E-Book

Bank Branch Audit

The Institute of Chartered Accountants of India

(Set up by an Act of Parliament)

Southern India Regional Council

Chennai

E-Book

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This e-book has been authored by

CA. Mony Ananthasivan

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Email: sirc@icai.in

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ICAI Bhawan
122, Mahatma Gandhi Road
Post Box No. 3314, Nungambakkam,
Chennai - 600034

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FOREWORD

A Bank audit is a routine examination of the records and services of a bank to ensure whether they are in compliance with the laws and standards of the industry. Banks have to get many types of audits done such as statutory audit, revenue audit, concurrent audit, etc. Statutory Auditors are appointed by RBI with due coordination of the concerned Bank Management, RBI and ICAI. Every year after the end of the previous financial year, in every branch of the banks, a very rigorous audit is conducted. The steps involved in Bank Audit are

a) Scrutiny of Loan Applications.
b) KYC Compliance.
c) Latest Audited Financial Statements of the borrowers.
d) Project Report, Projected P&L, Balance Sheet and Cash Flow Statement.
e) Board Resolution for Availing the Credit Facilities.
f) All the Government Department's Registration.
g) Technical Review.

This e-book gives an in-depth knowledge on the Bank Branch Audit requirements right from Verification of advances to NPA’s and auditing under computerized environment to various circulars norms applicable to Banks. The author has also provided various tips for conducting Bank Branch Audit to help the professionals conduct audit in an effective and diligent way.

This e-book also highlights the requirements to conduct the Bank Branch Audit but also provides detailed explanations ways through which the same can be conducted. Professionals who would have the opportunity to read this e-book would gain knowledge about Bank Audit and also understand the nuances of the subject.

On behalf of SIRC, I wish to place our sincere gratitude and appreciation to CA. Mony Ananthasivan, for sharing his rich experience and expertise on the Bank Branch Audit amongst our members through this e-book. I also take the privilege of thanking CA. T. Krishna Kumar and CA. Vijay Totapally for reviewing the basic draft of e-book and adding value to the substance of the e-book.

We are conscious of the fact that in a publication meant for professional accountants like this there is a scope for further improving form, contents, presentation and coverage. Accordingly comments and suggestions on the e-book are welcome at sirc@icai.in

CA.China Masthan Talakayala

Chairman, SIRC of ICAI

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Introduction

It is imperative that the bank/branch audit be conducted with utmost professional skills and acumen of Chartered Accountants. The quality of audit within the timeframe allowed requires focused approach towards the goal by the auditors. This book attempts to make a structural walk through of the Bank/Branch Audit including the practical tips for conducting the same as envisaged by the regulators and profession.

The first step of commencing the branch audit would be to analyze and understand the business profile of the branch. An auditor must bestow his professional knowledge to understand the business profile and nuances of the business of the branch. The SA for Understanding the Entity should be followed. The Business Mix of the branch between deposit and advances determine the checkpoints and audit plan. The following points are vital to analysis the Business Mix of the branch.

- Total Advances
- Total Deposits
- Total Off Balance Sheet items
- Total Income
- Total Expenses.

Any abnormal changes of the above business mix during the year between the period of previous balance sheet and present balance sheet must be justified with proper reasoning. In the same lines, the spurt/decline of the figure of advances, deposits, income and expenses at the year-end also should be properly analyzed.

The audit planning must further begin with the verification and analysis of the following:

1. The Concurrent Audit Report of the latest period.
2. Audit Conducted by the inspection department of the bank.
3. RBI Audit
4. Revenue Leakage Audit.
5. System Audit.
6. Any other Audit.

The report should be verified with utmost care to note down the major observations made by the respective auditors. This would give the moot points of preparing the audit program.

The major advance accounts of the branch, as required by the RBI in the LFAR, should be selected for in depth scrutiny and verification. The list of such advances should be included in the audit program with special emphasis.

The specialization of Business of the Branch, if any, should be understood to further fine tune the audit program. The specialization of the business of the branch can be classified as.

1. Designated Foreign Exchange Branch / AD
2. Overseas/ NRE branch
3. SME Branch
4. Industrial Finance branch
5. Large Corporate Branch
6. ARM Branch (Asset Recovery Management)
7. Service Branch etc…

The specialization business of the branch should be considered to prepare the audit program. Focus should be given accordingly on the relevant character of business apart from the specialization of business. Some banks adopt the business model of clusters. The later works under the different vertical of business model as designed by the corporate office. The latest development in the arena is briefed as follows.

1. A Cluster Branch/Office which focuses on all Advances, its Sanction, Disbursements, and Documentation.
2. Branches classified as Small-Cap, Mid Corporate, Large Corporate, etc.
3. Service Branches to conduct Clearing Operations and Chest Operations.

In the case of later branches the audit should be conducted keeping in mind the requirement of such specialized business.

Once the Audit Planning from the above perspective is completed, the execution of the audit process should be commenced by proper allocation of work and the manpower planning should be made. The advance portfolio which requires much attention and skill should be allocated to Senior Audit Executives or should be handled by the signing partner himself. The advances selected for in depth verification as per the LFAR stipulation and regulatory requirements should be further classified in the following category to give thrust on the intricate aspects.

1. Loans to Proprietary, Partnership, LLP, etc.
2. Loans to Private Companies.
3. Loans to Public Limited Companies.
4. Loans to Listed Companies.
5. Loans to Central Government or State Government Undertaking or companies.
6. Consortium Advances.
7. Borrower enjoying multiple banking facilities.
8. Group Exposures
9. Stand-alone Individual Loans granted to Individuals/Employees/Suppliers of the group/Corporate borrowers.
10. Line of Credit.
11. Stand-Alone Non-Fund-Based Advances sanctioned.

Chapter 1: Verification of Advances

The regulators as well as the Central Statutory auditor of the bank more relies on the verification of advances and its connected documents by the branch auditor. The major area of verification process is also emphasized in LFAR. The revised LFAR which is published by the RBI from the year 2021 requires the auditor to specifically verify the advances which are individually above Rs.10 Crores or 10% of the aggregate fund based and non-fund-based advances of the branch, whichever is less, as at the year end. Further, it also insists for any in-depth transaction verification for such large advances and its conduct of the account. Attention is drawn to Chapter 6 of this book on LFAR checklist and comprehensive verification points. The LFAR also stipulates for commenting on the adverse features of 5 standard large advances as per Clause (e) (ix) of Para 5 of the LFAR. All these points at the pinning of responsibility of the branch auditors by the RBI. The advance verification is ideally divided into the following functional areas/segments.

1. Credit Appraisal
2. Credit Sanction
3. Pre-Sanction and Post-Sanction inspections
4. Documentation
5. Creation of Mortgage
6. Registration and Legalization of the entire loan sanction with CERSAI, CIBIL, and CRIF etc.
7. Credit monitoring and control.
8. Recovery

Credit Appraisal

The verification of credit appraisal is an integral part of the Bank/Branch audit. Majority of the delinquencies and Non-Performing Assets (NPA) are emanated due to lack of proper credit appraisal at the various levels of sanction. The banks usually follow the fundamental principal of three**P's** in entertaining any Credit Appraisal.

1. First P denotes the Person
2. Second P the Purpose
3. Third P the Property.

This alludes that the entire conduct and performance of the advance depends on apt and accurate credit appraisal focusing on the above Three P's.

In order to verify the appraisal about the Person, we should be concentrating on appreciating the following facts and substantiating records held at the branch.

1. The constitution document of the borrower.
2. The legal aspects and regulatory sanctions required with respect to different constitution of the borrowers.
3. The previous record of performance of accounts including loan account of the borrower.
4. The performance and conduct of the other accounts, connected groups/ entities/organizations in which the persons/ key person of any borrower is involved.

5. The credit rating of the borrower and the related person/s directly attached with the borrower account and their rating score as per CIBIL report.
6. The credit rating of the Group/ Associates/ Connected entities.

The purpose of the advance is appraised at the beginning itself. The entire basis of the purpose depends on the viability of the project/ Business/endeavor for which the advance is applied for, apart from

- The capacity/efficiency and cash flow of the borrower/ the project to meet the repayment obligations.
- The regulatory clearance/NOCs/Permissions/ Sanctions etc. to be obtained in connection with the purpose of advance.
- The comparable other project/ product line/ industry and its performance level.
- The competition faced by the business in which the advance proposed.
- The above should be appraised at the branch level and the justification should be obtained from the borrower to meet such competition.
- The industry rating of the business line should be analyzed.

The security cover available for the advance should be appraised by the branch. The auditor is expected to go through the credit appraisal documents with specific thrust on the security cover as per the proposal and the final security obtained.

The security can be classified as Primary security, collateral security, and Third-party guarantee security.

PRIMARY SECURITY.

The primary security refers to the items/goods/property acquired out of the loan availed. The broad categories of Primary security with respect to the following types of advances are given in the table below:

Types of Advances	Primary Security
Housing Loan	The house proposed to be purchased/constructed
CC/OD	Stock or Debtors against which the advance is sanctioned.
Term Loans	The respective property/asset acquired out of the loan.
Personal Loan	The direct attachment /lien on the asset or income stream.

Collateral Security

The Collateral Security refers to the further backing of security in the event of the primary security failing to meet repayment obligations/value of the advance sanctioned.

The collateral security is usually obtained in the form of immovable properties of the borrower/ borrower company/promoters/ third parties. Third party guarantee would also be taken in many cases.

The Third-party security refers to the direct offer of guarantee and properties belonging to third parties extended to confer the right to the bank to recover the dues from such property belonging to the guarantors. The security offered and insisted will be comprehensively covered in the credit appraisal report prepared by the branch.

Further in the case of project/ business loans/ corporate loans, the bankers will be relying on the audited financial statements of the past years, unaudited provisional financial statements as up to the recent period and the projected financial statements to assess the profit/ cash flow generated from such business or organization.

The overall security cover is that indicates the cushion available for the bankers to assess the risk profile of the proposal. The auditor should be considering the value, enforceability, legal backing, existence, and valuation etc. of such securities.

The credit appraisal will be usually made in the form of an appraisal report attached to the advance proposal. The auditor is expected to go through the proposal in full. The observations raised by the controlling authorities against the proposal are also critical to assess the overall risk profile of the loan proposal.

Credit Sanctions

The loan proposals are finally approved in the form of documented sanctions by the sanctioning authority as per the delegated powers of such authority. It is very vital to examine the advance disbursed beyond delegated authority. The auditor is expected to verify the respective sanction documents, via the delegated authority. Further, when the loans are sanctioned by the higher authorities of the branch like Regional Office, Zonal Office, Credit Monitoring Department, Corporate Credit Department, the Board etc., there will be a proper sanction order duly signed by the appropriate authority. This sanction order should be verified by the auditors with reference to various limits/ exposures sanctioned and availed by the borrower.

The sanction order interlaid will contain specific and general sanction terms and conditions. The compliance and adherence to the sanction terms is a prime factor to be verified by the auditor. The general sanction terms include the submission of periodical stock/debtor statement, insurance cover, certificates to be obtained from various professionals, interchangeability of limits; if any, etc. The specific sanction terms are more relevant to the respective type of advances.

Every sanction will contain the time period of validity of such sanction. The branch is expected to renew/review the sanction once the validity period is over. The process of renewal/ renew is more elaborated in ensuing paragraphs under credit monitoring.

Pre-sanction and Post-sanction Inspections

The loan sanctioned will be further followed up and controlled through every phase of the loan disbursement. The sanction term will; include the field/ physical inspection to be conducted by the branch officials. Such inspection report is a vital document in credit monitoring. The auditor is expected to verify the existence of documented pre-sanction and post-sanction inspection report at periodical intervals as stipulated in the sanction.

The loan disbursement also should adhere to the protocols as prescribed by the regulators in general and terms of sanction order in particular. RBI has elaborated the disbursement procedure through a comprehensive **"loan delivery system**" to ensure strict monitoring of the disbursement of loans sanctioned. The major points of the loan delivery system to be verified by the auditor include,

1. In the case of Housing loan, the amount of the loan sanctioned should be disbursed only in phased manner progressively in tune with the completion of construction.
2. The disbursement should not be allowed to be withdrawn in cash except in exceptional circumstances.
3. In the case of loan for acquisition of an asset, the disbursement should be transferred only to the vendor/ supplier/ builder/ seller directly through the banking channels.
4. The completion of the project or construction should be monitored through the completion certificates obtained from professionals like chartered accountants, engineers etc.
5. The owner's/ borrowers/ Share of Investment/ Capital should be progressively ensured in proportion to the disbursement as per the sanction term.

Documentation

The enforcement and recovery of the advances totally depends on the care and caution exercised by the branch at the time of documentation. The various documents to be obtained for any loan product will be narrated in the general instructions of the controlling authorities of the Bank. The specific or exceptional documents to be obtained will be explicitly mentioned in the sanction order. The documentation also should be made as per the legal requirements of various regulatory frame works relating to the constitution of the borrower.

The banks have framed elaborate guidelines for obtaining various documents structured to cover the interest of the bank for different types of loan products. The structured documents would be forming part of the basic documentation. However, the comprehensive documentation also includes other legal and enforceable agreements, resolutions, NOCs, registration etc. The branch auditor's domain of verification is more to be converged on the availability, enforceability, legality, and sufficiency of documents pertaining to the constitution of the borrower and the documents of primary and collateral securities obtained from the borrower. In the process of verification and commenting on the documentation, the auditor should be relying on the work performed by other experts for valuation, legal compliance, technical compliance, mortgage ability of title documentation etc.…

The salient points to be covered in documentation and its verification by branch auditors are enumerated below:

1. The validity of the constitutional document like partnership deed, Memorandum of Association, Article of association, Trust deed, Bye laws etc. should be ensured.
2. The registration, filing etc. regarding compliance of various statutes governing the constitution of the borrower should be ensured.
3. The availability of expert certification like legal opinion, valuation certificate, technical inspection certificate etc. should be verified for its tenability. The periodicity of obtaining valuation certificate as required by RBI and the bank should be ensured.

4. The search report, charge creation, resolutions, MCA Data updating in respect of corporate borrowers should be given special attention.
5. The minor's interest, possession rights, compulsory acquisitions, agricultural/wetland restrictions, Ecologically Fragile Land (EFL), Coastal Regulation Zone (CRZ), other restricted zones in considering the location of the property etc. are intricate aspects to be verified by the auditor for ensuring enforceability of the landed properties held as collateral security.
6. The adherence to various stipulations with regard to change in constitution, mortgage of Company/Firm/LLP/Trust properties should be ensured.
7. Lien marking of deposits belonging to Company/Firm/LLP/Trust etc. should be critically verified to ensure its legal validity.

Creation of Mortgage

The borrower is expected to create mortgage on the properties offered to the bank as security for the loan. The mortgage can be in the form of hypothecation, pledge or equitable mortgage. The primary security against the loan may be created in the form of hypothecation. For example, stock held as primary security will be hypothecated in favor of the Bank. For this purpose, hypothecation agreement is executed in favor of the bank. The relevant creation of hypothecation should be displayed in the premises where the stock is held.

In the case of items directly mortgaged, a pledge is created, and the possession of the pledged item will be handed over to the bank. For example, gold pledged in gold loans, share certificates, FD Receipts, NSC, LIC Certificates, etc. wherever loans are sanctioned against such investments/deposits.

In the case of immovable properties held as collateral, security an equitable mortgage is created in favor of the bank. In the case of equitable mortgage, the title document of the property is deposited with the bank and a mortgage agreement is signed in favor of the bank.

In the case of company borrowers, apart from the mortgage, a creation of charge on the assets mortgaged with the bank is also done with the Registrar of Companies as per the Companies Act. The charge creation can be three types of viz.

a) First charge
b) Second charge
c) Pari-Passu charge

The first charge indicates the charge registered with the ROC giving first priority to the lender bank towards recovery against such assets charged.

The second charge indicates the second priority after exercising the lien of the first charge holder against such assets charged with the lender bank.

Pari-Passu charge on the other hand indicates equal and parallel rights of the charge holders against the assets charged.

The auditor should verify the following to ensure the proper mortgage of the securities.

1. The possession of the gold should be physically verified periodically as a part of the internal control by the bank by the bank officials and the concurrent auditors etc. The branch auditor should ensure proper adherence to the internal control procedures in respect of custody, handling and documentation.
2. The pledge of deposit receipts made with the bank should be properly marked lien in the system, the physical receipts should be properly discharged in favor of the bank.
3. Other documents of investments like National Saving Certificate, LIC Certificate, Share Certificate (in demit form) should be properly held and legally discharged in favor of the bank, for loans sanctioned against such deposits/investments.
4. The equitable mortgage created in favor of the bank should be verified with the mortgage register maintained at the branch which is a vital document to enforce the mortgage.
5. The legal opinion, valuation certificate, possession certificate, encumbrance certificate, tax paid receipts, approved building plan etc. should be held along with the property documents.
6. The auditor should verify the creation of charge in the case of Company borrowers with the ROC/MCA site as per the sanction terms. The nature of charge created the time limit of creation of charge, the details of the assets charged with the relevant amount of charge created should be verified with the total exposure and outstanding balance.
7. The search report and the filing of documents of charge with ROC, in the case of renewal, enhancement, ad-hoc limits etc. should be critically verified by the auditor.
8. The legality of mortgage of properties belonging to trust, society, and borrowers should be ascertained with the specific legal opinion in this regard.

Registration and Legalization of the entire Loan Sanction with CERSAI, CIBIL, CRIF etc.

The Reserve bank of India vide NotificationNo.DBR.LEG.No.BC15/09.08.20/18-19 Dated.27/12/2018 has made it mandatory to register creation of any security interest by any banks, NBFCs, RRBs **with the CERSAI** (Central Registry of Securitization Asset Reconstruction and Security Interest of India). This should be done for all assets hypothecated, pledged and deposited under equitable mortgage.

This registration process is stipulated for proper converged data base for controlling mortgage creation in a common portal to avoid malpractices/manipulation of duplication and multiplication of mortgage of same property with different banks.

The auditor should verify the documents of such registration at the branch level as per the guidelines of the bank and Reserve Bank of India.

The Credit Information is also to be **registered with the CRILC** (Central Repository of Information on Large Credits). The Reserve bank of India vide Notification dated 6/6/2018, has published a report on high level task force on Public Credit Registry of India, which interlaid stipulates that every banker must register the credit information regarding borrowers having exposure above Rs.5 Crores in aggregate of both fund- based and non-fund-based limits. The bankers are required to register the information with the CRLIC. The reporting is to be done on a monthly basis for all such borrowers. Further in the case of delinquent accounts, the information should be done on a weekly basis in respect of instances of default by such borrowers vide Circular No.DBS.OSMOSNo.14703/33.01.001/2013-14, Dated 22nd May 2014.***This information platform is now extended to ALL LOAN accounts with effect from 12.11.2021irrespective of size of advance.*** (**Refer Chapter 7 Recent Circulars on prudential norms in this book.)**

The auditor is expected to draw the report of advances classified under SMA-0, SMA-1, and SMA-2 from the CRILC platform to gauge the health of advance account with all banks and financial institutions. This is a very crucial information to determine the delinquency/irregularity of the advances availed by borrower across all banking channels.

Further, the data of the loans/advances and its repayment, irregularity, writing off if any etc. should be uploaded to the **CIBIL** platform by the bankers. This should be done for all borrowers and guarantors. The CIBIL is a bureau of credit information across all lenders. The bureau assigns a three-digit credit score to all borrowers. The information to the CIBIL is fed by the lenders across the Country. This score of the CIBIL is assigned based on repayment history, credit utilization ratio, excess loans, credit card dues, new accounts etc. maintained by every borrower across all banking channels. The auditor is expected to verify the CIBIL Score and its evaluation by the bank while making the credit appraisal of the loans.

Credit Monitoring and Control

The bankers are having the hierarchical/tier system of control of credits through its administrative officers and business verticals. The credit monitoring and control are also exercised through external professionals in the form of stock audit, legal audit, credit audit etc.

The Reserve Bank of India stipulated that the bank should conduct stock/debtors audit by external auditors every year in respect of working capital exposures above a benchmark. The stock audit primarily focuses on the adequacy, marketability, existence, enforceability including obsolescence of stock/Debtors of the borrower. The stock audit report on its authenticity and sufficiency compared to the loan balance and the stock/debtors figure reported in the stock statement submitted to bank.

The SBAs duty with the respect to stock audit is briefed as follows:

1. The audit should ensure that the stock audit is conducted periodically as per the guidelines of the Bank.
2. The time gap between initiation of stock audit process and obtaining stock audit report should be commented for any abnormality/irregularity in the overall process from appointment of stock auditor, conduct, submission of reports, its compliance etc.
3. It shall be ensured that the stock audit reports are obtained, and the observations of the stock audit report are properly addressed, especially with reference to the adverse features mentioned in the stock audit report. Regularization of the

discrepancies also should be addressed by the branch auditor. The later is made a requirement of reporting in the LFAR. (**refer Chapter 6, Revised LFAR in this book)**

The regulatory guidelines also prescribe **credit audit** for exposures beyond the benchmark to cover the over-all risk and monitoring the conduct of the account. The credit audit specifically covers the entire critical elements in the loan accounts of the borrower.

The auditor should verify the periodicity and adherence to the regulatory guidelines with respect to the credit audit. The adverse observations, or remarks made by the credit auditors also should be critically examined by the branch auditor.

Further, as a regular follow-up measure, the bankers internally would have structured various credit report in the form of Quarterly Information System (QIS), Loan Review and Monitoring (LRM), etc. to be submitted to the controlling authorities. The auditor should verify adherence to the guidelines and its proper follow-up and monitoring atoll levels of the bank.

External Credit Rating

The Bankers are required to obtain external rating from accredited credit rating agencies to support the credit appraisal. This requirement is specified as per the RBI guidelines to comply with the BASEL-II framework of banks. The credit rating should be taken periodically from such accredited agencies like CRISIL, ICRA, SMEARA, FITCH, etc. The credit rating given by such agencies would be based on the project standing, promoter standing, domestic and international market conditions, financial strength of the borrower etc. The better credit rating of the borrower could be an indicator to the risk profile of the exposure. The points of indicators by the auditors in respect of credit rating are as follows.

1. The auditor should ensure that the credit rating is obtained wherever stipulated from the accredited agencies, like CRISIL, ICRA, FITCH, etc.
2. The validity of the time period of such rating should be verified.
3. The deterioration or decline in the rating score assigned as per the latest credit rating report is to be viewed critically by the auditor.
4. The periodical renewal of credit rating should also be ensured by the auditor.

Internal Rating / Risk Rating

The bankers invariably have developed an internal rating module of every borrower to ascertain the risk profile of the exposure. This is done based on the financial data, both historical and future projections as submitted by the borrower. The internal rating is also reviewed at every periodical interval while enhancement, yearly renewal of loans etc.… The internal inspection team also assigns the risk-rating based on the Risk Based Internal Audit (RBIA) performed by the mass per the regulatory framework. The auditor should examine the risk-rating and the internal rating and comment on the inconsistencies, if any, observed.

Renewal / Review

The loans sanctioned by the bank are to be renewed/reviewed at periodical intervals and got duly approved/sanctioned by the appropriate controlling authorities. The process of renewal is more attached to Cash Credit or Overdraft accounts where the sanction period is one year. In the case of term loans, a process of review is undertaken as a part of periodical monitoring. In the case of conducting the renewal of loans the bank should make a comprehensive appraisal based on the current status and financial numbers submitted by the borrower. The figures are adopted as per the latest audited financial statements, projected financial statements and provisional financial statements submitted by the borrower.

Apart from the financial statements, many supporting and subordinating documents like GST Returns, Income Tax Returns, Certificate of completion of projects etc. will be obtained. The process of renewal is very important to ensure periodical monitoring of credit exposures by the bank. The following points are to be considered by the auditor to verify the review/renewal mechanism at the branch level.

1. The list of loan accounts pending for renewal/ review as at the year-end can be generated from the CBS. The pendency of renewal beyond a period of three months should be reported. In case, where the renewal is not conducted even after the expiry of 180 days from the due date, such accounts should be classified as a non-performing asset as per paragraph 4.2.4 of the Reserve Bank of India Master Circular dated 1/10/2021.

2. The bankers may resort to get an extension of time period for the purpose of renewal from the controlling authorities by conducting an exercise of a **"short review"** with the available information and records. The short review conducted cannot be treated as sufficient, if the pendency of comprehensive review/renewal is pending beyond six months from the due date to come out of the classification of the account as NPA as detailed in paragraph1.

3. There may be occasions where the controlling authorities would have made the review at the year-end which is pending communication to the branch at the time of year end audit. In such instances, the auditor is expected to obtain the sanction document from the controlling authorities. And report it to the Central Statutory Auditors, if it is not received.

Drawing Power

The concept of drawing power has wide significance in determining the conduct and performance of advance accounts especially in the case of cash credit and overdraft accounts. The drawing power is determined based on the primary security held by the bank in the form of stock and/or debtors. The limits sanctioned by the bank under cash credit or overdraft accounts are periodically evaluated based on the stock and/or debtors statement filed by the borrowers as per sanction terms. The borrower in such case is required to furnish the stock and debtors statement to the bank on a regular basis invariably at the end of every month. The monthly stock and or debtors statement is required to be filed by the borrower in the prescribed format are called a **"stock statement"**.

The auditors are expected to verify the stock statements obtained every month and calculate the drawing power as per the guidelines given by the controlling authorities of the bank. The major aspects to be covered in the stock statement include:

i) The position of stock and/or debtors held as at the end of the month both in quantity and value.
ii) The details of movement of stock during the month including opening stock, purchases, sales and closing stock.
iii) The value of stock which are procured out of direct or indirect finance or third-party line of credit and suppliers' credit etc… This should be deducted from the value of stock held to arrive at the **net paid stock** at the end of the month.
iv) The date of receipt of stock statement and its proper record at the branch is significant.

The basic methodology of calculating drawing power is explained as follows. This may change according to the policy of different banks. However, the following are pertinent to be verified by the auditor.

1	**Value of stock as per stock statement**		xxx
	Less: Sundry Creditors	xxx	xxx
	Less: Value of damage, non-moving and obsolete stock	xxx	
	Net Tradable Paid Stock		xxx
	Less: Margin as prescribed by the bank		xxx
	Drawing Power on Stock (A) (A)		xxx
2	**Drawing Power calculation on Debtors**		
	Debtors as per Stock/Debtors statement	xxx	
	Less: Debtors above 120 days	xxx	
	Less: Disputed/Litigated Debtors	xxx	
	Less: Doubtful Debts	xxx	
	Net Debtors		xxx
	Less: Margin		xxx
	Drawing Power on Debtors (B)		xxx
	Total Drawing Power (A)+ (B)		**xxx**

The following points are important to ensure the correctness of Drawing Power by the auditors.

1. The value of stock as per the stock statement should be verified for proper elimination of non-moving stock, obsolete stock, and damaged stock to arrive at the tradable stock.

2. The margin on stock and debtors are fixed by the bank as per the terms of sanction. Usually, the margin will be fixed at 25%. This margin rate may be increased according to the sensitivity of the stock/debtors. This should be properly verified and commented by the auditors. In the case of perishable goods, evaporating, goods etc. the adequacy of the margin requirement should be properly assessed and commented by the auditors.

3. The updating of the drawing power every month to the CBS database within the time frame should be verified by the auditor. <u>This is more relevant in the case of quarter end and year end as the figures are relied for the identification and classification of assets as per prudential norms and system generated NPA statement.</u>

4. In the case of consortium accounts and multiple banking arrangements, the Drawing Power is calculated in proportion to the share of advance of every bank in the consortium/MBA. The proportion of Drawing Power is allocated to every member bank. The auditor should critically examine the calculation of proportion of Drawing Power and ensure that only the allocated DP is considered for ascertainment of security value and feeding to the same to the CBS as DP. It is pertinent to know that the Drawing Power in the case of these accounts is calculated by the bank who is the leader of the consortium or MBA. The communication of the Drawing Power by the latter is expected to be followed up by the bank on a timely basis for proper monitoring and control. The procedure and adherence to the guidelines issued by the Head Office of the bank should be properly verified and commented by the auditor. Any deficiency in the system would leads to distortion of figures relied for the purpose of identification and classification of the accounts as NPA and its consequent provisioning as per IRAC norms.

5. In case of large advances, the various banks involved in financing of working capital would be allocated stocks/debtors lying at/pertaining to different branches or locations of the borrower. In such cases the auditor should examine the accuracy of the stocks/debtors furnished with the relevant information furnished for such location/ locations. <u>The overlapping of stock/debtors lying in the same location to different banks should be critically examined to comment on multiple financing, if any.</u>

Recovery

The advance sanctioned by the bank should be recovered as per the sanction terms which are very crucial as per the regulatory framework. The Reserve Bank of India has introduced many regulatory control and stipulations so that the recovery process of the Loan/Advances are properly managed, controlled and monitored by the bank. The breakthrough is the introduction of **"prudential norms"** on income recognition, asset classification and provisioning, pertaining to advance by the Reserve Bank of India. The bankers are guided by the master circulars issued by Reserve Bank of India every year with respect to credit monitoring under "**prudential norms**" which is totally based on record of recovery. The major ingredients and a comprehensive analysis of the "prudential norms" are separately covered under the caption Non-Performing Assets (NPA). (**Refer chapter 2 for more details on IRAC)**

Chapter 2: Non-Performing Assets and Prudential Norms

Reserve Bank of India has introduced issued prudential norms on asset classification and provisioning in the banking sector to ensure uniformity of income recognition and reporting of loans and advances by the bankers. The prudential norms are more explicitly covered in the Master Circular on prudential norms.

The latest Circular in this regard is issued by the RBI on 01-10-2021 vide. Circular No. DOR.NO.STR.REC.55/21.04.048/2021-22. The Circular covers the regulatory norms of identification, classification, provisioning, income recognition and reporting of non-performing assets of the bank.

The Non-performing assets are required to be identified by the bankers on an ongoing basis through the CBS platform. A report on the non-performing assets and asset classification is to be generated from the computer platform which should be verified and attested by the auditors at the year-end/quarter end.

The broad analysis of NPAs and prudential norms are given below:

- The advances or an asset of the bank which is irregular in repayment as per terms of sanction is identified as a non-performing asset (NPA).
- The Cash Credit account is classified as NPA, if it is **"out of order"** for more than 90 days.
- Likewise, a term loan is classified as an NPA if the instalment of Principal or interest remains overdue for more than 90 days.
- Bills, LC Bills, Loan against deposits are classified as NPA if is not regularised within 90 days of the due date of payment.

Out of Order

The Circular stipulates that the Cash Credit /OD account will become **"out of order"** in any of the following 3 situations.

1. If the account is operated continuously in excess of the sanctioned limit/ drawing power for more than 90 days.
2. If the accounts are not operated continuously for the period of more than 90 days.
3. Even if the account is operated and is within the sanction limits/ drawing power. The "**genuine credits**" in the accounts is not sufficient to meet the interest debited during the period of 90 days. This calculation of 90 days is clarified to be made on an ongoing basis rather than at the Balance Sheet date as per latest circular of RBI dated 12.11.202. (**refer chapter 7 of this book for more details**)

The bankers are required to classify the accounts as NPA and Mark the date of NPA to derecognize the income on such accounts from the date of it becoming NPA. The unrealized income in the form of interest in the account will be recognized only on recovery. The auditor should critically examine the following points while identification of NPAs

1. The availability of net worth or other assets of the borrower should not be considered while classifying the assets as NPA. The prescribed record of recovery is the sole criteria to classify an account as NPA.

2. An account where regular/ad-hoc credit limits have not been reviewed or renewed for more than 180 days from the due date will be treated as NPA.
3. The up gradation from NPA category to standard classification can be made only after repayment of the entire arrears of interest and principal.
4. The year-end credits, bulk credits, credits from other branches of same bank, credit from group/ connected accounts to regularize NPAs or irregular accounts should be examined critically.
5. The assets classification should be made borrower wise. Any account of a borrower becoming NPA would lead to classify all the other accounts of the borrower also as NPA.
6. Classification of NPA should be based on record of recovery of individual banks in the case of borrowers enjoying facilities from different banks under consortium or multiple banking arrangements.
7. Central Government guaranteed accounts will not be classified as NPA unless the Central Government repudiates its guarantee when invoked. This exception, however, is not applicable in State Government Guaranteed accounts.
8. The project under implementation and project finances are classified as NPA as per the date of commencement of commercial operation (DCCO). The paragraph No 4.2 of the Master Circular should be adhered to in respect of project under implementation.
9. The post shipment credit shall be treated as NPA only on the balance amount due after receipt of any guaranteed amount from the EXIM bank.
10. The balance due from credit card will be treated as NPA, in the event of the customer defaulting the repayment of "minimum amount due" stipulated by bank beyond 90 days.
11. Bills purchased and discounted are classified as NPA, if it is overdue for more than 90 days.
12. Agricultural loans
    I. Short duration crops: principal or interest overdue for two crop seasons
    II. Long duration crops: principal or interest overdue for one crop season
13. Derivative transactions: Overdue receivables remain unpaid for 90 days from the specified due date
14. LCs are classified as NPA if not paid for more than 90 days from the due date.

Asset Classification under Prudential Loans

The RBI has issued the various classifications of advances according to the record of recovery as

1. Standard Asset
2. Substandard Asset
3. Doubtful Asset

The advances which are regularly conducted and operated as per the sanction and regulatory framework which does not attract any risk of recovery other than the normal banking risk involved is treated as a "Standard Asset". The Assets which are not otherwise to be classified as a NPA (Non-Performing Asset) are also to be treated as Standard Assets. The bankers are permitted to recognize the income by way of interest to the standard advances as and when DEBITED to such accounts.

Sub-Standard Assets

The advances/assets which are classified as an NPA as per the prudential norms will be classified under the category of "substandard assets". A substandard asset is an advance which shows incipient weakness or deficiencies which possess a risk of recovery leading to the bank sustaining a loss due to such deficiency. The classification would remain for such NPA accounts for period of 12 months from the date of becoming NPA or lesser period if it is otherwise to be further downgraded as per the prudential norms.

Doubtful Assets

A doubtful asset is an advance which shows added characteristics of weakness which make the probability of recovery further deteriorated on the basis of the current known facts, conditions and values. An asset would be classified and migrated to the "doubtful asset" category once it remains as substandard for a period of 12 months. Thus, an NPA classified as substandard will get naturally migrated to the doubtful asset category at the end of the period of 12 months of it becoming a substandard asset.

The classification of an asset shall also be done as doubtful once there is substantial erosion in the value of securities. If the erosion in the value of the security of any account is more than 50% but not less than 10%, the account will be straightway classified as doubtful asset. The implies that an irregular advance need not pass through the test of time to be classified as substandard before it is classified as a doubtful asset. Refer para.4.2.9.1 (a) of the master circular.

The doubtful assets are again sub-classified as Doubtful Asset-1 or DA1, Doubtful Asset-2 DA2, Doubtful Asset-3 or DA3. These sub-classifications are mainly made to escalate the provision at an accelerated rate by the passage of years within which it is slipped as a doubtful asset. An advance slipping into doubtful assets will carry a provision of 25% on secured portion during the first year and 40% on secured portion during the second year and 100% during the third year. Hence, in order to identify and properly bifurcate the doubtful assets based on provision requirements, it is usually identified by the sub-classification of the doubtful asset of first year, then second year and third year as DA1, DA2 and DA3.

Loss Asset

An asset which is identified by the bank or internal/external auditors as uncollectible will be classified as "loss asset". Those accounts which are identified as loss during the course of RBI inspection will also be treated as a loss asset. In the event of such classification as "Loss Asset" even any salvage value of the security underlining the advances will be ignored and 100% provision is required to be made.

This classification is resorted to if the advance is identified to be not bankable or is uncollectable due to various practical or legal issues. Further, if the value of the securities is substantially eroded to more than 90%, such assets will be straight away classified as loss assets. This again implies that if erosion in the value of security becomes more than 90% or releasable value becoming less than 10% of the outstanding balance, the account will be straight away classified as loss assets. Hence it should be reiterated that an advance need not pass through the test of time to be classified as substandard, then as doubtful and further as loss assets. It can be straight away downgraded as a loss asset.

Provisioning Requirements

The advances which are identified and classified as standard, substandard, doubtful and loss asset attract the provisioning requirements as per the prudential norms. A major part of the branch audit lies in the verification and audit of identification of NPAs its classification and provisioning. The RBI stipulates the provision to be made by the bankers on each class of assets classified under the various categories such as standard, substandard, doubtful and loss. The percentage of provisioning is specified through the master circular on prudential norms. However, the following general points should be considered while determining the adequacy of provision.

1. The date of NPA is a critical factor to determine the classification and provisioning of advances. It is also stipulated that identification of NPA is a continuous and ongoing process. This alludes that different accounts of the same borrower may be classified as NPA on different dates, throughout the year. There cannot be any leverage to defer or postpone the date of NPA to month end, quarter end or year end. This is a vital factor to be verified by the auditor.
2. The reversal of income made on such accounts identified as NPA as per the salient provision of IRAC norms is very critical. The calculation of interest reversal assumes greater importance while conducting the audit. The auditor should do an auditing around the computer to identify the accuracy of reversal made by the bank. As per the guidelines issued on 12.11.2021, the entire unrealised interest of NPA account should be reversed. (**Refer chapter 7 of this book for further details)**
3. The up gradation of NPA can be made only on complete recovery of principal and interest in normal cases. Hence the auditor should verify the upgraded accounts during the year from NPA status. It should be treated as performing assets only upon recovery of arrears of interest and principal. It is pertinent to note that **entire arrears** of principal and interest of an NPA should be recovered for up gradation. In other words, any amount debited <u>which has not become due</u> and is in arrear should not be an impediment for up gradation. Up gradation in the case of restructured advances and DCCO related project finance, however, can be made only as per the specific guidelines prescribed.
4. Classification of the account as NPA and consequent provisioning in respect of devolvement of letter of credit and bank guarantees should be made on such DEBIT of the amount due and which is kept as outstanding in the books. This should be treated as an outstanding part of the borrower's principal operating account as per NPA norms.
5. Bills discounted which are backed by the letter of credit are not considered for asset classification and provisioning as per paragraph 4.2.7.3 of the master circular. However,

if the letter of credit is not accepted or payment of letter of credit is not made on due date for any reason by the issuing bank, then it will be treated as NPA, if the borrower fails to mitigate the amount immediately.

Provision requirement On Standard Assets

Sl. No.	Particulars			Rate
a)	Direct advantage to agriculture and SME Sector			0.25 %
b)	Commercial Real Estate			1.00 %
c)	Commercial real estate residential housing sector			0.75 %
d)	Housing loan at teaser rate i.e., lower Rates of interest at the initial phase.			2.00 %
e)	Restructured advances			
	i.	New reconstructed standards account with effect from 01-07-2013		5.00 %
	ii.	Increased in phased manner for the stock of reconstructed standard asset as on May 31, 2013 (AS per circular dated Nov 26, 2012)		2.75 %
		a.	with effect from March 31st 2014	3.50 %
		b.	with effect from March 31st 2015	4.25 %
		c.	with effect from March 31st 2013	5.00 %
	iii.	Provision for diminution in the fair value accounts on account of restructuring		
f)	Other loans & advances not included in above			0.40 %

Chapter 3: Other Areas requiring Critical Examination while Verification of Advances

The verification of advance accounts at the branch level has gained much importance as the security documents and other statements are physically available at the branch. The latest developments in the advance arena consequent to COVID pandemic and many regulatory packages introduced by the Reserve Bank of India should be focused by the auditors in the year 2021-22 and subsequent years. The latest developments can be grouped as follows.

I. The sanction of GECL (Guarantee Emergency Credit Line) advances post pandemic restructuring of advances.
II. COVID Resolution Framework-2, dated 5th May 2021 issued by Reserve Bank of India.
III. COVID Relief Package for MSME exposure at 25 Crores enhanced to 50 Crores.
IV. Restructuring of advances as per Circular No.BP.BC.18/2021.04.048/2018-19 Dated.1/1/2019 further clarified and relaxed vide Circular Dated 6/8/2020.

Non-Fund Based Exposure

The Reserve Bank of India has given equal thrust to non-fund-based exposures of the borrowers in the wake of high-risk rating and threat of loss the bank. The new Long Form Audit Report has specifically emphasized to verify the non-fund-based exposure of the borrowers by the auditors.

The non-fund-based exposure includes the Bank Guarantee, Letter of Credit etc. given by the bank on behalf of the borrowers. The invoking of bank guarantees by the beneficiaries would result in the bank liable to make the payment to the beneficiary and subsequently recover it from the customer. In the event of the customer not able to meet the obligations, the amount paid by the bank to meet its obligation, would become irregular and critical from asset classification and provisioning. This is more critical and riskier in the case of such customers whose accounts show delinquency or whose account has become NPA. The prudential norms Circular Dated 1/10/2021 stipulates that in the case of invocation of bank guarantee which is not met by the borrower within a period of 90 days would make the same NPA. However, when bank guarantee is invoked and the same is debited to the loan account of the borrower to his CC, OD account which has sufficient limits to contain the amount paid on invocation, then would be treated as met by the borrower unless the OD, CC account itself is out of order and classified as NPA. It is also very important to note that no fresh advance can be sanctioned to meet the bank guarantee obligations otherwise than debit to the running CC, OD limits within the sanction limits.

Year-end Credits

As per the prudential guidelines, the status of NPA is determined by properly examining the credits and its genuine nature to consider it as meeting the repayment obligations by the borrower. This is more significant in the case of the credits to the advance account at the year-end or near about the Balance Sheet dates. The auditor is expected to comment on the veracity of the year end credits to ensure that it is genuine and is from sources which are allowed within the framework of prudential norms. The following nature of credits and its usual connotation in the NPA parlance are given below.

a) Credits which are out of fresh loans to make an irregular account out of NPA classification are not permitted. This is more important, when such credits are originated from other branches of the same bank. In such cases, the auditor should confirm that the credits originating from other branches of the same bank are not out of fresh loan sanctioned at the other branch. This logic cannot be applied in the case of fresh loans sanctioned from "**other banks**".
b) The credits on the near about Balance Sheet dates from discounting or purchase of cheques/bills/or any other instruments should be verified with the fate of such discounted instruments after the Balance Sheet.
c) The credits which are originated from sister concerns or group, or associate accounts of the same bank should be critically examined and commented by the auditor to ensure that it does not result in "**ever greening of NPA accounts**".

One time settlement Accounts (OTS)

It is a usual practice of the banks to offer concession to borrowers for settlement of long pending, over dues in advances. The extant guidelines issued by the Head Office of the bank for allowing one time settlement and other concessions in settlement of advance accounts should be verified by the auditor. The adherence of terms and conditions of one-time settlement by the customer should be commented by the auditor. The recognition of amount settled by the borrower against OTS terms between interest and principal should be ensured to be accounted as per the accounting policy of the bank. The release of security documents; if any, to the borrower should be verified by the auditor to ensure that such release is not detrimental to the interest of the bank as a lender.

Borderline Accounts

The emphasis of advance verification should be more focused on accounts which are irregular and delinquent in repayments. Those advance accounts which are always operated with apparent stress in the conduct should be critically examined by the auditor. Those accounts which are operated and conducted at the brim and has technically escaped from classification as NPA are termed as "**borderline accounts**". All the checks and balances as stated in "**year-end credits**" are to be verified in the case of borderline account also. The identification of borderline accounts can also be made by generating the SMA (Special Mention Account) Reports. The SMA accounts are classified in to SMA-0, SMA-1, and SMA-2.

- SMA-0 accounts represent those standard assets which show an irregularity of repayment or conduct for a period from 0 to 30 days.
- SMA-1 accounts represent those irregular accounts which continue to show the irregularity between 31 and 60 days.
- Likewise, SMA-2 accounts are those with a continuous irregularity of repayment or conduct of the account between 61 and 90 days.

The SMA reports as on the Balance Sheet date would throw light on the borderline accounts. Further, if the SMA Report is generated for the previous three months, the movement of irregular accounts could be examined in detail.

For example, an advance account which is reported in SMA-0 in the month of January should be reported under SMA-01 during the month of February and SMA-02 during the month of March. Any

elimination/execution of the accounts which does not follow the natural migration as above would be the result of regularization of such accounts. The auditor is expected to classify such accounts as borderline accounts and do an auditing in depth to identify and comment on the credits resulting in regularization of the accounts.

Advance Accounts closed during the period of Audit

Special emphasis should be made by the auditor for verification of advance accounts which are closed during the period of audit. The concept of materiality should be adopted in the verification of such closed accounts. The closure should be verified with the following check points.

i. The interest up to the date of closure date is properly DEBITED as per the sanction.
ii. The waiver of interest/charges allowed in the account while closing are approved by designated authority who has such delegated powers to sanction.
iii. In the case of closure of borderline accounts or NPA accounts, the source of the credit should be properly verified.
iv. The appropriation of the amount received from the closure between principal and interest should be as per the guidelines and accounting policy of the bank.
v. The fresh loans sanctioned to the same borrower post closure of old loan should be verified critically to ensure proper protocols of fresh sanction. Any connectivity between fund flow of fresh loans and closed loans should be commented by the auditor.

Spurt in Advances or Deposits at the year end

The sudden spurt in the figures of advances and deposits nearby the Balance Sheet date should be examined by the auditor to alleviate the scope for any window dressing. The increase in quantum of advance/deposits and or increase in the number of accounts also are a regulatory concern. The auditor is expected to verify the credentials of the fresh deposits or advances. In the same lines, the adherence to KYC and AML norms should be ensured for large deposit accounts. The routing of the loan proceeds to its payee should be verified critically. The adherence of loan delivery stipulations should be checked by the auditor.

Enhanced or Ad-hoc limits at the year end

It may also be possible that the borrower is sanctioned with additional facilities over and above the limits sanctioned in the regular process to meet business/commercial exigencies. These additional finances or granted to tide over the temporary mismatches of cash flows of the existing borrowers. The sanction of such facilities may be in the form of Temporary Overdrafts, Ad-hoc limits or by exercising the interchangeability option as per the regular sanction terms. The ad-hoc limits/TODs sanctioned to an irregular account need critical examination.

Temporary Overdrafts

Temporary Overdrafts are granted mostly on existing cash credit or overdraft accounts were there is a regular limit sanctioned. The Temporary Overdrafts are usually granted up to 10% of the existing limits or Drawing Power to meet genuine business/commercial exigencies. The temporary overdrafts are to be regularized with in a period of maximum 15-30 days. This is done at the branch level within the delegated authority and powers vested. The auditor should verify the following in respect of such Temporary Overdrafts.

i. The Temporary Overdrafts are sanctioned within the delegated powers of the sanctioning authority.
ii. The Temporary Overdrafts are properly reported to the controlling authorities as per the instructions and guidelines of the bank.
iii. ***Frequent Temporary Overdrafts sanctioned to the same borrower or group of borrowers or different entities of group concerns are a critical sign of weakness in the conduct of the account***. The auditor should be doing a comprehensive analysis of the Temporary Overdrafts and its regularization process.
iv. The Temporary Overdrafts lying as outstanding on the Balance Sheet dates are of significant character. The Temporary Overdrafts pending and overdue for regularization beyond 90 days would make the account in NPA as per the prudential norms.
v. The abnormal time taken for regularization of Temporary Overdrafts should be critically verified by the auditor to ascertain incipient weakness in the conduct of the accounts.
vi. A borrower resorting to frequent Temporary Overdrafts should be placed under watch category by the auditor to further comment on the deficiencies in the credit monitoring and appraisal.
vii. Borrower's accounts which are frequently using the Temporary Overdrafts facilities to roll over the other irregular advances are a sign of mismanagement of facilities. This should be critically verified and commented by the auditor.

Ad-hoc Limits

Ad-hoc Limits are parallel or additional finances and limits sanctioned or a longer period than Temporary Overdrafts to meet seasonal requirements of credit of the borrowers. The ad-hoc limits should undergo all the sanction procedures and should be sanctioned from the appropriate authority who has sanctioned the original loan. The quantum of ad-hoc limits and its reasoning should be justified with the normal business/working capital cycle of the borrower. The documentation and extension of security cover on primary and collateral should be ensured by the auditor. The ad-hoc limits sanctioned at the year-end leading to any inference of ever greening of NPA should be critically examined by the auditor.

Inter-changeability of Limits Sanctioned

In the case of large borrowers enjoying different types of facilities, an option of interchangeability between the various types of limits with in the overall sanctioned exposure may be permitted as per sanction terms. The auditor should be vigilant in the verification of such borrowers who exercise the option of interchangeability very frequently or utilizing the option to tide over the irregularities in repayment of other facilities. Although it cannot be termed as an ever greening process as per the prudential norms, it warrants for critical examination by the auditor as the interchangeability may result in increasing the credit risk of the overall exposure. <u>More emphasis should be given in case the exercising the option made between non-fund-based limits to fund-based limits</u>. The auditor should vigilantly verify and comment on the probable incremental risk and loss to the bank on account of such interchangeability.

All the factors mentioned above should be verified by the auditor with an open mind and critical framework to comment and properly report about the delinquency/loss which may impact the interest of the bank as a lender.

Borrower with standalone Non-fund Exposures

As already explained the RBI while introduced the new LFAR in 2021 has given much thrust on non-fund exposures of banks which includes the bank guarantee and letter of credits. These are termed as Off-Balance Sheet items in the normal banking parlance. The risk of larger exposure in Off-Balance Sheet items should be examined by the auditors. In the case of borrowers enjoying standalone Off-Balance Sheet exposures, the risk is much more as there is lesser concurrent monitoring tool within the banking sector for such exposures. Usually, bankers may be entertaining only customers who have regular dealing with the bank for extending guarantee/LC facilities. However, in certain circumstances the bankers may sanction standalone guarantee or Letter of Credits (LC's) to customers. In such cases, it would be difficult for the branch to exercise proper monitoring system on a day today basis. The auditor is expected to identify such accounts and may focus on the following critical areas of examination.

i) The security cover involved in such exposures
ii) The enforceability of collateral offered by the customer.
iii) The SMA Report about the customer should be generated from the CRILC platform to ascertain the latest credit standing of the borrower in general.
iv) The release letter should be obtained from the beneficiary in the case of expiry of such bank guarantee or LC to eliminate it from the books.
v) The large off balance sheet exposures falling due immediately after Balance Sheet date should be critically examined with the overall risk profile of the customer.
vi) Proper reporting of any incipient weakness identified about the borrower from the available records, Audited Balance Sheet, SMA Reports, Press Notes, etc. should be commented and reported in the LFAR and to the central statutory auditor.

Round Stripping

The prudential norms issued by the Reserve Bank of India are more based on records of recovery and over all conduct of the account by the borrower. The auditor should verify analytically the figures of turnover transacted and put through the bank account with that of the total sales/business figures as per the financial statements of the borrower. The conduct of the account is generally viewed from the transactions put through the account and its geniuses. In certain cases, the account may appear to be operated briskly by more transactions, but the transactions may not be emanating from established business transactions. Instead, it would be mere deposits and withdrawal made from various accounts of the same group concerns or different account of the same borrower without any underlying business transactions. This methodology of filling the bank account with funds which would be rotated between the group concerns or different accounts of the same borrower is termed as Round Stripping. The Reserve Bank of India has very seriously viewed the errant practice followed by certain borrowers in order to evergreen the apparent conduct of the account by Round Stripping. The auditor should very critically examine the practice of Round Stripping and report it to the bank and the central statutory auditors.

Chapter 4: Audit under Computerized Environment

The audit of Bank/Branch is more relevant only if the auditor conducts the audit with proper evaluation of integrity and authenticity of the data and reports generated from the computer system. The computer system of all banking sector and majority of its transactions are under CBS platform. The Finale, Flex cube and TCS banks are the most popular and prevalent software used in CBS environment of majority of the banks. The auditors should commence the conduct of verification after properly accessing and familiarizing with the following:

1. The Menu Options available in the CBS.
2. The Report Module available in the CBS.
3. The integration of Foreign Exchange and Rupee transactions in the CBS.
4. Areas of activities/ transactions which are out of the ambit of CBS.
5. The MIS Reports which could be generated from the CBS platform.
6. The Exceptional Reports available in the CBS.
7. The Credit Control Report, NPA related reports, Capital Adequacy Report etc. which are generated from the CBS.

All the above are to be properly familiarized by the Senior Auditor and appropriate planning must be made to identify the important factors which will influence the integrity of data and report relied on for the purpose of the audit.

In this context, a great deal of importance is to be placed on the verification of **"Granular Data" which are fed into the master** of the system. The RBI has very strictly instructed the banks to follow up all the control protocols for ensuring the integrity and accuracy of the Basic Data/ Information/ Instruction flags which are fed into the master database as per RBI Regulations. The customer's account may have different master fed into the CBS like Account Master, Loan Master, Document Master, and Instruction Master Etc. Any minute discrepancy in the Granular Data would lead to distort the output generated from the system. Hence, it is indispensable and important to give thrust to verification of Master Data in the CBS. The following are the list of important databases requiring verification by the auditor as fed to the master.

1. The EMI set as per sanction and the master.
2. Initial holiday given; if any, as per the sanction and the master.
3. The frequency of interest application as per sanction and master.
4. The value of securities as per the valuation report, stock/ debtors' statement, and the master data.
5. Standing instruction for carving out loan installments from SB/Current account.
6. Lien marking against deposits held as securities.
7. Flagging/De- flagging for generation of control reports.

The above verification would throw light on various inconsistencies which might influence the system generated reports. The auditor should be more vigilant in updating his/her skills on the short keys used for generating these reports. At times the audit module activated for the branch auditor may not have the privilege to generate reports. Hence the branch auditor should insist on obtaining the necessary privilege of access and verify the same or get the reports generated in hard/soft copy form for verification.

Identification of NPAs under computerised environment.

The identification of NPAs aims at classification of advance accounts as per the prudential norms. Thus, it is confined to verification of the advance accounts classified as STANDARD by the branch. The weakness in the performance of standard advances needs to be evaluated. The advances return of standard assets need to be scrutinized to see any overdrawing, over dues and temporary overdrafts. For the above, the following reports generated in the system will be of use to the auditors.

a) The report on overdrawing in cash credit and overdraft accounts as at the yearend generally termed as TOD/TAL reports.

b) The reports of overdue loans.

c) The report on outstanding bills discounted, purchased, and negotiated.

d) The report on identification of advances under watch category.

e) Classification report under SMA0, SMA1, SMA2 which is classified as standard advances with inherent weakness as to repayment or operation.

Examination of NPA Returns and Provisions Made to Existing NPAs

The NPA returns are generated from system and the auditor has to verify the same for the adequacy of the provisioning, status of degradation from Sub-standard to doubtful, D/A 1 to D/A 2and D/A 3 and to loss assets. The fields which are input from the branch and such other fields which may vitiate the quality of the security need to be focused by the auditor. The value of security, the proof of existence of security as depicted in the report need to be verified. It is often noticed that latest figures of value of securities would not have been updated as at the year-end especially in case of stock in trade, depreciable assets, shares, etc. The calculation of provision by the system needs to be verified at random to ensure its correctness.

System Generated Asset Classification Statement

The ministry of finance through the RBI has directed all banks to adopt system generated NPA statements from CORE for all advance accounts. This direction has also posed many practical issues as many banks have not fine-tuned the software in CORE to generate the NPA statements accurately. The major input data for the system generated NPA statement is the ACCOUNT MASTER set at the branches and it’s further up ration in the data base in CORE from time to time. This is a vital factor as the Branch auditors may be misled by the fact that all data leading to NPA statements are controlled by the CBS resulting in less or no scope for the branch or branch auditor to interfere. This is wrong as the system only generate the report as per the data residing in the master. ***Thus, it becomes an integral part of the audit to vouch the accuracy and integrity of such granular data in the system used to generate the NPA statement.***

The data influencing the NPA statement at the branch level at any given date are,

- The outstanding balance.
- The drawing power of the borrower.

- The latest value of securities held as primary and collateral.
- The repayment term or EMI fixed for loans.
- Initial Holiday, if any, granted for the repayment.
- The unification of other facilities granted to the borrower.

Some of the above granular data are static and some set to change during the currency of the loan based on the documents, performance and other factors. The programme interfacing with these granular data will bring results as per the integrity of such data. If such are not properly updated/corrected at the branch level, there are many chances of mistakes in the system generated NPA statement. This enlarges the scope of our audit to verify the integrity of data and the schematic in which the NPA statement is generated.

As per prudential norms, for the purpose of provisioning, the security cover extended to one facility can be reckoned as security for the other facilities of the borrower, subject to the overall asset/security coverage available. This process is called **security optimization**. In generating the system generated NPA statement, the total security cover available is compared with the total exposure of the NPAs. Thus, apart from the integrity of granular data, the concept of security optimization also plays a vital role in ensuring the provisioning requirement. The overlapping and duplication of considering the same security value for different accounts will distort the accuracy of provisioning. This should be critically examined by the auditor.

The timely feeding of drawing power on the basis of the stock and book debts statement received, adjustment of deterioration in value of depreciable assets held as security, product specific vulnerability of security cover etc. In a long way influence the accuracy of the system generated NPA statement.

The software platform and its compatibility with the CBS platform also leads to lot of aberrations in the system generated NPA statement. The system of capturing the data, manual intervention for corrections at any stage including de-flagging also influences the correctness of the same.

Considering all the above, Branch auditors are required to vouch and ensure the correct classification based on the information available as on the date of audit and suggest for MOC for any changes.

The branches invariably commit the following errors which results in the distortion of NPA classification and provisioning as per system generated NPA statement.

- Non updation of latest value of primary and collateral security. This would vitiate the drawing power and classification as NPA. This is also relevant as the provisioning is based on value of security particularly in the case of Doubtful Assets.
- Non updation of classification of accounts as priority and otherwise. This is relevant as the branch auditor is certifying the sector wise classification of advance accounts.
- Non linking of advance accounts of the same borrower under one code. This would happen when the customer id given from system are different for different loans. This is vital since prudential norms require classifying NPAs borrower wise and not account wise.

- To reckon the original value of security at the time of opening of the loan account even after it becomes NPA. This is more relevant in the case of depreciable assets, motor vehicles, cattle, goat vehicles, cattle, goat etc. held as security. The security value should undergo deterioration by passage of time. This would not have been updated leading to distort the provisioning in the system generated NPA report.
- Omission in feeding the availability of guarantee in the system.
- Erroneous feeding of drawing power in the system and not updating the same from time to time. This is relevant as the status of NPA and further provision in the case of already identified NPAs fundamentally depends on the Drawing Power, for OD/CC accounts.
- Non up ration of terms of restructuring, if any, in the master data base leading to degrade the quality of the asset.

De-flagging or Unflagging of NPAs

For reasons stated above, the system generated NPA statement will tend to have many aberrations which is considered by the bank and the Reserve Bank of India for constant corrective actions. Thus, for any technical reason or due to genuine mistake of the data resulting in wrong classification of assets as NPA, the banks are given permission to cull out those advance accounts out of the system generated NPA. This process is technically called "unflagging or de-flagging" of NPAs. The Annual Financial Inspection conducted by the RBI on many banks has commented on the inconsistencies of de-flagging/unflagging. The delegated authority, the documentation procedure and the reasons de-flagging any account is commented adversely in the RBI inspection reports. These accounts, if un-flagged will not appear in the NPA statement submitted for audit at the branch level. This requires a through verification by the auditors. The branch auditors should obtain the list of such un-flagged accounts and verify it thread bear with respect to the prudential norms and pass MOC for any correction required. The following action points may be adopted for tracing out and dealing with such de-flagged accounts:-

- Obtain a list of un-flagged accounts from the branch and verify each such account from the angle of prudential norms. The reasons for un-flagging need to be analysed critically.
- The list of watch category accounts and accounts reported in SMA category should be obtained as on 31st March of previous year, 31st January of current year, 28th February of current year and verified with the system generated NPA statement. All accounts appearing in the former list but not appearing in the later should be verified individually to justify reasons for its elimination from the NPA.
- The accounts regularised by the year end and skipping out of the system generated NPA statement needs special attention.
- The comparison of such statement as on 31.12.2021 should be made with that of 31.3.2022 to cull out up gradations made during the quarter for further verification.
- The overall NPA percentage of the branch should be critically verified with reference to the movement of NPAs as the year end and prior periods.
- The branch auditor may obtain a management representation from the branch specifying the status and details of un-flagged accounts.

- Usually, the controlling offices of the banks are given the authority to de-flag the NPAs. Thus, if the branch auditor fails to obtain any information regarding the process of un-flagging, the branch auditor also can submit a disclaimer report specifying the reason thereon and escalate the matter for the attention and further verification by central auditors.

Material lapses in system driven transactions

The system driven transactions are mainly application of interest on advance and deposit accounts, posting of charges in some cases, auto renewal of term deposits etc. The action points of audit are briefed below:

- The CORE may fail to apply interest to certain accounts due to data mismatch or interface issues. The listing of such accounts where interest is not charged by CORE can be identified from the ***interest failure*** check report (or similar exception report expressed in different term/nomenclature). The report needs to be generated as at the year end and corrective entries passed wherever necessary. If no such report is generated to ensure completeness of interest application, the branch auditor should disclaim to that effect.
- The date of application of interest may not be 31st March by CORE in all cases to avoid last minute rush in the CBS. It would be applied on any dates close to the due date by running the application programme segment wise, zone wise etc. as per administrator convenience of CBS. In such cases the auditor should ensure that adjustments are made for transactions between the date of actual debit and as on 31st March, in such accounts.
- The system and data flow of auto renewal of term deposit need to be verified to ensure proper accounting of interest due on old and new deposits.

Chapter 5: Value Addition Process to Bank Branch Audit

It is imperative that Chartered Accountants should update with latest development and directions issued by Reserve Bank of India and know the intricate details and procedure of bank transactions in the conduct the Branch Bank Audit.

The following illustrative points may be kept in mind while performing the audit and reporting.

- Link observation with the effect on Income Tax for the bank.
- Link the impact of capital adequacy and profitability in all figures which COSTS the bank in the form of maintaining capital adequacy ratio.
- Give observations about legality and enforceability of document and security analyzing the same pragmatically.
- Comment on the system lapses and suggest for improvement in the internal control system with specific reference to newly introduced loan schemes, credit cards, ATM transactions, foreign exchange business etc.
- Give suggestion for overall reduction of balance sheet size and to save capital block on account of Capital to Risk (CRAR), by elimination of expired bank guarantee, letter of credit, suspense balances, expenses pending capitalization etc.
- Report about redundant/obsolete security stationery held at the branch like DD forms, Cheque Books, FD receipts etc… in the wake of computerization. Report on internal control in respect of structured and pre numbered computer stationery, in the event of reprint, damage, misprint etc.
- Comment about the compliance of company law of obtaining resolutions, informing/ filing with registrar, search report, any lapses on charge creation, borrowing powers of directors etc. for all company borrower/ deposit accounts.
- Comment on the accounting/ closing entries with specific reference to Accounting Standards and principles of accounting.
- Comment on any inconsistencies in the accounting policies adopted by the bank in the published accounts, with Accounting Standards.
- Comment on the matters which requires special attention of the Central Statutory auditors while consolidation.
- Credit appraisal of major loan account from financial statements submitted viz ratio analysis, leveraging by borrowers, overtrading, intrinsic value of security tangibility of security, etc.
- Comment on the data flow and transaction flow embedded in the system requiring improvement.
- Practice documenting all communications to and from the branch.
- Adhere to time schedule or document seeking for any information for the purpose ofaudit with a copy marked to the controlling authorities.

The entire exercise of audit reaches the TOP management and the regulators only through reports. The main report may be prepared as per the format furnished by the bankers with material qualifications, if any, however a detailed and descriptive observations on all irregular advances, other accounts, system lapses etc. may be attached separately. Observations about the balance sheet, profit & loss account also should be forming part of audit report. The revised LFAR also requires the auditor to report about any adverse comments on 5 major accounts of the branch. We may choose to report any other matters also to the central statutory auditors or the top management. The following points are noteworthy.

- The report should disclaim the figures in the branch balance which are not in the control of the branches like balance in inter branch in CBS environment, some figures relating to foreign exchange etc.
- The account heads and figures which require attention of the Central Statutory auditors.
- Give name of borrower, scheme of advance, limit sanctioned and balance outstanding in the observations attached to the main report.
- The reporting may be done as bullet points to make it brief and crisp.

The above are only illustrative suggestions of the author and the branch auditor may choose any other points for reporting under observations to ADD VALUE to the audit process.

Ensuring Authenticity of Figures in Financial Statements Certified

The above exercise is more relevant since the system generated statements would have undergone various adjustments, additions, or deletion etc. The action points for the above are briefed below:

- ✓ The figures of Balance Sheet and Profit and Loss account need to be checked with respective sub ledgers and General ledger balance book. It is desirable to obtain a working note on grouping of figures from the General Ledger Balances to the Balance sheet and Profit and Loss account for verification and keeping it as working papers.
- ✓ The reconciliation of figures between the advance returns, its consolidation and balance sheet and profit and loss account need to be ensured.
- ✓ Special care is to be taken to verify the groupings and classifications of advances both funded and non-funded in capital adequacy statement to assign respective risk weights.
- ✓ It is desirable to keep on record all screen prints of last page of balancing reports of all deposit and advance segments reflected in balance sheet as a part of audit working papers.

Chapter 6: Revised Long Form Audit Report

The Reserve Bank of India has revised the Long Form Audit report for the Banks including for statutory audit of Bank from the year 2020-21 vide circular Number **RBI/2020-21/33 DOS.CO.PPG/SEC.01/11.01.005/2020-21 dated 5th Sept 2020**. The revised form has widened the scope for verification and reporting various sensitive areas of the bank functioning. The LFAR is structured for the Central Statutory Auditors, Statutory Branch Auditors and the specialised branches like Foreign Exchange Branch, Asset Recovery Branch, and administrative offices of the bank. The revised format is more comprehensive requiring the auditor to go deep and discrete to the verification and reporting many intricate aspects of the bank functioning.

This is the only report which is monitored by the RBI. A consolidated LFAR for the bank will be submitted by the Central Statutory Auditors to the RBI including all the observations and details made in the branch report. The annual financial inspection team of the RBI also gives much importance to the branch LFAR.

The following points may be considered while preparing the Long Form Audit Report.

- ✓ Wherever possible descriptive analysis should be attached to the LFAR.
- ✓ Answers should be discrete, specific and should be quantified.
- ✓ All questions of qualitative nature should be given with details and the auditor's judgement.
- ✓ The observations attached to the main report can be attached to LFAR also as LFAR is separated from the main report at the head office for consolidation and for inspection by RBI.
- ✓ No need to certify annexure and office note on large and critical advances furnished by the branch.
- ✓ The respective head office instructions and circulars should be referred for reporting Frauds.
- ✓ Ensure accuracy of figures furnished by the management while preparing LFAR.
- ✓ Report on long outstanding, abnormal balances in Suspense account, Sundry Creditors, Parking account, Proxy account and Pipeline entries.

The major points to be considered in filling the LFAR are given below along with the respective questions.

1. **Cash**

   a) Have the cash balances at the branch/***ATMs*** been checked at periodic intervals as per the procedure prescribed by the controlling authorities of the bank?
   The ONLINE ATM cash should be checked with the cash scroll taken on the closing hours of 31st. In case of OFFLINE ATMs, the cash is controlled by the central Hub. Cash with ATM replenished should be reconciled with disbursement account maintained at branch.

   b) Does the branch generally maintain / carry cash balances, which vary significantly from the limits fixed by the controlling authorities of the bank?

   Verify the cash retention limit. See average cash balance, proper utilization of float. Desirable to verify physical cash on the date of audit. Physical cash at chest / need not be verified. But the reporting to RBI of cash balance may be verified. Obtain a letter mentioning

retention limit for auditor's records.

c) Whether the insurance cover available with the branch adequately meets the requirement to cover the cash-in hand and cash-in transit?

The blanket insurance is usually taken by head office. Ensure that the copy of policy is at branch or get a representation to the effect.

2. **Advances**

The answers to the following questions may be based on the auditor's examination of all large advances and a test check of other advances. In respect of large advances, all cases of major adverse features, deficiencies, etc., should be reported. In respect of other advances, the auditor may comment upon the relevant aspects generally, along with instances of situations giving rise to his reservations or adverse remarks. For this purpose, large advances are those in respect of which the outstanding amount is in excess of prescribed limits to be identified.

The limit of specific advance accounts to be verified by Branch Auditors has been re-fixed in the revised LFAR. Obtain a list of advances above 10 crores or 10% of branch aggregate advances including fund based and non-fund based whichever is less for thorough verification. Classify the borrower's constitution wise for allocation of work among auditors. Also classify it as consortium advances, syndicated loans, multiple banking arrangement, group accounts, etc. for bringing more focus to such accounts.

The specific methodology of Transaction Audit and Process Audit are included. Transaction Audit includes the verification and reporting of the overall conduct of the account with respect to:

- ***Overall operations***
- ***Quantum of each operations Cash Vs Account Transactions Business Vs Personal Transactions Cheque Returns.***
- ***Operated at the brim of limits. Frequent over-drawings Transfer to another bank frequently. Round Stripping.***
- **Process verification includes the overall control framework and procedure followed at the branch vis a vis the policy of the bank which mainly include**

a) **Credit appraisal**

i) 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? What, in your opinion, are the s major shortcomings in credit appraisal, etc?

Any comments on advance processing, preparation of proposals, analysis of financial credentials/ statements, rating need to be reported. The appraisal report of the branch manager and his comments and recommendations to the higher authorities should be verified. If it is branch sanction, the sanction order and comments of the credit manager and senior manager/branch head to be verified.

ii) *Have you come across cases of quick mortality in accounts, where the facility became non-performing within a period of 12 months from the date of first sanction? Details of such accounts may be provided in following manner:*
Account No.
Account Name, Balance as at year end

Quick mortality is referred to accounts becoming irregular/sticky and stagnant from the day one of its availing or becoming NPA within one year of sanction. The sanction procedure, appraisal, group accounts, accounts of new customer, take over loans etc… should be given more emphasis.

iii) *Have you come across cases of frequent renewal / rollover of short-term loans? If yes, give the details of such accounts.*

The process of renewal/review should be verified. Roll over of renewal dates and making short/ad-hoc/limited review should be verified.

Refer RBI Circular:RBI2020-21/Dos_CO-PPG_BC_1/11.01.002/2020-21-August-2020. Bank policy for renewal/review to be obtained and strict adherence to be verified and deviations reported.

iv) *Whether correct and valid credit rating, if available, of the credit facilities of bank's borrowers from RBI accredited Credit Rating Agencies has been fed into the system?*

The time lag between the last ratings to the balance sheet date should be commented, if it is more than 2 years. The deterioration in latest rating is to be considered for further monitoring. The interest rate setting attuned to the rating granted should be reported. Accounts becoming NPA even after high rating should be commented separately.

v) 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?

Obtain the latest extant guidelines of the bank regarding delegated powers and report for any deviation from the delegated powers by the branch. The TOD/TOL powers, casual business powers, loan sanction powers need to be examined. The reporting of each of such instances need to be made to controlling authority. Verify the records / register maintained for the same. Obtain the regular/exception report of TOD/TAL as on 31.3.2021 and compare it with same report as on 28.2.2021 and 20.3.2021.

vi) Credit facilities released by the branch without execution of all the necessary documents? If so, give details of such cases.

The legal audit report needs to be verified for reporting inadequacy of documentation. Obtain a letter of representation in this regard from the branch manager.

vii) Advances against lien of deposits have been granted without marking a lien on the bank's deposit receipts and the related accounts in accordance with the guidelines of the controlling authorities of the bank.

Compare the list of loan against fixed deposits with the lien marked report generated from system. Specific verification regarding modification in terms, date, rate of interest etc. should be done for reporting. Obtain a letter of representation in this regard from the branch manager. The deposit lien should have been extended to related loans/accounts of the borrower to ensure enforcement of general lien on deposits before it is given back to customer.

b) Review Monitoring System

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. What, in your opinion, are major short comings in monitoring, etc?

Obtain a list of due dates or report of review dates of advances and inspection. See that no review is overdue for more than six months. Any such cases need to be classified as NPA as per prudential norms. Ensure that comprehensive review is done. The short review, extension of time of review etc. need to be commented on merits. Obtain confirmation from higher authorities if the review is pending at their end during audit period and report. Due date diary/report generated from system for accounts pending renewal should be obtained to focus on such accounts pending for renewal.

ii) Whether there exists a system of obtaining reports on stock audits periodically? If so, whether the branch has complied with such system?
Details of:
Cases where stock audit was required but was not conducted.
Where stock audit was conducted but no action was taken on adverse features

Stock audits are to be conducted yearly for all advances above benchmark for working capital limits sanctioned against stock and or debtors as decided by the bank. Obtain list of accounts requiring stock audit from branch manager. Verify stock audit reports and consider adverse comments if any. The stock audit initiated and report pending from auditors should be reported with special reference to delinquent accounts. The comments of the stock audit report and the regularization of such comments by the branch should be reported.

iii) Indicate the cases of advances to non- corporate entities with limits beyond that are set by the bank where the branch has not obtained the duly audited accounts of borrowers.

Obtain a list of such advances. Verify the financial statements and ensure auditors sign with seal and membership number. The limit set by the bank should be obtained as a letter from the branch manager. *The limit for obtaining audited statements is now as per the bank policy. Earlier it was Rs.10 lakhs and above.*

iv) Indicate the cases of advances to non- corporate entities with limits beyond that are set by the bank where the branch has not obtained the duly audited accounts of borrowers.

Obtain a list of such advances. Verify the financial statements and ensure auditors sign with seal and membership number. The limit set by the bank should be obtained as a letter from the branch manager. The limit for obtaining audited statements is now as per the bank policy. Earlier it was Rs. 10 lakhs and above.

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?

The branch should record the periodical inspection report of unit which will include verification report of securities. The inspection report should be kept on record. Any large variation needs to be reported. Long pending inspection on COVID effected borrowers and its RISK of mortality to be reported.

vi) In respect of advances examined by you, have you come across cases of deficiencies, including in value of securities and inspection thereof or any other adverse features such as frequent/ unauthorized overdrawing beyond limits, inadequate insurance coverage, etc.?

A comprehensive analysis of loans to group concerns with overlapping charge on same security need to be verified. The asset coverage of all group loans vis avis all outstanding loans need be comprehensively analyzed, and any deficiency reported.

vii) Whether the branch has any red-flagged account? If yes, whether any deviations were observed related to compliance of bank's policy related with Red Flagged Accounts?

The policy and process of red flagging should be obtained from the branch. The SMA categorization and red flagging should be in sync with the norms prescribed. The EXIT marked accounts, watch category accounts, accounts with early warning signals, otherwise delinquent accounts etc. also should be seen for red flagging. If it is not done, it should be reported.

c) *Asset Classification, provisioning of Advances and Resolution of Stressed Assets*

i) Whether the upgradation in non-performing advances is in line with the norms of Reserve Bank of India Where the auditor disagrees with upgradation of accounts? If yes, give reasons thereof.

Upgradation only after satisfactory performance for one year for all restructured assets. Upgradation based on CRITICAL factors as below to be verified and reported. Fresh Valuation of assets/security infusion of capital by Borrowers Transfer of funds from other branches.

ii) Is the branch prompt in ensuring execution of decrees obtained for recovery from the defaulting borrowers? Give Age-wise analysis of decrees obtained and pending execution.

The decree obtained from courts/DRT pending execution should be obtained and reported. The branch may be insisted to obtain the list and details from the legal department for auditors to report here.

iii) In cases where documents are held at centralized processing centers / office, whether the auditor has received the relevant documents as asked by them on test check basis and satisfied themselves. Report the exceptions, if any.

Physical custody of documents, if centralized and not able to be verified should be reported. The overall control and coordination of documents and upkeep of the same need to be commented. The list of documents sought for verification and not provided should be reported separately.

3. Liabilities

i) Does the bank have a system of identification of dormant/ inoperative accounts and internal controls with regard to operations in such 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.

Study the system of internal control of identification, classification, and activation of operation on such accounts. Obtain a list of inoperative accounts having a balance of more than a benchmark. Verify the operation involving high value transactions put through inoperative accounts, immediately on activation from AML angle.

ii) Does your test check indicate any unusual items or material with drawls or debits in these accounts? If so, give details thereof.

Obtain the ledger copy of the sundry deposits account and verify the debits and its sanctity. Report on any matters requiring attention of management. The ledger copy should be kept for auditors' records. Obtain a letter of representation in this regard from the branch manager.

4. Books and Records

i) 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.

The software's used other than MS Office and regular operating system for correspondence should be verified. The export transaction platform, locker, cheque book issue software, Separate MIS Software, Software for EM Creation and its registers, and its integration with CBS should be identified and the influence of such software should be verified and reported.

ii) In case the branch has been subjected to IS Audit whether there are any adverse features reported and have a direct or indirect bearing on the branch accounts are pending compliance? If yes give details.

The financial aspects of IS audit other than technical aspects as per report of IS Audit should be CRITICALLY examined. If the IS Audit does not cover the financial implications of the system errors, it should be reported as a weakness in IS Audit. The pendency of IS Audit as per Bank Instructions should be reported.

5. Frauds

Furnish particulars of:

i) Frauds detected/classified but confirmation of reporting to RBI not available on record at branch.

Obtain details of fraud, if any and a letter of representation in this regard from the branch manager. Recommend 100% provision for any amount lying in fraud account. The vulnerability of internal control leading to such instances of fraud also may be reported.

ii) Whether any suspected or likely fraud cases are reported by branch to higher office during the year? If yes, provide the details thereof related to status of investigation.

The indication of any fraud or likely fraud on the basis of professional skepticism of auditor should be reported.

iii) Whether the system of Early Warning Framework is working effectively and as required, the early warning signals form the basis for classifying an account as RFA.

The reports generated and the overall management of early warning signals of accounts, SMA Classification and reporting framework should be reported.

6. Management Information System

i) Whether the branch has the proper Systems and procedures to ensure data integrity relating to all data inputs which are to be used for MIS at corporate office level and for supervisory reporting purposes. Have you come across any instances where data integrity was compromised?

The overall data accuracy and timelines like updation of drawing power, security value, insurance details, short review dates in system would in a long way impact the data integrity of MIS. This should be examined and reported.

Allied Certification/Reports

The major reports and certificates to be issued along with the branch audit include the following. The report and Certificate and its relevant action points are tabulated below:

Certificate of Capital Adequacy	▪ Verify the classification and grouping figures ▪ Obtain the detailed listing of grouping. ▪ The non-fund exposure as LC, Bank guarantee etc. should be net off with the available margin held in the form of banks own deposits. A list of such deposits needs to be kept on record.
DICGC Certificate (Refer Point 5(d)(xiii) of LFAR)	▪ The balance if any lying as liability in balance sheet for DICGC claim received need to be verified. The list of advance accounts against which such claim was received need to be obtained from branch. ▪ The sharing of recovery during the year on such loans and any other loans where claim is received from DICGC need to be ensured.
Tax Audit Certificate	▪ The applicable fields of the format need to be filled by obtaining details.
Ghosh Committee and Jillani	▪ The above reports are aimed at internal control and

Committee Report	the system control at the branches. The auditor should broadly narrate his comments wherever he has observations. Care should be taken to ensure that the reporting here is consistent with the reporting made in LFAR.

Chapter 7: Recent Circulars on Prudential Norms

Circular No. RBI/2021-22/125/DOR.STR.REC.68/21.1.048/2021-22, Dated.12/11/2021

Reserve bank of India vide above circular as clarified many ambiguities in the classification and treatment of Non-Performing Assets. This circular is specifically brought to ensure uniformity in the implementation of prudential norms. The auditors are expected to verify the advances and its classifications with the norms prescribed as per the above circular.

The following points are briefly explained for easy understanding and adoption of the clarifications in the circular while conducting the audit.

1. The Banks are required to specifically mention the due dates of repayment, frequency of repayment, breakup between principal and interest in EMI based repayment etc… in the loan agreements for all loans sanctioned afresh after 31/12/2021.
2. In respect of existing loans, the compliance of the above should be ensured, up on next earliest renewal/review.
3. The classification of "Special Mentioned Accounts" (SMA) are to be made on a continuous basis were principal or interest is overdue for more than 30 days, 60 days and up to 90 days for flagging the accounts under SMA-0, SMA-1 and SMA-2 respectively.
4. The cut-off date for the purpose of determining the number of days is the "**day end process**" run by the bank on a calendar day basis. The criteria to determine the classification under SMA is now based on a continuous basis and as per running the day end process at branch level. Thus, if any loan is not serviced with interest or principal on the due date till the day end process is run, then it will be classified under SMA-0, SMA-1 and SMA-2 on such due dates.
5. The classification of SMA is made applicable to all loans including retail loans irrespective of size of exposure. Thus, the auditor should verify the classification of accounts in to SMA category as per the latest instructions and the report is generated by the bank on such classification.
6. The "out of order" status in the case of CC/OD accounts also shall be reckoned on a continuous basis based on the day end process run by the branches.
7. The NPA classification for nonpayment of interest is clarified to be based on periodicity of "**interest rests**" adopted for the purpose of debiting interest. This alludes that if a term loan is due to be repaid after every quarter where the interest is applied on a monthly basis, then the categorization of overdue for non-payment of interest should be based on monthly basis than quarterly basis.

   E.g., if the repayment schedule is fixed every quarter asJune30thSeptember31st December and 31stMarch and if the interest is applied on a monthly basis, the overdue categorization should also be based on monthly basis. If the interest debited on June 30th is overdue for more than 90 days up to September 30ththen the account should be classified as NPA on September 30thitself. Thus, classification should not be on the basis of *completion of 90 days from the end of the quarter instead it should be as on September 30th.*

8. The upgradation of "**NPAs to Standard Assets"** shall be made only if the entire arrears of interest and principal are paid by the borrower. Partial payments of interest or principal shall not be considered for upgradation of NPAs to Standard Assets.
9. The Banks are allowed to recognize the interest debited during the moratorium period if the accounts is otherwise "**standard**". If the initial holidays or moratorium period is even more than 90 days, the interest debited during the moratorium period can be recognized to Profit and Loss account, if the account remains otherwise under standard category. This is more relevant in the case of education loans and project loans which may be sanctioned with an initial repayment holiday or moratorium period.
10. Reversal of income on accounts identified as NPA as per the prudential norms is clarified. The circular clarifies that the entire unrealized interest for the entire past period of the loan as on the date of NPA should be reversed in the Profit and Loss account to the extent it remains and realized.

    The auditors may ensure that the genuine credits in the account should be first apportioned to interest and then to principal for the purpose of interpreting the above clarification.

    The circular stipulates that the procedure as per the instruction should be followed by all lending institutions from the date of the circular that is 21/11/2021 except as specified in the respective clauses. In a nutshell the following are reiterated for better understanding.

Clarification regarding the definition of "Out of Order"	
Present Method	**New Method Effective from 12-11-2021**
An OD/CC account is classified as NPA if it is "Out of Order" on the date of Balance Sheet. The outstanding balance in the principal account < SL/DP: a. If there are no credits continuously for 90 days as **on the date of Balance Sheet**, or b. Credits are not enough to cover the interest debited during the period.	Out of Order status of CC/OD accounts on a continuous basis, it is clarified that an account shall be treated as 'out of order' if: a. The outstanding balance in the CC/OD account remains continuously in excess of the sanctioned limit/drawing power for 90 days, or b. The outstanding balance in the CC/OD account is less than the sanctioned limit/drawing power but there are no credits continuously for 90 days, or c. The outstanding balance in the CC/OD account is less than the sanctioned limit/drawing power but credits are not enough to cover the

	interest debited during the previous 90 days period.
NPA Classification in case of Interest Payments	
Present Method	**New Method Effective from 31-03-2022**
• As per Para 2.1.3 of Master Circular No. RBI/2021-2022/104DOR.No.STR.REC.55/21.04.048/2021-22 October 1, 2021 • An account is classified as NPA only if the interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter.	• RBI/2021-2022/125 DOR.STR.REC.68/21.04.048/2021-22 dated November 12, 2021 • In case of interest payments in respect of term loans, an account will be classified as NPA if the interest applied at specified rests remains overdue for more than 90 days

Other Salient Points

a. *Credit Card Accounts:* Credit card account will be treated as nonperforming 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. Banks shall report a credit card account as 'past due' to credit information companies (CICs) or levy penal charges, viz. late payment charges, etc., if any, only when a credit card account remains 'past due' for more than three days. The number of 'days past due' and late payment charges shall, however, be computed from the payment due date mentioned in the credit card statement.

Temporary Deficiencies

a. 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 shouldfollow the following guidelines:

   ✓ ***The outstanding in the account based on drawing power calculated from stock statements older than three months is deemed as irregular.***

   ✓ ***A working capital borrowing account will become NPA if such irregular drawings arepermitted 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.***

   ✓ ***Regular and ad hoc credit limits need to be reviewed/ regularized not later than three months from the due date/date of ad hoc sanction.***

b. *Advances Against Term Deposits, NSCs, KVPs/ IVPs, etc.*

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 should be continued in accordance with Crop Seasons only.

MSME Restructuring of Advance

- The RBI vide circular no. RBI/2021-22/32DOR.STR.REC.12/21.04.048/2021-22 dated May 5, 2021 Resolution Framework 2.0 – **Resolution of Covid-19 related stress of M SME.**
- Extend the above facility for restructuring existing loans without a downgrade in the asset classification subject to the following conditions:
- As on 31.03.2021 the borrower should be an MSME.
- The borrower entity is registered in GST, otherwise exempted from registration as per GST Act as on 31.03.2021.
- The aggregate exposure, including non-fund-based facilities, of all lending institutions to the borrower does not exceed `.25 crores as on March 31, 2021. Now, the aggregate limit has been extended to Rs. 50 Cr.
- The account was standard as on 31.03.2021.
- The account was not restructured in terms of earlier circulars.
- The restructuring of the borrower account is invoked by September 30, 2021.
- The restructuring of the borrower account is implemented within 90 days from the date of invocation.
- If the borrower is not registered in the Udyam Registration portal, such registration shall be required to be completed before the date of implementation of the restructuring plan for the plan to be treated as implemented.
- Upon implementation of the restructuring plan, the lending institutions shall keep provision of 10 percent of the residual debt of the borrower.
- It is reiterated that lending institutions shall put in place a Board approved policy on restructuring of MSME advances under these instructions at the earliest, and in any case not later than a month from the date of this circular.
- All other instructions specified in the circular no.DOR.No.BP.BC/4/21.04.048/2020-21 dated August 6, 2020, shall remain applicable.

Circular No. DOR.NO.BP.BC.47/21.04.048/201920, Dated 27th March 2020

Reserve Bank of India vide above circular as given regulatory package for asset classification and provisioning for loan accounts by granting a moratorium period of three months from 1stMarch 2020 to 31st May 2020. This period is further extended by another three months from 1st June 2020 to 31st August 2020 vide Circular No. Dor.No.BP.BC.71/21/4048/201920 dated 23rd May 2020. The salient features of the regulatory package are as follows:

- This six-month moratorium is extended for repayment, asset classification and provisioning.
- An account which is classified as standard as on 29th February 2020 will remain as standard till 31st August 2020 irrespective of overdue in loan repayments.
- In the case of working capital loans, recovery of interest applied during the period from 1st March 2020 to 31st August 2020 will be deferred and such interest charged during the deferment period shall be excluded for the purpose of determining 'out of order' status.
- The moratorium period exemption is also granted for the accounts to be classified as SMA.
- The second circular dated 23rdMay 2020 has further facilitated for the conversion of interest charged on CC/OD accounts for the above period into a Funded Interest Term Loan (FITL) account to be repaid in such number of installments but repayable not later than 31stMarch 2021.

The auditors should find that the regulatory package is only for such period falling within the financial year 2020-21. No moratorium or any other concessions are seen granted after first wave of COVID-19 pandemic in financial year 2020-2021. It is also important to note that all the FITL term loans granted shall be closed by 31st March 2021. Thus, any FITL loans granted as per COVID regulatory package shall not be pending as on 1st April 2021. The auditor should give special emphasis to such loans which are not closed as on 31st March 2021 and categorized in books for financial year 2021-22, under Standard Category.

GECL Loans (Guaranteed Emergency Credit Line Loans)

The Reserve Bank of India has granted a special scheme to guarantee the loans granted to MSME borrowers in the form of additional credit facilities. The following salient features may be verified by the auditors while conducting the bank branch audit.

- The GECL Loans are granted up to a maximum of 20% of the entire fund-based loans outstanding as on 29-02-2020.
- The repayment of such additional loans should be for a period of 4 years including one year moratorium from the date of disbursement. That is, in the first year there no repayment obligation of Principal. However, interest needs to be serviced as and when debited.
- Banks should be framing their own policies to comply with the GECL stipulations.
- The security already available both in the form of collateral or otherwise shall be ranking "*PARIPASSU*" with the existing credit facilities.
- No additional collateral, processing fee, pre-payment penalty, and inspection/document charges shall be collected from borrowers for the GECL Loans.
- The banks are at liberty however to collect proper documents duly signed by borrowers for the additional facility although additional securities are restricted to be insisted.

It is pertinent to note that for the year 2021-22 majority of GECL Loans will be due for repayment after the initial moratorium period of one year as per GECL norms. Branch auditors should verify the repayments of the GECL Loans in the same lines as in the case of other loans during the year 2021-22.

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