Due care is required to be exercised by the auditor in case of

- Documents retained in original at centralised offices where these are not available at the branches that are advised of drawing power limits; and
- consortium advances, where bank, not being the leader, gets related figures of drawing power from the leader bank, without related evidence of computation or appropriateness of drawing power.

Auditor needs to look into this aspect to verify that there is no slippage of the account into NPA classification.

11.188 These days most of the banks have their 'advances' statements generated through the system. Auditor should ensure that the fields which system copies from last year are the same and he should take extra care in relation with the date of NPA and date of becoming doubtful asset as these facts have great bearing on the provisioning. The auditor should obtain audit trail from the bank to verify whether there are any changes or not.

### ***Examination of Loan Documents***

11.189 Documents relating to advances would be affected by the legal status of the borrower and the nature of security. Thus, where the borrower is a company, loan documents would include certificate of incorporation, memorandum and

articles of association, certificate of commencement of business (in the case of public limited companies), resolution of board of directors, and special resolution of shareholders [in cases covered by section 180 (1)(c) of the Companies Act, 2013, etc. Where the borrower is a partnership firm, loan documents would include copy of partnership deed. Where the security is in the form of mortgage, apart from mortgage deed (in the case of English Mortgage) or letter of intent to create mortgage (in the case of Equitable Mortgage), the evidence of registration of the charge with the Registrar of Companies would also form part of loan documentation if the borrower is a company. Each bank has its own set of rules regarding the documents to be obtained from various types of borrowers and in respect of different kinds of securities. Formats of many of the documents are also prescribed. Auditor should evaluate the adequacy of loan documents in the context of the rules framed by the bank in this regard.

*Centralisation and location of original loan documents at Loan Processing Centres*

11.190 Of late, there is an increasing propensity in banks to process loans and advances, including appraisal, sanction, documentation, initial disbursements, etc., at Loan Processing Centres/Offices (by whatever name called) and to execute and physically hold all the documents at such locations, that may not be in very close proximity to the branch, where the borrower accounts are maintained/serviced. The Branch places reliance only on the Sanction letters, on the presumption that all required legal and documentation formalities are correct and complete at the centralized location.

11.191 In absence of the original documents (or even authenticated copies thereof) on an updated basis, auditor would need to request the management for the files identified for examination by him. Statutory Branch Auditor must be satisfied on the authenticity and terms of the sanction (in case the sanction letters are only computer generated but not authenticated), the completeness of the records, duly updated, for all accounts where the sanction was so conveyed; and further whether the number of accounts and amounts recorded at such centres tally with the corresponding data at the branch. It needs to be confirmed whether there are any cheques held by such centres that remain unbanked affecting the borrower account balance. Reference must also be made to any adverse observations in the related monitoring/supervisory report on the documentation aspects at the centralized location.

***Review of Operation of Account***

11.192 Auditor should review the operation of the advance accounts. In doing so, an intelligent scrutiny of the operation of the account should be carried out to see that the limit is not exceeded; that the account is not becoming stagnant; that

### **Guidance Note on Audit of Banks (Revised 2020)**

---

the customer is not drawing against deposits which are not free from lien; that the account is not window-dressed by running down overdrafts at the year end and again drawing further advances in the new year, etc. Audit procedure should be able to highlight disbursements from pre/freshly sanctioned limits made either to the same borrower or to group entities near the repayment dates of critical dues.

11.193 Auditor should also examine whether there is a healthy turnover in the account. It should be seen that the frequency and the amounts of credits in the account are commensurate with the sanctioned limit and the nature and volume of business of the borrower. Any unusual items in the account should be carefully examined by the auditor. If the auditor's review indicates any unhealthy trends, the account should be further examined. The auditor's examination should also cover transactions in the post-balance sheet date period. Large transactions in major accounts particularly as at the year-end may be looked into, to identify any irregularities in these accounts. A written note/explanation may be obtained from the management as regards any major irregularities which may have a bearing on his report.

11.194 Auditor may also review the following to assess recoverability of advances:

- (a) Periodic statements submitted by the borrowers indicating the extent of compliance with terms and conditions.
- (b) Latest financial statements of borrowers.
- (c) Reports on inspection of security.
- (d) Auditors' reports in the case of borrowers enjoying aggregate credit limits of Rs. 10 lakh (or as approved by Board of Directors of respective banks) or above for working capital from the banking system.

11.195 Auditor should verify that interest is being charged on all performing accounts regularly and should compare rate of interest with the agreement, sanction letter and credit rating reports where rate of interest is linked to credit rating. In case the interest rate is revised based on changes in PLR/BPLR/Base Rate of the bank, it needs to be ensured that the rate of interest to be charged from the borrower is suitably revised as and when there are changes in PLR/BPLR/Base Rate. Calculation of interest should be test-checked. The auditor should examine that interest not received on any account, which is a non-performing asset as per RBI guidelines. It may be noted that interest accrued but not due on advances does not form part of advances.

11.196 Penal interest on delayed submission of stock statements, non-creation of security, overdrawn accounts etc., needs to be charged as per sanctioned



terms and norms of the bank. Compliance of the same should be checked in detail by the auditors.

11.197 In case of advances covered by guarantees of DICGC/ECGC/CGTS, in case of default the auditor should examine whether appropriate steps are taken for lodging of claims for guarantees in accordance with applicable procedure. The claims declined by DICGC/ECGC/CGTS should not be considered as recoverable while calculating provisions against the respective advances.

11.198 In respect of consortium advances, auditor should examine–

- (a) Compliance with limits stipulated by consortium in lending moneys to the borrower;
- (b) Bank's monitoring of securities like stocks, etc., in its custody/charge; and
- (c) Follow-up with lead bank on pending issues.

11.199 The auditor should examine whether the bank has correctly classified the inter-bank participation certificates. In the case of participations on risk-sharing basis, the auditor should examine whether any loss has devolved on the bank as on the balance sheet date and, if so, whether adequate provision in respect of such loss is made.

***Verification of Security against Advances***

11.200 An advance is treated as secured to the extent of the value of the security on the reporting date. If a part of the advance is covered by the value of the security as at the date of the balance sheet, that part only should be classified as secured; the remaining amount should be classified as unsecured.

11.201 Following points are relevant for classifying advances based on security.

- (a) Government guarantees include guarantees of Central/State Governments and advances guaranteed by Central/State Government owned corporations, financial institutions like IDBI, IFCI, ICICI, State Financial Corporations, State Industrial Development Corporations, ECGC, DICGC, CGTS, etc.
- (b) Advances covered by bank guarantees include advances guaranteed against any negotiable instrument, payment of which is guaranteed by a bank.
- (c) Advances covered by bank/government guarantees should be included in unsecured advances to the extent the outstanding in these advances exceed the amount of related guarantees.

#### **Guidance Note on Audit of Banks (Revised 2020)**

---

- (d) While classifying advances as secured, the primary security should be applied first and for residual balance, if any, value of collateral security should be taken into account. If the advance is still not fully covered, then, to the extent of bank/government guarantees available, the advance should be classified as 'covered by bank/government guarantee'. Balance, if any, remaining after the above classification, should be classified as 'unsecured'.
- (e) There may be situations where more than one facility is granted to a single borrower and a facility is secured, apart from primary and collateral securities relating specifically to that facility, by the residual value of primary security relating to any other credit facility (or facilities) granted to the borrower. In such a case, in the event of shortfall in the value of primary security in such a credit facility, the residual value of primary security of the other facility (or facilities, as the case may be) may be applied first to the shortfall and the value of collateral securities should be applied next.
- (f) In case of common collateral security for advances granted to more than one borrower, if there is a shortfall in value of primary security in any one or more of the borrower accounts, the value of collateral security may be applied proportionately to the shortfall in each borrower account.
- (g) Advances covered by ECGC/DICGC,CGTS guarantees should be treated as covered by guarantees to the extent of guarantee cover available. The amount already received from DICGC/ECGC/CGTS and kept in sundry creditors account pending adjustment should be deducted from advances.
- (h) An account which is fully secured but the margin which is lower than that stipulated by the bank should nevertheless be treated as fully secured for purposes of balance sheet presentation.
- (i) All documentary bills under delivery-against-payment terms (i.e., covered by RR/Airway Bill/Bill of lading) for which the documents are with the bank as on the balance sheet date should be classified as 'secured'.
- (j) Documentary bills under delivery-against-acceptance terms which remain unaccepted at close of 31st March (i.e., for which documents of title are with the bank on this date) should be classified as secured. All accepted bills should be classified as 'unsecured' unless collaterally secured.
- (k) Cheques purchased including self-cheques (i.e., where the drawer and payee are one and the same) should be treated as unsecured.
- (l) Advances against supply bills, unless collaterally secured, should be classified as unsecured even if they have been accepted by the drawees.

### **Guidance Note on Audit of Banks (Revised 2020)**

---

- (m) 'Security' means tangible security properly discharged to the bank and will not include intangible securities like guarantees (including State government guarantees), comfort letters, etc. Moreover, rights, licenses, authorisations, etc., charged to banks as collateral in respect of projects (including infrastructure projects) financed by them, should not be reckoned as tangible security. (Ref Master Circular No. RBI/2015-16/99DBR.BP.BC.No.23/21.04.018/2015-16 dated July 1 2015 on Disclosure in Financial Statements- Notes to Accounts)

11.202 In examining whether an advance is secured and, if so, to what extent, the auditor is concerned with determining –

- (a) whether security is legally enforceable, i.e., whether necessary legal formalities regarding documentation, registration, etc., are complied with;
- (b) whether security is in effective control of the bank; and
- (c) to what extent the value of the security, assessed realistically, covers amount outstanding in the advance.

11.203 Auditor should examine the following aspects in respect of advances classified as 'secured':

- (a) Documents executed are complete and in force.
- (b) Where documents are not renewed, limitation period has not expired.
- (c) Evidence is available to the market value of the security.
- (d) Evidence is available that –
  - i. hypothecated/pledged goods are the property of the borrowers and are not old/obsolete or otherwise unsaleable;
  - ii. advances against book debts of borrowers are related to their current debts and not old/doubtful debts; and
  - iii. Stocks hypothecated/pledged are paid stocks owned by the borrower.
- (e) In case of companies, charge is appropriately registered with the Registrar of Companies and a certificate of registration of charge or other evidence of registration is held.
- (f) Borrowers are regular in furnishing requisite information regarding value of security lodged with the bank.
- (g) In respect of second charge being available in respect of certain assets, the amount of the lender(s) enjoying the first charge on such asset be worked out and only the residuary value, if any, available for second charge holders, be considered.

*Stock Exchange Securities and Other Securities*

11.204 Auditor should verify stock exchange securities and their market value in the same manner as in the case of investments. Auditor should examine whether the securities have been registered or assigned in favour of the bank, wherever required and verify the same with Demat Statement.

11.205 A quoted security may not have frequent transactions on the stock exchange and the quotation included in the official quotations may be that of a very old transaction. In such a case, the auditor should satisfy himself as to the market value by scrutiny of balance sheet, etc., of the company concerned, particularly, if the amount of advance made against such security is large.

11.206 Banks do not generally make advances against partly paid securities. If, however, any such shares are accepted by the bank as security and these are registered in the name of the bank, the auditor should examine whether the issuing company has called up any amount on such securities and, if so, whether the amount has been paid in time by the borrower/bank.

*Goods*

11.207 In respect of hypothecated goods, the auditor should check the quantity and value of goods hypothecated with reference to the statement received from the borrower. He should also examine the reasonableness of valuation. Letter of hypothecation should also be examined by the auditor. If the value of the goods is higher than the amount mentioned in the letter of hypothecation, the bank's security is only to the extent of the latter. Auditor should also verify that the Bank has system of maintenance of proper register in this regard and a system of scrutiny of stock/book debt statement furnished by the borrower.

11.208 The auditor should also check nature of goods hypothecated/pledged. If the goods are of perishable nature, it will not have a market value. In case of goods/book debts, movable assets hypothecated, auditor should also examine whether the Bank has system in place for periodical inspection of such goods/debts/assets and records of borrowers by its own officer or by external agencies like firm of Chartered Accountants. Whether proper register is maintained in this regard and timely action is taken whenever there is an adverse remark in the inspection report. Auditor should also check that there is adequate insurance cover in respect of goods /assets hypothecated and there is a bankers' clause in the policy.

11.209 In respect of goods pledged with the bank, the auditor should check the statement received from the borrower regarding the quantity and value of goods pledged by him. He should test check the godown registers and valuation of goods. If there is any outstanding delivery order against the goods as on the

balance sheet date, the same should be deducted from the total quantity in hand in ascertaining the value of the goods constituting the security. The auditor may also examine the key movement register to verify movement of goods inwards and/or outwards.

11.210 Sometimes, goods are in possession of third parties, such as clearing and forwarding agents, transporters, brokers, warehouse-keepers, etc. If these parties have given an undertaking to the bank that they will hand over the goods or sale proceeds thereof to the bank only, i.e., they have 'attorned' to the bank the advances made against such goods should be considered as secured. In such cases, certificates should be obtained by the bank from such third parties regarding quantities on hand on balance sheet date. The valuation of such goods should be checked by the auditor. In case the borrower is a company, the auditor should examine the certificate of registration of charge on the goods hypothecated with the Registrar of Companies. It may be mentioned that in case of pledge of goods, registration of charge is not necessary.

*Gold Ornaments and Bullion*

11.211 The auditor may inspect and weigh (on a test basis) the ornaments on the closing date. He should also see the assayer's certificate regarding the net gold content of the ornaments and their valuation. Valuation should also be checked with reference to the current market price of gold. In context to the valuation, attention is also invited to the valuation norms as given in the RBI circular no. DBOD.No.BP.BC.27/21.04.048/2014-15 on "Loans against Gold Ornaments and Jewellery for Non-Agricultural End-uses" dated July 22, 2014.

11.212 In respect of gold and silver bars, the auditor should inspect the bars on a test basis and see that the mint seals are intact. The weights mentioned on the bars may generally be accepted as correct.

*Life Insurance Policies*

11.213 The auditor should inspect the policies and see whether they are assigned to the bank and whether such assignment has been registered with the insurer. The auditor should also examine whether premium has been paid on the policies and whether they are in force. Certificate regarding surrender value obtained from the insurer should be examined. The auditor should particularly see that if such surrender value is subject to payment of certain *premia*, the amount of such *premia* has been deducted from the surrender value.

11.214 It should be verified whether policies are assignable in bank's favour. In certain types of policies where assignment to third party are restricted, due care has to be taken while considering it as a security.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

### *Bank's Own Deposit Certificates*

11.215 Auditor should inspect such certificates and examine whether they have been properly discharged and whether lien of the bank is noted on the face of the certificates, in the relevant register of the bank and in CBS master data.

### *Hire-purchase Documents*

11.216 These advances may be classified as secured against the hypothecation of goods. Where there is no hypothecation, the advance will be classified as unsecured.

### *Plantations*

11.217 These advances are classified as secured against the crop and/or the fixed assets (viz., mortgage of land) of the plantation. The auditor should examine the agreement and the title deeds. Regarding the estimate of the crop, he may examine the record of the garden for the last few years. He should also ascertain whether the crop is properly insured against natural calamities and other disasters such as hail, etc.

11.218 Auditor should keep in mind that where moratorium is available for payment of interest in such plantation projects, the payment of interest becomes due only after the moratorium or gestation period is over. In such a case the account will become NPA in case interest is not recovered after the due date after moratorium period, if specifically mentioned in the sanction letter.

### *Immovable Property*

11.219 The auditor should inspect title deeds, solicitor's/advocate's opinion taken by the bank in respect thereof, and the mortgage deed. For valuation, he may rely on the architect's or valuer's report (which should be taken at least once in three years) after carrying out appropriate audit procedures to satisfy himself about the adequacy of the work of the architect/valuer for this purpose.<sup>3</sup> He should also examine the insurance policies.

11.220 In some cases, banks make advances against immovable properties where the title deeds are not in the name of the borrower. For example, an advance may be given against the security of a flat in a co-operative group housing society, the title deeds of which may not be in the name of the borrower. In such cases, the auditor should examine the evidence regarding the right or interest of the borrower in the property mortgaged, e.g., power of attorney, share certificate of co-operative group housing society, 'no objection certificate' from the society/lessor (in the case of leasehold properties) for offering the property as security, etc.

---

<sup>3</sup> Reference may be made in this regard to SA 620, "Using the Work of an Auditor's Expert".

11.221 In case the bank have accepted third party property as a security, the owner of the property should also execute guarantee bond in bank's favour. The mortgage value in bank's favour should be equal/in excess of loan amount covered by such mortgage.

*Reliance on / review of other reports*

11.222 The auditor should take into account the adverse comments, if any, on advances appearing in the following:

- Previous years audit reports.
- Latest internal inspection reports of bank officials.
- Reserve Bank's latest inspection Report/Asset Quality Review/ Risk Based Supervision report.
- Concurrent /internal audit report.
- Report on verification of security.
- Any other internal reports specially related to particular accounts.
- Manager's charge-handing-over report when incumbent is changed.

11.223 The above reports should be reviewed in detail. Statutory Central Auditor's(SCAs) must review the Annual Financial Inspection report of RBI relating to the bank and should check whether variations in provisions, etc., reported by RBI have been properly considered by the bank management. SCA's should consider the issues emerging from recent RBI inspections and obtain an understanding of changes made by the banks pursuant to the inspection process to enhance their identification of NPAs. Further audit procedures should be suitably re-designed after considering such issues.

*Third Party Guarantees*

11.224 The auditor should examine guarantee bonds and demand promissory notes in order to verify the third party liability. Auditor should satisfy that the guarantee is in force as at the date of the balance sheet. In absence of a provision to the contrary, a guarantee terminates by revocation or upon death of the surety. The surety is also discharged (unless there is a specific covenant to the contrary) if the creditor arranges with the principal debtor for compromise, or agrees to give time or agrees not to sue him, without consulting the surety. If any variation is made in the terms of the contract between the principal debtor and the creditor without the surety's consent, it discharges the surety as to transactions subsequent to the variation. The guarantee forms used by banks normally seek to ensure the continuing obligation of the guarantor in spite of these contingencies. If such clause is absent then Auditor has to see the acknowledgement to debt from the borrower as well as guarantor is obtained by the Bank.

***Verification of Bills Purchased and Discounted***

11.225 Auditor should familiarise with the guidelines issued by RBI and the policies framed by the bank regarding discounting and rediscounting of bills. Auditor should ascertain that the policy framed by the bank conforms to RBI requirements.

11.226 Bills purchased and discounted have to be shown separately in the balance sheet as part of 'advances'. Further, under the head 'advances outside India' in the balance sheet, bills purchased and discounted outside India have to be shown separately. This category will include bills covering export of goods, bills discounted by foreign branches of the bank and payable in their respective countries, etc.

11.227 Banks purchase or discount bills of exchange drawn or endorsed by their customers. The bank credits the amount of the bill to its customer after deducting the discount. The total amount of such bills is shown as an asset in the balance sheet.

11.228 In certain eligible cases, the bills purchased or discounted by the bank may be rediscounted by it with the RBI IDBI/SIDBI. Such bills would not be included under advance but would constitute a contingent liability.

11.229 Bills purchased and discounted by the bank are generally drawn on outstation parties and are, therefore, sent by the bank to its branches or agents for collection immediately after their receipt. They are generally not in the possession of the bank on the closing date. The auditor therefore has to rely upon the Register of Bills Purchased and Discounted and the party-wise Register of Bills maintained by the bank. The auditor should examine these registers and satisfy himself that:

- (a) all outstanding bills have been taken in the balance sheet;
- (b) all details, including nature of the bills and documents, are mentioned in the register and that the bills have been correctly classified;
- (c) Bills purchased or discounted from different parties are in accordance with the agreements with them and total of outstanding bills of each party is not in excess of the sanctioned limit; and
- (d) Bills are not overdue. If there are any overdue bills, auditor should ascertain reasons for the delay and the action taken by the bank.

11.230 Auditor should examine whether registers of bills purchased and discounted are properly maintained and the transactions are recorded therein correctly. He should examine whether bills and documents accompanying the bills are properly endorsed and assigned in favour of the bank. In checking the



bills, it should be ensured that the bills are held along with the documents of title. In case of documentary bills, it should be examined whether related RRs/TRs are held along with the invoices/ hundies / bills and that these have not been parted with. Wherever such RRs/TRs are not held on record, the fact should be duly considered by the auditor. Auditor should also examine bills collected subsequent to year-end to obtain assurance regarding completeness and validity of recorded bill amounts.

**Verification of Buyer's Credit Transaction**

11.231 Following documents are required to be verified by auditors during review of Buyers' Credit Transaction and its accounting treatment in Bank's books.

- (a) (Loan) Agreement, if any, entered between the Indian importer (borrower), overseas bank (lender), the Indian bank (facilitator);
- (b) Underlying documents for import of capital goods or raw materials;
- (c) Maximum tenure of buyer's credit as per guidelines of RBI;
- (d) SWIFT messages originated by overseas bank specifying the terms of Buyer's Credit;
- (e) Calculation of contingent liability towards LoC/ LoU is inclusive of interest accrued on Buyer's Credit as on financial statement date;
- (f) Documentation / Agreement between overseas bank and Indian bank, and, any further confirmatory documents exchanged between overseas bank and Indian bank;
- (g) Review of documents specifying right of recovery against borrower, in case the borrower defaults in repayment of Buyer's Credit;
- (h) Balance confirmations obtained from overseas bank;
- (i) Charge created in records of RoC related to the security offered for Buyer's Credit *vis-à-vis* disclosure of Buyer's Credit in the financials of borrowers as secured / unsecured loan;
- (j) Acknowledgement of debt, if any, obtained from the borrower;
- (k) Calculation of drawing power for working capital finance availed by the borrower is net of the Buyer's Credit;
- (l) Form 15CA / Form 15CB compliance made by the borrower.

RBI vide circular no. RBI/2017-18/139 A. P. (DIR Series) circular no. 20 dated March 13, 2018 has advised the AD Category –I banks to discontinue the practice of issuance of LoUs / LoCs for Trade Credits for imports into India with immediate effect.

***Other Aspects***

11.232 Sometimes, a customer is sanctioned a cash credit limit at one branch but is authorised to utilise such overall limit at a number of other branches also, for each of which a sub-limit is fixed. In such a case, the determination of status of the account as NPA or otherwise should be determined at the limit-sanctioning branch with reference to the overall sanctioned limit/drawing power, and not by each of the other branches where a sub-limit has been fixed. Auditor of the limit-sanctioning branch should examine whether it receives particulars of all transactions in the account at sub-limit branches and whether status of the account has been determined considering the total position of operation of the account at all concerned branches. As far as sub-limit branches are concerned, they should follow classification adopted by the limit-sanctioning branch.

11.233 Auditor should examine that advances made by a banking company otherwise than in course of banking business, such as, prepaid expenses, advance for purchase of assets, etc., is not included under 'advances' but is included under 'other assets'.

11.234 Amounts of advances in India and those outside India are to be shown separately in the balance sheet. This classification will depend upon where the advance was actually made and not where it has been utilised. Generally speaking, figures of Indian branches will be shown as advances in India and figures of foreign branches as advances outside India.

11.235 Auditor should examine whether any loan has been granted in violation of statutory limitations in section 20 of the Banking Regulations Act, 1949. If any such loan is granted the report will have to be drafted with suitable qualifications, as the transaction is ultra vires.

11.236 It may also be examined whether the bank has a system of ensuring end use of the funds granted compared with the purpose of sanction.

***Drawing Power Consideration***

11.237 Working capital borrower account, drawing power calculated from stock statement older than 3 months has to be considered as "irregular" (overdue). If such "irregular" continues for 90 days, account has to be classified as NPA, even though the account is otherwise operated regularly.

11.238 Stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinized in detail.

11.239 Audited Annual Report submitted by the borrower 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.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

11.240 It needs to be examined whether the drawing power is calculated as per the extant guidelines formulated by the bank, which should also be in line with RBI guidelines/directives. Special consideration should be given to proper reporting of sundry creditors for purposes of calculating drawing power.

11.241 Stock audit should be carried out by the bank for all accounts having funded exposure over Rs.5 crores. Auditors can also conduct or advise for conduct of stock audit in other cases if situation warrants the same. Branches should obtain stock audit reports from lead bank or any other member, as decided in consortium in cases where Bank is not leader of the consortium of working capital. The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power.

11.242 Drawing power needs to be verified carefully in case of working capital advances to entities engaged in construction business. Valuation of work in progress should be calculated properly and consistently. It should be examined whether mobilization advance being received by the contractors is reduced while calculating drawing power. In respect of certain businesses such as diamond merchants and jewellers, auditor should exercise due caution while verifying realisable value of precious metals, diamonds, jewellery etc. Auditor may also consider obtaining assistance of an expert in case circumstances so warrant.

11.243 In case of consortium accounts, the drawing power calculation and allocation is made by the Lead Bank and is binding on the Member Banks.

### *Lending under Consortium Arrangement / Multiple Banking Arrangements*

11.244 In order to strengthen the information sharing system among banks in respect of borrowers enjoying credit facilities from multiple banks, banks are required to obtain regular certification by a professional, preferably a Company Secretary, Chartered Accountants or Cost Accountants regarding compliance of various statutory prescriptions that are in vogue, as per specimen given in Annexure III (Part I and II), to RBI Circular No. DBOD.No. BP.BC.110/08.12.001/2008-09 dated February 10, 2009.

11.245 Accounts under Consortium arrangements may, notwithstanding their classification as Standard, due to servicing thereof, may nonetheless be intrinsically weak or even be NPA in other participating bank(s), including on the basis of the certificate/report as aforesaid. Auditor should consider this aspect and classify the account appropriately based on facts and circumstances, particularly based on any serious adverse remarks/comments in the certificate issued pursuant to the RBI circular.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

11.246 Auditor should check compliance with RBI guidelines on unhedged foreign currency exposure. Self-declaration from the client or Independent auditors' certificate of foreign currency exposure should be obtained by the Bank. Such declaration/certificate can be cross checked with computation of standard asset provisioning.

11.247 Bank should ensure that correct, sensitized and vetted data is duly and timely captured so that analytics could be run intelligently through the system to make data predictions to generate foresights on trends, patterns that show incipient sickness. Pro-active monitoring of the Early Warning Signals (EWS) as per Appendix I of RBI Circular No. DBS.CO.ARS.BC.No.007/23.04.001/2014-15 dated 7th May, 2015 "Framework for dealing with loan frauds" should be ensured. These (EWS) should be used as indicators for Red Flagging Accounts. (RFA). Auditors should comment on the prevalence of the (EWS) - (RFA) system and its operational efficiency and effectiveness.

11.248 Auditors should comment on the frequency and periodicity of trainings given to Branch officials on knowledge and skill up-gradation especially on usage of technology and other advanced developments on appraisal, risk, controls and gap mitigation loan and cyber frauds.

### **Non fund based facilities**

11.249 Non-fund based facilities are letters of credit, bank guarantees, letter of comfort/undertaking, etc. Non-fund based facility may turn into a fund based facility on due date, if not paid by the borrower, for e.g. devolvement of bills under Letters of Credit, invocation of Bank Guarantee, etc. As on the date of a sanction and original booking they do not involve an outflow of funds.

11.250 Letter of credit: A Letter of Credit (LC) is a promise by a banker to honour the payments to be made by its customer (the buyer or importer) to the seller or exporter. This type of payment facility is generally used in international trade. In this type of facility, at the request of the buyer, his banker opens an LC, which is sent to the seller. Based on such LC, the seller despatches the goods and then sends the bills and other documents through his banker to the buyer's banker, which has opened the LC, to make payment of the bill. The buyer then makes the payment and routes it through his banker to the seller's banker. In case the buyer fails to make the payment (also known as devolvement of LC), the buyer's banker, which has opened the LC, is liable to make the payment to the seller. RBI has mandated banks not to discount bills drawn under LCs or otherwise for beneficiaries, who are not their regular clients.

11.251 Bank Guarantee: A Bank guarantee is written contract given by a bank on behalf of customer. By issuing this guarantee, a bank takes

responsibility for payment of a sum of money in case, if it is not paid by the customer on whose behalf the guarantee has been issued. In return, a bank gets some commission for issuing the guarantee. Anyone can apply for a bank guarantee, if his or her company has obligations towards a third party for which funds need to be blocked in order to guarantee that his or her company fulfils its obligation (For example:- carrying out certain works, payment of debt, etc.) In case of any changes or cancellation during the transaction process, bank guarantee remains valid until the customer duly releases bank from its liability. In the situations where customer fails to pay the money, bank must pay the amount within 3 working days. This payment can also be refused by bank if claim is found unlawful. Guarantees are of two types—financial guarantee, wherein the guarantor (the bank) promises to pay the stated amount to the beneficiary, if the person for whom the guarantee is given, fails to pay the same (also referred to as invoking the guarantee); performance guarantee, wherein the guarantor promises to pay the beneficiary a stated sum of amount, if the person for whom the guarantee is given, fails to perform, as expected, in a given period of time. Banks are generally discouraged from issuing performance guarantees. Guarantee transaction usually comprises two independent but related components— one is the guarantee issued by the banker (of the buyer) to the beneficiary (i.e., seller) and the other is a counter guarantee given by the buyer to his banker, who has issued the guarantee. Generally, guarantees should not be issued on behalf of customers, who do not enjoy credit facilities with the bank. Since guarantees invoked could get converted into funded advance to a borrower, banks should not encourage borrowers to over extend their commitments solely on the basis of guarantees. Guarantees could be for specific transaction (called specific guarantee) or it could be for multiple transactions within a specific time frame (called continuing guarantees). Guarantees should generally be for short durations; in any case, it should not have a maturity period of more than 10 years. Unsecured Guarantees to a particular borrower should generally not exceed 10% of the total exposure. Banks should also not concentrate its unsecured Guarantees to a particular borrower or a group. Ghosh Committee has recommended certain precautions to be taken by banks while issuing guarantees. Guarantees are generally issued by keeping margins, either in the form of cash/term deposit or some other security. In case of guarantees issued on behalf of share and stock brokers, the RBI has advised that banks should obtain a minimum margin of 50% (with 25% being cash margin). RBI has laid restrictions on guarantees of inter-company deposits/loans and inter institutional guarantees. In the above mentioned circular, the RBI has also given extensive guidelines on issue of guarantees on behalf of exporters and importers.

11.252 Co-Acceptance of Bills:- In this type of facility, the seller despatches the

### **Guidance Note on Audit of Banks (Revised 2020)**

---

goods and raises the bill on the buyer. The buyer accepts the bill and then it is co-accepted by buyer's banker. The seller's banker then discounts this bill. This type of facility is often used by customers to float accommodation bills (i.e., bills which are not supported by genuine sale and purchase of goods) and hence auditors should be careful while examining such bills.

11.253 Non fund based facilities are recorded in the Books of accounts as a contra item appearing on both sides of the Trial Balance. In the Balance sheet they appear under the prescribed schedule.

11.254 Auditor should ensure that –

- 1) There is a proper procedure for sanctioning non fund based facilities and these facilities are duly monitored and are within the sanctioned limits. Any outstanding beyond sanctioned amount is a deviation and should be promptly reported.

Banks do not issue these facilities especially Guarantees for walk-in customers even with 100% cash margins. Necessary KYC checks and a due sanction should be in place for issuance of these facilities.

- 2) There is a proper procedure for recording these amounts in the books of accounts through serial numbers or other appropriate methods.
- 3) Necessary margins as prescribed in the sanction letter have been duly collected. These margins are duly lien marked and not allowed to be withdrawn during pendency of the facility.
- 4) They have been issued in the prescribed standard format. Care should be taken to note the formats for issuance of Letters of Comfort / Undertaking.
- 5) They have been issued under proper authority. Banks have a schedule of powers for sanction of various facilities and it should be noted that these facilities are sanctioned under proper delegated authority levels.
- 6) They have been duly disclosed in the financials under appropriate prescribed heads in the prescribed manner. Some Banks disclose these facilities as Net of margins while some disclose this at Gross. Auditor should ensure that whatever practice is followed by banks is consistent as per their policy and is duly disclosed in the financial statements.
- 7) The Bank has proper policies, procedures, manuals which could also be a part of their credit manual that describes in detail how these facilities are to be sanctioned, disbursed, documented, monitored, accounted and cancelled. The auditor should ensure due compliance with these policies, procedures and manuals.

**Guidance Note on Audit of Banks (Revised 2020)**

---

- 8) If these facilities are devolved / invoked, then they would be funded advances. Appropriate removal from non fund based advances should be done to avoid duplicate disclosure as both funded and non funded advances.
- 9) The underlying documents should be kept under proper control and custody.
- 10) Where a number of guarantees / Letters of credit issued have been invoked / devolved, the auditor would have to consider the probability of invocation / devolvement of the guarantees / letters of credit on their due dates and consider making appropriate provisioning thereon as of current date.
- 11) On expiry of their term and if no letter of invocation / devolvement has been received and if the original Guarantee has been received back, there would be no liability due on these Guarantees / Letters of credit, these would have to be removed from the books of account.

Different banks have different practices in this regard especially for Guarantees. In case of Guarantees some Banks wait for receipt of the original guarantee back from the issuer before cancelling the liability from the books .In such cases the auditor should also note whether there is a timely system of sending letters to the issuers asking for return of the original guarantees immediately post the expiry date.

11.255 For Guarantees issued to Governments, specific rules apply and auditor should ensure that these are followed.

- 1) Auditor should ensure proper classification of Guarantees in to Performance or Financial as they carry separate risk weights.
- 2) Auditor should note that the RBI has issued Master Circular No. RBI/2015-16/76 DBR.No.Dir.BC.11/ 13.03.00/2015-16 dated July 01, 2015 on Guaranteed and Co-acceptances. RBI also keeps on issuing guidelines/ circulars from time to time, which should be duly noted for compliance. RBI vide circular no. RBI/2017-18/139 A. P. (DIR Series) circular no. 20 dated March 13, 2018 has also advised the AD Category-I banks to discontinue the practice of issuance of LoUs / LoCs for Trade Credits for imports into India with immediate effect.
- 3) Non fund based advances are prone to frauds as can be seen in recent times and due care needs to be taken while verifying these facilities.
- 4) These facilities are duly reviewed and renewed as per procedures prescribed in the same manner and alongside funded advances.
- 5) Care should be taken to ensure that the bank does not issue letters on

## Guidance Note on Audit of Banks (Revised 2020)

---

behalf of their customers to 3<sup>rd</sup> parties which are in the form of a Comfort / Undertaking and may need classification as a non fund based Liability. Necessary procedures framed by the bank in this regard should be verified including the awareness, training and sensitization thereof.

- 6) The internal controls designed and in operation over the process from start to end from the sanction to the cancellation should be verified in depth on a standalone basis. Any gaps noted in the control process should be promptly reported.

Since these are specialized operational areas, Staff with necessary, relevant experience with training are only posted to handle Guarantee / Letters of Credit transactions. Controls over job rotations and mandatory leaves to these staff should be verified and reported.

- 7) The LFAR contains specific questions needing reporting on non fund based facilities. The auditor should duly note the requirements of the LFAR while planning and conducting the audit.
- 8) Non fund based facilities should be duly considered for all reporting and calculation purposes as prescribed in appropriate guidelines.
- 9) These facilities earn a fee based income for Banks. Banks have different methods for booking fee based income especially in case of Guarantees. Some do it up-front either monthly or quarterly. Auditor should ensure there is consistency in the methodology followed for booking of income in accordance with prescribed policy at prescribed rates.

Banks should also note to collect processing fees on sanction, review and renewal of these facilities at prescribed rates.

- 10) There may be cases where the main non funded limit may be sanctioned at one branch and sub limits may be sanctioned at another branch. In such cases, appropriate monitoring should be done in the same manner as is done for sanctioned advances in similar situations.

For consortium accounts, monitoring and follow-up including obtaining of relevant information would be the same as would be done in case of a funded facility.

- 11) In some Banks especially Foreign Banks, non fund based facilities constitute a significant portion of their book size and at times even exceed their funded facilities.
- 12) Forward Contracts, Swaps – Currency or Interest Rate are also non fund based facilities which are also duly sanctioned, monitored, disclosed and



transacted as per policies and guidelines. Necessary details therein have been disclosed in appropriate section of this Guidance Note.

### **Selection of accounts**

11.256 The auditor should obtain a list or breakup of all advance accounts as at the yearend. This should be obtained Facility wise – Security wise – Sanction date and amount wise. The Auditor has to mandatorily comment on all advances - 2 Crores or 10% of the total advances of the Branch whichever is higher. Apart from the mandatory reporting the auditor should pick up advance accounts for each type – Each of Unsecured, Educational, Housing, Vehicle, Personal, Loan against FD, Loan against Shares, Loan against property, Loans granted against other Securities. Besides loans accounts - Cash Credit accounts, Overdraft against property, Bills discounting / purchase accounts should be selected for verification a mix of both - new sanctions in the current year 2019-20 and sanctions of previous years.

11.257 At least 2 accounts of each facility should be scrutinized each for current year sanctions and sanctions of previous years. These accounts should be scrutinized in depth end-end keeping in mind the reporting requirements of the LFAR. Selection has to be done in a manner that each distinct and unique type of credit facility is verified and reported. Averse issues noted on verification to be discussed with the Branch, Branch responses obtained and appropriate reporting to be made in the LFAR.

11.258 The format of reporting for advances below Rs 2 Crores is not specified. The auditor may report the same in the format he feels appropriate ensuring that adverse issues noted are brought out for corrective action. It should be noted that finding gaps in process is the key. The transactional errors noted is the outcome of a weakness in the process and the process will need strengthening to ensure that such transactional errors are minimized if not zeroised.

11.259 The LFAR specifies the format (given below) in which the auditor has to obtain data from the Branch for large advances. The compilation has to be done by the Branch. Auditor has to review on a test check basis whether the data keyed into the system is correct. The Key is point number 24 where the Branch Manager has to give his overall comments on the account and point number 26 where the auditor has to give his observations on the account.

11.260 While giving his observations, the auditor has not only to go through all the points filled in by the Branch but also through all the loan correspondence files of the Borrower. The process of appraisal, sanction, disbursement, documentation, monitoring, review or renewal, follow-up, classification as SMA-NPA will have to be independently verified for such accounts. Audit comments

**Guidance Note on Audit of Banks (Revised 2020)**

should not be simply based on the data submitted by the Branch. Independent verification and assessment is essential.

11.261 Reporting format (To be obtained from the branch Management by the Branch Auditors of branches dealing in large advances/ asset recovery branches) is as under –

1. Name of the Borrower
2. Address
3. Constitution
4. Nature of business/ activity
5. Other units in the same group
6. Total exposure of the branch to the Group+  
Fund Based (Rs. in lakhs)  
Non-Fund Based (Rs. in lakhs)
7. Name of Proprietor/ Partners/ Directors
8. Name of the Chief Executive, if any
9. Asset Classification by the Branch  
(a) during the current year  
(b) during the previous year
10. Asset Classification by the Branch Auditor  
(a) during the current year  
(b) during the previous year
11. Are there any adverse features pointed out in relation to asset classification by the Reserve Bank of India Inspection or any other audit.
12. Date on which the asset was first Classified as NPA. (where applicable)

Facilities sanctioned:

Date of Sanction	Nature of facilities	Limit (Rs. in Lakhs)	Prime Security	Collateral Security	Margin %	Balance outstanding at the year-end	
						Current Year	Previous Year

**Guidance Note on Audit of Banks (Revised 2020)**

Provision made: Rs. _____ lakhs							

13. Whether the advance is a consortium advance or an advance made on multiple-bank basis.
14. If Consortium,-
  - (a) names of participating banks with their respective shares.
  - (b) name of the Lead Bank in Consortium.
15. If on multiple banking basis, names of other banks and evidence thereof.
16. Has the Branch classified the advance under the Credit Rating norms in accordance with the guidelines of the Controlling Authorities of the Bank.
17. (a) Details of verification of primary security and evidence thereof;  
(b) Details of valuation and evidence thereof.

Date verified	Nature of Security	Value	Valued by
Insured for Rs. _____ lakhs (expiring on _____)			

18. (a) Details of verification of collateral security and evidence thereof;  
(b) Details of valuation and evidence thereof.

Date verified	Nature of Security	Value	Valued by
Insured for Rs. _____ lakhs (expiring on _____)			

19. Give details of the Guarantee in respect of the advance
  - (a) Central Government Guarantee;
  - (b) State Government Guarantee;
  - (c) Bank Guarantee or Financial Institution Guarantee;
  - (d) Other Guarantee.

**Guidance Note on Audit of Banks (Revised 2020)**

Provide the date and value of the Guarantee in respect of the above.

20. Compliance with the terms and conditions of the sanction:

Terms and Conditions	Compliance
(i) Primary Security a) Charge on primary security b) Mortgage of fixed assets c) Registration of charges with Registrar of Companies d) Insurance with date of validity of Policy	
(ii) Collateral Security a) Charge on collateral security b) Mortgage of fixed assets c) Registration of charges with Registrar of Companies d) Insurance with date of validity of policy	
(iii) Guarantees - Existence and execution of valid guarantees	
(iv) Asset coverage to the branch based upon the arrangement (i.e., consortium or multiple-bank basis)	
(v) Others: a) Submission of Stock Statements/ Quarterly Information Statements and other Information Statements b) Last inspection of the unit by the Branch officials: Give the date and details of errors/ omissions noticed c) In case of consortium advances, whether copies of documents executed by the company favouring the consortium are available. d) Any other area of non compliance with the terms and conditions of sanction	

**Guidance Note on Audit of Banks (Revised 2020)**

21. Key financial indicators for the last two years and projections for the current year: (Rs. in lakhs)

Indicators	Audited year ended 31 <sup>st</sup> March ____	Audited year ended 31 <sup>st</sup> March ____	Estimates for year ended 31 <sup>st</sup> March ____
Turnover			
Increase in turnover % over previous year			
Profit before depreciation, interest and tax Less: Interest Net Cash Profit before tax Less: Depreciation Less: Tax Net Profit after Depreciation and Tax			
Net Profit to Turnover Ratio			
Capital (Paid-up)			
Reserves			
Net Worth			
Turnover to Capital Employed Ratio (The term "Capital Employed" means the sum of Net Worth and Long Term Liabilities)			
Current Ratio			
Stock Turnover Ratio			
Total Outstanding Liabilities/Total Net Worth Ratio			
In case of listed			

**Guidance Note on Audit of Banks (Revised 2020)**

companies, Market Value of Shares (a) High; (b) Low; and (c) Closing			
Earnings Per Share			
Whether the accounts were audited? If yes, upto what date; and are there any audit qualifications			

22. Observations on the operations in the account:

	Excess over drawing power	Excess over limit
1. No. of occasions on which the Balance exceeded the drawing power/ sanctioned limit (give details)		
Reasons for excess drawings, if any		
Whether excess drawings were reported to the Controlling Authority and approved		

	Debit Summation (Rs. in Lakhs)	Credit Summation (Rs. in Lakhs)
2. Total summation in the account during the year Less: Interest Balance		

23. Adverse observations in other audit reports/ Inspection Reports/ Concurrent Auditor's Report/ Internal Audit Report/ Stock Audit Report/ Special Audit Report or Reserve Bank of India Inspection with regard to:

- (i) Documentation;
- (ii) Operations;
- (iii) Security/Guarantee; and
- (iv) Others.

24. Branch Manager's overview of the account and its operation.

25. (a) In case the borrower has been identified/ classified as Non-performing Asset during the year, whether any unrealised income including income accrued in the previous year has been accounted as income, contrary to the Income Recognition Norms.

(b) Whether any action has been initiated towards recovery in respect of accounts identified/ classified as Non-performing Assets.

26. Auditors Comments

Date:

Signature and Seal of Branch-in-Charge

### **Procedure for Sanction, Documentation, Disbursement, and Supervision**

11.262 Each bank has its own procedures for sanctioning, disbursal, documentation, supervision and renewal of advances. The procedures are stated in the Credit policy which is generally updated at annual intervals. The auditor should obtain the last updated credit policy and circulars issued post the credit policy. The auditor should ensure that the credit policy is in sync with RBI Master Circulars especially the Master Circular issued on Loan and Advances – Statutory and Other Restrictions.

#### **Sanction**

##### ***Loan Application***

11.263 Initiation of process of sanction of advance is on receipt of a formal request from the applicant. The request may be in the form of a standard format (Loan Application Form) of the Bank or in the form of a letter in which case the Bank requests the intending borrower to furnish the standard format duly filled in. All applications are entered in a Loan Applications Received Register (the exact nomenclature may vary from bank to bank). The required supporting documents are to be furnished along with the application. The Bank should ensure that the documents are obtained from respective borrowers as per the Loan policy of the Bank.

##### ***Credit Appraisal***

11.264 The proposal is evaluated in the context of the directions of the RBI including prudential exposure limits and the bank's own credit policy and risk management guidelines. The primary purpose is to ascertain the cash flows and the repayment capacity of the Borrower to repay the loan within the stipulated timelines that would be prescribed. The proposal is mainly appraised

### **Guidance Note on Audit of Banks (Revised 2020)**

---

to find the Default Risk or the possibility of the Borrower not repaying the loan amount that would be sanctioned or disbursed, either in full or in part. This process entails conducting a detailed SWOT – Strengths – Weakness – Opportunity Threat analysis of the Borrower. Besides, the proposal is appraised on the following parameters to ensure technical feasibility, economic viability and commercial acceptability (the degree of scrutiny depends largely on the amount of the advance):

- Performance of the unit *vis-a-vis* other similar units.
- Conduct of its accounts with the lenders.
- Experience, competence and profile of the management of the unit.
- Guarantees and collateral securities offered.
- Trend and ratio analysis to see that the unit's growth is healthy, financials are sound, liquidity is comfortable and the promoters have a reasonable stake in the unit.
- Availability of inputs for production – right time and price.
- Market condition – fast changing tastes and preferences -
- Technology in use – factoring in obsolescence in technology
- Unit's capability to achieve the projected operating and performance levels and to service the debt.
- Applicability of norms/benchmarks relating to scale of finance, e.g., Nayak Committee recommendations for SSI units, scale of finance fixed by the bank for agricultural finance to be extended in the local area, etc.
- CIBIL, RBI List of defaulter, Credit and confidential reports from other banks. These are to be checked from respective websites.
- Various disclosure/notices issued by the government/government authority such as with regard to shell companies, defunct companies, directors of these types of companies, etc.
- Latest Government. policy about particular industry / Locational restriction, etc.
- In the current complex scenario both internally and externally – VUCA world as some describe it for an environment characterized by Volatility, Uncertainty, Complexity and Ambiguity, assessment of cash flows over longer term period is a challenge. The auditor should exercise greater diligence while reviewing the appraisal process for such long tenor



advances.

- Diligence will be higher if the units are resorting to funding for the first time ever or with the bank. In case of existing facilities for renewal – review, there is a past performance or availability of data to base credit decisions. For new units, validating the projections or estimated will need deeper scrutiny.
- Banks generally have a Turn Around Time (TAT) for disposing off loan applications – i.e. the time from receipt of Loan application to its Rejection or Sanction. While causes for rejection also have to be noted in a Loan Rejection Register or similarly named Registers, The cases of appraisals have to be within (TAT). Deviations for (TAT) are monitored for process efficiency.

#### ***Sanctioning Authority***

11.265 If the official concerned finds the proposal acceptable, a detailed appraisal note is submitted along with necessary supporting documents with recommendations to the authority having powers to sanction it. Each official who has been vested with powers to sanction advances has a monetary ceiling upto which he/she can sanction advances to the specified kind of borrowers (like individuals, partnerships, companies, etc.) and/or for the specified activities (like agriculture, industry, professional education, business, etc.) and / or for the type of facility (term loan, overdraft, cash credit, etc.). Such powers are properly documented and circulated by the bank to all its offices as Delegation of Powers. The officials at the branch can sanction only those advances, which fall within their delegated powers. For advances, which require to be sanctioned by higher authorities, the branch has to carry out the appraisal and send the proposal along with its recommendations to its controlling office for necessary sanction. As and when the advance is sanctioned by the competent authority (which could be an official, a committee of officials or the board of directors of the bank, depending on the amount involved), the fact of sanction along with detailed terms and conditions of the sanction are communicated by the controlling office to the branch.

11.266 The auditor should ensure that all issues noted in the credit appraisal process have been duly factored while preparing the Sanction Note and the Sanction letter and no significant issue is missed out. Clarifications on any issues noted in the appraisal process should be duly documented. The auditor has to ensure that the sanctioning is done within the powers of the competent authority. Any deviations noted will have to be reported appropriately.

11.267 Processing fees as applicable should be collected as per the bank's policy but before the disbursement. Banks have a practice of debiting Cash

Credit accounts for processing fees. While this is in order for existing accounts, for new facilities sanctioned, the same should be collected separately up-front rather than being a part of disbursement

### **Documentation and Disbursement**

11.268 After the sanction of the advance, the branch communicates the terms and conditions of the sanction to the applicant and obtains its consent for the arrangement. Thereafter, the documents as prescribed by the bank are obtained, charges created and, the bank's charge over the unit's assets noted with the authorities concerned, e.g., Registrar of Companies, Road Transport Authority, Insurance Company, Land Records Authority, CERSAI, etc. In the case of an advance to a partnership firm, while the account is opened in the trade name of the firm, the security documents are got executed from the partners in both their individual capacity (i.e., without mentioning the name of the firm or affixing the stamp of the firm) and in their capacity as partners of the firm. This is to ensure that the advance may be recovered from the assets of the firm as well as from the individual assets of the partners. The bank generally records the sanction details and stipulation in the system. In many cases, the system is updated for pre-sanction, pre-disbursement documents for each loan. The document discrepancy report then acts as a check for documents received and pending for monitoring purposes.

11.269 After the above formalities have been completed, the advance is released in the following manner:

- Term loans (granted generally for acquisition of fixed assets, etc.) are disbursed on the basis of quotations/ proforma invoices obtained by the borrower from the vendors and submitted to the bank either along with the application or later. In case of large projects, the schedule and status of completion of projects have also to be seen. Banks generally stipulate a stated percentage of the cost to be met by the borrower from his own funds. Once the borrower provides his contribution to the bank, the branch debits the Term Loan account with the balance amount and pays the amount to the vendor directly along with a letter stating the purpose of the funds. The term loan may be released in one or more instalments. As and when the asset is received by the borrower, the bank officials inspect it, record the particulars in their books, and obtain copies of the final invoices for their record from the borrower.
- There may be instances where, on business considerations, the borrower has already acquired the asset. In such a case, he submits the documentary evidence to the branch and seeks reimbursement to the extent permissible. The branch officials inspect the asset and verify books

of account of the borrower and, if satisfied, credit the eligible amount to the borrower's account (current / cash credit, as desired by the borrower) by debiting his term loan account.

- Cash credit advances are released on the basis of drawing power calculated as per the stock statements submitted by the borrower as per the periodicity laid down in the terms of sanction. The branch officials verify the stock statements and calculate the 'drawing power' based on the security held by the borrower and the margin prescribed in the sanction. In case of consortium accounts, the drawing power calculation and allocation is made by the Lead Bank and is binding on the Member Banks (Circular No. C&I/Circular/2014-15/689 dated 29 September 2014 issued by the Indian Banks Association). This 'drawing power' is noted in the system in respect of Cash Credit accounts and is a guide to the official concerned while authorising debits to the account.
- The procedures of many banks require the branch manager to periodically submit a certificate to the controlling authority (i.e., regional or zonal office) that all disbursements during the relevant period have been made only after completion of the necessary formalities.
- Banks also require submission of End-Use certificates from Chartered Accountants. Some banks have a format in which the same is to be issued. It should be ensured that certificates are issued in the prescribed format. In all other cases, it should be ensured that the certificate is detailed as per the requirements of the ICAI guidelines on special purpose certification.
- Central Registry of Securitisation Asset Reconstruction and Security Interest of India (CERSAI) - The auditor needs to keep abreast the mandatory requirements related to registration of mortgages and compliance thereof by the lender bank, as applicable to the various forms of securities offered as security for the advances.
- Auditor has to ensure that all sanction terms and conditions have been complied. Pending sanction terms should be waived off by the appropriate sanctioning authority or a time frame post disbursal for their obtention be approved. In no case, the disbursal should take place without an formally approved waiver.
- Banks should maintain an updated tracker of all sanction terms still not complied. If the due dates for their obtention is breached, causes for the same should be noted for closure.

### **Monitoring and Supervision-**

11.270 The primary purpose of Monitoring and Supervision is to ensure that there is no Diversion or Siphoning of funds. Any adverse features have to be pro-actively tracked using technology to the fullest. Appendix to RBI Circular No. DBS.CO.CFMC.BC.No.007/23.04.001/2014-15 dated 7<sup>th</sup> May, 2015 “Framework for dealing with loan frauds” gives indicators for Early Warning Signals (EWS) which have to be followed up or possible Red Flagging.

11.271 Banks have to ensure that (EWS) are tacked through system, pro-actively so that early signs of liquidity problems are known and followed up with the Borrower for possible re-structuring or rehabilitation to preserve the economic value of the account and avoid it to slip into a NPA.

11.272 The following are the procedures usually adopted by banks for monitoring and supervision of advances after disbursement:

- Regular inspection of the borrower’s assets and books. The main purposes of inspection are as follows:
  - To ensure that the amounts disbursed have been utilised for purposes for which the advance was sought.
  - To check that the borrower has not acquired / disposed of any asset without the consent / knowledge of the bank, depending upon the terms of the advance. Acquisition of fixed assets from working capital funds may amount to diversion of short-term funds which, from the viewpoint of the bankers, is not a sign of financial prudence.
  - To cross-check the figures declared in the stock statements with the books maintained by the borrower (including excise and other statutory records, as applicable) as well as to physically verify the stock items, to the extent possible.
  - To check that the unit has been working on projected levels particularly in the areas of sales and production and the general working of the unit is satisfactory.
  - To ensure that the borrower has not availed of finance against stocks for which it has itself not made the payment.
  - To ensure that the borrower has not availed of unauthorised finance from any other lender.
  - To ensure that the Borrower has not defaulted on payment of Statutory Liabilities

### Guidance Note on Audit of Banks (Revised 2020)

---

- To ensure that the borrower has not made any investment in, or advances to, its associates without the bank's approval, if such approval is required as per the terms of the loan or otherwise diverted the funds.
- To check that there is a regular turnover of stocks and the unit does not carry any obsolete, unusable stocks. Generally, banks place a limit on the age of stocks which are eligible for bank finance; the items older than such limit are not financed. Similarly, in the case of book debts, debts outstanding beyond a specified period are also not eligible for bank finance. Also to check Sundry creditors for goods.
- To ensure that the borrower continues to be engaged in the activity for which the loan has been granted.
- Periodic review of the progress in implementation of the project (to note whether project timelines given at the time of processing loan are being adhered to. If there are delays, it may hamper the project completion and may affect servicing of loan). Generally, in large and complex projects, banks appoint lead engineer agency who provides the status of the project on periodically basis.
- Review of the conduct of the account.
- Obtaining and scrutinising stock statements.
- Obtaining other relevant financial data periodically and analysis of the data. Banks obtain information at monthly / quarterly / half yearly / yearly intervals about on the levels of sales, production, profit, cash accruals, break up of assets and liabilities, cash flows etc. The analysis covers the following points:
  - Comparison of the data with the projections contained in the appraisal note to find out the deviations, the reasons thereof, and the corrective action to be taken, wherever necessary.
  - Comparison of the unit's performance, on an on-going basis, with other similar units.
  - Ratio analysis based on the provisional data submitted by the unit to find out the liquidity and solvency position and any diversion of short-term resources towards long term uses.
  - Observing the credits to the account.
- Whenever the above analysis indicates weaknesses in operations, or the need for additional documentation or security, a dialogue is held with the borrower, with consequent follow-up.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

RBI, *vide* its circular no. DBS.CO.PPD.BC.No. 5 /11.01.005/2010-11 dated January 14, 2011 on “End Use of Funds - Monitoring”, has advised to evaluate and strengthen the efficacy of the existing machinery in the banks for post-sanction inspection by the bank officers, supervision and follow-up of advances. There needs to be a proper process of stock audit of the borrowers. Effective monitoring of the end use of funds lent is of critical importance in safeguarding a bank’s interest. Further, this would also act as a deterrent for borrowers to misuse the credit facilities sanctioned, and in the process, help build a healthy credit culture in the Indian banking system.

*Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair recovery of lenders – Framework for revitalisation of distressed assets*

11.273 The RBI has issued guidelines for classification of standard assets into three sub-categories, *viz.*, SMA-0, SMA-1 and SMA2 in order to recognise the financial distress in any performing asset at an early stage, besides regulatory compliances like forming of Joint Lender’s Forum, reporting to CRILC, etc. for specified categories of Special Mention Accounts (SMA). In case if the bank does not follow the said regulatory compliances, such accounts are subjected to accelerated provisions.

### **LFAR in respect of Advances for Bank Branches**

11.274

#### **(a) Credit Appraisal**

*In your opinion, has the branch generally complied with the procedures/ instructions of the Controlling Authorities of the bank regarding loan applications, preparation of proposals for grant/ renewal of advances, enhancement of limits, etc., including adequate appraisal documentation in respect thereof.*

- Refer circular issued by Head Office regarding Credit Appraisal.
- Enquire whether specific facility wise loan application form is prescribed by the Bank.
- Confirm that the instructions are followed by the Branch while accepting the loan application form.
- Refer circular issued by Head Office regarding preparation of proposals for grant / renewal of advances, enhancement of limits, etc., including adequate appraisal documentation in respect thereof.
- While reporting under this clause, auditor should consider the “Early mortality cases” in the branch.

The auditor would also need to consider whether:

- The branch is adhering to various guidelines issued by RBI regarding lending against own shares, lending to directors or their relatives.
- In respect of lending under consortium / multiple banking arrangement, the branch is obtaining declaration from the borrowers about the credit facilities already enjoyed by them from other banks in the format prescribed in circulars DBOD.No.BP.BC.46/08.12.001/2008-09 dated September 19, 2008 and DBOD.No.BP.BC.94/ 08.12.001/ 2008-09 dated December 08, 2008.
- Bank is exchanging / sharing information of the credit facilities sanctioned to the borrowers with other lending bankers as per RBI/2012-13/304 DBOD.BP.BC.No. 62/21.04.103/2012-13 dated 21/11/2012 including compliance to any sanction of fresh loans/ad hoc loans/renewal of loans to new/existing borrowers to be done only after obtaining/sharing necessary information.
- The branch is practicing due diligence to assess the credit worthiness of the borrowers and not relying on margin and security as a substitute for due diligence.
- The branch is adhering to the prudential exposure limits prescribed by RBI and Head Office.
- In case of corporate borrower, it is necessary for branch auditor to carefully go through the annual reports to ensure that there no adverse comments in main auditor report or CARO report on annual accounts of the borrower that affects sanction at the branch level.
- Latest IT returns of Borrowers / Guarantors have been obtained and verified with financial documents and other information available on record.
- Latest CIBIL or other Credit Information Company report has been obtained and verified.

**(b) Sanctioning/ Disbursement**

- (i) *In the cases examined by you, have you come across instances of credit facilities having been sanctioned beyond the delegated authority or limit fixed for the branch? Are such cases promptly reported to higher authorities?*
- Confirm sanctioning / disbursement discretionary power regarding advances.
  - Report the cases where credit facilities having been sanctioned beyond the delegated authority or limit fixed for the branch.
  - Whether such type of cases promptly reported to higher authorities.

**Guidance Note on Audit of Banks (Revised 2020)**

- Such type of cases may be reported in the following format.
- Generally, cases are seen in the branch where the limits of existing borrowers are allowed to be overdrawn for a period beyond permissible time. Such cases should be reported.

Sr. No.	Name of the borrower	Account Number	Type of facility	Sanction date/ Authority	Sanction limit	Balance outstanding on 31.03.20XX	Amount sanctioned exceeding the delegated authority	Date of sanction / ratification from Higher Authority

(ii) *In the cases examined by you, have you come across instances where advances have been disbursed without complying with the terms and conditions of the sanction? If so, give details of such cases.*

- Obtain original Title deed, Execution of Documents. Vetting of documents by legal dept./ legal resource.
- Report the cases where advances have been disbursed without complying with the terms and conditions of the sanction letter.

Main aspects to be covered are:

- Registration of charges – search report.
- Resolutions – guarantees – mortgage creation.
- Legal opinion – valuation – encumbrance certificate – insurance.
- Lien on deposits – margins for BG and LC and loan on deposits.

- Report the cases along with the deviations.

**(c) Documentation**

(i) *In the cases examined by you, have you come across instances of credit facilities released by the branch without execution of all the necessary documents? If so, give details of such cases.*

- Report the cases where credit facilities released by the branch without execution of all the necessary documents. Physical verification of documents is critical. This is one of the important functions of the branch audit and the reason why branch audit exists.
- Verify Custody of Documents – Whether document movement register



**Guidance Note on Audit of Banks (Revised 2020)**

tracking changes is maintained. Whether scanning of important documents is maintained.

- The exact nature of irregularity / document not obtained may be provided in the following format:

Sr. No.	Name of the borrower	Account Number	Type of facility	Sanction date / Authority	Sanction limit	Balance outstanding on 31.03.20XX	Nature of irregularity / documents not obtained

(ii) *In respect of advances examined by you, have you come across cases of deficiencies in documentation, non-registration of charges, non-obtaining of guarantees, etc.? If so, give details of such cases.*

- Report cases of deficiencies in documentation, non-registration of charges, non-obtaining of guarantees, etc.
- Make sure that the documents are adequately stamped and also that they are executed within six months of purchasing the stamp paper.
- The instances should be reported in the following format:

Sr. No.	Name of the borrower	Account Number	Type of facility & a/c no.	Sanction date / Authority	Sanction limit	Balance outstanding	Nature of irregularity

- Time barred documents list to be furnished as under:

Sr. No.	Name of the borrower	Account Number	Outstanding balance	Sanction limit / Authority	Date of document

- The time barred accounts statement can be generated through system.
- When the document becomes time barred, no legal action can be initiated against the borrower.

**Guidance Note on Audit of Banks (Revised 2020)**

---

(iii) *Whether advances against lien of deposits have been properly granted by marking a lien on the deposit in accordance with the guidelines of the Controlling Authorities of the bank.*

- Refer the guidelines issued by Head Office in this regard.
- Report the cases, where the deposits / NSCs, paper securities etc., are matured, however not adjusted against the respective advances.
- Instances should be given in the following format:

Sr. No.	Name of the borrower	Account Number	Sanction limit / Authority	Outstanding balance	Date of document	Particulars of Security
---------	----------------------	----------------	----------------------------	---------------------	------------------	-------------------------

**(d) Review/Monitoring/ Supervision**

(i) *Is the procedure laid down by the Controlling Authorities of the bank, for periodic review of advances including periodic balance confirmation/ acknowledgement of debts, followed by the branch?*

*Provide analysis of the accounts overdue for review/ renewal*

- *between 6 months and 1 year, and*
- *over 1 year*
- Refer the guidelines issued by Head Office in this regard.
- Date / month in which accounts were due for review and the date / month on which the review was done may be obtained.
- It may be noted that there would be cases that are seen performing at the balance sheet date but evidently stressed. Comments on such account with respect to branch efforts on monitoring and information availability on same should be commented upon.
- In view of changes in the reporting requirements in CARO for corporate borrowers, it is necessary for branch auditor to carefully go through the annual reports to ensure that there no adverse comments in the balance sheet of a borrower that affects reporting at the branch level.
- Date / Month of review can be verified from the sanction documents / terms
- Instances should be given in the following format:

**Guidance Note on Audit of Banks (Revised 2020)**

<b>Sr. No.</b>	<b>Name of the Borrower</b>	<b>Type of Facility &amp; Account Number</b>	<b>Balance outstanding as on 31.03.20XX</b>	<b>Review overdue since</b>	<b>Ageing</b>
----------------	-----------------------------	--	---	-----------------------------	---------------

(ii) *Are the stock / book debt statements and other periodic operational data and financial statements, etc., received regularly from the borrowers and duly scrutinised? Is suitable action taken on the basis of such scrutiny in appropriate cases?*

- Borrower wise / month wise record showing receipt of security statement be confirmed.
- Confirm the working of drawing power based thereon.
- Confirm whether these statements are obtained on time.
- Compare movement shown in book debt & creditors with debit/credits in the Bank.

Further, in respect of consortium advance, the drawing power should be determined by the lead bank and circulated to the other member banks as per Circular No. C&I/Circular/2014-15/689 dated 29 September 2014 issued by the Indian Banks Association.

(iii) *Whether there exists a system of obtaining reports on stock audits periodically? If so, whether the branch has complied with such system?*

- Refer the guidelines issued by Head Office in this regard and confirm the compliance thereof.
- Examine the compliances obtained, action taken in cases wherein deficiencies are reported by the stock auditors.
- Obtaining written reverts from the Borrower.
- Whether adverse issues in stock audit reports are duly factored in review / renewal notes.
- Compare with annual accounts for divergences and obtain satisfactory explanations.

(iv) *Indicate the cases of advances to non-corporate entities with limits beyond Rs.10 lakhs where the branch has not obtained the accounts of borrowers, duly audited under the RBI guidelines with regard to compulsory audit or under any other statute.*

- Obtain list of non corporate borrowers enjoying facilities in excess of Rs.10.00 lakhs and report where audited statements are not on record.

**Guidance Note on Audit of Banks (Revised 2020)**

- A list of such cases is to be given in the following format:

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Date of last audited accounts obtained

(v) *Has the inspection or physical verification of securities charged to the Bank been carried out by the branch as per the procedure laid down by the Controlling Authorities of the bank?*

- Refer the guidelines issued by Head Office in this regard.
- Reporting deviations if any reasons for the deviations.
- A list of such cases is to be given in the following format.

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Last date of inspection or physical verification

(vi) *In respect of advances examined by you, have you come across cases of deficiencies in value of securities and inspection thereof or any other adverse features such as frequent/unauthorised overdrawing beyond limits, inadequate insurance coverage, etc.?*

- Note down the remarks regarding deficiencies in value of securities and inspection report submitted by the concerned officer.
- Confirm whether Insurance is in favour of Bank.
- Check whether Insurance covers risks the mortgaged securities are subject to – Check adequacy of Insured value and location wise.
- The cases where frequent / unauthorized over drawings beyond limits are granted is to be given in the following format:

Sr. No.	Name of the Borrower	Account number	Sanction Limit	Balance Outstanding	Drawing power	Irregularity

- For cases, wherein insurance details are not available is to be given in the following format:

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Value of Security

- For cases, wherein there is inadequate insurance may be given in the following format:

**Guidance Note on Audit of Banks (Revised 2020)**

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Value of Security	Insured for Rs.	Inadequate Insurance
---------	----------------------	----------------	----------------	-------------------	-----------------	----------------------

(vii) *In respect of leasing finance activities, has the branch complied with the guidelines issued by the Controlling Authorities of the bank relating to security creation, asset inspection, insurance, etc? Has the branch complied with the accounting norms prescribed by the Controlling Authorities of the bank relating to such leasing activities?*

- Refer the guidelines issued by Head Office in this regard.

(viii) *Are credit card dues recovered promptly?*

- Refer the guidelines issued by Head Office in this regard.
- Whether the branch maintains debit balances in the card dues customers.
- Confirm, whether such debit balances are included in advances classification statements.

(ix) *Has the branch identified and classified advances into standard/sub-standard/ doubtful/ loss assets in line with the norms prescribed by the Reserve Bank of India.*

- Refer the guidelines issued by Reserve Bank of India together with Head Office in this regard.
- Wherever, such guidelines are not followed, Memorandum of Changes be given with reasons.
- The branch auditor shall also verify compliance with the guidelines issued by Head Office with regard to *identification and classification of loan accounts into special mention accounts and incremental provisioning requirement on account of unhedged foreign current exposures in line with the norms prescribed by the Reserve Bank of India.*

(x) *Where the auditor disagrees with the branch classification of advances into standard / sub-standard / doubtful / loss assets, the details of such advances with reasons should be given. Also indicate whether suitable changes have been incorporated / suggested in the Memorandum of Changes.*

- Refer the guidelines issued by Reserve Bank of India together with Head Office in this regard.

**Guidance Note on Audit of Banks (Revised 2020)**

- Wherever, such guidelines are not followed Memorandum of Changes be given with reason.

(xi) *Have you come across cases where the relevant Controlling Authority of the bank has authorised legal action for recovery of advances or recalling of advances but no such action was taken by the branch? If so, give details of such cases.*

- Refer the guidelines issued by Head Office in this regard.
- Wherever, such guidelines are not followed such cases be reported in the following format.

Sr. No	Name of the Borrower	Account Number	Sanction Limit	Instructions to take legal action on	Present Status
--------	----------------------	----------------	----------------	--------------------------------------	----------------

(xii) *Have all non-performing advances been promptly reported to the relevant Controlling Authority of the bank? Also state whether any rehabilitation programme in respect of such advances has been undertaken, and if so, the status of such programme.*

- Refer the guidelines issued by Head Office in this regard.
- Wherever, such guidelines are not followed such cases be reported:

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Rehabilitation programme sanctioned	Present Status
---------	----------------------	----------------	----------------	-------------------------------------	----------------

(xiii) *Have appropriate claims for DICGC/CGSTE and Export Credit Guarantee/ Insurance and subsidies, if any, been duly lodged and settled? The status of pending claims giving year wise break-up of number and amounts involved should be given in the following format:*

- DICGC not applicable, as most of the Banks have opted out of DICG.
- Report here the claims if any outstanding on account of ECGC/CGST.
- Report the cases not accepted / rejected by ECGC/CGST.

Particulars	Number	Amount (Rs.)
Claims as at the beginning of the year (Give year-wise details)		
Further claims lodged during the year		

**Guidance Note on Audit of Banks (Revised 2020)**

<b>Total A</b>	_____ _____ _____	_____ _____ _____
Amounts representing: (a) Claims accepted/ settled (give year-wise details) (b) Claims rejected (give year-wise details)		
<b>Total B</b>	_____ _____ _____	_____ _____ _____
Balance as at the year-end (give year-wise details) <b>A-B</b>	_____  ====	_____  =====

(xiv) *In respect of non-performing assets, has the branch obtained valuation reports from approved valuers for the fixed assets charged to the bank, once in three years, unless the circumstances warrant a shorter duration?*

- Refer the guidelines issued by Head Office in this regard.
- Wherever, such guidelines are not followed such cases be reported in the following format.
- Whether valuation is done on a consistent basis – at fair Market value, Realizable value, Distress value – Whether Fall in Market value has been factored in the valuation -

<b>Sr. No.</b>	<b>Name of the Borrower</b>	<b>Account Number</b>	<b>Sanction Limit</b>	<b>Balance Outstanding</b>	<b>Security</b>	<b>Value of Security</b>	<b>Latest Valuation Report date</b>
----------------	-----------------------------	-----------------------	-----------------------	----------------------------	-----------------	--------------------------	-------------------------------------

(xv) *In the cases examined by you has the branch complied with the Recovery Policy prescribed by the Controlling Authorities of the bank with respect to compromise/ settlement and write-off cases? Details of the cases of compromise/ settlement and write-off cases involving write-offs/ waivers in excess of Rs.50 lakhs may be given.*

- Refer the guidelines issued by Head Office in this regard.
- Wherever, such guidelines are not followed such cases be reported in

**Guidance Note on Audit of Banks (Revised 2020)**

the following format:

Sr. No.	Name of the Borrower	Account Number	Sanction Limit	Balance Outstanding	Compromised / Settlement Amt.	Recovery Effected	Recovery To be effected
---------	----------------------	----------------	----------------	---------------------	-------------------------------	-------------------	-------------------------

**(e) Guarantees and Letters of Credit**

- Normally handled at Corporate or Head Office.
- However, inquire whether such types of cases are handled at Branch and reply accordingly.

(i) *Details of outstanding amounts of guarantees invoked and funded by the branch at the end of the year may be obtained from the Management and reported in the following format:*

(a) Guarantees invoked, paid but not adjusted:

Sr. No.	Date of invocation	Name of the party	Name of beneficiary	Amount	Date of Recovery	Remarks
---------	--------------------	-------------------	---------------------	--------	------------------	---------

(b) Guarantees invoked but not paid:

Sr. No.	Date of invocation	Name of the party	Name of beneficiary	Amount	Date of Recovery	Remarks
---------	--------------------	-------------------	---------------------	--------	------------------	---------

(ii) *Details of the outstanding amounts of letters of credit and co-acceptances funded by the Branch at the end of the year may be obtained from the Management and reported in the following format:*

Sr. No.	Date of funding	Name of the party	Nature (LC/ co-acceptance, etc.)	Amount	Date of Recovery	Remarks
---------	-----------------	-------------------	----------------------------------	--------	------------------	---------

**Guidelines of the Reserve Bank of India on Income Recognition, Asset Classification, Provisioning and Other Related Matters**

11.275 In its report submitted in 1992, the Committee on Financial System set up by the RBI under the Chairmanship of Mr. M. Narasimham made several



recommendations concerning accounts of banks. The Committee recommended that a policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Likewise, the classification of assets should be done on the basis of objective criteria which would ensure a uniform and consistent application of norms. As regards provisioning, the Committee recommended that provisions should be made on the basis of classification of assets under different categories. Vide its Circular No. BP.BC.129/21.04.043-92 dated April 27, 1992, the Reserve Bank issued guidelines to be followed by all scheduled commercial banks (excluding regional rural banks) for income recognition, asset classification, provisioning and other related matters. These guidelines (commonly referred to as 'prudential guidelines' or 'prudential norms') have since been modified in several respects through various circulars of the Reserve Bank. The latest Master Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 was issued on July 1, 2015 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances'. The salient points of the guidelines as presently in force are discussed below:

### **Regulatory Guidelines vis-a-vis Audit Approach and Reporting**

**A. Has the branch identified and classified advances into standard/substandard/doubtful/loss assets in line with the norms prescribed by the Reserve Bank of India (The auditor may refer to the relevant H.O. instructions for identification of NPAs and Classification of Advances).**

***In addition to this, the auditor may review and comment as to whether such identification & classification through the computer system, without manual intervention?***

#### **Relevant Provision**

11.276 The guidelines require banks to classify their advances into four broad categories for the purpose of provisioning as follows:

(a) Standard assets:

A standard asset is one which is not a non-performing asset and does not carry more than normal banking risk attached to the business.

As per RBI Circular RBI/2018-19/ 203 DBR.No.BP.BC.45/21.04.048/2018-19 dated June 7, 2019 on Prudential Framework for Resolution of Stressed Assets, the banks shall recognise incipient stress in loan accounts, immediately on default, by classifying such assets as special mention accounts (SMA) as per the following categories:

### Guidance Note on Audit of Banks (Revised 2020)

SMA Sub-categories	Basis of Classification
SMA-0	1-30 days
SMA-1	31-60 days
SMA-2	61-90 days

In the case of revolving credit facilities like cash credit, the SMA sub-categories will be as follows:

SMA Sub-categories	Basis of Classification
SMA-1	31-60 days
SMA-2	61-90 days

Lenders shall report credit information, including classification of an account as SMA to Central Repository of Information on Large Credits (CRILC), on all borrowers having aggregate exposure of Rs. 50 Millions (5 Crores) and above with them on monthly basis. Further Lenders shall submit a weekly report on instances of defaults of all borrowers having aggregate exposure of Rs. 50 Millions (5 Crores) and above on close of business on every Friday.

Such classification also serves to be useful for bank officers monitoring as well as audit perspective to check the transactions & methods of keeping these standard at the balance sheet date

(b) Sub-standard assets:

A sub-standard asset is one which has remained NPA for a period less than or equal to 12 months. Such an asset will have well defined credit weaknesses that jeopardize the liquidation of the debt and are characterized by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

(c) Doubtful assets:

An asset is classified as doubtful if it has remained in the sub-standard category for a period of 12 months. Such an asset has all the inherent weaknesses as in a substandard asset and an added characteristic that the weaknesses make the

collection or liquidation in full highly improbable or questionable.

(d) Loss assets:

A loss asset is one which has been identified as wholly irrecoverable either by:

- (a) the bank; or
- (b) the internal or external auditors; or
- (c) the RBI inspectors.

but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

### **Classification Norms relating to NPAs**

#### ***Criteria for Classification of Various Types of Credit Facilities***

11.277 A Cash Credit / Overdraft account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but 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, these accounts should also be treated as 'out of order'. Further, 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.

11.278 The following criteria are to be applied for determining the status of various types of credit facilities:

- (a) Term Loans: A term loan is treated as a non-performing asset (NPA) if interest and/or instalment of principal remain overdue for a period of more than 90 days. Thus, in case of term loans wherein there is no amount due (i.e., the ledger balance is less than ideal drawing power), such accounts will not be marked as NPA as the criteria for marking a Term Loan account as NPA is not based on the concept of servicing of interest but is based on the overdue concept. In case of term loans, wherein only interest is due, the interest due and charged during any quarter is not serviced in 90 days from the end of the quarter, such account will be treated as NPA as per Para 2.1.3 of the Master Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 was issued on July 1, 2015 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances'.

### **Guidance Note on Audit of Banks (Revised 2020)**

---

- (b) Cash Credits and Overdrafts: A cash credit or overdraft account is treated as NPA if it remains out of order as indicated above.
- (c) Bills Purchased and Discounted: Bills purchased and discounted are treated as NPA if they remain overdue and unpaid for a period of more than 90 days.
- (d) Securitisation: The asset is to be treated as NPA if the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated February 1, 2006.
- (e) Agricultural Advances: A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons and, a loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.
- (f) Credit Card Accounts: credit card account will be treated as non-performing asset if the minimum amount due, as mentioned in the statement, is not paid fully within 90 days from the payment due date mentioned in the statement as per Circular DBR.No.BP.BC.30/21.04.048/2015-16 dated July 16 2015. It is further suggested by RBI that banks should follow this uniform method of determining over-due status for credit card accounts while reporting to credit information companies (CIC) and for the purpose of levying of penal charges, viz., late payment charges, etc., if any.

11.279 As per the guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops. The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made applicable to agricultural term loans availed of by him.

11.280 The above norms should be made applicable to all direct agricultural advances as listed in the Master Direction on Lending to Priority Sector-Target and Classification dated July 7, 2016 (updated December 05, 2019). In respect of all other agricultural loans, identification of NPAs would be done on the same basis as non-agricultural advances, which, at present, is the 90 days delinquency norm.

#### ***Temporary Deficiencies***

11.281 The classification of an asset as NPA should be based on the record of recovery. Bank should not classify an advance account as NPA merely due to

the existence of some deficiencies which are temporary in nature such as non-availability of adequate drawing power based on the latest available stock statement, balance outstanding exceeding the limit temporarily, non-submission of stock statements and non-renewal of the limits on the due date, etc. In the matter of classification of accounts with temporary deficiencies, banks have to follow the following guidelines:

- (a) Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets, since current assets are first appropriated in times of distress. Drawing Power (DP) is required to be arrived at based on current stock statement. Proper computation of drawing power (as per Bank's policy) is imperative as the advances are to be checked with reference thereto. The auditor should review the Bank's policy for treatment of creditor's balances for computation of DP. The auditor should factor in other considerations in the drawing power calculations, such as (i) comparison of the level of stock and books debts assumed at the time of assessment if the reduction of trade creditors is limited to the extent of excess over the level of trade creditors assumed at the time of assessment; (ii) Excess of other Sundry Creditors (i.e., other than trade creditors) over the level assumed at the time of assessment (as suggested in Annexure to IBA Circular No.: C&I/Circular/2014-15/689 dated September 29, 2014. Thus, if the bank is having a policy of considering trade creditors to the extent of excess over the level of trade creditors assumed at the time of assessment, the auditor will reciprocally review and verify the level of stock and book debts assumed at the time of assessment. Further, the auditor will refer and review the methodology adopted by the bank in calculation of MPBF (as regards netting off of trade creditors against stock and book debts) based on the level of stock, book debts and trade creditors. Further, the term 'paid stock' denotes value of stock as reduced by trade creditors at gross level. 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. In case of consortium accounts, the drawing power calculation and allocation is made by the Lead Bank and is binding on the Member Banks (circular No. C&I/Circular/2014-15/689 dated 29 September 2014 issued by the Indian Banks Association).
- (b) The outstanding in the account based on drawing power calculated from stock statements older than three months is deemed as irregular.
- (c) A working capital borrowing account will become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days

even though the unit may be working or the borrower's financial position is satisfactory.

- (d) Regular and ad hoc credit limits need to be reviewed/ regularised not later than three months from the due date/date of ad hoc sanction. In case of constraints such as non-availability of financial statements and other data from the borrowers, the branch should furnish evidence to show that renewal/ review of credit limits is underway and would be completed soon. In any case, delay beyond six months is not considered desirable as a general discipline. Hence, an account where the regular/ adhoc credit limits have not been reviewed/ renewed within 180 days from the due date/ date of adhoc sanction will be treated as NPA. It would be pertinent to note that the counting of 180 days would be required to be done from the date of original due date for renewal and not from the date of expiry of short reviews / technical reviews.

***Regularisation Near About Balance Sheet date***

11.282 The asset classification of borrower accounts where a solitary or a few credits are recorded before the balance sheet date should be handled with care and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA. In other genuine cases, the banks must furnish satisfactory evidence to the satisfaction of the auditor about the manner of regularisation of the account to eliminate doubts on their performing status.

***Cheque bounce***

11.283 In case the account is regularised by making payment through cheque, the Auditor should review the actual realisation of cheques to assess the NPA classification. In case, the cheque is bounced, same should not be considered as credit in the Advance account for assessing the NPA classification.

***Asset Classification to be Borrower-wise not Facility-wise***

11.284 All facilities granted to a borrower and investment made in securities issued by the borrower will have to be treated as NPA/ Non Performing Investments (NPI), once any or a part of the facility/investment has become irregular.

11.285 In case debits arising out of devolvement of letters of credit or invoked guarantees are parked in a separate account, the balance outstanding in that account also should be treated as a part of the borrower's principal operating account for the purpose of application of prudential norms on income recognition, asset classification and provisioning. The following provisions are given in the master circular in this regard:

- (i) The bills discounted under LC favouring a borrower may not be classified as a Non-performing advance (NPA), when any other facility granted to the borrower is classified as NPA. However, in case documents under LC are not accepted on presentation or the payment under the LC is not made on the due date by the LC issuing bank for any reason and the borrower does not immediately make good the amount disbursed as a result of discounting of concerned bills, the outstanding bills discounted will immediately be classified as NPA with effect from the date when the other facilities had been classified as NPA. Further, in case of bill discounted under LC, if the payment under the LC is not made on the due date by the LC issuing bank for any reason, unless the amount is immediately made good by the borrower, the auditor needs to review the availability of security in the light of the straight away classification norms specified.
- (ii) The overdue receivables representing positive mark-to-market value of a derivative contract will be treated as a non-performing asset, if these remain unpaid for 90 days or more. In case the overdues arising from forward contracts and plain vanilla swaps and options become NPAs, all other funded facilities granted to the client shall also be classified as non-performing asset following the principle of borrower-wise classification as per the existing asset classification norms. Accordingly, any amount, representing positive mark-to-market value of the foreign exchange derivative contracts (other than forward contract and plain vanilla swaps and options) that were entered into during the period April 2007 to June 2008, which has already crystallised or might crystallize in future and is / becomes receivable from the client, should be parked in a separate account maintained in the name of the client / counterparty. This amount, even if overdue for a period of 90 days or more, will not make other funded facilities provided to the client, NPA on account of the principle of borrower-wise asset classification, though such receivable overdue for 90 days or more shall itself be classified as NPA, as per the extant IRAC norms. The classification of all other assets of such clients will, however, continue to be governed by the extant IRAC norms.
- (iii) If the client concerned is also a borrower of the bank enjoying a Cash Credit or Overdraft facility from the bank, the receivables mentioned at item (ii) above may be debited to that account on due date and the impact of its non-payment would be reflected in the cash credit / overdraft facility account. The principle of borrower-wise asset classification would be applicable here also, as per extant norms.
- (iv) In cases where the contract provides for settlement of the current mark-to-market value of a derivative contract before its maturity, only the current

## **Guidance Note on Audit of Banks (Revised 2020)**

---

credit exposure (not the potential future exposure) will be classified as a non-performing asset after an overdue period of 90 days.

- (v) As the overdue receivables mentioned above would represent unrealised income already booked by the bank on accrual basis, after 90 days of overdue period, the amount already taken to 'Profit and Loss a/c' should be reversed and held in a 'Suspense Account-Crystallised Receivables' in the same manner as done in the case of overdue advances.
- (vi) Further, in cases where the derivative contracts provide for more settlements in future, the MTM value will comprise of (a) crystallised receivables and (b) positive or negative MTM in respect of future receivables. If the derivative contract is not terminated on the overdue receivable remaining unpaid for 90 days, in addition to reversing the crystallised receivable from Profit and Loss Account as stipulated above, the positive MTM pertaining to future receivables may also be reversed from Profit and Loss Account to another account styled as 'Suspense Account – Positive MTM'. The subsequent positive changes in the MTM value may be credited to the 'Suspense Account – Positive MTM', not to P&L Account. The subsequent decline in MTM value may be adjusted against the balance in 'Suspense Account – Positive MTM'. If the balance in this account is not sufficient, the remaining amount may be debited to the P&L Account. On payment of the overdues in cash, the balance in the 'Suspense Account-Crystallised Receivables' may be transferred to the 'Profit and Loss Account', to the extent payment is received.
- (vii) If the bank has other derivative exposures on the borrower, it follows that the MTMs of other derivative exposures should also be dealt with / accounted for in the manner as described above, subsequent to the crystallised/settlement amount in respect of a particular derivative transaction being treated as NPA.
- (viii) Since the legal position regarding bilateral netting is not unambiguously clear, receivables and payables from/to the same counterparty including that relating to a single derivative contract should not be netted.
- (ix) Similarly, in case a fund-based credit facility extended to a borrower is classified as NPA, the MTMs of all the derivative exposures should be treated in the manner discussed above.

### **Non-Financial Parameters**

11.286 Normally NPA assessment is done based on record of recovery of dues in advances account. However, there are many other non-financial parameters which also should be considered while assessing classification of NPA account



such as:

- Inherent weakness in account.
- Non-Achievement of DCCO.
- Failure to comply with key restructuring conditions.
- Erosion in value of security.

***Advances to Primary Agricultural Credit Society (PACS) Farmers Service Society (FSS) ceded to Commercial Banks***

11.287 In case of advances granted under the on-lending system, however, only the particular credit facility granted to PACSs or FSSs, which is in default for a period of two crop seasons in case of short duration crops and one crop season in case of long duration crops, as the case may be, after it has become due will be classified as NPA and not all the credit facilities sanctioned subject to such conditions as specified in the RBI's Master Circular on Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances dated July 1, 2015. The other direct loans & advances, if any, granted by the bank to the member borrower of a PACS/ FSS outside the on-lending arrangement will become NPA even if one of the credit facilities granted to the same borrower becomes NPA.

***Erosion in Value of Securities/ Frauds Committed by Borrowers***

11.288 In respect of accounts where there are potential threats for recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers, such accounts need not go through the stages of asset classification. In such cases, the asset should be straightaway classified as doubtful or loss asset, as appropriate. Further,

- (i) Erosion in the value of securities by more than 50% of the value assessed by the bank or accepted by RBI inspection team at the time of last inspection, as the case may be, would be considered as "significant", requiring the asset to be classified as doubtful straightaway and provided for adequately.
- (ii) In case of secured loan, if the realisable value of security as assessed by bank/approved valuers/RBI is less than 10% of the outstanding in the borrower accounts, the existence of the security should be ignored and the asset should be classified as loss asset and accordingly fully provided for.
- (iii) Provisioning norms in respect of all cases of fraud:

## **Guidance Note on Audit of Banks (Revised 2020)**

---

- a. The entire amount due to the bank (irrespective of the quantum of security held against such assets), or for which the bank is liable (including in case of deposit accounts), is to be provided for over a period not exceeding four quarters commencing with the quarter in which the fraud has been detected;
- b. However, where there has been delay, beyond the prescribed period, in reporting the fraud to the Reserve Bank, the entire provisioning is required to be made at once. In addition, Reserve Bank of India may also initiate appropriate supervisory action where there has been a delay by the bank in reporting a fraud, or provisioning there against;
- c. Where the bank chooses to provide for the fraud over two to four quarters and this results in the full provisioning being made in more than one financial year, banks should debit 'other reserves' [i.e., reserves other than the one created in terms of Section 17(2) of the Banking Regulation Act 1949] by the amount remaining un-provided at the end of the financial year by credit to provisions. However, banks should proportionately reverse the debits to 'other reserves' and complete the provisioning by debiting profit and loss account, in the subsequent quarters of the next financial year.

### ***Government Guaranteed Advances***

11.289 The credit facilities backed by guarantees of Central Government though overdue may be treated as NPA only when the government repudiates its guarantee, when invoked. This exemption from classification of Central Government guaranteed advances as NPA is not for the purpose of recognition of income and thus, in such instances the income would be required to be recognized on cash basis. In case of State Government guaranteed loans, this exemption will not be available and such account will be NPA if interest / principal / other dues remain overdue for more than 90 days.

### ***Advances under Consortium***

11.290 Consortium advances should be based on the record of recovery of the respective individual member banks and other aspects having a bearing on the recoverability of the advances. Where the remittances by the 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, the account should be treated as not serviced in the books of the other member banks and therefore, an NPA.

11.291 The banks participating in the consortium, therefore, 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.

***Advances Against Term Deposits, NSCs, KVPs/ IVPs, etc.***

11.292 Advances against Term Deposits, NSCs eligible for surrender, KVP/IVP and life policies need not be treated as NPAs, provided adequate margin is available in the accounts. Advance against gold ornaments, government securities and all other securities are not covered by this exemption and should be classified as NPA as per the extant IRAC norms. However, in respect of Jewel Loans taken for Agricultural Purposes, the classification has to be continued in accordance with Crop Seasons only.

***Agricultural Advances Affected by Natural Calamities***

11.293 Paragraph 4.2.13 of the Master Circular on Prudential Norms on Income Recognition, Asset Classification and Provisioning deals elaborately with the classification and income recognition issues due to impairment caused by natural calamities. Banks may decide on their own relief measures, viz., conversion of the short term production loan into a term loan or reschedulement of the repayment period and the sanctioning of fresh short-term loan, subject to the guidelines contained in RBI's latest Master Circular on "Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances" dated July 1, 2015 and guidelines contained in RBI FIDD.CO.FSD.BC No.9/05.10.001/2018-19 dated October 17, 2018 on Master Direction – Reserve Bank of India (Relief Measures by Banks in Areas affected by Natural Calamities) Directions 2018 – SCBs". In such cases the NPA classification would be governed by such rescheduled terms. The Auditors are advised to obtain the latest decisions of State Level Banking Committee (SLBC) and the minutes of the SLBC meeting will be accessible in website.

11.294 In such cases of conversion or re-schedulement, the term loan as well as fresh short-term loan may be treated as current dues and need not be classified as NPA. The asset classification of these loans would thereafter be governed by the revised terms & conditions and would be treated as NPA if interest and/or instalment of principal remain overdue for two crop seasons for short duration crops and for one crop season for long duration crops. For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" would be treated as "short duration" crops.

11.295 While fixing the repayment schedule in case of rural housing advances granted to agriculturist under Indira Awas Yojana and Golden Jubilee Rural Housing Finance Scheme, banks should ensure that the interest/ instalment payable on such advances are linked to crop cycles.

***Advances Granted Under Rehabilitation Packages Approved by BIFR/Term Lending Institutions***

11.296 In respect of advances under rehabilitation package approved by BIFR/term lending institutions, the provision should continue to be made in respect of dues to the bank on the existing credit facilities as per their classification as sub-standard or doubtful asset. This classification cannot be upgraded by the bank unless the package of renegotiated terms has worked satisfactorily for a period of one year. As regards the additional facilities sanctioned as per package finalised by BIFR and/or term lending institutions, the income recognition, asset classification norms would apply after a period of one year from the date of disbursement.

***Transactions Involving Transfer of Assets through Direct Assignment of Cash Flows and the Underlying Securities***

11.297 Originating Bank: The asset classification and provisioning rules in respect of the exposure representing the Minimum Retention Requirement (MRR) of the Originator of the asset would be as under:

- a) The originating bank may maintain a consolidated account of the amount representing MRR if the loans transferred are retail loans. In such a case, the consolidated amount receivable in amortisation of the MRR and its periodicity should be clearly established and the overdue status of the MRR should be determined with reference to repayment of such amount. Alternatively, the originating bank may continue to maintain borrower-wise accounts for the proportionate amounts retained in respect of those accounts. In such a case, the overdue status of the individual loan accounts should be determined with reference to repayment received in each account.
- b) In the case of transfer of a pool of loans other than retail loans, the originator should maintain borrower-wise accounts for the proportionate amounts retained in respect of each loan. In such a case, the overdue status of the individual loan accounts should be determined with reference to repayment received in each account.
- c) If the originating bank acts as a servicing agent of the assignee bank for the loans transferred, it would know the overdue status of loans transferred which should form the basis of classification of the entire MRR/individual loans representing MRR as NPA in the books of the originating bank, depending upon the method of accounting followed as explained in para (a) and (b) above.

11.298 **Purchasing Bank:** In purchase of pools of both retail and non-retail

loans, income recognition, asset classification and provisioning norms for the purchasing bank will be applicable based on individual obligors and not based on portfolio. Banks should not apply the asset classification, income recognition and provisioning norms at portfolio level, as such treatment is likely to weaken the credit supervision due to its inability to detect and address weaknesses in individual accounts in a timely manner. If the purchasing bank is not maintaining the individual obligor-wise accounts for the portfolio of loans purchased, it should have an alternative mechanism to ensure application of prudential norms on individual obligor basis, especially the classification of the amounts corresponding to the obligors which need to be treated as NPAs as per existing prudential norms. One such mechanism could be to seek monthly statements containing account-wise details from the servicing agent to facilitate classification of the portfolio into different asset classification categories. Such details should be certified by the authorized officials of the servicing agent. Bank's concurrent auditors, internal auditors and statutory auditors should also conduct requisite checks of these portfolios with reference to the basic records maintained by the servicing agent. The servicing agreement should provide for such verifications by the auditors of the purchasing bank. All relevant information and audit reports should be available for verification by the Inspecting Officials of RBI during the Annual Financial Inspections of the purchasing banks.

11.299 The above guidelines prescribed for Originating Bank and Purchasing Bank do not apply to:

- (a) Transfer of loan accounts of borrowers by a bank to other bank/FIs/NBFCs and vice versa, at the request/instance of borrower;
- (b) Inter-bank participations;
- (c) Trading in bonds;
- (d) Sale of entire portfolio of assets consequent upon a decision to exit the line of business completely. Such a decision should have the approval of Board of Directors of the bank;
- (e) Consortium and syndication arrangements and arrangement under Corporate Debt Restructuring mechanism;
- (f) Any other arrangement/transactions, specifically exempted by the Reserve Bank of India.

***Post Shipment Supplier's Credit***

11.300 In respect of post-shipment credit extended by the banks covering export of goods to countries for which the ECGC cover is available, EXIM Bank has introduced a guarantee-cum-refinance programme whereby, in the event of

## **Guidance Note on Audit of Banks (Revised 2020)**

---

default, EXIM Bank will pay the guaranteed amount to the bank within a period of 30 days from the day the bank invokes the guarantee after the exporter has filed claim with ECGC.

11.301 Accordingly, where the credit extended by banks are guaranteed by EXIM Bank, the extent to which payment has been received from EXIM bank on guarantee the advance may not be treated as NPA.

### ***Takeout Finance***

11.302 Takeout finance is the product emerging in the context of the funding of long-term infrastructure projects. Under such an arrangement, the bank or financial institution financing infrastructure projects will have an arrangement with any financial institution for transferring to the latter the outstanding in respect of such financing in their books on a predetermined basis. In view of the time-lag involved in taking-over, the possibility of a default in the meantime cannot be ruled out. The norms of asset classification will have to be followed by the concerned bank/financial institution in whose books the account stands as balance sheet item as on the relevant date. If the lending institution observes that the asset has turned NPA on the basis of the record of recovery, it should be classified accordingly. The lending institution should not recognise income on accrual basis and account for the same only when it is paid by the borrower/ taking over institution (if the arrangement so provides). The lending institution should also make provisions against any asset turning into NPA pending its takeover by taking over institution. As and when the asset is taken over by the taking over institution, the corresponding provisions could be reversed. However, the taking over institution, on taking over such assets, should make provisions treating the account as NPA from the actual date of it becoming NPA even though the account was not in its books as on that date.

### ***Export Project Finance***

11.303 Where the actual importer has paid the dues to the bank abroad and the proceeds have not been made good to the bank granting finance due to any political reasons, such account need not be classified as NPA if the bank is able to establish through documentary evidence that the importer has cleared the dues in full by payment received to the credit of account of exporter maintained in such country. The account will, however, have to be considered as NPA if at the end of one year from the date the amount was deposited by the importer in the bank abroad, the amount has not still been remitted to the bank.

### ***Net Worth of Borrower/Guarantor or Availability of Security***

11.304 Since income recognition is based on recoveries, net worth of

borrower/guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise, except to the extent provided in Para 4.2.9 of the Master Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 was issued on July 1, 2015 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances'. Likewise, the availability of security and/or guarantee is not relevant for determining whether an account is an NPA or not.

***Project Finance Under Moratorium Period***

11.305 In the case of bank finance given for industrial projects or for agricultural plantations etc., where moratorium is available for payment of interest, payment of interest becomes due after the moratorium or gestation period is over, and not on the date of debit of interest. Therefore, such amounts of interest do not become overdue and hence the accounts do not become NPA, with reference to the date of debit of interest. They become overdue after due date for payment of interest as per the terms of sanction and consequently NPA norms would apply to those advances from that due date.

***Advances to Staff***

11.306 Interest bearing staff advances as a banker should be included as part of advances portfolio of the bank. In the 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 first due date onwards. Such loans/advances should be classified as NPA only when there is a default in repayment of instalment of principal or payment of interest on the respective due dates. The staff advances by a bank as an employer and not as a banker are required to be included under the sub-head 'Others' under the schedule of Other Assets.

***Partial Credit Enhancement to Corporate Bonds***

11.307 In a waterfall mechanism, Credit Enhancement (CE) gets drawn only in a contingent situation of cash flow shortfall for servicing a debt / bond etc., and not in the normal course of business. Hence, such an event is indicative of financial distress of the project. Keeping this aspect in view, a drawn tranche of the contingent PCE facility will be required to be repaid within 30 days from the date of its drawal (due date). The facility will be treated as NPA if it remains outstanding for 90 days or more from the due date and provided for as per the usual asset classification and provisioning norms. In that event, the bank's other facilities to the borrower will also be classified as NPA as per extant guidelines.

### **NPA Management**

11.308 The RBI has issued Master Circular dated July 1, 2015 on Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances. The Circular stresses the importance of effective mechanism and availability of granular data on NPA management in the banks and provides as follows:

- Asset quality of banks is one of the most important indicators of their financial health. However, it has been observed that existing MIS on the early warning systems of asset quality, needed improvement. Banks are, therefore, advised that they should review their existing IT and MIS framework and put in place a robust MIS mechanism for early detection of signs of distress at individual account level as well as at segment level (asset class, industry, geographic, size, etc.). Such early warning signals should be used for putting in place an effective preventive asset quality management framework, including a transparent restructuring mechanism for viable accounts under distress within the prevailing regulatory framework, for preserving the economic value of those entities in all segments.
- The banks' IT and MIS system should be robust and able to generate reliable and quality information with regard to their asset quality for effective decision making. There should be no inconsistencies between information furnished under regulatory/statutory reporting and the banks' own MIS reporting. Banks are also advised to have system generated segment-wise information on non-performing assets and restructured assets which may include data on the opening balances, additions, reductions, (upgradations, actual recoveries, write-offs etc.) closing balances, provisions held, technical write-offs, etc.

### ***Audit Procedures and Reporting***

- The point requires the auditor to verify and comment whether the identification and classification of advances into standard/substandard/doubtful/loss assets have been done in compliance with the RBI Master Circular No. RBI/2015-16/101, DBR.No.BP.BC.2/21.04.048/2015-16 dated July 01, 2015 "Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances" in conjunction with H.O's instructions for identification of NPAs and Classification of Advances.
- The auditor should verify as to whether the bank has a system of ongoing identification and classification of advances through CBS without manual intervention and its accuracy in crystallising date of NPA. In case of



accounts identified as NPA by the auditor, the auditor needs to review the reasons of non-identification of such accounts through CBS as regards the effectiveness of the existing auto-identification and marking system in the CBS.

- Auditor should verify the deposit account having debit balances due to charging of service charges/interest time to time and pending for recovery since long. Verify whether, prudential norms on Income Recognition, Asset Classification and Provisioning have been followed. If there is any deviation to RBI circular and HO instructions same should be commented and MOC should be given if required.
- Auditor should also review quality and correctness of master data of loans accounts updated in Core Banking Software. Parameters viz. Instalment amount, tenure of loan, moratorium period, Interest Rate, Interest Flags, Limits setup, due date of first instalment and instalment amount. In case of errors in master data configuration, various advances related reports, statement of overdue accounts will not be generated correctly software. Such reports, if relied upon, lead to incorrect identification of NPAs. In view of the same, Auditor should take utmost care while verifying the compliance of NPA norms.
- Auditors should review and compare the date of NPA of loans accounts mentioned in current year statements with that of previous year. Normally there should not be change of date of NPA unless it is suggested by previous auditor in MOC or by RBI Inspectors. Any changes other than these, should be reviewed closely and reasons for such change should be ascertained.
- If an account is identified as NPA either by the bank or by the auditors, the crystallisation of date of NPA needs to be carefully reviewed / verified, which needs to be date of NPA after completion of requisite number days of default (e.g. 91st day in case of continuously overdrawn CC/OD Accounts). The said date of NPA need not be confined to the current financial year but can be of earlier date too. However, in such circumstances, the auditor should also verify the reasons for such accounts being not marked as NPA earlier through system.
- Whenever an incorrect master data related to interest or EMI or tenure of advance, is rectified by the bank, the effects of the same should be given as per the original terms of sanction and not prospectively as the prospective effects of such rectifications in certain cases (wherein the amounts due for repayment had been incorrectly considered on lower side as compared to the terms of sanction) may amount to restructuring of an advance. Further, the auditor needs review and consider the instances of

## **Guidance Note on Audit of Banks (Revised 2020)**

---

non-charging of Penal interest, bank charges, processing fees on the due dates and its effects of NPA classification.

- In case of advances upgraded during the year, the auditor needs to review such upgradation in the light of criteria's specified for upgradation of NPA accounts, considering the possibility of incorrect upgradation of account on the basis of partial recoveries made in the account wherein the overdue portion is not extinguished in entirety, recoveries made in the account subsequent to the cut-off date, (i.e., date of financial statements) and non-identification of NPAs on on-going basis resulting in an account being considered as standard though overdue portion of such unidentified NPAs is not recovered in entirety.
- The Auditor needs to ensure that each customer of the bank is tagged under one single Customer ID / Unique Customer Identification Code (UCIC) in respect of all its accounts, including those in which credit facilities are granted, irrespective of their location, to enable the bank, (subject to the relaxations/exceptions for the time being applicable to any account/facility), to accord the same NPA classification status to the customer/borrower, based on the most adverse classification determined for any of its account/ facility. The auditor should also review the facilities enjoyed by such borrower's related or group entities. The NPA classification so made does not automatically extend to such related or group entities, where the classification would have to be judged based on independently, i.e., at the entity level and not at a group level, unless there is a diversion of funds.
- Audit should also comment on banks' IT and MIS system should be robust and able to identify and generate reliable and quality information with regard to their asset quality for effective decision making without any manual intervention. There should be no inconsistencies between information furnished under regulatory/statutory reporting and the banks' own MIS reporting.

### **Other NPA related aspects**

#### **Income Recognition**

##### ***On Advances Granted***

11.309 Banks recognise income (such as interest, fees and commission) on accrual basis, i.e., as it is earned. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection. In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks

should not recognise income on non-performing assets until it is actually realised.

11.310 If any advance including Bills purchased and discounted, becomes NPA, the entire interest accrued and credited to the income account in the past periods should be reversed if the same is not realised. Interest for the current year if recognised till the date of identification but not realised should also be reversed. Further,

- i. Interest income 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.
- ii. Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit.
- iii. If Government guaranteed advances become NPA (subject to what is stated hereunder in respect of Central Govt. guaranteed accounts), the interest on such advances should not be taken to income account unless the interest has been realised.

Credit facilities backed by guarantee of the Central Government, though overdue, may be treated as NPA only when the Government repudiates its guarantee when invoked. Thus, where the guarantee is not invoked/repudiated, the related account cannot be classified as NPA and by implication, the advance is to be treated as "Standard" for the purpose of provisioning. This exemption from classification of such Central Government guaranteed advances as NPA is not for the purpose of recognition of income; and income is to be recognized only based on realisations made.

***Reversal of Income***

11.311 If any advance, including bills purchased and discounted, becomes NPA, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also. In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected. Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognised as income in the previous year(s).

***On Leased Assets***

11.312 The finance charge component of finance income (as defined in AS 19 – Leases) on the leased asset which has accrued and was credited to income account before the asset became non-performing, and remaining unrealised, should be reversed or provided for in the current accounting period.

***On Take-out Finance***

11.313 In the case of take-out finance, if based on record of recovery, the account is classified by the lending bank as NPA, it should not recognise income unless realised from the borrower/taking-over institution (if the arrangement so provides).

***On Partial Recoveries in NPAs (Appropriation of recoveries in NPAs)***

11.314 In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner. The appropriate policy to be followed is to recognise income as per AS 9 when certainty attaches to realisation and accordingly amount reversed/de-recognised or not recognised in the past should be accounted.

11.315 Interest partly/fully realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.

***Memorandum Account***

11.316 On an account turning NPA, banks should reverse the interest already charged and not collected by debiting Profit and Loss account, and stop further application of interest. However, banks may continue to record such accrued interest in a Memorandum account in their books for control purposes. For the purpose of computing Gross Advances, interest recorded in the Memorandum account should not be taken into account.

***Treatment of interest suspense account***

11.317 Amounts held in Interest Suspense Account should not be reckoned as part of provisions. Amounts lying in the Interest Suspense Account should be deducted from the relative advances and thereafter, provisioning as per the norms, should be made on the balances after such deduction.

***Guidelines on Restructuring of Advances by Banks***

11.318 The RBI, vide its Master Circular No.DBR.No.BP.BC.2/21.04.048/

2015-16 dated July 1, 2015 issued guidelines on prudential norms on Income Recognition, Assets Classification and Provisioning pertaining to Advances. The Guidelines also contain the organisational framework for restructuring of advances under consortium/ multiple banking/ syndication arrangements, i.e., the CDR mechanism.

11.319 In line with the recommendation of the Working Group under the Chairmanship of Shri B. Mahapatra, to review the existing prudential guidelines on restructuring of advances by banks/financial institutions, the extant incentive for quick implementation of restructuring package and asset classification benefits ((paragraph 20.2.1 & 20.2.2 of Master Circular No. RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 was issued on July 1, 2015 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances" (available on restructuring on fulfilling the conditions will however be withdrawn for all restructurings effective from April 1, 2015 with the exception of provisions related to changes in DCCO in respect of infrastructure as well as non-infrastructure project loans. It implies that with effect from April 1, 2015, a standard account on restructuring (for reasons other than change in Date of Commencement of Commercial Operations (DCCO)) would be immediately classified as sub-standard on restructuring as also the non-performing assets, upon restructuring, would continue to have the same asset classification as prior to restructuring and slip into further lower asset classification categories as per the extant asset classification norms with reference to the pre-restructuring repayment schedule.

**Key Concepts**

11.320 Key concepts used in these guidelines are defined in Annex – 5 to the RBI's Master Circular on "Prudential Norms on Income Recognition, Asset Classification and Provisioning to Advances" dated July 1, 2015.

**Eligibility criteria for restructuring of advances**

11.321 Banks may restructure the accounts classified under 'standard', 'sub-standard' and 'doubtful' categories. Banks cannot reschedule / restructure / renegotiate borrowal accounts with retrospective effect. While a restructuring proposal is under consideration, the usual asset classification norms would continue to apply. The process of re- classification of an asset should not stop merely because restructuring proposal is under consideration. The asset classification status as on the date of approval of the restructured package by the competent authority would be relevant to decide the asset classification status of the account after restructuring/ rescheduling/ renegotiation. In case there is

## **Guidance Note on Audit of Banks (Revised 2020)**

---

undue delay in sanctioning a restructuring package and in the meantime the asset classification status of the account undergoes deterioration, it would be a matter of supervisory concern.

11.322 Normally, restructuring cannot take place unless alteration / changes in the original loan agreement are made with the formal consent / application of the debtor. However, the process of restructuring can be initiated by the bank in deserving cases subject to customer agreeing to the terms and conditions.

11.323 No account will be taken up for restructuring by the banks unless the financial viability is established and there is a reasonable certainty of repayment from the borrower, as per the terms of restructuring package. Any restructuring done without looking into cash flows of the borrower and assessing the viability of the projects / activity financed by banks would be treated as an attempt at ever greening a weak credit facility and would invite supervisory concerns / action. Banks should accelerate the recovery measures in respect of such accounts. The viability should be determined by the banks based on the acceptable viability benchmarks determined by them, which may be applied on a case-by-case basis, depending on merits of each case. Illustratively, the parameters may include:

- The Return on Capital Employed;
- Debt Service Coverage Ratio;
- Gap between the Internal Rate of Return;
- Cost of Funds; and
- The amount of provision required in lieu of the diminution in the fair value of the restructured advance.

11.324 The borrowers indulging in frauds and malfeasance will continue to remain ineligible for restructuring. Banks may review the reasons for classification of the borrowers as wilful defaulters, especially in old cases where the manner of classification of a borrower as a wilful defaulter was not transparent, and satisfy itself that the borrower is in a position to rectify the wilful default.

11.325 Following are the erstwhile types of Restructuring mechanisms.

- i. Joint Lenders Forum (JLF) and Corrective Action Plan (CAP).
- ii. Strategic Debt Restructuring (SDR).
- iii. Scheme for Sustainable structuring of Stressed Assets (S4A).
- iv. Corporate Debt Restructuring (CDR) Mechanism.

11.326 With issuance of circular on Prudential Framework for Resolution of Stressed Assets on February 12, 2018 and June 7, 2019, the extant instructions on resolution of stressed assets such as Framework for Revitalising Distressed Assets, Corporate Debt Restructuring Scheme, Flexible Structuring of Existing Long Term Project Loans, Strategic Debt Restructuring Scheme (SDR), Change in Ownership outside SDR, and Scheme for Sustainable Structuring of Stressed Assets (S4A) stand withdrawn with immediate effect. Accordingly, the Joint Lenders' Forum (JLF) as mandatory institutional mechanism for resolution of stressed accounts have been discontinued.

***Resolution of Stressed Assets – Revised Framework w.e.f. February 12, 2018***

11.327 The RBI has issued a circular dated February 12, 2018 about 'Resolution of Stressed Assets – Revised Framework', wherein the existing provisions w.r.t. stress assets have been revised in entirety with discontinuation of various enabling provisions for retention of class of assets (under Corrective Action Plan (CAP), Strategic Debt Restructuring (SDR), Scheme for Sustainable Structuring of Stressed Assets (S4A). All accounts including the one where any of the schemes have been invoked but not yet implemented, shall be governed by revised framework.

11.328 RBI had put a comma for restructuring by discontinuing special regulatory treatment for Asset classification from 31 March 2015. However, the introduction / continuation of schemes like CAP, SDR, S4A, etc. allowed banks to keep accounts standard after restructuring. With the new guidelines issued on February 12, 2018, the RBI has overhauled the restructuring framework by discontinuing prevalent restructuring schemes like CAP, SDR, S4A, etc. The new framework goes one step ahead as it aims at resolution of stressed asset and not just restructuring. With the enactment of Insolvency & Bankruptcy Code, 2016 (IBC), the process of resolution in case of failure of restructuring can be expedited.

***Prudential Framework for Resolution of Stressed Assets – Revised Framework w.e.f. June 7, 2019***

11.329 The earlier circular related to revised framework for Resolution of Stressed Assets was replaced vide circular dated June 7, 2019 for 'Prudential Framework for Resolution for Stressed Assets'. The purpose of these guidelines is to provide framework for early recognition, reporting and time bound resolution of stressed assets.

11.330 These directions are issued without prejudice to issuance of specific

## Guidance Note on Audit of Banks (Revised 2020)

directions, from time to time, by the Reserve Bank to banks, in terms of the provisions of Section 35AA of the Banking Regulation Act, 1949, for initiation of insolvency proceedings against specific borrowers under the Insolvency and Bankruptcy Code, 2016 (IBC). It has provided a framework for resolution of stressed assets as follows:

### I. Early Identification and reporting of stress

Lenders shall recognise incipient stress in loan accounts, immediately on default by classifying such assets as per special mention accounts (SMA) as per following categories.

SMA Sub-categories	Basis of Classification
SMA-0	Principal or Interest payment or any other amount wholly or partly overdue between 1-30 days
SMA-1	31-60 days
SMA-2	61-90 days

In the case of revolving credit facilities like cash credit, the SMA sub-categories will be as follows:

SMA Sub-categories	Basis of Classification
SMA-1	Outstanding balance remains continuously in excess of the sanctioned limit or drawing power, whichever is lower, for a period of 31-60 days
SMA-2	61-90 days

### II. Implementation of Resolution Plan

All lenders must put Board Approved Policy for resolution of stressed assets, including timelines for resolution. It is expected that the lenders initiate the process of implementing Resolution Plan even before a default. Once default is reported, "Review Period" of 30 days, wherein lenders may decide on resolution strategy, may choose to initiate legal proceedings for insolvency or recovery. If RP is to be implemented, all lenders to sign inter creditor agreement (ICA) during Review Period. Decision to be taken as agreed by lenders representing 75% by value of total outstanding credit facilities (FB+NFB) and 60% of lenders by number.



### **Guidance Note on Audit of Banks (Revised 2020)**

In case of accounts with aggregate exposure above a threshold with the lenders, on or after the reference date, resolution plan must be implemented within 180 days from end of review period

Aggregate exposure of the borrower to lenders	Reference Date
Rs. 20 Billion (2000 Crores) and Above	Date of these directions
Rs. 15 Billion (1500 Crores) and above but less than Rs. 20 Billion (2000 Crores)	January 1, 2020
Less than Rs. 15 Billion (1500 Crores)	To be announced in due course

#### **III. Implementation conditions of Resolution Plan**

For 1 billion (100 Cr) and above exposure – Independent Credit Evaluation (ICE) of the residual debt by Credit Rating Agencies (CRAs) specifically authorised by RBI for this purpose.

For 5 billion (500 Cr) and above exposure – Two such Independent Credit Evaluation (ICE) of the residual debt by Credit Rating Agencies (CRAs) specifically authorised by RBI for this purpose.

RP is implemented if following conditions are to be met:

- i. RP Not involving Restructuring / Change in Ownership shall be deemed to be implemented only if the borrower is not in default with any of the lenders as on 180th day from the end of Review Period
- ii. RP involving Restructuring / Change in Ownership shall be deemed to be implemented only if following conditions are met:
  - a. All related documentation, creation of security/charge / perfection of security are completed by the lenders
  - b. New Capital Structure and changes in terms of conditions of the existing loans gets duly reflected in the books of the lenders and borrower
  - c. Borrower is not in default with any of the lenders.

#### **IV. Delayed implementation of Resolution Plan**

Additional provision required when viable RP is not implemented as follows:

### Guidance Note on Audit of Banks (Revised 2020)

Timeline for implementation of viable RP	Additional Provision as % of total outstanding
180 days from the end of review period	20%
365 days from the commencement of Review Period	15%

An additional provision is to be made over and above the higher of following (max 100% of outstanding):

- a. Provisions already held.
- b. Provisions required to be made as per asset classification status of the borrower account.

#### V. Prudential Norms

Restructuring is an act in which a lender, for economic or legal reasons relating to the borrower's financial difficulty, grants concessions to the borrower. Restructuring may involve modification of terms of the advances / securities, which would generally include, among others, alteration of payment period / payable amount / the amount of instalments / rate of interest; roll over of credit facilities; sanction of additional credit facility/ release of additional funds for an account in default to aid curing of default / enhancement of existing credit limits; compromise settlements where time for payment of settlement amount exceeds three months.

11.331 A Non exhaustive indicative list of "financial difficulty" (Based on Basel Committee Guidelines) is as follows:

- i. Borrower not in default, but is probable that the borrower will default on any of its exposures in foreseeable future without the concession,
- ii. Borrowers outstanding securities have been delisted
- iii. Actual performance vs estimates, cash flows to be assessed insufficient to service all of its loans or debt securities
- iv. Borrowers credit facilities are NPA
- v. Borrowers existing exposures are categorised as exposures that have already evidenced difficulty in borrowers ability to repay in accordance with banks internal credit rating system

#### Asset Classification

11.332 On restructuring account will be downgraded from Standard to Substandard. NPAs will remain in same category.

#### Upgradation

11.333 Only when all the outstanding loan / facilities in the account demonstrate 'satisfactory performance' during the period from the date of implementation of RP up to the date by which at least 10% of the sum of outstanding principal debt as per RP and interest capitalisation sanctioned as a part of the restructuring, if any is repaid (provided that account cannot be upgraded before one year from the commencement of the first payment of interest or principal, whichever is later, on the credit facility with longest period of moratorium under the terms of RP).

11.334 In addition to the satisfactory performance, in case of aggregate exposure of Rs. 1 Billion and above, External credit rating of investment grade should be BBB- or better and in case of aggregate exposure of Rs. 5 Billion and above, two such external credit ratings of investment grade should be BBB- or better

11.335 On failure to demonstrate satisfactory performance during monitoring period, asset classification upgrade is subjected to fresh restructuring / change of ownership framework as per IBC and additional provision of 15% for such accounts should be made at the end of review period.

#### Provisioning Norms

11.336 Accounts restructured under the revised framework shall attract provisioning as per the asset classification category as laid out in the Master Circular on Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated July 1, 2015. The circular further provides guidelines for Supervisory Review and related to Disclosures.

Accounts restructured under earlier framework in which accounts are continued to be classified as Standard post restructuring, if satisfactory performance after the specified period is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to pre-restructuring schedule.

#### **Upgradation of Loan Accounts Classified as NPAs**

11.337

- (i) If arrears of interest and principal are paid by the borrower in the case of loan accounts classified as NPAs, the account should no longer be treated as non-performing and may be classified as 'standard' accounts. Upgradation is allowed only if the account reaches "no overdues" status. This should not be misunderstood with "overdues brought within 90 days". Upgradation of a restructured/ rescheduled/CDR accounts is governed by

## Guidance Note on Audit of Banks (Revised 2020)

---

the restructuring / reschedulement /CDR norms . Further, in case of borrowers wherein the bank has multiple exposures, it would be pertinent note that the 'no overdue' status needs to be achieved w.r.t. all exposures of the bank as on the date of upgradation of the account.

- (ii) Auditor has to verify that any upgrading of accounts classified as 'Sub-Standard' or 'Doubtful' category wherein restructuring / rephasing of principal or interest has taken place should be upgraded to the 'Standard Asset' category only after a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms, subject to satisfactory performance during the period. The total amount becoming due during this period of one year should be recovered and there should be no overdues to make it eligible for upgradation. If the amount which has become due during this one year period is on a lower side *vis a vis* total amount outstanding, the other aspects of the account, *viz* financial performance, availability of security, operations in account, etc., should be reviewed in detail and only if found satisfactory, the account should be upgraded.
- (iii) Recovery in an advance which was rescheduled cannot give the advance a better classification than the previous one. NPA accounts can be upgraded to Performing Accounts, provided all overdue are adjusted.
- (iv) Upgradation within the NPA category is not permitted i.e. a Doubtful account cannot be made Sub-standard even if the overdue are reduced to less than 12 months. Relief for MSME borrowers registered under GST.

11.338 The RBI has issued a circular (no. RBI/2017-18/129 DBR.No.BP.BC.100/21.04.048/2017-18) dated February 07, 2018 granting relief for MSME Borrowers registered under GST, thus, the auditors need to be vigilant as regards the applicability of the said circular and eligibility of the borrower. This circular applies only to borrowers which are classified as micro, small and medium enterprise under the MSMED Act, 2006. The exposure of banks to such borrowers would be classified as standard assets subject to conditions specified in the circular:

1. The borrower is registered under the GST regime as on January 31, 2018.
2. The aggregate exposure including non-fund-based facilities of banks and NBFCs, to the borrower does not exceed Rs. 25 crores as on January 31, 2018.

Thus, the overall exposure of the borrower (including that of multiple banking, consortium banking) as on January 31, 2018 should not exceed Rs. 25 crores, i.e. the overall exposure of the borrower to banks and NBFCs

combined should not exceed the cap of Rs. 25 crores. Further, it is to be noted that as per RBI Master Circular on Exposure Norms – ‘Exposure’ shall include credit exposure (funded and non-funded credit limits) and investment exposure (including underwriting and similar commitments). The sanctioned limits or outstandings, whichever are higher, shall be reckoned for arriving at the exposure limit. However, in the case of fully drawn term loans, where there is no scope for re-drawal of any portion of the sanctioned limit, banks may reckon the outstanding as the exposure.

3. The borrower’s account should be standard account as on August 31, 2017.  
It would be pertinent to note that some banks may be following a system of marking of accounts as NPA in the system as at quarter-end instead of marking the accounts on on-going basis. However, the borrower account needs to be tested for classification purpose as on August 31, 2017 and in case if such account is a NPA account as per the extant of IRAC norms specified by RBI as on August 31, 2017, irrespective of the account being marked or not by the bank, such accounts will not be eligible for relief granted by this circular.
4. The amount from the borrower, overdue as on September 01, 2017 and payments from the borrower due between September 01, 2017 and January 31, 2018 are paid not later than 180 days from their respective original due date.  
As per para 2.3 of Master Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 was issued on July 1, 2015 on ‘Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances’ – ‘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’. Thus, the extension period of 180 days granted for the repayment of the overdue amount as on September 01, 2017 as well as the amounts due between the specified period is restricted to the extent of 180 days from the respective ‘due date’. Further, as per the email dated April 03, 2018 from DBR, Reserve Bank of India, Central Office – “It is clarified that CC/OD limits are part of the aggregate exposure to the borrower. OD/CC accounts which become ‘out of order’ as per para 2.2 of our Master Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 was issued on July 1, 2015 on ‘Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances’ between September 01, 2017 and January 31, 2018 may continue to be classified as standard provided that the irregularity in the account is removed within a period not exceeding 90 days from the original date of the account becoming ‘out of order’.
5. A provision of 5% shall be made against such exposures which are not

## Guidance Note on Audit of Banks (Revised 2020)

classified as NPA (due to the relaxation as provided above), which otherwise would have been classified as NPA as per usual IRAC norms (of accounts overdue beyond 90 days period).

6. The additional time provided is for the purpose of asset classification only and not for income recognition.

Thus, if an account is otherwise eligible to be classified as NPA as per usual IRAC norms (of accounts overdue beyond 90 days period) but is classified as PA based on the above-mentioned relaxation granted, the income is required to be recognised on realisation basis and not on accrual basis.

11.339 Further RBI has issued a circular (no. RBI/2017-18/186 DBR.No.BP.BC.108/ 21.04.048/ 2017-18) dated June 06, 2018 for Encouraging Formalisation of MSME Sector. This circular is in continuity with the February 07, 2018 Circular on MSME Borrowers registered under GST, thus, the auditors needs to be vigilant as regards the applicability of these both circulars and eligibility of the borrowers. This circular applies only to borrowers which are classified as micro, small and medium enterprise under the MSME Act, 2006. The exposure of banks to such borrowers would be classified as standard assets subject to conditions specified in the circular as detailed below:

- i. The aggregate exposure, including non-fund based facilities, of banks and NBFCs to the borrower does not exceed ₹ 250 million as on May 31, 2018.
- ii. The borrower's account was standard as on August 31, 2017.
- iii. The payments due from the borrower as on September 1, 2017 and falling due thereafter up to December 31, 2018 were/are paid not later than 180 days from their original due date.
- iv. In respect of dues payable by GST-registered MSMEs from January 1, 2019 onwards, the 180 days past due criterion shall be aligned to the extant IRAC norms in a phased manner, as given below. However, for MSMEs that are not registered under GST as on December 31, 2018, the asset classification in respect of dues payable from January 1, 2019 onwards shall immediately revert to the extant IRAC norms.

Period during which any payment falls due	Time Permitted
September 01, 2017 – December 31, 2018	180 days
January 01, 2019 – February 28, 2019	150 days
March 01, 2019 – April 30, 2019	120 days
May 01, 2019 onwards	90 days

- v. The other terms and conditions of the circular dated February 07, 2018 remain unchanged.

### **Guidance Note on Audit of Banks (Revised 2020)**

---

11.340 The RBI has issued a circular (no. RBI/2018-19/100 DBR.No.BP.BC.18/21.04.048/2018-19) dated January 01, 2019 permitting one-time restructuring of existing loans of MSMEs classified as 'Standard' without a downgrade in asset classification subject to certain conditions. The said circular is issued with reference to the earlier circulars related to MSME borrowers issued on February 07, 2018 and June 06, 2018. The one-time restructuring as stated above is subject to conditions in specified in the circular as detailed below:

- i. The aggregate exposure, including non-fund based facilities, of banks and NBFCs to the borrower does not exceed ₹ 250 million as on January 01, 2019.
- ii. The borrower's account (can be in default but) is standard as on January 01, 2019 and continues to be standard asset till the date of implementation of the restructuring.
- iii. The borrower is registered under GST as on the date of implementation of restructuring. However, this condition will not apply to MSMEs which are exempt from GST registration. The condition of exemption should be determined on the basis of exemption limit obtaining as on January 1, 2019
- iv. The restructuring of the borrower account is implemented on or before March 31, 2020. A restructuring would be treated as implemented if the following conditions are met:
  - a. All related documentation including execution of necessary agreements between lenders and borrowers / creation of security charges / perfection of securities are completed by all lenders; and,
  - b. The new capital structure and / or changes in the terms and conditions of existing loans gets duly reflected in books of all lenders and the borrower.
- v. A provision of 5% in addition to the provision already held shall be made w.r.t. the accounts restructured under these instructions. Such provision can be reversed at the end of specified period subject to the account demonstrating satisfactory performance during the specified period.

'Specified Period' means a period of one year from the commencement of the first payment of interest or principal, whichever is later, on the credit facility with longest period of moratorium under the terms of restructuring package. 'Satisfactory Performance' means no payment (interest and/or principal) shall remain overdue for a period of more than 30 days. In case of cash credit / overdraft account, satisfactory performance means that the outstanding in the account shall not be more than the sanctioned limit or drawing power, whichever is lower, for a period of more than 30 days.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

- vi. Subsequent to the restructuring, NPA Classification of these accounts shall be as per extant IRAC norms.
- vii. Appropriate disclosure in the financial statements under 'Notes on Accounts' related to MSME restructured accounts under these instructions would be required specifying number of accounts restructured and Amount.
- viii. All other instructions applicable to restructuring of loans to MSME borrowers shall continue to be applicable.

11.341 The RBI has further clarified that the accounts classified as NPA can be restructured, however, the extant asset classification norms governing restructuring of NPAs continues to apply. As a general rule, barring the above one-time exception, any MSME account, which is restructured must be downgraded to NPA upon restructuring and will slip into progressively lower asset classification and higher provisioning requirements as per extant IRAC norms. Such an account may be considered for upgradation to 'standard' only if it demonstrates satisfactory performance during the specified period.

### **Provisioning for Loans and Advances**

11.342 The RBI's Master Circular of July 1, 2015 on Income Recognition, Asset Classification and Provisioning Pertaining to Advances contains the principles to be followed by the bank in calculating the provisions required for the NPAs in conformity with the prudential norms. The circular also requires the bank to take into consideration aspects such as time lag between an account becoming an NPA, its recognition as such, realisation of security and the erosion over time in the value of security charged to the bank, while calculating the required amount of provision. The specific requirements of the Master Circular in respect of provisioning are as follows:

#### **(a) Loss assets**

11.343 The entire amount should be written off. If the assets are permitted to remain in the books for any reason, 100 percent of the outstanding should be provided for.

#### **(b) Doubtful assets**

11.344 The provisioning for doubtful assets under loans and advances is as under:

- (i) Full provision to the extent of the unsecured portion should be made. In doing so, the realisable value of the security available, to which the bank has a valid recourse, should be determined on a realistic basis. Auditor should verify whether that the security is considered based on the latest information available with the bank. DICGC/ECGC cover is also taken into account.



### Guidance Note on Audit of Banks (Revised 2020)

- (ii) In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 25% to 100% of secured portion depending upon the period for which the asset has remained doubtful. In case the advance covered by CGTSI guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per the extant guidelines on provisioning for non-performing advances.

<i>Period for which the advance has been considered as doubtful</i>	<i>% of provision on secured portion</i>
Upto 1 year	25
More than 1 year and upto 3 years	40
More than three years	100

*Valuation of Security:* With a view to bringing down divergence arising out of difference in assessment of the value of security, in cases of NPAs with balance of Rs. 5 crore and above, stock audit at annual intervals by external agencies appointed as per the guidelines approved by the Board is mandatory in order to enhance the reliability on stock valuation. Collaterals, such as immovable properties charged in favour of the bank are required to be got valued once in three years by valuers appointed as per the guidelines approved by the Board of Directors.

**(c) Sub-standard assets**

11.345 A general provision of 15% on total outstanding should be made without making any allowance for DICGC/ECGC cover and securities available. Unsecured exposures, which are identified, as sub-standard would attract an additional provision of 10%. (i.e., total 25% of total outstanding). However, in view of certain safeguards such as escrow accounts available in respect of infrastructure lending, infrastructure loan accounts which are classified as sub-standard will attract a provisioning of 20 per cent instead of the aforesaid prescription of 25 per cent. To avail of this benefit of lower provisioning, the banks should have in place an appropriate mechanism to escrow the cash flows and also have a clear and legal first claim on these cash flows. Unsecured exposure' is defined as an exposure (including all funded and non-funded exposures) where realisable value of the tangible security properly charged to the bank, as assessed by bank/approved valuers/RBI inspectors, is not more than 10%, *ab initio*, of the outstanding exposure. 'Security' means

## **Guidance Note on Audit of Banks (Revised 2020)**

---

tangible security properly discharged to the bank and will not include intangible securities like guarantees (including State government guarantees), comfort letters, etc.

11.346 In order to enhance transparency and ensure correct reflection of the unsecured advances in Schedule 9 of the banks' balance sheet, the following RBI requirements are applicable from the financial year 2009-10 onwards:

- a) For determining the amount of unsecured advances for reflecting in schedule 9 of the published balance sheet, the rights, licenses, authorisations, 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.
- b) However, banks may treat annuities under Build-Operate-Transfer (BOT) model in respect of road / highway projects and toll collection rights, where there are provisions to compensate the project sponsor if a certain level of traffic is not achieved, as tangible securities subject to the condition that banks' right to receive annuities and toll collection rights is legally enforceable and irrevocable.
- c) It is noticed that most of the infrastructure projects, especially road/highway projects are user-charge based, for which the Planning Commission has published Model Concession Agreements (MCAs). These have been adopted by various Ministries and State Governments for their respective Public-Private Partnership (PPP) projects and they provide adequate comfort to the lenders regarding security of their debt. In view of the above features, in case of PPP projects, the debts due to the lenders may be considered as secured to the extent assured by the project authority in terms of the Concession Agreement, subject to the following conditions:
  - i) User charges / toll / tariff payments are kept in an escrow account where senior lenders have priority over withdrawals by the concessionaire;
  - ii) There is sufficient risk mitigation, such as pre-determined increase in user charges or increase in concession period, in case project revenues are lower than anticipated;
  - iii) The lenders have a right of substitution in case of concessionaire default;
  - iv) The lenders have a right to trigger termination in case of default in debt service; and

- v) Upon termination, the Project Authority has an obligation of (i) compulsory buy-out and (ii) repayment of debt due in a pre-determined manner.

In all such cases, banks must satisfy themselves about the legal enforceability of the provisions of the tripartite agreement and factor in their past experience with such contracts.

- d) 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.

11.347 As per the existing instructions of RBI, in the Balance Sheet of the banks, the amounts comprising Debtors (though not tangible assets), charged as security are grouped as secured by tangible assets and disclosure is made with a remark in parenthesis in the Schedule 9, without any quantification of the advances covered by security of Debtors. The amounts comprising the intangibles as per the RBI's Master Circular on Income recognition and Asset Classification Norms will need to be culled out of the secured exposures and quantified to be reflected as unsecured advances; which would also require corresponding reclassification of advances for the earlier year. More importantly, in case of NPAs, the unsecured portion would attract a higher provision, when segregated from the secured portion.

**(d) Standard Assets**

11.348 The bank is required to make a general provision for standard assets at the following rates for the funded outstanding on global loan portfolio basis. The general provision towards standard assets as per Master Circular is as follows:

- a) Farm Credit to Agricultural and Small and Micro Enterprises (SMEs) sectors - 0.25%.
- b) Advances to Commercial Real Estate (CRE) sector – 1.00%.
- c) Advances to Commercial Real Estate – Residential Housing Sector (CRE - RH) at 0.75 per cent.

For this purpose, CRE-RH would consist of loans to builders/developers for residential housing projects (except for captive consumption) under CRE segment. Such projects should ordinarily not include non-residential commercial real estate. However, integrated housing projects comprising

## Guidance Note on Audit of Banks (Revised 2020)

---

of some commercial space (e.g. shopping complex, school, etc.) can also be classified under CRE-RH, provided that the commercial area in the residential housing project does not exceed 10% of the total Floor Space Index (FSI) of the project. In case the FSI of the commercial area in the predominantly residential housing complex exceeds the ceiling of 10%, the project loans should be classified as CRE and not CRE-RH.

- d) Housing loans extended at teaser rates– 2.00%- The provisioning on these assets would revert to 0.40 per cent after 1 year from the date on which the rates are reset at higher rates if the accounts remain 'standard'.
- e) In terms of RBI Circular No. RBI/2016-17/317-DBR.BP.BC.No. 72/08.12.015/2016-17 dated June 7, 2017, the bank should make standard asset provision of 0.25% on individual housing loan sanctioned on or after 7<sup>th</sup> June 2017. In respect of individual housing loan sanctioned before that date provisions @ 0.40% is required to be made on standard assets in terms of Circular No. DBR.BP.BC.No.44/ 08.12.015/ 2015-16 dated October 8, 2015.
- f) Restructured accounts classified as standard advances will attract a higher provision (as prescribed from time to time) in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract the prescribed higher provision for the period covering moratorium and two years thereafter.

Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a higher provision (as prescribed from time to time) in the first year from the date of upgradation.

11.349 As per para 17.4.1 of Master Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 was issued on July 1, 2015 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances', with effect from April 1, 2016 provision on new restructured standard accounts would be made at 5 per cent. The phased manner plan for increase in the provision to 5 per cent was in existence till March 31, 2016.

All other loans and advances not included in (a), (b), (c), (d) and (e) above - 0.40%.

11.350 It is clarified that the Medium Enterprises will attract 0.40% standard asset provisioning. The definition of the terms Micro Enterprises, Small Enterprises, and Medium Enterprises shall be in terms of Master Circular on Lending to Micro, Small & Medium Enterprises (MSME) Sector.

**Guidance Note on Audit of Banks (Revised 2020)**

---

11.351 While the provisions on individual portfolios are required to be calculated at the rates applicable to them, the excess or shortfall in the provisioning, *vis-a-vis* the position as on any previous date, should be determined on an aggregate basis. If the provisions required to be held on an aggregate basis are less than the provisions held as on November 15, 2008, the provisions rendered surplus should not be reversed to P&L account but should continue to be maintained at the level, existed as on November 15, 2008. In case of shortfall determined on aggregate basis, the balance should be provided for by debit to P&L account.

11.352 The provisions on standard assets should not be reckoned for arriving at net NPAs. The provisions towards Standard Assets need not be netted from gross advances but included as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions - Others' in Schedule 5 of the balance sheet.

11.353 Banks shall make additional provision of 2% (in addition to country risk provision that is applicable to all overseas exposures) against standard assets representing all exposures to the step-down subsidiaries of Indian companies, to cover the additional risk arising from complexity in the structure, location of different intermediary entities in different jurisdictions exposing the Indian company, and hence the bank, to greater political and regulatory risk. All the step-down subsidiaries, including the intermediate ones, must be wholly owned subsidiary of the immediate parent company or its entire shares shall be jointly held by the immediate parent company and the Indian parent company and / or its wholly owned subsidiary. The immediate parent should, wholly or jointly with Indian parent company and / or its wholly owned subsidiary, have control over the step-down subsidiary.

11.354 A high level of unhedged foreign currency exposures of the entities can increase the probability of default in times of high currency volatility. Hence, banks are required to estimate the riskiness of unhedged position of their borrowers as per the instructions contained in RBI circular DBOD.No.BP.BC.85/21.06.200/2013-14 dated January 15, 2014 and circular DBOD.No.BP.BC.116/21.06.200/2013-14 dated June 3, 2014 and make incremental provisions on their exposures to such entities:

<b>Likely Loss / EBID (%)</b>	<b>Incremental Provisioning Requirement on the total credit exposures over and above extant standard asset provisioning</b>
-------------------------------	---

### Guidance Note on Audit of Banks (Revised 2020)

Upto 15 per cent	0
More than 15 per cent and upto 30 per cent	20 bps
More than 30 per cent and upto 50 per cent	40 bps
More than 50 per cent and upto 75 per cent	60 bps
More than 75 per cent	80 bps

#### **Unhedged Foreign Currency Exposure of Corporates**

11.355 To ensure that each bank has a policy that explicitly recognises and takes account of risks arising out of foreign exchange exposure of their clients, foreign currency loans above US\$ 10 million, or such lower limits as may be deemed appropriate *vis-à-vis* the banks' portfolios of such exposures, should be extended by banks only on the basis of a well laid out policy of their Boards with regard to hedging of such foreign currency loans. Further, the policy for hedging, to be framed by their Boards, may consider, as appropriate for convenience, excluding the following:

- Where forex loans are extended to finance exports, banks may not insist on hedging but assure themselves that such customers have uncovered receivables to cover the loan amount.
- Where the forex loans are extended for meeting forex expenditure.

11.356 Banks may also consider stipulating a limit on unhedged position of corporates on the basis of bank's Board approved policy. In this context, attention of the readers is also invited to RBI's Circular No. DBOD.No.BP.BC.85/ 21.06.200/2013-14 on "Capital and Provisioning Requirements for Exposures to entities with Unhedged Foreign Currency Exposure" dated January 15, 2014 and clarification DBOD.No.BP.BC.116/ 21.06.200/2013-14 dated June 3, 2014 providing requirements for exposures to entities with unhedged foreign currency exposure.

11.357 The auditor while carrying out the audit of the Unhedged Foreign Currency Exposure (UFCE) should ensure that the Bank has:-

- Obtained the UFCE information from all its branches (including foreign branches) in respect of large borrowers.
- Obtained a certificate in respect of UFCE from entities on a quarterly basis on self-certification basis, and which has preferably been internally audited by the entity concerned. However, at least on an annual basis, UFCE information should be audited and certified by the statutory auditors of the entity for its authenticity.

- Computed “Capital and Provisioning Requirements for Exposures to entities with UFCE” at least on a quarterly basis, as per the applicable RBI guidelines.

***Provisioning requirements for derivative exposures***

11.358 Credit exposures computed as per the current marked to market value of the contract, arising on account of the interest rate & foreign exchange derivative transactions, and gold, shall also attract provisioning requirement as applicable to the loan assets in the 'standard' category, of the concerned counterparties. All conditions applicable for treatment of the provisions for standard assets would also apply to the aforesaid provisions for derivative and gold exposures.

***Provisioning Norms for Leased Assets***

11.359

- i) Substandard assets
  - a) 15 percent of the sum of the net investment in the lease and the unrealised portion of finance income net of finance charge component. The terms 'net investment in the lease', 'finance income' and 'finance charge' are as defined in 'AS 19 Leases' issued by the ICAI.
  - b) Unsecured lease exposures which are identified as 'substandard' would attract additional provision of 10 per cent, i.e., a total of 25 per cent.
- ii) Doubtful; and
- iii) Loss assets

This is same as for Loan Assets

***Accounting and Provisioning Norms for Equipment Leasing Activity***

11.360 While the accounting and provisioning norms discussed above shall also apply in respect of equipment leasing activities the bank should follow the AS 19 on “Leases” issued by ICAI in accounting for lease transactions.

***Advances Guaranteed by ECGC***

11.361 In the case of advances guaranteed by ECGC, provision should be made only for the balance in excess of the amount of such guarantee. Further, while arriving at the provision required to be made for doubtful assets, realisable value of the securities should first be deducted from the outstanding balance in respect of the amount guaranteed by these Corporations and then

provision should be made. (For examples on calculation of the provision, refer the Master Circular on Income Recognition, Asset Classification and Provisioning Pertaining to Advances, dated July 1, 2015)

***Advance covered by guarantees of Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) or Credit Risk Guarantee Fund Trust for Low Income Housing (CRGFTLIH)***

11.362 In case the advance covered by CGTMSE or CRGFTLIH guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per the extant guidelines on provisioning for non-performing advances. For illustrative examples of provisioning in case of advances covered by CGTSL guarantee, refer the paragraph 5.9.5 of the Master Circular No. on Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances, dated July 1, 2015. After statutory audit, RBI conducts annual financial inspection of banks. Auditors may go through the divergence reported by RBI, if any, in terms of classification as well as provisioning and whether the same divergence has been appropriately addressed /clarified, by Banks. Accordingly, auditor would be well advised to consider these aspects while take final view on classification /provisioning of such accounts.

***Reserve for Exchange Rate Fluctuations Account (RERFA)***

11.363 When exchange rate movements of Indian rupee turn adverse, the outstanding amount of foreign currency denominated loans (where actual disbursement was made in Indian Rupee) which become overdue goes up correspondingly, with its attendant implications of provisioning requirements. Such assets should not normally be revalued. In case such assets need to be revalued as per requirement of accounting practices or for any other requirement, the following procedure may be adopted:

- The loss on revaluation of assets has to be booked in the bank's Profit & Loss Account.
- Besides the provisioning requirement as per Asset Classification, banks should treat the full amount of the Revaluation Gain relating to the corresponding assets, if any, on account of Foreign Exchange Fluctuation as provision against the particular assets.

***Provisioning For Country Risk***

11.364 Banks are required to make provisions, with effect from the year



### Guidance Note on Audit of Banks (Revised 2020)

ending 31 March 2003, on the net funded country exposures on a graded scale ranging from 0.25 to 100 percent according to the risk categories mentioned below. To begin with, banks are required to make provisions as per the following schedule:

<b>Risk Category</b>	<b>ECGC Classification</b>	<b>Provisioning requirement (per cent)</b>
Insignificant	A1	0.25
Low	A2	0.25
Moderate	B1	5
High	B2	20
Very high	C1	25
Restricted	C2	100
Off-credit	D	100

11.365 Banks are required to make provision for country risk in respect of a country where its net funded exposure is one per cent or more of its total assets. The provision for country risk shall be in addition to the provisions required to be held according to the asset classification status of the asset. In the case of 'loss assets' and 'doubtful assets', provision held, including provision held for country risk, may not exceed 100% of the outstanding. Banks may not make any provision for 'home country' exposures i.e. exposure to India. The exposures of foreign branches of Indian banks to the host country should be included. Foreign banks shall compute the country exposures of their Indian branches and shall hold appropriate provisions in their Indian books. However, their exposures to India will be excluded. Banks may make a lower level of provisioning (say 25% of the requirement) in respect of short-term exposures (i.e., exposures with contractual maturity of less than 180 days).

11.366 Provisioning norms for sale of financial assets to Securitisation Company (SC) / Reconstruction company (RC) –

- (i) When a bank / FI sells its financial assets to SC/ RC, on transfer the same will be removed from its books.
- (ii) If the sale of financial assets to SC/RC, is at a price below the net book value (NBV) (i.e., book value less provisions held), the shortfall should be debited to the profit and loss account of that year. Banks can also use countercyclical / floating provisions for meeting any shortfall on sale of NPAs i.e., when the sale is at a price below the net book value (NBV).

## Guidance Note on Audit of Banks (Revised 2020)

---

However, for assets sold on or after February 26, 2014 and upto March 31, 2015, as an incentive for early sale of NPAs, banks can spread over any shortfall, if the sale value is lower than the NBV, over a period of two years. This facility of spreading over the shortfall will be subject to necessary disclosures in the Notes to Account in Annual Financial Statements of the banks. The RBI vide Notification dated May 21, 2015 had decided to extend this dispensation for assets sold on or after March 31, 2015 and up to March 31, 2016.

Further RBI has vide notification DBR.No.BP.BC.102/21.04.048/2015-16 dated June 13, 2016 has decided to extend the dispensation of amortising the shortfall up to March 31, 2017. However, for the assets sold from the period April 1, 2016 to March 31, 2017, banks will be allowed to amortise the shortfall over a period of only four quarter from the quarter in which the sale took place.

Further, where a bank chooses to make the necessary provisions over more than one quarter and this results in the full provisioning remaining to be made as on the close of a financial year, banks should debit 'other reserves' [i.e., reserves other than the one created in terms of Section 17(2) of the Banking Regulation Act 1949] by the amount remaining un-provided at the end of the financial year, by credit to specific provisions. However, banks should proportionately reverse the debits to 'other reserves' and complete the provisioning by debiting profit and loss account, in the subsequent quarters of the next financial year.

Banks shall make suitable disclosures in Notes to Accounts with regard to the quantum of provision made during the year to meet the shortfall in sale of NPAs to SCs/RCs and the quantum of unamortised provision debited to 'other reserves' as at the end of the year.

- (iii) For assets sold on or after February 26, 2014, banks can reverse the excess provision on sale of NPAs, if the sale value is for a value higher than the NBV, to its profit and loss account in the year the amounts are received. However, banks can reverse excess provision arising out of sale of NPAs only when the cash received (by way of initial consideration and / or redemption of SRs / PTCs) is higher than the net book value (NBV) of the asset. Further, reversal of excess provision will be limited to the extent to which cash received exceeds the NBV of the asset. With regard to assets sold before February 26, 2014, excess provision, on account of sale value being higher than NBV, should not be reversed but should be utilized to meet the shortfall/ loss on account of sale of other financial assets to SC/RC.

(iv) When banks/ FIs invest in the security receipts/ pass-through certificates issued by SC/RC in respect of the financial assets sold by them to the SC/RC, the sale shall be recognised in books of the banks / FIs at the lower of:

- the redemption value of the security receipts/ pass-through certificates, and
- the NBV of the financial asset.

The above investment should be carried in the books of the bank / FI at the price as determined above until its sale or realization, and on such sale or realization, the loss or gain must be dealt with in the same manner as at (ii) and (iii) above.

11.367 All instruments received by banks/FIs from SC/RC as sale consideration for financial assets sold to them and also other instruments issued by SC/ RC in which banks/ FIs invest will be in the nature of non SLR securities. Accordingly, the valuation, classification and other norms applicable to investment in non-SLR instruments prescribed by RBI from time to time would be applicable to bank's/ FI's investment in debentures/ bonds/ security receipts/PTCs issued by SC/ RC. However, if any of the above instruments issued by SC/RC is limited to the actual realisation of the financial assets assigned to the instruments in the concerned scheme the bank/ FI shall reckon the Net Asset Value (NAV), obtained from SC/RC from time to time, for valuation of such investments.

11.368 Banks'/ FIs' investments in debentures/ bonds/ security receipts/PTCs issued by a SC/RC will constitute exposure on the SC/RC. As only a few SC/RC are being set up now, banks'/ FIs' exposure on SC/RC through their investments in debentures/ bonds/security receipts/PTCs issued by the SC/ RC may go beyond their prudential exposure ceiling. In view of the extra ordinary nature of event, banks/ FIs will be allowed, in the initial years, to exceed prudential exposure ceiling on a case-to-case basis. Banks/ FIs, which sell their financial assets to an SC/ RC, shall be required to make the disclosures in the Notes on Accounts to their Balance sheets. For guidelines on the presentation of the disclosures, refer para 6.6 of the master circular BR.No.BP.BC.2/21.04.048/2015-16 - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances.

### **Write-off of NPAs**

11.369 The banks should either make full provision as per the guidelines or write off the advances and claim the tax benefits as are applicable, by evolving appropriate methodology in consultation with their auditors/tax consultants.

Recoveries made in such accounts should be offered for tax purposes as per the rules. Banks may write-off advances at Head Office level, even though the advances are still outstanding in the branch books. At the branch level, provision requirement as per classification norms shall be made and in respect of loss assets 100% provision shall be made.

Readers may refer Chapter 25 “Recovery of Non-Performing Assets by Asset Recovery Branches” of Section B of the Guidance Note for Guidelines on Sale/Purchase of NPAs.

### **Audited Financial Statements in case of Bank Borrowers**

11.370 The RBI *vide* its circular no. DBOD.No. CAS(COD)BC.146/27-77 dated December 22, 1977 had prescribed that all borrowers having credit limit of Rs.10 lakh and above from the banking system should get their annual accounts audited by chartered accountants. Further the RBI *vide* its circular DBOD.No.BP.BC.33/21.04.018/2002-03 dated October 21, 2002 has authorised the Board of Directors of banks to fix a suitable cut off limit with reference to the borrowing entity's overall exposure on the banking system, over which audit of accounts of borrower by chartered accountants would be mandatory.

### **Projects under Implementation**

11.371 For all projects financed by the FIs/ banks after 28<sup>th</sup> May 2002, the date of completion of the project should be clearly spelt out at the time of financial closure of the project.

### **Project Loans**

11.372 There are occasions when the completion of projects is delayed for legal and other extraneous reasons like delays in Government approvals etc. All these factors, which are beyond the control of the promoters, may lead to delay in project implementation and involve restructuring/reschedulement of loans by banks. Accordingly, the following asset classification norms would apply to the project loans before commencement of commercial operations. These guidelines will, however, not be applicable to restructuring of Advances classified as Commercial Real Estate exposures; Advances classified as Capital Market exposure; and Consumer and Personal Advances which will continue to be dealt with in terms of the extant provisions. For this purpose, all project loans have been divided into the following two categories:

- a. Project Loans for infrastructure sector.
- b. Project Loans for non-infrastructure sector.

'Project Loan' would mean any term loan which has been extended for the

purpose of setting up of an economic venture. Banks must fix a Date of Commencement of Commercial Operations (DCCO) for all project loans at the time of sanction of the loan / financial closure (in the case of multiple banking or consortium arrangements).

*Project Loans for Infrastructure Sector*

11.373

- (i) A loan for an infrastructure project will be classified as NPA during any time before commencement of commercial operations as per record of recovery (90 days overdue), unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (v) below.
- (ii) A loan for an infrastructure project will be classified as NPA if it fails to commence commercial operations within two years from the original DCCO, even if it is regular as per record of recovery, unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (v) below.
- (iii) If a project loan classified as 'standard asset' is restructured any time during the period up to two years from the original date of commencement of commercial operations (DCCO), in accordance with the provisions of Part B of this Master Circular, it can be retained as a standard asset if the fresh DCCO is fixed within the following limits, and further provided the account continues to be serviced as per the restructured terms.
  - (a) Infrastructure Projects involving court cases  
Up to another 2 years (beyond the existing extended period of 2 years i.e. total extension of 4 years), in case the reason for extension of date of commencement of production is arbitration proceedings or a court case.
  - (b) Infrastructure Projects delayed for other reasons beyond the control of promoters  
Up to another 1 year (beyond the existing extended period of 2 years i.e. total extension of 3 years), in other than court cases.
- (iv) It is re-iterated that the dispensation is subject to adherence to the provisions regarding restructuring of accounts as contained in the Master Circular which would *inter alia* require that the application for restructuring should be received before the expiry of period of two years from the original DCCO and when the account is still standard as per record of recovery.

The other conditions applicable would be:

**Guidance Note on Audit of Banks (Revised 2020)**

- a. In cases where there is moratorium for payment of interest, banks should not book income on accrual basis beyond two years from the original DCCO, considering the high risk involved in such restructured accounts.
- b. Banks should maintain provisions on such accounts as long as these are classified as standard assets as under:

Particulars	Provisioning Requirement
If the revised DCCO is within two years from the original DCCO prescribed at the time of financial closure	0.40 per cent
If the DCCO is extended beyond two years and upto four years or three years from the original DCCO, as the case may be, depending upon the reasons for such delay	<p>Project loans restructured with effect from June 1, 2013:</p> <p>5.00 per cent – From the date of such restructuring till the revised DCCO or 2 years from the date of restructuring, whichever is later</p> <p>Stock of project loans classified as restructured as on June 1, 2013:</p> <ul style="list-style-type: none"> <li>• 3.50 per cent - with effect from March 31, 2014 (spread over the four quarters of 2013-14)</li> <li>• 4.25 per cent - with effect from March 31, 2015 (spread over the four quarters of 2014-15)</li> <li>• 5.00 per cent - - with effect from March 31, 2016 (spread over the four quarters of 2015-16)</li> </ul> <p>The above provisions will be applicable from the date of restructuring till the revised DCCO or 2 years from the date of restructuring, whichever is later.</p>

- (v) For the purpose of these guidelines, mere extension of DCCO would not be considered as restructuring, if the revised DCCO falls within the period of

two years from the original DCCO. In such cases the consequential shift in repayment period by equal or shorter duration (including the start date and end date of revised repayment schedule) than the extension of DCCO would also not be considered as restructuring provided all other terms and conditions of the loan remain unchanged.

- (vi) In case of infrastructure projects under implementation, where Appointed Date (as defined in the concession agreement) is shifted due to the inability of the Concession Authority to comply with the requisite conditions, change in date of commencement of commercial operations (DCCO) need not be treated as 'restructuring', subject to following conditions:
  - a. The project is an infrastructure project under public private partnership model awarded by a public authority;
  - b. The loan disbursement is yet to begin;
  - c. The revised date of commencement of commercial operations is documented by way of a supplementary agreement between the borrower and lender; and
  - d. Project viability has been reassessed and sanction from appropriate authority has been obtained at the time of supplementary agreement.

*Project Loans for Non-Infrastructure Sector*

11.374

- (i) A loan for a non-infrastructure project will be classified as NPA during any time before commencement of commercial operations as per record of recovery (90 days overdue), unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (iv) below.
- (ii) A loan for a non-infrastructure project will be classified as NPA if it fails to commence commercial operations within one year from the original DCCO, even if is regular as per record of recovery, unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (iv) below.
- (iii) In case of non-infrastructure projects, if the delay in commencement of commercial operations extends beyond the period of one year from the date of completion as determined at the time of financial closure, banks can prescribe a fresh DCCO, and retain the "standard" classification by undertaking restructuring of accounts in accordance with the provisions contained in this Master Circular, provided the fresh DCCO does not extend beyond a period of two years from the original DCCO. This would among others also imply that the restructuring application is received before the

**Guidance Note on Audit of Banks (Revised 2020)**

expiry of one year from the original DCCO, and when the account is still "standard" as per the record of recovery.

The other conditions applicable would be:

- a. In cases where there is moratorium for payment of interest, banks should not book income on accrual basis beyond one year from the original DCCO, considering the high risk involved in such restructured accounts.
- b. Banks should maintain provisions on such accounts as long as these are classified as standard assets as under:

Particulars	Provisioning Requirement
If the revised DCCO is within one year from the original DCCO prescribed at the time of financial closure	0.40 per cent
If the DCCO is extended beyond one year and upto two years from the original DCCO prescribed at the time of financial closure	<p>Project loans restructured with effect from June 1, 2013:</p> <p>5.00 per cent – From the date of restructuring for 2 years</p> <p>Stock of Project loans classified as restructured before June 01, 2013:</p> <ul style="list-style-type: none"> <li>• 3.50 per cent - with effect from March 31, 2014 (spread over the four quarters of 2013-14)</li> <li>• 4.25 per cent - with effect from March 31, 2015 (spread over the four quarters of 2014-15)</li> <li>• 5.00 per cent - with effect from March 31, 2016 (spread over the four quarters of 2015-16)</li> </ul> <p>The above provisions will be applicable from the date of</p>



**Guidance Note on Audit of Banks (Revised 2020)**

Particulars	Provisioning Requirement
	restructuring for 2 years.

- (iv) For this purpose, mere extension of DCCO would not be considered as restructuring, if the revised DCCO falls within the period of two years from the original DCCO. In such cases the consequential shift in repayment period by equal or shorter duration (including the start date and end date of revised repayment schedule) than the extension of DCCO would also not be considered as restructuring provided all other terms and conditions of the loan remain unchanged.

***Change in Ownership***

11.375

- i. In order to facilitate revival of the projects stalled primarily due to inadequacies of the current promoters, if a change in ownership takes place any time during the periods quoted in paragraphs 4.2.15.3 of the Master Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 was issued on July 1, 2015 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances" or before the original DCCO, banks may permit extension of the DCCO of the project up to two years in addition to the periods quoted at paragraph 4.2.15.3 of the aforesaid circular as the case may be, without any change in asset classification of the account subject to the conditions stipulated in the following paragraphs. Banks may also consequentially shift/extend repayment schedule, if required, by an equal or shorter duration.
- ii. In cases where change in ownership and extension of DCCO (as indicated in paragraph 4.2.15.5 (i) of the aforesaid circular) takes place before the original DCCO, and if the project fails to commence commercial operations by the extended DCCO, the project will be eligible for further extension of DCCO in terms of guidelines quoted at paragraph 4.2.15.3 of the aforesaid circular. Similarly, where change in ownership and extension of DCCO takes place during the period quoted in paragraph 4.2.15.3 (i) of the aforesaid circular, the account may still be restructured by extension of DCCO in terms of guidelines quoted at paragraph 4.2.15.3 (ii) of the aforesaid circular, without classifying the account as non-performing asset.
- iii. The provisions of paragraphs 4.2.15.4 (i) and 4.2.15.4 (ii) of the aforesaid circular are subject to the following conditions:
- a. Banks should establish that implementation of the project is stalled/affected primarily due to inadequacies of the current

#### **Guidance Note on Audit of Banks (Revised 2020)**

---

- promoters/management and with a change in ownership there is a very high probability of commencement of commercial operations by the project within the extended period;
- b. The project in consideration should be taken-over/acquired by a new promoter/promoter group with sufficient expertise in the field of operation. If the acquisition is being carried out by a special purpose vehicle (domestic or overseas), the bank should be able to clearly demonstrate that the acquiring entity is part of a new promoter group with sufficient expertise in the field of operation;
  - c. The new promoters should own at least 51 per cent of the paid up equity capital of stake in the acquired project. If the new promoter is a non-resident, and in sectors where the ceiling on foreign investment is less than 51 per cent, the new promoter should own atleast 26 per cent of the paid up equity capital or up to applicable foreign investment limit, whichever is higher, provided banks are satisfied that with this equity stake the new non-resident promoter controls the management of the project;
  - d. Viability of the project should be established to the satisfaction of the banks;
  - e. Intra-group business restructuring/mergers/acquisitions and/or takeover/acquisition of the project by other entities/subsidiaries/associates etc. (domestic as well as overseas), belonging to the existing promoter/promoter group will not qualify for this facility. The banks should clearly establish that the acquirer does not belong to the existing promoter group;
  - f. Asset classification of the account as on the 'reference date' would continue during the extended period. For this purpose, the 'reference date' would be the date of execution of preliminary binding agreement between the parties to the transaction, provided that the acquisition/takeover of ownership as per the provisions of law/regulations governing such acquisition/takeover is completed within a period of 90 days from the date of execution of preliminary binding agreement. During the intervening period, the usual asset classification norms would continue to apply. If the change in ownership is not completed within 90 days from the preliminary binding agreement, the 'reference date' would be the effective date of acquisition/takeover as per the provisions of law/regulations governing such acquisition/takeover;

- g. The new owners/promoters are expected to demonstrate their commitment by bringing in substantial portion of additional monies required to complete the project within the extended time period. As such, treatment of financing of cost overruns for the project shall be subject to the guidelines prescribed in paragraph 13 of the circular. Financing of cost overrun beyond the ceiling prescribed in paragraph 13 of the circular would be treated as an event of restructuring even if the extension of DCCO is within the limits prescribed above;
  - h. While considering the extension of DCCO (up to an additional period of 2 years) for the benefits envisaged hereinabove, banks shall make sure that the repayment schedule does not extend beyond 85 per cent of the economic life/concession period of the project; and
  - i. This facility would be available to a project only once and will not be available during subsequent change in ownership, if any.
- iv. Loans covered under this guideline would attract provisioning as per the extant provisioning norms depending upon their asset classification status.

**Other Issues**

11.376

- (i) All other aspects of restructuring of project loans before commencement of commercial operations would be governed by the provisions of Part B of Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances. Restructuring of project loans after commencement of commercial operations will also be governed by these instructions.
- (ii) Any change in the repayment schedule of a project loan caused due to an increase in the project outlay on account of increase in scope and size of the project, would not be treated as restructuring if:
  - (a) The increase in scope and size of the project takes place before commencement of commercial operations of the existing project.
  - (b) The rise in cost excluding any cost-overrun in respect of the original project is 25% or more of the original outlay.
  - (c) The bank re-assesses the viability of the project before approving the enhancement of scope and fixing a fresh DCCO.
  - (d) On re-rating, (if already rated) the new rating is not below the previous rating by more than one notch.
- (iii) Project loans for Commercial Real Estate

## Guidance Note on Audit of Banks (Revised 2020)

---

CRE projects mere extension of DCCO would not be considered as restructuring, if the revised DCCO falls within the period of one year from the original DCCO and there is no change in other terms and conditions except possible shift of the repayment schedule and servicing of the loan by equal or shorter duration compared to the period by which DCCO has been extended. However, the asset classification benefit would not be available to CRE projects if they are restructured.

- (iv) Multiple revisions of the DCCO and consequential shift in repayment schedule for equal or shorter duration (including the start date and end date of revised repayment schedule) will be treated as a single event of restructuring provided that the revised DCCO is fixed within the respective time limits stipulated at paragraphs 4.2.15.3 (iii) and 4.2.15.4 (iii) of the Master Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, dated July 1, 2015 and all other terms and conditions of the loan remained unchanged.
- (v) Banks, if deemed fit, may extend DCCO beyond the respective time limits stipulated at paragraphs 4.2.15.3 (iii) and 4.2.15.4 (iii) of the Master Circular No. RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, dated July 1, 2015; however, in that case, banks will not be able to retain the 'standard' asset classification status of such loan accounts.
- (vi) In all the above cases of restructuring where regulatory forbearance has been extended, the Boards of banks should satisfy themselves about the viability of the project and the restructuring plan.
- (vii) The RBI vide its Circular No. RBI/2014-15/182 DBOB. No.BP.BC.33/21.04.048/2014-15 dated August 14, 2014 on "Prudential Norms on Income Recognition, Assets Classification and Provisioning Pertaining to Advances – Project under Implementation" mentions that banks have represented to RBI that in respect of funding of cost overruns, which may arise on account of extension of DCCO within the above (i.e.; two years and one year for infrastructure and non-infrastructure projects from original DCCO date with other terms and conditions remain unchanged), time limits may be allowed without treating the loans as restructured.
- (viii) In cases where banks have specifically sanctioned a 'standby facility' at the time of initial financial closure to fund cost overruns, they may fund cost overruns as per the agreed terms and conditions.

- (ix) In cases Where the initial financial closure does not envisage such financing of cost overruns, based on the representations from banks, it has been decided to allow banks to fund cost overruns, which may arise on account of extension of DCCO within the time limits quoted at paragraph (i) above, without treating the loans as 'restructured asset' subject to the following conditions:
- (a) Banks may fund additional 'Interest during Construction', which may arise on account of delay in completion of a project;
  - (b) Other cost overruns (excluding Interest during Construction) up to a maximum of 10% of the original project cost;
  - (c) Debt Equity Ratio as agreed at the time of initial financial closure should remain unchanged subsequent to funding cost overruns or improve in favour of the lenders and the revised Debt Service Coverage Ratio should be acceptable to the lenders;
  - (d) Disbursement of funds for cost overruns should start only after the Sponsors/Promoters bring in their share of funding of the cost overruns; and
  - (e) All other terms and conditions of the loan should remain unchanged or enhanced in favour of the lenders.

**Flexible structuring of Long Term Project Loans to Infrastructure and Core Industries**

11.377

- (i) In view of the challenges faced by Banks, the RBI has clarified in its circular no. DBOD.No.BP.BC.24/21.04.132/2014-15 on Flexible Structuring of Long Term Project Loans to Infrastructure and Core Industries dated July 15, 2014, that it has no objection to banks' to fix longer amortisation period for loans to projects in infrastructure and core industries sectors, say 25 years, based on the economic life or concession period of the project, with periodic refinancing, say every 5 years. For details refer to the circular.
- (ii) The RBI has further clarified in its circular no. DBOD.No.BP.BC.24/21.04.132/2014-15 Flexible Structuring of Long Term Project Loans to Infrastructure and Core Industries dated December 15, 2014 that the flexible structuring of existing loans will be allowed in addition to new loans as per the norms given in the circular.
- (iii) For detailed guidelines on the Flexible structuring of Long Term Project Loans, refer para 10 and 11 of the master circular DBR.No.BP.BC.2/

## **Guidance Note on Audit of Banks (Revised 2020)**

---

21.04.048/ 2015-16 - Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances.

### ***Income recognition***

11.378

- (i) Banks may recognise income on accrual basis in respect of the projects under implementation, which are classified as 'standard'.
- (ii) Banks should not recognise income on accrual basis in respect of the projects under implementation which are classified as a 'substandard' asset. Banks may recognise income in such accounts only on realisation on cash basis. Consequently, banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognised as income in the previous year(s). As regards the regulatory treatment of 'funded interest' recognised as income and 'conversion into equity, debentures or any other instrument' banks should adopt the following:
  - a) **Funded Interest:** Income recognition in respect of the NPAs, regardless of whether these are or are not subjected to restructuring/ rescheduling/ renegotiation of terms of the loan agreement, should be done strictly on cash basis, only on realisation and not if the amount of interest overdue has been funded. If, however, the amount of funded interest is recognised as income, a provision for an equal amount should also be made simultaneously. In other words, any funding of interest in respect of NPAs, if recognised as income, should be fully provided for.
  - b) **Conversion into equity, debentures or any other instrument:** The amount outstanding converted into other instruments would normally comprise principal and the interest components. If the amount of interest dues is converted into equity or any other instrument, and income is recognised in consequence, full provision should be made for the amount of income so recognised to offset the effect of such income recognition. Such provision would be in addition to the amount of provision that may be necessary for the depreciation in the value of the equity or other instruments, as per the investment valuation norms. However, if the conversion of interest is into equity which is quoted, interest income can be recognised at market value of equity, as on the date of conversion, not exceeding the amount of interest converted to equity. Such equity must thereafter be classified in the

“available for sale” category and valued at lower of cost or market value. In case of conversion of principal and /or interest in respect of NPAs into debentures, such debentures should be treated as NPA, *ab initio*, in the same asset classification as was applicable to loan just before conversion and provision made as per norms. This norm would also apply to zero coupon bonds or other instruments which seek to defer the liability of the issuer. On such debentures, income should be recognised only on realization basis. The income in respect of unrealised interest which is converted into debentures or any other fixed maturity instrument should be recognized only on redemption of such instrument. Subject to the above, the equity shares or other instruments arising from conversion of the principal amount of loan would also be subject to the usual prudential valuation norms as applicable to such instruments.

**Provisioning norms on restructured advances**

***Normal provisions***

11.379

- (i) Banks will hold provision against the restructured advances as per the extant provisioning norms.
- (ii) Restructured accounts classified as standard advances will attract a higher provision (as prescribed from time to time) in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract the prescribed higher provision for the period covering moratorium and two years thereafter.
- (iii) Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a higher provision (as prescribed from time to time) in the first year from the date of upgradation.
- (iv) The above-mentioned higher provision on restructured standard advances (2.75 per cent as prescribed vide circular dated November 26, 2012) would increase to 5 per cent in respect of new restructured standard accounts (flow) with effect from June 1, 2013 and increase to 5% by FY: 2015-16 in a phased manner for the stock of restructured standard accounts as on May 31, 2013.

***Provision for diminution in the fair value of restructured advances-***

11.380

- (i) Reduction in the rate of interest and/or reschedulement of the repayment of principal amount, as part of the restructuring, will result in diminution in the

## Guidance Note on Audit of Banks (Revised 2020)

---

fair value of the advance. Such diminution in value is an economic loss for the bank and will have impact on the bank's market value of equity. It is, therefore, necessary for banks to measure such diminution in the fair value of the advance and make provisions for it by debit to Profit & Loss Account. Such provision should be held in addition to the provisions as per existing provisioning norms and in an account distinct from that for normal provisions.

For this purpose, the erosion in the fair value of the advance should be computed as the difference between the fair value of the loan before and after restructuring. Fair value of the loan before restructuring will be computed as the present value of cash flows representing the interest at the existing rate charged on the advance before restructuring and the principal, discounted at a rate equal to the bank's BPLR or Base Rate<sup>4</sup> (whichever is applicable to the borrower) as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring. Fair value of the loan after restructuring will be computed as the present value of cash flows representing the interest at the rate charged on the advance on restructuring and the principal, discounted at a rate equal to the bank's BPLR or base rate (whichever is applicable to the borrower) as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring.

The above formula moderates the swing in the diminution of present value of loans with the interest rate cycle and will have to be followed consistently by banks in future. Further, it is reiterated that the provisions required as above arise due to the action of the banks resulting in change in contractual terms of the loan upon restructuring which are in the nature of financial concessions. These provisions are distinct from the provisions which are linked to the asset classification of the account classified as NPA and reflect the impairment due to deterioration in the credit quality of the loan. Thus, the two types of the provisions are not substitute for each other.

- ii) There could be divergences in the calculation of diminution of fair value of accounts by banks. For example, divergences could occur if banks do not appropriately factor in the term premium on account of elongation of repayment period on restructuring. In such a case the term premium used while calculating the present value of cash flows after restructuring would

---

<sup>4</sup> This change has been introduced as a result of the introduction of Base Rate System w.e.f. July 1, 2010 vide circular DBOD.No.Dir.BC.88/13.03.00/2009-10 dated April 9, 2010 on 'Guidelines on the Base Rate'.



be higher than the term premium used while calculating the present value of cash flows before restructuring.

Further, the amount of principal converted into debt/equity instruments on restructuring would need to be held under AFS and valued as per usual valuation norms. Since these instruments are getting marked to market, the erosion in fair value gets captured on such valuation. Therefore, for the purpose of arriving at the erosion in the fair value, the NPV calculation of the portion of principal not converted into debt/equity has to be carried out separately. However, the total sacrifice involved for the bank would be NPV of the above portion plus valuation loss on account of conversion into debt/equity instruments.

Auditor should therefore verify that Bank has correctly captured diminution in fair value of restructured accounts as it will have a bearing not only on the provisioning required to be made by them but also on the amount of sacrifice required from the promoters.

Auditors should also verify that there is no any effort on the part of banks to artificially reduce the net present value of cash flows by resorting to any sort of financial engineering. Auditor should also verify that there is a proper mechanism in place of checks and balances to ensure accurate calculation of erosion in the fair value of restructured accounts.

11.381 In the case of working capital facilities, the diminution in the fair value of the cash credit / overdraft component may be computed as indicated in para 17.4.2 (i) of Master Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 was issued on July 1, 2015 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances', reckoning the higher of the outstanding amount or the limit sanctioned as the principal amount and taking the tenor of the advance as one year. The term premium in the discount factor would be as applicable for one year. The fair value of the term loan components (Working Capital Term Loan and Funded Interest Term Loan) would be computed as per actual cash flows and taking the term premium in the discount factor as applicable for the maturity of the respective term loan components.

11.382 In the event any security is taken in lieu of the diminution in the fair value of the advance, it should be valued at Re.1/- till maturity of the security. This will ensure that the effect of charging off the economic sacrifice to the Profit & Loss account is not negated.

11.383 The diminution in the fair value may be re-computed on each balance sheet date till satisfactory completion of all repayment obligations and full repayment of the outstanding in the account, so as to capture the changes in the

## **Guidance Note on Audit of Banks (Revised 2020)**

---

fair value on account of changes in BPLR or base rate (whichever is applicable to the borrower), term premium and the credit category of the borrower. Consequently, banks may provide for the shortfall in provision or reverse the amount of excess provision held in the distinct account.

11.384 If due to lack of expertise / appropriate infrastructure, a bank finds it difficult to ensure computation of diminution in the fair value of advances, as an alternative to the methodology prescribed above for computing the amount of diminution in the fair value, the banks has the option of notionally computing the amount of diminution in the fair value and providing therefor, at five percent of the total exposure, in respect of all restructured accounts where the total dues to bank(s) are less than rupees one crore. The total provisions required against an account (normal provisions plus provisions in lieu of diminution in the fair value of the advance) are capped at 100% of the outstanding debt amount.

### ***Risk-Weights***

11.385 The RBI circular also provides that:

- a. Restructured housing loans should be risk weighted with an additional risk weight of 25 percentage points.
- b. With a view to reflecting a higher element of inherent risk which may be latent in entities whose obligations have been subjected to restructuring / rescheduling either by banks on their own or along with other bankers / creditors, the unrated standard / performing claims on corporates should be assigned a higher risk weight of 125% until satisfactory performance under the revised payment schedule has been established for one year from the date when the first payment of interest / principal falls due under the revised schedule.
- c. For details on risk weights, Master Circular RBI/2015-16/58 DBR.No.BP.BC.1/21.06.201/ 2015-16 dated July 1, 2015 on 'Basel III Capital Regulations' may be referred.

### **Prudential Norms for Conversion of Principal into Debt / Equity**

#### ***Asset classification norms***

11.386 A part of the outstanding, principal amount can be converted into debt or equity instruments as part of restructuring. The debt / equity instruments so created will be classified in the same asset classification category in which the restructured advance has been classified. Further movement in the asset classification of these instruments would also be determined based on the subsequent asset classification of the restructured advance.

***Income recognition norms***

*Standard Accounts*

11.387 In the case of restructured accounts classified as 'standard', the income, if any, generated by these instruments may be recognised on accrual basis.

*Non- Performing Accounts*

11.388 In the case of restructured accounts classified as non-performing assets, the income, if any, generated by these instruments may be recognised only on cash basis.

***Valuation and provisioning norms***

11.389 These instruments should be held under AFS and valued as per usual valuation norms. Equity classified as standard asset should be valued either at market value, if quoted, or at break-up value, if not quoted (without considering the revaluation reserve, if any) which is to be ascertained from the company's latest balance sheet. In case the latest balance sheet is not available, the shares are to be valued at Re. 1. Equity instrument classified as NPA should be valued at market value, if quoted, and in case where equity is not quoted, it should be valued at Re. 1. Depreciation on these instruments should not be offset against the appreciation in any other securities held under the AFS category.

**Prudential Norms for Conversion of Unpaid Interest into 'Funded Interest Term Loan' (FITL), Debt or Equity Instruments**

***Asset classification norms***

11.390 The FITL / debt or equity instrument created by conversion of unpaid interest will be classified in the same asset classification category in which the restructured advance has been classified. Further movement in the asset classification of FITL / debt or equity instruments would also be determined based on the subsequent asset classification of the restructured advance.

***Income recognition norms***

11.391 The income, if any, generated by these instruments may be recognised on accrual basis, if these instruments are classified as 'standard', and on cash basis in the cases where these have been classified as a non-performing asset.

11.392 The unrealised income represented by FITL / Debt or equity instrument should have a corresponding credit in an account styled as "Sundry Liabilities Account (Interest Capitalization)".

11.393 In the case of conversion of unrealised interest income into equity, which is quoted, interest income can be recognized after the account is upgraded to standard category at market value of equity, on the date of such upgradation, not exceeding the amount of interest converted into equity.

11.394 Only on repayment in case of FITL or sale / redemption proceeds of the debt / equity instruments, the amount received will be recognized in the P&L Account, while simultaneously reducing the balance in the "Sundry Liabilities Account (Interest Capitalisation)".

**Valuation & Provisioning norms**

11.395 Valuation and provisioning norms would be as referred above. The depreciation, if any, on valuation may be charged to the Sundry Liabilities (Interest Capitalisation) Account.

**B. Where the auditor disagrees with the branch classification of advances into standard (Including SMA-0, SMA-1, SMA-2) /substandard/doubtful/ loss assets, the details of such advances with reasons should be given. Also indicate whether suitable changes have been incorporated/ suggested in the Memorandum of Changes.**

**Audit Procedures and Reporting**

11.396

- If auditor does not agree with classification given by branch, he should give details along with reasons for the same.
- This point also requires the Auditor to indicate whether suitable changes have been incorporated in Memorandum of Changes as well.

**C. Have you come across cases where the relevant Controlling Authority of the bank has authorized legal action for recovery of advances or recalling of advances but no such action was taken by the branch? If so, give details of such cases.**

**Audit Procedures and Reporting:**

11.397 Auditor should ask for the list of cases from the management, where approval for legal action for recovery of advances has been obtained from controlling authority of bank. Auditor should verify these cases and comment where branch has not taken any legal action so far or taken with delay.

**D. Have all non-performing advances been promptly reported to the relevant Controlling Authority of the bank? Also state whether any rehabilitation program in respect of such advances has been undertaken, and if so, the status of such program.**

**Audit Procedures and Reporting:**

11.398 Auditor should examine that all NPA are being promptly reported to controlling authority of the bank. Auditor should verify the cases, where process of rehabilitation has been initiated and give the present status of such cases.

**E. Have appropriate claims for DICGC and Export Credit Guarantee/ Insurance and subsidies and Others, if any, been duly lodged and settled? The status of pending claims giving year wise break-up of number and amounts involved should be given in the following format.**

***In addition to this: Give details of claims rejected? Whether the rejection is appropriately considered while determining the provisioning requirements.***

Particulars	Number		Amount (Rs)
Claims as at the beginning of the year (Give year-wise details)	-----	N.A.	-----
Further claims lodged during the year	-----	N.A.	-----
Total A			
Amounts representing :			
(a) claims accepted/settled (give year-wise details)	-----		-----
(b) claims rejected (give year-wise details)			
Total B			
Balance as at the year-end (give year-wise details)			
A-B	-----	N.A.	-----

**Audit Procedures and Reporting:**

11.399

- Auditor should verify that there is process of identifying the cases, where claims are required to be lodged with DICGC, ECGC and any other department.
- Auditor should verify, whether in required case, branch has taken step for lodging the claims and same have been lodged.
- Auditor should obtain the numbers of accounts with outstanding balance relating to DICGC, ECGC and any other claims. He should furnish year-wise breakup of number of account with amount in prescribed format for claims as at beginning of the year, claims lodged, accepted /settled/ rejected during the year and balance at year end.
- In cases where claims have been rejected, auditor should verify and comment whether the rejection is appropriately considered while determining the provisioning requirements.

**F. In respect of non-performing assets, has the branch obtained valuation reports from approved valuers for the fixed assets charged to the bank, once in three years, unless the circumstances warrant a shorter duration?**

**Relevant Provision**

11.400 According to the guidelines; the provisioning for doubtful assets under loans and advances is as under:

- (i) Full provision to the extent of the unsecured portion should be made. In doing so, the realisable value of the security available, to which the bank has a valid recourse, should be determined on a realistic basis. Auditor should verify whether that the security is considered based on the latest information available with the bank. DICGC/ECGC cover is also taken into account.
- (ii) In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 25% to 100% of secured portion depending upon the period for which the asset has remained doubtful. In case the advance covered by CGTMSE / CRGFTLIH / CGTSI guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per the extant guidelines on provisioning for non-performing advances.

Period for which the advance has been considered as doubtful	% of provision on secured portion
Upto 1 year	25
More than 1 year and upto 3 years	40
More than three years	100

**Note on valuation of Security:** With a view to bringing down divergence arising out of difference in assessment of the value of security, in cases of NPAs with balance of Rs. 5 crore and above, stock audit at annual intervals by external agencies appointed as per the guidelines approved by the Board is mandatory in order to enhance the reliability on stock valuation. Collaterals, such as immovable properties charged in favour of the bank are required to be got valued once in three years by valuers appointed as per the guidelines approved by the Board of Directors.

## Audit Procedures and Reporting

11.401

- Auditor should verify and comment whether, in case of NPA accounts, branch has obtained approved valuer report for fixed assets charged to bank once in three years or shorter duration as prescribed by the bank. If there is any deviation same should be commented upon.

Auditor should also verify and comment on compliance of Notes given at the end of clause 5.3 of prudential norms master circular dated July 1, 2014 for stock audit and valuation of collaterals by external agencies in case of NPAs with balance of Rs. 5 crore and above.

**G. In the cases examined by you has the branch complied with the Recovery Policy prescribed by the controlling authorities of the bank with respect to compromise/settlement and write-off cases? Details of the cases of compromise/settlement and write-off cases involving write-offs/ waivers in excess of Rs.50.00 lakhs may be given.**

### 11.402 Audit Procedures and Reporting

- Auditor should verify the cases of compromise/settlement and write off during the year. Auditor should verify that prescribed policy of the bank for compromise/settlement and write off is followed by the branch. Approval from designated authority has been obtained as per policy in all cases.
- Auditor should obtain the details of all cases of compromise/ settlement and write off cases involving write off/waiver in excess of Rs. 50 lacs and submit along with report.

## Renewal/ Enhancement/ Reschedulment/ Balance Confirmation

### Renewal

11.403 WCDL is granted for a fixed period on the expiry of which it has to be liquidated, renewed or rolled over. Depending on the terms of sanction the repayment of WCDL can either be in the form of instalments spread over the tenure of the facility or bullet payment at the end of the tenure of the loan. WCDL is generally granted to meet the gap in working capital requirement & considered as a part of working capital facility at the time of renewal or roll over.

Each bank has its own procedures for sanctioning, disbursal, supervision and renewal of advances. Following is the common process across banks w.r.t. advances.

***Renewal of Advances***

11.404 Working capital advances are generally granted for one year at a time and require renewal if the borrower wants to continue the facility beyond that period at the same level, reduced level or increased level, depending upon the borrower's needs, its financial ratios, the bank's perception of risk and so on. Loans repayable over a period of time in instalments are not renewed. However, some banks have a system of reviewing these loans from time to time primarily with the objective of risk evaluation and interest rate resetting. The procedure described above for sanction of advances is also followed, to the extent applicable, for renewal of advances already granted to an applicant.

11.405 The RBI guidelines require banks to renew the advances within 6 months of the expiry of the limit. Hence no working capital limit can remain without reviewed for more than 18 months. It should be ensured that the latest audited balance sheet, various compliance proofs should be on bank's record. Further the various monitoring reports such as inspections, stock audit and operations in the account should be taken cognisance of during renewal.

Non-renewal sometimes may appear to be administrative delay but it may not be so. Hence stricter compliances should be ensured.

***Long Form Audit Report***

11.406 The auditor has to comment on various specific issues as mentioned in the Long Form Audit Report of the bank. While evaluating the efficacy of internal controls over advances, the auditor should particularly examine those aspects on which he is required to comment in his long form audit report. Thus, he should examine, *inter alia*, whether the loan applications are complete and in prescribed form; procedural instructions regarding grant/ renewal/enhancement of facilities have been complied with; sanctions are within delegated authority and disbursements are as per terms of the sanction; documentation is complete; and supervision is timely, effective and as per prescribed guidelines. The auditor can gather the requisite evidence by examining relevant documents (such as loan application forms, supporting documentation, sanctions, security documents, etc.) and by obtaining information and explanations from the branch management in appropriate cases. The auditors must familiarise themselves with those issues and guidance relating to the same and should cover the same during the regular course of audit of advances.

***Enhancement***

11.407 At the time of renewal of working capital facilities, borrower may ask for increase in the existing facilities, which is called enhancement. All the other process is similar to that of renewal of working capital facilities, except the exposure is higher than the earlier sanction.



## **Reschedulement / Restructuring**

### ***Retail Assets***

11.408 The retail assets in various banks at present form a significant part of their portfolio. As there are large numbers of accounts in these cases, the same poses a challenge for the auditors. The classification and provisioning towards the same should, however, be done as in case of other assets.

11.409 There may be a large number of accounts under retail assets, which have been restructured/rescheduled during respective years including repetitive rephasements. The process of the bank to report / record all such reschedulement/restructuring needs to be reviewed and adequacy of the same should be checked. In case of restructuring of consumer and personal advances, the same should immediately be treated as NPA. The accounts are treated as restructured when the bank, for economic or legal reasons relating to borrower's financial difficulty, grants to the borrower concessions that the bank would otherwise not consider. The HO of the bank should instruct properly to branches in this regard.

### ***Restructuring of cases***

11.410 RBI has given guidelines for treatment of restructured accounts in part B of the Master Circular on Prudential Norms on Income Recognition, Assets Classification and Provisioning Pertaining to Advances dated July 1, 2015.

11.411 RBI has given guidelines for early recognition of financial distress whereby Joint Lenders Forum (JLF) will give a Corrective Action Plan (CAP) in part C of the Master Circular on Prudential Norms on Income Recognition, Assets Classification and Provisioning Pertaining to Advances dated July 1, 2015.

11.412 RBI has given Flexible restructuring scheme in Circular DBOD.No.BP.BC.24/ 21.04.132/2014-15 dated July 15, 2014.

11.413 RBI has given SDR restructuring scheme in Circular DBR.BP.BC.No.101/ 21.04.132/2014-15 dated June 8, 2015.

11.414 RBI has given outside SDR restructuring scheme in Circular DBR.BP.BC.No.41/ 21.04.048/2015-16 dated September 24, 2016.

11.415 RBI has given S4A Scheme for sustainable structuring of stressed assets in Circular DBR.No.BP.BC.103/21.04.132/2015-16 dated June 13, 2016.

11.416 RBI has issued circular dated February 12, 2018 regarding Resolution of Stressed Assets – Revised Framework, and subsequently RBI has issued circular dated June 7, 2019 regarding Prudential Framework for Resolution of

Stressed Assets, whereby the extant instructions on resolution of stressed assets such as Framework for Revitalising Distressed Assets, Corporate Debt Restructuring Scheme, Flexible Structuring of Existing Long Term Project Loans, Strategic Debt Restructuring Scheme (SDR), Change in Ownership outside SDR, and Scheme for Sustainable Structuring of Stressed Assets (S4A) stand withdrawn with immediate effect. Accordingly, the Joint Lenders' Forum (JLF) as mandatory institutional mechanism for resolution of stressed accounts also stands discontinued.

11.417 Once the bank receives an application/proposal in respect of an account for restructuring, it implies that the account is intrinsically weak. Thereby during the time the account remains pending for restructuring, the auditors need to take a view whether provision needs to be made in respect of such accounts pending approval for restructuring.

***Funding of Interest***

11.418 In addition, the auditor should also consider the fact that during the course of restructuring/rescheduling in any manner, the interest element, in addition to the principal may also be rescheduled by the bank. This rescheduling of interest may be with or without sacrifice. In some cases future interest may also be funded apart from the principal. In such cases, the auditor should examine whether the RBI's requirements with regard to provisioning for sacrifice have been complied with by the bank. In case of interest sacrifice, the model prescribed by RBI includes calculation and provisioning for sacrifice on future interest as well. The auditor should examine the terms of funding of interest and if the same is in the nature of moratorium for payment of interest, then the interest would become due only after the moratorium period is over. The funded interest cannot be recognised as income if the account is treated as NPA.

***Sacrifice of interest***

11.419 In respect of sacrifice of interest, the auditor should examine whether:

- (a) Interest sacrifice involved in the amount of interest has been provided for by debit to Profit & Loss account and held in a distinct account.
- (b) Sacrifice is recomputed on each balance sheet date till satisfactory completion of all repayment obligations and full repayment of the outstanding in the account, so as to capture the changes in the fair value on account of changes in BPLR/ Base Rate, term premium and the credit category of the borrower and the consequent shortfall in provision or reversal of the amount of excess provision has been held in the distinct account.

- (c) In the event any security is taken against interest sacrifice, the same has been valued at Re.1/- till maturity of the security. As per RBI norms, the interest sacrifice in all the restructured cases needs to be worked out including for Working Capital Loans. In the case of working capital facilities, the diminution in the fair value of the cash credit /overdraft component may be computed reckoning the higher of the outstanding amount or the limit sanctioned as the principal amount and taking the tenor of the advance as one year. The term premium in the discount factor would be as applicable for one year. The fair value of the term loan components (Working Capital Term Loan and Funded Interest Term Loan) would be computed as per actual cash flows and taking the term premium in the discount factor as applicable for the maturity of the respective term loan components. The process of identifying such interest sacrifice in case of working capital loans needs to be looked upon in detail.

In case the bank has agreed to convert existing/future exposure to the borrower in to Funded Interest Term Loan, such interest should be parked under sundry liabilities and should not be reckoned as income.

## **Balance Confirmation**

### ***Examining the Validity of Recorded Amounts***

11.420 The auditor should ascertain the status of balancing of subsidiary ledgers relating to advances. The total of balances in the subsidiary ledgers should agree with the control accounts in the General Ledger. The auditor should also tally the total of the statement of advances with the balances as per general ledger/ subsidiary ledgers. He should also cross-check the balances of the advances selected for examination as listed in the statement of advances with the balances in the relevant advance accounts in the subsidiary ledgers. Banks often obtain balance confirmation statements from borrowers periodically. Such statements have a dual advantage in preventing disputes by the customer and extending the period of limitation by reference to the date of confirmation. Wherever available, such confirmations may be seen.

## **Borrowing Arrangements**

### **Nature of Borrowing Arrangements**

11.421 The following paragraphs explain the different ways in which a banking arrangement can be tied up by a borrower.

#### ***Sole Banking***

11.422 In this arrangement, the borrower obtains credit from a single bank. This is the simplest form of tie-up and is operationally convenient for both the lender

and the borrower. Most of the banking tie-ups in India are of this type because the quantum of bank finance in an individual case is usually small. Depending on the nature and extent of credit facility offered, the lending bank itself may stipulate that the borrower will not avail of finance from another bank.

***Consortium Arrangement***

11.423 In this type of arrangement, the number of lending banks is more than one. The lending banks form a formal consortium. Salient features of the arrangement are:

- The consortium has a formal leader, called the 'lead bank' (normally though not necessarily, the bank with the largest exposure).
- The consortium frames and adopts its rules within the RBI framework for conducting its business with the borrower.
- There is a common set of loan documents, which is obtained by the lead bank on behalf of other participating banks also.
- The lead bank is responsible for overall monitoring.
- The member banks of the consortium have rights over the security in an agreed proportion.
- The borrower maintains direct business relationship with all member banks of the consortium.
- Minutes of the consortium meetings are circulated amongst the members.
- Banks should exchange information about the conduct of the borrowers' accounts with other banks at least at quarterly intervals.

***Multiple Banking***

11.424 In this type of arrangement, there is no formal arrangement amongst the lending banks. Each of them has its set of loan documents, securities and mode of lending, independent of other lending banks. The borrower has to deal with each of the banks separately.

11.425 The RBI, *vide* its Circular No. DBOD No. BP. BC.46/ 08.12.001/2008-09 dated September 19, 2008 on "Lending under Consortium Arrangement/Multiple Banking Arrangements", encourages the banks to strengthen their information back-up about the borrowers enjoying credit facilities from multiple banks as under:

- (i) At the time of granting fresh facilities, banks may obtain declaration from the borrowers about the credit facilities already enjoyed by them from

other banks, as prescribed in the RBI Circular No. DBOD.No.BP.BC.94 /08.12.001/2008-09 dated December 08, 2008 on "Lending under Consortium Arrangement/Multiple Banking Arrangements". In the case of existing lenders, all the banks may seek a declaration from their existing borrowers availing sanctioned limits of Rs.5.00 crores and above or wherever, it is in their knowledge that their borrowers are availing credit facilities from other banks, and introduce a system of exchange of information with other banks as indicated above.

- (ii) Subsequently, banks should exchange information about the conduct of the borrowers' accounts with other banks at least at quarterly intervals.

**Obtain Diligence Report by a professional at regular intervals, regarding compliance of various statutory prescriptions that are in vogue, as per specimen given in the RBI Circular.**

## **Prudential Exposure Norms**

### **Prudential Exposure Limits**

11.426 With a view to achieve a better risk management and avoidance of concentration of credit risk, the RBI from time to time, prescribes, limits on exposure of a bank to individual borrowers and groups of borrowers in India. The Master Circular No. RBI/2015-16/70 DBR.No.Dir.BC.12/13.03.00/ 2015-16 dated July 1, 2015 on "Exposure Norms", lays down the ceiling on credit exposure to individual/group borrowers in relation to bank's capital fund as defined under capital adequacy standards (Tier-I and Tier-II Capital). Further Circular DBR.No.BP.BC.43/21.01.003/2018-19 dated June 03, 2019 were issued on "Large Exposures Framework (LEF)".

#### **Single and Group Borrower Limits**

11.427 The Large Exposure limits: Single Counterparty: The sum of all the exposure values of a bank to a single counterparty must not be higher than 20 percent of the bank's available eligible Tier I capital base at all times. In exceptional cases, Board of banks may allow an additional 5 percent exposure of the bank's available eligible capital base. Banks shall lay down a Board approved policy in this regard.

11.428 Groups of Connected Counterparties: The sum of all the exposure values of a bank to a group of connected counterparties must not be higher than 25 percent of the bank's available eligible Tier I capital base at all times.

11.429 Exposures to NBFCs: Single NBFC: Banks' exposures to a single NBFC will be restricted to 15% of their eligible Tier I capital base.

11.430 Group of connected NBFCs or group of connected counterparties

## **Guidance Note on Audit of Banks (Revised 2020)**

---

having NBFCs in the group: banks' exposure will be restricted to 25 %of their Tier I Capital. Where the bank has exceeded the above referred prudential exposure limit, the same should be appropriately disclosed in the "Notes to Accounts" to the Balance Sheet.

11.431 With effect from June 03, 2019, In order to capture exposures and concentration risk more accurately and to align the above instructions with international norms, the following amendments have been incorporated in the above mentioned instructions:

- i) Exclusion of entities connected with the sovereign from definition of group of connected counterparties.
- ii) Introduction of economic interdependence criteria in definition of connected counterparties.
- iii) Mandatory application of look-through approach (LTA) in determination of relevant counterparties in case of collective investment undertakings, securitisation vehicles and other structures.

### ***Disinvestment Programme of the Government of India***

11.432 On account of banks' financing of acquisition of PSU shares under the Government of India disinvestment programmes, if any bank, is likely to exceed the regulatory ceiling of single / group borrower limit, RBI will consider relaxation on specific requests from banks in the single/group credit exposure norms on a case by case basis, provided that the bank's total exposure to the borrower, net of its exposure due to acquisition of PSU shares under the Government of India disinvestment programme, should be within the prudential single/group borrower exposure ceiling prescribed by RBI.

### **Sector Specific Limit**

11.433 Apart from limiting the exposures to an individual or a borrower group as indicated above, banks may also consider fixing internal limits for aggregate commitments to specific sectors, e.g. textiles, jute, tea, etc., so that the exposures are evenly spread over various sectors. These limits could be fixed by the banks having regard to the performance of different sectors and the risks perceived. The limits so fixed may be reviewed periodically and revised, as necessary.

### ***Bills Purchased/Discounted under Letter of Credit***

11.434 In cases where the bills discounting/purchasing/negotiating bank and LC issuing bank are different entities, bills purchased/ discounted/ negotiated under L/C (where payment to the beneficiary is not "under reserve") is to be

treated as an exposure on L/C issuing bank and not on borrower. In the case of negotiations “under reserve”, the exposure will be treated as an exposure on the borrower. However, in cases where the bills discounting/purchasing/negotiating bank and LC issuing bank are part of the same bank, i.e. where LC is issued by the Head Office or branch of the same bank, then the exposure should be taken on the third party/borrower and not on the LC issuing bank.

***Lending for Real Estate***

11.435 Banks are required to frame comprehensive prudential norms relating to the ceiling on the total amount of real estate loans, single/group exposure limits for such loans, margins, security, repayment schedule and availability of supplementary finance and the policy should be approved by the banks' Boards. The disbursements in case of these loans should be made only after the borrower has obtained requisite clearances from the government authorities.

11.436 RBI has also required that the banks' Boards may also consider incorporation of aspects relating to adherence to National Building Code (NBC) in their policies on exposure to real estate. The information regarding the NBC can be accessed from the website of Bureau of Indian Standards ([www.bis.org.in](http://www.bis.org.in)). Banks should also adopt the National Disaster Management Authority (NDMA) guidelines and suitably incorporate them as part of their loan policies, procedures and documentation.

***Financing of Joint Ventures***

11.437 Banks are allowed to extend credit/non-credit facilities (*viz.* letters of credit and guarantees) to Indian Joint Ventures/Wholly-owned Subsidiaries abroad and step-down subsidiaries which are wholly owned by the overseas subsidiaries of Indian Corporates. Banks are also permitted to provide at their discretion, buyer's credit/acceptance finance to overseas parties for facilitating export of goods and services from India. The above exposure will, however, be subject to a limit of 20 percent of banks' unimpaired capital funds (Tier I and Tier II capital) and would be subject to the conditions laid down in this regard in the Master Circular on 'Loans and Advances – Statutory and Other Restrictions' dated July 1, 2015.

***Limits on Banks' Exposure to Capital Markets***

*Statutory limit on shareholding in companies*

11.438 No banking company is permitted to hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30 percent of the paid-up share capital of that company or 30 percent of its own

## Guidance Note on Audit of Banks (Revised 2020)

---

paid-up share capital and reserves, whichever is less, except as provided in sub-section (1) of Section 19 of the Banking Regulation Act, 1949. Shares held in demat form should also be included for the purpose of determining the exposure limit. This is an aggregate holding limit for each company.

### *Regulatory Limit*

#### *A. Solo Basis*

11.439 The aggregate exposure of a bank to the capital markets in all forms (both fund based and non-fund based) should not exceed 40 per cent of its net worth as on March 31 of the previous year. Within this overall ceiling, the bank's direct investment in shares, convertible bonds / debentures, units of equity-oriented mutual funds and all exposures to Venture Capital Funds (VCFs) [both registered and unregistered] should not exceed 20 per cent of its net worth.

#### *B. Consolidated Basis*

11.440 The aggregate exposure of a consolidated bank to capital markets (both fund based and non-fund based) should not exceed 40 per cent of its consolidated net worth as on March 31 of the previous year. Within this overall ceiling, the aggregate direct exposure by way of the consolidated bank's investment in shares, convertible bonds/debentures, units of equity-oriented mutual funds and all exposures to Venture Capital Funds (VCFs) [both registered and unregistered] should not exceed 20 per cent of its consolidated net worth<sup>5</sup>.

### **Sectoral Distribution**

11.441 Advances are required to be classified, *inter alia*, into those in India and those outside India, with further sub-classification under each category. One such sub-classification that merits discussion from an auditor's perspective is advances in India to priority sectors.

11.442 Priority sector advances include:

- Advances for agriculture and other allied activities – However, RBI, *vide* its circular no. RPCD.CO.Plan.BC. 51 /04.09.01/2010-11 dated February 2, 2011 on "Classification of loans against gold jewellery" clarifies that loans sanctioned to NBFCs for on-lending to individuals or other entities against gold jewellery, are not eligible for classification under agriculture sector. Similarly, investments made by banks in securitised assets

---

<sup>5</sup> Attention of the readers is drawn to Master Circular of RBI, DBR.No.Dir.BC.12/13.03.00/2015-16 dated 1 July 2015, for components of capital exposure, exclusions, method of computation of capital exposure for the purpose and Intra-day limits.



## Guidance Note on Audit of Banks (Revised 2020)

---

originated by NBFCs, where the underlying assets are loans against gold jewellery, and purchase/assignment of gold loan portfolio from NBFCs are also not eligible for classification under agriculture sector.

- RBI *vide* its master circular no RBI/2018-19/07 FIDD.FID.BC.No.04/12.01.033/ 2018-19 dated July 02, 2018 has provided details on SHG- Bank linkage Programme. In order to enable the banks to report their SHG lending without difficulty, it was decided that the banks should report their lending to SHGs and/or to NGOs for on-lending to SHGs/members of SHGs under the new segment, *viz.* 'Advances to SHGs' irrespective of the purposes for which the members of SHGs have been disbursed loans. Lending to SHGs should be included by the banks as part of their lending to the weaker sections (under priority section).
- Advances to minority communities.
- Advances to micro/small/medium scale enterprises<sup>6</sup>.
- Advances to small road transport operators.
- Advances to retail traders and small business enterprises.
- Advances to professionals and self-employed.
- Advances sanctioned to State sponsored organisations for scheduled castes/scheduled tribes.
- Educational loans upto the prescribed limit – RBI, *vide* its circular no. RPCD.SME & NFS.BC.No. 69/06.12.05 /2009-10 dated April 12, 2010 on “Collateral Free Loans - Educational Loan Scheme”, clarified that banks must not, mandatorily, obtain collateral security in the case of educational loans upto Rs. 4 lakh.
- Housing loans upto prescribed limits<sup>7</sup>.
- Funds provided to RRBs.
- Micro credit<sup>8</sup>.

---

<sup>6</sup> The RBI has issued a master Direction no. RBI/FIDD/2017-18/56 FIDD.MSME & NFS. 12/06.02.31/2017-18 on “Lending to Micro, Small and Medium Enterprises (MSME) Sector” dated July 24, 2017. Also refer to the circular no. RPCD.SME & NFS.BC.No.79/06.02.31/2009-10 dated May 6, 2010 on “Working Group to Review the Credit Guarantee Scheme for Micro and Small Enterprises (MSEs) – Collateral free loans to MSEs”.

<sup>7</sup> Attention is also invited to circular no. DBOD.No.BP.BC. 69 /08.12.001/2010-11 dated December 23, 2010 on “Housing Loans by Commercial Banks – LTV Ratio, Risk Weight and Provisioning”, circular no. RPCD.MSME & NFS.BC.No. 30 /06.11.01/ 2012-13 dated September 18, 2012 on “Scheme of 1% interest subvention on housing loans up to Rs. 15 lakh” and Master circular no. DBR. No.DIR.BC.13/08.12.001/2015-16 dated July 1, 2015 on “Housing Finance”.

<sup>8</sup> The RBI has issued a master circular no. RPCD.MFFI.BC.No. 05/12.01.001/2010-11 dated July 1, 2010 on “Micro Credit”.

## Guidance Note on Audit of Banks (Revised 2020)

---

- Any other priority sector advances, such as SEPUP (Self-Employment Programme for Urban Poor), PMRY (Prime Minister's Rozgar Yojana), SEEU (Self-Employment Scheme for Educated Unemployed Youth) SGSY (Swarna jayanti Gram swaraj Swarozgar Yojana)<sup>9</sup>, SJSRY (Swarna jayanti Sahakari Rozgar Yojana).

11.443 Priority sector advances generally carry an interest rate, which is lower than the normal rate of interest on lending to other sectors. These advances are also known as DRI advances, i.e., advances on which differential rate of interest is applicable. Under the Reserve Bank of India's guidelines, a specified proportion of the total advances of banks are to be made to priority sectors necessarily. Depending upon the nature and type of facilities extended, the bank may get subsidy from the Government to fully or partly offset the shortfall in interest rate and/or get indemnified for bad debts for the whole or a portion of such advances.

11.444 RBI has issued guidelines for the targets and sub-targets set under priority sector lending for all scheduled commercial banks operating in India. For detailed information on the guidelines, refer RBI Direction no. RBI/FIDD/2016-17/33 FIDD.CO.Plan.BC.1/04.09.01/2016-17 on "Priority Sector Lending – Targets and Classification".

11.445 Government of India vide Notification dated February 04, 2016 has specified "Dealing in Priority Sector Lending Certificates (PSLCs) in accordance with the Guidelines issued by Reserve Bank of India" as a form of business under Section 6 (1)(o) of the Banking Regulation Act, 1949. The purpose of PSLCs is to enable banks to achieve the priority sector lending target and sub-targets by purchase of these instruments in the event of shortfall and at the same time incentivize the surplus banks; thereby enhancing lending to the categories under priority sector. Refer RBI circular NO. FIDD.CO.Plan.BC.23/04.09.01/2015-16 dated April 07, 2016 for detailed guidelines on PSLCs.

### Recovery mechanisms

11.446 This topic has been prepared with the sole intention of helping the auditors who are doing the audit of Asset Reconstruction Management Branches (ARMB) or any other branch which have one or more of the non-performing assets (NPA) of a Bank or an Institution, understand the usual legal recovery options available in a broad manner. This note is not intended to provide a

---

<sup>9</sup> Attention is the readers is drawn to master circular No. FIDD.CO.Plan.BC.04/04.09.01/2015-16 dated July 1, 2015 on "Priority Sector Lending - Special Programmes – Swarna jayanti Gram Swarozgar Yojana (SGSY)" and Circular No. RPCD.GSSD.BC.No.30 /09.01.01/2010 -11 dated December 15, 2010 on "Swarna jayanti Gram Swarozgar Yojana (SGSY) - Group Life Insurance Scheme". (Add circular related to NRLM as well)

detailed insight to such options but only to provide a quick and an overall perspective in a simple and brief manner. In this topic, the term “Bank” also stands for Financial Institutions.

11.447 An account declared as NPA by a Bank warrants that the Bank take steps for recovery of the outstanding dues. Such steps can involve steps like rescheduling, rephasing or restructuring of the outstanding loans. However, with the spurt in the NPA levels across the banking sector, the Reserve Bank of India – in departure to earlier guidelines – has issued revised guidelines from time to time which usually makes it mandatory for Banks to declare an account as NPA irrespective of the fact that the account could have been/ or is restructured.

11.448 This topic provides an insight to the following measures that a Bank initiates once an account has been classified as NPA:

1. Recovery using the provisions of the SARFAESI Act, 2002.
2. Recovery using the provisions of the Recovery of Debt dues to Banks and Financial Institutions Act, 1993.
3. Recovery using the Lok Adalats.
4. Recovery using the provisions of the Insolvency and Bankruptcy Code (IBC).

#### **1. Recovery using the provisions of the SARFAESI Act, 2002**

11.449 The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI) empowers Banks / Financial Institutions to recover their Non-Performing Assets (NPA) without the intervention of the Court.

11.450 The provisions of this Act are applicable only for NPA loans where:

- Contractual dues is above Rs. One Lakh. (Rs. 1.00 lakh)
- The default must have occurred i.e. account should have become NPA as per RBI norms.
- Securities are available in the loan account by way of hypothecation or mortgage or assignment.
- The security charges to the Bank must be specific, clear and available to the Bank. It must be duly and effectively charges to the Bank and therefore, enforceable if the Borrower fails to pay in response to notice.
- The securities available are enforceable in nature – agricultural land, aircrafts and vessels are not covered under the Act.
- Amount due is more than 20% of the Principal amount and interest thereon.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

- There is a single lender for an account or a secured asset or 60% of the lenders in a consortium structured consent for action.

11.451 The Act provides three alternative methods for recovery of non-performing assets, namely: -

- a. Securitisation
- b. Asset Reconstruction
- c. Enforcement of Security without the intervention of the Court

### **a. Securitisation:**

It refers to the process of drawing and converting of loans and other financial assets into marketable securities worth selling to the investors. In other words, it involves repackaging of less liquid assets into saleable securities. The securitization company takes over the mortgaged assets of the borrower and is entitled to adopt the following steps:

- Getting hold of financial assets from bank.
- Creating funds from eligible institutional buyers by dint of issuing security receipts to acquire the financial assets.
- Fund raising in any legal way.
- Financial asset acquisition along with taking over the mortgaged assets. (such as building, land etc)

Asset Reconstruction Companies (ARC) – which can do the above – have been created as a result of this Act.

### **b. Asset Reconstruction:**

It refers to conversion of non-performing assets into performing assets. There are multiple steps to reconstruct asset. The point to be noted in this context is reconstruction must be done in accordance with the SARFAESI Act and RBI regulations.

### **c. Enforcement of Security without the intervention of the Court**

The Act empowers the Bank/ ARC:

- To issue demand notice (Section 13 (2)) to the defaulting borrower and guarantor, calling upon them to discharge their dues in full within 60 days from the date of the notice.
- To give notice to any person who has acquired any of the secured assets from the borrower to surrender the same to the Bank.
- To ask any debtor of the borrower to pay any sum due or becoming due to the borrower.

11.452 If on receipt of demand notice, the borrower makes any representation or raises any objection, Authorised Officer shall consider such representation or objection carefully and if he comes to the conclusion that such representation or objection is not acceptable or tenable, he shall communicate the reasons for non-acceptance within one week of receipt of such representation or objection.

11.453 A borrower / guarantor aggrieved by the action of the Bank can file an appeal with DRT and then with DRAT, but not with any civil court. The borrower / guarantor has to deposit 50% of the dues before an appeal with DRAT.

11.454 If the borrower fails to comply with the notice, the Bank may take recourse to one or more of the following measures:

- Take possession of the security
- Sale or lease or assign the right over the security
- Manage the same or appoint any person to manage the same

#### **Concluding remarks**

11.455 Recovery action under this route is very popular as it does not entail a Court administered mechanism and therefore is much faster and often cost effective. Action under SARFAESI provisions must adhere to the provisions of the Limitation Act though SARFAESI action itself is not considered to be an action tenable under Limitation Act and hence a separate suit must be filed in the Court to adhere to the provisions of the Limitation Act by the Bank.

## **2. Recovery using the provisions of the Recovery of Debt dues to Banks and Financial Institutions Act, 1993**

11.456 This Act was promulgated in 1993 to facilitate speedy recovery of loans due to Banks and Institutions that were until then in the domain of Civil Courts. Debt Recovery Tribunals (DRTs) were created as a result of this Act. The main objective and role of DRT is the recovery of funds from borrowers which is payable to banks and financial institutions. The Tribunals power is limited to settle cases regarding the restoration of the unpaid amount from NPAs as declared by the banks under the RBI guidelines. The Tribunal has all the powers vested with the District Court. The Tribunal also has a Recovery officer who guides in executing the recovery Certificates as passed by the Presiding Officers

#### **Applicability of the Act**

11.457 The Act applies to the following:

- It applies where the amount of debt due is not less than Rs. 20,00,000/-.
- It applies when the original application for recovery of Debts is filed only by

Banks and Financial Institutions.

**Composition of DRT**

11.458 DRT is controlled over by a Presiding Officer, who is qualified to be a District Judge and is appointed by notification by Central Government. The Central Government may also authorise another presiding officer of a DRT other than discharging the function of a presiding officer of a DRT.

**Documents Required**

11.459 Every application should be furnished by a paper book (called Original application or OA in short), by the affected Bank containing details such as:

- A statement showing details of the debt due from a Borrower and the circumstances under which such debt has become due.
- Any documents relied upon by the Bank and those mentioned in the application by the Bank.
- Details including crossed Bank Draft or Indian Postal Order representing the application fee.
- Index of the documents produced.

**DRT Application contents**

11.460

- Particulars of Debt.
- Particulars of security interest.
- Estimated value of security.
- If estimated value is less than the amount due then details of other assets owned by debtor.
- Application to DRT seeking an order to disclose the other properties owned by debtor.
- The application must be accompanied by true copies all documents relied upon to substantiate claim.
- Documents include statement of account or entry duly certified.

**Procedure at Filing the Case in DRT**

11.461 The following procedures are to be followed at the time filing the case in debt recovery tribunal.

- The Recovery Application, in the prescribed format, should be submitted with the DRT within the specified time (as applicable under the Limitation Act).

## **Guidance Note on Audit of Banks (Revised 2020)**

---

- Recovery Application should contain the description of all relevant documents and securities charged to the Bank.
- Interim reliefs such as the injunction against properties, attachment before judgement, the appointment of Receiver, Recovery Certificate for admitted dues should be appealed as a rule.
- Account Extracts to be provided and certified as per the provisions of Bankers Books Evidence Act and be annexed to the Recovery Application.

### **Procedure after Filing the Case in DRT**

11.462 The following procedures are to be followed after filing the case in debt recovery tribunal.

- If the Recovery Application filed is satisfied in all respects, DRT will issue a serial number and summons to borrowers or guarantors called defendants.
- Serving of warrant for quick disposal of the case and the Branch/Advocate should get to see that summons are served within one month.
- If the summons is served on the defendants, proceedings commence with evidence by way of affidavits filed by the bank followed by cross-examination of Bank's witnesses and vice versa followed by arguments ending up in Recovery Certificates in respect of the Bank.
- Evidence by way of affidavits as preceding, clarifications or reports excepted by the DRT should be filed.

### **Execution of Recovery Certificate**

11.463 The Presiding Officer finally grants Recovery Certificate and sends it to Recovery Officer (R.O.) for execution. On receipt of the Recovery certificate, the recovery officer can issue the notice to Certificate Debtors, giving 15 days for payment of the amount stated in the Recovery Certificate.

11.464 If the defendant neglects to pay the amount, Recovery Officer will proceed to recover the amount by any one or more of the methods, which are listed below:

- Attachment and sale of Movable or Immovable Property of the defendant.
- Arrest and Detention of the defaulter.
- Appointment of Receiver.

After full recovery of bank dues, the application is closed by Recovery officer.

### **Appeal Against Recovery Officer**

11.465 The appeal against an order of Recovery Officer to DRT can be requested within 30 days from the date of order. The Tribunals have to resolve the claim within six months. The appeal against the judgment of DRT can be made within 45 days only to DRAT (Debt Recovery Appellate Tribunal).

### **Concluding remarks**

11.466 Banks resort to DRT as it is considered to be a legally tenable action and therefore suffices the condition of the Limitation Act. It is common for Banks to simultaneously initiate action under SARFAESI and this Act. Having said that, SARFAESI led resolution is usually must faster than DRT led action. However, as mentioned earlier, SARFAESI action applies for eligible securities clearly charged to the Bank. In cases, where recovery from secured assets are not enough to cover the dues of the Bank, the Bank needs to get additional assets charged to recover its balance amount. Such attachment happens through the DRT platform.

## **3. Recovery using the Lok Adalats**

11.467 Lok Adalats is a process of administering justice in a cost free and speedy manner without resorting to Courts. It is established under the Legal Services Authority Act, 1987. Under the provisions of the Act, States have constituted Legal Services Authorities at High Court, District and at Taluka level. Under such Authorities, Courts are organising Lok Adalats in their respective areas.

11.468 Lok Adalat settles the dispute through assuagement and compromise. Lok Adalat acknowledges the cases pending in the general courts inside their purview which could be settled by conciliation.

11.469 There are several advantages in utilising the forum of Lok Adalats:

- No court fees are payable when cases are referred to it.
- It can take cognizance of existing suits and look into fresh disputes cases as well.
- If no settlement is arrived, parties can continue their legal proceedings.
- Every award by Lok Adalat shall be deemed to be decree passed by Civil Court and is binding on the parties and execution proceeding can be filed accordingly.
- No appeal lies against the decree passed by Lok Adalats as the matter settles through negotiation and mutual consent.



## **Types of Lok Adalat**

### **11.470**

- Continuous Lok Adalat  
This type of Lok Adalat is organized for a number of days continuously.
- Daily Lok Adalat  
As the name suggests, these are held every day.
- Mobile Lok Adalat  
These are the utility vans which are set up in different areas to resolve petty issues.
- Mega Lok Adalat  
This is held on a single day on the state level, in all the courts of the state.
- National level Lok Adalats  
These are held at regular intervals throughout the country. The pending cases are disposed of in huge numbers.
- Permanent Lok Adalats  
The other type of Lok Adalat is the Permanent Lok Adalat, organized under Section 22-B of The Legal Services Authorities Act, 1987. Permanent Lok Adalats have been set up as permanent bodies with a Chairman and two members for providing the compulsory pre-litigation mechanism.

## **Applicability**

11.471 If any of the party involved in a dispute, prior to approaching the court, files a grievance to the legal service authority of the state, the case is taken by the Lok Adalats. This is the pre-litigation stage.

Cases already pending before any court can also be referred to the Lok Adalats if both the parties consent to it.

## **Process involved**

### **11.472**

- After referring the case, the Lok Adalat tries to communicate with the parties. They might invite the disputing parties for a meeting or communicate with them in writing or orally. In this stage, the factual information is discussed and if any one-party desires to keep the information confidential from another party, it can be done.

- Suggestions are invited from both the parties to settle the case.
- When the Lok Adalat believes that there are elements of settlement of the dispute and that the terms might be acceptable by the parties, it is informed to the parties for observation and modifications and accordingly, the dispute is resolved.
- If the case is referred via a court then the award granted by Lok Adalat mentions a clause regarding refund of court fee to the parties.
- The members of Lok Adalat ensure that the issue is settled by mutual consent and that there is no element of coercion or force.

**Concluding remarks**

11.473 Lok Adalats are low cost and speedy platform for recovery and Banks do use this platform especially for settlement of cases where the amount involved is low and protracted legal battle is uneconomical and not viable in relation to the amount involved.

**4. Recovery using the provisions of the Insolvency and Bankruptcy Code (IBC)**

11.474 The Insolvency and Bankruptcy Code was first introduced in 2016 and subsequently amended in 2019. The Code provides a time-bound process for resolving insolvency in companies and among individuals. Insolvency is a situation where individuals or companies are unable to repay their outstanding debt.

**Applicability**

11.475 The Insolvency and Bankruptcy code at present can only be triggered if there is a minimum default of Rs 1 lakh. This process can be triggered by way of filing an application before the National Company Law Tribunal (NCLT). The process can be initiated by two classes of creditors which would include financial creditors and operational creditors. But for the application to be admitted, the creditor will have to show that a requisite default is ascertainable.

11.476 Another important aspect that has to be seen in respect of Insolvency and Bankruptcy Code (IBC) is that at present only companies (both private and public limited company) and Limited Liability Partnerships (LLP) can be considered as defaulting corporate debtors. This code also contains provisions in respect of individual insolvency, but these provisions have not been notified. Therefore cases relating to unpaid debts against individuals and partnership firms would fall outside the purview of this code.

11.477 As soon as the matter is admitted by the NCLT, the NCLT proceeds with the appointment of an Interim Resolution Professional (IRP) who takes over the management of the defaulting debtor. The Resolution Professional may then be continued or removed, contingent on the wishes of the Committee of Creditors (COC). The role of the Resolution Professional primarily entails making on efforts to ensure that the defaulting debtor should as far as possible continue to operate as a going concern. All efforts will be made to ensure that maximum realization of debts can take place as a consequence of the Corporate Insolvency Resolution Process (CIRP) process.

#### **Corporate Insolvency Resolution Process (CIRP)?**

11.478 The CIRP may include necessary steps to revive the company such as raising fresh funds for operation, looking for new buyer to sell the company as going concern. The outstanding debts may be satisfied by way of another person submitting a Resolution plan to take over the Company and pay off the remaining debts. In the event a resolution plan is not submitted or not approved by the committee of creditors (COC), the CIRP process is deemed to have failed. In such a situation the liquidation proceedings would then commence subject to the order of the tribunal.

#### **Timeline**

11.479 The Code states that the insolvency resolution process must be completed within 180 days, extendable by a period of up to 90 days. In light of the recent amendment to the code, for conducting the entire process a time period is specified which is 330 days.

#### **Facilitating Institutions**

11.480 The Code creates various institutions to facilitate resolution of insolvency. These are as follows:

- *Insolvency Professionals:* A specialised cadre of licensed professionals is proposed to be created. These professionals will administer the resolution process, manage the assets of the debtor, and provide information for creditors to assist them in decision making.
- *Insolvency Professional Agencies:* The insolvency professionals will be registered with insolvency professional agencies. The agencies conduct examinations to certify the insolvency professionals and enforce a code of conduct for their performance.
- *Information Utilities:* Creditors will report financial information of the debt

owed to them by the debtor. Such information will include records of debt, liabilities and defaults.

- *Adjudicating authorities:* The proceedings of the resolution process will be adjudicated by the National Companies Law Tribunal (NCLT), for companies; and the Debt Recovery Tribunal (DRT), for individuals. The duties of the authorities will include approval to initiate the resolution process, appoint the insolvency professional, and approve the final decision of creditors.
- *Insolvency and Bankruptcy Board:* The Board will regulate insolvency professionals, insolvency professional agencies and information utilities set up under the Code. The Board will consist of representatives of Reserve Bank of India, and the Ministries of Finance, Corporate Affairs and Law.

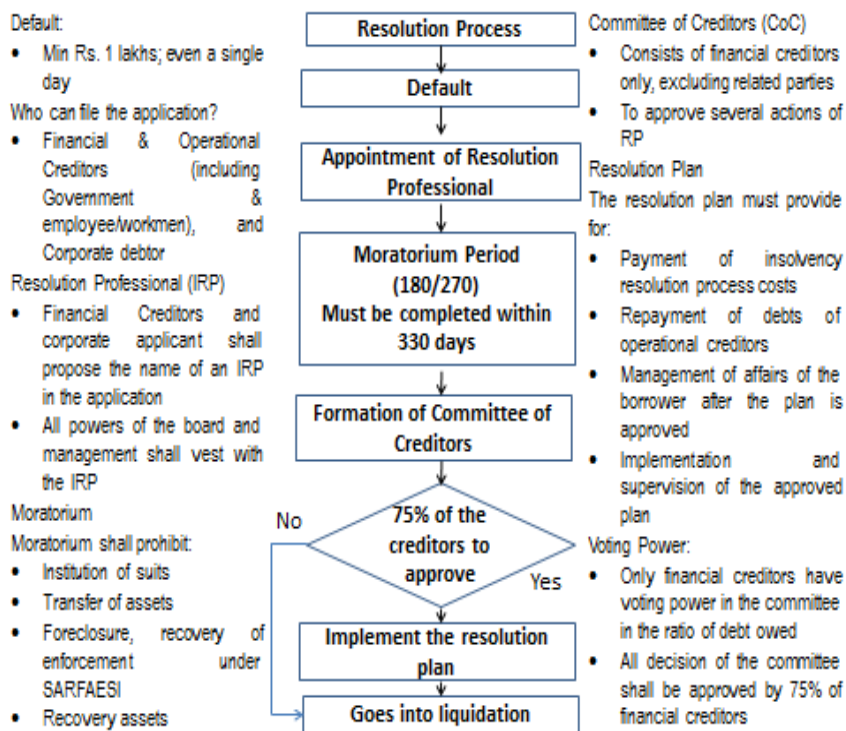
#### **Procedure to resolve insolvency**

11.481 The Code proposes the following steps to resolve insolvency:

- *Initiation:* When a default occurs, the resolution process may be initiated by the debtor or creditor. The insolvency professional administers the process. The professional provides financial information of the debtor from the information utilities to the creditor and manage the debtor's assets.
- *Decision to resolve insolvency:* A committee consisting of the financial creditors who lent money to the debtor will be formed by the insolvency professional. The creditors committee will take a decision regarding the future of the outstanding debt owed to them. They may choose to revive the debt owed to them by changing the repayment schedule, or sell (liquidate) the assets of the debtor to repay the debts owed to them.
- *Liquidation:* If the debtor goes into liquidation, an insolvency professional administers the liquidation process. Proceeds from the sale of the debtor's assets are distributed in the following order of precedence: i) insolvency resolution costs, including the remuneration to the insolvency professional, ii) secured creditors, whose loans are backed by collateral, dues to workers, other employees, iii) unsecured creditors, iv) dues to government, v) priority shareholders and vi) equity shareholders.

**Corporate Insolvency Process**

11.482



**Concluding remarks**

11.483 The IBC platform is relatively new but the processes are fast settling in as the Code has been challenged on various aspects of it has been clarified and also made more robust. In the days to come, resolution through IBC mechanism is bound to pick up even more especially for the bigger ticket exposures of Banks.

## **Fixed Assets and Other Assets**

---

### **Fixed Assets**

12.01 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.

12.02 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.

12.03 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**

12.04 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).

12.05 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'.

12.06 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.

12.07 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. The leasehold improvements are usually written off over the period of the lease. In case of Banks, usually the lease periods are for longer durations and mostly get renewed unless there is some dispute with the landlord. The auditor should check the accounting policy of the bank and ascertain the lease period and verify whether the depreciation has been appropriately calculated and accounted.

12.08 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.

12.09 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**

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

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

12.11 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.

12.12 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**

12.13 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.

12.14 The SBA 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 SBA 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.

The auditor should be careful regarding the date of recording the fixed asset in the books of accounts and commencement of depreciation which should be from the date, the asset is put to use. Banks do give advance payments and the final payment is made after receipt of final invoice. It should be ensured that depreciation is not calculated from either the receipt of invoice or date of final payment.

### **Premises**

12.15 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,

## **Guidance Note on Audit of Banks (Revised 2020)**

---

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.

12.16 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.

12.17 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).

12.18 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.

12.19 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".

12.20 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***

12.21 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. Policy regarding verification of fixed assets at premises used by bank officials, if any, should be noted. For assets used by the branch officials at their residences as per the Banks policy; the auditor should obtain confirmation from the staff for the assets lying at the residences of the staff members. 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.

12.22 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.

12.23 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

## **Guidance Note on Audit of Banks (Revised 2020)**

---

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.

12.24 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.

12.25 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.

12.26 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 is in use. The auditor has to examine the reasonableness of the internal controls with respect to recording such inter branch transfer of assets.

12.27 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.

12.28 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.

12.29 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.

12.30 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.

12.31 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**

12.32 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**

12.33 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 impaired 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

## **Guidance Note on Audit of Banks (Revised 2020)**

---

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**

12.34 The Statutory Branch Auditor may carry out the audit of various items appearing under the head 'Other Assets' in the following manner.

### **Inter-Office Adjustments**

12.35 Inter Office Adjustments/Inter Branch Account is dealt separately in Chapter 20, "Inter Branch/Office Accounts" of Section B of the Guidance Note on Audit of Banks, 2020 edition.

### **Interest Accrued**

12.36 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.

12.37 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**

12.38 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.

12.39 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**

12.40 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 the LFAR.as follows

*Does the system of the Bank ensure adequate internal control over issue and custody of stationery comprising security items (Term Deposit Receipts, Drafts, Pay Orders, Cheque Books, Traveller's Cheques, Gift Cheques, etc.)? Whether the system is being followed by the branch?*

- The Head Office instructions to be seen and confirm whether internal control is in existence.
- Carry out the physical verification of security items including stamps.
- Whether lost security items are reported to Controlling Authority.
- Note down the accounting treatment given to Stationery items as every Bank is having different policy in this regard.
- Comment on the usage of security items during the year and the stock of such items *vis a vis* usage.
- Report lacunas observed in the system at the branch as this is a fraud prone area.

12.41 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.

12.42 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. It may be noted that the branch auditor is required to specifically comment on the loss items of *stationery* as follows:

*Have you come across cases of missing/ lost items of such stationery?*

- Deficiencies in controls that lead to the missing stationery to be stated.

Sr. No	Description of the security item	Consecutive No. of the item	Date of Loss	Missing Reported on
--------	----------------------------------	-----------------------------	--------------	---------------------

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**

12.43 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.

12.44 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.

12.45 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.

12.46 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**

12.47 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***

12.48 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.

12.49 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***

12.50 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.

12.51 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**

12.52 '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.

12.53 The auditor should study the process of creation of suspense accounts, who is authorized to post and reverse entries in these accounts? especially, the necessity of posting these entries, controls over monitoring of ageing and reversal of entries therein. Auditors should also ensure that multiplicity of accounts and unnecessary accounts are not opened as suspense accounts. 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 No. DBOD.BP.BC.4/21.04.018/2003-04 dated 19 July, 2003 "Guidelines on netting off of old and small value entries - Clearing Differences".

12.54 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***

12.55 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. Timely apportionment of entries from prepaid accounts as per Bank policy should be ensured.

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

12.56 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.

12.57 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. It should be ensured that major items are disclosed separately instead of being clubbed together.

## **Borrowings and Deposits**

---

### **Borrowings**

13.01 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. Mostly the borrowings are handled by the Treasury Branches and form part of the Balance Sheet of the Treasury Branch. As such, this item generally does not figure in the balance sheets of most branches of the bank.

13.02 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.

### **Deposits**

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

#### **Types of Deposits**

13.04 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***

13.05 Current accounts are the most common form of demand deposits of banks. Current accounts can be opened in the names of individuals,

## **Guidance Note on Audit of Banks (Revised 2020)**

---

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***

13.06 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 (Trusts, Educational Institutes etc). 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.

13.07 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 No. RBI/2015-16/39 DBR.No.Dir.BC. 7/13.03.00/2015-16 dated July 01, 2015 “Master Circular on Interest Rates on Rupee Deposits held in Domestic, Ordinary Non-Resident (NRO) and Non-Resident (External) (NRE) Accounts”; and the banks have been given freedom to fix the rate of interest on savings accounts.

13.08 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***

13.09 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.

13.10 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.

13.11 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/2016-17/32FMRD. 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 lakh (for a single subscriber) or in multiple of Rs 1 lakh and without the benefits of repatriation if issued to NRI. Other than for NRIs, CDs are transferrable by endorsement and delivery.

13.12 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.

13.13 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.

13.14 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.

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

**(a) FCNR Accounts**

Foreign Currency Non-Resident (FCNR) Accounts are the accounts, as the name suggests opened by Non-Resident Indians.

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.
- (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 (RFC) Accounts**

- Exporters having good track record to open foreign currency account with banks.
- 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) Export Earners Foreign Currency (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 (NRO & NRE) Bank Accounts**

RBI, *vide* its Master Direction No. RBI/DBR/2015-16/19DBR. 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/2009-10/408DBOD. 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.

**Unclaimed Deposits/ Inoperative Accounts**

13.16 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**

13.17 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 said circular also specifies old amounts held under several accounting heads usually mapped under Sundry Liabilities/ Sundry Creditors/ Other Creditors etc. 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.

13.18 Normally the list of the dormant accounts is generated at the Head Office and transmitted to the Branches to follow up with the account holders. The System identifies dormant accounts at the Branches and transfers the balances ageing more than 10 years to the DEAF usually through the RBI current account maintained at the Treasury Branch. The auditors should check all such balances which have been dormant more than 10 years and not transferred to the DEAF and make the necessary rectifications at the Branches. Sometimes the System fails to identify these balances due to some links attached to the accounts such as interest credits of the terms deposits etc; only when the links are deleted the System is able to confirm the ageing of these balances and transfer to DEAF. As the auditors are required to issue a certificate in this regards hence a careful scrutiny of such balances at the Branches is advisable.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

13.19 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**

13.20 The RBI issued Master Direction No.DBR.IBD.No.45/23.67.003/2015-16 dated 22-10-2015 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.

13.21 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.

13.22 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.

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

13.23 Reserve Bank of India *vide* its master direction no. RBI/DBR/2015-16/18DBR.AML.BC.No.81/ 14.01.001/2015-16 updated as on April 20, 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**

13.24 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.

13.25 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.

13.26 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.

13.27 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.

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

13.29 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**

13.30 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**

13.31 The auditor should verify the balances in individual accounts on a test

## **Guidance Note on Audit of Banks (Revised 2020)**

---

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.

13.32 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'.

13.33 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. The auditor should check the internal policy of the Bank whereby dormant balances after certain period should be transferred by the Branches to Head Office.

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

13.34 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.

13.35 Similar to in-operative current accounts, the auditor should pay special attention to inoperative savings bank accounts.

### ***Term Deposits***

13.36 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.

13.37 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.

13.38 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.

***Deposits Designated in Foreign Currencies***

13.39 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***

13.40 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'.

***Inoperative Accounts***

13.41 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.

13.42 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***

13.43 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.

13.44 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.

### ***LFAR reporting***

#### **Deposits**

##### **13.45**

(i) *Have the Controlling Authorities of the bank laid down any guidelines with respect to conduct and operations of Inoperative Accounts? In the cases examined by you, have you come across instances where the guidelines laid down in this regard have not been followed? If yes, give details thereof.*

It is necessary that auditor examines whether the bank have a system of identification of dormant/ inoperative accounts and internal controls regarding operations in such accounts?

- Refer the guidelines issued by Head Office in this regard.
- Whether system identifies the inoperative accounts and converts the status of such accounts to inactive.
- Whether branches are transferring inoperative accounts and shown under a separate DEAF Deposits accounts in the branch General Ledger.
- Whether unclaimed liabilities (whether amount due has been transferred to DEAF) is reflected as Contingent Liability.

(ii) *After the balance sheet date and till the date of audit, whether there have been any unusual large movements (whether increase or decrease) in the aggregate deposits held at the year-end? If so, obtain the clarifications from the Management and give your comments thereon.*

- Compare the aggregate deposits as on 15th March, 20XX, 31st March, 20XX and last day of audit.



**Guidance Note on Audit of Banks (Revised 2020)**

---

- Ascertain the reason for large variation other than due to application of interest / provision as on 31st March, 20XX.
  - Ensure there is no evergreening.
- (iii) *Are there any overdue/ matured term deposits at the end of the year? If so, amounts thereof should be indicated.*
- Refer the guidelines issued by Head Office in this regard.
  - Whether interest is provided on matured deposit as per RBI guidelines.

# 14

## Other Liabilities

---

### **Bills Payable**

14.01 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.

The important aspect to look for in Bills Payable is; whether there are material movements in the older balances. The reasonableness of such transactions must be verified.

### **Inter-office Adjustments**

14.02 The balance in inter-office adjustments account, if in credit, is to be shown under this head.

14.03 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.

14.04 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

### **Guidance Note on Audit of Banks (Revised 2020)**

---

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.

14.05 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.

### **Guidance Note on Audit of Banks (Revised 2020)**

---

- 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

14.06 Banks generally have a separate department to deal with the process of reconciliation of inter branch transactions. Hence reconciliation is not a responsibility at the branch level. As all the Banks are on CBS, hence the inter branch entries are reconciled and adjusted by the system on a regular basis; but the auditor has to scrutinise the old credit entries and check the nature of such entries and confirm whether the same should remain in branch books or should be transferred to Head Office as per the policy of the Bank.

#### **Interest Accrued**

14.07 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 it includes provisioning of interest on Matured Term Deposits.

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

14.08 At branch level, this includes only the expense provisions at the branch.

14.09 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).

### Guidance Note on Audit of Banks (Revised 2020)

- (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.

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.

#### LFAR REPORTING

##### ***Bill Payable, Sundry Deposits, etc.***

14.10 The number of items and the aggregate amount of old outstanding items pending for three years or more may be obtained from the Branch and reported under appropriate heads. Does the scrutiny of the accounts under various sub-heads reveal old balances? If so, give details in the following format:

**As mentioned above, the balances under this head are susceptible to higher risks if movement in the old balances is seen. The auditor will ensure the transactions are genuine.**

The number of items and the aggregate amount of old outstanding items pending for one years or more be obtained from the Branch and reported under appropriate heads. Auditor shall maintain the details thereof in following format.

Year	No. of items	Amount (Rs.)	Remarks

Does your test check indicate any unusual items or material withdrawals or debits in these accounts? If so, report their nature and the amounts involved.

Any unusual transactions in this account must be reported.

# 15

## Contingent Liabilities and Bills for Collection

---

### Introduction

#### Contingent Liabilities

15.01 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>10</sup>

15.02 Letters of Credit, Bank Guarantees and Letters of Comfort, Letter of Undertaking are contingent liabilities, which need to be disclosed as off Balance Sheet items. The procedure for verification of these items is discussed under Chapter 11, "Reporting for Advances" of Section B of the Guidance Note.

---

<sup>10</sup> The reserve bank of India has issued circular no. RBI/2017-18/139 A. P. (DIR Series) circular no. 20 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**

15.03 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**

15.04 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 Over The Counter (OTC) derivatives contracts like Interest Rate Swap, Cross currency Swaps, etc. Similarly, the Bank may also be transacting in derivative contracts including forward exchange contracts on exchanges, which are known as Exchange Traded derivatives. The notional amount of these contracts should be disclosed either separately or under this head as separate sub head. The auditor should verify that notional value of that leg of the contract where the Bank is under obligation to deliver is only considered as liability and therefore receivable leg of the contract should not be included in the liability.

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

15.05 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**

15.06 This item includes the following balances:

- (a) letters of credit opened by the bank on behalf of its customers; and
- (b) Letters of Comfort issued by the bank on behalf of its customers for availing buyers' credit facilities
- (c) Bills drawn by the bank's customers and accepted or endorsed by the bank (to provide security to the payees) whether drawn under letters of credit or letters of comfort

15.07 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***

15.08 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.

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**

15.09 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.

15.10 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. It also includes commitment made to participate in the venture capital fund or private equity fund or AIF or similar funds, which has not been called up till the Balance Sheet date.

15.11 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.

15.12 Tax demands, which has been disputed are in the nature of contingent liability, unless the same is considered as “remote” as per *Accounting Standard (AS) 29, “Provisions, Contingent Liabilities and Contingent Assets”*), 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”.

15.13 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.

15.14 **Depositor Education and Awareness Fund:** As per RBI Circular No. 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**

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

15.16 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.

15.17 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.

15.18 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.

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

15.20 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**

15.21 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**

15.22 In respect of contingent liabilities, the auditor is primarily concerned with seeking reasonable assurance that all contingent liabilities are identified, accounted 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 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) While testing adequacy of internal control procedure, the auditor should

## Guidance Note on Audit of Banks (Revised 2020)

---

test whether there exist a proper system of numbering of such transactions for performing completeness test and whether there exists a proper system over recording of such transactions in straight through processing. In case the straight through processing has not been implemented or controls over straight through processing is not adequate, the auditor should perform such additional procedure including the as may be appropriate in the circumstances so that the risk of material misstatement is adequately addressed.

- (i) 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>11</sup>. The period of guarantees is co-terminus with the period of credit reckoned from the date of shipment.
- (j) 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.
- (k) 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.
- (l) The auditor may also perform analytical procedure by analysing the commission/fee earned from these transaction vis a vis aggregate transactions during the period.
- (m) Obtain representation from the management that:
  - (i) all off-balance sheet transactions have been accounted in the books of accounts as and when such transaction has taken place;
  - (ii) all off balance sheet transactions have been entered into after following due procedure laid down
  - (iii) all off balance sheet transactions are supported by the underlying documents
  - (iv) all contingent liabilities have been disclosed;
  - (v) the disclosed contingent liabilities do not include any

---

<sup>11</sup> In terms of the Circular No. RBI/2004/34 A.P. (Dir. Series) Circular no. 60 dated January 31, 2004 "External Commercial Borrowings (ECB)", any trade credit extended for a period of three years and above comes under the category of external commercial borrowings.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

contingencies which are likely to result in a loss/ expense and which, therefore, require creation of a provision in the financial statements;

- (vi) 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;
- (vii) 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
- (viii) 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.

15.23 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***

15.24 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 and available evidence, the auditor should verify whether the item is likely to remain a claim against the bank not acknowledged as debt or it is likely to be a liability requiring provisioning. The auditor may ask the Bank 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 needs to be provided and which claim can be construed as a contingent liability, unless the likelihood of the claim being crystallised is remote.

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

15.25 Forward Exchange Contract: The auditor may verify the outstanding forward exchange contracts with the statement of outstanding forward exchange contracts generated from the bank's computerised accounting system or manual register maintained by the branch. The auditor may physically verify the underlying documents including confirmations from merchants to test the existence of such outstanding contracts.

15.26 Derivatives Contract: The auditor may verify outstanding derivatives contracts (options, cross currency swaps, interest rate swaps, etc.) with report generated from treasury application. The audit procedure mentioned in Para 5.27 may be used for verification of derivative contract also.

- The auditor may also verify the outstanding margin *vis a vis* the outstanding forward foreign exchange contracts/derivative contracts with reference to margin, if any, stipulated in terms of sanction.
- The auditor may also perform analytical procedure by analysing the commission/fee earned from these transaction *vis a vis* aggregate transactions during the period.

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

15.27 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.

15.28 The auditor should ascertain whether there are adequate controls over unused guarantee forms, if the bank has process of issue of guarantees in pre-printed 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.

15.29 The auditor should examine the guarantee register/statements generated from the computerised system to seek evidence whether the prescribed procedure of marking off the expired guarantees is being followed or not.

15.30 The auditor should check the relevant guarantee registers/statements generated from the computerised system 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 where claim period is also over 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".

15.31 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 up to the balance sheet date 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. Where the original guarantees are not received back from the beneficiary before cancellation of the same, the auditor should ascertain whether the prescribed procedure for cancellation of such guarantees after the claim period has been scrupulously followed, The auditor should also verify the adherence to the bank procedure for cancellation of guarantees, where the beneficiary of the guarantee is any government department. 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.

15.32 In case of counter guarantee issued in favour of foreign banks for guaranteeing the obligation of bank's constituents in India, generally these guarantees are termed as "stand by letter of credit" or "letter of credit". These guarantees, standby letters of credit, letter of credit are transmitted through SWIFT messages, which has standard formats of different types of transactions. The auditor may verify the SWIFT message to test such transactions.

15.33 Auditor should verify whether proper guidelines have been paid down for classification of Guarantees as Performance or Financial and whether such guidelines have been scrupulously followed as the risk weights are different for performance and Financial Guarantees. The commission and margin are generally different for the performance and financial guarantees, which may also be verified to ascertain proper classification.

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

15.34 The auditor should evaluate the adequacy of internal controls over issuance of letters of credit and over custody of unused LC forms, if the bank has process of issue of LCs in pre-printed forms, in the same manner as in the case of guarantees.

15.35 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. The audit procedure applicable for auditing bank guarantees, mutatis mutandis, applies to the audit of the LCs and acceptances.

*Other Acceptances and Endorsements*

15.36 The auditor should study the arrangements made by the bank with its customers. He should verify the amounts of the bills with the register maintained/statements generated from computerised system 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.

15.37 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. The audit procedure applicable for auditing bank guarantees as mentioned above, mutatis mutandis, applies to the audit of the acceptances, endorsements and other obligations.

*Common Procedures*

15.38 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 balance sheet date, which are yet to be recorded.

15.39 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, the auditor should assess whether a provision is required to be made in the accounts for the bank's obligation, which should be determined after taking into account the probable recovery from the customer.

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

15.40 The auditor should examine whether commitments under all outstanding underwriting contracts have been disclosed as contingent liabilities. Similarly, the auditor should also examine whether commitment made to participate in the venture capital fund or private equity fund or AIF or similar funds, which has not been called up or unpaid till the Balance Sheet date have been disclosed as contingent liabilities. For this purpose, the auditor should examine the terms and conditions of the relevant contracts.

15.41 Rediscounting is generally done with the RBI or other financial

## **Guidance Note on Audit of Banks (Revised 2020)**

---

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.

15.42 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.

15.43 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.

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

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

### **Bills for Collection**

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

15.47 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.

15.48 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.

15.49 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.

15.50 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***

15.51 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**

15.52 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

---

16.01 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

16.02 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

16.03 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.

16.04 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. The relevant extract of LFAR on income is as under:

**Has the test checking of interest/discount/ commission/ fees etc. revealed excess/short credit of a material amount? If so, give details thereof.**

### **Background & Audit Approach**

#### **Interest Earned**

16.05 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**

16.06 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**

16.07 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.

## Guidance Note on Audit of Banks (Revised 2020)

---

- (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>12</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)***

16.08 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

---

<sup>12</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.

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 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.

16.09 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***

16.10 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***

16.11 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***

16.12 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.

16.13 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.

### **Income**

16.14 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.

16.15 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**

16.16 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/ Interest Not Collected Account (INCA)/ Unrealised interest of previous year (UIPY) ' 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 no. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/ 2015-16 dated July 01, 2015 “Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances”. These norms are also applicable to Government Guaranteed Advances.

16.17 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.

16.18 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.

16.19 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.

16.20 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

## **Guidance Note on Audit of Banks (Revised 2020)**

---

loans, etc. Further, the auditor should understand the process of computation of the average balance and re-compute the average balance on sample basis.

16.21 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.

16.22 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.

16.23 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) Any interest subsidy received (or receivable) from RBI in respect of advances made at concessional rates of interest is correctly computed.

16.24 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.

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

16.26 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.

16.27 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. Also for the overdue bills, the auditor should confirm whether the interest for the overdue period has been accrued by the system or is calculated manually by the Branch.

16.28 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.

16.29 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.

16.30 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.

16.31 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

## **Guidance Note on Audit of Banks (Revised 2020)**

---

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.

16.32 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**

16.33 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.

16.34 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.

16.35 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.

16.36 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.

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

16.38 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.

16.39 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.

16.40 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.

### **Expenses**

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

**Has the test check of interest on deposits revealed any excess/short debit of material amount? If so, give details thereof.**

### **Interest Expended**

16.42 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.

16.43 The RBI has issued Master Direction no. RBI/DBR/2015-16/19 DBR.Dir.No.84/13.03.00/2015-16 "Reserve Bank of India (Interest Rate on Deposits) Directions, 2016 on March 03, 2016 (updated as on February 22, 2019) 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.

16.44 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.

16.45 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.

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

16.46 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

### **Guidance Note on Audit of Banks (Revised 2020)**

---

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.

16.47 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.

16.48 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.

16.49 Does the bank have a system of estimating and providing interest accrued on overdue/matured/ unpaid/ unclaimed term deposits including in respect of deceased depositors?

In most of the Banks, now a days, the Term Deposits are auto renewed. If the

Bank is not following the practice of auto renewal or customer has not given consent for auto renewal, then the Bank should provide for interest on overdue Term Deposit. The auditor should check whether Branch has practice of generating overdue report and making provision for interest as per the Bank's policy. If the same is carried out centrally then the Auditor can check whether all overdue deposits are considered by Central team by taking report from them.

16.50 Are there any divergent trends in major items of income and expenditure, in comparison with corresponding previous year, which are not satisfactorily explained by the branch? If so, the same may be reported.

As explained earlier the Auditor should carry out variance analysis of all expenses head and seek clarification from the Branch for major variances, if any. Also based on variances, the auditor shall modify samples in respect of specific expenses

16.51 The other expenses head and audit procedure is as under:

- (i) *Payments to and Provisions for Employees:* This item includes salaries and wages of staff, allowances, bonus, other staff benefits like provident fund, pension, gratuity, leave fare concession, staff welfare, medical allowance to staff, etc. It may be noted that provision for terminal benefits like pension and gratuity is usually made only at the head office level. Salaries and allowances payable to the bank's staff and officers are usually governed by agreement with the employee unions or awards of a judicial tribunal. The payroll process is generally centralized in all banks. Auditors should ascertain the control available to branch level and test check sample working.
- (ii) *Rent, Taxes and Lighting:* This item includes rent paid by the bank on buildings, municipal and other taxes, electricity charges and other similar charges and levies. Auditor should specifically review cases where rental increases are in dispute & unpaid. Necessary provisions / disclosures should be appropriately made. It may be noted that income-tax and interest on tax are not to be included under this head. Similarly, house rent allowance and other similar payments to staff would not appear under this head.
- (iii) *Printing and Stationery:* This item includes books and forms and stationery used by the bank and other printing charges except those incurred by way of publicity expenditure. While some stationery may have been purchased by the branch, other stationery (security paper like draft forms, cheque books) would have been received by the branch from the head office. Auditor should specifically note the bank policy in this regard whether the same is expensed out on purchase or on usage. In any case

## Guidance Note on Audit of Banks (Revised 2020)

---

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'.



### Guidance Note on Audit of Banks (Revised 2020)

---

- (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>13</sup>, subscriptions to papers, periodicals, entertainment expenses, travel expenses, etc. The Notes and Instructions for compilation of profit and

---

<sup>13</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.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

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.

### ***Operating Expenses***

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

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

16.53 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.

16.54 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. 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.

16.55 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*

16.56 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*

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

*Advertisement and Publicity*

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

*Repair and Maintenance Expenses*

16.59 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*

16.60 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

## **Guidance Note on Audit of Banks (Revised 2020)**

---

bank, provision for depreciation may either be centralised at the head office level or decentralised.

16.61 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.

16.62 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**

16.63 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.

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**

16.64 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.

16.65 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**

16.66 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.

16.67 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 Statutory Central 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).

### **Expenditure**

#### **Provisions and Contingencies**

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

#### **Guidance Note on Audit of Banks (Revised 2020)**

---

16.69 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.

16.70 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.

## Audit Reports and Certificates

---

### BASEL

17.01 Basel III norms relate to the Capital Adequacy requirement compliance which the Bank has to achieve as contained in the BASEL III accord. The conclusive working or the calculation of capital adequacy is undertaken at the Head Office of the Bank. The information related to Capital is available at the Head Office which is verified by the Statutory Central Auditors of the Bank along with verification of working and calculation of capital adequacy for bank as a whole. However, the calculation of risk weighted asset (RWA) values is undertaken at the branch level w.r.t. the assets at the respective branches and the same is required to be verified and certified by the SBAs. The calculation of RWAs as certified by SBAs (as well as departmental auditors) is consolidated at the head office.

Thus, a SBA needs to understand the fundamental concept of methodology of calculation capital adequacy as per Basel III norms to ensure that the preliminary level calculations of RWAs at branch level are duly verified.

### Introduction

17.02 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.

17.03 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.

17.04 The Basel III accord, aims at:

- a. improving the banking sector's ability to absorb shocks arising from financial and economic stress, irrespective of reasons thereof;
- b. improving risk management and governance practices; and
- c. strengthening banks' transparency and disclosure standards.

17.05 Basel II was fully implemented in all commercial banks (except RRBs and LABs) in India by March 31, 2009. In this regard, the RBI had issued a

## Guidance Note on Audit of Banks (Revised 2020)

---

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)".

17.06 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, without affecting the core capital adequacy of 9%.
- (c) **Counter cyclical Buffer:** The counter cyclical buffer is designed to achieve broader macro-prudential goal of protecting banking sector from periods of excess aggregate credit growth (wherein excessive credit growth results in system-wide (national level) build-up of risk). The counter cyclical buffer is implemented on need-based basis.
- (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 and excess of Tier I capital can be used for Tier II capital. 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 overall capital requirement increases to 11.50% of RWA by 31<sup>st</sup> March, 2020 (as per RBI circular dated January 10, 2019). Please refer to Press Release for Domestic Systemically Important Banks (D-SIBs).
- (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). It has been decided that the minimum Leverage Ratio shall be 4% for Domestic Systemically Important Banks (DSIBs) and 3.5%



for other banks. These guidelines shall be effective from the quarter commencing October 1, 2019.

- (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.

17.07 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, 2020. 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**

17.08 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. However as per RBI Circular No. DBR.BP.BC.No.20/21.06.201/2018-19 dated 10<sup>th</sup> January, 2019 It has been decided to defer the implementation of the last tranche of 0.625% of Capital Conservation Buffer (CCB) from March 31, 2019 to March 31, 2020. Accordingly, minimum capital conservation ratios in ‘Capital Conservation Buffer Framework’ as applicable from March 31, 2018 will also apply from March 31, 2019 till the CCB attains the level of 2.5% on March 31, 2020. Further, the pre-specified trigger for loss absorption through conversion / write-down of Additional Tier 1 instruments (PNCPS and PDI) shall remain at 5.5% of RWAs and will rise to 6.125% of RWAs on March 31, 2020.
- 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.

### Guidance Note on Audit of Banks (Revised 2020)

- 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

17.09 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

	Regulatory Capital	As % to RWAs
(i)	Minimum Common Equity Tier 1 Ratio	5.5
(ii)	Capital Conservation Buffer (comprised of Common Equity)	2.5
(iii)	Minimum Common Equity Tier 1 Ratio plus Capital Conservation Buffer [(i)+(ii)]	8.0
(iv)	Additional Tier 1 Capital	1.5
(v)	Minimum Tier 1 Capital Ratio [(i) +(iv)]	7.0
(vi)	Tier 2 Capital	2.0
(vii)	Minimum Total Capital Ratio (MTC) [(v)+(vi)]	9.0
(viii)	Minimum Total Capital Ratio plus Capital Conservation Buffer [(vii)+(ii)]	11.5

### Capital – What Constitutes Tier 1 and Tier 2 – a Representative Sample

17.10 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:

**Guidance Note on Audit of Banks (Revised 2020)**

	<b>Indian Banks</b>	<b>Foreign Banks operating in India</b>
<b>Tier I Capital Common Equity Tier I (CET 1)</b>	Paid up equity capital (ordinary shares) <sup>14</sup>	Interest free funds from Head Office <sup>15</sup>
	Share premium on issue of common shares	
	Statutory reserves	Statutory reserves kept in Indian books
	Capital reserves representing surplus arising out of sale proceeds of assets	Capital reserves representing surplus arising out of sale of assets in India held in a separate account and which is not eligible for repatriation so long as the bank functions in India
	Other disclosed free reserves, if any	Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India
	Revaluation reserves with discount of 55% (with effect from 1 <sup>st</sup> March 2015), subject to meeting conditions prescribed in RBI circular dated 1 <sup>st</sup> March 2016	Revaluation reserves with discount of 55% (till 29 <sup>th</sup> February 2016), subject to meeting conditions prescribed in RBI circular dated 1 <sup>st</sup> March 2016
	Foreign currency translation reserve arising due to translation of financial statements of their foreign operations in terms of Accounting Standard (AS) 11 at a discount of 25%, subject to meeting conditions	Foreign currency translation reserve arising due to translation of financial statements of their foreign operations in terms of Accounting Standard (AS) 11 at a discount of 25%, subject to meeting conditions prescribed in RBI circular dated 1 <sup>st</sup> March

<sup>14</sup> Refer Annexure 1 to Master Circular on Basel III Capital Regulations for criteria.

<sup>15</sup> Refer Annexure 2 to Master Circular on Basel III Capital Regulations for criteria.

**Guidance Note on Audit of Banks (Revised 2020)**

	prescribed in RBI circular dated 1 <sup>st</sup> March 2016	2016
	Balance in Profit & Loss Account at the end of the previous financial year	
	Profits of current financial year on a quarterly basis provided the incremental provisions made for NPA at the end of any of the four quarters of the previous financial year have not deviated more than 25% from the average of the four quarters with certain adjustments given in the Master Circular	
		Interest free funds remitted from abroad for the purpose of acquisition of property and held in a separate account in Indian books provided they are non-repatriable and have the ability to absorb losses regardless of their source
	Less: Regulatory adjustments / deductions applied in the calculation of Common Equity Tier 1 capital	Less: Regulatory adjustments / deductions applied in the calculation of Common Equity Tier 1 capital
<b>Additional Tier I (AT 1)</b>	Perpetual non-cumulative preference shares <sup>16</sup>	Head office borrowings in foreign currency by foreign banks operating in India as per criteria <sup>17</sup>

<sup>16</sup> Refer Annexure 3 to Master Circular on Basel III Capital Regulations for criteria.

<sup>17</sup> Refer Annexure 4 to Master Circular on Basel III Capital Regulations for criteria.

**Guidance Note on Audit of Banks (Revised 2020)**

	Share premium on instruments included in AT 1 capital	
	Debt Capital instruments including Perpetual Debt instruments <sup>18</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 against future but presently unidentified losses and loss reserves	General provisions against future but presently unidentified losses and loss reserves
	Debt Capital instruments <sup>19</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>20</sup>	Perpetual Cumulative Preference Shares (PCPS) / Redeemable Non-Cumulative Preference Shares (RNCPS) / Redeemable cumulative preference shares (RCPS) <sup>21</sup>
	Premium on instruments	

<sup>18</sup> Refer Annexure 4 to Master Circular on Basel III Capital Regulations for criteria.

<sup>19</sup> Refer Annexure 5 to Master Circular on Basel III Capital Regulations for criteria.

<sup>20</sup> Refer Annexure 6 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.

**Guidance Note on Audit of Banks (Revised 2020)**

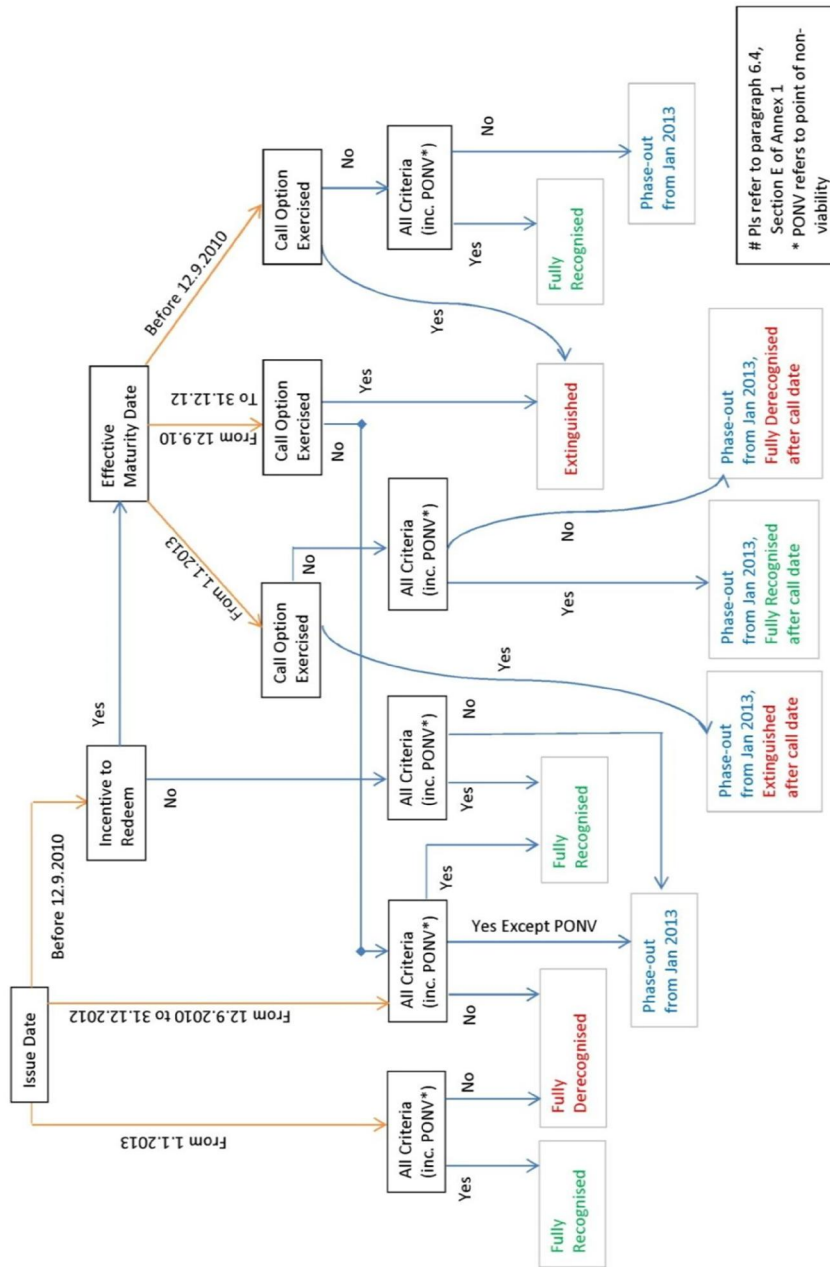
---

	included in Tier 2	
	Less: Regulatory adjustments / deductions applied in the calculation of Tier 2 capital	Less: Regulatory adjustments / deductions applied in the calculation of Tier 2 capital

17.11 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.

17.12 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**



**Guidance Note on Audit of Banks (Revised 2020)**

**Deductions from CET I, AT I and Tier II**

17.13 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		



**Guidance Note on Audit of Banks (Revised 2020)**

Item	Extent of Deduction (in %)		
	CET I	AT 1	Tier II
Investments in equity instruments of other subsidiaries and capital of other Banks, insurance companies etc. which is more than 10% of Bank's CET1	100		
Equity investments in non-financial subsidiaries	100		
Intra group transactions beyond permissible limits	100		
Reciprocal cross investments in capital of other banks in the same component of capital	Full	Full	Full
Securitization exposure	50	50	
Investment in financial subsidiaries and associates which is above 30 per cent in the paid-up equity of entity and not consolidated for the capital adequacy purposes	50	50	
Shortfall in the regulatory capital requirements in the de-consolidated entity	50	50	
Such amount of investment in the following which is in excess of 10% of investing bank's capital funds: <ul style="list-style-type: none"> <li>• Equity shares;</li> <li>• Perpetual Non- Cumulative Preference Shares;</li> <li>• Innovative Perpetual Debt Instruments;</li> <li>• Upper Tier II Bonds;</li> <li>• Upper Tier II Preference Shares;</li> <li>• Subordinated debt instruments; and</li> <li>• Any other instrument approved as in the nature of capital.</li> </ul>	50	50	

## Guidance Note on Audit of Banks (Revised 2020)

Item	Extent of Deduction (in %)		
	CET I	AT 1	Tier II
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)

17.14 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.

17.15 The CRAR is computed as follows:

$$\frac{\text{Eligible Total Capital funds} \times 100}{\text{Credit Risk RWA} + \text{Market Risk RWA} + \text{Operational Risk RWA}}$$

17.16 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

17.17 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)

17.18 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 Statutory Branch Auditors (SBAs)**

17.19 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 SBAs check only the computation process and test check the source rather than getting into the credit rating process. The SBAs 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 a pyramid approach whereby data from branches get consolidated at head office. The SCAs may choose to test check certain source data and also verify the basis considered at the head office.

17.20 It will not be practical to expect the branch to comprehensively understand the Basel III requirements in its entirety. Thus, the SBAs 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 level, especially when a large number of branches are involved.

17.21 At the Branch Level, the auditors will have to verify whether proper bucketing of assets has been done correctly or not. The risk weights are allocated to each bucket and therefore it has to be ensured by the SBAs that the respective advances have been reflected in the correct bucket so the risk weights are correctly calculated for the advances held at the branch. While verifying the bucketing of Corporate and Institutional advances auditors should call for the latest credit ratings of the Borrowers which should not be more than one year old. The auditors should further confirm whether separate ratings are obtained for short term as well as long term advances. Although the reports shall be generated from the system, it is important to verify whether the figures match with the General ledger balances (or limits whichever is higher) where ever required and the aggregate advances match with the return. Auditors are also required to verify the bucketing for non-fund based advances like Bank Guarantees and Letter of Credit which are also allotted risk weights.

17.22 Proper classification of all advances in SME sector, Commercial and Institutional Sector (with appropriate External Credit Rating), Restructured Advances, Non-Performing Assets, Unrated Institutional advances, etc. should be ensured.

17.23 Appropriate classification of Guarantees into Performance and Financial along with the cash margins held there against should also be verified.

## **Special Purpose Reports and Certificates**

### **Introduction**

17.24 The SBAs have to issue various Special Purpose Reports and Certificates at branch level. SBAs should ensure the correctness of financial / non financial information given in these various certificates.

17.25 The Appointment letter normally contains the exhaustive list of all such Reports and Certificates which are required to be certified by the SBA's. These are to be verified and certified by the SBAs to ensure its correctness and accuracy. Since the SBAs have a direct access to the supporting branch documents and the relevant information, various readers / users of these certificates, such as Bank Management, CSA's, State Government/Central Government as well as RBI rely upon the Reports and Certificates issued by the SBAs and actually uses them to release the various grants and subvention amounts to Banks.

17.26 The purpose of these Reports/Certificates may be for:

- a) Disclosure Requirements. SLR/CRR, Provisions of NPA's, Movement of NPA Provisions, Gross/Net NPA, Asset Liability Management related returns, Exposure to Sensitive Sectors, Unhedged foreign currency exposures, etc.
- b) Related to Provisions to be made (other than advances) e.g. Fraud, Suspense Account, etc.
- c) Certificates related to Compliance of Internal Control Systems and Prevention of Frauds ( Ghosh /Jilani Reports/Certificates).
- d) Certification relating to various Subsidies, Interest subvention, loan waivers, etc. to be issued to RBI who is acting as an agency on behalf of Central and State Governments for administration of various Public welfare schemes. Normally the advances to Priority sectors like Agriculture, SME Sector, Educational Loans, Public Housing loans, etc. are covered under this head.

- e) Certification from SBAs relating to correctness of Provisions and compliance of IRAC norms in respect of advances.
- f) Memorandum of Changes – MOCs for the changes recommended by the SBAs to be considered by the Bank and SCAs in respect of increase/decrease in assets/liabilities balances and/or increase/decrease in profit/loss at the branch.
- g) Certificates in respect of Physical custody of Branch in respect of Investment scrips e.g. Local Municipal Bonds, Gold Coins, etc. held by the Branch on behalf of Head Office.

### **Regulatory Requirements**

17.27 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.

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**

17.28 At the time of accepting the Audit, issuing engagement letter, preparing audit program, maintaining adequate working papers, the SBAs should appropriately comply with the requirements of Guidance Note on Reports or Certificates for Special Purposes (Revised 2016) issued by the Institute of Chartered Accountants of India (ICAI). Readers may also refer covering report for certificates as prescribed in Annexure A “Illustrative Format of Covering Report for various Certificates issued by SBAs” of the Chapter.

17.29 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. In case of frauds, 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.

17.30 Considering various types of Certificates and Reports to be issued by the SBAs, it is very important for the auditors to verify its correctness and accuracy from the available branch records and documents, as the Bank, SCAs, RBI and other Governmental agencies use this data for consolidation, disclosure and also releasing various subsidies and waivers. Mostly the data certified by SBAs is consolidated and further certified and endorsed by the SCAs at the head office.

17.31 Where ever possible SBAs should reconcile or tally the closing balance of the return with the General Ledger Heads in the Trial Balance of the Branch as at the year end. This will be specially important for semi-automatic or manual returns. For system generated returns without manual intervention, it should still be ensured that they tally with the year end figures, though detailed verification may not be warranted.

### **Certificates and Reports**

17.32 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.
- Certificate regarding 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 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 of cash and bank balances.
- Certificate relating to MOC entries of the previous years being accounted for.

As the MOC's are prepared and passed after the accounting year is over during the course of the statutory audit itself, the actual accounting entries in the records of the branch are passed during the next year. Therefore SBA's need to verify whether the previous year's MOCs have been effected at the Branch and accordingly they have to issue the necessary certificate. Thus, for the current year audit of 2019-20, SBAs would verify the MOCs accounting effects recommended by previous year's SBAs i.e. for the year 2018-19.

### **Guidance Note on Audit of Banks (Revised 2020)**

---

- Certificate relating to credit/ deposit ratio.
- 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 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 of Interest subvention for certain Housing Loans.
- Certificate of Interest subvention for certain Education Loans.
- 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.
- Certificate in respect of ECGC Claims filed at the Branch and its status.
- Memorandum of Changes –

In case of disagreement of the SBA with the Branch management on any matter related to compliance of IRAC Norm or in case of any mistake observed by the SBA, it necessitates a change either in Asset/Liability and/or Income/Expenditure at the Branch which would affect the financial statements of the branch for the year under audit, then SBA can issue MOC for such disagreement or the mistake observed. Only thing the SBA should confirm that the amount is material enough warranting MOC and is above the threshold limit prescribed in the bank circular. It should be further ensured that MOC is prepared with correct account heads and codes and also the correct amount, since these MOCs would be consolidated at the HO level and these should not contain any

discrepancy. A short reason or remark leading to MOC also should be mentioned in the MOC to make it self explanatory. Further MOCs effected at the branch should be countersigned by the Branch Manager.

- Certain other additional 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**

### **Introduction**

17.33 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.

17.34 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**

17.35 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.

17.36 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.

17.37 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.

17.38 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**

17.39 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.

17.40 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**

17.41 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.

17.42 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.

17.43 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.

17.44 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.

17.45 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.

17.46 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.

17.47 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.

17.48 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.

17.49 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.

17.50 Further, in terms of RBI Circular RBI / 2016-17 / 284 Ref.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

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**

17.51 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.

17.52 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**

17.53 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.

17.54 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.

17.55 The *Annexure B* 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.

## **Tax audit**

### **Introduction**

17.56 Normally Tax Audit at the branch has a limited scope. Many times the scope of work is defined by the Head office in its letter of appointment. As most of the information is available at the Head office, the scope is limited to the verification process limited to the Branch data and supporting documents available there. Some of the Banks allot the work to SCAs or to External Audit firms other than SCAs/SBAs.

17.57 In the following paragraphs, we shall cover only the important matters relevant at the branch level. Although, it is expected that the Branch makes full and correct disclosures in Form 3CD, the branch auditors are expected to exercise their professional skepticism to confirm whether the disclosures made

by the branch are correct and exhaustive and accordingly give their report in Form 3 CA for the branch under audit.

**17.58 Fixed Assets and Depreciation – Clause No. 18 of Form 3CD**

Branch Auditors should verify the Fixed Assets register maintained at the branch and more specifically the new assets purchased during the year and its tax invoices. The amount capitalized in the books of the branch, GST input credit (if any) and proper asset classification in the Block of assets also needs to be verified. From the last year's audited return, the opening balances of current year's return should be verified block wise. The calculation of depreciation should be verified in the light of the latest circular or as per closing instructions circular issued by the Head Office.

**17.59 General Scrutiny of Expenses/Charges – Clause No. 21 (a) of Form 3CD**

General scrutiny of charges or the Profit and Loss expense heads should be done to identify any nature of expenses which would be of personal nature (not related to the business of the Bank and other than contractual nature), capital or revenue nature. It should also be ensured that if the Branch has paid any penalty or fine which requires disclosure under the relevant clause of the Form 3CD, whether it has been done or not.

**17.60 Non deduction/Non Payment of TDS and General compliance related to TDS Provisions – Clause 21(b) of Form 3 CD**

General scrutiny of expenses should also be made keeping in mind the relevant TDS provisions covered under various sections and sub sections of 194 and 195 of the Income tax Act, 1961. The payments made to Non residents (including interest payments made to NRE Account holders) interest, contractors, professionals , property owners , etc. should be verified keeping in mind the TDS provisions. It should be confirmed whether appropriate tax has been deducted and paid on various payments made to certain persons. The TDS on fixed deposit interest shall be deducted by the system automatically , which also needs to be checked on a test check basis.

Any cases of non compliance should be reported under the appropriate sub-clause of Form 3CD.

**17.61 Disallowance under Section 40A(3) read with Rule 6 DD – Clause No. 21(d) of Form 3CD**

General scrutiny of expenses or charges may also reveal any disallowance under Section 40A(3) (read with Rule 6 DD) of the Income Tax Act, 1961 if the payment of more than Rs 10,000/- is made otherwise than by way of account

## **Guidance Note on Audit of Banks (Revised 2020)**

---

payee cheque or account payee draft. Auditors are expected to make an appropriate disclosure about the non availability of evidence under this clause, apart from any specific case of non compliance.

### **17.62 Payment of Interest to any MSME Supplier – Clause no. 22 of Form 3CD**

Auditors should obtain an appropriate representation from the Branch management whether it has paid any interest to any of its vendors or suppliers registered under MSME for delayed payment. under Section 23 of the Micro, Small and Medium Enterprises Development Act, 2006. As such interest is required to be disclosed under this clause and to be claimed disallowed in the computation of income for the Bank.

### **17.63 – GST Compliance with respect of ITC – Clause 27 (a)**

Normally the Bank has got a global GST number and files one consolidated return at the head office level. For the purpose of claiming the Input tax credit, it obtains the monthly return about the Input tax credit along with other details from all its branches and submits a consolidated claim in the return filed at the head office. Then in such cases Branch Auditor can give a suitable disclosure.

### **17.64 – Prior Period Income/Expenses – Clause 27 (b)**

Branch auditor while doing a general scrutiny of Charges should also identify any prior period expenditure debited to Branch Profit and Loss account.

### **17.65 - Repayment of loan or deposit exceeding the limit specified in Section 269T – Clause 31 (c) and (d)**

Considering the high volume of transactions at the branch, auditor should obtain suitable Management representation from the Branch Management and make appropriate disclosure in the relevant clause of the tax audit report.

### **17.66 – TDS Compliance – Clause No. 34 (a) to (c).**

This is the most important reporting clause in the Branch tax audit report. This clause required the auditors to verify and report Section wise details about the Total expenditure incurred at the branch covered under various sections 194 A-Interest

194 I – Rent

194 J – Fees for Professional and Technical Services.

194 C – Payment made to Contractors.

17.67 The branch Expenditure heads are required to be further classified into



### **Guidance Note on Audit of Banks (Revised 2020)**

---

above sections, especially the payments made to contractors are spread in various expenditure heads at the branch are required to be considered wherever applicable. Similarly is the case of fees for Professional and Technical services. While reporting the amounts in column no. 3 these have to be matched with the PL heads year end figures wherever necessary.

17.68 Further, from the total amount from each head above the amount on which TDS is not applicable due to various reasons are to be excluded to determine the amount on which the TDS is required to be deducted. From the balance amount in column 4 where the TDS is required to be deducted again needs to be classified under following categories:

- a) Amounts on which TDS at regular rates to be deducted and TDS on above.
- b) Amounts on which TDS to be done at concessional rate ( based on the certificates obtained from Income Tax authority) and TDS on above
- c) Amounts on which TDS is not deducted (to be matched with disclosure at Clause No.21 (b) of Form 3CD
- d) TDS Deducted but not paid.

17.69 The accuracy in reporting under this clause is important because, this is the most voluminous consolidation statement for reporting on the consolidated tax audit report for the Bank as a whole and if there are any discrepancies in this particular clause, then regional/zonal/HO consolidation is hampered and delayed.

17.70 Clause No. 34 (b) and (c) are applicable if the Branch has obtained a TAN and it is doing its compliance at the Branch level. In such a case the Branch auditor is also required to verify the position, accuracy and timeliness of filing of Quarterly ETDS returns filed by the branch and confirm the appropriate disclosure about the dates of filing, Interest payment and delayed filing fees paid by the branch. It is better to obtain CONSO files from TRACES and do the independent consolidation of 4 quarters and verify the data furnished by the branch to avoid the delay in verification of voluminous data.

17.71 As most of the points in Form 3CD are required to be verified only at the head office level, the branch auditors should make appropriate disclosure about the limitation of its scope Form 3CA submitted along with Form 3CD.

## **Annexure A**

### **Illustrative Format of Covering Report for various Certificates issued by SBAs**

**Independent Auditor's Certificate for various certificates issued during the Statutory Audit of [Name of the Branch] [Branch Code] of [Name of the Bank] for the Financial year 2019 – 2020.**

1. This Certificate is issued in accordance with the terms of our agreement dated [date of Engagement Letter].
2. The accompanying Statement contains various certificates issued by us during the Statutory Audit of [Name of the Branch] [Branch Code] of [Name of the Bank] for the Financial year 2019 – 2020, listed in Annexure [Name], which we have initialed for identification purposes only.

#### **Managements' Responsibility for the Statement**

3. The preparation of the accompanying Statement is the responsibility of the Management of the Bank. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and presentation of the Statement, and applying an appropriate basis of preparation; and making estimates that are reasonable in the circumstances.
4. The Management is also responsible for ensuring that the (Name of the Branch) (Branch Code of Bank) (Name of the Bank) complies with the requirements of the Equity Listing Agreement and for providing all relevant information to the Securities and Exchange Board of India.

#### **Auditor's Responsibility**

5. Pursuant to the requirements of the various RBI guidelines, our responsibility is to express reasonable assurance in the form of an opinion based on our audit and examination of books and records on test check basis, as to whether the [Name of the Branch] [Branch Code] of [Name of the Bank] has undertaken only those activities that have been specifically permitted by the RBI and has complied with the specified terms and conditions.
6. We audited the financial statements of [Name of the Branch] [Branch Code] of [Name of the Bank] for the Financial year 2019 – 2020, on which we issued an unmodified audit opinion vide our reports dated [date of Audit Report]. Our audit of these financial statements was conducted in accordance with the Standards on Auditing and other applicable authoritative pronouncements issued by the Institute of Chartered Accountants of India. Those Standards require that we plan and perform the audit to obtain reasonable assurance

about whether the financial statements are free of material misstatement.

7. We conducted our examination of the Statements/Certificates given in Annexure [Name] , in accordance with the Guidance Note on Reports or Certificates for Special Purposes issued by the Institute of Chartered Accountants of India. The Guidance Note requires that we comply with the ethical requirements of the Code of Ethics issued by the Institute of Chartered Accountants of India.

8. We have complied with the relevant applicable requirements of the Standard on Quality Control (SQC) 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

**Opinion**

9. Based on our examination as above, and the information and explanations given to us, we report that the Statement in Annexure [Name] is in agreement with the books of account and other records of [Name of the Branch] [Branch Code] of [Name of the Bank] for the Financial year 2019 – 2020 as produced to us for our examination, and the information thereof is prepared, in all material respects, in accordance with the applicable criteria.

**Restriction on Use**

10. This certificate has been prepared at the request of the [Name of the Branch] [Branch Code] of [Name of the Bank] solely with reference to our appointment letter, for the purpose of onward compilation of various certificates and disclosure requirements for [Name of the Bank] as a whole. It should not be used by any other person or for any other purpose. Accordingly, we do not accept or assume any liability or any duty of care or for any other purpose or to any other party to whom it is shown or into whose hands it may come without our prior consent in writing.

For  
Chartered Accountants  
Firm's Registration Number:

Partner / Proprietor  
Membership Number:  
UDIN

Place:

Date:

**Annexure B**

**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)  
UDIN

# 18

## Gold/Bullion

---

18.01 The Reserve Bank of India has discontinued the Gold/ Bullion sale at Branches. RBI designates certain Banks every year for the purpose of importing Gold and selling it onward to customers. Besides some Banks sell retail Gold coins of a specific purity in specific denominations to its customers.

18.02 In such cases the auditor should ensure:

- 1) Gold coins are stored properly in fire proof safe custody
- 2) Insurance cover is obtained
- 3) Stock records are properly maintained showing receipts, sales and closing stock
- 4) Verification and balancing of stocks are done daily
- 5) Sales are made at prices determined by a systematic central driven process.
- 6) Proper Entries are made in the Books
- 7) Tax payments if any including billing of invoices is properly done.

18.03 Auditor should duly verify the process and report discrepancies if any. Escalations could be made depending on the gravity of the issue. Appropriate reporting could be made in the LFAR as follows:

- a) Does the system ensure that gold/bullion is in effective joint custody of two or more officials, as per the instructions of the controlling authorities of the bank?
- b) Does the branch maintain adequate records for receipt, issues and balances of gold/bullion and updated regularly? Does the periodic verification reveal any excess/shortage of stocks as compared to book records and if any discrepancies observed have been promptly reported to controlling authorities of the bank?

# 19

## Books and Records

---

19.01

- a) In case any books of account are maintained manually, does general scrutiny thereof indicates whether they have been properly maintained, with balances duly inked out and authenticated by the authorized signatories?
- Now a days CBS is followed hence question of maintaining manual books of accounts does not arise.
  - Balancing is also done through system.
  - Balancing report may be generated to confirm that no difference is appearing in the balancing report.
  - Exception Reports can be generated from the system to verify whether there are differences. If there are differences, the same should be reconciled / rectified by branch.

This section is not applicable now as all the banks and their branches are on CBS and connected. However, there could be some reconciliations done manually which could be verified. Auditor should obtain list of all manual registers and records maintained.

- b) In respect of computerized branches:
- Whether hard copies of accounts are printed regularly?
  - Indicate the extent of computerization and the areas of operation covered.
  - Are the access and data security measures and other internal controls adequate? Please report in case measures are found inadequate.
  - Whether regular back-ups of accounts and off-site storage are maintained as per the guidelines of the controlling authorities of the bank?
  - Whether adequate contingency and disaster recovery plans are in place for loss/encryption of data?
- c) Do you have any suggestions for the improvement in the system regarding computerized operations of the branch?

19.02 In addition to the above, this section should address the following issues:

- Whether there are any software / systems (manual or otherwise) used at the branch which are not integrated with the CBS? If yes, give details thereof.

There is a tendency to use Excel sheets etc., the calculations from which flow into the financial statements of the branches. It is necessary to verify whether the data used for such final flow into financial statements is matching with that of CBS. Further, in respect of non-fund based facilities, often the entries flow into CBS through offline documents such as Guarantees/ Letters of Credit etc. It is necessary to verify the movements in the non-fund based facilities and ensure that every transaction entered by the branch flows into CBS.

In respect of Non-fund based transactions, the monetary impact may not be visible in the period of audit. However, if the transaction remains to be captured, it may have significant impact subsequently in respect of the transactions during the audit period, for which the auditor is responsible.

In most of the Banks the classification of the advances and the provisioning is done in another software which is integrated with the CBS. The final advances statements are usually generated from the Zonal offices/ Regional offices and sent to the branches for the auditor's verification and attestation. In these cases, the auditor should check whether the total of the advances as per this statement tallies with the total of the advances as reflected in the CBS.

- In case the branch has been subjected to information system (IS) Audit whether there are any adverse features reported and have a direct or indirect bearing on the branch accounts and are pending compliance? If yes give details.

The auditor should check the report and ascertain the status of the implementation of the observations and may draw attention of the Statutory Central Auditor and Management to any material adverse observation which still persists at the Branch.

- Whether branch is generating, and verifying exception reports at the periodicity as prescribed by the bank

All the banks, besides CBS, also use various software to provide the MIS to the branch management giving advance signals for their proposed action. The triggers are provided in respect of every critical aspect such as:

- Deposit expiry

### Guidance Note on Audit of Banks (Revised 2020)

---

- Guarantee expiry
- Review/ Renewals of loan accounts
- Rate of interest, if abnormal from the centrally decided rate
- And many other such triggers that gives enough information to the branch management to conduct their business

It is important for the auditor to ask and review these reports before finalizing the branch audit. Generally, these reports are provided by the central departments through head office. Hence, these are available on real time basis.

- Whether the system of the bank warrants expeditious compliance of daily exception reports and whether there are any major observations pending such compliance at the year end.

The auditor is expected to report on major pending triggers provided by the MIS software.

- Whether the bank has laid down procedures for manual intervention to system generated data and proper authentication of the related transactions arising there from along with proper audit trail of manual intervention has been obtained.

19.03 Although CBS provides all the pre-decided reports and the data is not allowed to be intervened manually, the branch where transactions are originated, have significant amount of data input. The auditor is expected to understand and list down the various data entry points. Generally, they are:

- Rate of Interest
- Salary inputs to central processing department
- Upgradation of NPA accounts
- Changes in the repayment schedules/ moratorium.
- Date of review/ Renewal
- Stock statement receipt dates
- Suspense account
- Other such originating transactions at branch level.

The auditor is expected to keep on records the samples selected for audit and look for authenticity of the data entered in respect of selected transactions.



## **Inter Branch/Office Accounts**

---

### **A. Introduction and Bank Process**

20.01 Office Accounts are mostly used for internal business transaction of banks or transactions to facilitate movement of funds in a flow of transaction. Banks have number of transactions amounting to large sums with the other banks, branches and controlling office or other business establishments, hence such transaction are carried out through office accounts. Therefore, 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.

20.02 Followings are the major transactions which occur between branches and Head office through inter-office accounts-

- 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.
- 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 / traveller's cheques, etc.
- g. Profit/loss transferred by the branch to head office.
- h. Government receipts and payments handled by the banks.
- i. Operations by the authorised branches on the bank's NOSTRO accounts through the Treasury/ International Banking Division.
- j. 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.
- k. Deposits into and withdrawal of money, by branches into currency chest maintained by another branch.

### **Guidance Note on Audit of Banks (Revised 2020)**

---

- l. Transactions through NEFT, RTGS, NACH, UPI, etc.
- m. ATM transactions of the customer either at ATM linked with other banks or branches or with merchant establishments.
- n. Internet based transactions.
- o. Credit card related transactions of the customers.
- p. Control Accounts of Indian Branches maintained with Overseas Branches of the bank.
- q. Capital Funds with the Overseas Branches.
- r. Head Office balances with the overseas branches including subordinated debt lent to the overseas branches.
- s. GST transactions of Bank branches within a zone and Zonal or Head office.

20.03 In respect of CBS, office accounts are bifurcated between accounts which mandatorily require to enter a reference number while passing entry (pointing) and accounts which do not have such mandate (non-pointing). In respect of pointing accounts, reconciliation is easier as the entries can be knocked off based on reference number and each outstanding entry constituting outstanding balance at reporting date can be identified. In case of non-pointing, reconciliation require manual intervention and tracking due to non availability of unique reference number.

20.04 In CBS most of the above mentioned cases the transactions are automatically executed by the system. Hence only where there is manual intervention are to be monitored.

Following are the most common types of errors observed in office accounts:

- Recording of particulars in incorrect fields.
- Posting of transactions in incorrect office accounts
- Errors in writing the amounts.
- Recording the same transaction twice.
- Squaring off the transaction by same amount without checking the transactions.
- Forced matched transactions.

20.05 RBI has issued a letter to all Banks regarding certain objectionable practise observed by RBI in respect of office accounts. RBI has also instructed the Banks to conduct a comprehensive audit of office accounts and place the

same before Audit Committee.

- Disguising Cash transaction of customer to avoid AML reporting and bypassing CTR/STR reporting of the same.
- Disbursal of loan or repayment of loan through office account General Ledger resulting in misuse of funds and window dressing.
- No mandatory requirement of keying in reference number in case of pointing accounts
- Opening of saving and current account and funds movement thereon misused and routed through office accounts.
- Crediting a dummy entry by debiting in office account to the credit of borrowers account and then debiting so as to maintain the "standard" status of borrower or to prevent from becoming NPA.
- Netting off liability related GLs with debit balances with credit balances in other GLs resulting in disclosing net outstanding in Financials of the Bank.
- Many income accounts do not have debit freeze or reference id for reversing charges.

## **B. Audit Approach**

20.06 Office accounts have been a 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 accounts. 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.

- Every bank has its own procedures and methodology for office accounts transactions, hence it is very important for the auditor to understand the procedure followed by the bank for recording the same.
- Every office account is opened for specific purpose, hence the auditor on sample basis should review transactions in office accounts to verify whether the transactions in accounts are matching with the purpose of account.
- Normally as part of MIS reporting, branches report only Ageing analysis of the outstanding Balances of office accounts, however the auditor should verify whether there are any entries near to reporting date where second effect is to either office accounts or borrower account especially overdue account. In former scenario, the Branch is avoiding long pending entry in

### **Guidance Note on Audit of Banks (Revised 2020)**

---

office account by transferring to other office account and in later, branch is trying to avoid classifying an account as NPA.

- RBI has directed banks to carry out comprehensive audit to ensure that internal accounts are not allowed to be used unauthorized and proper checks are exercised before opening any such account, including adherence to the delegated power.
- Banks have to make 100% provision against the net debit balance arising out of the un-reconciled entries outstanding for more than six 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 1st April 1999, banks should maintain category wise/Head wise accounts of various types of transactions under inter branch accounts, if any 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 have 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 office accounts just before the year end and where required, request the bank management to rectify the same by accounting in the correct account head.

**Guidance Note on Audit of Banks (Revised 2020)**

- The auditor should cautiously review all material transactions outstanding in office accounts even if it is outstanding for more than 6 months for which 100% provision is made.
- The auditor should check all adjustments in the office accounts 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 auditor should report on the year end status of office 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.
- 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.
- Also, the auditor may review jottings/listing of Current / Savings Bank account to check whether any account is opened with Generic Name/ Branch Address/ Bank Address/ Bank PAN, etc. If such account is identified then auditor should verify purpose of opening account and thoroughly review the transactions in the account. Also report about existence of such account and transactions in the same in LFAR.

20.07 In CBS environment, in case of inter branch transactions the inter branch account is automatically debited or credited by the system. An example of the same is as under:

If person A having savings bank account in X branch withdraws cash from Y branch. In such scenario, the following entries are passed

In the Books of Branch Y	In the Books of Branch X
Inter Sol/ Branch A/c (Branch Y).... Dr To Cash	'A' savings bank A/c Dr To Inter Sol/ Branch (Branch X) A/c

At day end the balance in Inter Sol / Branch A/c for Bank as a whole should be Nil. Statutory Central Auditor should verify the same.

## C. Reporting

20.08 The auditor needs to verify

- Whether the bank has an effective system of office accounts w.r.t. each type of entries?
- Whether the bank has requisite audit trail w.r.t. reconciled entries?
- Age-wise analysis of unreconciled entries for each type of entry covered under office accounts, as on balance sheet date along with subsequent clearance, thereof if any.
- Whether the bank has a defined procedure for auto and forced matching of entries?
- Whether there are any unusual entries observed in the reconciliation process?
- Whether the bank has made adequate provision w.r.t. unreconciled entries as per the RBI guidelines and to the satisfaction of the auditor?
- Suggest for improvement in existing system related to inter-branch reconciliation.

### **For LFAR purpose the auditor needs to comment on Inter-Branch Accounts**

20.09

- Check for any entries not responded -
- Now a day's CBS is implemented hence question of reconciliation of Inter – Branch Accounts does not arise at Branch.
  - (i) *Does the branch forward on a daily basis to a designated cell/ Head Office, a statement of debit/ credit transactions in relation to other branches?*
  - (ii) *Does a check of the balance in the Head Office Account as shown in the said statement during and as at the year-end reveal that the same is in agreement with the Head Office Account in the general ledger?*
  - (iii) *Are there any outstanding debits in the Head Office Account in respect of inter-branch transactions?*
  - (iv) *Does the branch expeditiously comply with/ respond to the communications from the designated cell/ Head Office as regards*

**Guidance Note on Audit of Banks (Revised 2020)**

---

*unmatched transactions? As at the year-end are there any unresponded/ uncomplined queries or communications? If so, give details?*

- (v) Have you come across items of double responses in the Head Office Account? If so, give details.*
- (vi) Are there any old/ large outstanding transaction/ entries at debits as at year-end which remain unexplained in the accounts relatable to inter-branch adjustments?*

# 21

## Fraud

---

### Introduction

#### Definitions of Fraud

21.01

- **Indian Contract Act, 1872:** As per section 17, "Fraud" means and includes any of the following acts committed by a party to a contract, or with his connivance, or by his agents, with intent to deceive another party thereto of his agent, or to induce him to enter into the contract:-
  - (1) the suggestion, as a fact, of that which is not true, by one who does not believe it to be true;
  - (2) the active concealment of a fact by one having knowledge or belief of the fact;
  - (3) a promise made without any intention of performing it;
  - (4) any other act fitted to deceive;
  - (5) any such act or omission as the law specially declares to be fraudulent.

*Explanation.*—Mere silence as to facts likely to affect the willingness of a person to enter into a contract is not fraud, unless the circumstances of the case are such that, regard being had to them, it is the duty of the person keeping silence to speak, or unless his silence is, in itself, equivalent to speech.

- **Companies Act, 2013:** As per Section 447, "Fraud" in relation to affairs of a company or any body corporate, includes any act, any omission, concealment of any fact, or, abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the Company or its shareholders or its Creditors or any other person, whether or not there is any wrongful gain, or any wrongful loss.
- **Reserve Bank of India** has defined the term "fraud" in its guidelines on frauds which reads as under.

"A deliberate act of omission or commission by any person, carried out in



the course of a banking transaction or in the books of accounts maintained manually or under computer system in banks, resulting into wrongful gain to any person for a temporary period or otherwise, with or without any monetary loss to the bank”.

- **Standard on Auditing 240 issued by ICAI** defines Fraud – “An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.”

### Types of Fraud in Banking System

21.02 There are numerous ways in which banking frauds are committed. The frauds committed in banking system can be classified under different types, based on the historical data available. Some examples of banking frauds are as under:

- **Account opening fraud:** This involves an account being opened with either fake or original KYC documents with an intent to depositing and cashing of fraudulent cheques/ instruments.
- **Cheque kiting:** It is the method where by a depositor utilizes the time required for cheques (which is issued from an account having insufficient funds) to clear, to obtain an unauthorized loan with or without any interest charge.
- **Cheque fraud:** It is most common method where frauds are committed through stolen cheques and forged signatures.
- **Counterfeit securities:** In this type of fraud, forged, duplicated or tampered documents, securities, bonds and certificates are presented as security for availing loan.
- **Digital fraud:** Under this type of fraud, fraudster resorts to hacking, tampering to gain unauthorised access to siphon off or misappropriate funds.
- **Loan fraud:** This type of fraud is committed by lending funds to a non-borrowing customer or allowing a borrowing customer to exceed his credit limit, without adequate sanction / authority.
- **Money laundering fraud:** This type of fraud is committed by concealing the existence, source or use of illegally obtained money, by converting the cash into untraceable transactions in banks.
- **Letters of Credit:** This type of fraud is most common in international trade

but has been observed in domestic trade also. In respect of international trade, these instruments used in cross borders transactions with underlying trade documents which are forged, altered, adjusted and take longer to identify ultimate destiny of merchandise. In respect of domestic trade these instruments are used to convert non funded facility into cash in purported trade transactions. Cash generated through such transactions is diverted or misappropriated out of system.

- **Advanced Fees Fraud:** This is popularly also known as “419 scam”. Advanced fees fraud may involve agent with an offer of a lucrative business proposition / promise to make substantial funds available against advance fee or series of advance fees.

### **Expectations of Regulator**

21.03 Central Fraud Monitoring Cell (CFMC) of RBI has analysed statistics of reported frauds in Banking system during the period Financial Year 2014 to Financial Year 2018. Based on the said analysis some of the points worth noting are as under:

- There has been increasing trend in terms of number of frauds reported on both counts volume and value.
- About 90% of the frauds in terms of value involved have happened in credit portfolio.
- Out of the frauds reported in Financial Year 2018, frauds involving amount above ₹ 50 crores accounted for 80% of total frauds reported.

21.04 The identified factors facilitating fraud are as under:

- Opening current account with banks outside consortium without the No Objection Certificate from lenders.
- Deficient and fraudulent services/certificates by Third Party Entities (TPEs).
- Diversion of funds by the borrowers through various means including through associated / shell / front-end companies.
- Lapses in credit underwriting standards.
- Failure to identify the Early Warning Signals (EWS) of incipient frauds.

It is expected that while conducting bank branch audit the auditor should plan and perform the audit to obtain reasonable assurance with respect to existence and effectiveness of fraud identification and reporting framework laid down as per Master Directions on Fraud and Master Circular on Wilful Defaulter.

## Role and Responsibility of Auditor

21.05 Branch Auditor's primary objective is to opine on true and fair view of branch financial statements. The audit process needs to confirm compliance with standards on auditing issued by the Institute of Chartered Accountants of India (ICAI). Specific to the area concerning fraud, as laid down in SA-240, the auditor has responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements taken as a whole are free of material misstatement, whether caused by error or fraud. SA 240 requires auditor to perform procedures with objectives of:-

- To identify and assess the risks of material misstatement in the financial statements due to fraud;
- To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
- To respond appropriately to identified or suspected fraud.

While reporting on fraud in LFAR, the Statutory Branch Auditor has to provide appropriate responses to identified or suspected fraud

## Audit Approach and Procedures

21.06 Suggested audit approach and procedures to be performed are as follows:

- Based on review of advances consider whether the branch is having an effective credit monitoring for its Advances portfolio.
- Obtain internal circulars of the bank pertaining to fraud identification and reporting.
- Examine whether the branch has an adequate system in place to identify Early Warning Signals (EWS) of incipient sickness / fraudulent activities in respect of loans within shortest possible time.
- Obtain and review reports of internal auditor, concurrent auditor, internal inspector, revenue audit, system audit and vigilance functions and assess existence of any of the early warning signals (EWS).
- If any of the aforesaid reports are pointing out existence of early warning signals in any of the accounts, conduct further enquiries with the branch to assess the branch has taken appropriate action and current status thereof.
- Enquire about any fraud reported to Controlling Authority/vigilance department, Head Office during the financial year and current status thereof.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

- Whether frauds are examined from staff angle and, wherever necessary, the cases are reported to the Vigilance Cell for further action.
- Whether Preventive/punitive steps have been taken by the bank during the year to reduce/minimise the incidence of frauds.
- Whether frauds have taken place because of laxity in following the systems and procedures and, if so, whether effective action has been taken to ensure that the systems and procedures are scrupulously followed by the staff concerned.
- Whether frauds are reported to local Police or CBI, as the case may be, for investigation, as per the guidelines issued in this regard to public sector banks by Government of India.
- Review the analysis of frauds according to different categories detailed in Paragraph 2.2.1 of Master Directions on Frauds and also the different business areas.
- Review and analyse modus operandi of major frauds reported during the year along with their present position.
- Whether adequate provision for fraud has been done.
- Based on the audit procedures carried out, provide your suggestions.

### **Reporting**

21.07 Though the objective of statutory auditor is not to find out fraud / fraudulent activity or its possibility, it would be advisable for the statutory auditor to assess the existence and effectiveness of fraud risk mitigating and avoidance framework and controls implemented by the auditee bank.

### **Main report**

21.08 Branch auditor needs to consider the impact of his observations made in respect of fraud on overall presentation of financial statements of the bank while opining on these financial statements.

### **LFAR**

21.09 The branch auditor needs to report the particulars of frauds discovered during the year under audit. The auditor is also required to provide his suggestions based on his audit to minimise the possibilities of their occurrence.

### **Relevant circulars**

1. RBI Master Circular No. RBI/2015-16/100 DBR.No.CID.BC.22/20.16.003/2015-16 dated July 01, 2013 "Wilful Defaulters".

**Guidance Note on Audit of Banks (Revised 2020)**

---

2. RBI Master Direction on Fraud – Classification and Reporting by commercial banks and selected FIs RBI/DBS 2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 dated July 01, 2016 (Updated as on July 03, 2017).
3. RBI Circular No. DBS.CO.CFMC.BC.No.007/23.04.001/2014-15 dated May 07, 2015 on “Framework for dealing with loan frauds”.

## Miscellaneous

---

22.01 The Long Form Audit Report (LFAR) mentions a separate clause of "Miscellaneous" wherein the auditors are required to provide their specific comments on the relevant questions. The LFAR is a detailed questionnaire on several of the key aspects which the Branch auditor has to reply for the perusal of the Bank Management. Miscellaneous includes a residuary clause wherein the branch auditor can specify his observations on any of the areas of the Branch, which he feels necessary to be highlighted for the specific attention of the Management. The relevant questions are detailed below:

- a) Does the examination of the accounts indicate possible window-dressing?

The auditor has to comment instances of any possible window dressing observed by him during the course of audit. Some of the possible window dressing cases are mentioned below:

- i. Year-end debits in unutilized CC/OD accounts and credits to savings accounts or term deposit accounts and reversal of these entries in first week of April.
- ii. Fresh sanction and disbursements of advances at year ends and recalling them subsequently post balance sheet date.
- iii. Debits to savings and current accounts and opening fresh term deposits.
- iv. Sudden credits in potential NPA accounts and reversal of the same post balance sheet date.

- b) Does the branch maintain records of all the fixed assets acquired and held by it irrespective of whether the values thereof and depreciation thereof have been centralised/ where documents of title in relation to branch or other branches are available at the branch, whether the same have been verified.

The auditor needs to check the policy of the Bank in this regards. Most of the Banks maintain the records of fixed assets in the CBS. Also the depreciation is mostly taken care at the Head Office. The auditor should carry out the physical verification of the assets and reconcile the same with the details as held in the CBS. For all the assets received from other Branches/ sent from Branch, the supporting documents should be checked

### **Guidance Note on Audit of Banks (Revised 2020)**

---

and confirmed with the Branch and appropriate changes in the CBS data should be ensured. For purchases made during the year, the relevant invoices should be checked and the amounts and the date of capitalisation along with the classification should be confirmed by the auditor.

- c) Are there any other matters, which you as branch auditor would like to bring to the notice of the management or the Statutory Central Auditors?

The auditor can put his observations under this clause which have not been reported elsewhere in the report. The auditor should use this clause to highlight any matter which he feels is of importance for the attention of the SCA and the Management. Some of the observations can be – the software licences being used at the Branch are not genuine, pen drive can be used on the desktop PCs, placement of the branch server, router etc. General housekeeping of the branch, overall monitoring of the accounts etc.

- d) Implementation status of Ghosh and Jilani committee recommendations

The auditor should obtain the details from the Branch and discuss the same with the Branch and mention the observations accordingly.

- e) To enquire upon compliance status on the matters applicable at branch and comment

The auditor needs to check the compliance status submitted by the branch towards the observations of the concurrent auditor, statutory auditor, stock auditor, internal inspections, RBI inspections etc and confirm whether the compliance mentioned by the Branch have actually been complied by the Branch.

## **Audit of Foreign Exchange Business**

---

23.01 Long Form Audit Report (LFAR) for Bank branches requires auditors to review and comment on following aspects w.r.t. Branches Dealing in Foreign Exchange Business.

1. *Are there any material adverse features pointed out in the reports of concurrent auditors, internal auditors and / or the Reserve Bank of India's inspection report which continue to persist in relation to NRE/ NRO/ NRNR/ FCNR-B/ EEFC/ RFC and other similar deposit accounts. If so, furnish the particulars of such adverse features.*
2. *Whether the Branch has followed the instructions and guidelines of the controlling authorities of the bank with regard to the following in relation to the foreign exchange. If not, state the irregularities:*

*The branch is following instructions and guidelines.*

- a. *Deposits*
  - b. *Advances*
  - c. *Export bills*
  - d. *Bills for collection*
  - e. *Dealing room operations (where a branch has one)*
  - f. *any other area*
3. *Obtain a list of all Nostro Accounts maintained / operated by the Branch from the branch management.*
    - a. *Are the Nostro Accounts regularly operated?*
    - b. *Are periodic balance confirmations obtained from all concerned overseas branches / correspondents?*
    - c. *Are these accounts duly reconciled periodically? Your observations on the reconciliation may be reported.*
  4. *Does the Branch follow the prescribed procedures in relation to maintenance of Nostro Accounts?*

23.02 Accordingly, this Chapter of the Guidance Note is divided into following parts.



**Guidance Note on Audit of Banks (Revised 2020)**

Part – 1: Material and persistent adverse features during review of Special Accounts

Part – 2: Adherence to instructions and guidelines of controlling authorities in relations to Foreign Exchange business carried out

Part – 3: Nostro Accounts related

**Part – 1: Material and persistent adverse features during review of Special Accounts**

23.03 The Branch auditor should obtain the account opening policy and is required to review the compliances w.r.t. provisions on opening and maintenance of NRE, NRO, NRNR, FCNR-B, EEFC, RFC and other similar deposit accounts. Strictly compliance with KYC, AML requirements, requirements of relevant FEMA, AP-DIR circulars issued from time to time. These branches are generally under internal/ concurrent audit and adverse feature raised in Audit Reports issued by Concurrent Auditors, Internal Auditors and RBI's inspectors to be reviewed.

23.04 Further, the auditor should refer to the master directions issued by RBI in this respect which are stated as under:

1. Master Directions – Deposits & Accounts (RBI/FED/2015-16/9 FED Master Direction No. 14/2015-16)
2. Master Direction – Remittance of Assets RBI/FED/2015-16/8 FED Master Direction No. 13/2015-16)
3. Master Direction – Miscellaneous (RBI/FED/2017-18/14 FED Master Direction No. 19/2015-16)
4. Master Direction – Opening and Maintenance of Rupee/Foreign Currency Vostro Accounts of Non-resident Exchange Houses (RBI/FED/2015-16/16 FED Master Direction No.2/2015-16)

**Summary of EEFC, RFC(D) and RFC Accounts**

Particulars	Exchange Earners Foreign Currency (EEFC) Account	Resident Foreign Currency (Domestic) [RFC(D)] Account	Resident Foreign Currency (RFC) Account
Who can open the account	Exchange Earners	Individuals	Individuals
Joint	Jointly with eligible	Jointly with any person eligible to	Same as EEFC

**Guidance Note on Audit of Banks (Revised 2020)**

<b>Particulars</b>	<b>Exchange Earners Foreign Currency (EEFC) Account</b>	<b>Resident Foreign Currency (Domestic) [RFC(D)] Account</b>	<b>Resident Foreign Currency (RFC) Account</b>
account	persons; or With resident relative(s) on former or survivor' basis. Relative as defined under Companies Act, 2013 (viz. members of HUF, spouse, parents, step-parents, son, step-son, daughter-in-law, daughter, son-in-law, brother/sister, step-brother/ step-sister) Relative joint account holder cannot operate the account during the life time of the account holder	open the account	
Type of Account	Current only	Current only	Current/ savings/ term deposits
Interest	Non-interest earning	Non-interest earning	De-regulated (As decided by the AD bank)
Permitted Credits	1) 100% of foreign exchange received on account of export transactions. 2) advance remittance received by an exporter towards export of goods or services 3) Repayment of loans	1) Foreign exchange received as payment/ service/ gift/ honorarium while on visit abroad or from a non-resident who is on a visit to India	1) Foreign exchange received by him as superannuation/ other monetary benefits from overseas employer 2) Foreign

**Guidance Note on Audit of Banks (Revised 2020)**

Particulars	Exchange Earners Foreign Currency (EEFC) Account	Resident Foreign Currency (Domestic) [RFC(D)] Account	Resident Foreign Currency (RFC) Account
	<p>given to foreign importers</p> <p>4) Disinvestment proceeds on conversion of ADR/ GDR</p> <p>5) professional earnings like director's/ consultancy/ lecture fees, honorarium and similar other earnings received by a professional by rendering services in his individual capacity</p> <p>6) Interest earned on the funds held in the account</p> <p>7) Re-credit of unutilised foreign currency earlier withdrawn from the account</p> <p>8) Payments received in foreign exchange by an Indian startup arising out of sales/ export made by the startup or its overseas subsidiaries</p>	<p>2) Unspent amount of foreign exchange acquired from AD for travel abroad</p> <p>3) Gift from close relative</p> <p>4) Earning through export of goods/ services, royalty</p> <p>5) Disinvestment proceed on conversion of shares into ADR/ GDR</p> <p>6) Foreign exchange received as earnings of LIC claims/ maturity/ surrendered value settled in forex from an Indian insurance company</p>	<p>exchange realised on conversion of the assets referred to in Section 6(4) of FEMA 1999</p> <p>3) Gift/ inheritance received from a person referred to in Section 6(4) of FEMA 1999</p> <p>4) Foreign exchange acquired before July 8, 1947 or any income arising on it held outside India with RBI permission</p> <p>5) Foreign exchange received as earnings of LIC claims/ maturity/ surrendered value settled in forex from an Indian insurance company</p> <p>6) Balances in</p>

**Guidance Note on Audit of Banks (Revised 2020)**

Particulars	Exchange Earners Foreign Currency (EEFC) Account	Resident Foreign Currency (Domestic) [RFC(D)] Account	Resident Foreign Currency (RFC) Account
			NRE/ FCNR (B) accounts on change in residential status
Permitted Debits	1) Any permissible current or capital account transaction 2) Cost of goods purchased 3) Customs duty 4) Trade related loans and advances	Can be used for any permissible current/ capital account transactions.	No restrictions on utilisation in/ outside India.

**Summary of NRE, FCNR(B) and NRO Accounts**

Particulars	Non-Resident (External) Rupee Account Scheme [NRE Account]	Foreign Currency (Non-Resident) Account (Banks) Scheme [FCNR (B) Account]	Non-Resident Ordinary Rupee Account Scheme [NRO Account]
(1)	(2)	(3)	(4)
<b>Who can open an account</b>	NRIs and PIOs Individual/entities of Pakistan and Bangladesh shall require prior approval of the Reserve Bank of India		Any person resident outside India for putting through bonafide transactions in rupees.  Individuals/ entities of Pakistan nationality/ origin and entities of Bangladesh origin require the prior approval of the Reserve Bank of India.

**Guidance Note on Audit of Banks (Revised 2020)**

<b>Particulars</b>	<b>Non-Resident (External) Rupee Account Scheme [NRE Account]</b>	<b>Foreign Currency (Non-Resident) Account (Banks) Scheme [FCNR (B) Account]</b>	<b>Non-Resident Ordinary Rupee Account Scheme [NRO Account]</b>
			<p>A Citizen of Bangladesh/Pakistan belonging to minority communities in those countries i.e. Hindus, Sikhs, Buddhists, Jains, Parsis and Christians residing in India and who has been granted LTV or whose application for LTV is under consideration, can open only one NRO account with an AD bank subject to the conditions mentioned in Notification No. FEMA 5(R)/2016-RB dated April 01, 2016, as updated from time to time.</p> <p>Post Offices in India may maintain savings bank accounts in the names of persons resident outside India and allow operations on these accounts subject to the same terms and conditions as are applicable to NRO accounts maintained with an authorised dealer/ authorised bank.</p>
<b>Joint account</b>	<p>May be held jointly in the names of two or more NRIs/ PIOs.</p> <p>NRIs/ PIOs can hold jointly with a resident relative on 'former or survivor' basis</p>	<p>May be held jointly in the names of two or more NRIs/ PIOs.</p> <p>May be held jointly with residents on 'former or survivor' basis.</p>	

Guidance Note on Audit of Banks (Revised 2020)

Particulars	Non-Resident (External) Rupee Account Scheme [NRE Account]	Foreign Currency (Non-Resident) Account (Banks) Scheme [FCNR (B) Account]	Non-Resident Ordinary Rupee Account Scheme [NRO Account]
	(relative as defined in Companies Act, 2013). The resident relative can operate the account as a Power of Attorney holder during the life time of the NRI/ PIO account holder.		
<b>Currency</b>	Indian Rupees	Any permitted currency i.e. a foreign currency which is freely convertible	Indian Rupees
<b>Type of Account</b>	Savings, Current, Recurring, Fixed Deposit	Term Deposit only	Savings, Current, Recurring, Fixed Deposit
<b>Period for fixed deposits</b>	From one to three years, However, banks are allowed to accept NRE deposits above three years from their Asset-Liability point of view	For terms not less than 1 year and not more than 5 years	As applicable to Resident accounts.

**Guidance Note on Audit of Banks (Revised 2020)**

<b>Particulars</b>	<b>Non-Resident (External) Rupee Account Scheme [NRE Account]</b>	<b>Foreign Currency (Non-Resident) Account (Banks) Scheme [FCNR (B) Account]</b>	<b>Non-Resident Ordinary Rupee Account Scheme [NRO Account]</b>
<b>Permissible Credits</b>	<p>Credits permitted to this account are inward remittance from outside India, interest accruing on the account, interest on investment, transfer from other NRE/ FCNR(B) accounts, maturity proceeds of investments (if such investments were made from this account or through inward remittance).</p> <p>Current income like rent, dividend, pension, interest etc. will be construed as a permissible credit to the <b>NRE account</b>.</p> <p>However, only those credits which have not lost repatriable character are allowed in these type of accounts.</p>		<p>Inward remittances from outside India, legitimate dues in India and transfers from other NRO accounts are permissible credits to NRO account.</p> <p>Rupee gift/ loan made by a resident to a NRI/ PIO relative within the limits prescribed under the Liberalised Remittance Scheme may be credited to the latter's NRO account.</p>
<b>Permissible Debits</b>	<p>Permissible debits are local disbursements, remittance outside India, transfer to other NRE/ FCNR(B) accounts and investments in India.</p>		<p>The account can be debited for the purpose of local payments, transfers to other NRO accounts or remittance of current income abroad.</p> <p>Apart from these, balances in the NRO account cannot be repatriated abroad except by NRIs and PIOs up to USD 1 million, subject to conditions</p>

Guidance Note on Audit of Banks (Revised 2020)

Particulars	Non-Resident (External) Rupee Account Scheme [NRE Account]	Foreign Currency (Non-Resident) Account (Banks) Scheme [FCNR (B) Account]	Non-Resident Ordinary Rupee Account Scheme [NRO Account]
			<p>specified in Foreign Exchange Management (Remittance of Assets) Regulations, 2016.</p> <p>Funds can be transferred to NRE account within this USD 1 Million facility.</p>
<b>Repatriability</b>	Repatriable		<p>Not repatriable except for all current income.</p> <p>Balances in an NRO account of NRIs/ PIOs are remittable up to USD 1 (one) million per financial year (April-March) along with their other eligible assets.</p>
<b>Taxability</b>	Income earned in the accounts is exempt from income tax and balances exempt from wealth tax		Taxable
<b>Loans in India</b>	<p>AD can sanction loans in India to the account holder/ third parties without any limit, subject to usual margin requirements. These loans cannot be repatriated outside India and can be used in India only for the purposes specified in the regulations.</p> <p>In case of loans sanctioned to a third party, there should be no direct or indirect foreign exchange consideration for</p>		<p>Loans against the deposits can be granted in India to the account holder or third party subject to usual norms and margin requirement. The loan amount cannot be used for relending, carrying on agricultural/ plantation activities or investment in real estate.</p> <p>The term "loan" shall include all types of fund based/ non-fund based facilities.</p>



**Guidance Note on Audit of Banks (Revised 2020)**

Particulars	Non-Resident (External) Rupee Account Scheme [NRE Account]	Foreign Currency (Non-Resident) Account (Banks) Scheme [FCNR (B) Account]	Non-Resident Ordinary Rupee Account Scheme [NRO Account]
	<p>the non-resident depositor agreeing to pledge his deposits to enable the resident individual/ firm/ company to obtain such facilities.</p> <p>In case of the loan sanctioned to the account holder, it can be repaid either by adjusting the deposits or through inward remittances from outside India through banking channels or out of balances held in the NRO account of the account holder.</p> <p>The facility for premature withdrawal of deposits will not be available where loans against such deposits are availed of.</p> <p>The term "loan" shall include all types of fund based/ non-fund based facilities.</p>		
<b>Loans outside India</b>	<p>Authorised Dealers may allow their branches/ correspondents outside India to grant loans to or in favour of non-resident depositor or to third parties at the request of depositor for bona fide purpose against the security</p>		Not permitted

Guidance Note on Audit of Banks (Revised 2020)

Particulars	Non-Resident (External) Rupee Account Scheme [NRE Account]	Foreign Currency (Non-Resident) Account (Banks) Scheme [FCNR (B) Account]	Non-Resident Ordinary Rupee Account Scheme [NRO Account]
	<p>of funds held in the NRE/FCNR (B) accounts in India, subject to usual margin requirements.</p> <p>The term “loan” shall include all types of fund based/ non-fund based facilities</p>		
<b>Rate of Interest</b>	As per guidelines issued by the Department of Banking Regulations		
<b>Operations by Power of Attorney in favour of a resident</b>	Operations in the account in terms of Power of Attorney is restricted to withdrawals for permissible local payments or remittance to the account holder himself through normal banking channels.	Operations in the account in terms of Power of Attorney is restricted to withdrawals for permissible local payments in rupees, remittance of current income to the account holder outside India or remittance to the account holder himself through normal banking channels. While making remittances, the limits and conditions of repatriability will apply.	
<b>Change in residential status from Non-resident to resident</b>	NRE accounts should be designated as resident accounts or the funds held in these accounts may be	On change in residential status, FCNR (B) deposits may be allowed to continue till maturity at the contracted rate of interest, if so desired by the	NRO accounts may be designated as resident accounts on the return of the account holder to India for any purpose indicating his intention to stay in India for an uncertain period. Likewise, when a resident Indian becomes a person resident outside India, his existing resident

**Guidance Note on Audit of Banks (Revised 2020)**

<b>Particulars</b>	<b>Non-Resident (External) Rupee Account Scheme [NRE Account]</b>	<b>Foreign Currency (Non-Resident) Account (Banks) Scheme [FCNR (B) Account]</b>	<b>Non-Resident Ordinary Rupee Account Scheme [NRO Account]</b>
	transferred to the RFC accounts, at the option of the account holder, immediately upon the return of the account holder to India for taking up employment or on change in the residential status.	account holder. Authorised dealers should convert the FCNR(B) deposits on maturity into resident rupee deposit accounts or RFC account (if the depositor is eligible to open RFC account), at the option of the account holder.	account should be designated as NRO account.

23.05 On November 22, 2019 vide its Circular (RBI/2019-20/102 A.P. (DIR Series) Circular No. 09) RBI has rationalized certain processes w.r.t. SNRR Account (Special Non-Resident Rupee Account) with banks for following transactions:

- (i) External Commercial Borrowings in INR;
- (ii) Trade Credits in INR;
- (iii) Trade (Export/ Import) Invoicing in INR; and
- (iv) Business related transactions outside International Financial Service Centre (IFSC) by IFSC units at GIFT city like administrative expenses in INR outside IFSC, INR amount from sale of scrap, government incentives in INR, etc. The account will be maintained with bank in India (outside IFSC).

## **Guidance Note on Audit of Banks (Revised 2020)**

---

23.06 RBI vide the above referred circular, further rationalized following aspects w.r.t. SNRR and NRO / NRE Accounts:

- i. Removal of restriction on the tenure of the SNRR account opened for the above referred purposes.
- ii. Apart from Non-Resident Ordinary (NRO) Account, permission is granted for credit of amount due/ payable to non-resident nominee from account of a deceased account holder to Non-Resident External (NRE) Account or direct remittance outside India through normal banking channels.

The LFAR requires auditors to comment on persistent adverse features observed during their review.

### **Part – 2 – Adherence to instructions and guidelines of controlling authorities in relations to Foreign Exchange business carried out**

23.07 The LFAR deals with review of adherence to instructions and guidelines issued by RBI by branch w.r.t. Foreign Exchange Business in the field of:

- a. Deposits,
- b. Advances,
- c. Export Bills,
- d. Bills for Collection,
- e. Dealing Room operations and
- f. Any other area.

23.08 The auditor should ensure compliances with internal policies of the Bank and with various Master Directions as stated below:

For the purpose of review of the said aspects the auditor should refer to various master directions issued by RBI in this respect. Few relevant master directions are listed below.

1. Master Direction - External Commercial Borrowings, Trade Credits and Structured Obligations (RBI/FED/2018-19/67 FED Master Direction No.5/2018-19)
2. Master Direction – Foreign Investment in India (RBI/FED/2017-18/60 FED Master Direction No. 11/2017-18)
3. Master Direction - Establishment of Branch Office (BO)/ Liaison Office (LO)/ Project Office (PO) or any other place of business in India by foreign entities (RBI/FED/2015-16/6 FED Master Direction No.10/2015-16)
4. Master Direction – Direct Investment by Residents in Joint Venture (JV) /

Wholly Owned Subsidiary (WOS) Abroad (RBI/FED/2015-16/10 FED Master Direction No. 15/2015-16)

5. Master Direction – Borrowing and Lending transactions in Indian Rupee between Persons Resident in India and Non-Resident Indians/ Persons of Indian Origin (RBI/FED/2015-16/2 FED Master Direction No. 6/2015-16 )
6. Master Direction - Liberalised Remittance Scheme (LRS) (RBI/FED/2017-18/3 FED Master Direction No. 7/2015-16)
7. Master Direction - Other Remittance Facilities (RBI/FED/2015-16/4 FED Master Direction No. 8/2015-16)
8. Master Direction - Remittance of Assets (RBI/FED/2015-16/8 FED Master Direction No. 13/2015-16)
9. Master Direction - Deposits and Accounts (RBI/FED/2015-16/9 FED Master Direction No. 14/2015-16)
10. Master Direction – Import of Goods and Services (RBI/FED/2016-17/12 FED Master Direction No. 17/2016-17)
11. Master Direction – Reporting under Foreign Exchange Management Act, 1999 (RBI/FED/2015-16/13 FED Master Direction No.18/2015-16)
12. Master Direction – Miscellaneous (RBI/FED/2017-18/14 FED Master Direction No. 19/2015-16)
13. Master Direction – Opening and Maintenance of Rupee/Foreign Currency Vostro Accounts of Non-resident Exchange Houses (RBI/FED/2015-16/16 FED Master Direction No.2/2015-16)
14. Master Direction – Export of Goods and Services (RBI/FED/2015-16/11 FED Master Direction No. 16/2015-16)

**Part 2 (a) – Deposits**

23.09 The detailed guidance for Deposit accounts is provided in Part 1 of this Chapter.

**Part 2 (b) – Advances**

23.10 Advances funded in foreign currency are handled in specialized branches. The auditor should note the following:

**Export Financing**

**A. Pre-Shipment Credit to Exporters**

23.11 Important Points:

- Export packing credit can be in Indian Rupees and in Foreign Currency.

### Guidance Note on Audit of Banks (Revised 2020)

---

- Maximum period for Packing credit is 360 days.
- EPC / PCFC is disbursed against specific orders, in one lumpsum tranche or against the requirement as per export orders.
- EPC / PCFC is also disbursed as per Running Account Facility where availability of Letter of Credit / Confirmed orders before disbursement are not insisted.
- Liquidation of EPC / PCFC will be by way of exports proceeds only. Liquidation by any other means than by way of exports will attract higher rate of interest as per Bank's Policy. However, as per Master Directions on Export of Goods and Services issued by RBI it is prescribed that AD Category – I banks may permit exporters to repay packing credit advances whether availed in Rupee or in foreign currency from balances in their EEFC account and / or Rupee resources to the extent exports have actually taken place.

#### Accounting aspects:

- Banks open separate Loan account in CBS for EPC / PCFC. It helps in monitoring the utilization and liquidation.
- Bank at the request of the borrower may convert the amount of Pre-Shipment credit into Post-Shipment credit by discounting / purchasing the export bills.

#### Compliance aspects

- *End use of funds*  
Banks should keep a close watch on the end-use of the funds and ensure that credit at lower rates of interest is used for genuine requirements of exports. Banks should also monitor the progress made by the exporters in timely fulfilment of export orders.

#### Order Book Maintenance

- Banks maintain order book / register to track export orders vis-a-vis Export Credit extended.

#### Submission of Export Documents

- If the liquidation of Export Credit is by other than the way of Export of Goods / Services within the maximum period of 360 days, the advance will cease to qualify for prescribed rate of interest for export credit ab initio. It means that the bank will have to collect the difference in concessional rate of interest and normal rate of interest. The rate of interest to be applied will be as per Bank's Policy.

Auditing aspects:

- Generate the list of EPC / PCFC accounts opened and maintained by the branch.
- Verify whether all details are correctly filled in Masters.
- Whether the liquidation of EPC / PCFC is as per RBI guidelines? If not, whether interest rate as per Bank's Policy is charged or not.
- Documents evidencing end use of funds should be verified.
- Whether genuineness of Export LC is confirmed before sanctioning EPC / PCFC?

## **B. Post-Shipment Credit to Exporters**

### **Export Bills Discounted / Purchased**

23.12

- Banks extend credits to Exporters by way of purchasing / discounting export bills. Banks also provide facility of advance against Exports on collection basis.
- Facility of discounting / purchase of bill is available in both Indian Rupee and in Foreign Currency.

Revenue aspects

- Interest on Bill Discounting / Purchase is revenue for the bank.
- Bank also charges fees for export bill lodgment and claims courier and other charges for submission of Export Documents.

Accounting aspects

- In case of Discounting / Purchase in Foreign Currency.
- The rupee equivalent of the discounted value of the export bills will be payable to the exporter and the same should be utilised to liquidate the outstanding export packing credit.
- As the discounting of bills/extension of foreign exchange loans (DP bills) will be in actual foreign exchange, banks may apply appropriate spot rate for the transaction.
- The rupee equivalents of discounted amounts/foreign exchange loan may be held in the bank's books distinct from the existing post-shipment credit accounts.

## Guidance Note on Audit of Banks (Revised 2020)

---

- In case of overdue bills, banks may charge overdue interest as per the interest rate policy of bank from the due date to the date of crystallization.

### Compliance aspects

- In case of overdue bills, IRAC Norms for overdue bills will be applicable and the advance will be subject to Asset Classification.
- Export Bills will be subject to maximum period of 365 days.

### Auditing aspects

- Generate a report on Export Bills purchased during the audit period.
- Verify whether details are correctly filled in Masters specifically Amount, discounting rate.
- Generate a report on outstanding / realized during the audit period.
- In case of overdue bills check whether the interest has been charged as per Bank's Policy.
- Verify whether the period of sanction is within the period prescribed by RBI i.e. 360 days.

## Import Financing

### Trade Credits

23.13 Trade Credit (TC) is defined by RBI in Master Direction - External Commercial Borrowings, Trade Credits and Structured Obligations as follows.

*'Trade Credits (TC) refer to the credits extended by the overseas supplier, bank, financial institution and other permitted recognised lenders for maturity, as prescribed in this framework, for imports of capital/non-capital goods permissible under the Foreign Trade Policy of the Government of India. Depending on the source of finance, such TCs include suppliers' credit and buyers' credit from recognised lenders.'*

23.14 *Framework prescribed for TCs:* TC for imports into India can be raised in any freely convertible foreign currency (FCY denominated TC) or Indian Rupee (INR denominated TC), as per the framework given in the table below:

Sr. No.	Parameters	FCY denominated TC	INR denominated TC
i	Forms of TC	Buyers' Credit and Suppliers' Credit.	
ii	Eligible	Person resident in India acting as an importer.	



**Guidance Note on Audit of Banks (Revised 2020)**

<b>Sr. No.</b>	<b>Parameters</b>	<b>FCY denominated TC</b>	<b>INR denominated TC</b>
	borrower		
iii	Amount under automatic route	Up to USD 150 million or equivalent per import transaction for oil/gas refining & marketing, airline and shipping companies. For others, up to USD 50 million or equivalent per import transaction.	
iv	Recognised lenders	<p><b>1. For suppliers' credit:</b> Supplier of goods located outside India.</p> <p><b>2. For buyers' credit:</b> Banks, financial institutions, foreign equity holder(s) located outside India and financial institutions in IFSCs located in India.</p> <p><b>Note:</b> Participation of Indian banks and non-banking financial companies (operating from IFSCs) as lenders will be subject to the prudential guidelines issued by the concerned regulatory departments of the Reserve Bank. Further, foreign branches/subsidiaries of Indian banks are permitted as recognised lenders only for FCY TC.</p>	
v	Period of TC	The period of TC, reckoned from the date of shipment, shall be up to three years for import of capital goods. For non-capital goods, this period shall be up to one year or the operating cycle whichever is less. For shipyards / shipbuilders, the period of TC for import of non-capital goods can be up to three years.	
vi	All-in-cost ceiling per annum	Benchmark rate plus 250 bps spread.	
vii	Exchange rate	Change of currency of FCY TC into INR TC can be at the exchange rate prevailing on the date of the agreement between the parties concerned for such change or at an exchange rate, which is less than the rate prevailing on the date of agreement, if consented to	For conversion to Rupee, exchange rate shall be the rate prevailing on the date of settlement.

**Guidance Note on Audit of Banks (Revised 2020)**

Sr. No.	Parameters	FCY denominated TC	INR denominated TC
		by the TC lender.	
viii	Hedging provision	The entities raising TC are required to follow the guidelines for hedging, if any, issued by the concerned sectoral or prudential regulator in respect of foreign currency exposure. Such entities shall have a board approved risk management policy.	The overseas investors are eligible to hedge their exposure in Rupee through permitted derivative products with AD Category I banks in India. The investors can also access the domestic market through branches / subsidiaries of Indian banks abroad or branches of foreign banks with Indian presence on a back to back basis.
ix	Change of currency of borrowing	Change of currency of TC from one freely convertible foreign currency to any other freely convertible foreign currency as well as to INR is freely permitted.	Change of currency from INR to any freely convertible foreign currency is not permitted.

23.15 The typical flow of transaction of TC (with underlying import through LC transaction) is as follows:

- 1) The borrower imports goods from foreign supplier against Foreign Letter of Credit (FLC) drawn in favour of foreign supplier. *[The Buyer's Credit can be arranged for transactions of Import on Collection basis and Direct Import cases.];*
- 2) The borrower either through its Indian bank or on its own approaches foreign bank (or overseas / foreign branches / offices of Indian banks), financial institutions foreign equity holder for Buyer's Credit and Supplier for availing Suppliers' Credit for payment to be made to the foreign supplier;
- 3) Issuance of Letter of Comfort by Indian bank to the foreign bank is not permitted. However, Banks are permitted to issue Bank Guarantee in favour of overseas TC lender (subject to compliance with provisions contained in Master Circular No.DBR.No.Dir.BC.11/13.03.00/2015-16 dated July 1, 2015 on "Guarantees and Co-acceptances", as amended from time to time.) Banks are also permitted to create charge on assets for TC so arranged;

**Guidance Note on Audit of Banks (Revised 2020)**

---

- 4) The TC Lender remits funds to the NOSTRO Account of Indian bank which is handling import transaction (under buyer's credit) or agree to extend date of payment under Supplier's credit for buyer and securing payment through bill discounting with all expenses on buyer;
- 5) The Indian bank remits the funds to foreign supplier through its NOSTRO Accounts in case of Buyer's Credit;
- 6) The Indian bank subsequently retires and reverses the Letter of Credit in its book and passes another entry for creation of a non-fund based (contingent) liability of Bank Guarantee (if issued);
- 7) On the due date of TC, the Indian bank remits the funds (inclusive of interest) to the overseas bank and recovers the similar amount from its customer;  
The entries of the inward and outward remittances (specified in steps 3 and 4) are to be recorded in the books of accounts (NOSTRO Mirror Account) of the Indian bank;
- 8) For the purpose of raising TC, the importer may also offer security of movable assets (including financial assets) / immovable assets (excluding land in SEZs) / corporate or personal guarantee for raising TC. ADs may, therefore, be allowed to permit creation of charge on security offered / accept corporate or personal guarantee, duly ensuring that (i) there exists a security clause in the loan agreement requiring the importer to create charge, in favour of overseas lender / security trustee on immovable assets / movable assets / financial securities / issuance of corporate and / or personal guarantee; (ii) No Objection Certificate, wherever necessary, from the existing lenders in India has been obtained; (iii) such arrangement is co-terminus with underlying TC; (iv) In case of invocation, the total payments towards guarantee should not exceed the dues towards TC; and (v) Creation/ enforcement / invocation of charge shall be as per the provisions contained in Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India) Regulations, 2000 and Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 or any other relative Regulations framed under the Foreign Exchange Management Act, 1999 and should also comply with FDI/FII/SEZ policy/ rules/ guidelines. The directions on issuance of guarantee mentioned under this provision shall come into force from the date of publication, in the Official Gazette, of the relative Regulations issued under FEMA.

23.16 Following documents are required to be verified by the statutory auditors during review of Buyers' Credit and Suppliers' Credit Transaction and its accounting treatment in the Indian Bank's books.

### **Guidance Note on Audit of Banks (Revised 2020)**

---

- 1) (Loan) Agreement, if any, entered between the Indian importer (borrower), overseas TC lender, the Indian bank (facilitator);
- 2) SWIFT messages originated by overseas bank specifying the terms of TC;
- 3) The calculation of contingent liability towards Bank Guarantee is inclusive of interest accrued on the TC as on financial statement date;
- 4) Documentation / Agreement between overseas TC lender and Indian Bank, (if any) and, any further confirmatory documents exchanged between overseas bank and Indian bank;
- 5) Review of documents specifying right of recovery against borrower, in case if the borrower defaults in repayment of TC;
- 6) Balance confirmations obtained from the overseas TC lender;
- 7) Charge created in records of RoC related to the security offered for TC vis-à-vis disclosure of TC in the financials of borrowers as secured / unsecured loan;
- 8) Acknowledgement of debt, if any, obtained from the borrower;
- 9) The calculation of drawing power for working capital finance availed by the borrower is net of the Buyer's Credit;
- 10) Form 15CA / Form 15CB compliances made by the borrower;

#### **Revenue aspects of TC transaction**

23.17 Bank issuing BG for TC Transaction earns commission / charges.

#### **Accounting aspects of TC transaction**

23.18

- Issuance of BG for TC is considered as Non-Funded facility by banks.
- The important aspect is to ensure that the fields in CBS match with details reported in SWIFT Message sent for BG. The BG is generally communicated through MT760 which includes certain separately identifiable details.
- The auditor should also review the text of the Guarantee to confirm correctness of accounting treatment in books of accounts.
- The auditor should also review any messages sent through MT799 (Free Text Format) type SWIFT Messages. In this type of message the vital details are included as a text and not as separately identifiable fields. In view of this even when an automated information reporting system (from

CBS to SWIFT) has been implemented, there is still a possibility of flowing certain vital information through SWIFT message text which may not have been recorded in CBS.

### **Compliance aspects of TC transactions**

23.19

- TC transaction should be within the prescribed tenure.
- Interest Rate and other costs for TC transaction must be within the prescribed All-in-Cost ceiling.
- There are certain restrictions on availing TC for select commodities. Prescribed tenure in Master Circular issued by RBI for the said TC transaction must be adhered to. For instance, certain restrictions have been imposed on TC for import of Gold, Diamonds, precious metals etc. The auditor may refer to Master Directions on Import of Goods and Services for the same.

### **Auditing aspects of TC transactions**

23.20

- Underlying transaction for TC is Import Transactions. Hence, it is important for the auditors to verify the Evidence of Import. Exchange Control Copy of Bill of Entry / Entry in IDPMS is the document / confirmation which can be said to be Evidence of Import. In case of TC availed by SEZ units the auditor may review the compliance of provisions provided under Master Directions for Trade Credit.
- Auditor should check Offer Letter issued by overseas lender and conformity of TC transaction with FEMA guidelines.
- Are there any cases of devolvement by borrower in remitting TC amount in past? In such cases Bank who has issued LoU / LoC / BG has to remit the funds on due date to Foreign Lender. Check whether there are any cases of such nature during Audit Period?
- Whether Fees / Charges for BG issuance / charges creation is collected upfront?
- Whether liability for Fees / Charges collected for unexpired period is reversed and shown as Liability?

### **Part 2 (c) – Export Bills**

23.21 There are different types of Export Bills in Foreign Exchange transactions viz. Export Bills on Collection, Export Bills Discounted / Purchased,

Advance against Export Bills etc.

Important aspects of Export Bills discount/ purchase have been mentioned in the Part – 2 above. For detailed guidelines the Auditor should refer Master Direction – Export of Goods and Services.

**Part 2 (d) – Bills for collection**

23.22 Under Import bills for collection the Foreign Seller sends goods through shipping channel and documents to its banker with an instruction to send the same to the Importer's Banker. The document so sent contains instructions on handling of the said documents. The Importer's Bank will follow the instruction mentioned in the bill schedule and deliver the documents to the buyer.

In this type of transaction Importer's Banker is dealing only as a mediator i.e. in case the Importer does not pay the bill amount the Importer's bank will notify the Exporter's Bank and will act as per Exporter's Bank instruction.

**Revenue aspects of Import Bills on Collection**

23.23

- Bank charges fees / commission for handling bills on Collection.
- Generally, it is observed that in case of Forex Transactions handled through CBS, the charges are collected by CBS. However, the auditor should carry out walkthrough process of collection of charges.

**Accounting aspects of Import Bills on Collection**

23.24

- The bills are Lodged in CBS / recorded in Import Bills on Collection register
- In case of CBS, the payment of Bill made through Bill module in CBS. CBS will update the outstanding Bill Liability on realization event.
- Only contra transaction for Contingent Liability is created for Import Bills on Collection.

**Compliance aspects of Import Bills on Collection**

23.25

- Import Bills under collection must form part of Contingent Liability.
- Lodgement, Realization and Closure of Bill should be carried out through Bill module under CBS.

**Auditing aspects of Import Bills on Collection**

23.26

- Generate Bill Balancing Report for Import Bills on Collection Transaction. It is preferable to have the said report generated for 31st March.
- Carry out physical verification of all outstanding bills appearing under Bill Balancing Reports. Special attention should be given to bills under “Lodgement” status for availability of Transport Documents. (In normal course, Transport documents alongwith other documents are handed over only after payment in case of Sight Bill or only after acceptance of Bill of Exchange in case of Usance Bill.)
- Verify whether total of Outstanding Import Bills on Collection as per Bill Balancing Report agrees with Bills for Collection under Contingent Liability?
- Whether the activity of collection of charges is system driven or manual? Select appropriate sample based on the review of process.
- It is generally observed that activity of collection of charges for discrepancy memo is manual. If so, verify whether the charges have been properly collected or not.
- Compliance of GST on the Charges so collected and accounting thereof.

**Part 2 (e) – Dealing Room operations**

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

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

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

**Front Office (Dealing Room)**

- Money and fixed income dealings
- Forex & Derivatives
- Treasury Sales
- Equities

## **Guidance Note on Audit of Banks (Revised 2020)**

---

- Primary Dealers
- Debt Sales
- Credit Default Swaps

### **Middle Office (Risk)**

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

### **Back Office**

- Settlement and follow up
- Reconciliations
- Accounting
- Valuation

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

### **Front office Operations**

23.30 The front office operations consist of dealing room operations wherein the dealers transact deals with the various approved counterparties. Deals are transacted by dealers on various anonymous order matching platforms such as NDS-OM, CROMS, NDS-CALL, FX-CLEAR, FX-SWAP, E-Kuber and over communication platform such as Reuters', Bloomberg, telephonic conversation with counter party or through empaneled brokers.

23.31 The dealers are primarily responsible to check for counterparty exposure limits, eligibility, and other requirements of the Bank before initiating any deal with the counter-party. Dealers must ensure that all risk/credit limits are available before transacting a deal. Also, the deal must not contravene the current regulations regarding dealing in INR with overseas banks/counterparties. All counterparties are required to execute the International Swaps and Derivatives Association ('ISDA') agreement as well as pass a board resolution allowing it to enter into derivative contract. As soon as the deal is struck with counterparty, the deal details are noted in a dealers' deal pad and thereafter captured in front office system of the Bank which gets queued in for authorization by back office.



### **Middle office Operations**

23.32 Middle office is responsible for online risk measurement, monitoring and management reporting. The other functions of Middle Office are:

- Limit setting and monitoring exposures in relation to limits;
- Assessing likely impact of market movements based on internal assessments and external/Internal research;
- Evolving hedging strategies for assets and liabilities;
- Interacting with the bank's Risk Management Department on liquidity and market risk;
- Monitoring open currency positions;
- Calculating and reporting VAR;
- Stress testing and back testing of investment and trading portfolios;
- Risk-return analysis; and
- Marking open positions to market to assess unrealized gain and losses.

### **Back office Operations**

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

23.34 An important development in the back office has been the advent of straight-through processing (STP), also called 'hands-off' processing. This has been made possible through enhancement of computer system to real time online input in the trading platform, which in turn has meant that the back office can authorise/confirm deals pending for authorisation in the trading platform. In practice this is done automatically by matching incoming data from counterparties and thereby focusing on investigating exceptions. With the introduction of online trading systems, the deal is 'confirmed' as it is done, allowing the back office to concentrate principally on handling exceptions, settlement and monitoring and risk control.

23.35 One of the basic tenets for a treasury area in a bank is the strict segregation and allocation of duties between the front, middle and back office, the latter controlling confirmations, settlement and accounting of transactions.

These are even more important in an era of straight-through processing where the checks are fewer and must essentially be independent. However, while this is straight forward for the processing functions, the independent monitoring and management of complex trading risks can be much more problematical, requiring the ability and market knowledge to understand how the trades and hedges in the dealer's book are structured.

### **Functions of Back Office**

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

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

#### ***Counterparty confirmation***

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

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

### **Settlement**

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

The Brokerage is paid on settlement basis in case of Forex Transactions.

### **Reconciliation**

23.40 Operations areas are typically involved in a number of reconciliation processes, including the reconciliation of dealers' overnight positions, NOSTRO accounts and brokerage payments. This can also mean reconciling positions for margin calls in futures trading or reconciling custody accounts to the underlying securities in securities trading. However, the basic reconciliation function is to agree or reconcile the entries that have passed over an account with correspondent bank against those that have been passed internally in the books of the bank to a NOSTRO account. After reconciliation, the unmatched items in both accounts then represent those that have not been responded to in either the books of the bank or its correspondent and should therefore requires to be investigated.

### **Net Overnight Open Position Limit (NOOPL)**

23.41 NOOPL may be fixed by the boards of the respective banks and communicated to the Reserve Bank immediately. However, such limits should not exceed 25 percent of the total capital (Tier I and Tier II capital) of the bank.

23.42 The Net Open position may be calculated as per the method given below:

#### **Calculation of the Net Open Position in a Single Currency**

The open position must first be measured separately for each foreign currency. The open position in a currency is the sum of (a) the net spot position, (b) the net forward position and (c) the net options position.

##### **a) Net Spot Position**

The net spot position is the difference between foreign currency assets and the liabilities in the balance sheet. This should include all accrued income/expenses.

##### **b) Net Forward Position**

This represents the net of all amounts to be received less all amounts to be paid in the future as a result of foreign exchange transactions, which have been

## Guidance Note on Audit of Banks (Revised 2020)

---

concluded. These transactions, which are recorded as off-balance sheet items in the bank's books, would include:

- i. spot transactions which are not yet settled;
- ii. forward transactions;
- iii. Guarantees and similar commitments denominated in foreign currencies which are certain to be called;
- iv. Net future income/expenses not yet accrued but already fully hedged (at the discretion of the reporting bank);
- v. Net of amounts to be received/paid in respect of currency futures, and the principal on currency futures/swaps.

### c) Net Options Position

The net options position is the "delta-equivalent" spot currency position as reflected in the authorized dealer's options risk management system, and includes any delta hedges in place which have not already been included under 1(a) or 1(b) (i) and (ii) above.

**23.43 Calculation of the Overall Net Open Position** involves measurement of risks inherent in a bank's mix of long and short position in different currencies. It has been decided to adopt the "shorthand method" which is accepted internationally for arriving at the overall net open position. Banks may, therefore, calculate the overall net open position as follows:

- i. Calculate the net open position in each currency (paragraph 1 above).
- ii. Calculate the net open position in gold.
- iii. Convert the net position in various currencies and gold into Rupees in terms of existing RBI / FEDAI Guidelines. All derivative transactions including forward exchange contracts should be reported on the basis of Present Value (PV) adjustment.
- iv. Arrive at the sum of all the net short positions.
- v. Arrive at the sum of all the net long positions.

Overall net foreign exchange position is the higher of (iv) or (v). The overall net foreign exchange position arrived at as above must be kept within the limit approved by the bank's Board.

23.44 Authorised Dealer banks should report all derivative transactions including forward exchange contracts on the basis of PV adjustment for the purpose of calculation of the net open position. Authorised Dealer banks may

select their own yield curve for the purpose of PV adjustments. The banks however should have an internal policy approved by its ALCO regarding the yield curve/(s) to be used and apply it on a consistent basis.

**Audit Approach and Procedures**

23.45 Examination of compliance with statutory and regulatory requirements is also an important objective in audit of dealing rooms. The auditors should keep this in view while designing their audit procedures relating to dealing rooms.

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

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

23.47 In today's scenario, most of the dealing room functions of banks are performed in an automated environment (for example, trade booking, settlement and accounting). In such a situation, it becomes imperative for the auditors to test the general information technology controls and system application controls around the functioning of the systems involved and also the interfaces between various systems.

23.48 Some of the typical audit procedures would include:

- perusing reports on concurrent audit of treasury transactions, system audit report, if any and follow-up action taken by the management thereon.
- perusing the half yearly review of portfolio by the Board of Directors of the bank and also reviewing annual inspection report of the RBI carried out under Section 35 of the Banking Regulation Act, 1949.
- Verification of voice recording mechanism and to ensure user ids of dealers left / transferred/ on leave is deactivated / suspended on timely basis.

**Part 2(f) – Any other area**

23.49 Apart from the transactions referred to above in detailed, the Bank Branches carry out various other transactions as well. The Auditor should review

## **Guidance Note on Audit of Banks (Revised 2020)**

---

the nature of transactions carried out by branch, the role of bank branch in transaction in terms of FEMA guidelines and should review applicable Master Directions / Circulars, Notifications.

23.50 The auditors should also review linkages between CBS system and SWIFT system.

23.51 The RBI has suggested banks to centralize / ensure effective control over access and sending messages through SWIFT system by bank branches. In case the SWIFT message system is centralized the auditor should review system / process of generation of SWIFT Messages. Auditors may on test check basis get the SWIFT messages generated from the said system and compare the same with CBS information. Any deviation observed should be reported under this clause of LFAR.

### **Part – 3: Nostro Accounts related**

23.52 As per the need of LFAR for NOSTRO Accounts as follows:

***Obtain from the branch management, a list of all NOSTRO Accounts maintained/ operated by the Branch***

23.53 A nostro account refers to an account that a bank holds in a foreign currency in another bank. As explained earlier in case of receipts in foreign currency by the Bank from other countries, the counter party/ foreign bank will remit funds in nostro account of the Bank. Then based on transaction types and obtention of necessary documents, the Bank will transfer amount in nostro account to customer Rupee account post conversion or EEFC accounts.

23.54 The starting phase of this audit should be to obtain a list of all the NOSTRO accounts maintained / operated by the branch. Also, the Branch will have mirror account of each nostro account in its Trial Balance. The list shall contain all the relevant details in this regard including the account number, country, currency, etc. Ideally list of Nostro accounts provided by the Branch and details of mirror accounts should match.

- a) Whether the bank has a system of periodic confirmation/ reconciliation of the balances in NOSTRO accounts maintained with each overseas Bank/ correspondent? Has such confirmation been received and account reconciled at year end in each case. If not, give details.

One of the important elements of the audit of NOSTRO accounts is to check on the transactions entered through these accounts. It is important that these accounts are duly confirmed and reconciled between the two branches. The auditor should check the confirmations received by the bank branch from their overseas bank and also the reconciliation of the same.

### **Guidance Note on Audit of Banks (Revised 2020)**

---

The auditor should not only verify the same relating to year end but also verify if the branch had process of periodic reconciliation and confirmation of the same. With respect to year end, the auditor may also consider to obtain independent confirmation from the overseas branch in case of material balances / transactions. The reconciliation also needs to be tallied with the subsequent transactions after year end.

- b) Whether the system of the Bank ensures that all entries originated by overseas banks/correspondents, have been duly responded promptly in the respective NOSTRO accounts maintained by the Bank?

The overseas bank / correspondent intimates to the respective branch for each transaction entered by them relating to them. It is imperative on the part of the branch to respond to the same at the earliest. Timely response results in proper entries and reconciliation of the same on timely basis.

The auditor should study the process and system of the bank in this regard and also whether the branch is acting as per the system defined. The delays in the same if any should be properly highlighted and the impact of the same at year end needs to be looked upon and wherever required, appropriate entries should be passed or given in MOC.

- c) Are there any dormant/closed NOSTRO accounts in respect of which balances continue to exist in the books of the Branch, at year end?

The auditor needs to examine the transactions entered in the respective NOSTRO accounts. There could be some of the accounts where there are no transactions but still the balances are lying outstanding. The reasons for the same needs to be taken and verified and reported accordingly.

- d) Have the NOSTRO balances been converted at year end at the rates of exchange as prescribed by controlling authorities?

The NOSTRO accounts are in foreign currency. For the purposes of the accounting as per norms, these would need to be converted into Indian Rupees at each period end. Accordingly, it is imperative that the rate of conversion used for the same is proper. Generally, the rate of conversion is put in the system of the bank and the same rate is used for conversion of all the such balances at the whole bank. The auditor needs to check that the rates feeded in the system are the ones which is as prescribed by the controlling authorities. It also needs to be verified that the rates prescribed by the controlling authorities are appropriate.

As per RBI circular RBI/2018-19/34/ DBR.Ret.BC. No.01/ 12.01.001 /2018-19 dated August 02, 2018 for conversion of foreign Currency

#### **Guidance Note on Audit of Banks (Revised 2020)**

---

Assets/ Liabilities reference rate from FBIL should be taken. If reference rate is not available from FBIL, Banks may continue to use New York closing pertaining to the day and of the reporting Friday for conversion of such currency into USD.

- e) In case, any matter deserves special attention of the management, the same may be reported

The auditor needs to use his professional skepticism to check if there are any unusual transactions or any unusual trend or significant transactions reflected in the NOSTRO accounts. If any such transactions are noted, the same needs to be further verified with respect to documents and purpose and in case if the auditor is not satisfied, the same should be referred in LFAR.

The reconciliation of Nostro accounts (with Nostro Mirror Accounts) needs to be scrutinized carefully to analyze and ascertain if any inwards remittances are received on behalf of the customers / constituents of the bank and have remained unaccounted and / or any other debit (inward) entries have remained unaccounted and are pertaining to any liabilities for the bank. These need to be properly reported.

Borrowings from abroad by banks in India needs to be considered as 'liabilities to other' and thus, needs to be considered at gross level unlike 'liabilities towards banking system in India', which are permitted to be netted off against 'assets towards banking system in India'. Thus, the adverse balances in Nostro Mirror Account needs to be considered as 'Liabilities to other'

- (f) Does the Branch follow the prescribed procedures in relation to maintenance of Vostro Accounts?

The procedure and process reported for NOSTRO needs to be carried out for VOSTRO accounts as well.



# 24

## Clearing House Operations by Service Branches

---

### Introduction/ Bank's Process

24.01 Service Branch/ Clearing House primarily acts as an intermediary between branches and banks to ensure processing of negotiable instruments. Considering functions of this branch, primary objective of auditor is to ensure that there are no long old outstanding open entries as well as unreconciled entries.

24.02 The Service Branch ensures that the duly balanced outward clearing batches are received from the various branches within the prescribed time schedule. The outward clearing presentation for the bank as a whole, duly balanced and with the necessary control documents, should be forwarded to the Cheque Processing Centre as per the time schedule stipulated by it.

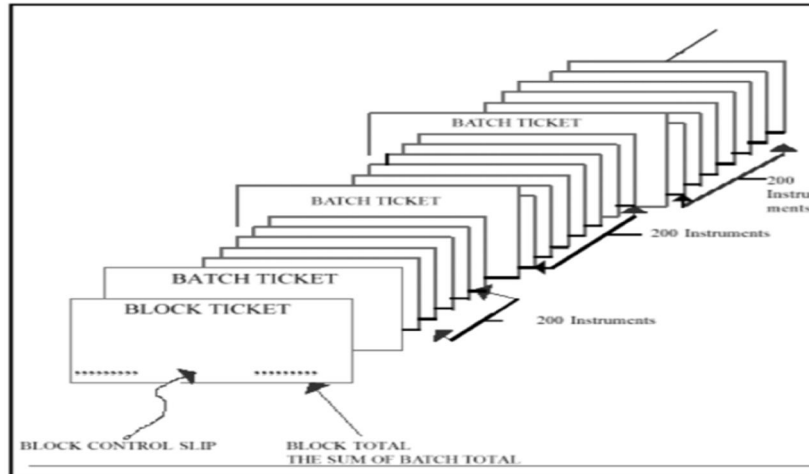
24.03 The Service Branch has the following broad functions:

- a) Receive fully encoded cheques from branches who have encoders.
- b) Provide encoding facility to its branches who do not have the encoding machine.

Note: The encoding procedure will be similar to the procedure followed in the branch with an encoder except that instead of comparing the totals with pay-in slips, the control total indicated in the forwarding schedule will be entered for zero proofing. Discrepancies noticed, if any, should be reconciled with the add list provided by the branch. The total branch presentation (total of Batch Tickets of the branch) should also be tallied with the figures furnished in the Branch Clearing Control Report.

- c) Cross reference each Batch Ticket with the corresponding audit trail by assigning serial number and branch identification.
- d) Add up the Batch Ticket figures and prepare a Block Ticket representing the aggregate claim of the bank as a whole, in respect of the batches and cheques included in the presentation.
- e) Keep the audit trails duly cross referenced at the end, in an envelope.
- f) A chart indicating a representative Block of Outward Clearing sent to the Cheque Processing Centre (CPC) is furnished below:

**CHART INDICATING OUTWARD CLEARING PRESENTATION**



- g) Send the outward clearing to the Cheque Processing Centre through a representative.
- h) Hold the Branch Clearing Control Report for verification of actual credit received from the CPC.

**Income Recognition and verification by auditors**

24.04 Auditor should get the SOP for income accrual at these branches. Basis of income booking should be understood, normally amount is accrued based on number of instruments processed and charges / fees for processing is booked in service / clearing branch and it is debited to the branch for which instruments are processed / decoded. Income recognized needs to be checked by auditor with respective instruments processed.

24.05 Auditor should also examine correspondence with RBI Clearing house and ensure that branches directly dealing with RBI clearing house are following applicable rules, regulations. Auditor should check that RBI account, if any, is reconciled as at year-end. Auditor should also check that Penalty / charges / late fees if any charged by RBI are accounted for by the branch.

**24.06 LFAR Reporting**

- 1. Does the branch has a system of periodic review of the outstanding entries in clearing adjustments accounts? In your view has the system generally been complied with?
  - To obtain note or to review existing SOP followed by the Branch / Bank.

**Guidance Note on Audit of Banks (Revised 2020)**

---

- To check process to review outstanding entries. Whether nature of entries examined and reason assessed. Check action taken to reconcile the unreconciled entries.
- Any MIS/ exceptional report generated from System
- System for reporting of long outstanding entries to Head Office

The auditor should check all relevant documents maintained by the branch and comments on level of compliance by the Branch. In case Branch has not followed the defined process/ system like non-reporting of long outstanding entries etc., the Auditor should make reporting of same.

2. Whether review of the clearing adjustments accounts (inwards/ outwards) reveals any old/ large/ unusual outstanding entries, which remain unexplained? Give year-wise break-up of outstanding entries in number and value:
- To obtain clearing adjustment account and review old entries
  - To obtain ageing of old entries along with nature of such entries.
  - On sample basis, check old entries from system, to ensure correctness of ageing given by the Branch.
  - On sample basis, check origination of old outstanding entries.
  - Check action taken to reconcile the unreconciled entries.

Year-wise break up should be given of outstanding clearing in number and value in the following format:

Inward Clearing	Number Value
Normal Clearing	
High Value	
Inter-Branch Clearings	
National Clearings	
Returned/ Dishonored Clearings	

Outward Clearing	Number Value
Normal Clearing	

**Guidance Note on Audit of Banks (Revised 2020)**

---

High Value
Inter-Branch Clearings
National Clearings
Returned/ Dishonored Clearings

3. Has the Branch strictly followed the guidelines of the controlling authority of the bank with respect to operations related to clearing transactions? Comment on the systems and procedures followed by the Branch in this regard.
- Considering the unique nature of operations of the clearing branch, the Controlling authority (Head Office) normally issues guidelines with respect to operations of clearing transactions. The Auditor should obtain those guidelines from the Branch / controlling office and ensure that the Branch is complying with it.
  - The auditor should carry out walk-through of some sample transactions & check reporting done by the Branch to Head office to understand process followed by the Branch.

# 25

## Recovery of Non-Performing Assets by Asset Recovery Branches

---

### Introduction and Bank's Process

25.01 Banks have designated branches/ department for recovery of Non-Performing Assets. The accounts which are already marked as NPA are transferred from other branches to this branch for centralized monitoring. The responsibility of this branch is to ensure the best resolution/ recovery from these NPA accounts either by recovery or restructuring or realization from liquidation of security. The details of primary and collateral security available with Bank with respect to these NPA accounts are also maintained at this branch.

### Audit approach, procedures including regulatory considerations

25.02 Refer chapter 11 "Reporting for Advances" for guidance on audit of NPA, Provisioning, Restructuring.

25.03 Other critical aspects to be considered by the auditor are as follows:

- The auditor should obtain list of all NPA accounts at the start of the financial Year, Movement during the year and closing NPA Accounts. To ensure that opening and closing balances are matching with respective trial balance.
- The accounts get classified as NPA either due to record of recovery or non-financial indicators like Inherent weakness in account, Non-Achievement of DCCO, Failure to comply with key restructuring conditions, Erosion in value of security etc. It is important to understand reason of NPA for each account.
- To analyse the reason for movement during the year. Key reasons for movement will be as follows:
  - Accounts transferred from other branches to Asset recovery branches during the year or vice-versa.
  - Accounts upgraded during the year – special attention is required for audit of these accounts.
  - Recovery effected during the year.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

- Movement in provision due to change in classification of NPA or change in value of security.
- To check that interest income on NPA is recognized only on actual receipt, Interest accrued earlier and not received should be reversed.
- Recovery - In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner. The appropriate policy to be followed is to recognise income as per AS 9 when certainty is attached to realisation and accordingly amount reversed/derecognised or not recognised in the past should be accounted. Interest partly/fully realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.
- To ensure compliance with the requirements of RBI circular on Prudential Framework for Resolution of Stressed Assets dated June 07, 2019 and the requirements of the Insolvency and Bankruptcy Code, 2016, in case where the Borrower has been referred to IBC.

### **Guidelines on Sale/Purchase of NPAs**

25.04 The Master Circular on Advances requires the Board of Directors of banks to lay down policy in respect of the aspects relating to sale/ purchase of NPAs, including:

- (a) Non-performing financial assets that may be purchased/ sold;
- (b) Norms and procedure for purchase/ sale of such financial assets;
- (c) Valuation procedure to be followed to ensure that the economic value of financial assets is reasonably estimated based on the estimated cash flows arising out of repayments and recovery prospects;
- (d) Delegation of powers of various functionaries for taking decision on the purchase/ sale of the financial assets etc.; and
- (e) Accounting policy.

25.05 RBI also casts a responsibility on the Board to satisfy itself that the bank has adequate skills to purchase non-performing financial assets and deal with them in an efficient manner which will result in value addition to the bank.

25.06 Banks should, while selling NPAs, work out the net present value of the

estimated cash flows associated with the realisable value of the available securities net of the cost of realisation. The sale price should generally not be lower than the net present value so arrived.

25.07 The estimated cash flows are normally expected to be realised within a period of three years and at least 10% of the estimated cash flows should be realised in the first year and at least 5% in each half year thereafter, subject to full recovery within three years.

25.08 A bank may purchase/sell non-performing financial assets from/to other banks only on 'without recourse' basis, i.e., the entire credit risk associated with the non-performing financial assets should be transferred to the purchasing bank. Selling bank shall ensure that the effect of the sale of the financial assets should be such that the asset is taken off the books of the bank and after the sale there should not be any known liability devolving on the selling bank.

25.09 Banks should ensure that subsequent to sale of the non-performing financial assets to other banks, they do not have any involvement with reference to assets sold and do not assume operational, legal or any other type of risks relating to the financial assets sold. Consequently, the specific financial asset should not enjoy the support of credit enhancements / liquidity facilities in any form or manner.

25.10 Under no circumstances can a sale to other banks be made at a contingent price whereby in the event of shortfall in the realisation by the purchasing banks, the selling banks would have to bear a part of the shortfall. Further, NPAs can be sold to other banks only on cash basis. The entire sale consideration should be received upfront and the asset can be taken out of the books of the selling bank only on receipt of the entire sale consideration.

25.11 A non-performing financial asset should be held by the purchasing bank in its books at least for a period of 15 months before it is sold to other banks. Banks should not sell such assets back to the bank, which had sold the NPA.

25.12 Banks are also permitted to sell/buy homogeneous pool within retail non-performing financial assets, on a portfolio basis provided each of the non-performing financial assets of the pool has remained as non-performing financial asset for at least 2 years in the books of the selling bank. The pool of assets would be treated as a single asset in the books of the purchasing bank.

25.13 The selling bank should pursue the staff accountability aspects as per the existing instructions in respect of the non-performing assets sold to other banks.

25.14 Prudential norms for banks for the purchase/sale transactions issued by RBI, from time to time, should be adhered to.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

As per the Master Circular on Prudential Norms on Advances dated July 1, 2015, if the sale is in respect of Standard Asset and the sale consideration is higher than the book value, the excess provisions may be credited to Profit and Loss Account. Excess provisions which arise on sale of NPAs can be admitted as Tier II capital subject to the overall ceiling of 1.25% of total Risk Weighted Assets. Accordingly, these excess provisions that arise on sale of NPAs would be eligible for Tier II status.

### **Asset Classification Norms for sale/purchase of NPA**

25.15 The asset classification norms for sale/purchase of NPAs are as follows:

- (i) The non-performing financial asset purchased, may be classified as 'standard' in the books of the purchasing bank for a period of 90 days from the date of purchase. Thereafter, the asset classification status of the financial asset purchased, shall be determined by the record of recovery in the books of the purchasing bank with reference to cash flows estimated while purchasing the asset which should be in compliance with requirements as discussed in preceding paragraphs.
- (ii) The asset classification status of an existing exposure (other than purchased financial asset) to the same obligor in the books of the purchasing bank will continue to be governed by the record of recovery of that exposure and hence may be different.
- (iii) Where the purchase/sale does not satisfy any of the prudential requirements prescribed in these guidelines the asset classification status of the financial asset in the books of the purchasing bank at the time of purchase shall be the same as in the books of the selling bank. Thereafter, the asset classification status will continue to be determined with reference to the date of NPA in the selling bank.
- (iv) Any restructure/reschedule/rephrase of the repayment schedule or the estimated cash flow of the non-performing financial asset by the purchasing bank shall render the account as a non-performing asset.

### **Provisioning Norms**

#### ***Books of Selling Bank***

25.16 The provisioning norms for books of selling bank are as under:

- (i) When a bank sells its non-performing financial assets to other banks, the same will be removed from its books on transfer.
- (ii) If the sale is at a price below the net book value (NBV) (i.e., book value



less provisions held), the shortfall should be debited to the profit and loss account of that year.

- (iii) If the sale is for a value higher than the NBV, the excess provision shall not be reversed but will be utilised to meet the shortfall/ loss on account of sale of other non-performing financial assets.

### ***Books of Purchasing Bank***

25.17 The provisioning norms for books of purchasing bank are as under:

The asset shall attract provisioning requirement appropriate to its asset classification status in the books of the purchasing bank.

### **Accounting of Recoveries**

25.18 Any recovery in respect of a non-performing asset purchased from other banks should first be adjusted against its acquisition cost. Recoveries in excess of the acquisition cost can be recognised as profit.

### **Capital Adequacy**

25.19 For the purpose of capital adequacy, banks should assign 100% risk weights to the non-performing financial assets purchased from other banks. In case the non-performing asset purchased is an investment, then it would attract capital charge for market risks also.

### **Exposure Norms**

25.20 The purchasing bank will reckon exposure on the obligor of the specific financial asset. Hence these banks should ensure compliance with the prudential credit exposure ceilings (both single and group) after reckoning the exposures to the obligors arising on account of the purchase.

### **Disclosure Requirements**

25.21 Banks which purchase non-performing financial assets from 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: (Amounts in Rupees crore)
1. (a) No. of accounts purchased during the year.  
(b) Aggregate outstanding.
  2. (a) Of these, number of accounts restructured during the year.  
(b) Aggregate outstanding.

### **Guidance Note on Audit of Banks (Revised 2020)**

---

- B. Details of non-performing financial assets sold: (Amounts in Rupees crore)
1. No. of accounts sold.
  2. Aggregate outstanding.
  3. Aggregate consideration received.
  4. Additional consideration realized in respect of accounts transferred in earlier years.
  5. Aggregate gain / loss over net book value.
- C. Details of Book Value of investments in Security receipts: (Amounts in Rupees crore)
1. Book Value of investments in Security receipts - Backed by NPA's sold by bank as underlying.
  2. Book Value of investments in Security receipts – Backed by NPA's sold by other banks / financial institutions/ non – banking financial companies as underlying.
  3. Totals of above.

The purchasing bank shall furnish all relevant reports to RBI, Credit Information Company which has obtained Certificate of Registration from RBI and of which the bank is a member etc. in respect of the non-performing financial assets purchased by it.

#### **Sale/ Purchase of NPAs**

25.22 In case of a sale/ purchase of NPAs by the bank, the auditor should examine the policy laid down by the Board of Directors in this regard relating to procedures, valuation and delegation of powers.

25.23 The auditor should also examine that:

- (i) only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years.
- (ii) the assets have been sold/ purchased “without recourse’ only.
- (iii) subsequent to the sale of the NPA, the bank does not assume any legal, operational or any other type of risk relating to the sold NPAs.
- (iv) the NPA has been sold at cash basis only.
- (v) the bank has not purchased an NPA which it had originally sold.

25.24 In case of sale of an NPA, the auditor should also examine that:

- (i) on the sale of the NPA, the same has been removed from the books of the account.
- (ii) the short fall in the net book value (NBV) has been charged to the profit and loss account.
- (iii) where the sale is for a value higher than the NBV, no profit is recognised and the excess provision has not been reversed but retained to meet the shortfall/ loss on account of sale of other non-performing financial assets.

25.25 Similarly, in case of purchase of NPAs, the auditor should verify that:

- (i) the NPA purchased has been subjected to the provisioning requirements appropriate to the classification status in the books of the selling bank.
- (ii) any recovery in respect of an NPA purchased from other banks is first adjusted against its acquisition cost and only the recovered amount in excess of the acquisition cost has been recognised as profit.
- (iii) for the purpose of capital adequacy, bank has assigned 100% risk weights to the NPAs purchased from other banks.

#### **25.26 LFAR Reporting**

1. In respect of borrowers with outstanding of Rs. 10.00 Crores and above the information should be obtained from the Branch Management. Comments of the Branch Auditor on advances with significant adverse features and which might need the attention of the management / Statutory Central Auditors should be appended to the Long Form Audit Report.
  - To obtain list and information of borrowers having outstanding of Rs.10.00 Crores and above
  - To review movement during the year in those accounts
  - The branch auditors should review each account and give comments on adverse features, if any in accounts.
  - The comments of branch auditors will be either account specific or observations on system which may have impact on bank as whole. Auditor should highlight nature of each comments for proper action to be taken by the management / Statutory Central Auditors
  - The reporting in LFAR is not substitute for qualification or modification in audit report. Hence if the observation of auditors warrants qualification in audit report, the auditor should make reporting of same in main report.

**Guidance Note on Audit of Banks (Revised 2020)**

- If the observation of auditor is having impact on financial numbers like short provisioning, error in valuation of securities etc, the auditor should get same rectified by suggesting appropriate MOC for same.
2. List the accounts with outstandings in excess of Rs. 10.00 Crores, which have been upgraded from Non-Performing to Standard during the year and the reasons therefore.

Sr. No.	Name of the Unit / Account	Outstanding [Rs. In lacs]	IRAC Status as on 31st March [Last Year]	IRAC Status as on 31st March [Current Year]	Reasons
1					
2					
3					
4					
5					

- To obtain list of all upgrade accounts during the year. In Some cases, once the accounts are upgraded same are being transferred to other branches hence may not appear in closing balances of this branch.
  - To analyse the reason of upgrade and link same with reason for classifying an account as NPA.
  - To check entries for recovery in core banking system to ensure there is full recovery of all dues before upgrade of account.
3. Whether the Branch has a system of updating periodically, the information relating to the valuation of security charged to the Bank?
- To obtain details of security charged to the bank against all NPA accounts.
  - To understand and review process of updating value of security in the system.
  - The branch auditor should enquire as to the existence of the system, if any, pertaining to the valuation of security charged to the bank. If the system is in existence, the auditor should examine whether the system periodically updates the information pertaining to the value of such security and takes necessary steps for increase/diminution in the value of such security.

**Guidance Note on Audit of Banks (Revised 2020)**

---

4. Age-wise analysis of the recovery suits filed and pending may be furnished, along with latest status thereof.

Year	No. of Accounts	Amount [Rs. In lacs]
Upto March 2015		
2015-16		
2016-17		
2017-18		
2018-19		
2019-20		

- To obtain list of all recovery suits filed and pending as at reporting date
  - To give details of age-wise details of recovery suits
5. Is the Branch prompt in ensuring execution of decrees obtained for recovery from the defaulting borrowers? Also list the time barred decrees, if any, and reasons therefor. Give age-wise analysis of decrees obtained and not executed.
- In case decrees have been obtained for recovery from the defaulting borrowers, the auditor should check whether the branch is prompt in execution of decrees like, drawings from the account and payment from these accounts have been stopped. If not, the same should be reported. The list should be given in the case of time barred decrees with the reasons therefor.
6. List the recoveries and their appropriation against the interest and the principal and the accounts settled / written off / closed during the year as per the bank's policy. Give particulars of recoveries which are pending for appropriation as on year-end with reasons therefor.
- A list will have to be annexed which will specify the non-performing advances recovered and the amounts adjusted towards interest and principal. A list of the accounts settled, written off or closed, if any, will also have to be attached. The auditor should satisfy himself whether the recoveries appropriated against interest are in accordance with the RBI guidelines and normal accounting principles.
7. List the new borrower accounts transferred to the Branch during the year. Have all the relevant documents and records relating to these borrower

#### **Guidance Note on Audit of Banks (Revised 2020)**

---

accounts been transferred to the Branch? Has the Branch obtained confirmation that all the accounts of the borrower [including non-fund-based exposures and deposits pending adjustment / margin deposits] been transferred to the Branch?

- A list of new borrower accounts transferred to the branch from the other branches during the year should be annexed. The auditor should verify whether the documents and records relating to the transferred accounts have been obtained like, letter from the transferor branch, detail of the accounts, etc. The branch should also obtain a confirmation that all the accounts of the borrower (including non-fund based exposures and deposits pending adjustment/ margin deposits) have been transferred to the branch. In case any adverse features have been observed in such transfer, the same should be reported.

# 26

## Bank Branch Audit and GST Compliance

---

26.01 GST, a paradigm shift from origin based to destination-based tax in indirect tax regime was implemented in India from 1<sup>st</sup> July 2017.

Article 366(12A) of the Constitution of India provides that, "**Goods and Services Tax**" means any tax on supply of goods, or services or both except taxes on the supply of the alcoholic liquor for human consumption.

India adopted Dual GST model in view of the federal structure of the country. Here, Centre and States simultaneously levy GST on taxable supply of goods or services or both which, takes place within a State or Union Territory. The Centre also has the power to tax intra-State sales & States are also empowered to tax services.

### Extent of GST

26.02 GST in India comprises of:

- (A) **Central Goods and Services Tax Act, 2017** ("the CGST Act") which extends to the whole of India.

Where, in terms of Section 2(56) of CGST Act-

*"India" means the territory of India as referred to in article 1 of the Constitution, its territorial waters, seabed and sub-soil underlying such waters, continental shelf, exclusive economic zone or any other maritime zone as referred to in the Territorial Waters, Continental Shelf, Exclusive Economic Zone and other Maritime Zones Act, 1976, and the air space above its territory and territorial waters*

Central Goods and Service Tax (CGST) is levied on all intra-State supplies of taxable goods and/or services and collected by the Central Government.

- (B) **State Goods and Services Tax Act, 2017** ("the SGST Act") is levied and collected by the State Government/ Union Territory with State Legislatures. The SGST Act of the respective State/Union Territory with State Legislature [Delhi and Pondicherry]\*\* extends to whole of that respective State/Union Territory.

*\*\*State: includes a Union territory with Legislature [Section 2(103) of CGST Act].*

- (C) **Union Territory Goods and Services Tax Act, 2017** (“the UTGST Act”) extends to the Union territories of the Andaman and Nicobar Islands, Lakshadweep, Dadra and Nagar Haveli, Daman and Diu, Chandigarh and other territory, i.e. the Union Territories without State Legislature [Section 1 of the UTGST Act]. UGST is levied and collected by Central Government through appointed administrator.
- (D) **Integrated Goods and Services Tax Act, 2017** (“the IGST Act”) extends to the whole of India. IGST is levied on all inter-State supplies of goods or services or both (except alcoholic liquor for human consumption) at a rate recommended by the GST Council (not exceeding 40%). It is collected by Central Government.

Apart from above Acts there is one more Act under GST namely “The Goods and Services (Compensation to States) Act 2017”. This Act was introduced to provide for compensation to the States for the loss of VAT revenue, if any arising on account of implementation of GST. This tax is levied on a few supplies at present. It is provided that such levy will be collected for five years but this period can be extended on recommendation of the GST Council.

NOTE: It is pertinent to mention here that, GST extends to whole of India including the State of Jammu and Kashmir. Though, GST was implemented in the State of Jammu and Kashmir from 8<sup>th</sup> July, 2017 *vide* the Central Goods and Services Tax (Extension to Jammu and Kashmir) Ordinance, 2017 and the Integrated Goods and Services Tax (Extension to Jammu and Kashmir) Ordinance, 2017 extending the domain of Central GST Act and the Integrated GST Act to the State of Jammu and Kashmir.

26.03 Now with advent of Jammu and Kashmir Reorganisation Act, 2019, from 31<sup>st</sup> October, 2019, State of Jammu and Kashmir has been re-constituted into two union territories:

- Jammu and Kashmir (Union territory of Jammu and Kashmir with Legislature) and
- Ladakh (Union territory of Ladakh without Legislature) *vide* Jammu and Kashmir Reorganisation Act 2019.

26.04 In this regard, Ministry of Home Affairs (Department of Jammu and Kashmir Affairs) issued Jammu and Kashmir Reorganisation (Removal of Difficulties) Order, 2019 which *inter alia* stipulates that-

- the Jammu and Kashmir Goods and Services Tax Act, 2017 shall be applicable to the Union Territory of J&K; and
- the Union Territory Goods and Services Tax Act, 2017 shall be applicable to the Union Territory of Ladakh.



### **Guidance Note on Audit of Banks (Revised 2020)**

---

26.05 In this regard, CBIC vide Notification no. 62/2019 dated 26-11-2019 has notified transition plan with respect to J&K reorganization w.e.f. 31.10.2019 to be followed till 31.12.2019. Persons whose principal place of business was in J&K till 30-10-2019 and continues to be so in either of the Union Territories (UTs) from 31-10-2019:

- The October 2019 tax period will be from 1<sup>st</sup> to 30<sup>th</sup> October 2019 and for November 2019 tax period it will from 31<sup>st</sup> October till 30<sup>th</sup> November 2019.
- The tax to be declared and paid through GSTR-3B shall be irrespective of the tax amounts shown in the invoices raised between 31 -10- 2019 to 31-12-2019. This implies that any adjustments can be allowed in GSTR-3B.
- Such taxpayers are allowed to transfer the input tax credit available under GSTIN registered under the erstwhile State of J&K to the new GSTIN now logged in either of two UTs, subject to following conditions:
  - The taxpayers must inform of the transfer to the jurisdictional officers of both the erstwhile State of J&K as well as newly formed UTs as may be applicable.
  - proportion of transfer must be based on the ratio of the turnover earned in each of the UTs.
  - the transfer must be indicated by filing in the GSTR-3B of any tax period transition date, debiting ITC in the transferor's electronic credit ledger [Table 4 (B) (2)] and crediting the transferee's electronic credit ledger [Table 4 (B) (5)].
- The State taxes will be converted to Union territory taxes from 31-10-2019. All such taxpayers are relieved from compulsory registration if they make interstate supplies till 31-12-2019.

26.06 However, there is ambiguity with regard to fresh registration for the taxpayer who were registered in the state of Jammu & Kashmir before the reorganization Act and having additional place of registration in the state of Ladakh UT (Formed after reorganization). In respect of such taxpayers, no clarity has been provided by the government as the till date neither such taxpayers have been automatically provided the fresh GSTN or nor any mechanism has been provided mechanism for obtaining the fresh registration to the taxpayer who have premises in the UT of Ladakh. For the existing taxpayers registered under J & K State earlier with State code(01), having Principal Place of Business in jurisdiction of Union territory of Ladakh then such taxpayer has been allotted the New GSTN no with (with UT code "38"). In respect of such taxpayers, instruction have been issued that they are requested to use new GSTINs while generating the invoices and receiving of supplies etc. w.e.f. 1<sup>st</sup> Jan 2020.

### **Levy**

26.07 In terms of charging section 9(1) of the CGST Act/ Section 5(1) of the IGST Act, the Central goods and services tax (CGST)/ Integrated goods and services tax (IGST) shall be levied on all intra-State/ inter State supplies of goods or services or both, except on the supply of alcoholic liquor for human consumption, on the value determined under section 15 and at such rates, not exceeding 20 %, as may be notified by the Government on the recommendations of the Council and collected in such manner as may be prescribed and shall be paid by the taxable person.

As inferred from above, the taxable event under GST is a “**Supply**”.

26.08 Where, the term Supply as per Section 7(1) of the CGST Act includes -

- (a) all forms of supply of goods or services or both such as sale, transfer, barter, exchange, licence, rental, lease or disposal made or agreed to be made for a consideration by a person in the course or furtherance of business;
- (b) import of services for a consideration whether or not in the course or furtherance of business; and
- (c) the activities specified in Schedule I, made or agreed to be made without a consideration.

26.09 Further, Section 7(1A) of the CGST Act stipulates that, certain activities or transactions which constitute supply as per Section 7(1), to be treated as supply of goods or supply of services as referred to in Schedule II.

26.10 Section 7 (2) of the CGST Act, states that notwithstanding anything contained in section 7(1):

- (a) activities or transactions specified in Schedule III; or
- (b) such activities or transactions undertaken by the Central Government, a State Government or any local authority in which they are engaged as public authorities, as may be notified by the Government on the recommendations of the Council;

shall be treated neither as a supply of goods nor a supply of services.

26.11 Section 7(3) provides that the Government may, on the recommendations of the Council, specify, by notification, the transactions that are to be treated as:

- (a) a supply of goods and not as a supply of services; or
- (b) a supply of services and not as a supply of goods.

26.12 Hence, following parameters, can be adopted to characterize a transaction as supply:

1. Supply of goods or services. Supply of anything other than goods or services does not attract GST.
2. Supply should be made for a consideration.
3. Supply should be made in the course or furtherance of business.
4. Supply should be made by a taxable person.
5. Supply should be a taxable supply.

26.13 While aforesaid parameters describe the concept of supply, there are a few exceptions to the requirement of supply being made for a consideration and in the course or furtherance of business. Any transaction involving supply of goods or services without consideration is not a supply, barring few exceptions, in which a transaction is deemed to be a supply even without consideration. Further import of services for a consideration, whether or not in the course or furtherance of business is treated as supply.

26.14 Supply may be **composite supply** or **mixed supply**. Composite supply means a supply made by a taxable person to a recipient consisting of two or more taxable supplies of goods or services or both, or any combination thereof, which are naturally bundled and supplied in conjunction with each other in the ordinary course of business, one of which is a principal supply. While, "mixed supply" means two or more individual supplies of goods or services, or any combination thereof, made in conjunction with each other by a taxable person for a single price where such supply does not constitute a composite supply. The tax liability on a composite or a mixed supply shall be determined in the following manner, namely:

- a) a composite supply comprising two or more supplies, one of which is a principal supply, shall be treated as a supply of such principal supply; and
- b) a mixed supply comprising two or more supplies shall be treated as a supply of that particular supply which attracts the highest rate of tax.

26.15 At this juncture, after understanding the term supply, it is of paramount importance to know what goods or services under GST is:

Section 2(52) of the CGST Act defines goods as:

*"goods" means every kind of movable property other than money and securities but includes actionable claim, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before supply or under a contract of supply.*

## Guidance Note on Audit of Banks (Revised 2020)

---

Section 2(102) of the CGST Act defines Services as:

*“services” means anything other than goods, money and securities but includes activities relating to the use of money or its conversion by cash or by any other mode, from one form, currency or denomination, to another form, currency or denomination for which a separate consideration is charged.*

26.16 Now since money and securities both are excluded from definition of goods and services, it is imperative to understand these terms under GST:

As per Section 2(75) of the CGST Act:

*“money” means the Indian legal tender or any foreign currency, cheque, promissory note, bill of exchange, letter of credit, draft, pay order, traveller cheque, money order, postal or electronic remittance or any other instrument recognised by the Reserve Bank of India when used as a consideration to settle an obligation or exchange with Indian legal tender of another denomination but shall not include any currency that is held for its numismatic value*

Section 2(101) of the CGST Act defines:

*“securities” shall have the same meaning as assigned to it in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956.*

Where, section 2 of the Securities Contracts (Regulation) Act, 1956 defines “securities” include—

- (i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;
- (ia) derivative;
- (ib) units or any other instrument issued by any collective investment scheme to the investors in such schemes;
- (ic) security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;
- (id) units or any other such instrument issued to the investors under any mutual fund scheme;
- (ii) Government securities;
- (iia) such other instruments as may be declared by the Central Government to be securities; and

**Guidance Note on Audit of Banks (Revised 2020)**

(iii) rights or interest in securities;

26.17 Further, from definition of securities, GST applicability on certain transactions can be analyzed:

<b>Sr. No.</b>	<b>Nature</b>	<b>Applicability of GST</b>
1	Shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;	Specifically covered in definition of Security, hence no GST.
2	units or any other instrument issued by any collective investment scheme to the investors in such schemes;	Specifically covered in definition of Security, hence no GST.
3	Security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;	Specifically covered in definition of Security, hence no GST.
4	Units or any other such instrument issued to the investors under any mutual fund scheme;	Specifically covered in definition of Security, hence no GST.
5	Government securities;	Specifically covered in definition of Security, hence no GST.
6	Forward Contract in Currencies - Actual delivery of underlying currency	It is not covered in definition of securities, hence would be treated as normal supply of goods and liable to GST (Commission portion).
7	Forward Contract in Currencies - Where the settlement takes place by way of net settlement of differential of the forward rate over the prevailing market rate on the settlement date	These are derivative transaction and is covered in definition of securities, hence no GST

**Guidance Note on Audit of Banks (Revised 2020)**

8	Future Contracts	It is financial derivative and falls within the definition of securities, hence not liable to GST. Commission and documentation charges will be liable for GST.
---	------------------	---

26.18 Therefore, no GST will be levied on activities and transactions covered in the definition of money and securities.

26.19 As evident from above, GST is applicable on Banking services as far as it qualifies the taxable event i.e. Supply of Services. However, following Supplies made without consideration as specified in Schedule I of the CGST Act, 2017 are subject to GST:

- Permanent transfer or disposal of business assets where input tax credit has been availed on such assets.
- Inter Unit Supply: Supply of goods/ services or both between related persons or between distinct persons as specified in section 25, when made in the course or furtherance of business.

Therefore, any supply of goods or services or both supplied or received by one branch bank to another or by Head office bank to branch bank or *vice versa* without consideration, shall be considered as supply under GST for payment of tax.

- Activity performed by employer to employee without consideration will be taxable under GST, except where the value such supply does not exceed Rs. 50,000 in a financial year.

Although no consideration is involved here, payment of tax needs to done on value determined in terms of section 15 of the CGST Act read with Rule 28 of the CGST Rules.

Kindly note that, since such transactions are generally not captured in books of accounts therefore, auditor should apply substantial audit procedure to check compliances.

26.20 GST is applicable on all services provided by the banks except followings:

- Services by the Reserve Bank of India;

Kindly note services provided by Bank to RBI are exigible to GST Services provided by the banks to Reserve Bank of India/ United

Nations, etc. are taxable as these are not specifically exempted or excluded from GST.

Services by way of—

- (i) extending deposits, loans or advances in so far as the consideration is represented by way of interest or discount (other than interest involved in credit card services);
- (ii) *inter se* sale or purchase of foreign currency amongst banks or authorised dealers of foreign exchange or amongst banks and such dealers.

*Where-*

*(zk) "interest" means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) but does not include any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized;*

- Services provided by a banking company to Basic Saving Bank Deposit (BSBD) account holders under Pradhan Mantri Jan Dhan Yojana (PMJDY). *[inserted w.e.f. 01-01-2019 vide Notification No. 28/2018-Central Tax (Rate), dated 31-12-2018 in CGST and vide Notification No. 29/2018-Integrated Tax (Rate), dated 31-12-2018 in IGST.]*
- Services by an acquiring bank, to any person in relation to settlement of an amount upto Rs. 2,000 in a single transaction transacted through credit card, debit card, charge card or other payment card service.

Explanation. — For the purposes of this entry, "*acquiring bank*" means any banking company, financial institution including non-banking financial company or any other person, who makes the payment to any person who accepts such card.

- Services supplied by Central Government, State Government, Union territory to their undertakings or Public Sector Undertakings (PSUs) by way of guaranteeing the loans taken by such undertakings or PSUs from the banking companies and financial institutions. *[Initially this exemption was inserted w.e.f. 27-07-2018 vide Notification No. 14/2018-Central Tax (Rate), dated 26-07-2018 in CGST and vide Notification No. 15/2018-Integrated Tax (Rate), dated 26-07-2018 in IGST. Later, the words "banking companies and" were inserted w.e.f. 01-01-2019 vide Notification No. 28/2018-Central Tax (Rate), dated 31-12-2018 in CGST and vide Notification No. 29/2018-Integrated Tax (Rate), dt.31-12-2018.]*

### Guidance Note on Audit of Banks (Revised 2020)

---

- Services by way of collection of contribution under the Atal Pension Yojana.
- Services by way of collection of contribution under any pension scheme of the State Governments.
- Services by the following persons in respective capacities:
  - (a) business facilitator or a business correspondent to a banking company with respect to accounts in its rural area branch;
  - (b) any person as an intermediary to a business facilitator or a business correspondent with respect to services mentioned in entry (a); or
  - (c) business facilitator or a business correspondent to an insurance company in a rural area.
- Services by an intermediary of financial services located in a multi services SEZ with International Financial Services Centre (IFSC) status to a customer located outside India for international financial services in currencies other than Indian rupees (INR).

Where-

The intermediary of financial services in IFSC is a person,-

- (i) who is permitted or recognised as such by the Government of India or any Regulator appointed for regulation of IFSC; or
- (ii) who is treated as a person resident outside India under the Foreign Exchange Management (International Financial Services Centre) Regulations, 2015; or
- (iii) who is registered under the Insurance Regulatory and Development Authority of India (international Financial Service Centre) Guidelines, 2015 as IFSC Insurance Office; or
- (iv) who is permitted as such by Securities and Exchange Board of India (SEBI) under the Securities and Exchange Board of India (International Financial Services Centres) Guidelines, 2015.

*[inserted w.e.f. 25-01-2018 vide Notification No. 2/2018-Central Tax (Rate), dated 25-01-2018 in CGST and vide Notification No. 2/2018-Integrated Tax (Rate), dated 25-01-2018 in IGST]*

- Services provided to the Central Government, State Government, Union



territory under any insurance scheme for which total premium is paid by the Central Government, State Government and Union territory.

The intra/ inter-state supply of above services has been specifically exempted *vide Notification No. 12/2017- Central Tax (Rate) dated 28<sup>th</sup> June, 2017*["Notification No. 12/2017"] and *Notification No. 09/2017-Integrated Tax (Rate) dated 28-6-2017*["Notification No. 9/2017-ITR"] as amended from time to time.

26.21 Further, relevant additional exemption under IGST are:

- services are received by RBI from outside India in relation to management of foreign reserves. [*Notification No. 9/2017-ITR*]
- services imported by a unit or a developer in the Special Economic Zone for authorised operations [*Notification No. 18/2017-Integrated Tax (Rate) dated 5-7-2017*]

26.22 Services provided by Asian Development Bank (ADB) and International Finance Corporation (IFC) are exempt from GST as clarified by CBIC vide Circular No. 83/02/2019-GST, dated 1-1-2019 read with C.B.I. & C. Circular No. 211/1/2019-S.T., dated 15-1-2019.

26.23 The ADB Act, 1966 provides that notwithstanding anything to the contrary contained in any other law, the Bank, its assets, properties, income and its operations and transactions shall be exempt from all the taxation and from all customs duties. The Bank shall also be exempt from any obligation for payment, withholding or collection of any tax or duty [Section 5 (1) of the ADB Act, 1966 read with Article 56 (1) of the schedule thereto refers]. *Vide letter No. 1/28/2002-ADB dated 22-01-2004* to ADB, it is conveyed that services provided by ADB are exempted from service tax.

26.24 Similarly, IFC Act, 1958 also provides that notwithstanding anything to the contrary contained in any other law, the Corporation, its assets, properties, income and its operations and transactions authorised by the Agreement, shall be immune from all taxation and from all customs duties. The Corporation shall also be immune from liability for the collection or payment of any tax or duty [Section 3 (1) of IFC Act, 1958 read with Article VI, Section 9 (a) of the Schedule thereto refers].

26.25 CESTAT Mumbai *vide* final order dated 17-10-2016 in the case of M/s Coastal Gujarat Power Ltd. has held that when the enactments that honour international agreements specifically immunize the operations of the service provider from taxability, a law contrary to that in the form of Section 66A of Finance Act, 1994 will not prevail. With the provider being not only immune

## Guidance Note on Audit of Banks (Revised 2020)

from taxation but also absolved of any obligation to collect and deposit any tax, there is no scope for subjecting the recipient to tax. There is no need for a separate exemption and existing laws enacted by the sovereign legislature of the Union suffice for the purpose of giving effect to Agreements.

26.26 Accordingly, it is clarified that the services provided by IFC and ADB are exempt from GST in terms of provisions of IFC Act, 1958 and ADB Act. The exemption will be available only to the services provided by ADB and IFC and not to any entity appointed by or working on behalf of ADB or IFC.

### Income Earned by Banks

26.27 Albeit interest income forms the major part of the incomes of bank but due to globalisation banking sector has involved themselves into numerous activities resulting into variety of incomes. So let us analyze the applicability of GST on various income so earned by banks:

- 1) **Interest income** - The income earned by way of grant of loans, deposits etc., is a taxable supply. However, by virtue of entry 27(a) of Notification No. 12/2017 and entry 28(a) of Notification No. 12/2017-ITR, no GST is payable on income earned by way of interest **except interest income earned through credit card**. The relevant extract of the said entry is as under:

Sl No.	Chapter, Section, Heading, Group or Service Code (Tariff)	Description of services	Rate (%)	Condition
27	Heading 9971	(a) Services by way of— (a) extending deposits, loans or advances in so far as the consideration is represented by way of interest or discount <b><u>(other than interest involved in credit card services)</u></b> ;	NIL	NIL

*Para 2 clause (zk) of Notification No. 12/2017 clarifies that interest does not include any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilised.*

Therefore, audit from the perspective of GST into the same may be restricted to the fundamental question as to whether the income is rightly characterized as 'interest' to enjoy the exemption under GST and especially the income earned from credit card services as it is taxable under GST

- 2) **Commission income** – Such income is classified as a supply of service transaction and accordingly would be classified in terms of chapter heading as specified in the relevant notifications issued under GST.

Commission earned (on accrual) is liable to GST. For e.g.: M/s. A Ltd. wants to invest in fixed securities / bonds which can be only routed through ICICI bank as they have exclusive rights for subscribing the same. ICICI bank gets 2% commission on the amounts so subscribed. For the period 2018-19, the bank earns ` 250 crores of commission from such subscription which is recorded as 'Other Income'. The auditor has to check

- Whether GST is appropriately disbursed on the said amount.
- Whether payments are made by complying with the due date for payment of GST.

If the tax is not discharge, then appropriate disclosure would be required

- Verify returns filed reveals the correct amount of liability. Discrepancy in the returns filed (after any revision) and liability as determined may be disclosed.
- Interest being mandatory may be suitably included in the disclosure.
- Suitable disclosure as to whether any contingency exists in respect of applicable penalty may also be provided.

Further, review of agreements where commission is earned must be carried out thoroughly and if any milestone incentives, performance bonus, time bonus etc., is provided then appropriate tax treatment should be suggested.

- 3) **Brokerage income**-The instant income is classified as a supply of service transaction and accordingly would be classified in terms of chapter heading as specified in the relevant notifications issued under GST.

- 4) **Agency charges** -Generally, such income is earned by way of being appointed as an agency either by RBI, State Governments, Central

Governments or by some corporates. Under such arrangements, banks act as a facilitator/collection centre and in lieu of provision of such services such banks collect certain fees as "Agency charges". Such charges are liable for payment of GST. Very often, the underlying arrangement will be of agency, but it may be described in a contemporary terminology like 'enablement charge' or 'facilitation fee' or simple 'management fee' which may appear misleading.

The auditor needs to analyse the relevant agreements entered and has to study the flow of consideration and its nature and thereafter decide taxability and the amount on which GST is applicable. The same has to be communicated to the management if no GST is being paid till date.

- 5) **Portfolio management service:** Generally, the said services are being provided by different entities within the banking sector. Due to stiff competition and one-stop window for priority customer's (i.e. customers who are depositing amount beyond a certain limits) only one person provides all such services and thereafter relevant commissions are split between entities or costs are shared. In fact, inter-branch sharing of portfolio management services in lieu of the skill set available in selected branches between different states is taxable and a fair value has to assigned to such transaction and applicable GST is payable on such transaction. Further, appropriate classification has to be made for such supply of services under relevant chapter heading as per the notifications issued under GST.
- 6) **Account maintenance charges:** It is a common practice that in most of the banks certain charges are recovered towards maintenance. The said charges are nominal but the same is liable for payment of GST. Accordingly, the concerned concurrent /internal /statutory auditor would have to check on this aspect of taxability and ensure compliance.
- Further, even locker charges are being recovered from the customers on an annual basis which is liable for payment of GST. There can be different modes of arrangement for availing such income, but such income is taxable under GST.
- 7) **Credit/Debit card charges-** Income earned by way of issuing and maintaining such transactions were liable for payment of GST. Therefore, auditor should carefully examine such transactions and appropriate disclosures be made in case of non- compliance with relevant tax provisions.

*Q. Whether GST will be levied on **interchange fees on card settlement fees paid/shared by banks?***

*Ans. Fees charged for card settlement is a consideration which is part of a separate transaction between the banks which are parties to this transaction and shall be liable to GST. This is a B2B supply and credit of this transaction is available.*

- 8) Digital payment facilities-** Banks charges some convenience fees from the person who accepts payment through debit card, credit card or through other some other card service. The charges earned by the bank are chargeable under GST. And no GST will be payable in respect to services provided by bank, to any person in relation to settlement of an amount up to ` 2000 in a single transaction transacted through credit card, debit card or charge card or other payment card service.
- 9) Sale and purchase of foreign currency:** Banking companies receiving consideration for providing services by way of securities and foreign exchange broking and purchase or sale of foreign currency, including money changing is chargeable to GST on special value calculated as per option availed in terms of Rule 32 of CGST Rules, 2017.

However, pursuant to entry no. 27(b) of Notification No. 12/2017 and entry no.28(b) of Notification no 9/2017-ITR, inter-bank transactions of sale or purchase of foreign currency or transactions with authorized dealers of money changing are exempted under GST regime.

**10) Other income-**

- Income earned by banks by way of penalties, retention charges etc are liable for payment of GST.
- Realisation of payment (NPA) by way of disposal of NPA to an asset reconstruction company [ARC] or to any other buyer is a debatable issue. There is variant view to the aforesaid transaction and the taxability will depends upon the structuring of the transaction. One view is that this transaction may be considered as actionable claim and GST will also not apply as definition of supply [Clause 6 Schedule III read with Section 7] under CGST Act exclude actionable claim. Another view is that, this transaction may be an outright sale. And when there is outright sale, the GST applicability will depend on the nature of underlying asset sold and is to be paid by borrower. e.g. IVY Bank sells one of its NPA as a going concern to Company ABC then the instant transaction is taxable under GST but the same is classified as a supply of service and accordingly the rate of tax payable is NIL in terms of Entry 2 classified under Chapter 99 as specified under Notification No. 12/2017.

**Guidance Note on Audit of Banks (Revised 2020)**

26.28 Aforesaid discussion on nature of services by bank and their taxability is summarised as under:

SI No.	Nature of Service	Remark about Taxability
1.	Assignment or Sale of Debts	Not Chargeable (Sale, transfer or assignment of debts falls within the purview of the actionable claims, which are neither good nor service as per Schedule III of the CGST Act. )
2.	Bank Guarantee Commission Charges	Taxable
3.	Bill Discounting	Exempt to the extent of interest component. However, Commission, fees, brokerage or documentation charges will be taxable.
4.	Charges on Cheque Bouncing	Taxable
5.	Interest and charges on delay/ non-payment of credit card bills	Taxable
6.	Charges for issuance of Demand Draft	Taxable
7.	Loan or other Documentation Charges	Taxable
8.	Forward Contract in Currencies	<p>Where the settlement takes place by way of actual delivery of underlying currency, then such forward contracts would be treated as normal supply of goods and liable to GST (Commission portion).</p> <p>Where the settlement takes place by way of net settlement of differential of the forward rate over the prevailing market rate on the settlement date, the same would be falling within the purview of 'securities' as and securities are neither 'goods' nor</p>

**Guidance Note on Audit of Banks (Revised 2020)**

		'services' as defined in the CGST Act, 2017, therefore future contracts are not chargeable to GST.
9.	Future Contracts	Not Chargeable (Since it is financial derivative and falls within the definition of securities (which is neither good nor service in GST), hence they are not liable to GST. Commission and documentation charges will be liable for GST.
10.	Income from Commercial Paper or Certificate of Deposit	Exempt, due to nature of interest.
11.	Inspection Charges	Taxable
12.	Interest/ Discount on Loans / Deposits or Advances	Exempt
13.	Issuance of Bank Statement Charges	Taxable, except for Basic Saving Bank Deposit (BSBD) account holders under Pradhan Mantri Jan Dhan Yojana (PMJDY).
14.	Issuance of Letter of Credit	Exempt, as it is included in the definition of Money as defined u/s 2(75) of CGST Act and hence outside the definition of goods and services.
15.	Ledger Folio Charges	Taxable
16.	Loan takeover transactions	Taxable (GST will be charged on the processing fees charged for the takeover of the loan.)
17.	Processing Fees on Loans	Taxable
18.	Promissory Notes	Not Chargeable ( As it is covered in the definition of "money" (which is neither good nor service in GST) and hence exempt. However, if any extra amount charged in the name of commission, fees, brokerage etc. then it will be chargeable.)

**Guidance Note on Audit of Banks (Revised 2020)**

19.	Sale of Derivatives	Not Chargeable (Since derivatives falls within the definition of securities (which is neither good nor service in GST), hence they are not liable to GST. However, if any extra amount charged in the name of commission, fees, brokerage etc. than it will be chargeable.
20.	Security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act	Exempted, as covered under definition of "securities", which is excluded from definition of "Goods" and "Services".
21.	Services provided to Reserve Bank of India	Interest charge on deposit kept with RBI is exempted. Other charges are taxable, as not exempted specifically.
22.	Standing Instruction Charges	Taxable, except for Basic Saving Bank Deposit (BSBD) account holders under Pradhan Mantri Jan Dhan Yojana (PMJDY).
23.	Stop Payment Charges	Taxable, except for Basic Saving Bank Deposit (BSBD) account holders under Pradhan Mantri Jan Dhan Yojana (PMJDY).
24.	Services supplied by a recovery agent to a bank.	Taxable under RCM
25.	Services supplied by individual Direct Selling Agents (DSAs) other than a body corporate, partnership or limited liability partnership firm to bank.	Taxable under RCM
26.	Services provided by BF/BC to a banking company in compliance with RBI's CircularNo.DBOD.No.BL.BC.5 8/22.01.001/2005-2006dated	Exempted in Entry no. 39 [Heading no. 9971] of Notification 12/2017



**Guidance Note on Audit of Banks (Revised 2020)**

	25.01.2006 and subsequent instructions on the issue.	
27.	Services provided by a banking company to Basic Saving Bank Deposit (BSBD) account holders under Pradhan Mantri Jan Dhan Yojana (PMJDY).	Exempted by NN 28/2018 dated 31 <sup>st</sup> December 2018.
28.	business facilitator or a business correspondent to a banking company with respect to accounts in its rural area branch;	Exempted by Notification 12/2017
29.	any person as an intermediary to a business facilitator or a business correspondent with respect to services mentioned in Entry 28	Exempted by Notification 12/2017
30.	Penal interest in case of delay payment of EMI	Exempt in reference to Circular No. 102/21/2019- GST dated 28 <sup>th</sup> June 2019

Hence all income sources of the banks, have to be thoroughly scrutinized thereafter the auditor has to comment on its taxability, classification and compliance with tax payment along with interest, applicable penalty and transparency in disclosure in the returns filed.

**Rate of Tax under GST**

26.29 Broadly Rates of tax in GST are – Nil; 0.25%; 3%; 5%; 12%; 18%; 28%. Depending upon the classification of goods or types of services, different rates are applicable on different goods or services. These rates are uniform across India. In case IGST is levied, the rate is applied in consolidation, say 18% IGST; and in case CGST and SGST are levied, the rate is applied in two equal parts say 9% CGST and 9% SGST.

The charging section of CGST Act and IGST Act provides an upper cap of rate as 20% and 40% respectively. However, currently the actual maximum tax prescribed on any commodity or services is 28% plus cess, if applicable.

There is an increase in the tax rate from 15% in service tax (erstwhile indirect tax) to 18% under GST on the transaction charges levied on the financial services provided by the banks in relation to credit card, fund transfer, ATM transactions, processing fees on loans etc.

### **Classification of Goods and Services**

26.30 When we say that different rates have been prescribed for different types of goods and services or when we say that tax is payable under reverse charge for specific types of goods and services, we recognise these different types of goods and services by their classification in the GST Law. How the law has classified these goods and services is explained below.

1. **Classification of goods-** The classification of goods in the GST Law is based on HSN Codes. HSN system is a '*Harmonised System of Nomenclature*' to give a unique code to each commodity by which it is recognized for the purpose of international trade. Each code is accompanied with the corresponding description of goods which are covered under that code.

In the GST Law, the HSN codes in the Customs Tariff Act have been recognised. In the Customs Tariff Act, 1985, there are 98 Chapters containing these codes. Each Chapter pertains to a broader class of commodities and contains sub-codes for sub-classes of such commodity.

2. **Classification of services -** In GST, a list of different classes of services has been given *vide Annexure to Notification No. 11/2017-Central Tax (Rate)*. This Annexure contains 4 to 6 digits numeral codes for every description of services. One has to identify the service code which matches with the description of service.

### **TIME OF SUPPLY under GST**

26.31 Supply has been understood to hold the key to the incidence of GST, but it is the 'time of supply' that dictates the occasion when this incidence will come to rest.

26.32 Therefore, it is essential to comprehend **time of supply of services** provided by the banks. Pursuant to section 13 of the CGST Act, time of supply of services shall be the earliest of the following dates, namely: —

- a) the date of issue of invoice by the supplier, if the invoice is issued within the period prescribed under ~~sub-section (2) of~~<sup>22</sup> section 31 or the date of receipt of payment, whichever is earlier; or

---

<sup>22</sup> Omitted vide The Central Goods and Services Tax Amendment Act, 2018 w.e.f. 01.02.2019.

- b) the date of provision of service, if the invoice is not issued within the period prescribed under ~~sub-section (2) of~~<sup>23</sup> section 31 or the date of receipt of payment, whichever is earlier; or
- c) the date on which the recipient shows the receipt of services in his books of account, in a case where the provisions of clause (a) or clause (b) do not apply.

Explanation: -

- Date of receipt of payment: The date on which the payment is entered in the books of account of the supplier or the date on which the payment is credited to his bank account, whichever is earlier.
- Date of issue of invoice: If the supplier of services is an insurer or banking company or financial institution including NBFC, invoice is to be issued within 45 days from the date of supply of service.

26.33 It is pertinent to mention that, where the supplier of taxable service receives an amount up to ` 1,000/- in excess of the amount indicated in the tax invoice, the time of supply to the extent of such excess amount shall, at the option of the said supplier, be the date of issue of invoice relating to such excess amount.

**26.34 Time of supply in case of reverse charge:** In case of supplies in respect of which tax is paid or liable to be paid on reverse charge basis, the time of supply shall be, earlier of the following dates, namely: -

- (a) the date of payment as entered in the books of account of the recipient or the date on which the payment is debited in his bank account, whichever is earlier; or
- (b) the date immediately following sixty days from the date of issue of invoice or any other document, by whatever name called, in lieu thereof by the supplier;

Further, where it is not possible to determine the time of supply under clause (a) or clause (b), the time of supply shall be the date of entry in the books of account of the recipient of supply.

26.35 Moreover, in case of supply by associated enterprises, where the supplier of service is located outside India, the time of supply shall be the date of entry in the books of account of the recipient of supply or the date of payment, whichever is earlier.

---

<sup>23</sup> Omitted vide The Central Goods and Services Tax Amendment Act, 2018 w.e.f. 01.02.2019.

## Invoice

26.36 As inferred from above, GST is chargeable at the time of supply. Invoice is an important indicator of the time of supply. Tax invoice is the primary document evidencing the supply by the supplier and vital for availing input tax credit by the recipient. Under the GST regime, an “invoice” or “tax invoice” means the tax invoice referred to in section 31 of the CGST Act. This section mandates issuance of invoice or a bill of supply for every supply of goods or services or both.

26.37 The type of invoice to be issued depends upon the category of registered person making the supply. For eg. if a registered person is making supplies, then a tax invoice needs to be issued by such registered person. However, if a registered person is dealing only in exempted supplies or is availing composition scheme, then such registered person needs to issue a bill of supply in lieu of tax invoice. Further, where a registered person is supplying taxable as well as exempted goods or services or both to an unregistered person, a single-invoice-cum-bill of supply may be issued for all such supplies.

26.38 In terms of Rule 46 of the CGST Rules, 2017, subject to Rule 54 (*Tax invoice in special cases*), a tax invoice referred to in section 31, shall be issued by the registered person containing the following:

- (a) name, address and GSTIN of the supplier;
- (b) a consecutive serial number, not exceeding sixteen characters, in one or multiple series, containing alphabets or numerals or special characters hyphen or dash and slash symbolised as “-” and “/” respectively, and any combination thereof, unique for a financial year;
- (c) date of its issue;
- (d) name, address and GSTIN or UIN, if registered, of the recipient;
- (e) name and address of the recipient and the address of delivery, along with the name of State and its code, if such recipient is un-registered and where the value of taxable supply is ` 50,000/- or more;
- (f) name and address of the recipient and the address of delivery, along with the name of the State and its code, if such recipient is un-registered and where the value of the taxable supply is less than ` 50,000/- and the recipient requests that such details be recorded in the tax invoice;
- (g) Harmonised System of Nomenclature code for goods or services;

### Guidance Note on Audit of Banks (Revised 2020)

[As regards the requirement to quote the HSN of the supplies, the annual turnover of the registered person for the previous year shall be referred. In case of suppliers having annual turnover in the previous year:

- i. Upto Rs.1.5 Crore – No HSN required;
- ii. Exceeding Rs. 1.5 Crore upto Rs. 5 Crore – HSN upto 2 digits required;
- iii. Exceeding Rs.5 Crore – HSN upto 4 digits required.

8 Digit HSN Code needs to be quoted in case of Export Turnover irrespective of turnover.

Please note that the term 'annual turnover' has not been defined. Therefore, it may be understood, to be the Turnover in the State as defined in Section 2(112) of the Act, computed for the preceding financial year.

It is also relevant to note that there has been no notification issued in respect of services, separately. However, considering that the term 'HSN' has been used commonly in respect of both goods and services, the aforesaid order can be applied even in respect of services, while quoting the code from the scheme of Classification of Services, as provided in *Notification No. 11/2017-Central Tax (Rate) dated.28-06-2017.*]

- (h) description of goods or services;
- (i) quantity in case of goods and unit or Unique Quantity Code thereof;
- (j) total value of supply of goods or services or both;
- (k) taxable value of supply of goods or services or both considering discount or abatement, if any;
- (l) rate of tax (central tax, State tax, integrated tax, Union territory tax or cess);
- (m) amount of tax charged in respect of taxable goods or services (central tax, State tax, integrated tax, Union territory tax or cess);
- (n) place of supply along with the name of State, in case of a supply in the course of inter-State trade or commerce;
- (o) address of delivery where the same is different from the place of supply;
- (p) whether the tax is payable on reverse charge basis; and

## Guidance Note on Audit of Banks (Revised 2020)

---

- (q) signature or digital signature of the supplier or his authorized representative.

However, such signatures or digital signature shall not be required in the case of issuance of an electronic invoice in accordance with the provisions of the Information Technology Act, 2000 (21 of 2000).

26.39 Further, that the Government may, by notification, on the recommendations of the Council, and subject to such conditions and restrictions as mentioned therein, specify that the tax invoice shall have Quick Response (QR) code. In this regard, w.e.f. 1<sup>st</sup> April 2020, Government have notified *vide* N/N- 72/2019 of CGST Act dated 13<sup>th</sup> December 2019, an invoice issued by a registered person, whose aggregate turnover in a financial year exceeds Rs. 500 crore, to an unregistered person (hereinafter referred to as B2C invoice), shall have Quick Response (QR) code. Where such registered person makes a Dynamic QR code available to the recipient through a digital display, such B2C invoice issued by such registered person containing cross-reference of the payment using a Dynamic QR code, shall be deemed to be having QR code.

26.40 Further, Notification No 68/2019-Central Tax dated 13<sup>th</sup> December 2019, *inter alia* insert Rule 48(4) of CGST Rules, 2017, which stipulates that the invoice shall be prepared by including particulars contained in Form GST INV-01 after obtaining an Invoice Reference Number by uploading information contained therein on the Common Goods and Services Tax Electronic Portal in such manner and subject to such conditions and restrictions as may be specified in the notification. In this regard, w.e.f. 1<sup>st</sup> April 2020, *vide* Notification No. 70/2019 dated 13<sup>th</sup> December 2019, the Government have notified registered person, whose aggregate turnover in a financial year exceeds Rs. 100 crores, as a class of registered person who shall prepare invoice in terms of Rule 48(4) in respect of supply of goods or services or both to a registered person.

The Government have also notified the Common Goods and Services Tax Electronic Portal for the purpose of preparation of the invoice as per Rule 48(4).

26.41 It is pertinent to mention that in case of export of goods or services, the invoice shall carry an endorsement as follows:

1. Where the supply is effected on payment of IGST: “*Supply meant for export/supply to SEZ unit or SEZ developer for authorised operations on payment of integrated tax*” or
2. Where the supply is effected without payment of IGST: “*Supply meant*”

*for export/supply to SEZ unit or SEZ developer for authorised operations under bond or letter of undertaking without payment of integrated tax”.*

26.42 And details in lieu of the details specified in Rule 46 (e) *cited supra*, contain the following details:

- (i) name and address of the recipient;
- (ii) address of delivery; and
- (iii) name of the country of destination.

**Time Limitation for Issuance of Invoice**

26.43 Section 31(2) read Rule 47 provides that a registered person supplying taxable services shall, before or after the provision of service but within 30 days (*or 45 days in case of suppliers of services being an insurer / banking company / financial institution, including a NBFC*) from the date of supply of the service, issue a tax invoice, showing the description, value, tax charged thereon and such other particulars as has been prescribed in the Invoice Rules.

26.44 Further, an insurer or a banking company or a financial institution, including a NBFC, or a telecom operator, or any other class of supplier of services as may be notified by the Government on the recommendations of the Council, making taxable supplies of services between distinct persons as specified in section 25, may issue the invoice before or at the time such supplier records the same in his books of account or before the expiry of the quarter during which the supply was made.

26.45 Moreover, the Government may, on the recommendations of the Council, by notification and subject to such conditions as may be mentioned therein, specify the categories of services in respect of which:

- (a) Any other document issued in relation to the supply shall be deemed to be a tax invoice; or
- (b) Tax invoice may not be issued.

Therefore, an insurer / banking company / financial institution, including a NBFC may issue an invoice or any other document in lieu thereof.

26.46 Rule 54 of the CGST Rules which provide provisions relating tax invoices in cases of special services, *inter alia* stipulates that, an insurer or a banking company or a financial institution, including a non-banking financial company, may issue a consolidated tax invoice or any other document in lieu

## **Guidance Note on Audit of Banks (Revised 2020)**

---

thereof, by whatever name called for the supply of services made during a month at the end of the month, whether issued or made available, physically or electronically whether or not serially numbered, and whether or not containing the address of the recipient of taxable service but containing other information as mentioned under rule 46.

26.47 The signature or digital signature of the supplier or his authorised representative shall not be required in the case of issuance of a consolidated tax invoice or any other document in lieu thereof as per the Information Technology Act, 2000.

26.48 Further, Section 31 (1)(b) and read with proviso rule 46 provides that a registered person [other than the supplier engaged in making supply of services by way of admission to exhibition of cinematograph films in multiplex screens,] may not issue a tax invoice if the value of the goods or services or both supplied is less than Rs. 200/- subject to the following conditions, namely:

- (1) the recipient is not a registered person; and
- (2) the recipient does not require such invoice,

However, the supplier shall issue a consolidated tax invoice for such supplies at the close of each day in respect of all such supplies.

26.49 Therefore, Banking companies have the option to issue a consolidated tax invoice or any other document in lieu of tax invoice for the supply of services made during a month, at the end of the month, either in physical form or electronically.

### **Note**

- A registered person shall on receipt of advance payment with respect to any supply shall issue Receipt voucher.
- Further, where at the time of receipt of advance:
  - the rate of tax is not determinable; the tax shall be paid at the rate of 18%.
  - the nature of supply is not determinable, the same shall be treated as inter-State supply.
- Where, on receipt of advance payment with respect to any supply of goods or services or both the registered person issues a receipt voucher, but subsequently no supply is made and no tax invoice is issued in pursuance thereof, the said registered person may issue to the person who had made the payment, a refund voucher against such payment.



### Guidance Note on Audit of Banks (Revised 2020)

- A registered person who is liable to pay tax under section 9(3) or 9(4) shall issue an invoice in respect of goods or services or both received by him from the supplier who is not registered on the date of receipt of goods or services or both. Here, a registered person may issue a consolidated invoice at the end of a month for supplies covered under section 9(4), the aggregate value of such supplies exceeds ` 5,000/- in a day from any or all the suppliers.
- A registered person who is liable to pay tax u/s 9(3) or (4) shall issue a payment voucher at the time of making payment to the supplier.
- GST Law specify the particulars to be contained in document evidencing supply:

<b>CGST Rule</b>	<b>Document substantiating supply</b>
Rule 46	Invoice
Rule 49	Bill of supply
Rule 50	Receipt voucher
Rule 51	Refund voucher
Rule 52	Payment voucher
Rule 53	Revised tax invoice and credit or debit notes

- In cases where tax invoice has been issued for supply of any goods or services or both and subsequently it is found that the value or tax charged in that invoice is more than what is actually payable/chargeable or where the recipient has returned the goods, the supplier can issue a credit note to the recipient.

In cases where tax invoice has been issued for supply of any goods or services or both, and subsequently it is found that the value or tax charged in that invoice is less than what is actually payable/chargeable, the supplier can issue a debit note to the recipient.

The adjustment of GST already paid is allowed only by way of issuance of credit/debit note in terms of Section 34 of the CGST Act, 2017. The proviso to section 34(2) of the CGST Act, 2017 provides that no reduction in liability would be allowed if the incidence of tax has been passed on to another person. If bad debts are on account of deficiency in supply of services, or tax charged being greater than actual tax liability, or goods returned, GST paid on the same is refundable subject to fulfilment of the prescribed conditions. Therefore, GST already paid on bad debts, as used in the trade parlance, cannot be adjusted.

**Guidance Note on Audit of Banks (Revised 2020)**

- The tax invoice must be prepared in triplicate for goods, and in duplicate for services. Each copy of the tax invoice in case of service, is required to be marked as follows:

<b>Goods</b>	<b>Services</b>
1. ORIGINAL FOR RECIPIENT	1. ORIGINAL FOR RECIPIENT
2. DUPLICATE FOR TRNSPORTER	2. DUPLICATE FOR SUPPLIER
3. TRIPLICATE FOR SUPPLIER	–

**Value of Taxable Supply Under GST**

26.50 Once it is determined that an activity or transaction is leviable under GST, ascertaining the value of the same becomes significant.

26.51 Sec 15(1) The value of a supply of goods or services or both shall be: Transaction value, which is the price actually paid or payable for the said supply of goods or services or both where the supplier and the recipient of the supply are not related, and the price is the sole consideration for the supply

26.52 Where Explanation to Section 15 of the CGST Act deems the persons below to be “related persons”:

- Officers / Directors of one another’s business
- Partners in business
- Employer – employee
- A person directly / indirectly owns / controls / holds 25% more of the outstanding voting stock or shares of both the persons
- One directly / indirectly controls the other
- Both are directly / indirectly controlled by a third person
- Together, they directly / indirectly control a third person
- Members of the same family
- Sole agent / distributor / concessionaire of the other

<b>S-15(2) Transaction Value INCLUDES:</b>	<b>Transaction Value EXCLUDES discount</b>
(i) Amounts charged by supplier to	(vi) Before / at the time of supply

**Guidance Note on Audit of Banks (Revised 2020)**

<p>recipient in respect of any taxes, duties, cesses, fees and charges levied under any statute, other than taxes paid under GST regime;</p> <p>(ii) Amount incurred by Recipient which is liable to be paid by the Supplier and not included in price actually paid or payable;</p> <p>(iii) Charges by Supplier to Recipient being: Incidental expenses (e.g.: packing, commission)</p> <p>(iv) Charges for anything done by the Supplier at the time or before the supply, in respect thereof Interest/ late fee/ penalty for delayed payment of consideration</p> <p>(v) Subsidies directly linked to price – for supplier receiving the subsidy (excluding Central and State Govt subsidies; i.e., Government subsidies will not be included in transaction value)</p>	<p>Single condition: Such discount is duly recorded in the invoice</p> <ul style="list-style-type: none"> <li>▪ After the supply: Cumulative conditions:                     <ul style="list-style-type: none"> <li>Agreement establishing discount entered into before / at the time of supply</li> <li>Discount specifically linked to relevant invoices</li> <li>ITC reversed by the recipient to the extent of tax on discount</li> </ul> </li> </ul>
---	---

To determine value of certain specific transactions, Determination of Value of Supply rules have been prescribed in CGST Rules, 2017 (Rule 27-35). **The Rules pertaining to banking Sector are:**

Banking sector provides services of purchase and sale of foreign currency to its customers, the value of which can be ascertained in terms of Rule 32(2) of the CGST Rules as:		
<b>OPTION –I [Section 32(2)(a)]</b>	<b>OPTION -II [Section -32(2)(b)]</b>	
<p>When exchanged from or/ to INR:</p> <p>(i) Difference of Buying rate / Selling rate and RBI reference rate X Total units of currency (If RBI reference rate is not</p>	<b>Where Amount of currency exchanged</b>	
	Upto Rs. 1	1% of the gross amount of currency

**Guidance Note on Audit of Banks (Revised 2020)**

available, value shall be 1% of gross amount of INR received or provided)	lakh	exchanged or Rs. 250/-, <i>whichever is higher</i>
(ii) If neither of two currencies exchanged in INR,	Rs. 1 lakh and up to Rs. 10 lakhs	Rs. 1,000/-plus 0.5% of the gross amount of currency exchanged above Rs. 100,000/-
(iii) the value shall be equal to 1% of the lesser of the two amounts		
(iv) the person changing the money would have received by converting any of the two currencies into INR	exceeding Rs. 10 lakhs	Rs. 5,500/- plus 0.10% of the gross amount of currency exchanged above Rs. 10 lakhs or Rs. 60,000/-, <i>whichever is lower</i>
(v) on that day at the reference rate provided by RBI.		

Note - A person supplying the services may exercise the option to ascertain the value in terms of clause(b) for a financial year and such option shall not be withdrawn during the remaining part of that financial year.

26.53 Further, it is pertinent to mention here Rule 34 of the CGST Rules which provides the Rate of exchange of currency, other than Indian rupees, for determination of Value as under:

26.54 Transactions undertaken in foreign currency must be translated into Indian Rupees. The rate of exchange for the determination of the value of taxable goods shall be the applicable rate of exchange as notified by the Board under section 14 of the Customs Act, 1962 and for the determination of the value of taxable services shall be the applicable rate of exchange determined as per the generally accepted accounting principles for the date of time of supply in respect of such supply in terms of section 12 or, as the case may be, section 13 of the Act.

**Valuation of services between the distinct and related persons (excluding agents)**

26.55 Generally, banks would have lot of common/ shared services being supported from Head Office such as call centre, security software etc. Further, many times one branch would internally provide service to other branches for example: resolving issue of a customer having PAN India accounts, providing local information etc. to other branches etc. The value will be determined in terms of Rule 28 of the CGST Rules, 2017 as:

(a) The open market value of such supply	
<b>(b) If open market value is not available</b>	Value of supply of goods or services of like kind and quality
<b>(c) If value of supply is not determinable under clause (a) or (b)</b>	Value as determined by application of Rule 30 or Rule 31, in that order
<i>Provided that where goods are intended for further supply as such by the recipient, the value shall, at the option of the supplier, be an amount equivalent to 90% of the price charged for the supply of goods of like kind and quality by the recipient to his customer not being a related person</i>	
<i>Where the recipient is eligible for full input tax credit, the value declared in the invoice shall be deemed to be the open market value of goods or services</i>	

Value of supply based on cost i.e. cost of supply plus 10% mark-up. (Rule 30 of the CGST Rules 2017)

Value of supply determined by using reasonable means should be consistent with principles and general provisions of GST law. (Rule 31 of the CGST Rules 2017)

### Value of supply in case of Re-possessed Assets

26.56 Rule 32(5) provides that where a taxable supply is provided by a person dealing in buying and selling of second hand goods i.e., used goods as such or after such minor processing which does not change the nature of the goods and where no input tax credit has been availed on the purchase of such goods, the value of supply shall be the difference between the selling price and the purchase price and where the value of such supply is negative, it shall be ignored

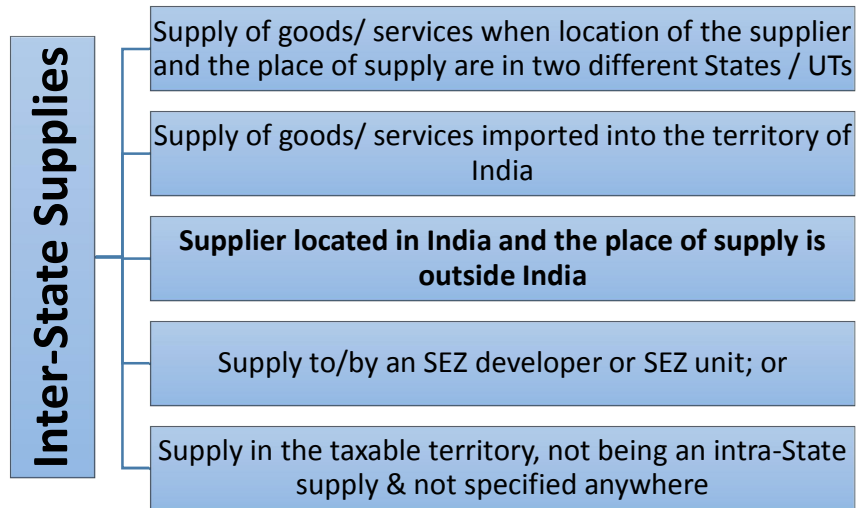
Provided that the purchase value of goods repossessed from a defaulting borrower, who is not registered, for the purpose of recovery of a loan or debt shall be deemed to be the purchase price of such goods by the defaulting borrower reduced by 5% points for every quarter or part thereof, between the date of purchase and the date of disposal by the person making such repossession.

### Nature of Supply and Place of Supply

26.57 CGST and SGST will be levied on intra-state supply while inter-state

supplies will be charged to IGST. Determination of Nature of supply is very important to determine whether a supply is inter-state or intra-state.

### Inter-State Supplies



26.58 Section 7 of the IGST Act, provides as to when the supplies of goods and/or services shall be treated as Supply in the course of inter-State trade/commerce.

Section 7(1) and 7(2) of IGST Act, primarily covers two kinds of supplies – Supply of *goods* within India and supply of *goods* imported into India respectively and Section 7(3) and 7(4) of IGST Act, covers two kinds of supplies – supply of *services* within India and import of *services* into India respectively. Certain supplies of goods or services are treated as supplies in the course of inter-State trade or commerce as defined in Section 7(5) of the IGST Act.

26.59 Inter-State Supplies- Section 8(1) of IGST Act, deals with Supply of *goods* and Section 8(2) of IGST Act with Supply of *Services* treated as supplies in the course of intra-State trade or commerce.

EXTRACT of Section 8 of IGST Act

8(2) *Subject to the provisions of section 12, supply of services where the location of the supplier and the place of supply of services are in the same State or same Union territory shall be treated as intra-State supply:*

*Provided that the intra-State supply of services shall not include supply*

*of services to or by a Special Economic Zone developer or a Special Economic Zone unit.*

*Explanation 1 —For the purposes of this Act, where a person has, —*

- (i) an establishment in India and any other establishment outside India;*
- (ii) an establishment in a State or Union territory and any other establishment outside that State or Union territory; or*
- (iii) an establishment in a State or Union territory and any other establishment ~~being a business vertical~~<sup>24</sup> registered within that State or Union territory,*

*then such establishments shall be treated as establishments of distinct persons.*

*Explanation 2 —A person carrying on a business through a branch or an agency or a representational office in any territory shall be treated as having an establishment in that territory.*

With regard to supply of service, if the twin factors – “location of supplier of services’ and ‘place of supply of services’ – are in the same State or UT, then such supply will be treated as intra-State supply. Location of supplier of services has been defined in the Act to mean ‘place of business from where supply is made and duly registered for the purpose’. It also includes other places and reference may be had to the discussion in respect of inter-State supply of services for the implications of this definition.

For e.g. Consider audit services being provided by a Chartered Accountant located in Delhi to a company in Delhi. For the purpose of the audit, the Chartered Accountant visits the company’s factory located in Noida. Here, although the Chartered Accountant is physically moving to Noida, he is not supplying the audit services from Noida. Here, the transaction will be an intra-State supply from Delhi to Delhi.

Therefore, it is relevant to understand the term “location of supplier of services’ and “place of supply of services’ to determine the nature of supply

26.60 Section 2 (15) of IGST Act states that, location of supplier of services means –

- (a) where a supply is made from a place of business for which the

---

<sup>24</sup> Omitted vide The Integrated Goods And Services Tax (Amendment) Act, 2018 w.e.f 01.02.2019

## Guidance Note on Audit of Banks (Revised 2020)

---

- registration has been obtained, the location of such place of business;
- (b) where a supply is made from a place other than the place of business for which registration has been obtained (a fixed establishment elsewhere), the location of such fixed establishment;
  - (c) where a supply is made from more than one establishment, whether the place of business or fixed establishment, the location of the establishment most directly concerned with the provision of the supply; and
  - (d) in the absence of such places, the location of the usual place of residence of the supplier.

26.61 Where, Section 2(85) provides inclusive definition of place of business and Section 2(50) provides exclusive definition of fixed establishment, as:

- place of business includes:
  - (a) a place from where the business is ordinarily carried on, and includes a warehouse, a godown or any other place where a taxable person stores his goods, supplies or receives goods or services or both; or
  - (b) a place where a taxable person maintains his books of account; or
  - (c) a place where a taxable person is engaged in business through an agent, by whatever name called.
- fixed establishment means;
  - a place (other than the registered place of business)
  - which is characterised by –
    - a sufficient degree of permanence and
    - suitable structure in terms of human and technical resources to supply services, or to receive and use services for its own needs.

It can be inferred from above that, in case of services provided by bank to a customer from multiple locations, the location of supplier will be the home branch/ account branch. The other branches providing services to such customer actually provide services to the home branch/ account branch.

### Place of Supply

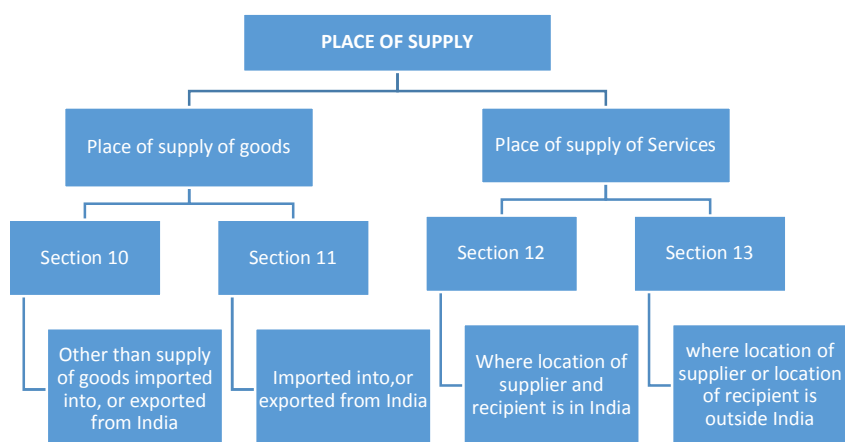
26.62 Provisions relating to place of supply are provided in section 10 to 14 of IGST Act. For understanding place of supply in case of services, it is imperative to know the phrase "*Location of the recipient*" as provided in the



**Guidance Note on Audit of Banks (Revised 2020)**

following 4 sub-clauses of Section 2(14) of IGST Act:

- (a) Services received at a place of business where registration is obtained – Location of such place of business;
- (b) Services received at a fixed establishment (i.e., a place of business not registered, but having a sufficient degree of permanence involving human and technical resources) – Location of such fixed establishment;
- (c) Services received at more than one establishment – Location of the establishment most directly concerned with the receipt of the supply;
- (d) Services received at a place other than above – Location of the usual place of residence of the recipient (address where the person is legally registered/ constituted in case of recipients other than individuals).



<b>Default Rule for the services other than the 12 specified services</b>		
<b>S.No.</b>	<b>Description of Supply</b>	<b>Place of Supply</b>
1.	B2B	Location of such Registered Person
2.	B2C	(i) Location of the recipient where the address on record exists, and (ii) Location of the supplier of services in other cases

<b>Default Rule for cross-border supply of services other than 9 specified services</b>	
<b>Description of Supply:</b> ANY	<b>Place of Supply:</b> Location of the recipient of service; If not available in the ordinary course of business, the location of the supplier of service

### Place of supply for Banking Sector

26.63

- In case, where the location of the banks or location of the recipient of service is in India, section 12(12) of the IGST Act, 2017, provides for the place of supply of services -

*The place of supply of banking and other financial services, including stock broking services to any person shall be the location of the recipient of services on the records of the supplier of services.*

*Provided that, if the location of recipient of services is not on the records of the supplier, the place of supply shall be the location of the supplier of services.*

Hence, the place of supply of banking and other financial services, to any person shall be the location of the recipient of services on the records of the supplier of services. Address available on the records of the Bank or Financial Institution, which is ordinarily used for communication with the customer, may be considered as the Place of Supply. In case where the address location of recipient of services is not on the records of the supplier, the place of supply shall be the location of the supplier of services.

- In case, where the location of the banks or location of the recipient of service is outside India, section 13(8) of the IGST Act, 2017, provides that-

*The place of supply of the following services shall be the location of the supplier of services, namely: —*

- (a) services supplied by a banking company, or a financial institution, or a non-banking financial company, to account holders;*
- (b) intermediary services;*
- (c) services consisting of hiring of means of transport, including yachts but excluding aircrafts and vessels, up to a period of one month*

*Explanation - For the purposes of this sub-section, the expression, —*

- (a) *“account” means an account bearing interest to the depositor, and includes a non-resident external account and a non-resident ordinary account;*
- (b) *“banking company” shall have the same meaning as assigned to it 2 of 1934. under clause (a) of section 45A of the Reserve Bank of India Act, 1934;*
- (c) *“financial institution” shall have the same meaning as assigned to it 2 of 1934. in clause (c) of section 45-I of the Reserve Bank of India Act, 1934*
- (d) *“non-banking financial company” means, —*
  - (i) *a financial institution which is a company;*
  - (ii) *a non-banking institution which is a company, and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner; or*
  - (iii) *such other non-banking institution or class of such institutions, as the Reserve Bank of India may, with the previous approval of the Central Government and by notification in the Official Gazette, specify.*

In terms of section 13(8) of the IGST Act, 2017 service provided by the bank to its account holder shall be deemed to be provided at the place where such bank is located. Where, account means an account bearing interest to the depositor, and includes a non-resident external account and a non-resident ordinary account.

26.64 Further, in terms of section 13 of the IGST Act, 2017, where Location of Supplier or Location of Recipient is outside India, place of supply will be the location of the recipient of the services. But, where the location of the recipient of services is not available in the ordinary course of business, the place of supply shall be the location of the supplier of services. Therefore, service provided by the bank to person other than account holder located outside India, is location of the supplier of services. Accordingly place of supply of service provided by the bank to its customer located outside India shall be location of bank and Central tax and State tax or Union territory tax, as the case may be, will be payable.

26.65 Further Section 2(13) of IGST Act define intermediary

## Guidance Note on Audit of Banks (Revised 2020)

---

*“intermediary” means a broker, an agent or any other person, by whatever name called, who arranges or facilitates the supply of goods or services or both, or securities, between two or more persons, but does not include a person who supplies such goods or services or both or securities on his own account;*

As inferred from section 13(8)(b) of IGST Act, place of supply in case intermediary services provided by a banking company, or a financial institution, or a non-banking financial company, to account holders shall be the location of the supplier.

### Registration

26.66 One of the criteria to exemplify a transaction to be a supply under GST is that - Supply should be made by a taxable person. Where Section 2 (107) of the CGST provided that taxable person means a person who is registered or liable to be registered under section 22 or section 24. Therefore, understanding provisions pertaining to registration under GST is indispensable.

26.67 In pre-GST regime, services provided by the banks were liable to service tax, which was a central tax only. Therefore, in spite of banks having their branches spread in multiple states, they had an option to have a centralised registration, payment and compliance. Accordingly, most of the banks opted for centralised registration and its compliance activities were managed at this centralised registration centre.

26.68 Unlike concept of Centralized registration available under erstwhile Service tax, under GST every supplier effecting taxable supplies, subject to a threshold limit and hence no concept of Centralized registration exists.

26.69 In terms of section 22 of the CGST Act, every supplier shall be liable to be registered under this Act in the State or Union territory, other than special category States [as specified in sub-clause (g) of clause (4) of Article 279A of the Constitution], from where he makes a taxable supply of goods or services or both, if his aggregate turnover in a financial year exceeds Rs. 20 lakh and in case of special category state wherein the registration limit is Rs. 10 lakhs. It is important to note that registration is required ‘in’ the State ‘from which’ taxable supplies are made. Registration is not required ‘in’ the State ‘to’ which taxable supplies are made, even though this is a destination-based tax.

26.70 Explanation to Section 22 defines ‘Special Category States’ as the states as specified in subclause (g) of clause (4) of Article 279A of the Constitution except Jammu & Kashmir.<sup>25</sup> Following are the list of States

---

<sup>25</sup> Inserted vide CGST (Extension to Jammu and Kashmir) Act, 2017 w.e.f. 8-07-2017.

provided in Article 279A(4)(g) of the Constitution:

“Arunachal Pradesh, Assam, Jammu & Kashmir, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, Tripura, Himachal Pradesh, Uttarakhand”.

Further, *w.e.f.1-02-2019 vide CGST, (Amendment) Act, 2018 read with Notification No.2/2019 dated 29.01.2019*, the States of Arunachal Pradesh, Assam, Meghalaya, Sikkim, Himachal Pradesh, and Uttarakhand have been excluded from the definition of Special category States for the purpose of Section 22 of GST Act, 2017.

Therefore, now except 4 State namely, Manipur, Mizoram, Nagaland and Tripura, threshold limit for registration is Rs.20 lakhs for rest all States.

Moreover, *w.e.f. 1-02-2019 vide the CGST, (Amendment) Act, 2018*, second proviso to section 22(1) has been inserted to provide that Government may, at the request of a special category State and on the recommendations of the Council, enhance the aggregate turnover referred to in the first proviso from ` 10 lakhs to such amount, not exceeding ` 20 lakhs and subject to such conditions and limitations, as may be so notified.

26.71 Please note that the proviso to section 22(1) appearing in the CGST Act also appears in the SGST Act(s). As a result, for a taxable person in a non-Special Category State, who has a branch in Special Category State, the threshold becomes Rs. 10 lacs and not Rs. 20 lacs.

26.72 Besides above, with effect from 1<sup>st</sup> April 2019, the Central Government vide Notification No. 10/2019 dated 7<sup>th</sup> March 2019 exempt a person engaged exclusively in supply of goods and whose aggregate turnover in the financial year does not exceed Rs 40 lakh from obtaining registration except persons making intrastate supplies in the States of Arunachal Pradesh, Manipur, Meghalaya, Mizoram, Nagaland, Puducherry, Sikkim, Telangana, Tripura and Uttarakhand.

26.73 From above it is important to understand the term aggregate turnover. Where, aggregate turnover means the aggregate value of all taxable supplies, exempt supplies, export of goods or services or both and inter-State supplies of persons having the same PAN, to be computed on all India basis and excludes CGST/SGST, IGST, UTGST and cess.

26.74 Aggregate turnover does not include value of inward supplies on which tax is payable on reverse charge basis.

26.75 For calculating the threshold limit, the turnover shall include all supplies made by the taxable person, whether on his own account or made on behalf of all his principals. Further, supply of goods by a registered job worker, after completion of job work, shall be treated as the supply of goods

## Guidance Note on Audit of Banks (Revised 2020)

---

by the “principal” referred to in section 143 (i.e. Job work procedure) of this Act. The value of such goods shall not be included in the aggregate turnover of the registered job worker.

26.76 Now, it is important to mention that section 23 provides relaxation from the requirement of obtaining registration to two categories of persons.

- Agriculturist;
- Persons engaged exclusively in the supply of exempted goods or services or both.

26.77 The term exclusive indicates engaging in only those supplies which are exempted. Therefore, if a supplier is supplying both exempted and non-exempted goods and/or services, then this provision is not applicable, and he is required to obtain registration under section 22.

26.78 Any person whose ‘entire’ supply consists of ‘exempt supplies’, then such person is excluded from obtaining registration in terms of section 23 of the CGST Act.

### Compulsory Registration Under GST

26.79 Section 24 of the CGST Act provides the categories of persons who shall be required to be registered under this Act irrespective of the threshold. The following categories of persons are required to obtain registration compulsorily under this Act:

- (i) persons making any inter-State taxable supply; [Please Note *vide Notification 10/ 2017–Integrated Tax, dated 13.10.2017*, persons making inter-States supply of services and having turnover not exceeding ` 20 lakhs have been exempted u/s. 23 from obtaining registration. Accordingly, only persons who make inter-State supply of goods have to compulsorily obtain registration irrespective of the all-India turnover.

However, the aggregate value of supply of services should not exceed Rs. 10 lakhs in respect of special category Special Category States except the States of Jammu and Kashmir, Arunachal Pradesh, Assam, Himachal Pradesh, Meghalaya, Sikkim and Uttarakhand.

- (ii) casual taxable persons making taxable supply;
- (iii) persons who are required to pay tax under reverse charge;
- (iv) person who are required to pay tax under section 9(5);
- (v) non-resident taxable persons making taxable supply;

- (vi) persons who are required to deduct tax under section 51;
- (vii) persons who make taxable supply goods or services or both on behalf of other taxable persons whether as an agent or otherwise;
- (viii) input service distributor;
- (ix) persons who supply goods or services or both, other than supplies specified under section 9(5), through such electronic commerce operator who is required to collect tax at source under section 52;
- (x) every electronic commerce operator who is required to collect tax at source under section 52<sup>26</sup>;
- (xi) every person supplying online information and database access or retrieval services from a place outside India to a person in India, other than a registered person; and
- (xii) such other person or class of persons as may be notified by the Government on the recommendations of the Council.

Two such Categories of Compulsory registration, the persons who are required to pay tax under reverse charge and input service distributor is relevant to Banking sector.

### **Effective date of Registration**

26.80 Where the application for registration has been submitted within thirty days from the date on which the person becomes liable to registration, the effective date of registration shall be date on which he become liable for registration.

26.81 Where an application for registration has been submitted by the applicant after thirty days from the date of his becoming liable to registration, the effective date of registration shall be the date of grant of registration.

26.82 In case of *suo-moto* registration, i.e. registration pursuant to any survey, enquiry, inspection, search or any other proceedings, the effective date of registration shall be the date of order of registration.

26.83 Section 25 read with Rule 8 to 26 of the CGST Rules, 2017 related to registration provides a detailed road map on the procedural aspects of the registration. The time limit for application is within 30 days (for persons other than casual taxable person or a non-resident taxable person) and casual taxable person or a non-resident taxable person shall have to obtain the registration at least 5 days prior to the commencement.

---

<sup>26</sup> Inserted vide The Central Goods and Services Tax Amendment Act, 2018 w.e.f. 01.02.2019

### GST applicability on receipt of services under RCM

26.84 Generally, obligation to discharge GST lies on the supplier of supply. But there exist certain cases on which Reverse charge is applicable and hence the duty to discharge tax is casted on recipient of supply. Even various expenses incurred by the banks are exigible to tax under on Reverse Charge Mechanism (“RCM”). No partial reverse charge will be applicable under GST. 100% tax will be paid by the recipient if reverse charge mechanism applies.

26.85 All taxpayers required to pay tax under reverse charge have to mandatorily obtain registration and the threshold exemption is not applicable on them. Payment of taxes under Reverse Charge cannot be made with utilisation of Input Tax Credit and has to be made in Cash.

26.86 Section 9(3) of CGST/ Section 5(3) of the IGST Act specify categories of supply of goods or services or both as notified by Government on recommendations of the Council on which RCM is applicable. In this regard, Govt. vide Notification No. 13/2017- Central Tax (Rate) dated 28.06.2017 (“**Notification 13/2017**”) / Notification No. 10/2017- Integrated Tax (Rate) dated 28.06.2017 (“**Notification 10/2017-ITR**”) as amended from time to time specify the category of services on which RCM is applicable

26.87 The list of such services under Notification 13/2017 are as under:

Sl. No.	Category of Supply of Services	Supplier of service	Recipient of Service
(1)	(2)	(3)	(4)
1	Supply of Services by a goods transport agency (GTA), [who has not paid central tax at the rate of 6%,] <sup>27</sup> in respect of transportation of goods by road to-  (a) any factory registered under or governed by the Factories Act, 1948(63 of 1948);or  (b) any society registered	Goods Transport Agency (GTA)	(a) Any factory registered under or governed by the Factories Act, 1948 (63 of 1948); or  (b) any society registered under the Societies Registration Act, 1860 (21 of 1860) or under any other law for the time being in force in any part of

<sup>27</sup> Inserted vide Notification No. 22/2017 – Central Tax (Rate) dt. 22.08.2017



**Guidance Note on Audit of Banks (Revised 2020)**

<p>under the Societies Registration Act, 1860 (21 of 1860) or under any other law for the time being in force in any part of India; or</p> <p>(c) any co-operative society established by or under any law; or</p> <p>(d) any person registered under the CGST Act or the IGST Act or the SGST Act or the UTGST Act; or</p> <p>(e) any body corporate established, by or under any law; or</p> <p>(f) any partnership firm whether registered or not under any law including association of persons; or</p> <p>(g) any casual taxable person.</p> <p>[Provided that nothing contained in this entry shall apply to services provided by a goods transport agency, by way of transport of goods in a goods carriage by road, to,</p> <p>-</p> <p>(a) a Department or Establishment of the Central Government or State Government or Union territory; or</p> <p>(b) local authority; or</p> <p>(c) Governmental agencies, which has taken registration</p>		<p>India; or</p> <p>(c) any co-operative society established by or under any law; or</p> <p>(d) any person registered under the CGST Act or the IGST Act or the SGST Act or the UTGST Act; or</p> <p>(e) any body corporate established, by or under any law; or</p> <p>(f) any partnership firm whether registered or not under any law including association of persons; or</p> <p>(g) any casual taxable person; located in the taxable territory.</p>
--	--	---

**Guidance Note on Audit of Banks (Revised 2020)**

	under the CGST Act, 2017 (12 of 2017) only for the purpose of deducting tax under section 51 and not for making a taxable supply of goods or services.] <sup>28</sup>		
2	[Services provided by an individual advocate including a senior advocate or firm of advocates by way of legal services, directly or indirectly. <i>Explanation.-</i> “legal service” means any service provided in relation to advice, consultancy or assistance in any branch of law, in any manner and includes representational services before any court, tribunal or authority.] <sup>29</sup>	An individual advocate including a senior advocate firm	Any business entity located in the taxable territory.
3	Services supplied by an arbitral tribunal to a business entity.	An arbitral tribunal.	Any business entity located in the taxable territory.
4	Services provided by way of sponsorship to any body corporate or partnership firm.	Any person	Any body corporate or partnership firm located in the taxable territory.
5	Services supplied by the Central Government, State Government, Union territory or local authority to a	Central Government, State Government, Union	Any business entity located in the taxable territory.

<sup>28</sup> Inserted vide Notification No. 29/2018 – Central Tax (Rate) dt. 31.12.2018.

<sup>29</sup> Substituted vide corrigendum to Notification No. 13/2017-Central Tax (Rate), dt. 25.09.2017. Prior to substitution it read: “Services supplied by an individual advocate including a senior advocate by way of representational services before any court, tribunal or authority, directly or indirectly, to any business entity located in the taxable territory, including where contract for provision of such service has been entered through another advocate or a firm of advocates, or by a firm of advocates, by way of legal services, to a business entity.”

**Guidance Note on Audit of Banks (Revised 2020)**

	<p>business entity excluding, -</p> <p>(1) renting of immovable property, and</p> <p>(2) services specified below-</p> <p>(i) services by the Department of Posts by way of speed post, express parcel post, life insurance, and agency services provided to a person other than Central Government, State Government or Union territory or local authority;</p> <p>(ii) services in relation to an aircraft or a vessel, inside or outside the precincts of a port or an airport;</p> <p>(iii) transport of goods or passengers.</p>	territory or local authority	
[5A]	<p>Services supplied by the Central Government, State Government, Union territory or local authority by way of renting of immovable property to a person registered under the Central Goods and Services Tax Act, 2017 (12 of 2017).</p>	Central Government, State Government, Union territory or local authority	Any person registered under the Central Goods and Services Tax Act, 2017. <sup>30</sup>
[5B]	<p>Services supplied by any person by way of transfer of development rights or Floor Space Index (FSI) (including</p>	Any person	Promoter] <sup>31</sup>

<sup>30</sup> Inserted vide Notification No. 3/2018 – Central Tax (Rate) dt. 25.01.2018

<sup>31</sup> Inserted vide Notification No. 5/2019 – Central Tax (Rate) dt. 29.03.2019.

**Guidance Note on Audit of Banks (Revised 2020)**

	additional FSI) for construction of a project by a promoter.		
[5C]	Long term lease of land (30 years or more) by any person against consideration in the form of upfront amount (called as premium, salami, cost, price, development charges or by any other name) and/or periodic rent for construction of a project by a promoter.	Any person	Promoter] <sup>32</sup>
6	Services supplied by a director of a company or a body corporate to the said company or the body corporate.	A director of a company or a body corporate	The company or a body corporate located in the taxable territory.
7	Services supplied by an insurance agent to any person carrying on insurance business.	An insurance agent	Any person carrying on insurance business, located in the taxable territory.
8	Services supplied by a recovery agent to a banking company or a financial institution or a non-banking financial company.	A recovery agent	A banking company or a financial institution or a non-banking financial company, located in the taxable territory.
<sup>33</sup> (9)	Supply of services by a music composer, photographer, artist or the like by way of transfer or permitting the use or enjoyment of a copyright covered under clause (a) of sub-section (1) of section 13	Music composer, photographer, artist, or the like	Music company, producer or the like, located in the taxable territory.

<sup>32</sup> Inserted vide Notification No. 5/2019 – Central Tax (Rate) dt. 29.03.2019.

<sup>33</sup> Substituted vide Notification No. 22/2019-Central Tax (Rate) dated 30.09.2019 effective from 1.10.2019.

**Guidance Note on Audit of Banks (Revised 2020)**

	of the Copyright Act, 1957 relating to original dramatic, musical or artistic works to a music company, producer or the like.		
9	<del>Supply of services by an author, music composer, photographer, artist or the like by way of transfer or permitting the use or enjoyment of a copyright covered under clause (a) of sub-section (1) of section 13 of the Copyright Act, 1957 relating to original literary, dramatic, musical or artistic works to a publisher, music company, producer or the like.</del>	<del>Author or music composer, photographer, artist, or the like</del>	<del>Publisher, music company, producer or the like, located in the taxable territory.)</del>
<sup>34</sup> [9A]	Supply of services by an author by way of transfer or permitting the use or enjoyment of a copyright covered under clause (a) of sub-section (1) of section 13 of the Copyright Act, 1957 relating to original literary works to a publisher.	Author	Publisher located in the taxable territory:  Provided that nothing contained in this entry shall apply where,-  (i) the author has taken registration under the Central Goods and Services Tax Act, 2017 (12 of 2017), and filed a declaration, in the form at Annexure I, within the time limit prescribed therein, with the jurisdictional CGST or SGST commissioner, as the case may be, that

<sup>34</sup> Inserted vide Notification No. 22/2019- Central Tax (Rate) dated 30.09.2019 effective from 1.10.2019.

**Guidance Note on Audit of Banks (Revised 2020)**

			<p>he exercises the option to pay central tax on the service specified in column (2), under forward charge in accordance with Section 9 (1) of the Central Goods and Service Tax Act, 2017 under forward charge, and to comply with all the provisions of Central Goods and Service Tax Act, 2017 (12 of 2017) as they apply to a person liable for paying the tax in relation to the supply of any goods or services or both and that he shall not withdraw the said option within a period of 1 year from the date of exercising such option;</p> <p>(ii) the author makes a declaration, as prescribed in Annexure II on the invoice issued by him in <b>Form GST Inv-I</b> to the publisher.]</p>
10	Supply of services by the members of Overseeing Committee to Reserve Bank of India	Members of Overseeing Committee constituted by the Reserve Bank of India	Reserve Bank of India.] <sup>35</sup>

<sup>35</sup> Inserted vide Notification No. 33/2017 – Central Tax (Rate) dt 13.10.2017

**Guidance Note on Audit of Banks (Revised 2020)**

[11]	Services supplied by individual Direct Selling Agents (DSAs) other than a body corporate, partnership or limited liability partnership firm to bank or non-banking financial company (NBFCs).	Individual Direct Selling Agents (DSAs) other than a body corporate, partnership or limited liability partnership firm.	A banking company or a non-banking financial company, located in the taxable territory.] <sup>36</sup>
[12]	Services provided by business facilitator (BF) to a banking company	Business facilitator (BF)	A banking company, located in the taxable territory.] <sup>37</sup>
[13]	Services provided by an agent of business correspondent (BC) to business correspondent (BC).	An agent of business correspondent (BC)	A business correspondent, located in the taxable territory.] <sup>38</sup>
[14]	Security services (services provided by way of supply of security personnel) provided to a registered person:  Provided that nothing contained in this entry shall apply to, -  (i)(a) a Department or Establishment of the Central Government or State Government or Union territory; or	Any person other than a body corporate	A registered person, located in the taxable territory.] <sup>39</sup>

<sup>36</sup> Inserted vide Notification No. 15/2018 – Central Tax (Rate) dt 26.07.2018.

<sup>37</sup> Inserted vide notification No. 29/2018 – Central Tax (Rate) dt 31.12.2018.

<sup>38</sup> Inserted vide notification No. 29/2018 – Central Tax (Rate) dt 31.12.2018.

<sup>39</sup> Inserted vide notification No. 29/2018 – Central Tax (Rate) dt 31.12.2018.

**Guidance Note on Audit of Banks (Revised 2020)**

	(b) local authority; or (c) Governmental agencies; which has taken registration under the Central Goods and Services Tax Act, 2017 (12 of 2017) only for the purpose of deducting tax under section 51 of the said Act and not for making a taxable supply of goods or services; or (ii) a registered person paying tax under section 10 of the said Act.		
<sup>40</sup> [15	Services provided by way of renting of any motor vehicle designed to carry passengers where the cost of fuel is included in the consideration charged from the service recipient, provided to a body corporate	Any person, other than a body corporate who supplies the service to a body corporate and does not issue an invoice charging central tax at the rate	Any body corporate located in the taxable territory.]

<sup>40</sup> Substituted vide Notification No. 29/2019- Central Tax (Rate) dt. 31.12.2019. Prior to this substitution it was read as below which was inserted vide Notification No. 22/2019- Central Tax (Rate) dated 30.09.2019 effective from 1.10.2019.

15.	Services provided by way of renting of a motor vehicle provided to a body corporate	Any person other than a body corporate, paying central tax at the rate of 2.5% on renting of motor vehicles with input tax credit only of input service in the same line of business	Any body corporate located in the taxable territory
-----	---	--	---



**Guidance Note on Audit of Banks (Revised 2020)**

		of 6 % to the service recipient	
<sup>41</sup> [16	Services of lending of securities under Securities Lending Scheme, 1997 ("Scheme") of Securities and Exchange Board of India ("SEBI"), as amended.	Lender i.e. a person who deposits the securities registered in his name or in the name of any other person duly authorised on his behalf with an approved intermediary for the purpose of lending under the Scheme of SEBI	Borrower i.e. a person who borrows the securities under the Scheme through an approved intermediary of SEBI.]

In addition to the above list given under Central Tax- Rate, following additional category of supply of services is listed under **Notification 10/2017-ITR** on which GST shall be paid by the recipient on reverse charge basis:

---

<sup>41</sup> Inserted vide Notification No. 22/2019- Central Tax (Rate) dt. 30.09.2019 effective from 1.10.2019

**Guidance Note on Audit of Banks (Revised 2020)**

Sl. No.	Category of Supply of Services	Supplier of service	Recipient of Service
(1)	(2)	(3)	(4)
1	Any service supplied by any person who is located in a non-taxable territory to any person other than non-taxable online recipient	Any person located in a non-taxable territory	Any person located in the taxable territory other than non-taxable online recipient.
2	Services supplied by a person located in non-taxable territory by way of transportation of goods by a vessel from a place outside India up to the customs station of clearance in India	A person located in non-taxable territory	Importer, as defined in clause (26) of section 2 of the Customs Act, 1962(52 of 1962), located in the taxable territory.

**RCM as per section 9(4) of the CGST Act or section 5(4) of the IGST Act**

26.88 Prior to 1.02.2019, pursuant to per section 9(4) of the CGST Act or section 5(4) of the IGST Act, supply of taxable goods or services or both by an unregistered supplier to a registered person was exigible to CGST/ IGST under RCM.

26.89 Thereafter, vide *Notification No.8/2017-Central Tax (Rate) dated 28.06.2017*, intra-State supply of taxable goods or services or both by an unregistered supplier to a registered person are exempt from CGST provided the aggregate value of such supplies of goods and/or services received by a registered person from any or all the unregistered suppliers does not exceed Rs. 5,000 in a day. However, no such parallel notification was issued in IGST for inter-state supplies.

26.90 Subsequently, the aforesaid limit was withdrawn vide *Notification no. 38/2017- Central Tax (Rate) dated 13.10.2017* and hence, intra-State supply of taxable goods or services or both by an unregistered supplier to a registered person was exempted till 31.03.2018. Moreover, vide *Notification No. 32/2017 – Integrated Tax (Rate) dated 13.10.2017*, the Central Government exempted inter-State supply of goods or services or both received by a registered person from any unregistered supplier, from IGST leviable under section 5(4) of IGST Act till 31.03.2018.

**Guidance Note on Audit of Banks (Revised 2020)**

26.91 Later, this provision of reverse charge was deferred till 30.09.2019, the relevant notifications numbers are:

Exempted From	Notification under CGST	Notification under IGST
From 1.04.2018 to 30.06.2018	Notification No. 10/2018 – Central Tax (Rate) dated 23.03.2018	Notification No. 11/2018 – Integrated Tax (Rate) dated 23.03.2018
From 1.07.2018 to 30.09.2018	Notification No. 12/2018 – Central Tax (Rate) dated 29.06.2018	Notification No. 13/2018 – Integrated Tax (Rate) dated 29.06.2018
From 01.10.2018 to 30.09.2019	Notification No. 22/2018 – Central Tax (Rate) dated 06.08.2018	Notification No. 23/2018 – Integrated Tax (Rate) dated 06.08.2018

26.92 Then, in view of bringing into effect the amendments (regarding RCM on supplies by unregistered persons) in the GST Acts, reverse charge exemption *Notification No.8/2017-Central Tax (Rate) dated 28.06.2017* and *Notification No. 32/2017 – Integrated Tax (Rate) dated 13.10.2017* has been rescinded with effect from 1.02.2019 vide *Notification No 01/2019-Central/Integrated Tax (Rate) ,dated 29-01-2019* .

26.93 Further, with effect from 1<sup>st</sup> February 2019, the Central/Integrated Goods and Services Tax (Amendment) Act, 2018 has substituted section 9(4) of the CGST Act/ 5(4) of the IGST Act, as:

*“(4) The Government may, on the recommendations of the Council, by notification, specify a class of registered persons who shall, in respect of supply of specified categories of goods or services or both received from an unregistered supplier, pay the tax on reverse charge basis as the recipient of such supply of goods or services or both, and all the provisions of this Act shall apply to such recipient as if he is the person liable for paying the tax in relation to such supply of goods or services or both.”*

Hence, reverse charge on inward supply of goods and / or services effected by a registered person from an unregistered supplier is applicable only in respect of notified (a) ‘class of registered persons’ and (b) ‘categories of goods or services’

26.94 Some of the services which are relevant with respect to the Banking sector are explained in detailed below:

- **Services provided by recovery agent** -Generally, loans are the areas wherein the banks earn major portion of their income. It is the most organized form of extending credit to customers and interest is earned as an income in respect of such credits extended. Majority of banks spend great time and effort in recovering credits so granted.

Further, many banks sell their loans to third parties or hire third party agents to initiate recovery on their behalf.

Loans sold to factoring agents are not liable for payment of GST. Please examine that these transactions would be 'exempt supply' depending on whether these are with or without recourse.

Further, another type of transaction third parties is hired to initiate recovery on behalf of the banks which is purely a service transaction and liable to payment of GST. Further, RCM is applicable on such transactions and therefore the banks who hire such third-party agents are liable for payment of GST on the fees so paid to these recovery agents/third party agents. Banks also provide infrastructure, phone facilities and such other benefits to these third-party agents in order to perform their services. Even such value is required to be taken into consideration while determining the value of supply for the purpose of payment of GST.

As an auditor, one should check the agreements between the bank and the recovery agent. Under GST regime, the bank should raise a self-invoice and thereafter appropriate GST @ 18% should be paid on the same. The income so earned should be disclosed in the relevant chapter heading as classified under the GST regime.

- **Services provided by insurance agent**- If the banks are also engaged in business of insurance, then the services provided by such insurance agent who sell insurance products of the banks is liable for payment of GST. Further, the amount on which tax is payable is commission so paid to the insurance agent. Such commission also includes reimbursement by any mode.

The insurance division of the banks so receiving the services from those insurance agents are liable for payment of GST under RCM.

As an auditor, one should check the agreements between the bank and the insurance agent. Under GST regime, the bank should raise a self-

invoice and thereafter appropriate GST @ 18% should be paid on the same. The income so earned should be disclosed in the relevant chapter heading as classified under the GST regime.

- **Services provided by goods transport agency service** -W.e.f. July 1,2017 *vide Entry No.1 of Notification 13*, if any services in respect of transportation of goods by road are provided by goods transport agency (GTA) to the following recipient located in the taxable territory then recipient of service is liable to pay tax under reverse charge:
  - (a) Any factory registered under or governed by the Factories Act, 1948 (63 of 1948); or
  - (b) any society registered under the Societies Registration Act, 1860 (21 of 1860) or under any other law for the time being in force in any part of India; or
  - (c) any co-operative society established by or under any law; or
  - (d) any person registered under the CGST Act or the IGST Act or the SGST Act or the UTGST Act; or
  - (e) any body corporate established, by or under any law; or
  - (f) any partnership firm whether registered or not under any law including association of persons; or
  - (g) any casual taxable person.

However, w.e.f. from 22<sup>nd</sup> August 22,2017 *vide* Notification No. 22/2017 dated 22.08.2017 which amended Notification 13/2017, the GTA was given an option to pay to GST @ 5% (2.5 CGST+2.5 SGST/ 5% IGST) if no input tax credit is availed subject to RCM. Further, if GTA has availed ITC, GST is to be paid by GTA @12%.

Further, w.e.f. 1<sup>st</sup> January,2019 *vide Notification No. 29/2018-Central Tax (Rate), dated 31-12-2018*, nothing contained in this entry shall apply to services provided by a GTA, by way of transport of goods in a goods carriage by road, to, -

- (a) a Department or Establishment of the Central Government or State Government or Union territory; or
- (b) local authority; or
- (c) Governmental agencies,

which has taken registration under the CGST, 2017 (only for the purpose of deducting tax under section 51 and not for making a taxable supply of goods or services.

## Guidance Note on Audit of Banks (Revised 2020)

---

Therefore, auditor has to check that correct ITC is taken, and appropriate person has discharged the tax. Carriage of Goods by Road Act, 2007 requires that no motor vehicle undertake transport of goods by road except with a proper registration of such motor vehicle. And every consignment be accompanied by a forward note or receiving note. Merely because goods are not of substantial value or not involving supply or involving inter-branch movement, it is not appropriate to avoid issuing such a 'note'. When such 'note' is issued, the transporter will be a GTA. Under the GST notification, GTA is one who issues a consignment note '*by whatever name called*'.

- **Services provided by advocates:** W.e.f. 1<sup>st</sup> July , 2017 In terms of entry no. 2 of vide Notification 13/2017, RCM was applicable on Services supplied by an individual advocate including a senior advocate by way of representational services before any court, tribunal or authority, directly or indirectly, to any business entity located in the taxable territory, including where contract for provision of such service has been entered through another advocate or a firm of advocates, or by a firm of advocates, by way of legal services, to a business entity

Thereafter a Corrigendum to Notification No. 13/2017 was issued [M.F. (D.R.) Corrigendum F. No. 336/20/2017-TRU, dated 25-9-2017], subsequently RCM is applicable on Services provided by an individual advocate including a senior advocate or firm of advocates by way of legal services, directly or indirectly.

Where - "*legal service*" means any service provided in relation to advice, consultancy or assistance in any branch of law, in any manner and includes representational services before any court, tribunal or authority.

Very often, legal services are availed by banks 'on account of' their customers. Here, auditors to ensure that banks do not withhold themselves from payment of RCM on legal fee paid on the premise that these services are availed 'on account of' their customers, especially when the legal fee is debited to customer's account. It is more appropriate that banks discharge RCM as fee from advocate will be issued to bank. Very often, it is observed that where expenses are incurred but debited to customer's account, RCM liability thereon, is somehow omitted. Customer's being unaware of the various components of costs that are embedded in the amounts debited to the account, RCM liability cannot possibly be discharged by them. Hence, banks may be advised to suitably ensure RCM is complied with.

- **Service provided by way of import of services:** Many banks do spend a lot of funds on procuring services from abroad. Where the supply of goods or services or both are taxable in nature, GST is payable by the recipient bank. Some important areas are summarized as under:

1. **Bond floating expenditure:** Generally, bond floating expenditure is an expenditure which though appropriately recorded in the books of accounts, skips the attention and the applicable taxes are not discharged often in respect of the same. Therefore, the concerned auditor should thoroughly inspect the books of accounts and identify all payments in foreign currency for compliance with these provisions.

For e.g.: IVY Bank wants to issue bonds in NYSE and for the said purpose has appointed WYE bank a leading bank of America for floating the said bonds and acting as a lead merchant banker. The fee for the same is generally some fixed % of the ticket size which is recorded appropriately in the books of accounts. The instant transaction is taxable in terms of Section 13 (2) of the IGST Act, 2017.

Under the GST regime, the same requires a thorough analysis of the transaction, these are generally taxable as per Section 13 of the IGST Act, 2017. However, the actual answer may vary depending upon the structuring of the transaction.

2. **Underwriting charges:** If underwriting charges are paid in foreign currency to an underwriter who is located outside India, then GST is payable on such transactions. Appropriate ledgers, contracts etc., should be scrutinised in great detail and thereafter relevant disclosures should be made regarding taxability on the same.
3. **I.T infrastructure cost:** It is a common cost which the banks bears on all-India basis and executes one common contract for the same. If the vendor is based outside India or the technicians are outside India and payment is being disbursed in foreign currency. Though, such cost requires careful apportionment in terms of appropriate provisions including rules and depending upon the nature of the transaction appropriate GST (generally @ 18%) is payable. Further, credit for GST so paid is available.

NOTE-It is pertinent to mention here that, the certain services exigible to service tax under RCM has been discontinued under GST like rent-a-cab, Manpower Supply, Security services, works contract service etc.

## Input Tax Credit

26.95 Under the GST regime, a banking company or a financial institution including a non-banking financial company engaged in supplying services by way of accepting deposits, extending loans or advances shall have following two options to avail Input tax credit in terms of Section 17(4) of the CGST Act 2017. And the option once exercised shall not be withdrawn during the remaining part of the financial year.

### Option I

Reverse the credit pertaining to exempted services as per the method stated in Section 17(2) of the CGST Act, 2017 read with the relevant State Act and Rules thereof

**OR**

### Option II

Avail 50% of the eligible input tax credit on inputs, capital goods and input services in that month and the rest shall lapse. And accordingly follow the following procedure in accordance with Rule 38 of the CGST Rules, 2017:

1. Such banking company or financial institution shall not avail credit of:
  - the tax paid on inputs and input services that are used for non-business purposes and
  - the credit attributable to the supplies specified in Section 17(5), in **FORM GSTR-2**
2. Further, the condition of 50% restriction would not be applicable in case of the tax paid on supplies made by one registered person to another registered person having the same PAN. Hence, banking company or financial institution shall avail the credit of tax paid on inputs and input services in case of supplies made to its own branches i.e. inter branch i.e., by one registered person to another registered person having different GSTIN.

Avail full credit on inter-branch supply of services between distinct persons of the banking or NBFC company. In other words, if HO has restricted credit to 50% and those goods or services are involved in inter-branch taxable supplies, the receiving branch is NOT required to further apply the 50% restriction. This relief is provided in second proviso to section 17(4); and

3. 50% of the remaining amount of input tax shall be admissible and shall be furnished in **FORM GSTR-2**



4. The amount referred in point 2. and 3 above shall subject to the provisions of Section 41,42 and 43, be credited to the electronic credit ledger of the said banking company or financial institution.

NOTE- The non-applicability of 50% reversal is only to the extent of inter-branch services between registered branches having the same PAN in India. Thus, tax paid on services received from a related person / distinct person located outside India would be liable to 50% reversal.

### **Apportionment of credit**

26.96 Section 17 (2) of the CGST Act stipulates that, where the goods or services or both are used by the registered person partly for effecting taxable supplies including zero-rated supplies under this Act or under the IGST Act and partly for effecting exempt supplies under the said Acts, the amount of credit shall be restricted to so much of the input tax as is attributable to the said taxable supplies including zero-rated supplies.

26.97 Credit attributable to exempt supplies is not available to a registered person. Exempt Supplies' for this purpose mean all supplies other than taxable and zero-rated supplies and specifically include the following:

- Supplies liable to tax under reverse charge mechanism;
- Transactions in securities;
- Sale of land; and
- Subject to Para 5(b) of Schedule II, sale of building.

26.98 Moreover, *vide CGST Amendment Act, 2018 w.e.f 1-02-2019*, the "value of exempt supply" shall not include the value of activities or transactions specified in Schedule III, except those specified in paragraph 5 of the said Schedule i.e., Sale of Land (S-III) / building (S-II).

26.99 Hence, they will not entail any reversal of credit. Further, *vide CGST Amendment Act, 2018 w.e.f. 1-02-2019*, a couple of clauses has been inserted within Schedule III of the CGST Act:

*"7. Supply of goods from a place in the non-taxable territory to another place in the non-taxable territory without such goods entering into India.*

*8. (a) Supply of warehoused goods to any person before clearance for home consumption; (b) Supply of goods by the consignee to any other person, by endorsement of documents of title to the goods, after the goods have been dispatched from the port of origin located outside India but before clearance for home consumption"*

**Guidance Note on Audit of Banks (Revised 2020)**

From the above, it can be gathered that excluding of supplies covered under Schedule III has resulted in lower reversal of credit particularly in case of high sea sales and merchant trade transactions.

Rule 42 of the CGST Rules, 2017: Manner of determination of ITC in respect of inputs or input services and reversal thereof *via* illustration:

Sl. No	Particulars	Reference	CGST	SGST/UTGST	IGST
1	Total input tax on inputs and input services for the tax period May 2018	T	1,00,000	1,00,000	50,000
	Out of the total input tax (T):				
2	Input tax used exclusively for non-business purposes (Note 1)	T1	10,000	10,000	5,000
3	Input tax used exclusively for effecting exempt supplies (Note 1)	T2	10,000	10,000	5,000
4	Input tax ineligible under Section 17(5) (Note 1)	T3	5,000	5,000	2,500
	<b>Total</b>		<b>25,000</b>	<b>25,000</b>	<b>12,500</b>
	ITC credited to Electronic Credit Ledger (Note 1)	$C1 = T - (T1 + T2 + T3)$	<b>75,000</b>	<b>75,000</b>	<b>37,500</b>
	Input tax credit used exclusively for taxable supplies (including zero-rated supplies) [Note 4]	T4	50,000	50,000	25,000
	<b>Common credit</b>	$C2 = C1 - T4$	<b>25,000</b>	<b>25,000</b>	<b>12,500</b>
	Aggregate value of exempt supplies for the tax period May 2018 (Note 2 & 3)	E	25,00,000	25,00,000	25,00,000

**Guidance Note on Audit of Banks (Revised 2020)**

Total Turnover of the registered person for the tax period May 2018 (Note 2)	F	1,00,00,000	1,00,00,000	1,00,00,000
Credit attributable to exempt supplies (Note 5)	D1 = (E/F) * C2	6,250	6,250	3,125
Credit attributable to non-business purposes	D2 = C2 * 5%	1,250	1,250	625
Net eligible common credit [Note 6]	C3 = C2 - (D1 + D2)	17,500	17,500	8,750
<b>Total credit eligible (Exclusive + Common)</b>	<b>G = T4 + C3</b>	<b>67,500</b>	<b>67,500</b>	<b>33,750</b>

Note 1: T1, T2, T3 and T4 shall be DETERMINED AS ABOVE and declared in Form GSTR-2 and at summary level in FORM GSTR-3B

Note 2: If the registered person does not have any turnover for May 2018, then the value of E and F shall be considered for the last tax period for which such details are available

Note 3: Aggregate value of exempt supplies and the total turnover shall exclude the amount of any duty or tax levied under entry 84 and entry 92A of List I of the Seventh Schedule to the Constitution and entry 51 and 54 of List II of the said Schedule.

*Remarks: Please note in case of supply of services covered by clause (b) of paragraph 5 of Schedule II of the Act (in case of apartment construction project-promoter), the calculation of Note 4 and 5 will done differently. For detail Refer Rule 42 of the CGST Rules*

Note 6: Amount of 'C3', 'D1' and 'D2' shall be computed separately for ITC of CGST, SGST, UTGST and IGST declared in FORM GSTR-3B or through FORM GST DRC-03.

And the amount equal to aggregate of 'D1' and 'D2' shall be reversed by registered person in FORM GSTR-3B or through FORM GST DRC-03.

Note 7: The registered person is expected to make such computation for each tax period and reverse the same in the periodic returns being filed by such registered person. However, on completion of the financial year, input

## Guidance Note on Audit of Banks (Revised 2020)

---

tax credit shall be determined accurately based on actuals, in the same manner as provided in Rule 42. A reconciliation is required to be done on an annual basis (between the amounts reversed for each tax period during the year and the amount determined at the end of the financial year) and any excess credit availed needs to be reversed with interest while short credit, if any, needs to be re-availed within 6 months from end of the financial year.

26.100 It is to be noted that the registered person would be required to remit excess ITC claimed (as determined in Note 7 above) with interest calculated at for the period starting from the first day of April of the succeeding financial year till the date of payment. However, no interest can be claimed if, at the end of the financial year, it is found that short credit was availed.

26.101 Therefore, an auditor can check whether, concerned branch is reversing ITC in compliance to the above Rule. If ITC is not reversed in compliance to the above Rules, it shall be treated as ITC wrongly taken and the same will be recovered along with the interest under Section 50 of the CGST Act, 2017.

26.102 Please Note that the following pre-requisites for availing credit by registered person pursuant to section 16(2) of the CGST Act:

- (a) He (Registered Person) is in possession of tax invoice or any other specified tax paying document.
- (b) He has received the goods or services. "Bill to ship to" scenarios also included.
- (c) Tax is actually paid by the supplier.
- (d) He has furnished the return.
- (e) If the inputs are received in lots, he will be eligible to avail the credit only when the last lot of the inputs is received.
- (f) He should pay the supplier the value of the goods or services along with the tax within 180 days from the date of issue of invoice, failing which the amount of credit availed by the recipient would be added to his output tax liability, with interest [rule 37(1) & (2) of CGST Rules, 2017]. However, once the amount is paid, the recipient will be entitled to avail the credit again. In case part payment has been made, proportionate credit would be allowed.

26.103 Beside above, the value of supplies in respect of following shall be deemed to have been paid and ITC shall not be reversed in such cases:

- Value of supplies made without consideration as per Schedule-I

**Guidance Note on Audit of Banks (Revised 2020)**

- Value of supplies on account of any amount added in accordance with section 15(2) (b), i.e. any amount that the supplier is liable to pay in relation to such supply but which has been incurred by the recipient of the supply and not included in the price actually paid or payable for the goods or services or both (Notification No. 26/2018-Central Tax, dated 13.06.2018)
- Value representing discount for which financial credit notes have been issued by the supplier
- Note- The provisions of section 18(6) of the CGST Act, 2017 for reversal of input tax credit availed on capital goods would be applicable to banks only to the extent of the input tax credit availed by it.

**Documents required for availing credit (Sec 36 of the CGST Act)**

(a) Invoice issued by a supplier of goods or services or both as per S-31	(b) Invoice issued as per S-31(2)(f) by recipient along with proof of payment of tax	(c) A debit note issued by supplier u/s 34
(d) Bill of entry or similar document prescribed under Customs Act, 1962	(e) Revised invoice	(f) Document issued by Input Service Distributor.

**Restriction/ No ITC allowed to be availed**

- Beyond September of the following FY to which invoice pertains or date of filing of annual return, whichever is earlier. However, due date of taking ITC for FY 17-18 was extended till 31<sup>st</sup> March, 2019.
- In terms of Section 36(4), ITC to be availed by a registered person in respect of invoices or debit notes, the details of which have not been uploaded by the suppliers under section 37(1), shall not exceed 10%<sup>42</sup> of the eligible credit available in respect of invoices or debit notes the details of which have been uploaded by the suppliers under section 37(1) of the CGST Act

<sup>42</sup> Substituted vide Notification No. 75/2019 - Central Tax dated 26-12-2019 w.e.f.1-01-2020. Prior to such substitution it was 20 % vide Notification No. 495/2019 - Central Tax dated dt. 09.10.2019 via which Section 36(4) was inserted

**Guidance Note on Audit of Banks (Revised 2020)**

**No ITC can be availed in terms of S- 17(5) of CGST Act, 2017 – No ITC shall be available in respect of the following namely:**

- (a) motor vehicles for transportation of persons having approved seating capacity of not more than 13 persons (including the driver), except when they are used for making the following taxable supplies, namely:

(A) further supply of such motor vehicles; or	(B) transportation of passengers; or	(C) imparting training on driving such motor vehicles;
---	--------------------------------------	--

(aa) vessels and aircraft except when they are used—

(i) for making the following taxable supplies, namely	(ii) for transportation of goods
---	----------------------------------

(A) further supply of such vessels or aircraft; or	(B) transportation of passengers; or	(C) imparting training on navigating such vessels; or	(D) imparting training on flying such aircraft;
--	--------------------------------------	---	---

(ab) services of general insurance, servicing, repair and maintenance in so far as they relate to motor vehicles, vessels or aircraft referred to in clause (a) or clause (aa):

<b>However, ITC is available respect of such services</b>	
(i) where the motor vehicles, vessels or aircraft referred to in clause (a) or clause (aa) are used for the purposes specified therein;	(ii) where received by a taxable person engaged – (I) in the manufacture of such motor vehicles, vessels or aircraft; or (II) in the supply of general insurance services in respect of such motor vehicles, vessels or aircraft insured by him;

(b) the following supply of goods or services or both—

(i) food and beverages, outdoor catering, beauty treatment, health services, cosmetic and plastic	(ii) membership of a club, health and	(iii) travel benefits extended
---	---------------------------------------	--------------------------------

**Guidance Note on Audit of Banks (Revised 2020)**

<p><i>surgery, leasing, renting or hiring of motor vehicles, vessels or aircraft referred to in clause (a) or clause (aa) except when used for the purposes specified therein, life insurance and health insurance ###</i></p>	<p><i>fitness centre; and</i></p>	<p><i>to employees on vacation such as leave or home travel concession @@@</i></p>
--	-----------------------------------	--

*### Provided that the ITC shall be available where an inward supply of such goods or services or both is used by a registered person for making an outward taxable supply of the same category of goods or services or both or as an element of a taxable composite or mixed supply;*

*@@@ Provided that the input tax credit in respect of such goods or services or both shall be available, where it is obligatory for an employer to provide to its employees under any law for the time being in force.*

**Note-** The provisions have been amended so as to allow ITC in respect of goods or services or both specified above if it is made obligatory for an employer to provide such services under any law for the time being in force.

In all the above cases [section17(5)(b)], the credit will be available if the goods or services are required to be provided by the employer through any obligation imposed under any law

- (c) *works contract services when supplied for construction of immovable property, (other than plant and machinery), except where it is an input service for further supply of works contract service;*
- (d) *goods or services or both received by a taxable person for construction of an immovable property (other than plant and machinery) on his own account, including when such goods or services or both are used in the course or furtherance of business;*

*Explanation. - For the purpose of clause (c) and (d), the expression "construction" includes re-construction, renovation, additions or alterations or repairs, to the extent of capitalization, to the said immovable property.*

**Guidance Note on Audit of Banks (Revised 2020)**

---

- (e) *goods or services or both on which tax has been paid under section 10;*
- (f) *goods or services or both received by a non-resident taxable person except on goods imported by him;*
- (g) *goods or services or both used for personal consumption;*
- (h) *goods lost, stolen, destroyed, written off or disposed of by way of gift or free samples; and*
- (i) *any tax paid in accordance with the provisions of sections 74, 129 and 130. i.e., any tax paid due to short payment on account of fraud, suppression, mis-declaration, seizure, detention*

Note- From 1<sup>st</sup> February, 2019, Section 17(5) (a) and (b) has been amended vide CGST Amendment Act, 2018. Prior to substitution they were as under:

- (a) *motor vehicles and other conveyances except when they are used—*
  - (i) *for making the following taxable supplies, namely: —*
    - (A) *further supply of such vehicles or conveyances; or*
    - (B) *transportation of passengers; or*
    - (C) *imparting training on driving, flying, navigating such vehicles or conveyances;*
  - (ii) *for transportation of goods;*
- (b) *the following supply of goods or services or both—*
  - (i) *food and beverages, outdoor catering, beauty treatment, health services, cosmetic and plastic surgery except where an inward supply of goods or services or both of a particular category is used by a registered person for making an outward taxable supply of the same category of goods or services or both or as an element of a taxable composite or mixed supply;*
  - (ii) *membership of a club, health and fitness centre;*
  - (iii) *rent-a-cab, life insurance and health insurance except where—*
    - (A) *the Government notifies the services which are obligatory for an employer to provide to its employees under any law for the time being in force; or*
    - (B) *such inward supply of goods or services or both of a particular category is used by a registered person for making an outward taxable supply of the same category of goods or services or*



- both or as part of a taxable composite or mixed supply; and*
- (iv) travel benefits extended to employees on vacation such as leave or home travel concession;*

**Credit utilization**

26.104 In terms of section 49 of the CGST Act, the amount of ITC available in the electronic credit ledger of the registered person on account of:

- IGST shall first be utilised towards payment of IGST and the amount remaining, if any, may be utilised towards the payment of CGST and SGST/UTGST, in that order;
- CGST shall first be utilised towards payment of CGST and the amount remaining, if any, may be utilised towards the payment of IGST;
- SGST/UTGST shall first be utilised towards payment of SGST/UTGST and amount remaining, if any, may be utilised towards payment of IGST. However, w.e.f. 1-02-2019 *vide* the CGST (Amendment) Act, 2018, ITC on account of SGST/UTGST shall be utilised towards payment of IGST only where the balance of ITC on account of CGST is not available for payment of IGST;
- CGST shall not be utilised towards payment of SGST/ UTGST and vice versa respectively [*section 49(5)(e) and (f)*]

26.105 Subsequently, w.e.f. 1-02-2019, Section 49A and 49B has been inserted *vide* the CGST Amendment Act 2018. Section 49A stipulates that notwithstanding anything contained in section 49, ITC on account of CGST, SGST/UTGST shall be utilised towards payment of IGST, CGST, SGST or UTGST as the case may be, only after the ITC available on account of IGST has first been utilised fully towards such payment.

26.106 Further, Section 49B of the CGST Act, 2017 provides that notwithstanding anything contained in ITC Chapter V of the CGST Act and subject to section 49(5)(e) and (f) of the CGST, the Government may, on the recommendations of the Council, prescribe the order and manner of utilisation of the ITC on account of IGST, CGST, SGST or UTGST, as the case may be, towards payment of any such tax.

26.107 In this regard, w.e.f. 29-03-2019 *vide Notification No. 16/2019 – Central Tax dated 29.03.2019*, Rule 88A of the CGST Rules has been inserted which provides order of utilization of ITC.as:

*“Input tax credit on account of integrated tax shall first be utilised towards payment of integrated tax, and the amount remaining, if any, may be*

## Guidance Note on Audit of Banks (Revised 2020)

*utilised towards the payment of central tax and State tax or Union territory tax, as the case may be, in any order:*

*Provided that the input tax credit on account of central tax, State tax or Union territory tax shall be utilised towards payment of integrated tax, central tax, State tax or Union territory tax, as the case may be, only after the input tax credit available on account of integrated tax has first been utilised fully.”*

### Return Under GST – Banking Sector

26.108 To avoid Interest and penalties, timely filling GST Return is of paramount importance. Every registered banking and/or financial institution including non-banking financial company is liable to file GSTR-3B, GSTR-1, GSTR-6, GSTR 9 and GSTR-9C.

FORM	PARTICULARS	DUE DATE	APPLICABLE TO
GSTR-3B	Monthly summary return	20 <sup>th</sup> of the next month	All registered persons (other than Input Service Distributor (ISD), person liable to deduct TDS and personally liable to collect tax at source).
GSTR-1	Outward Supplies > 1.5 Crore Outward Supplies < 1.5 Crore	11 <sup>th</sup> of the next month Last date of month subsequent to the quarter	Normal / Regular Taxpayer
GSTR-5	Return by non-resident tax payers [foreigners]	20 <sup>th</sup> of the next month or within 7 days after expiry of registration, whichever is earlier	Non-Resident taxpayer
GSTR-6	Monthly Return by input service distributors	13 <sup>th</sup> of the next month	Input Service Distributor
GSTR-9	Annual return	31 <sup>st</sup> December of the next Financial Year	Normal tax payer (other than

**Guidance Note on Audit of Banks (Revised 2020)**

		FY 2017-18 has been extended till 30 <sup>th</sup> June, 2019	casual tax payer)
GSTR-9C	Annual return along with the copy of audited annual accounts and a reconciliation statement	31 <sup>st</sup> December of the next Financial Year FY 2017-18 has been extended till 30 <sup>th</sup> June, 2019	Normal tax payer having aggregate turnover of more than ` 2 crores

**Note:**

New returns can be used on trial basis from July 2019 and mandatorily from April 2020. In the new GST Return System, there will be 3 main components to the new return – 1 main return (FORM GST RET-1) and 2 annexures (FORM GST ANX-1 and FORM GST ANX-2). FORM GST RET-1 is to be filled by 20<sup>th</sup> of the month succeeding the month to which the tax liability pertains. Annexure of outward supplies (ANX-1) and Annexure of Inward Supplies (ANX-2) will be filed as part of these returns. All the outward supplies will be detailed in GST ANX-1 while GST ANX-2 will contain details of inward supplies auto-populated mainly from the suppliers' GST ANX-1. Hence, the current FORM GSTR-1 will be replaced by FORM GST ANX-1

Further, tax payers are categorized, on the basis of aggregate annual turnover in the previous financial year ("AT") as:

- o Taxpayer with AT > 5 crore is termed as Large Tax Payer
- o Taxpayer with AT < 5 crore is termed as Small Tax Payer

26.109 Large tax payers has to file FORM GST RET-1 on monthly basis on the basis of aforesaid annexures and also make payment of GST monthly.

26.110 While Small Tax Payers has the option to file Monthly or Quarterly Returns i.e. FORM GST RET-1. If he chooses to file quarterly return, he has 3 options - FORM GST RET-1 or FORM GST RET-2 (Sahaj) or Form GST RET-3 (Sugam) on quarterly basis, but the payment of tax has to be done monthly by filling FORM GST PMT-08. However, E-commerce operators are ineligible to file Sahaj or Sugam.

- Small Tax Payer who have supplies (outward) only to consumers and unregistered persons (B2C supplies) and inward supplies attracting reverse charge only, can file Form GST RET-2 based on FORM GST ANX-1 and FORM GST ANX-2;
- Small Tax Payer who have made supplies (outward supplies) to

consumers and un-registered persons (B2C) and to registered persons (B2B) and inward supplies attracting reverse charge only can file Form GST RET-3 based on FORM GST ANX-1 and FORM GST ANX-2.

New return system also provides Option to file NIL return through SMS.

### **Obligation to furnish information return**

26.111 Any person, being a banking company within the meaning of section 45A(a) of the Reserve Bank of India Act, 1934, who is responsible for maintaining record of registration or statement of accounts or any periodic return or document containing details of payment of tax and other details of transaction of goods or services or both or transactions related to a bank account or consumption of electricity or transaction of purchase, sale or exchange of goods or property or right or interest in a property under any law for the time being in force, shall furnish an information return of the same in respect of such periods, within such time, in such form and manner and to such authority or agency as may be prescribed.[Section150(1)(e) of the CGST Act]

26.112 Furthermore, if the Commissioner, or an officer authorised by him in this behalf, considers that the information furnished in the information return is defective, he may intimate the defect to the person who has furnished such information return and give him an opportunity of rectifying the defect within 30 days from the date of such communication of information or within such further period. If the defect in the return is not rectified within the time prescribed, the information return should be treated as not submitted and penalty of Rs.100/- per day for each day during which the failure continues, would be payable subject to a maximum of ` 5,000 in terms of section 123 of the CGST Act.

26.113 Moreover, if no information return is filed, within the stipulated period, authority may serve a notice requiring him to furnish of such return within a period not exceeding 90 days from the date of service of the notice and such person shall furnish the information return.

**Guidance Note on Audit of Banks (Revised 2020)**

**Note:**

Department in terms of Circular no.129/48/2019-GST dated 24<sup>th</sup> December 2019 follow Standard operating procedure in case return is not filed on time as:

<b>Timeline</b>	<b>Action by Department</b>
3 Days prior to Due Date i.e. on 17 <sup>th</sup> of any month	A system generated message would be sent to all the registered persons to remind them about filing of the return for the tax period by the due date.
After due date i.e. any day after 20 <sup>th</sup> of any month	A system generated mail / message would be sent to all the defaulters immediately after the due date to the effect that the said registered person has not furnished his return for the said tax period; the said mail/message is to be sent to the authorized signatory as well as the proprietor/ partner/director/ karta, etc.
Five days after due date i.e. 25 <sup>th</sup> of any month	A notice in FORM GSTR-3A (under section 46 of the CGST Act read with rule 68 of the CGST Rules) shall be issued electronically to such registered person who fails to furnish return under section 39, requiring him to furnish such return within fifteen days.
15 days from 25 <sup>th</sup> of any month	<ol style="list-style-type: none"> <li>1. In case the said return is still not filed by the defaulter within 15 days of the said notice, the proper officer may proceed to assess the tax liability of the said person (under section 62) of the CGST Act, to the best of his judgement taking into account all the relevant material which is available or which he has gathered and would issue order (under rule 100) of the CGST Rules in FORM GST ASMT-13.</li> <li>2. The proper officer would then be required to upload the summary thereof in FORM GST DRC- 07.</li> <li>3. For the purpose of assessment of tax liability under section 62 of the CGST Act, the proper officer may take into account the details of outward supplies available in the statement furnished (under section 37 (FORM GSTR-1)), details of supplies auto-populated in FORM</li> </ol>

**Guidance Note on Audit of Banks (Revised 2020)**

	<p>GSTR-2A, information available from e-way bills, or any other information available from any other source, including from inspection (under section 71).</p> <p>4. In deserving cases [Not specified] , based on the facts of the case, the Commissioner may resort to provisional attachment to protect revenue (under section 83 of the CGST Act) before issuance of FORM GST ASMT-13.</p>
30 days after service of assessment order	<p>In case the defaulter furnishes a valid return within 30 days of the service of assessment order in <b>FORM GST ASMT13</b>, the said assessment order shall be deemed to have been withdrawn (in terms of section 62(2) of the CGST Act).</p> <p>However, if the said return remains unfurnished within the statutory period of 30 days from issuance of order in <b>FORM ASMT-13</b>, then proper officer may initiate recovery proceedings (under section 78) and recovery of Tax (under section 79) of the CGST Act</p>
Any time after above 30 days	<p>The proper officer would initiate action for cancellation of registration(under section 29(2) of the CGST Act) in cases where the return has not been furnished for the period specified in section 29</p>

**Input Service Distributor**

26.114 Input Service Distributor (ISD) is an office of the supplier of goods or services or both where a document (like invoice) of services attributable to other locations are received (since they might be registered separately). Since the services relate to other locations the corresponding credit should be transferred to such locations (having separate registrations) as services are supplied from there. Please note ISD cannot be an office that does any supply of its own but must be one that merely collects invoice for services and issues prescribed document for its distribution.

26.115 ISD cannot normally be used in a situation where there is a liability to pay GST. It can only receive input tax credits on invoices related to input services and distribute such credits in the manner discussed below. An ISD cannot discharge tax liability under reverse charge. This would require obtaining another registration as a regular registered person and discharge RCM liability.

## **Guidance Note on Audit of Banks (Revised 2020)**

---

26.116 Section 20 read with Rule 39 of the CGST Act deals with manner and procedure of distribution of credit by ISD. ISD shall distribute the credit of CGST as CGST or IGST and IGST as IGST or CGST, by way of issue of a document containing, the amount of ITC credit being distributed in such manner as may be prescribed and subject to certain conditions. ISD may distribute the credit available for distribution in the same month in which it is availed. As per Rule 39(1)(e) and (f) of the said rules, ISD shall distribute:

- ITC on account of CGST and SGST or UTGST
  - in respect of recipient located in the same state shall be distributed as CGST and SGST or UTGST respectively.
  - in respect of a recipient located in a State or Union territory other than that of the ISD, be distributed as IGST and
- the amount to be so distributed shall be equal to the aggregate of the amount of ITC of CGST and SGST or UTGST that qualifies for distribution to such recipient in accordance with Rule 39(1)(d).
- ITC on account of IGST shall be distributed as IGST.

26.117 The conditions to be adhered as prescribed in section 20 are:

- the credit can be distributed to recipients of credit against a document containing such details as may be prescribed.

Where ISD is an office of a banking company or a financial institution, including a nonbanking financial company, a tax invoice shall include any document in lieu thereof, by whatever name called, whether or not serially numbered but containing the prescribed information.

Each type of tax must be distributed through a separate ISD invoice. However, there is no requirement to issue ISD invoices at an invoice-level (received from the supplier of the service). However, there is no requirement to issue ISD invoices at an invoice-level (received from the supplier of the service).

- the amount of ITC distributed shall not exceed the amount of credit available for distribution
- the credit of tax paid on input services attributable to recipient of credit shall be distributed only to that recipient
- the credit of tax paid on input services attributable to more than one recipient of credit shall be distributed amongst such recipient(s) to whom the input service is attributable and such distribution shall be pro rata on the

## Guidance Note on Audit of Banks (Revised 2020)

---

basis of the turnover in a State or turnover in a Union Territory of such recipient, during the relevant period, to the aggregate of the turnover of all such recipients to whom such input service is attributable and which are operational in the current year, during the said relevant period

- the credit of tax paid on input services attributable to all recipients of credit shall be distributed amongst such recipients and such distribution shall be pro rata on the basis of the turnover in a State or turnover in a Union Territory of such recipient, during the relevant period, to the aggregate of the turnover of all recipients and which are operational in the current year, during the said relevant period.

### Payment dates

26.118 GST should be disbursed by following the due dates mentioned below: — 20<sup>th</sup> of the next month. FORM GST PMT-6 Challan for deposit of GST — valid for 15 days from the date of generation of challan.

26.119 Further, interest under Section 50, to be paid in case of failure to pay tax or part thereof to the Government within period prescribed is 18% from the due date of payment to the actual date of payment of tax And 24% in case Excess claim of Input Tax Credit or excess reduction in output tax liability

### Accounts and Records

26.120 Section 35-36 of the CGST Act and Rule 56 to 58 of CGST Rules deals with provisions pertaining to accounts and records. Rule 56 of the CGST Rules provide for the documents with maintenance of accounts by registered persons. Rule 56(7) stipulates that every registered person shall keep the books of account at the principal place of business and books of account relating to additional place of business mentioned in his certificate of registration and such books of account shall include any electronic form of data stored on any electronic device.

26.121 Section 36 *inter alia* prescribes that, every assessee shall retain the books of accounts and other records until the expiry of 72 months (6 years) from the due date for filing of Annual Return for the year pertaining to such accounts and records. If the annual returns for the FY 2017-18 are filed on say 31.12.2018, even then, the books of account and other records are to be maintained till 31.12.2024. Even if the annual return is filed earlier, the start date for considering 72 months runs from the end of due date to file the annual return.

26.122 In case an appeal or revision or any other proceeding is pending



**Guidance Note on Audit of Banks (Revised 2020)**

before any Appellate Authority or Provisional Authority or Appellate Tribunal or Court, or in case the assessee is under investigation for an offence under Chapter XIX, the assessee shall retain the books of account and other records pertaining to the subject matter of such appeal or revision or proceeding or investigation for a period of one year after final disposal of such appeal or revision or proceeding, or for the period specified records u/s 35(1), whichever is later

26.123 Based on above discussions, an exemplary Questionnaire for GST Audit of Banks is prepared as under:

**Name of the Branch:**

**GSTIN:**

**Particulars/information for the year**

<b>PART A: Basic Details of Assessee</b>	
1.	Name of the Supplier/ Recipient of Supply
2.	Full address of: <b>(Note- In GST, there is no Concept of Centralised Registration. State wise registration prevails and each unit in the respective states should be added in the registration certificate classifying as a principal place of business in the State and others as additional place of business.)</b> of the Branch under audit and address of the branches in the State:
3.	List of GST registration numbers in the State with date of registration and nature of registration as Supplier/ Recipient of Supply.
4.	Validity Period of Registration (in case of casual person and NRI)
5.	PAN of Assessee
6.	List principal activities <b>(Note- In order to understand the taxability of various supplies provided by the concerned branch/head office, it is important to identify the various supplies provided by such branch or head office. For this purpose, the auditors may analyse the various income heads (Operating and Non-Operating).Hence in GST various List principal supplies need to be provided by the unit registered (assessee) i.e., branch)</b>
7.	Is there any change in the activities stated above during the year as compared to immediately preceding year? Whether the same is included in registration <b>(Note- Check whether any new service is provided by the concerned branch or head office. If yes, being an</b>

**Guidance Note on Audit of Banks (Revised 2020)**

	<i>auditor, we can check whether the same is updated in the GST Registration Certificate or not? However, GST portal allows addition of Top 5 supplies only. It becomes important because taxability of any activity depends upon its nature and any exemption or relief will be available accordingly.)</i>
8.	Whether taxpayer has maintained accounts and records in terms of Section 35 -36 of the CGST Act, 2017 read with Rule 56 to 58 of the CGST Rules, 2017.
<b>PART B: EXEMPTION AVAILABLE UNDER CGST/SGST/IGST</b>	
9.	Broad description of nature of Income
10.	Erstwhile service tax law was not applicable in case of J&K but GST is applicable, so check no transaction is left.  (b) Are services provided outside India? If Yes, please specify nature of Service and amount involved
11.	Broad description of exempted services provided, if any, along with Notification No. and amount Involved
12.	Whether GST is leviable on Transaction in Money under GST?
13.	Whether Securities/ derivatives are exigible tor GST?
14.	Whether any service charges or administrative charges or entry charges are recovered in addition to interest on a loan, advance or a deposit such as locker rent, folio charges, loan processing fee, late payment fee, lease management fee, rent, management fee etc. are exigible to GST?
15.	Whether the Bank is trading in Commercial paper /Certificates of deposits?  If yes, whether any separate charges are collected, and GST being paid on the same and provide details thereon.
16.	Whether GST is levied on late fee charges collected from credit card holders?  If yes, then whether GST is being paid on the same and give details thereof.
<b>PART C: COMPLIANCES UNDER GST ACTs AND RULES, 2017</b>	
11 (a)	Is Section 9(3) of the CGST Act read <i>with Notification No.13/2017</i>

**Guidance Note on Audit of Banks (Revised 2020)**

	as amended followed by the bank?
11 (b)	If the answer (a) is No, Specify the head of expenditure and corresponding details
11 (c)	<ul style="list-style-type: none"> <li>• Whether GST have been paid on RCM on services procured from supplier in terms of Section 9(3) of the CGST Act?</li> <li>• Whether GST have been paid on advances paid by the banks u/s 9(3) of the CGST Act ?</li> <li>• Whether all inward supplies (whether creditable or not) flow into the books of the bank through the GSTR-1 of any registered supplier? If not, have such supplies been reported in GSTR-2/ 3B u/ s 9(3) of CGST Act / 5(4) of IGST Act, even if no tax is payable from 13<sup>th</sup> October, 2017?</li> <li>• Whether in respect of each inward supply where no tax has been paid, is there a clear disclosure made to the auditors as to the reasons for the tax position taken in each case? Auditor may examine, if the tax position taken requires to be reported in the audit report or other communication?</li> <li>• Whether the credit taken in respect of services covered under RCM is taken only after making payment of GST under RCM?</li> </ul>
17.	<p>(a) Whether payment and other ledger entries are made in terms of the CGST Act and payment rules given in CGST Rules, 2017?</p> <p>(b) If Tax is paid belatedly, specify interest paid on delayed payment under Section 50 of the CGST Act,2017</p> <p>(c) Whether RCM tax liability is not discharged by utilizing the accumulated ITC?</p>
18.	Banking sector provides services of purchase and sale of foreign currency to its customers, the value of which can be ascertained in terms of Rule 32(2) of the CGST Rules, hence liable to GST. However, (i) inter se sale or purchase of foreign currency amongst banks or authorised dealers of foreign exchange or amongst banks and such dealers is exempt vide Notification No.12/2017.[Note-Auditor has to check , the value of supply of services in relation to the purchase or sale of foreign currency, including money changing is determined in terms of Rule 32(2)] and also check the parties involved in the supply.

**Guidance Note on Audit of Banks (Revised 2020)**

<b>PART D: COMPLIANCE OF ITC PROVISIONS GIVEN UNDER GST ACT AND CGST RULES, 2017</b>	
19.	<p>(a) Whether ITC taken/ utilized is matching with Books of accounts and GST returns (<b>Annexure A</b>)</p> <p>(b) If the answer of (a) above is negative, Report differences thereof. (<b>Annexure C</b>).</p>
20.	Whether ITC credit taken, utilized and reversed on input services / inputs and Capital goods is as per the CGST Act read with CGST Rules?
21.	<ul style="list-style-type: none"> <li>• Whether the head office has not availed depreciation u/s 32 of the Income Tax Act, 1961 on the amount of GST on the capital goods on which input tax credit has been availed?</li> <li>• Whether the bank has taken the Input Tax Credit in respect of input and capital goods / services on the basis of proper duty paying documents, containing all particulars as prescribed by CGST Rules read with section 31 of the CGST Act, 2017.?</li> </ul>
22.	<p>If the taxpayer is registered as an ISD. <i>Being an auditor, few points to be checked are:</i></p> <p>(a) <i>Ensure every person being an ISD shall make a separate application for registration as such Input Service Distributor?</i></p> <p>(b) <i>Whether an ISD invoice is issued to each recipient of credit on every distribution in terms of CGST Act read with CGST Rules?</i></p> <p>(c) <i>Ensure, Credit distributed does not exceed the credit available for distribution?</i></p> <p>(d) <i>Whether ISD is distributed to those taxable persons whose PAN no is same as that of ISD (Under GST)?</i></p> <p>(e) <i>Whether credit attributable to a specific unit is distributed to that unit only?</i></p> <p>(f) <i>Whether, Section 20 of the CGST Act is adhered in reference to the manner of distribution of credit by ISD?</i></p> <p>(g) <i>Whether, procedure for distribution of ITC by ISD is adhered?</i></p> <p>(h) <i>Whether Tax paid on input services used by a particular location (registered as supplier), is to be distributed only to that location?</i></p>

**Guidance Note on Audit of Banks (Revised 2020)**

	<p>(i) Whether, Credit of tax paid on input service used by more than one location who are operational is to be distributed to all of them based on the pro rata basis of turnover of each location in a State to aggregate turnover of all such locations who have used such services.</p> <p>(j) Ensure that, each type of tax must be distributed through a separate ISD invoice?</p> <p>(k) Whether the credit of IGST is distributed as IGST, irrespective of the location of the ISD?</p> <p>(l) Whether the aggregate of CGST and SGST and UTGST), as IGST, where the ISD is located in a State other than that of the recipient of credit?</p> <p>(m) Whether the CGST and SGST (or UTGST) is distributed as the CGST and SGST (or UTGST), respectively, where the ISD is located in the same State as that of the recipient?</p> <p>(n) Whether turnover for the distribution has been determined in accordance with the CGST Rules?</p> <p>(o) Ensure every ISD shall, for every calendar month or part thereof, furnish a return in FORM GSTR-6 within 13 days after the end of such month?)</p>
23.	List of major Input services /inputs on which the company takes ITC: whether it comply with CGST Act read with CGST Rules.
24.	<p>Whether credit has been reversed for every month for an amount equal to 50% of the Input Tax Credit availed on inputs, input services and capital goods or input tax credit has been reversed in respect of exempted supplies on actual basis?</p> <p>Note- such reversal is not required in case of cross charge made to other branches (refer Rule 42 )</p>
25.	<p>Whether ITC distributed is in compliance to Section 20 of the CGST Act 2017,</p> <p>If answer to above is negative, provide the discrepancy in the distribution and reasons thereof.</p>
26.	Amount of ITC received from ISD, if any together with address of the unit from which it is received.

**Guidance Note on Audit of Banks (Revised 2020)**

27.	Whether any Credit - has been claimed of input tax credit on invoice/ debit notes after the latter of due date of furnishing of the return under section 39 for the month of September of the subsequent financial year or furnishing of the relevant annual return?
<b>PART E: COMPLAINTS OF GST ACTS AND CGST RULES, 2017</b>	
28.	(i) Value of service provided to persons other than account holders where tax not charged on the ground that the place of supply is outside the taxable territory.  (ii) Value of services exported <ul style="list-style-type: none"><li>• With payment of IGST and claimed refund</li><li>• Without payment of IGST under the cover LUT or Bond and claimed refund</li></ul>
29.	Whether conditions for export of supply of service satisfied to avail benefit of export supply without payment of tax, as such benefit is subject to furnishing of LUT/Bond?
30.	Is the payment for services exported received by the service provider in convertible foreign currency within the time limit prescribed by RBI? If not, give details.
<b>PART F- OTHERS</b>	
31.	<ul style="list-style-type: none"><li>• Whether GST have been properly charged by the head office, regional offices, zonal offices in case of inter unit / branch transactions?</li><li>• Whether the registered person have filed the applicable returns on timely basis as notified by the Government?</li><li>• Whether IGST has been paid on 'import of services'?</li><li>• Whether ITC has been reversed with Interest, if recipient fails to pay the amount to the supplier within 180 days(Rule 37)</li><li>• Whether Tax wrongfully collected and paid to Central or State Government (interstate supply considered as intra state supply or vice versa)?</li><li>• If Yes, state the details of transaction (quantum)</li></ul>

**Guidance Note on Audit of Banks (Revised 2020)**

**NOTE:** Please also refer Frequently Asked Questions (FAQ) issued by CBIC on Banking, Insurance and Stock Brokers Sector updated as on 27.12.2018 which is relevant in GST Audits as given at below cited link:

[http://cbic.gov.in/resources//htdocs-cbec/gst/27122018-UPDATED FAQs%20ON%20BANKING,%20INSURANCE%20AND%20STOCK%20BROKERS.pdf;jsessionid=26FC0CC2AE1BD05BAEB2B153C4EEE8E8](http://cbic.gov.in/resources//htdocs-cbec/gst/27122018-UPDATED%20FAQs%20ON%20BANKING,%20INSURANCE%20AND%20STOCK%20BROKERS.pdf;jsessionid=26FC0CC2AE1BD05BAEB2B153C4EEE8E8)

**NAME OF THE ASSESSEE**

**ANNEXURE A**

**RECONCILIATION OF TURNOVER FOR THE YEAR.....**

<b>GSTR 1: RECON WITH BOOKS</b>		
	<b>Total Credits in statement of profit and loss</b>	<b>XXX</b>
<b>Less:</b>	Not Goods / Not Services - e.g. Dividend Income	(XXX)
<b>Less:</b>	Sch III Items which is not a Supply e.g.: Land & Building etc	(XXX)
<b>Less:</b>	April - June Supplies (only for FY 2017-18)	(XXX)
<b>Less:</b>	Receipts Not in the Course of Business	(XXX)
<b>Add:</b>	Sch I Supplies like Branch Transfer not in books, but supply as per GST Law	XXX
<b>Add:</b>	Receipts capitalised but taxable to GST	XXX
<b>Less:</b>	Profit on Sale of Capital Goods	(XXX)
<b>Add:</b>	Taxable Value of Supply of Capital Goods	XXX
<b>Add:</b>	Advance received during the Current Period	XXX
<b>Less:</b>	Advance of earlier period adjusted during the Current period	(XXX)
<b>Less:</b>	Closing unbilled revenue recognised - But Time of Supply did not arise	(XXX)
<b>Add:</b>	Opening unbilled revenue (Billed during the period/Time of supply falls in the month)	XXX

**Guidance Note on Audit of Banks (Revised 2020)**

	<b>Total Value in GSTR 1</b>	<b>XXX</b>
<b>Less:</b>	Exempted Supply	(XXX)
<b>Less:</b>	Non-Taxable Supplies: Supplies Like HSD, Motor Spirit Etc including Liquor	(XXX)
<b>Less:</b>	NIL Rated Supply	(XXX)
	<b>Taxable Value in GSTR 1</b>	<b>XXX</b>

**NAME OF THE ASSESSEE**

**ANNEXURE B**

**Details of Discharge of Liabilities**

A	Month	CGST				SGST				IGST				Cess			
		Liability	Credit utilised	Cash utilised	Ratio	Liability	Credit utilised	Cash utilised	Ratio	Liability	Credit utilised	Cash utilised	Ratio	Liability	Credit utilised	Cash utilised	Ratio
	Apr																
	May																
	Jun																
	Jul																
	Aug																
	Sep																
	Oct																
	Nov																
	Dec																
	Jan																
	Feb																
	Mar																
	Tot al																



**Guidance Note on Audit of Banks (Revised 2020)**

B	Month	CGST				SGST				IGST				Cess			
		Liability for	Liability	Delay	Date of	Interest	Liability	Delay	Date of off-	Interest	Liability	Delay	Date of off-	Interest	Liability	Delay	Date
	Apr																
	May																
	Jun																
	Jul																
	Aug																
	Sep																
	Oct																
	Nov																
	Dec																
	Jan																
	Feb																
	Mar																
	Total																

**ANNEXURE C**

**Details of Input Tax Credit**

A	Goods / services on which ITC is eligible (A)				Goods / services on which ITC is ineligible (B)				Total inward supplies	Out of (B), Value of capital goods on which credit is not availed on account of Sec. 16(3) of the CGST Act, 2017 <i>(Depreciation claimed on Capital Goods on GST component under the IT Act, 1961)</i>
	Month	Value of Inputs	Value of Input services	Value of Capital goods	Total ineligible	Value of Inputs	Value of Input services	Value of Capital goods		
	Apr									
	May									
	Jun									
	Jul									
	Aug									
	Sep									
	Oct									
	Nov									
	Dec									
	Jan									
	Feb									
	Mar									
	<b>Total</b>									

**B. Out of total of (A), eligible credits on supplies received from related persons and distinct persons**

GSTIN of supplier	Nature of relationship	Value of supply		Tax		
		Goods	Services	CGST	SGST	IGST

Out of total of (A), eligible credits on supplies received from related persons and persons

**ITC reversal**

**A Details of amount of tax credit paid as output tax liability u/s 16 r/w Rule 37, which was reclaimed during the year**

Month in which the credit was paid as output liability	Amount of ITC paid as output tax liability u/s 16(2) r/w Rule 37	Amount of credit reclaimed upon payment of consideration											
		Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar
PY -3													
PY -2													
PY -1													
Apr		-											
May		-	-										
Jun		-	-	-									
Jul		-	-	-	-								
Aug		-	-	-	-	-							
Sep		-	-	-	-	-	-						
Oct		-	-	-	-	-	-	-					
Nov		-	-	-	-	-	-	-	-				
Dec		-	-	-	-	-	-	-	-	-			
Jan		-	-	-	-	-	-	-	-	-	-		
Feb		-	-	-	-	-	-	-	-	-	-	-	
Mar		-	-	-	-	-	-	-	-	-	-	-	-
Total													

**B Details of amount of tax credit paid as output tax liability u/s 16 r/w Rule 37, which was reclaimed during the year**

Month in which the credit was paid as output liability	Amount of ITC paid as output tax liability u/s 16(2) r/w Rule 37	Month in which the amount of credit should have been paid as output liability u/s 16(2) r/w rule 37											
		Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar
Apr													
May													
Jun													
Jul													
Aug													
Sep													
Oct													
Nov													
Dec													
Jan													
Feb													
Mar													
<b>Total</b>													