

Guidance Note on Audit of Banks (2021 Edition)



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

Guidance Note on Audit of Banks (2021 Edition)

Attention

Members' attention is invited to relevant directions/circulars issued by the Reserve Bank of India up to February 05, 2021 available at ICAI website for ease of use and reference. Members are advised to keep track of legislative/regulatory developments, for example, circulars of the Reserve Bank of India, issued subsequent to the aforementioned date and having a bearing on the statutory audit of banks/bank branches for the year ended March 31, 2021.

Members are also advised to read this Guidance Note in conjunction with other two publications (Technical Guide on Audit of Internal Financial Controls in Case of Public Sector Banks and Technical Guide on Revised Formats of Long Form Audit Report) of AASB.



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Foreword

Banking Sector in India is rapidly changing due to technological innovation, financial liberalization with entry of new private and foreign banks, introduction of new products/services and geographical expansion. Banks function under the supervisory and regulatory directions of the Reserve Bank of India to minimise the internal and external risks that are faced by banks. Statutory Audit helps banks to provide the stakeholders a comfort with regard to credibility of the financial statements of banks.

In order to maintain quality of bank audits, it is essential that the statutory auditors are well equipped in terms of their knowledge of the banking sector and keep themselves abreast with the latest developments in banking sector. The Guidance Note on Audit of Banks brought out by the Auditing and Assurance Standards Board of ICAI every year is an important resource which provides detailed guidance to the members on various aspects of bank audits.

I am happy to note that the Auditing and Assurance Standards Board of ICAI has come out with revised 2021 edition of the “Guidance Note on Audit of Banks” for the benefit of the members and stakeholders at large. The Guidance Note is comprehensive and self-contained reference document. The Revised edition incorporates the impact of the various circulars of the Reserve Bank of India as well as certain important advisories, pronouncements of the ICAI which would be relevant to bank audits for the financial year ending March 31, 2021.

I compliment CA. G. Sekar, Chairman, CA. Shriniwas Y. Joshi, Vice-Chairman, and other members of the Auditing and Assurance Standards Board for bringing out this revised Guidance Note to assist the members in maintaining quality in bank audits. I also acknowledge the contribution of CA. (Dr.) Debashis Mitra, Vice President, ICAI (Contributed as Co-Convenor of the study group) and CA. Prasanna Kumar D, Convenor of the study group in revising this Guidance Note.

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

New Delhi
March 19, 2021

CA. Nihar N Jambusaria
President, ICAI

Preface

Banking in India has become service oriented, maturing from the days of 'walking in business' to the present situation of 24*7 banking solutions to attract customers. With such widespread and rapid growth of the banking industry and their entry into a wide variety of services like insurance, mutual funds, etc., the onus of the healthy sustenance and growth of the banking industry lies on the back of reliable financial statements which can only be assured by quality audits. The bank audit is thus an important step for all banks who seek a better optimization of its overall management. It is essential that the members undertaking statutory audit of banks, both at the branch as well as the central level, keep themselves abreast with the latest developments in the banking sector. The Auditing and Assurance Standards Board of ICAI has been helping the members in maintaining quality in bank audits by bringing out its benchmark publication "Guidance Note on Audit of Banks" to provide detailed guidance to the members who undertake audits of banks and their branches. The Guidance Note is updated every year to incorporate the recent updates, impact of amendments and changes in banking environment which require attention of statutory auditors, such as, master directions/circulars of RBI, relevant advisories, pronouncements of ICAI having bearing on bank audits and amendments/changes in applicable laws or regulations.

We are happy to place in your hands this revised 2021 edition of the Guidance Note on Audit of Banks. The Guidance Note is broadly bifurcated into two Sections i.e. Section A - Statutory Central Audit and Section B - Bank Branch Audit. For benefit of the members, the Guidance Note also contains various Appendices like illustrative formats of engagement letter, illustrative formats of auditor's report both in case of nationalized banks and banking companies, management representation letter, the text of master directions, master circulars and other relevant circulars issued by RBI.

RBI has made reporting on internal financial controls mandatory for statutory auditors of public sector banks from the financial year 2020-21 onwards. Further, RBI has issued revised formats of LFAR in September 2020 which will be applicable for audits of banks for the financial year 2020-21 and onwards. To provide specific guidance to the members on these aspects, two separate publications i.e. "Technical Guide on Audit of Internal Financial Controls in case of Public Sector Banks" and "Technical Guide on Revised Formats of Long Form

Audit Report” have been issued by Auditing and Assurance Standards Board. Accordingly, we request the members to use this Guidance Note in conjunction with the aforesaid publications.

At this juncture, we wish to place on record our sincere gratitude to CA. Prasanna Kumar D, Central Council Member, ICAI and Convenor of the Study Group and other study group members for revising the Guidance Note.

We express our sincere thanks to CA. Nihar N Jambusaria, Honourable President, ICAI, CA. (Dr.) Debashis Mitra, Honourable Vice-President, ICAI and CA. Atul Kumar Gupta, Honourable Immediate Past President, ICAI for their guidance and support to the activities of the Board.

We are thankful to all the Board Members and Central Council Members for their guidance and support in finalizing this Guidance Note. We appreciate the efforts made by CA. Megha Saxena, Secretary, AASB, CA. Nitish Kumar, Executive Officer, CA. Samriddhi Bhatt, Assistant Project Officer, Ms. Anitha P., and Mr. Chirag Popli for their hard work in giving the Guidance Note its final shape.

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

CA. Shriniwas Y. Joshi
Vice Chairman
Auditing and Assurance Standards Board

CA. G. Sekar
Chairman
Auditing and Assurance Standards Board

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

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 - Appendix IV : Illustrative Format of Engagement Letter in case of a Nationalised Bank (Separate only for Audit of Internal financial controls over financial reporting)
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F. Text of Relevant Notifications, FAQs and General Circulars

**Section A –
Statutory Central Audit**

Personal Banking and Operations Department

Introduction

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

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

Preparation / Planning

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

Conduct / Execution

1.04 The Auditor is required to carry out the following:

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

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- Verify whether the TDS flag is correctly configured wherever Form 15G/15H have been received by the Bank and that TDS as per the rates in force has been deducted on interest payments made during the year.
- Verify whether the accounting effects of interest payable in the form of interest accrued but not due and interest accrued and due are correctly given and TDS compliances thereon.
- Verify the compliance of internal circulars of the bank in terms of categorisation of customers and application of the said terms in the master data of such deposit holders.
- Verify the compliance with the rules and regulations formulated by the bank related with the deposit products based on sample check.
- Verify the complaints lodged w.r.t. the customer services and contingent liability / liability arising thereon.
- Verify the special rate deposits (those deposits wherein rate of interest is deviated as compared to the interest table) as regards the eligibility and approval of the same as per the internal policy of the bank.

Reporting / Conclusion

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

1.06 Readers may note that for the reference and benefit of the members various illustrative formats for Auditor's Report, Engagement Letter, and Management Representation Letter are given in the Appendices to Section A (Available on ICAI website) of the Guidance Note on Audit of Banks (2021 Edition) as follows:

- | | |
|---------------------|--|
| Appendix I | – Illustrative Format of Report of the Auditor of a Nationalised Bank |
| Appendix II | – Illustrative Format of Report of the Auditor on the Standalone Financial Statements of Banking Company |
| Appendix III | – Illustrative Format of Engagement Letter in case of a Nationalised Bank |

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| Appendix VII | – Illustrative Format of Management Representation Letter to be obtained from Bank Management in case of Statutory Central Audit |
| Appendix VIII | – Illustrative Format of Management Representation Letter to be obtained from Bank Management in connection with the Limited Review |

Retail Banking and Marketing Department

Introduction & Bank's process

2.01 Banks generally provide various retail advances namely:

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

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

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

2.04 Generally, the credit assessment process is different from corporate loans. The bank generally collects following documents:

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

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

Credit Due Diligence for Retail Financing

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

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

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

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

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

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

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

Post Disbursement Monitoring

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

Retail Financing

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

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

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

Credit Risk Rating Process

Audit approach, procedures including regulatory considerations

A. Preliminary Check

2.13 An auditor should review product note or circular or policy related to every loan product under the audit. Also, review that the product note/ policy/ circular is in line with RBI guidelines.

2.14 In retail advance, the volume of transactions are high; hence the

auditor needs to apply effective sampling to ensure proper coverage. While selecting sample, the auditor may consider loan sanctioned/ disbursed near to reporting date, high/low in interest rate sanctions as compared to average rate, coverage of different branches and different type of loans.

2.15 An auditor should look at the following documents for checking the bank process for selected sample accounts:

- i. Prescribed Application form.
- ii. CIBIL Check of borrower and guarantor.
- iii. KYC Compliance.
- iv. Income proof like salary slip, financial statement, Income tax returns, Bank statement.
- v. Property Valuation Report.
- vi. Title clearance report in case where property like flat, plot, building is mortgaged.
- vii. Technical review in case of mortgage of machinery.
- viii. In case of vehicle loans, copy of original invoices, copy of RC and insurance policy of vehicle with bank clause should be obtained.
- ix. In case of education loans, document for the studies in affiliated universities/colleges, prospectus and fees details should be obtained.
- x. Whether the Bank has complied with the particulars given in the documentation manual.
- xi. If the loan is taken over from another bank, satisfactory performance report from that Bank needs to be collected.
- xii. If any additional limit is granted, ensure the security and eligibility is being considered.
- xiii. Whether the Bank has obtained legal security report addition to valuation report.
- xiv. Whether all registers required by the Bank/Branch are kept updated.
- xv. Confidential Report and NOC from the existing bankers.
- xvi. Valuation report in case of Gold loan.

B. Disbursement

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

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

C. Post Disbursement Inspection

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

- i. There should be an acceptance letter duly acknowledged by the borrowers & guarantors, if any for all the loan accounts.
- ii. Execution of the loan documents should be as per the terms and conditions of the sanction letter.
- iii. All the original documents are held in the safe custody in fire resistance safe.
- iv. Valuation of Securities.
- v. External and Internal Credit Rating.
- vi. Due Diligence Certificate.
- vii. Verify if the payment schedule as per the sanction letter is implemented. If any, check the approval document for the same.
- viii. Perform ledger scrutiny.
- ix. Whether the interest and principal repayment are received in time in accordance with the repayment schedule as mentioned in the loan agreement/term sheet.
- x. Whether the SMAs/EWS are reported to the management on regular intervals and what course of action is taken to mitigate the same.
- xi. Verify whether the group exposure and industry exposure are within the prescribed limits.
- xii. The auditor should set the expectation for the movement in yield based on the discussion and inquiries made with the management; rate movement observed in the industry, etc., and should obtain explanations for major variances in the yield on monthly basis or quarterly basis.
- xiii. The auditor should perform analytical procedures for computing the processing fee percentage for different ticket size loans.
- xiv. The Auditor should check the master data of the borrower in the CBS to ensure correct feeding of data with regard to sectorial classification of advances, e.g. priority sector and non-priority sector [in terms of RBI circular No.FIDD.CO.Plan1/04.09.01/2016-17 dated July 7 2016 (as updated from time to time)], amount of instalments with due dates of payment etc.

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

Other Aspects

2.19 RBI Master Direction DBR.Dir.No.85/13.03.00/2015-16 updated on 26th February 2020 Master Direction - Reserve Bank of India (Interest Rate on Advances) Directions, 2016. Vide this direction, it had been decided to link all new floating rate personal or retail loans (housing, auto, etc.) and floating rate loans to Micro and Small Enterprises extended by banks with effect from October 01, 2019 and floating rate loans from 1st April 2020 to external benchmarks.

- (a) All new floating rate personal or retail loans (housing, auto, etc.) and floating rate loans to Micro and Small Enterprises extended by banks from October 01, 2019 shall be benchmarked to one of the following: -
- Reserve Bank of India policy repo rate;
 - Government of India 3-Months Treasury Bill yield published by the Financial Benchmarks India Private Ltd. (FBIL);
 - Government of India 6-Months Treasury Bill yield published by the FBIL;
 - Any other benchmark market interest rate published by the FBIL.
- (b) Banks are free to offer such external benchmark linked loans to other types of borrowers as well.
- (c) In order to ensure transparency, standardisation, and ease of understanding of loan products by borrowers, a bank must adopt a uniform external benchmark within a loan category; in other words, the adoption of multiple benchmarks by the same bank is not allowed within a loan category.

Direct Marketing Expenses

2.20 These are the expenses incurred mainly for sourcing of retail loans/credit cards and collection of retail overdue loans. RBI circular RBI/2006/167/DBOD.NO.BP.40/21.04.158/2006-07 dated 3rd November 2006 on "Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by banks" clearly states that activities of internal audit, compliance function and decision making functions like compliance with KYC norms for opening deposit accounts, according sanction for loans (including retail loans) and management of investment portfolio cannot be outsourced.

Wealth Management and Third Party Products

Introduction

Wealth management

3.01 Wealth management involves advice and execution of investments on behalf of high net worth individuals/clients of Banks. Each bank will have its own criteria for defining High Net Worth Individuals based on the relationship with the bank and the amount of assets (under management) kept by the customers. The focus is on the asset allocation of the client considering his financial goals, plans and his risk appetite of such individuals/clients.

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

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

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

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

3.06 Some banks might have a separate subsidiary for wealth management activity but some banks are carrying out such activity on their own. The suggestive Audit Process would cover:

- The Auditors should check client service agreement with wealth

management clients and ensure that the bank is complying with all terms contained in the agreement.

- The auditor should also check that the terms of such service agreements are in compliance with the requirements/provisions of other market regulators like SEBI etc.
- The Auditor should check fee income recognized by the Bank with charges mentioned / agreed with the clients.
- The Auditor should ensure that these charges are recovered as per the terms and old outstanding recoverable balances are dealt with accordingly by the bank's management.
- The Auditor should carry out cut-off procedures and ensure completeness of fee income recognized for the year and accrue the earned income/commission and defer income received in advance based on services rendered.

Third party products

3.07 Banks not only have their own products in terms of Deposits, Loans, Remittances, Lockers, Credit Cards etc. but also offer a variety of third-party products. Third party products are those financial products that are sold by a bank for some other Institutions. Banks only distribute or sell these products on fee/commission/brokerage basis. These products are not created by the Bank. Since such products do not form part of the Balance sheet of the Bank as Deposit or Loans and Advances, banks do not have any requirement to allocate Capital towards these products and hence these are not part of Bank's CRAR calculations. Bank can act as distributor/ Broker permitting them to sell such products like insurance policies, mutual funds etc.

3.08 A third party (in this context) is an entity that is involved in a transaction acting as an intermediary between two principal parties (like service provider & recipient) but is not one of the principals. Third party activities are carried out to provide overall financial service to customers for a fee.

3.09 Following the few Examples of Third Party Products:

- Insurance Products
- Mutual Funds
- Collection of utility bills and taxes
- Investment Advisory Services
- Mobile Recharge

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- Government Bonds/Securities
- Demat Accounts
- Portfolio Management Services
- Referral Services
- Equipment Leasing and Hire Purchase Business
- Sponsoring Infrastructure Debt
- Underwriting Activities
- Primary Dealership Business
- Pension Fund Management

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

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

- There shall be a Board approved policy for the activity that shall comprehensively cover the said activity including the various risks associated with it and suitable risk mitigation measures.
- The instructions/ guidelines on KYC/AML/CFT applicable to Banks, issued by RBI from time to time, shall be complied with.
- The general principles as enunciated in the Charter of Customer Rights issued by RBI shall be adhered to.
- Specific conditions of IRDA, SEBI, PFRDA and Accounting Standards issued by ICAI need to be complied.
- No Bank shall engage in a financial Activity without prior approval of RBI other than approved activities.
- A Bank that is a trading/clearing member shall keep its and clients' position distinct from one another.
- Professional Clearing Member of the commodity derivatives segment of

SEBI recognised exchanges need to satisfy the prudential criteria.

- Bank shall take exposure on its trading members as per the policy approved by its board.
- Bank shall ensure strict compliance with various margin requirements as may be prescribed by the Bank's board or the Commodity Exchanges as also the extant RBI guidelines regarding guarantees issued on behalf of commodity brokers.
- Banks may invest in other equipment leasing/ hire purchase/factoring companies within the limits specified in Section 19(2) of Banking Regulation Act, 1949, with the Reserve Bank's prior approval but they shall not act as promoters of such companies.

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

3.13 The Auditor should note the following aspects while conducting audit of third-party product operations:

- 1) Agreements are entered into with reputed third-party product providers. Due diligence on the financial credentials and the reputation of the third party is comprehensively done before the tie-up. Detailed diligence testing and validation documents should be in place.
- 2) There is an approved policy in place detailing the products and the manner in which they can be and are sold. The policy should be in conformity with extant RBI and other regulatory guidelines. Adherence to the policy should be strictly ensured.
- 3) Whether there is a policy in place for identifying vulnerable customers; if any and the adequacy of governance and oversight process right from product launch to ongoing monitoring.
- 4) Bank's staff who are designated to sell these products have the necessary prescribed qualifications and training. The sale should be done by the designated employees only. The suitability and appropriateness of the product to the customer to whom it is sold must be ensured.
- 5) Revenue earned on sale of these products is properly accounted and received as per the contractual rates specified in the agreement entered into between these parties. These rates could change from time to time. Correct applicable rates should be accounted. The point of accounting of Income is critical and it should be consistently applied. The Auditor should

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also verify compliances with GST & withholding tax provisions while recognising revenue from distribution of third-party products.

- 6) The original agreements must be on record, properly filed and stored. Compliance with the terms and conditions of the agreement from both parties must be ensured. Timely renewal of these agreements should be ensured.
- 7) Complaints, if any, on mis-selling of these products or deficiency in service should be looked into for proper redressal and closure. These complaints may pose both a regulatory and a reputational risk to the Bank. Necessary disciplinary action against the concerned staff should be initiated as per bank's internal policy.
- 8) For any outstanding receivables from these third parties, balance confirmations should be called for and be on record. Any old outstanding should be verified for disputes, appropriate provisioning or write-off.
- 9) The auditor should verify the income recognized by cross checking data received from principals (such as Mutual Funds/Insurance Companies) with their internal systems. The Auditor should also insist on regular income statements and balance confirmations from such parties.
- 10) General IT controls and controls over Management Information.

International Banking Division

Functions of International Banking Division

4.01 The functions of International Banking Division include the following:

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

4.02 The auditor should understand the organization structure and the functionalities of the specialized centralized division. If there is a manual of operations in place, then he should obtain the latest updated version. The auditor should also obtain copies of inspection or other internal audit reports of this division which covers the efficiency of various functional operations. The auditor should seek and peruse the inspection report by the local central bank or

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regulatory or monitoring authority. The audit scope, frequency of audit and the accuracy of MIS generated and communicated should be looked in to. Any open issues should be followed up for closure and also the reasons why these issues were not addressed till date should be understood.

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

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

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

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

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

4.08 The auditor should satisfy that the translations of such overseas operations are in accordance with the requirements of AS 11, 'The Effects of Changes in Foreign Exchange Rates (Revised 2018)'.

4.09 The auditors should note the methodology and approach to audit, the extent of coverage and any good practices that can be benchmarked or adopted locally should also be noted for incorporation.

4.10 Deviations or discrepancies noted should be appropriately reported in the Long Form Audit Report.

Treasury Operations

(A) Introduction and Bank's Process

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

Core functions of Treasury Operations in Bank

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

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

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

Front Office (Dealing Room)

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

- Debt Sales
- Credit Default Swaps

Mid Office (Risk)

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

Back Office

- Settlement and follow up
- Reconciliations
- Accounting
- Valuation

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

Front office Operations

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

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

Middle office Operations

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

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

Back office Operations

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

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

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

Functions of Back Office

Input and completion

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

Counterparty confirmation

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

5.13 Deals done with customers (non-banks) will normally be confirmed by e-mail, with instructions swapped on the telephone, depending on the arrangement. Increasingly, however, corporate customers are using automatic confirmation-matching services. It is essential that the deal is confirmed independently of the trader before any kind of value is given or payment is made.

F-TRAC (FIMMDA Trade Reporting and Confirmation) System

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

Settlement

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

Reconciliation

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

Important Terms

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

Approved Securities

5.18 Section 5(a) of the Banking Regulation Act, 1949 defines 'approved securities' to mean securities in which a trustee may invest money under

clauses (a) to (d) and (f) of section 20 of the Indian Trusts Act, 1882. Approved securities comprise primarily the securities issued or guaranteed by the Central or State Government, or any other security expressly authorised by the Central Government by notification in the Official Gazette.

Subsidiary General Ledger (SGL)

5.19 This is a ledger maintained by the Public Debt Office (PDO) of RBI in which accounts of different banks are maintained regarding their holding of Government securities. The transactions through SGL Accounts should be in compliance with Master Circular no. RBI/2015-16/97 DBR No BP.BC.6 /21.04.141/2015-16 on Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Bank dated July 1, 2015.

Repo and Reverse Repo Transactions

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

5.21 The RBI has issued Repurchase Transactions (Repo) (Reserve Bank) Directions, 2018 vide circular no. FMRD.DIRD.01/14.03.038/2018-19 dated 24th July 2018 and in supersession of all earlier instructions on this subject. This circular has been further amended vide circular no. FMRD.DIRD.21/14.03.038/2019-20 dated 28th November 2019. RBI has decided to: (a) align the accounting norms to be followed by market participants for repo/reverse repo transactions under Liquidity Adjustment Facility (LAF) and Marginal Standing Facility (MSF) of RBI with the accounting guidelines prescribed for market repo transactions. Accordingly, all repo/reverse repo transactions are required to be accounted for as lending and borrowing transactions.

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

5.23 Repo transactions are now allowed between the permitted entities, namely, (a) SGL A/c holders; (b) SGL A/c holder and its own gilt account holder (GAH); (c) SGL A/c holder and GAH under another custodian; (d) GAHs under the same custodian; and (e) GAHs under two different custodians, subject to the conditions as specified in the said notification.

Short Sale

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

STRIPS

5.25 STRIPS stand for Separate Trading of Registered Interest and Principal Securities. Stripping is a process of converting periodic coupon payments of an existing Government Security into tradable zero-coupon securities, which will usually trade in the market at a discount and are redeemed at face value. For instance, stripping a five-year Government Security would yield 10 coupon securities (representing the coupons), maturing on the respective coupon dates

and one principal security representing the principal amount, maturing on the redemption date of the five-year security. Reconstitution is the reverse process of stripping, where, the Coupon STRIPS and Principal STRIPS are reassembled into the original Government Security. Detailed guidelines outlining the process of stripping/ reconstitution and other operational procedures regarding transactions in STRIPS are given in Master Circular no. RBI/2015-16/97 DBR No BP.BC.6 /21.04.141/2015-16 on Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Bank dated July 1, 2015.

“When Issued” Securities

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

Certificate of Deposit (CD)

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

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

Commercial Paper (CP)

5.29 It is an unsecured money market instrument issued in the form of a promissory note by Corporates, PDs, FIs subject to compliance with the guidelines issued by RBI vide Master Direction no. RBI/FMRD/2016-17/32FMRD.Master Direction No.2/2016-17 dated July 7, 2016 on Money Market Instrument: Call/Notice Money Market, Commercial Paper, Certificate of Deposit and Non Convertible Debentures (original maturity up to one year).

The tenure of CP should not be less than 7 days and not more than one year, from the date of issue.

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

Non-Convertible Debentures (NCDs)

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

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

REITs & InvITs

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

5.34 The Reserve Bank of India vide Circular no. RBI/2016-17/280 DBR. No. FSD. BC. 62/24.01.040/2016-17 April 18, 2017 on "Prudential Guidelines – Banks' investment in units of REITs and InvITs" and as further amended by Master Direction/DBR.FSD.No.101/24.01.041/2015-16 dated May 26, 2016 and updated as on September 25, 2017 has allowed banks to participate in Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs) within the overall ceiling of 20 per cent of their net worth permitted for direct investments in shares, convertible bonds/ debentures, units of equity-oriented mutual funds and exposures to Venture Capital Funds (VCFs) [both registered and unregistered]. Before making investments, Banks are required to put in place a Board approved policy on exposures to REITs/ InvITs which should lay down an internal limit on such investments within the overall exposure limits in respect of the real estate sector and infrastructure sector. Banks are not permitted to invest more than 10 per cent of the unit capital of a REIT/ InvIT. Banks need to ensure adherence to the prudential guidelines issued by RBI from time to time on

Equity investments by Banks, Classification and Valuation of Investment Portfolio, Basel III Capital requirements for Commercial Real Estate Exposures and Large Exposure Framework, as applicable.

State Development Loans

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

TREPS

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

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

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

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

5.40 RBI has made the reserve requirements for Triparty Repo borrowing similar to borrowing in market repo and no CRR is required to be maintained for Triparty Repo borrowings outstanding in the books of Member.

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

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

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

Process Review, Walk through and Control Testing

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

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

5.45 Some of the typical audit procedures include:

- Identification of specific application controls based on process understanding and walkthroughs.

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

In the Covid-19 scenario, an Auditor should also verify the controls put in place to ensure appropriate functioning of the treasury operations from off premise locations without compromising safety and security of the data. The auditor should ensure that appropriate approvals have been taken from the respective authorities before enabling and allowing dealing from off-premise locations. RBI Circular no. FE.CO.FMD. No. 18380/02.03.137/2010-11 dated 3rd February 2011 prescribes the requirements for off premise dealings.

Substantive Audit Procedures

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

Examination of Reconciliation

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

5.48 Some typical audit procedures would include:

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

- Obtaining direct balance confirmations.

Inspection of Documents

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

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

5.51 Some typical audit procedures would include:

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

Examination of Existence of Investments

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

5.53 The Auditor should verify the investments held with PDO, custodians and the depository, at the close of business on the date of the balance sheet with the statement of holdings. The Auditor should circulate and maintain control over independent investments' balance confirmation requests to the

custodian and other constituents (for example, RBI for SGL and CSDL balances) in accordance with SA 505, "External Confirmations" issued by ICAI. Furthermore, the Auditor should design sufficient alternative audit procedures in situations where the independent confirmations are not received back (after reasonable follow up procedures) before the Auditor signs off on the bank's financial statements. These alternative procedures should also be designed in such a way that independent data points are used for corroborating investment balances (E.g. the Auditor gets the bank personnel download the investment statement in his own presence e.g. from E-Kuber for Government Securities, DP's website for Shares and Bonds etc.).

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

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

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

Cut-off Procedures

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

5.58 Some typical audit procedures would include:

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

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

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

Examination of Classification and Shifting

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

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

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

5.63 In the case of transfer of securities from HTM to AFS / HFT category the following should be noted:

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

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

5.65 If the value of sale or transfer (excluding one-time shifting and additional shifting explicitly permitted by RBI), exceeds 5% of the book value of

HTM investments as at the beginning of the year, the bank should disclose market value of the investments under HTM category along with disclosure of excess of book value over market value for which provision is not made.

5.66 The audit procedures in this regard would include:

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

Examination of Accounting and Valuation

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

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

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

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

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Held for Trading (HFT) category, the same should be marked to market at monthly or at more frequent intervals in similar manner, except in the following cases:

- i) Equity shares should be marked to market preferably on daily basis. If not, at least on a weekly basis;
- ii) Banks which undertake short sale transactions, the entire HFT portfolio including the short position should be marked to market on daily basis.

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

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

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

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

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

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

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

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

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

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

5.78 The classification of investments into "held-to-maturity", "held-for-trading" and "available-for-sale" categories is based on the intention with which the respective investments have been acquired by the bank. The Auditor should examine whether the investments have been properly classified in either of the three categories at the time of acquisition based on such intention as evidenced by dealers' pad or equivalent, along with reference to the

decision of the competent authority such as Board of directors, ALCO or Investment Committee.

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

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

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

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

5.83 Some of the typical audit procedures would include:

- Obtaining list of investment as at reporting period from the bank and ascertaining completeness of the same by reconciliation process as highlighted above.
- Checking the carrying amount of investments and ensuring that the same is calculated on a consistent basis. This is normally calculated by the system and hence the Auditor needs to check IT controls and calculation on sample basis for ensuring accuracy.

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

5.84 The following Table gives the basis of Marked to Market procedure based on the type of investments (unquoted)

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

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

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

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

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

- (a) the provisions made for depreciation of investment portfolio for the quarters ended December, 2017 and March, 2018 made during the quarter/ year;

- (b) the balance provisions required to be made in the remaining quarters; and
- (c) creation of IFR.

5.86 The RBI vide circular no. DOR.BP.BC.No.42/21.04.141/2019-20 dated March 17, 2020 has given certain additional guidance regarding considering IFR forming part of General Provisions and Loss Reserves for capital purposes

Non-Performing Investments (NPI)

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

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

- (i) Interest/ instalment (including maturity proceeds) is due and remains unpaid for more than 90 days.
- (ii) The above would apply *mutatis-mutandis* to preference shares where the fixed dividend is not paid. If the dividend on preference shares (cumulative or non-cumulative) is not declared/paid in any year it would be treated as due/unpaid in arrears and the date of balance sheet of the issuer for that particular year would be reckoned as due date for the purpose of asset classification.
- (iii) In the case of equity shares, in the event the investment in the shares of any company is valued at Re.1 per company on account of the non availability of the latest balance sheet in accordance with the instructions contained in paragraph 3.5.5 of the RBI Master Circular no. RBI/2015-16/97 DBR No BP.BC.6 /21.04.141/2015-16 dated July 1, 2015 on Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks, those equity shares would also be reckoned as NPI.
- (iv) If any credit facility availed by the issuer is NPA in the books of the bank, investment in any of the securities, including preference shares issued by the same issuer would also be treated as NPI and *vice versa*. However, if only the preference shares are classified as NPI, the investment in any of the other performing securities issued by the same issuer may not be classified as NPI and any performing credit facilities granted to that borrower need not be treated as NPA. The Auditor should review the mechanism adopted by the Bank for classifying the investments as NPI

where the credit facility has been classified as NPA and vice versa and test the effectiveness of the mechanism followed particularly the timeliness of such classification.

- (v) The investments in debentures / bonds, which are deemed to be in the nature of advance would also be subjected to NPI norms as applicable to investments.
- (vi) In case of conversion of principal and / or interest into equity, debentures, bonds, etc., such instruments should be treated as NPA *ab initio* in the same asset classification category as the loan if the loan's classification is substandard or doubtful on implementation of the restructuring package and provision should be made as per the norms. Further movement in the asset classification of these instruments would also be determined based on the subsequent asset classification of the restructured advance.
- (vii) When a Bank restructures credit facilities in accordance with RBI circular no. DBR.No.BP.BC.45/21.04.048/2018-19 dated June 7, 2019 dealing with Prudential Framework for Resolution of Stressed Assets, the investments made by the Bank in the instruments of such borrowers will also be dealt with in accordance with these guidelines.

Classification of State Government guaranteed investments as NPI

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

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

5.91 The audit procedures would include:

- Identifying Non-Performing Investments based on RBI guidelines as defined above. In case advances given to a party is classified as NPA, investment in securities issued by the same party also needs to be classified as NPI and *vice-versa* except in case of preference shares, wherein if a preference share is classified as NPI, the performing securities and performing credit facilities granted to the said party need

not be treated as NPI / NPA.

- Ascertaining whether the bank has made appropriate provision for the depreciation in the value of the NPI.
- Ensuring that the banks have not off-set the depreciation on NPI against the appreciation in respect of other performing securities.
- Obtaining separate list of investments as a result of conversion of interest/ principal. These investments need to be classified as NPI *ab initio*, if the loan's classification is NPA on implementation of the restructuring package.

Special Aspects

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

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

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

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

5.95 The RBI had specified the following guidelines with respect to IFR and IRA:

Investment Fluctuation Reserve

- (i) Banks were advised to build reserves towards investment fluctuation, of a minimum 5% of the investment portfolio within 5 years period.
- (ii) To ensure smooth transition to Basel II norms, banks had been advised to

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build adequate reserve towards capital charge for market risks in a phased manner over a two year period as follows:

- (a) In respect of securities included in the HFT category, open gold position limit, open foreign exchange position limit, trading positions in derivatives and derivatives entered into for hedging trading book exposures by March 31, 2005; and
 - (b) In respect of securities included in the AFS category by March 31, 2006.
- (iii) As advised by RBI in October, 2005, Banks maintaining capital of at least 9 per cent of the risk weighted assets for both credit risk and market risks for both HFT (of items - open gold position limit, open foreign exchange position limit, trading positions in derivatives and derivatives entered into for hedging trading book exposures) and AFS category as on March 31, 2006 were permitted to treat the entire balance of IFR as Tier I capital, transfer the balance in the IFR 'below the line' in the Profit & Loss Appropriation account to statutory reserve, general reserve or balance of Profit and Loss Account.

Investment Reserve Account

- (i) Provisions created for depreciation on investments in the AFS and HFT categories if found excessive should be credited to the Profit & Loss Account and equivalent amount (net of taxes, if any and net of transfer to Statutory Reserve as applicable to such excess provision) should be appropriated to an Investment Reserve Account in Schedule 2 – "Reserves and Surplus" under the head "Revenue and Other Reserves" and would be eligible for inclusion under Tier II capital within the overall ceiling of 1.25% of total risk weighted assets prescribed for general provisions/ Loss Reserves.
- (ii) The Investment Reserve Account can be utilised in the prescribed manner.
- (iii) The amounts debited to the Profit & Loss Account for provision should be debited under the head "Expenditure - Provisions & Contingencies". The amount transferred from the Investment Reserve Account to the Profit & Loss Account should be shown as "below the line" item in the Profit and Loss Appropriation Account after determining the profit for the year. Provision towards any erosion in the value of an asset is an item of charge on the profit and loss account and hence should appear in that account before arriving at the profit for the accounting period. Adoption of the following would not only be adoption of a wrong accounting principle

but would, also result in a wrong statement of the profit for the accounting period:

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

Hence none of the above options are permissible.

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

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

5.97 Investments should not normally be held by any other person. If any investments are so held, proper enquiry should be made to ensure that there is some justification for it, e.g., shares may be held by brokers for the purpose of transfer or splitting-up etc. Shares may also be lodged with the companies concerned for transfer etc. When investments are held by any other person on behalf of the bank, the Auditor should obtain a certificate from him. The certificate should state the reason for holding the investment (e.g., in safe custody or as security). The receipt originally issued by such person while taking delivery of the investment is not adequate for audit purposes. In the case of inscribed stock also, a certificate should be obtained which should certify the holding of the bank as at the date of the balance sheet.

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

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

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

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

Income from investments

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

5.103 Some of the typical audit procedures would include:

- Re-computation of amortisation of premium / discount on investment securities.
- Re-performance of profit / loss on sale of investments keeping into consideration the method of allocating cost to securities (FIFO or weighted average).

- Assessing the dividend recognition policy of bank considering revenue recognition principles of Accounting Standard 9, 'Revenue Recognition'.
- Re-computation of interest income on investments and checking the treatment of broken period interest, including ensuring proper cut-offs at reporting period ends.
- Checking of proper recognition of investment valuation loss as at reporting date.
- Checking of interest accrual in respect of interest-bearing investment outstanding at reporting date.

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

5.105 There may be cases where the certificates of tax deduction at source (TDS) received along with the dividend/interest on investments are found missing. This increases the incidence of tax on the bank. The Auditor should see that there is a proper system for recording and maintenance of TDS certificates received by the bank. The Auditor may also review Form 26AS (Income-tax Rules, 1962) to ensure that proper credit will be made available to the bank.

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

Legal Requirements

5.107 For the purposes of section 24 of the Banking Regulation Act, 1949, the valuation of securities is to be done with reference to the cost price, market price, carrying cost or face value, or a combination of these methods, as may be specified by the RBI from time to time.

5.108 Section 19 of the Act places restrictions on overall holding of investments by banks in the shares of companies (except in the shares of subsidiary company. As per Section 19(2) of the Act, no banking company shall hold shares in any company, whether as pledgee, mortgagee or absolute

owner, of an amount exceeding thirty per cent of the paid-up share capital of that company or thirty per cent of its own paid up share capital and reserves, whichever is less.

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

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

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

- (a) Shares in a subsidiary may be held in the name(s) of the company's nominee(s) to the extent necessary to ensure the minimum number of members as required by law.
- (b) Investments may be deposited with the bankers of the company for collection of dividend or interest.
- (c) Investments may be deposited with, or transferred to, or held in the name of, the State Bank of India or a scheduled bank to facilitate transfer thereof, subject to the conditions laid down in this behalf.
- (d) Investments may be deposited with, or transferred to, any person by way of security for repayment of a loan or performance of an obligation undertaken by the company.
- (e) Investments in the form of securities may be held in the name of a depository.

5.112 In respect of investments not held in the company's own name as per the exceptions made under section 187 of the Companies Act, 2013, a register

has to be maintained by the company, as per format prescribed from time to time. Section 186 of the Companies Act, 2013, which imposes certain restrictions on the purchase of securities in other companies, does not apply to a banking company.

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

Guidelines of the RBI regarding transactions in Securities

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

Classification of Investments

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

(i) Held-to-maturity (HTM)

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

(ii) Held-for-trading (HFT)

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

(iii) Available-for-sale (AFS)

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

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

- (a) SLR Securities up to prescribed percentage of their DTL as on the last Friday of the second preceding fortnight (updated vide RBI circular no.DBR.No.Ret.BC.10/12.02.001/2018-19 dated December 05, 2018 on "Section 24 and Section 56 of the Banking Regulation Act, 1949 – Maintenance of SLR and holdings of SLR in HTM category).
- (b) Non-SLR securities included under HTM as on September 02, 2004.
- (c) Fresh re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in Investment portfolio, excluding re-capitalisation bonds of other bank acquired for investment purpose.
- (d) Fresh investment in the equity of subsidiaries and joint ventures.
- (e) RIDF/SIDBI/RHDF deposits.
- (f) Investment in long-term bonds (with a minimum residual maturity of seven years at the time of investment) issued by companies engaged in infrastructure activities.

5.117 The banks will have the freedom to decide on the extent of holdings under HFT and AFS. This will be decided by them after considering various aspects such as basis of intent, trading strategies, risk management capabilities, tax planning, manpower skills, capital position. RBI vide its circular no. DBR.BP.BC.No.31/21.04.018/2015-16 dated 16th July 2015 on "Deposits placed with NABARD/SIDBI/NHB for meeting shortfall in Priority Sector Lending by Banks-Reporting in Balance Sheet" decided that for accounting periods commencing on or after April 1, 2015, deposits placed with NABARD/SIDBI/ NHB on account of shortfall in priority sector targets should be included under Schedule 11- 'Other Assets' under the subhead 'Others' of the Balance Sheet instead of disclosing under Schedule 8 "Investments".

5.118 Vide RBI circular no. DoR.No.BP.BC.9/21.04.141/2020-21 dated September 1, 2020 Banks were allowed to hold under HTM category, SLR securities acquired on or after September 1, 2020 up to an overall limit of 22 per cent of NDTL, up to March 31, 2021. This was further relaxed upto March 31, 2022 vide circular no. DoR.No.BP.BC.22/21.04.141/2020-21 dated October 12, 2020 w.r.t. the securities acquired between September 01, 2020 and March 31, 2021. Subsequently, it was further relaxed vide Circular no.: RBI/2020-21/94 DOR.No.MRG.BC.39/21.04.141/2020-21 dated February 5, 2021, to extend the dispensation of enhanced HTM of 22 per cent to March 31, 2023 to include SLR securities acquired between April 1, 2021 and March 31, 2022. Thus, banks may exceed the limit specified w.r.t. total SLR securities held under HTM category (as specified in paragraph 2(b) of the above circular) up to 22 per cent of NDTL (instead of 19.5 per cent of NDTL) till March 31, 2023, provided such excess is on account of SLR securities acquired between September 1, 2020 and March 31, 2022. Thereafter it shall be progressively reduced such that the total SLR securities held in the HTM category as a percentage of the NDTL does not exceed

- a. 21.00 per cent as on June 30, 2023.
- b. 20.00 per cent as on September 30, 2023.
- c. 19.50 per cent as on December 31, 2023.

Exposure Limits

5.119 The RBI, vide its Master Circular no. RBI /2015-16/70 DBR.No.Dir.BC.12 /13.03.00/2015-16 dated July 1, 2015 on "Exposure Norms" provides requirements in respect of exposure limits for banks. Further, the Reserve Bank of India vide Circular No. RBI/2018-19 /196 DBR.No.BP.BC.43/21.01.003/2018-19 dated June 03, 2019 "Large Exposures Framework" has issued guidelines on Large Exposure Framework (LEF). These guidelines came into effect with effect from April 1, 2019. Further amendments to these guidelines have also been made vide Circular no. DOR.No.BP.BC.70/21.01.003/2019-20 dated May 23, 2020.

5.120 As per guidelines banks cannot participate in the equity of financial services ventures including stock exchanges, depositories, etc., without obtaining the prior specific approval of the Reserve Bank of India, notwithstanding the fact that such investments may be within the ceiling prescribed under Section 19(2) of the Banking Regulation Act. The RBI vide its Circular no. DBR.No.FSD.BC.37/24.01.001/2015-16 dated September 16, 2015 on "Equity Investment by Banks – Review" has permitted banks which have CRAR of 10 per cent or more and have also made net profit as of March

31 of the previous year that they need not approach RBI for prior approval for equity investments in cases where after such investment, the holding of the bank remains less than 10 per cent of the investee company's paid up capital, and the holding of the bank, along with its subsidiaries or joint ventures or entities continues to remain less than 20 per cent of the investee company's paid up capital. Financial Services Companies have been defined in Annex I to the Master Circular DBR.No.FSD.BC.19/ 24.01.001/2015-16 dated July 1, 2015. The investment will continue to be subject to prudential limits as mentioned in Para 3.1 (a) and (c) of Master Circular DBR.No.FSD.BC.19/24.01.001/2015-16 on 'Para-banking Activities' dated July 1, 2015.

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

(C) Certificate/ Reports (covering the requirements and approach/ procedures)

Special-purpose Certificates Relating to Investments

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

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

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

(D) Accounting Aspects

Disclosure Requirements

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

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

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

Balance Sheet Presentation

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

I. *Investments in India*

- (i) Government securities
- (ii) Other Approved Securities
- (iii) Shares
- (iv) Debentures and Bonds
- (v) Subsidiaries and/or Joint Ventures
- (vi) Others (to be specified)

II. *Investments outside India*

- (i) Government securities (including local authorities)
- (ii) Subsidiaries and/or Joint Ventures Abroad
- (iii) Other Investments (to be specified)

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

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

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

5.127 The Auditor should consider the following points in respect of Investments held outside India –

- a. Review the delegation of authority to confirm that in respect of branches outside India holding investments, whether the foreign branches are authorised to transact and hold investments in their books of accounts and that the transactions have been duly executed as per the said delegation matrix.
- b. Physically verify these investments held by branches outside India. In case it is not possible to verify these physically, undertake alternative audit procedures to verify the existence and ownership of these investments as at the reporting date.
- c. Verify the valuation of these investments. The same should be in line with RBI requirements. Similarly, local regulations in the country in which the investments are made should also be referred to. The valuations should be in line with the regulations that are more stringent.

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

5.128 The Auditors should familiarise themselves with the instructions/ directions issued by the RBI regarding transactions in investment securities. Banks should frame Internal Investment Policy Guidelines and obtain the Board's approval. The investment policy may be suitably framed / amended to include Primary Dealer (PD) activities also. Further, the Reserve Bank of India has issued Master Directions no. RBI/IDMD/2016-17/29 Master Direction

IDMD.PDRD.01/03.64.00/2016-17 on Operational Guidelines for Primary Dealers dated July 1, 2016 (updated November 22, 2018), which should be complied by Banks. The Auditor should review the investment policy of the bank to ascertain that the policy conforms, in all material respects, to the RBI's guidelines as well as to any statutory provisions applicable to the bank.

5.129 Banks' management should ensure that there are adequate internal control and audit procedures for ensuring proper compliance in regard to the conduct of the investment portfolio. The banks should institute a regular system of monitoring compliance with the prudential and other guidelines issued by the Reserve Bank of India. While examining the internal controls over investments the Auditor should particularly examine whether the same are in consonance with the guidelines of the RBI a gist of which has also been included in the Master Circular no. RBI/2015-16/97 DBR No BP.BC.6 /21.04.141/2015-16 on Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks dated July 1, 2015. They should also judge their efficacy. By efficacy, it is meant that not only the Auditor would check the operating effectiveness of various internal controls but also in the first instance check and evaluate the design of such internal controls.

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

5.131 Some of the typical audit procedures would include:

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

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- perusing reports on concurrent audit of treasury transactions, system audit report, if any and follow-up action taken by the management thereon.
- perusing the half yearly review of portfolio by the Board of Directors of the bank and also reviewing annual inspection report of the RBI carried out under Section 35 of the Banking Regulation Act, 1949.
- Verification of voice recording mechanism and to ensure user ids of dealers left / transferred/ on leave is deactivated / suspended on timely basis.

Dealings in Securities on Behalf of Others

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

5.133 The Auditor should examine whether bank's income from such activities have been recorded and is fairly stated in the bank's financial statements. The Auditor also needs to consider whether the bank has any material undisclosed liability from a breach of its fiduciary duties, including the safekeeping of assets. The Auditor also needs to give certificate for reconciliation of securities held by the bank as custodian. An Illustrative Checklist for the verification of the aspects of the Treasury/ Investments of the Bank in Statutory Audit is given as Annexure to this Chapter.

(F) Compliance with CRR and SLR requirements

Introduction

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

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

Regulatory Requirements

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

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

5.137 Further, Reserve Bank has specified *vide* circular no. RBI/2016-17/83 DBR.No.Ret.BC.15/12.02.001/2016-17 dated October 13, 2016 on Section 24 and Section 56 of the Banking Regulation Act, 1949 - Maintenance of Statutory Liquidity Ratio (SLR) that every Scheduled Commercial Bank shall continue to maintain in India assets as detailed below, the value of which shall not, at the

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close of business on any day, be less than a specified percentage of the total net demand and time liabilities (NDTL) as on the last Friday of the second preceding fortnight valued in accordance with the method of valuation specified by the Reserve Bank of India from time to time:

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

5.138 This has been amended by RBI circular no. DBR.No.Ret.BC.10/12.02.001/2018-19 dated December 5, 2018 on Section 24 and Section 56 of the Banking Regulation Act, 1949 - Maintenance of Statutory Liquidity Ratio (SLR), which has reduced the SLR by 0.25% in a phased manner beginning from 5.1.2019 till it reaches 18% by 11.4.2020 as follows –

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

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

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06.07.2019 ¹	18.75
12.10.2019 ¹	18.50
04.01.2020 ¹	18.25
11.04.2020 ¹	18.00

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

5.140 However, in terms of Master Circular RBI/2015-16/104 DBR.No.FID.FIC.3/01.02.00/2015-16 on Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks dated July 1, 2015, the regulatory treatment of market repo transactions in Government securities will continue as hitherto, i.e., the funds borrowed under repo will continue to be exempt from CRR/SLR computation and the security acquired under reverse repo shall continue to be eligible for SLR.

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

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

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

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preceding working day. The return in form VIII is to be furnished within 20 days after the end of the month to which it relates. Banks should also submit a statement as annexure to form VIII giving daily position of –

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

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

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

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

5.147 The Reserve Bank of India *vide* its Circulars no.: DOR.No.Ret.BC.52/12.01.001/2019-20 dated March 27, 2020, DOR.RRB. No.28/31.01.001/2020-21 dated December 4, 2020, RBI/2020-21/91 DOR.No. Ret.BC.36/12.01.001/2020-21 February 05, 2021 and Press Release No.2020-2021/401 dated September 28, 2020 on Marginal Standing Facility (MSF), allowed banks to avail of funds under the MSF by dipping into the Statutory Liquidity Ratio (SLR) up to an additional one per cent of their net demand and time liabilities (NDTL), i.e., cumulatively up to three per cent of NDTL. The said MSF relaxation has been extended upto September 30, 2021

Computation of CRR

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

5.149 RBI issued circular no.: RBI/2020-21/92 DOR.No.Ret.BC.37/12.01.001/2020-21 dated February 05, 2021 whereby Scheduled Commercial Banks will be allowed to deduct the amount equivalent to credit disbursed to 'New MSME borrowers' from their Net Demand and Time Liabilities (NDTL) for calculation of the Cash Reserve Ratio (CRR). For the purpose of this exemption, 'New MSME borrowers' shall be defined as those MSME borrowers who have not availed any credit facilities from the banking system as on January 1, 2021. This exemption will be available only up to Rs. 25 lakh per borrower disbursed up to the fortnight ending October 1, 2021, for a period of one year from the date of origination of the loan or the tenure of the loan, whichever is earlier.

5.150 The Reserve Bank of India reduced the CRR to 3% vide Circular DOR.No.Ret.BC.49/12.01.001/2019-20 dated March 27, 2020 up to a period of one year ending March 26, 2021. The said dispensation would be restored in two phases - banks will be required to maintain the CRR at 3.50 per cent of their NDTL effective from the reporting fortnight beginning March 27, 2021 and 4.00 per cent of their NDTL effective from fortnight beginning May 22, 2021.

Computation of SLR

5.151 Refer Master circular No. DBR.No.Ret.BC.24/12.01.001/2015-16 on "Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)" dated July 1, 2015, for guidance on computation of SLR. Further, RBI notification RBI/2016-17/83 DBR.No.Ret.BC.15/12.02.001/2016-17 dated October 13, 2016 on "Section 24 and Section 56 of the Banking Regulation Act, 1949 - Maintenance of Statutory Liquidity Ratio (SLR)", as amended from time to time, has been issued in this regard.

Audit Approach and Procedures

5.152 The certificate of the statutory Auditors in relation to compliance with CRR and SLR requirements has to cover two aspects:

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

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

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

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

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

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

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

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

- a) Paid up capital, reserve, any credit balance in Profit and loss Account of the bank, amount of any loan taken from the RBI and amount of refinance taken from EXIM Bank, NHB, NABARD, SIDBI.
- b) Bills discounting by a bank with eligible financial institutions as approved by RBI.
- c) Net Income tax provision.
- d) Amount received from DICGC towards claims held by banks pending adjustments thereof.
- e) Amount received from ECGC by invoking the guarantee.

- f) Amount received from insurance companies for adhoc settlement of claims pending judgement of court.
- g) Amount received from court receiver.
- h) Net unrealized gain/loss arising from derivatives transactions under trading portfolio.
- i) Income flows received in advance such as annual fees and other charges which are not refundable.
- j) Liabilities arising on account of utilisation of limit under bankers acceptance facility (BAF).
- k) Part amounts of recoveries from the borrowers in respect of debts considered bad and doubtful of recovery.
- l) Amounts received in Indian currency against import bills and held in sundry deposits pending receipts of final rates.
- m) Un-adjusted deposits/balances lying in link branches for agency business like dividend warrants, interest warrants, refund of application money, etc., in respect of shares/debentures to the extent of payment made by other branches but not adjusted by the link branches.
- n) Margins held and kept in sundry deposits for funded facilities.

5.160 Similarly, the Auditor may specifically examine whether the following items have been included in liabilities:

- (a) Net credit balance in Branch Adjustment Accounts. The credit entries in branch adjustment account which are outstanding for more than 5 years are required to be considered at gross.
- (b) Interest accrued on deposits should be calculated on each reporting fortnight (as per the interest calculation methods applicable to various types of accounts), whether or not such interest is accounted for in books of accounts, so that the bank's liability in this regard is fairly reflected in the total NDTL of the same fortnightly return.

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

- (c) Borrowings from abroad by banks in India need to be considered as 'liabilities to other' and should be considered at gross level unlike 'liabilities towards banking system in India', which are permitted to be netted off against 'assets towards banking system in India'. Thus, the adverse balances in Nostro Mirror Account should be considered as 'Liabilities to other'.
- (d) The reconciliation of Nostro accounts (with Nostro Mirror Accounts) needs

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to be scrutinized carefully to analyze and ascertain if any inward remittances are received on behalf of the customers / constituents of the bank and have remained unaccounted and / or any other debit (inward) entries have remained unaccounted and are pertaining to any liabilities for the bank.

5.161 While examining the computation of DTL, the Auditor may specifically examine the details of exempted categories of the following items:

- a) Minimum eligible credit (EC) and outstanding Long term bonds (LB) to finance Infrastructure loans and affordable housing loan, as per RBI circular no. DBOD.BP.BC.No.25/08.12.014/2014-15 dated July 15, 2014 on "Issue of Long Term Bonds by Banks – Financing of Infrastructure and Affordable Housing" as amended by circular no. DOR.No.BP. BC.41/08.12.014/2019-20 dated March 17, 2020.
- b) The eligible amount of incremental FCNR(B) and NRE deposits of maturities of three years and above.

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

5.163 As per RBI circular RBI/2018-19/34/ DBR.Ret.BC. No.01/ 12.01.001 /2018-19 dated August 02, 2018, "Maintenance of CRR/SLR on Foreign Currency Assets/Liabilities– Reference rate for INR/USD and exchange rate of other major currencies", for conversion of foreign Currency Assets/ Liabilities reference rate from FBIL should be taken. If reference rate is not available from FBIL, banks may continue to use New York closing rate for conversion of such currency in USD.

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

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

5.166 The Auditor should examine the correctness of data in Form A return for CRR and Return in Form VIII for SLR purposes on sample basis.

5.167 As stated in the preceding paragraphs, a considerable part of the information required by the Statutory Central Auditor for reporting on compliance with the SLR requirements will flow from the branches. It is

suggested that the relevant information pertaining to the branches within a region may be consolidated at the regional level. The Auditor of the region concerned should verify the same in the manner described in the above paragraphs and report on the same. The consolidated statement should also be counter-signed by the regional manager. The Auditor at the central level should apply the audit procedures listed in the above paragraphs to the overall consolidation prepared for the bank as a whole. Where such a procedure is followed, the SCA should adequately describe the same in his certificate.

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

Treasury Operations-Foreign Exchange and Derivative Transactions

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

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

5.171 Foreign exchange transactions, to be distinguished from transactions in foreign currencies, consist of contracts in which each party is committed to deliver one currency while, at the same time, receive another. Until the time of delivery, when settlement is to be made on the contract, the contract represents a future commitment of the Bank's resources. Thus, the maturity of a contract culminates in the realisation of the transaction envisaged in the contract, at which time the counterparties are given value for the currencies the contract says they are to receive.

5.172 In foreign exchange contracts, the value date is the date on which the contract matures, that is the date on which settlement is to be made. For loans

and borrowings, including those in the money markets, on the other hand, the value date is that date on which the borrower receives constructive use of the funds loaned, while the maturity date is that future date on which it will repay the funds it has borrowed.

Derivatives

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

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

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

Products offered in Forex and Derivative business

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

- IDMC.MSRD.4801/06.01.03 dated June 3, 2003 Exchange-Traded Interest Rate Derivatives;
- IDMD.PDRD.No. 1056/03.64.00/2009-10 dated September 1, 2009 Guidelines on Exchange Traded Interest Rate Derivatives;
- RBI/2010-11/147 A.P. (DIR Series) Circular No. 05 dated July 30, 2010 “Guidelines on trading of Currency Options on Recognised Stock /New Exchanges;

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- DBOD.No.BP.BC.51 / 21.06.101 / 2010-11 dated October 28, 2010 Introduction of Exchange Traded Currency Options – Permitting Banks to Participate in Currency Options on Recognized Stock / New Exchanges;
- DBOD.No.BP.BC. 44/21.04.157/2011-12 dated 2 November 2011 “Comprehensive Guidelines on Derivatives: Modifications” modifying the 20 April 2007 circular; and further amended vide circular no. DBR.No.BP.BC.103/21.04.157/2017-18 dated April 6, 2018;
- DBOD.BP.BC.No. 61/21.06.203/2011-12 of 30th November 2011 “Prudential Guidelines on Credit Default Swaps (CDS)” regarding credit default swaps;
- RBI/2016-17/199 FMRD.DIRD.12/14.01.011/2016-17, December 29, 2016 Introduction of Interest Rate Options in India, detailed directions of which are given in Notification No. FMRD-DIRD.11/2016 dated December 28, 2016 as amended vide circular no. FMRD.DIRD.20/2019 dated June 26, 2019; and
- FMRD.DIRD.19/14.03.046/2018-19 dated June 26, 2019 Rupee Interest Rate Derivatives (Reserve Bank) Directions, 2019.

Derivatives Markets

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

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

RBI vide its circular RBI/2017-18/134 A. P. (DIR Series) Circular No. 18 dated February 26, 2018 on “Risk Management and Inter-bank Dealings: Revised guidelines relating to participation of a person resident in India and Foreign Portfolio Investor (FPI) in the Exchange Traded Currency Derivatives (ETCD) Market” permit persons resident in India and FPIs to take positions (long or short), without having to establish existence of underlying exposure, upto a single limit of USD 100 million equivalent across all currency pairs involving INR, put together, and combined across all exchanges. This circular, alongwith other requirements has been consolidated in FMRD Master Direction No. 1/2016-17 dated July 5, 2016 (updated as on June 01, 2020).

Participants

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

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

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

Purpose

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

Objectives/Purpose	Reasons
Balance Sheet Management	<ul style="list-style-type: none">• Use of derivatives by the Bank to manage its balance sheet exposures.• The Bank will use derivatives as a means for managing the interest rate, liquidity and foreign exchange risks arising from its banking operations.
Client servicing	<ul style="list-style-type: none">• Offering derivative products to existing and new clients as an additional product from the Bank.• The Bank will offer derivative products to enhance product offerings to its existing clients as well as to build new client relations.
Proprietary Trading	<ul style="list-style-type: none">• The Bank will undertake derivative transactions to earn trading profits.• The Bank's treasury may take view-based transactions as well as offer two-way quotes on derivatives within the limits prescribed by this policy.
Hedging On-Balance sheet transactions	<ul style="list-style-type: none">• Banks are exposed to interest-rate risk from their on-balance-sheet activities when their assets do not reprice at the same time as their liabilities. Hence banks undertake derivatives transactions to hedge their Balance sheets transactions such as banks may use swaps to hedge on-balance-sheet interest-rate risk.

Bank's Process, Regulatory requirements/ restrictions & updates

5.180 The major requirements for undertaking any derivative transaction include the following:

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

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

- a. Marking the product to market, if a liquid market in the product exists.

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

Risk Management and Corporate Governance Aspects

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

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

Suitability and Appropriateness

5.183 While undertaking any derivative transactions with a user, a market-

maker should:

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

5.184 Before offering any derivative product to a client the Auditor should adopt the following measures:

- (a) Obtain Board resolution from the corporate which contains the details specified in the Comprehensive Guidelines on derivatives. Identify whether the proposed transaction is consistent with the user's policies and procedures with respect to derivatives transactions, as they are known to the market-maker.
- (b) Ensure that the terms of the contract are clear and assess whether the user is capable of understanding the terms of the contract and of fulfilling its obligations under the contract.
- (c) Inform the customer of its opinion, where the market-maker considers that a proposed derivatives transaction is inappropriate for a customer. If the customer nonetheless wishes to proceed, the market-maker should document its analysis and its discussions with the customer in its files to lessen the chances of litigation in case the transaction proves unprofitable to the customer. The approval for such transactions should

be escalated to next higher level of authority at the market-maker as also for the user.

- (d) Ensure the terms of the contract are properly documented, disclosing the inherent risks in the proposed transaction to the customer in the form of a Risk Disclosure Statement which should include a detailed scenario analysis (both positive and negative) and pay outs in quantitative terms under different combination of underlying market variables such as interest rates and currency rates, etc., assumptions made for the scenario analysis and obtaining a written acknowledgement from the counterparty for having read and understood the Risk Disclosure Statement.
- (e) Guard against the possibility of misunderstanding all significant communications between the market-maker and user should be in writing/email or recorded in meeting notes.
- (f) Ensure to undertake transactions at prevailing market rates and to avoid transactions that could result in acceleration/deferment of gains or losses.
- (g) Should establish internal procedures for handling customer disputes and complaints. They should be investigated thoroughly and handled fairly and promptly. Senior management and the Compliance Department/Officer should be informed of all customer disputes and complaints at a regular interval.
- (h) The market-makers should carry out proper due diligence regarding 'user appropriateness' and 'suitability' of products before offering derivative products to users. Each market-maker should adopt a Board-approved 'Customer Appropriateness & Suitability Policy' for derivatives business.

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

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

Documentation

5.186 This can range from simple customer mandates through to full legal documentation with both banks and customers. The bank's legal department is responsible for legal agreements depending on what types of business is being conducted and, crucially, whether the counterparties intend to net payments at settlement. Organizationally, this area can be viewed in a similar way to the

accounting function. If documentation forms part of the back office then the business will be more understood by management and better controlled as a result.

5.187 The Circular on the Comprehensive Guidelines on Derivatives require the market participants to ensure that documentation requirements in respect of derivative contracts are complete in all respects. The following instructions in this regard may, therefore, be strictly adhered to:

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

Identification and Management of Risk

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

- Credit risk
- Market risk
- Liquidity risk
- Interest risk
- Operational risk
- Legal risk

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

Risk limits

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

Independent Risk control

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

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

Operational Controls

5.192 Operational risk arises as a result of inadequate internal controls, human error or management failure. This risk in derivatives activities is particularly important, because of the complexity and rapidly evolving nature of some of the products. The nature of the controls in place to manage operational risk must be commensurate with the scale and complexity of the derivatives activity being undertaken. The operational controls could, in addition to segregation of duties, cover aspects such as:

- Trade entry and transaction documentation
- Confirmation of trades
- Settlement and disbursement
- Reconciliations

- Revaluation
- Exception reports
- Accounting treatment
- Audit trail

Prudential Norms Relating to Derivatives

5.193 The prudential norms relating to derivatives – minimum capital adequacy requirement, credit exposure norms, ALM etc. will be as prescribed by the RBI from time to time. Attention of the readers may be drawn on RBI's Circular No. DBOD.No.BP.BC.48 / 21.06.001/2010-11 dated October 1, 2010 and DBOD.No.BP.BC.31/21.04.157/2008-09 dated August 8, 2008, DBOD.No.BP.BC.57/21.04.157/2008-09 dated October, 13 2008, DBOD.No.BP.BC.28/21.04.157/2011-12 dated August 11, 2011 and DBOD.No.BP.BC.31/21.04.157/2012-13 dated July 23, 2012, RBI/2016-17/45DBR.No.BP.BC.7/21.04.157/2016-17 dated August 25, 2016 on "Prudential Norms for Off-Balance Sheet Exposures of Banks" and RBI's Master Circular No.RBI/2015-16/70/DBR.No.Dir.BC. 12/13.03.00/2015-16 dated July 1, 2015 on "Exposure Norms".

Asset Classification of Derivatives

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

- i. The overdue receivables representing positive mark-to-market value of a derivative contract will be treated as a non-performing asset, if these remain unpaid for a period of 90 days from the specified due date for payment.
- ii. In case the overdues arising from forward contracts and plain vanilla swaps and options become NPAs, all other funded facilities granted to the client shall also be classified as non-performing asset following the principle of borrower-wise classification as per the existing asset classification norms.
- iii. However, any amount, representing positive mark-to-market value of the foreign exchange derivative contracts (other than forward contract and

plain vanilla swaps and options) that were entered into during the period April 2007 to June 2008, which had already crystallised or might crystallise in future and is / becomes receivable from the client, should be parked in a separate account maintained in the name of the client /counterparty. This amount, even if overdue for a period of 90 days or more, will not make other funded facilities provided to the client, NPA on account of the principle of "borrower-wise asset classification", though such receivables overdue for 90 days or more shall itself be classified as NPA, as per the extant IRAC norms. The classification of all other assets of such clients will, however, continue to be governed by the extant IRAC norms.

- iv. If the client concerned is also a borrower of the bank enjoying a Cash Credit or Overdraft facility from the bank, the receivables mentioned at item (i) above may be debited to that account on due date and the impact of its non-payment would be reflected in the cash credit/overdraft facility account. The principle of "borrower-wise asset classification" would be applicable here also, as per extant norms.
- v. In cases where the contract provides for settlement of the current mark-to-market value of a derivative contract before its maturity, only the current credit exposure (not the potential future exposure) will be classified as a non-performing asset after an overdue period of 90 days.
- vi. As the overdue receivables mentioned above would represent unrealised income already booked by the bank on accrual basis, after 90 days of overdue period, the amount already taken to Profit and Loss Account should be reversed.

5.195 RBI *vide* its Circular No. DBOD.No.BP.BC.48 / 21.06.001/2010-11 dated October 1, 2010 on "Prudential Norms for Off-Balance Sheet Exposures of Banks - Bilateral netting of counterparty credit exposures" has decided that since the legal position regarding bilateral netting is not unambiguously clear, bilateral netting of mark-to-market (MTM) values arising on account of such derivative contracts cannot be permitted. Accordingly, banks should count their gross positive MTM value of such contracts for the purposes of capital adequacy as well as for exposure norms.

5.196 RBI *vide* its Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 dated July 1, 2015 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances" advised banks that credit exposures computed as per the current marked to market value of the contract, arising on account of the interest rate & foreign exchange derivative transactions, credit default swaps, shall also attract provisioning requirement as applicable to

the loan assets in the 'standard' category, of the concerned counterparties. All conditions applicable for treatment of the provisions for standard assets would also apply to the aforesaid provisions for derivative exposures.

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

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

5.198 Also RBI *vide* its circular no. RBI/2012-13/139DBOD.No.BP.BC.31/21.04.157/2012-13 dated July 23, 2012 clarifies that there may be situations

where the clients of banks may like to reduce the notional exposure of the hedging derivative contract. In such cases, banks may partially or fully terminate the contract before maturity, at their discretion, thereby reducing the notional exposure of the contract. This reduction in notional exposure would not be treated as re-structuring of the derivative contract provided all other parameters of the original contract remain unchanged.

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

- i. Banks should have a Board approved policy in this regard.
- ii. Banks should permit repayment in instalments only if there is a reasonable certainty of repayment by the client.
- iii. The repayment period should not extend beyond the maturity date of the contract.
- iv. The repayment instalments for the crystallized MTM should be uniformly received over the remaining maturity of the contract and its periodicity should be at least once in a quarter.
- v. If the client is permitted to pay the crystallized MTM in instalments:
 - a. if the amount becomes overdue for 90 days from the date of partial / full termination of the derivative contract, the receivable should be classified as NPA.
 - b. if the amount becomes overdue for 90 days from the due date of payment of subsequent instalments, the receivable should be classified as NPA.
- vi. Banks should reverse the entire MTM which has been taken to Profit and Loss account on accrual basis in case of (v)(a) and (v) (b) above. For the accounting of reversed MTM in these cases, banks should follow an approach similar to the one stipulated in circulars DBOD.No.BP.BC.57/21.04.157/2008-09 dated October 13, 2008 and DBOD.No.BP.BC.28/21.04.157/2011-12 dated August 11, 2011 on 'Prudential Norms for Off-balance Sheet Exposures of Banks'. Accordingly, the crystallized MTM of these derivative contracts should be reversed from Profit and Loss account and credited to another suspense account styled as '*Suspense Account - Crystallised Receivables*'.

5.200 If the client is not granted the facility of paying the crystallised MTM value in instalments and the amount becomes overdue for 90 days from the date of partial / full termination of the derivative contract, the entire receivable should

be classified as NPA and banks should follow the instructions stipulated in RBI circulars dated October 13, 2008 and August 11, 2011, referred to above.

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

Re-structuring of derivative contracts

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

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

Purpose

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

Products

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

Operational Guidelines, Terms and Conditions

5.205 The AD Category I banks can opt for either Model I or Model II as mentioned in RBI circular vide RBI/2017-18/75 A.P. (DIR Series) Circular No. 08 dated October 12, 2017. The said circular has been consolidated in FMRD Master Direction No. 1/2016-17 dated June 01, 2020.

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

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

Risk management

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

5.208 This is a function that can sit well in the middle office provided it is properly staffed by officers who understand fully the business and risks involved – which usually means ex-market practitioners. It can range from agreeing overnight cash positions for the trading room through to full-risk modeling associated with derivatives trading and hedging. In between can come monitoring of counterparty, country, dealer and market-related limits that have been set and approved in other areas of the bank such as the credit department. Banks shall comply with guidelines issued by RBI with regard to Internal Controls vide circular FE.CO.FMD. No. 18380 /02.03.137/2010-11 February 3, 2011.

Risk Identification Process

Foreign Exchange Rate Movement Risk

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

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

5.211 Three important issues that need to be addressed in this regard are:

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

US\$ / INR FX Forwards Risk

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

Timing Risk

5.213 As per market practice, FX contracts with timing discretion (Option Period Forwards or OPFs) versus INR are typically for a period of one week to a maximum of one month. The customer has the discretion to pick up the contract on any day of the window period. In case the customer is buying the foreign currency ('FCY'), the swap points/contract rate is fixed based on the last date of the period in case the FCY is at a premium against the INR or the first date in case the FCY is at a discount. Hence, unless the swap points change from

premium to discount or vice versa after entering into the contract, the counterparty would not benefit by taking delivery before last date in case of premium or after first date in case of discount. In the unlikely event of this happening and if the bank has not hedged the contract similarly with another contract with discretion period, an adverse impact on Profit and Loss Account could arise. In such a case, the market counterparty could pick up the contract early while the hedge contract would still be outstanding and the gap would have to be covered again at incremental cost.

Credit Risk

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

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

Pre-Settlement Exposure

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

Settlement Risk

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

Market risk

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

Liquidity Risk

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

Market Liquidity Risk

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

Funding Liquidity Risk

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

Sovereign Risk or Cross Border Risk

5.222 This is the risk that the Government of a particular country may interfere with a payment due to the Bank from a client resident in that country and preclude the client from converting and/or transferring the funds. In such cases, bank's oblige may be economically sound and capable of repaying its obligation, but its country's Government may place an embargo on remittances for political/economic reasons.

Operations Risk

5.223 Basel I defined operational risk as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events". Basel II, however, defined operational risk as, "the risk of

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

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

Risk Management Limits and Monitoring

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

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

5.225 NOOPL may be fixed by the boards of the respective banks and communicated to the Reserve Bank immediately. However, such limits should

not exceed 25 percent of the total capital (Tier I and Tier II capital) of a bank, [Refer RBI Master Directions – Risk Management and Inter Bank Dealings dated July 5, 2016 (updated as on June 01, 2020)]. This limits the maximum allowable excess of assets plus exchange bought contracts over liabilities plus exchange sold contracts ("overbought" position) and the reverse ("oversold" position) that may be carried overnight in foreign currencies.

Daylight Limit

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

Value at Risk (VAR) limits

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

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

Gap or Matured band limits

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

5.230 For example, the management can establish Gap limits for each maturity band of 3 months, 6 months, 9 months, one year, etc. to avoid maturities concentrating in certain maturity bands. Such limits can be used to reduce the volatility of derivatives revenue by staggering the maturity and/or repricing and

thereby smoothening the effect of changes in market factors affecting price. Maturity limits can also be useful for liquidity risk control and the repricing limits can be used for interest rate management. Similar to notional and stop loss limits, Gap limits can be useful to supplement other limits, but are not sufficient to be used in isolation as they do not provide a reasonable proxy for the market risk exposure which a particular derivatives position may present to the institution.

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

Aggregate Contract Limit

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

Options Limit

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

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

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

Stop Loss Limit

5.234 These limits are established to avoid unrealized loss in a position from exceeding a specified level. When these limits are reached, the position will

either be liquidated or hedged. Typical stop loss limits includes those relating to accumulated unrealized losses for a day, a week or a month.

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

Limit Exceptions

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

Regulatory Reporting Requirements

5.237 Derivatives are governed by the Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000. Derivatives are allowed only under the provisions of these regulations and amendments, or with the prior permission of the Reserve Bank of India. The reporting requirements under RBI Master Direction No. RBI/FMRD/2016-17/31 FMRD master direction no. 1/2016-17 dated July 5, 2016 (updated as on June 01, 2020) on 'Risk Management and Inter-Bank Dealings' and RBI Circular No. DBOD. No. BP.BC.86/21.04.157/2006-07 dated April 20, 2007 on "Comprehensive Guidelines on Derivatives" should be adhered to.

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

- i) Daily statements of Foreign Exchange Turnover in Form FTD and Gaps, Position and Cash Balances in Form GPB.
- ii) Statement of Nostro / Vostro Account balances.

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- iii) Consolidated data on cross currency derivative transactions undertaken by residents on half yearly basis.
- iv) Details of exposures in foreign exchange as at the end of every quarter as per those details of exposures of all corporate clients who meet the prescribed criteria have to be included in the report. The AD banks should submit this report based on bank's books and not based on corporate returns.
- v) Details of option transactions (FCY-INR) undertaken on a weekly basis.
- vi) Total outstanding foreign currency borrowings under all categories as on the last Friday of every month.
- vii) Monthly report (as on the last Friday of every month) on the limits granted and utilized by their constituents under the facility of booking forward contracts on past performance basis.
- viii) Statement in Form BAL giving details of their holdings of all foreign currencies on fortnightly basis through Online Returns Filing System (ORFS).
- ix) A monthly statement, in respect of cover taken by FIIs, indicating the name of the FII / fund, the eligible amount of cover, the actual cover taken, etc.
- x) List (in triplicate) of all bank's offices/branches, which are maintaining Rupee accounts of non-resident banks as at the end of December every year.
- xi) Quarterly report on the forward contracts booked and cancelled by SMEs and Resident Individuals.
- xii) Consolidated data on the transactions undertaken by non-residents under the scheme.
- xiii) Doubtful transactions involving frequent cancellation of hedge transactions and / or the underlying trade transactions by non-residents under the scheme.
- xiv) Report of Commodity Hedging in Overseas Market on Quarterly basis.

5.239 Another significant feature of the foreign exchange business of banks in India is the requirement of reporting of transactions, at specified intervals, by the branches to the Reserve Bank of India by means of 'R' returns, as enumerated in the Exchange Control Manual. Those branches which handle foreign exchange transactions and are under an obligation to report them directly to Reserve Bank are called the 'Authorised Dealers' (AD—also called 'position maintaining branches'). The ADs can be nominated only with the

approval of the Reserve Bank of India and each AD would have a unique Code Number, which must be mentioned in all reports to the Reserve Bank. In addition to these ADs, individual banks may also, subject to report to the Reserve Bank, nominate some other branches to handle the specified type of foreign exchange business but these branches will have to route their transactions through an AD only (such branches are often called 'reporting branches').

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

5.241 As required by RBI circular FMD.MSRG.No.67/02.05.002/2011-12 dated March 9, 2012 on "Reporting Platform for OTC Foreign Exchange and Interest Rate Derivatives", all inter-bank OTC foreign exchange derivatives are required to be reported on a platform to be developed by the Clearing Corporation of India (CCIL). All/selective trades in OTC foreign exchange and interest rate derivatives between the Category-I Authorised Dealer Banks/market makers (banks/PDs) and their clients are required to be reported on the CCIL platform subject to a mutually agreed upon confidentiality protocol. This circular was further updated vide circular no. FMD.MSRG.No. 75/02.05.002/2012-13 March 13, 2013.

5.242 As per RBI circular FMD.MSRG.No.72/02.05.002/2012-13 dated October 12, 2012 on "Reporting Platform for OTC Foreign Exchange and Interest Rate Derivatives", it was decided with effect from November 5, 2012 that the following derivative products need to be reported to CCIL by the banks:

- FCY(excluding USD)-INR forwards.
- FCY(excluding USD)-INR FX swaps.
- FCY-FCY forwards.
- FCY-FCY FX Swaps.
- FCY-FCY options.

5.243 Further the RBI vide Circular No. RBI/2013-14/400 FMD.MSRG.No.94/02.05.002/2013-14 dated December 4, 2013 on "Reporting Platform for OTC Foreign Exchange and Interest Rate Derivatives" provides that the CCIL had now completed development of the platform for reporting of the following transactions in OTC derivatives (with effect from December 30 2013):

- Inter-bank and client transactions in Currency Swaps.
- Inter-bank and client transactions in FCY FRA/IRS.
- Client transactions in INR FRA/IRS.

Accounting

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

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

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

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

Rate Reasonability

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

Position and P&L Reconciliation

5.249 This is one of the most important controls on deals position which is carried out by the bank's risk department / back office. The trader's net currency-

wise exchange position as per front office system should be matched on a daily basis by risk department / back office with the back office systems position. The position exceptions should be communicated to the front office and a resolution is arrived at.

Valuation of foreign exchange forwards and derivative products

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

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

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

5.253 Valuation of derivatives should be based on marked to market (MTM) and on net present value (NPV) basis.

Audit Approach

5.254 While innovative products and ways of trading create new possibilities for earnings for the bank, they also introduce novel and sometimes unfamiliar risks that must be identified and managed. Failure to do so can result in losses entailing financial and reputational consequences that linger long after the loss has been recognized in financial statements. Hence, the Auditor should assess controls as part of audit work.

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

Audit Programming and Procedures

5.256 In framing the audit program, the Auditor needs to take into consideration their findings of the adequacy of controls within the processes as explained in this Guidance Note. The Reserve Bank of India prescribes concurrent audit /internal audit for a 100% verification of treasury transactions. Hence, the selection of samples can be influenced by the nature, extent and timings of concurrent/internal audit function including the compliance mechanism of the Bank. Further, RBI requires compliance reports on derivatives separately to be prepared by the Bank as per RBI circular no. DBOD.No.BP.BC.44/21.04.157/ 2011-12 dated November 2, 2011 on “Comprehensive Guidelines on Derivatives: Modifications” which the Auditor should take into consideration. This circular was further updated vide circular no. DBR.No.BP.BC.103/21.04.157/2017-18 dated April 06, 2018.

5.257 The following paragraphs illustrate the audit procedures/ approach that may form part of the audit program.

Product Program and Policy

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

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

Customer/User Suitability and Appropriateness Policy

5.260 The Auditor should obtain approved ‘Customer/User Suitability and Appropriateness Policy’ and verify that such policy is in line with the Comprehensive Guidelines on derivatives and is approved by the Board.

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

Credit limits

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

- Check whether the name of the counterparty is in the approved

counterparty list for the purpose of treasury transactions.

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

Deal Initiation and Recording

5.263 For deal initiation and recording, the Auditor should check the following:

- For the selected samples, the Auditor should check whether deals carried out by the front office are appropriately recorded in the deal slips and whether the same is correctly entered in the front office deal recording system.
- For the selected samples check whether the deal ticket is complete and accurate with respect to all transaction details like counterparty name, contract rate, notional amount, transaction date / maturity date, value date / settlement agent and buy / sell date.
- Check the flow of transaction from initiation of deal to the verification and approval.
- Check whether deal tickets are generated automatically by front office

systems, or trader should use sequentially numbered deal tickets.

- Check whether the dealers use dedicated calling lines and all the telephone lines are linked to a voice recording machine.
- Verify the adherence to the voice recording mechanism.
- Check whether the proper back-up of voice recordings is being maintained.
- Verify whether user IDs of dealers left / transferred/ on leave is deactivated / suspended on timely basis.
- Verify whether, the Use of Mobile Phones is restricted in the Dealing Room and the mechanism for ensuring adherence thereto.
- Verify the recordings for few of the selected samples to ascertain that the recording machine is working in order.
- Check whether there is access of unauthorized persons in the dealing room. If yes, whether proper approvals have been taken.
- Check whether dealers entering the deals have signed the code of conduct for respective segment in which trades dealt in (e.g. FIMMDA, FEDAI, FX Global etc).

Deal Authorisation

5.264 Following audit procedures may be followed by the Auditor while checking the procedures for deal authorisation:

- Check the process flow of authorizations of deals in the system and check areas of manual intervention in the system.
- Check whether proper authorization levels are set for treasury operations and observe and verify whether the prescribed procedure is followed.
- For the selected samples, check whether deals entered in front office system are authorised by the back office team after verifying the deal details with external evidences like Reuters' conversation, telephonic conversation with customers' back office, etc.
- Examine the selected deals from the front office and establish that they are confirmed by the back office operations.
- Check that all sample deals are authorised at the proper levels of authority against the deal slip.
- Check whether alterations and cancellations on deal slips are duly authorised.
- Check whether bank is preparing trade amendments sheets and whether the reasons for such amendments are mentioned in the sheet.

- Check whether any exceptional reports are being generated.

Segregation of Duties

5.265 For this aspect, the audit procedure may include:

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

Counterparty confirmations

5.266 For this aspect, the Auditor would inter alia:

- Understand the process of sending and tracking the confirmations including follow – up procedures.
- Exchange of deal confirmations is mandatory. The counterparties should exchange the rate fixing notices. However, in the case of an OTC Overnight Index Swap (OIS) the trades are reported to CCIL. If the counterparties have a bilateral agreement waiving the requirement to exchange of confirmations, then exchanging of physical confirmations may not be required for such IRS deals.
- Understand the process of MIS reporting to the senior management in respect of the non-receipt of counterparty confirmations.
- Verify that confirmations from Bank to counterparty are sent within a reasonable time and there exists a mechanism for follow-ups for pending counterparty confirmations.

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- Determine the status of any missing / pending confirmations (currently in the Confirmation Tracking List) and assess whether there are any provisioning concerns on the trades.
- Check whether the format of the counterparty confirmation is as approved by the Local Legal Counsel of the Bank from time to time.
- Verify controls implemented by the bank to ensure completeness of all deal confirmations.
- Check whether there is any persisting non-receipt of Counterparty confirmation.
- Inquire of any exception report or other mechanism of tracking missing confirmations.

Customer Complaints

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

Underlying document

5.268 The audit procedures for this aspect include:

- Understanding the process and policy of the Bank in respect of the underlying documents.
- The Auditor should ensure that the bank should obtain the original documents from the client and/or certified document by the person who is authorised to do the derivative deal. The Auditor should check the details in client master page by checking the board resolution.
- Understand the process of MIS reporting to the senior management in respect of the non-receipt of underlying documents.
- The Auditor should ascertain whether the bank has a mechanism whereby, if the documents are not submitted by the customer within 15 days, the contract gets cancelled, and the exchange gain, if any, is not passed on to the customer. The primary responsibility for ensuring this remains with the Bank and the Auditor should verify controls around the same.

- The Auditor should ensure that the Bank has a mechanism to ensure that if the underlying is not provided three times a year; then the client will have to produce upfront underlying and the 15 days grace will not be allowed to the client.
- For the selected samples, review and check the underlying documents duly received by the bank.
- In cases, where the underlying documents with regard to the forex transactions are maintained at branches, then, the Auditor may obtain confirmation from such branches about existence of the underlying documents and review sudden spurt in foreign exchange transactions of any branch in a particular month/period, if any, and test adherence to the RBI guidelines relating to merchant transactions.
- The Auditor should check whether any transaction was undertaken without execution of one time documents and approval for deferral of the same is held on record and said documents were received before the expiry of such deferral approval.
- Auditor should check whether the Bank has process of tracking deferrals.

Accounting of transactions in the general ledger

5.269 The audit procedures for this aspect include:

- Checking whether there is a direct hands-off between front end system and the accounting system for passing accounting entries in the general ledger.
- Checking whether correct accounting entries are recorded in the general ledger and the back office regularly reviews the accounting entries passed in the general ledger.
- Checking whether the treasury department generates a daily P&L (desk-wise) and the same has been reviewed and compared with the general ledger to identify any mismatches.
- Understand the accounting scheme for the various products. Further, inquire about the routine and non – routine accounting entries with the bank.
- Check whether any exceptional reports are being generated by the system.
- For the selected samples, verify the accounting entries passed.

Position Reconciliation

5.270 The audit procedures include:

- Checking whether daily position reconciliations are performed between front office deal positions and back office deal positions by the treasury

back office and position differences if any are appropriately enquired into.

- Checking whether the Bank maintains customer wise, currency wise and deal wise positions on a daily basis in-order to monitor customer limit breaches and sectoral limit breaches.
- Checking whether the inter branch reconciliations between the Treasury Branch and the Authorised Branches are carried out on a periodic basis and there are no old and long outstanding items uncleared.

Deal Settlements

5.271 The audit procedures include:

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

Realised profit / loss on derivative transactions

5.272 The audit procedures include:

- Recalculating the profit or loss for sample trades selected and tally with the general ledger.
- Test the general and IT application controls for automated computation of profit or loss.
- Vouch to cash settlement in the case of realized gains and losses.
- Verify if the bank is reckoning only the NOSTRO balances for adjustment of the profit / loss revealed in mirror account or did it also consider the outstanding forward transactions as at the date of valuation.

- The increase / decrease in profit is in line with increase / decrease in volume of transactions.
- Check marking-to-market of risk exposures and reconciliation of risk positions and profit/loss between the front and back offices.
- Verify preparation of management reports, including daily profit/loss results and gross and net risk positions.
- Verify exceptional reports showing details of deals resulting in exceptional profits and losses.
- In case of early termination/cancellation of contracts, check whether amount of profit/loss is properly arrived at and paid to /recovered from customer as per Bank's policy.

Valuation of FX contracts and Derivatives

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

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

5.274 In case of valuations of swaps, options and other derivative products most of the banks have proprietary valuation models developed by them or standard valuation software installed. In case of proprietary valuation models, a model validation coupled with checking of input parameters would provide reasonable comfort on valuations. In case of standard valuation models, the Auditor can resort to checking of input parameters along with limited re-performance of derivative valuations. In such cases, the Auditor should also check system controls and if deemed necessary, consider involving an expert to check the integrity of the system logic. Further, the Auditor can select certain samples as per the methodology or depending upon the nature, timing and extent for getting it revalued from the valuation expert. The Auditor should also obtain the understanding of rate upload process and verify the timing of rates upload in the system for valuation of derivative contracts. The Auditor should

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carry out the valuation of the samples selected in a spreadsheet and compare the end results with the valuation as provided by the software system. Sometimes the software systems are not capable of valuing certain treasury products such as partly redeemable perpetual bonds, Security Receipts etc., for which the Bank has to value such products manually and the Auditor should gain sufficient knowledge to understand and confirm their valuation.

Guidance for Arriving at Fair / Market Value

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

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

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

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

FX spot / forwards	Prices as published by Foreign Exchange Dealers Association of India ('FEDAI'). With effect from 31 December 2014, these are further required to be adjusted for arriving at the net present value.
Exchange traded interest rate futures	Prices quoted on the relevant exchange.
Commodity futures	Prices quoted on the relevant exchange.
OTC derivatives:	
Options	Black Scholes Merton Method.
Swaps / Forward Rate Agreements	Discounted cash flows using the applicable Interest Curves (ROI can be taken from FIMMDA / NSE / Reuters' site based on the nature and currency of the product).

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

5.280 In case of hedge swaps, the income/ expense is accounted for on an accrual basis except the swap designated with an asset or liability that is marked to market or lower of cost or market value in the financial statements. In that case, the swap should be marked to market with the resulting gain or loss recorded as an adjustment to the market value of designated asset or liability. Whereas, the trading swaps are marked to market as per the instructions contained in the RBI circular NO. Ref. No. MPD. BC. 187/07.01.279/1999-2000 dated July 7, 1999 on "Forward Rate Agreements/ Interest Rate Swaps". Circular no. FMRD.DIRD.19/14.03.046/2018-19 dated June 26, 2019 has been issued in supersession of the above circular and has consolidated the instructions issued earlier.

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

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

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

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

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

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

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

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

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

5.289 For swaps, which involve multiple (and sometimes two-way) payments, the market or fair value is the net present value of the payments to be exchanged between the counter parties between the reporting date and the contracts maturity, where the discount factor to be applied would normally reflect the market interest rate for the period of the contract's remaining maturity. Thus, a fixed/floating swap which at the interest rates prevailing at the reporting date involves net annual receipts by the reporter of say, 2% of the notional principal amount for the next three years has a positive marked to market (or replacement) value equal to the sum of three net payments (each 2% of the notional amount), discounted by the market interest rate prevailing at the reporting date. If the contract is not in the reporter's favour (i.e., the reporter would have to make net annual payments), the contract has a negative net present value.

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

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

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

Rate Scan

5.293 The audit procedures for this would include:

- Checking whether for the selected deals, the rates taken are the prevailing rates in the market at the time of striking the deal. In doing so the Auditor needs to assess the process of advising card rates to customers, through its branches or relevant operating departments.
- Checking whether in outright deals the back office checks the rate scans for the veracity of the rate at which the dealer has struck the deal. Any deviation should be enquired into for compliance with AS 11.
- Check whether any exceptional reports are being generated in this respect.
- In case of deviations, reasons should be obtained and check whether the same have been reported to the senior management.

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

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

- Sending independent third party confirmations to confirm the balances held as at the reporting date.

- Agreeing the balances to underlying supporting such as margin statements.

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

Assessment of controls

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

- Existence of comprehensive treasury policy and operating procedures manual (SOP).
- Review of the policies and procedures document and assess comprehensiveness of the same.
- Determining whether the above document addresses, in granular detail, the framework within which the treasury business and operations have to be conducted.
- Inquiring on the procedures the bank has when there is a change over or new appointment to a 'review' role within the treasury function.
- Check whether proper system of rotation of dealer is in place.
- Understanding the level of detail in which the process of handover of responsibilities operates.
- Check whether mandatory leave policy is being complied in the bank.
- Inquiring whether there has been any change in responsibilities in the current period and in case there are changes, verifying whether there is an appropriate training mechanism and whether signoffs have been regularized after the new superior has taken over the responsibilities.
- On a test check basis, verifying whether the review process and controls were working effectively during the transition period.
- Obtaining and reviewing on test check basis, the daily Profit and Loss prepared for MIS purpose and assessing the granularity and exhaustiveness of the same.
- Assessing whether such Profit and Loss is granular enough to provide desk wise, product wise and various price component wise Profit and Loss.
- Assessing whether gross position reviews are undertaken and also whether such Profit and Loss are prepared and reviewed at a gross trade level.
- Reviewing the Bank's policy on valuation. On a test check basis, verifying whether the material valuation adjustments are reviewed, authorized and are appropriate.

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- Verifying whether these valuation adjustments are disclosed / visible in the reconciliation.
- Assessing whether there is an independent 'Valuation Control' team.
- Checking whether dealers have access to adjust or modify trade values.
- Checking whether the reconciliations are prepared on a timely basis and the un-reconciled items are independently inquired by the back office.
- Reviewing the ageing and quantum of the un-reconciled items and inquire for the high value and long outstanding reconciling items.
- Assessing whether the escalations are done in a timely manner for the large / unusual / recurring reconciliation items.

Market Risk System

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

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

- Reviewing the policy of the bank as regards the cancelled / amended / late booked trades and whether there is a clear policy describing the Front office supervisor's responsibility in respect of reviewing and signing off on these instances.
- Reviewing whether these instances are reported to the senior management as per the policy and are ratified.
- Verifying whether the system is capable to capture the C/A/L and obtaining a complete inventory of these instances.
- Reviewing the frequency of such instances during the period and verifying on a test check basis whether there is a justification of such cancellations / amendments / delays.
- Checking the process relating to late trades – how does these get captured in risk reporting's (if there is a time cut off when such reports are generated).
- Check the approval and control process of the said transactions.
- Sample check of the same can be done by making dummy entries for verification purpose.

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

- Reviewing the controls over cancellation of trades before reaching

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settlement dates and checking whether these are ratified by the authorized personnel with appropriate justifications.

- Reviewing the “Rate scan” process performed by mid-office and whether the exceptions noted in the rate scan are inquired and reasons are obtained for the same.
- Reviewing the Day 1 Profit or Loss assessment process and verify whether the Day-1 Profit or Loss is sufficiently assessed and explained.
- Verifying whether the change in pricing / other criterion is approved and confirmed with the counterparty.

Breaches of the Net Delta Limits

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

Failure to identify and escalate risk issues

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

Quality of supervision

- Assessing and determining the nature of comments and queries that are posed by the reviewer on any reconciliation breaks, long unexplained balances, exceptional trades, follow up on responses, etc.
- Determining and assessing whether the review function is not a mere sign off and it is conducted with appropriate supervisory intent.
- Verification of training sessions conducted by the bank.

Temporary discontinuance of a process or control

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

Rewards and recognition policy not in sync with ideal ‘risk and control’ culture

- Reviewing the remuneration policy and independently assessing how and to what degree it addresses matters relating to risk and compliance with

control policies as part of the employee remuneration for treasury staff members.

Outsourced/Hubbed process

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

NOSTRO and VOSTRO Accounts

5.296 A fundamental feature of foreign exchange transactions is that the useful possession of any currency can be had only in the country in which it is a legal tender or countries in which it is circulated (e.g., US Dollar is widely circulated in Russia, CIS countries). Therefore, in order to be able to put through foreign exchange transactions, banks normally maintain stocks of foreign currencies in the form of bank accounts (usually current accounts) with their overseas branches/correspondents. Such a foreign currency account maintained by a bank at an overseas centre is usually designated by it as 'NOSTRO Account' (i.e. "Our account with you"). Thus, banks in India may maintain a pound-sterling account with its London office/correspondent; such account would be called by it as NOSTRO Account. Conversely, if a foreign bank is to deal in a local currency of another country, it would maintain a 'VOSTRO Account' (i.e. 'your account with us') with the local bank, e.g. a bank in England may maintain a 'VOSTRO Account' in Indian Rupee with a correspondent bank in India. A VOSTRO account is in substance no different from any other account in the local currency.

NOSTRO / VOSTRO Reconciliation

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

5.298 The Auditor may consider the following aspects in respect of NOSTRO reconciliation:

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

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

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

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

5.301 Any adjustment from the Blocked Accounts should be permitted with the authorisation of two officials, one of whom should be from outside the branch concerned, preferably from the Controlling branch/ head office if the amount exceeds Rs.1 lakh. Further, vide Circular no. DBOD.BP.BC.No.133/21.04.018/2008-09 dated May 11, 2009, the RBI has advised accounting treatment for old outstanding entries in NOSTRO Mirror accounts. It further stated that Banks are advised to minimize the number of nostro accounts to have a better control over reconciliation and put in place a system of fast reconciliation and close monitoring of pending items in nostro accounts by top management at short intervals. Banks are also advised to leverage technology to avoid building up of such unreconciled balances.

5.302 The audit considerations for this aspect include:

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

Evaluation of Internal Audit/Concurrent Audit

5.303 The audit considerations for this aspect include:

- Examining whether treasury transactions are separately subjected to concurrent audit by internal Auditors / external Auditors and monthly reports containing their findings are submitted to the management for corrective action.

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

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

Risk Management

5.304 The audit considerations for this aspect include:

- Checking whether the bank has adequate risk management process, sound risk measurement procedures, sound information systems, continuous risk monitoring and frequent management reporting for treasury operations.
- Examining whether the mid-office monitors the exchange and gap positions for cut loss limits, overnight limits, daylight limit, liquidity, counterparty exposure limit and aggregate gap limit fixed in the banks trading policy/guidelines.
- Reviewing the adequacy and effectiveness of the overall risk management system, including compliance with policies, and procedures.
- Investigating unusual occurrences such as significant breaches of limits, unauthorized trades and unreconciled valuation or accounting differences.
- Inquiring whether there is a 'New Product Approval' process prior to undertaking transactions in new or structured derivative products and verifying whether the 'New Product Paper' for all new derivative products is approved and signed-off by the Chief Compliance Officer of the bank.
- Obtaining the 'Risk Management Policy' of the bank and verifying whether risk management pertaining to derivative transactions is an integral part of the policy.
- Verify whether the Policy is updated on a periodic basis in line with the dynamic market and regulatory changes.
- The Board should have overall responsibility for management of risks and should decide the risk management policy of the bank and set limits for liquidity, interest rate, foreign exchange and equity price risks and verifying

that the policy inter alia covers the following aspects:

- i. Defines the approved derivative products and the authorized derivative activities.
- ii. Details the requirements for the evaluation and approval of new products or activities.
- iii. Ensures appropriate structure and staffing for the key risk control functions, including internal audit.
- iv. Establishes management responsibilities.
- v. Identifies the various types of risks faced by the bank and establishes a clear and comprehensive set of limits to control these.
- vi. Establishes risk measurement methodologies which are consistent with the nature and scale of the derivative activities.
- vii. Requires stress testing of risk positions.
- viii. Details the type and frequency of reports for monitoring risks which are submitted to the Board (or committees of the Board).
- ix. Typical risks and commonly used risk limits in respect of derivative transactions.
- x. It is essential that banks have interest rate risk measurement systems that capture all material sources of interest rate risk and that assess the effect of interest rate changes in ways that are consistent with the scope of their activities. The assumptions underlying the system should be clearly understood by risk managers and bank management.

Information Technology ('IT') Controls

5.305 The audit considerations for this aspect include:

- Check controls over creation of all masters Like counterparty, broker, limit, dealer, etc.
- Check the integration of various treasury application with Core Banking Application.
- Check interface controls between various applications used in treasury department (viz. SWIFT and CBS, Finacle Treasury and Finacle core, etc.).
- To verify the integration of CBS, including Trade Finance and/or aligned software/modules, with SWIFT system and status of automation thereon.
- The Auditor should specifically verify whether any special privileges or rights are given for operating SWIFT system allowing direct initiation of transactions through SWIFT without initiating the transactions through CBS.

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And whether such transactions are reflected correctly in CBS.

- Obtain IT related information from the bank for treasury operations and review, as appropriate, minutes of any committees responsible for overseeing and coordinating IT resources and activities to determine user involvement and organizational priorities.
- Check functional separation in the system.
- Verification of limit system and determination and reconciliation of positions and results.
- Check whether there were any changes in EDP systems.
- Review organizational charts, job descriptions, and training programs to ascertain that the bank has sufficient number of technology personnel and that these personnel have the expertise the bank requires.
- Review MIS reports for significant IT systems and activities to ascertain that risk identification, measurement, control, and monitoring are commensurate with the complexity of the bank's technology and operating environment.
- Evaluate the separation of duties and responsibilities in the operation and data processing of treasury functions.
- Evaluate the adequacy of input/output controls and reconciliation procedures for batch capture and image capture systems.
- Review controls and audit trails over master file change requests (such as address changes, due dates, commission / interest rates, and service charge indicator) and also consider individuals authorized to make changes and potential conflicting job responsibilities and documentation/audit trail of authorized changes and procedures used to verify the accuracy of master file changes.
- Assess adequacy of controls over changes to systems, programs, data files, and PC-based applications and consider procedures for implementing program updates, releases, and changes.
- Check if controls are in place to restrict and monitor use of data-altering utilities and adequate process management to select system and program security settings (i.e., whether the settings were made based on using sound technical advice or were simply default settings).
- Check whether controls are established to prevent unauthorized changes to system and programs security settings.
- Evaluate the effectiveness of password administration for employee and customer passwords considering the complexity of the processing environment and type of information accessed and consider confidentiality of passwords - (whether only known to the employee/customer),

procedures to reset passwords to ensure confidentiality is maintained, frequency of required changes in passwords, password design (number and type of characters), security of passwords while stored in computer files, during transmission, and on printed activity logs and reports.

- Check whether any system audit has been conducted by the bank.
- Determine whether the bank has removed/reset default profiles and passwords from new systems and equipment and determine whether access to system administrator level is adequately controlled.
- Check whether the “data hands off” process from one product processor to another or to any other system is conducted under a secure environment and without or with least but controlled manual intervention.
- Check whether proper backup of records is being maintained.
- Whether any dealer/employee has accessed the dealing room on holidays. If yes, verify the reasons and approvals for the same.
- Check whether mandatory leave policy has been adhered to.
- Check BCP details of the bank in relation to Treasury activities.
- Check whether the voice recording systems are periodically tested by the operations team and process to tag trades and corresponding unique voice records. Concurrent Auditors are also required to verify this at periodic intervals.
- Check compliance with Internal Control Guidelines issued by RBI vide FE.CO.FMD. No. 18380 /02.03.137/2010-11 February 3, 2011.

Asset Liability Management (ALM)

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

types of risks and altering the asset-liability portfolio in a dynamic way in order to manage risks.

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

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

5.309 The ALM process rests on three pillars:

- ALM Information Systems
 - Management Information Systems
 - Information availability, accuracy, adequacy and expediency
- ALM Organisation
 - Structure and responsibilities
 - Level of top management involvement
- ALM Process
 - Risk parameters
 - Risk identification
 - Risk measurement
 - Risk management
 - Risk policies and tolerance levels.

5.310 Banks are required to disclose the maturity pattern of Deposits, Advances, Investments, Borrowings, Foreign Currency assets, Foreign Currency liabilities as on balance sheet date. The maturity pattern needs to be disclosed in several time buckets.

5.311 Measuring and managing liquidity needs are vital for effective operation of commercial banks. By assuring a bank's ability to meet its liabilities as they become due, liquidity management can reduce the probability of an adverse situation developing. The importance of liquidity transcends individual institutions, as liquidity shortfall in one institution can have repercussions on the entire system. Banks management should measure not only the liquidity positions of banks on an ongoing basis but also examine how liquidity

requirements are likely to evolve under different assumptions. Experience shows that assets commonly considered as liquid like Government securities and other money market instruments could also become illiquid when the market and players are unidirectional. Therefore liquidity has to be tracked through maturity or cash flow mismatches. For measuring and managing net funding requirements, the use of a maturity ladder and calculation of cumulative surplus or deficit of funds at selected maturity dates is adopted as a standard tool.

Auditor's Approach

5.312 The approach of the Auditors should be as under:

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

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

Annexure**Illustrative Checklist for the Verification of the Aspects of the Treasury/Investments of the Bank in Statutory Audit**

SN	Area	Description
1.	Investment Policy	Verify if the Bank has a Board Approved Investment Policy in place and the same has been reviewed on annual basis. Verify if the Investment policy has been framed in concurrence with RBI guidelines.
2.	Prudential Limits	Verify if the Bank has adhered to the prudential limits relating to investments as prescribed by RBI from time to time and Internal Policies.
3.	Income Calculation & Accounting	Verify if the Income on various Investments has been correctly calculated and recorded in the Books of Account taking into consideration RBI guidelines issued from time to time and Accounting Policies followed by Bank.
4	Verification of Investments	Verify the investments physically and/or with the available holding statements/confirmations.
5.	Classification/ Valuation	Refer RBI Master Circular No. RBI/2015-16/97 DBR No BP.BC.6/21.04.141/2015-16 dated July 01, 2015 on Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks Classification: Check if entire investment portfolio is classified under three categories viz: AFS, HFT & HTM. Sale/Transfer/Shifting: Verify there are no securities held in the HFT for more than 90 days. Verify there has been no shifting of securities to/from HTM Portfolio without the approval of the Board beyond the allowed percentage as per the RBI i.e. 5% of the HTM Portfolio is allowed only in the beginning of the year.

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		<p>For Shifting in excess of 5% of the HTM Portfolio, the Bank should disclose in the Notes to Accounts the Market Value of Investments held in HTM and also indicate the Book Value in excess of Market Value to the extent not provided for.</p> <p>Profit & Loss from the HFT & AFS Category of Investments is taken to P&L Account.</p> <p>Valuation:</p> <p>Check if the valuation of various securities have been made in line with the RBI Master Circular – Prudential Norms for Classification, Valuation & Operation of Investment Portfolio of Banks.</p> <ul style="list-style-type: none"> • HTM Portfolio is carried at acquisition cost unless it is more than the face value, in which case the premium should be amortised over the period remaining to. • AFS has to be marked to market on quarterly or frequent intervals. To arrive at net appreciation or net depreciation in the portfolio, The securities under same classification can be aggregated to arrive at the net appreciation or net depreciation. No set off can be done for the depreciation of one classification against the other. • Net depreciation to be provided for and net appreciation to be ignored. • HFT also has to be marked to market or monthly or more frequent intervals.
6	Verification of Non-Performing Investments (NPI)	Verify that the investments are classified as NPI as per the extant guidelines issued by RBI from time to time.
7.	Regulatory Returns	Verify the accuracy of all the Regulatory Returns submitted to the RBI and also verify whether the same have been submitted within the deadlines.
8.	Computation of SLR & CRR	Verify the mechanism and accuracy of the computation of NDLT and SLR & CRR and compliance thereof.

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9.	Disclosure Requirements	<p>Verify the following disclosures required to be made to the Notes to Accounts have been made and made accurately.</p> <ol style="list-style-type: none">1. Details regarding securities sold under Repo and Purchased against Reverse Repo.2. Details of the issuer composition of non-SLR investments and the non-performing non-SLR investments.3. Details of Transfer of Securities from HTM portfolio to AFS in excess of 5%, Banks should disclose the market value of the Investments and Book Value in excess of Market value for which provision is not been made.4. Details of corporate debt securities lent or acquired under repo or reverse repo transactions.5. In respect of the Non SLR Securities portfolio, the issuer details in the format prescribed vide RBI Master Circular on Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks.6. Penalty paid to Reserve Bank of India during the financial year.
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Audit of Information Technology and Digital Banking Division

Introduction

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

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

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

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

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

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

- Entity level IT Controls
 - IT Governance and Organization
 - IT Policies and Standards
 - IT Procedures and Guidelines
 - IT Strategy and Plan
- Business Process and Automated Controls
- Access Controls
- Change Management Controls
- IT Asset Management
- System Acquisitions/Development and/or Migration Controls
- IT Services Management Controls
 - Incident Management
 - IT Capacity and Performance Management
- Backup Management
- RBI Cyber Security Controls (including Physical, Network, Application and Database Security)
- Payment Systems (including SWIFT) Controls

Other areas to be covered:

- Digital Banking - Key considerations
- Cryptography Key Management Controls
- Consumer Identity and Access Management
- Data Protection/ Privacy
- Outsourcing Risks
- RPA and AI
- Aadhaar Controls
- Blockchain

Scope

6.07 Range of the activities that are to be subjected to an IT audit are discussed in the following paragraphs:

Business process controls

6.08 Applications and systems such as ERP (Enterprise Resource Planning) solutions, core banking applications, treasury systems, investment management, core insurance, CRM (Customer Relationship Management) and other custom systems shall be identified to audit processes with reference to the following:

Banking: Retail, Corporate and Investment Banking; Treasury

Insurance: New Business, Claims processing; Billing, Purchase to Pay, Order to Cash, Record to Report,

Customer Relationship: Lead, Relationship, service management

Finance and Accounts: General Ledger, Accounts Payable/Receivable, Fixed Assets

HR Processes: Hire to Retire.

It shall also include the test of the adequacy of: system configuration controls, process controls, maker checker controls, master data controls, reporting controls, data upload/ interface controls, Information produced by the Entity (IPE) controls, controls around end user computing sheets and information security controls.

User Access Management

6.09 User access management controls are put in place to protect organization's internal and client confidential information by controlling who has the rights to use or access information resources as per permissible responsibilities' / roles matrix. "Need to know, Need to do" principle should be followed in user access management.

Policies and procedures for user access management

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

User access creation including administrative and vendor IDs

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

Administrative accounts are accounts with access rights that may override controls that exist at the assertion level, database level and at the application

level (e.g., system administrators, security administrators, database administrators).

Administrative access should be restricted to a small group of individuals and to personnel/teams who require the administrative access as a part of their job responsibilities.

Activities performed by users having administrative access should be monitored and reviewed for appropriateness.

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

User access modification including administrative and vendor IDs

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

- A review of the existing permission should be performed to check what access permissions are needed to be preserved during transition period and when completed, these permissions must be removed (if applicable). Ideally, no cross functioning access should be available with that user.
- New permissions required by the user as per his/her job responsibilities in their new role.

User access revocation including administrative and vendor IDs

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

Review of role – right matrix

6.14 Access rights should be reviewed periodically to determine deviations from role baselines and to validate rights in alignment to the job responsibilities. Moreover, the system of review of validity of approval granted in exceptional cases should be reviewed periodically.

Segregation of Duties/Conflicting Access

6.15 Segregation of duties (SOD) is the concept of having more than one person required to complete a task end to end. In business, the separation by

sharing of more than one individual in one single task is an internal control intended to prevent fraud and error. SOD and critical access review shall be performed on a periodic basis along with the assessment of the appropriateness of access to critical transactions. Core application transactions shall be reviewed along with the master data to determine instances of SOD violation and related risk amounts.

Change Management

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

The objectives of the Change Management processes are to:

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

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

- Receiving change requests from requesters.
- Assigning the change to resources within organization for solution.
- Identification, sizing and risk analysis.
- Accepting or rejecting the requested change.

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- Assigning the change to solution development resources.
- Segregation between the production and test environment.
- Reviewing the solution prior to implementation.
- Scheduling the change.
- Coordinating the change activities, including:
 - Planning the change
 - Documenting the change
 - Developing back out plan
 - Acquiring change approvals
 - Change Implementation
 - Post Implementation Testing
- Communicating change implementation date as required to all concerned parties.
- Closing the change.

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

IT Service management

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

Incident Management

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

System acquisition, development and maintenance

6.21 System requirements as part of the system acquisition / development,

System Requirement Study (SRS) and its maintenance shall be formulated as a part of the Information Security policy. Due care should be taken during executing change control procedure including correct processing techniques such as input data validation, control of internal processing, output data validation and securing application services on public networks. Also, technical review of application shall be conducted after operating platform changes.

Information security risk management

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

Capacity Management

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

Backup Management

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

Information asset management

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

Information and Cyber security review

6.26 Security controls are safeguards or countermeasures to avoid, detect, counteract, or minimize security risks to physical property, information, computer systems, or other assets. There are various guidelines, circulars and mandates released by RBI and other regulatory bodies for information technology, cyber security and information security. It is advisable to check the latest RBI

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guidelines on Information and Cyber Security aspect before conducting the statutory audit. The RBI vide Circular No. RBI/2015-16/418 DBS.CO/CSITE/BC.11/ 33.01.001/ 2015-16 dated June 2, 2016 on Cyber Security Framework in Banks has provided as follows:

- Review of cyber security policy.
- Cyber crisis management plan (CCMP) - CCMP should address the following four aspects: (i) Detection (ii) Response (iii) Recovery and (iv) Containment. Banks need to take effective measures to prevent cyber-attacks and to promptly detect any cyber-intrusions so as to respond / recover / contain the fall out.
- Cyber security preparedness indicators - The adequacy of and adherence to cyber resilience framework should be assessed and measured through development of indicators to assess the level of risk/preparedness. These indicators should be used for comprehensive testing through independent compliance checks and audits carried out by qualified and competent professionals.
- Vulnerability assessment.
- Information sharing initiatives - banks need to report all unusual cyber security incidents (whether they were successful or were attempts which did not fructify) to the Reserve Bank. Banks are also encouraged to actively participate in the activities of their CISOs' (Chief Information Security Officer) Forum coordinated by IDRBT and promptly report the incidents to Indian Banks – Center for Analysis of Risks and Threats (IB-CART) set up by IDRBT (Institute for Development and Research in Banking Technology).
- Baseline Cyber Security and Resilience Requirements - An indicative but not exhaustive list of requirements to be put in place by banks to achieve baseline cyber-security/resilience is given. This may be evaluated periodically to integrate risks that arise due to newer threats, products or processes. To ensure adequate cyber-security preparedness among banks on a continuous basis and to enhance the resilience of the banking system following shall be followed but not limited to, putting in place an adaptive incident response, management and recovery framework to deal with adverse incidents/disruptions, preventing execution of unauthorized software, environmental controls, network management and security, application security life cycle, secure configuration, vendor risk management, removable media, data leakage prevention strategy, maintenance, monitoring, and analysis of audit logs, advanced real time threat defense and management and user/employee/management awareness.

- Organizational arrangements - Banks shall review the organizational arrangements so that the security concerns are appreciated, receive adequate attention and get escalated to appropriate levels in the hierarchy to enable quick action.
- Cyber-security awareness among stakeholders / Top Management / Board – As management of the cyber risk requires the commitment of the entire organization to create a cyber-safe environment, a high level of awareness among staff at all levels shall be ensured. Top Management and Board shall also have a fair degree of awareness of the fine nuances of the threats and appropriate familiarization may be organized. Banks shall proactively promote, among their customers, vendors, service providers and other relevant stakeholders an understanding of the bank's cyber resilience objectives and ensure appropriate action to support their synchronized implementation and testing. It is well recognized that stakeholders' (including customers, employees, partners and vendors) awareness about the potential impact of cyber-attacks helps in cyber-security preparedness of banks. Banks are required to take suitable steps in building this awareness.

RBI Cyber Security engagements for banks

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

- Discussion and process understanding with the bank.
- Review of notes/reports/documents submitted to various committees (Board, Board level and Executive level) of the bank.
- Review of the audit reports – external as well as internal and their compliance level as submitted to the Audit Committee (Board/Executive).
- Review of returns submitted by the bank to RBI (CSITE Cell, Department of Banking Supervision (DBS)).
- List of circulars and advisories issued by RBI (CSITE Cell, DBS) to banks to be referred for comments on the compliance including outstanding observations and reviewing bank's response/actions taken to the advisories/alerts/circulars.
- Review of the organization structure for assuring the implementation of controls or measures suggested as part of circulars/advisories/alerts.
- Reviewing third party assurance report.
- Reviewing the notes put up to Information Security Committee, ITSC

(Information Technology Sub Committee) on major issues – committee minutes and actions.

- Review of the steps taken for assuring that controls gaps- identified, critical or reoccurring gaps are reported to appropriate top committees and controls are sustained.
- Review whether bank has conducted audit of Third-party vendors (outsourcing).
- Review the role of CISO.
- Check for the incidents reported by the bank to RBI (CSITE Cell) and its status of closure at their end – reporting to customers, regulator, Root Cause Analysis (RCA), Forensics etc.
- Review of the submissions made by the Bank to RBI through Risk Based Supervision Tranche submission

Application Security

6.28 Application security mechanisms such as structural analysis, input validation, application and user control, data transaction analysis along with review of password policy controls, user access management, root/admin access controls, SOD matrices, system administration and change management process shall be taken into consideration for an application security review. It is expected that the auditor will review the control framework as established by the bank as part of general IT Control Testing.

Enterprise security

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

Physical and Environmental security

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

Human resource security

6.31 Human resource security shall include defined activities, processes and

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

Platform/ Infrastructure Security and Network Security

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

Cryptography and Key Management

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

Aadhaar Guidelines review for banks based on AADHAAR ACT 2016

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

- Review of the IT Landscape based on the following applicable guidelines of UIDAI (Unique Identification Authority of India) for AUA's
- The Aadhaar (Targeted Delivery of Financial and Other Subsidies, Benefits and Services) Act, 2016
- AADHAAR (Authentication) Regulations, 2016
- AADHAAR (Data Security) Regulations, 2016
- AADHAAR (Sharing of Information) Regulations, 2016
- Updated UIDAI Information Security Policy in respect of AUA (Authentication User agency)/ KUA (KYC User Agency) for circulation
- Instruction for providing Authentication or eKYC Services by AUA KUA to Sub-AUA
- Circular on AADHAAR Data Vault
- Procurement of Registered Devices for AADHAAR Authentication
- Registered Device Certification of Biometric Devices along with STQC

(Standardization Testing and Quality Certification) certificate

- Circular on Registered Devices (Implementation Timelines)
- Circular on AUA/KUA and ASA (Authentication Service Agency) Agreements V 4.0
- Delta Certification process of Biometric Devices for Registered Devices
- Implementation of HSM (Hardware-based security module) by AUA/KUA/ASA

SWIFT review (vide RBI Press Release 2017-2018/2249)

6.35 RBI, as part of its ongoing efforts for strengthening of the supervisory framework in the country, has been issuing necessary instructions to banks from time to time on a variety of issues of prudential supervisory concern, including the management of operational risks inherent in the functioning of banks. The risks arising from the potential malicious use of the SWIFT infrastructure, created by banks for their genuine business needs, has always been a component of their operational risk profile. RBI had, therefore, confidentially cautioned and alerted banks of such possible misuse, advising them to implement the safeguards detailed in the RBI's communications, for pre-empting such occurrences.

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

SWIFT review primarily includes –

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

Audit Approach

6.37 This section provides description of the audit approach that will be adopted to perform the IT audit for the applications having an impact on the statutory financial statements of a bank and for the support applications (such as change management tool, incident management tool, user access management tool, ticketing tool) that aid to assist the IT processes for such financial statements impacting applications or the overall bank security processes. During

audit planning and risk assessment stage, audit engagement teams are required to determine the scope and extent of audit procedures for their IT audit based on the following set of illustrative factors:

- Whether the IT application system is used in the financial statements preparation or passing accounting entry- such as CBS, NPA (Non-Performing Asset) module, Loan and Treasury systems etc.
- The Auditor needs to ensure that each customer of the bank is tagged under one single Customer ID / Unique Customer Identification Code (UCIC) in respect of all its accounts, including those in which credit facilities are granted, irrespective of their location, to enable the bank, (subject to the relaxations/exceptions for the time being applicable to any account/facility), to accord the same NPA classification status to the customer/borrower, based on the most adverse classification determined for any of its account/facility. The NPA classification of a group entity as such does not automatically extend to other related / group entities, where the classification would have to be judged based on independently, i.e., at the entity level and not at a group level, unless there is a diversion of funds
- Whether the IT application system directly or indirectly assists the processes which are relevant in the preparation of financial statements or for ensuring adequate control framework and governance over the financial statements preparation and reporting process e.g. transaction processing systems, Reconciliation systems etc. It is important to see to what level these application systems are integrated / interfaced with each other.
- Whether IT application system is used for generation of reports or data elements which will be used as audit evidence for the financial statements. The may also include reports which are used by management for the purpose of passing an accounting entry or for making a decision having impact on financial statements e.g. applications systems used for preparation of disclosures in the financial statements etc.
- IT systems not having direct impact on financial statements but necessary for overall bank security posture of the Bank e.g. applications systems used for compliance with RBI requirements around cyber security where auditor also needs to provide a certificate etc.
- Any other IT application system or IT processes which the auditor believes is relevant for the audit.

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

Strategic anchoring

6.38 Strategic anchoring requiring the following:

- Identify key stakeholders responsible and accountable for the Account and preparation of financial statements / statutory audits.
- Perform interviews with process owner, stakeholders & various other functional teams.
- Understand the bank's strategic goals, their competitors and identify what is considered the major business risks within the bank.
- Walkthrough the internal and external service catalogue and map services to strategic goals.
- Walkthrough of the operating model for different functions and validate with leadership.
- Define capability characteristics and agree a desired target operating model.
- Understand if the current set-up is capable of achieving the desired state.
- Understand the requirements of Long Form Audit Report pertaining to IT systems and control and take due consideration to the reporting responsibilities

Functional review

6.39 Functional review would cover the following:

- Processes and procedures for the management and administration of the security architecture, implementation of security solution controls in place to protect data, network and systems against any kind of attack, the monitoring and incident response efforts to ensure continuous compliance to security requirements.
- Interviews will be followed by document review and sample-based testing.
- The security capability model will be used leveraging the technical security domain to assess operating models while the detailed Control Security methodology will be used to assess content and detailed operational processes.

Report and Roadmap

6.40 This would require the following:

- Define findings to close the identified gaps by -

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

Reporting

Long Form Audit Report (LFAR)

6.41 Given below is the general flow and critical sections covered as a part of the Long Form Audit Report as amended on September 5, 2020 under “Long Form Audit Report (LFAR) – Review”

- **Asset Quality:** Special emphasis should be given on continuous monitoring of classification of accounts into Standard, SMA, Sub-standard, Doubtful or loss as per IRAC Norms by the system, preferably without manual intervention, correct recognition of income, and adequacy of provision

thereof. Effectiveness of the system for compiling data relating to NPA and their provision, data integrity, system of suspension of charging of interest and adherence thereto, should be examined and commented upon. Deviations observed, if any, should be provided along with requisite examples.

- **Management Information System:** Review of Management Information System for existence and adequacy, method of compilation and accuracy of information, appropriateness of procedures for preparation of supervisory returns and its reliability under the Off Site Surveillance System of the RBI, reliability of information flow for the internal risk management system. Moreover, review of effective system of preparation and consolidation of branch returns and financial statements.
- **Robustness of IT Systems:** Auditors should comment on the robustness of IT systems covering all the software used by the bank along with functions thereof, inter-linkage/interface between different IT Systems, ATM network and its security, payment system products and services among others. Further, it should be examined whether the software used by the bank were subjected to Information System & Security Audit, Application function testing and any other audit mandated by RBI. Adequacy of IS Audit, migration audit (as and where applicable) and any other audit relating to IT and cyber security system and bank's compliance to the findings of those audits should be commented upon.
- **IT Security and IS Policy:** The Auditors should comment whether the bank has duly updated and approved IT Security and IS Policy and whether the bank has complied with the RBI advisory/directives relating to IS environment/cyber security, issued from time-to-time.
- **Critical Systems / Processes:** It should be examined whether there is an effective system of inter-linkage including seamless flow of data under Straight Through Process (STP) amongst various software / packages deployed. Special emphasis should be placed on outsourced activities and bank's control over them, including bank's own internal policy for outsourced activities.

In addition to above, Point No. iii of Guiding Principles on objective, strategy, scope and coverage of LFAR for branch auditors under LFAR to Management and Statutory Central Auditors by Bank Branch auditors in case of bank branches provides that *"Verification of data integrity and data related control systems and processes should be carried out and commented upon, with the special thrust on those data inputs which are to be used for MIS at corporate office level and for supervisory reporting purposes."*

Outsourcing

6.42 Technology Outsourcing framework of the bank should be documented which must include IT related outsourcing process. This process should be formulated after considering all the guidance and circulars issued by regulatory authorities such as RBI. For instance Circular No. RBI/2010-11/494 DBS.CO.ITC.BC.No.6/31.02.008/2010-11 dated 29 April 2011 on “Working Group on Information Security, Electronic Banking, Technology Risk Management and Cyber Frauds- Implementation of recommendations”. Key areas to be covered as per the framework are (but not limited to):

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

Other aspects

Digital banking - Key considerations

6.43 The Auditor's key considerations on digital banking are the following:

- Digital Banking has completely changed the way banks function in today's times. With Digital Banking, the customer can transact with higher speed, ease and convenience. By definition, digital banking is banking done through the digital platform, doing away with all the paperwork like cheques, pay-in slips, Demand Drafts, and so on. It means availability of all banking activities online. The first phase of the Digital Banking revolution was through the internet. The second phase of Digital Banking involves mobile phone platforms. After smartphones came into the market, Digital Banking has taken off in a big way.
- Bank offers various services such as Internet banking, Mobile banking, Credit Card/Debit Card, IMPS, RTGS, NEFT, ATM, Aadhaar based payment and Prepaid Instruments. Digital banking involves high levels of process

automation, web-based services and may include APIs enabling cross institutional services, use of payment gateway. Seamless flow of transaction within fraction of second supported by integration of various applications is possible only with the help of third-party service providers.

6.44 The Auditor should get an understanding of the following:

1. List of digital products offered by banks
2. Involvement of third-party service providers, NPCI, VISA, Master, aggregator, payment gateways, debit card/ credit card manufacturing company
3. Flow of transactions of each product
4. Security of transaction flow, data confidentiality
5. Customer on-boarding process, authentication and OTP generation
6. Daily reports generated from bank's own system and received from vendors
7. The Bank's mechanism of monitoring vendors
8. RBI guidelines on digital products and for third party service providers.

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

6.46 Though the bank is providing services through digital mode that cannot absolve it from regulatory compliance such as KYC, Anti Money Laundering (AML) and Combating the financing of terrorism (CFT). The bank shall file suspicious transactions report (STR) with Financial Intelligence unit (FIU-IND) for mobile banking and internet banking transactions.

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

(i) Role of NPCI in Digital Payment

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

(ii) Settlement process

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

In this context, the Auditor should examine control over:

- Settlement accounts, suspense or office accounts maintained for such transactions,
- Daily reconciliation process, three-way matching of data from ATM switch files, CBS files and NFS files,
- Chargeback, dispute resolution procedure.

(iii) Third party service provider

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

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

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

6.52 The Auditor should consider:

- Bank's mechanism of monitoring service providers
- Audit reports (Internal and External) to check compliance with relevant controls

- Third party service provider's compliance with relevant standards- PCI DSS, ISO 27001, PA-DSS
- Confirmation on various RBI requirements
- Third Party assurance report

Consumer identity and access management

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

6.54 Important aspects of Consumer IAM:

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

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

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

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

RPA (Robotics Process Automation) Assessment

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

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

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

6.61 It is to be seen how RPA is having an impact on the transaction capturing and processing level including its impact on accounting.

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

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

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

Blockchain

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

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

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

- Infrastructure and application management - Secure software development practices and testing of blockchain applications, platform, infrastructure and communication interfaces.
- Access and permissions management - Permissions configured for defined roles for access, validation and authorization of blockchain transactions by internal and external participants.

Information Technology related frauds in banks

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

Types of frauds possible in banks

6.66 Some of the possible frauds in banks are enumerated in the following paragraphs:

- Frauds in banks – Cash lending during working hours, Missing notes in bundles, use of same note bundles by two branches, Posting in wrong accounts, Misuse of sensitive stationery, etc. These frauds are committed by Bank's Staff.
- Frauds on banks – Includes Technology related frauds, Deposit related frauds, and Advances portfolio frauds.

6.67 Technology related frauds - The fraudsters employ hostile software programs or malware attacks, phishing (mails), vishing (voice-mail), Smishing (Text messages), whaling (Targeted phishing on high net worth individuals), Card duplication Techniques apart from stealing confidential data to perpetrate Frauds.

6.68 Deposit related frauds - Lack of compliance with KYC Guidelines, misuse of inoperative accounts, Non-reconciliation of Suspense and Sundry accounts and lack of control over transactions, in these accounts, result in frauds.

6.69 Advances portfolio frauds - Majority of credit related frauds are on account of deficient appraisal system, poor post-disbursement supervision and inadequate follow-up. Most of the frauds relating to advances come to light only during the recovery process initiated after the accounts have been classified as

NPA. Fabricated/fudged Financial Statements, inflated security valuation report, defective search report for title deeds of mortgaged property are commonly discovered.

Fraud risks involving Digital Banking

6.70 Information Technology (IT) plays a significant role in the development of Digital banking to make the banking operations fast, effective and efficient. Use of IT in banking system made banking more customer oriented, quality driven and easy to use by both bank and customer. Various initiatives have been taken by the banks to converge themselves from their traditional banking to Digital banking. The initiatives by the banks are as follows:

- Core Banking Systems (CBS)
- Digital Payment System
- Credit / Debit Cards
- ATMs/ POS Terminals/CDMs
- Internet Banking like NEFT/RTGS
- Mobile Banking
- Branchless Banking
- Digital Wallet

6.71 The following are the most common ways in which exploitation of IT is being done on the most popular initiatives:

- **Fraud Risk on CBS:** When the letter of understanding (LOU) is issued, message for the credit transfer is conveyed to the overseas banks through SWIFT (Society for Worldwide Interbank Financial Telecommunication) system by the sending bank and this message through SWIFT is termed as sending bank's consent and guarantee to the overseas bank. The sending bank official must log into its CBS system to route the transaction on SWIFT. fraud on CBS occurs when SWIFT is not integrated with CBS and a perpetrator can easily send LOUs to overseas bank simply bypassing the CBS.
- **Fraud Risk on Digital Payment System:** Digital payment system spread across globe due to its scalability and acceptability by all class of users. Handling of account by a user either through online or through mobile is increasing day by day and hence they are the common target for the perpetrator. The perpetrator may deploy different techniques to make fraud happen.

Some techniques are explained as follows:

Phishing: The Perpetrator sends emails to lure users, that he has won the lottery, or some money needs to be deposited in his account and then requesting user to provide the details of his bank account.

Device Compromise: Device through which the bank customer is operating his account either through online or through mobile usually prone to be compromised by the perpetrator for execution of the fraud. Compromising the Operating system of the smart phone or any other status change like firewall setting etc. may lead to fraud.

Man in the Middle Attack: The perpetrator, in this case by altering the communication between the two legitimate parties executes the fraud. The legitimate parties think that they are communicating with one another but in real scenario their communication is received and altered by the perpetrator.

Spoofing Attack: This attack is used to disguise the user by sending fraudulent communication from the fraud site as legitimate site. For example, instead of sbionline.com perpetrator may use sbionline.com for the user and force the user to enter the credentials in the fraudulent site.

APT Attacks: Advance persistence threat used for the infiltration of credentials of the customers of a bank. The perpetrator generally used botnets (malicious software) to infect the computers in the bank network for the infiltration of the credentials.

Location Manipulation: The perpetrator generally manipulates the actual location of the device for the outstation account fraud.

- **Credit / Debit Cards:** There are two types of Credit / Debit Cards frauds as detailed below:

Card physically Not Present Fraud: This type of Credit / Debit Cards fraud prepared by the perpetrator by sending phishing emails to the card holder and lure him to enter the card information in the email or disguised portal directed by the link in the email. When all the information is available related to the Credit / Debit Card the perpetrator uses the information to do illegal transaction online without having the physical possession of the card.

Card physically present Fraud: This type of Credit / Debit Cards fraud is executed by the perpetrator by using some device either at swiping machine at sales counter or parallel reader in an ATM machine. Skimming money from the Credit / Debit card in the later stages would follow the departure of the Credit / Debit Card holder from the said venue.

- **Internet Banking Fraud:** Internet banking used by the bank customer to do the transaction to purchase from the E-Commerce websites, transfer the money from his account to other accounts, to submit the EMI for loans to the lending banks, instalments of PPF, RD etc. Bank customer logs into the bank portal by providing the credentials to open his account page. The perpetrator tries to crack the credentials of the users by different tricks which are explained as follows:

Social Engineering: The perpetrator projects himself to be the person which he is not, to get the credentials of the user. He exploits the emotions and traits of the human like fear, greed, curiosity etc. as his tools to force the user to disclose his credentials.

Shoulder Surfing: Shoulder surfing happens when a perpetrator tries to look over other person in the hope to see his credentials at the time when the said person is about to place his credentials in the bank portal. Once the perpetrator is able to see the credentials, he will use the same to divert the money from the user account.

Key Logger: Key logger is surveillance software installed by the perpetrator in such a way that every keystroke by the user (including credentials) in his computer is captured in an encrypted file. The perpetrator using other means collects this file and figures out the credentials in the long text.

Spoofing Attack: As discussed above this is used to obtain the credentials of the user.

APT Attacks: As explained above, advance persistence threat is used for the infiltration of the credentials of the customers of a bank.

6.72 These are the most common frauds that occur in Digital banking, although banks are taking considerable and continuous efforts to arrest such fraudulent activities by putting proper controls, customers trainings and sending alerts but it is also the responsibility of the customer to follow the guidelines issued by the bank from time to time. However an auditor is expected to review the Fraud Reporting and Monitoring mechanism within the bank and adequacy of provision / penalties / compensations.

Key Take Aways

1. As technology is fast moving the Auditor needs to show resilience and adapt the technology and its impact on the auditee.
2. Map the technology with any of the financial monitoring mechanisms of the bank

3. Data integrity is a crux in any IT platform
4. When technology can be good, it creates numerous challenges for the auditor in the risk assessment of the auditee. [The Auditor should do this risk assessment basis the risk monitoring framework of the Bank, internal audit coverage on the IT and Network security of the Bank, system auditors' comments, Bank's business needs and objectives]

Human Resources Department

7.01 Human Resources (HR) Department is one of the most important departments of a Bank. It plays vital roles including the drawing up HR policy for the Bank and getting it vetted by the Management.

7.02 The HR policy would normally cover the following aspects:

- 1) Organizational and functional structure and chart including reporting obligations.
- 2) Background checks – pre-employment medical checks – fixing turnaround times for various activities related to recruitment.
- 3) Interviews, Selection and Recruitment processes.
- 4) Issuing Appointment Letters – fixing job roles, responsibilities and designations.
- 5) Induction, awareness, sensitization and training.
- 6) Salary Fixation, structure and payment, TDS calculations, deductions and payment, Issuance of Form 16, Salary slips, Profession tax payments, fixing perks and privileges including insurance entitlements.
- 7) Provident Fund recoveries and contributions.
- 8) Grant of staff Loans and Advances, interest rates thereon and recovery from salary.
- 9) Banking Holidays, Leave and attendance record management.
- 10) Performance appraisal process, transfers and promotions.
- 11) Skill set gap assessment and development.
- 12) Succession planning.
- 13) Disciplinary mechanism in case of any wrongdoings including issuance of warnings and show cause notices.
- 14) Complaint Resolution.
- 15) Conflicts of interest and bribery.
- 16) Investigation mechanism for determining staff accountability in case of frauds.

- 17) Handling employee retirements, resignations, retrenchments, terminations.
- 18) Full and Final settlements, Exit interviews.
- 19) Handling deviations from policy and ratifications, escalations thereof.
- 20) MIS – generation, circulation list and frequency.

7.03 HR department will also be responsible for the following for which there might be specific policies:

- a) Code of Conduct and Ethics
- b) Dispute resolution mechanism
- c) Whistle blower policy and hotlines
- d) Prevention of Sexual Harassment Policy

7.04 Each Bank may have its own organization structure. While the policy framing, sign off and periodical reviews would happen centrally, monitoring and implementation could be decentralized at the Zonal, Regional or Cluster level as the case may be, which will also depend on the size of the Bank in terms of number of employees, branches and geographical spread.

7.05 HR department is generally headed by a Chief Human Resource Officer who would also be designated separately. He could be assisted by functional experts who would be individually and separately responsible for:

- 1) Recruitment
- 2) Training
- 3) Payment
- 4) Compliance

7.06 Each of these functional heads would have individual teams centrally and at zonal, regional or cluster levels. This may vary from Bank to Bank. These functional heads would be responsible for executing and enforcing various activities as stated in the bank's HR policy.

7.07 The Auditor will have to ensure that:

- 1) There is a comprehensive HR policy in place encompassing in detail all the issues mentioned above. Such policy is periodically updated, reviewed and signed-off.
- 2) The policy is not in violation of existing applicable laws especially labour laws.

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- 3) The policy has been adhered to and this is monitored / validated independently either internally by a distinct HR team or by internal audit or internal audit conduct by external professionals.
- 4) Parameters are set to generate Exception reports to capture deviations. These Exception Reports are generated, monitored and reviewed for closure / resolution at defined intervals normally daily.
- 5) Any deviation or non-adherence to the policy should be appropriately approved, addressed and closed. Ageing of open deviations is duly monitored. Classification of deviations is done risk wise into 'High', 'Medium' and 'Low' categories as per pre-defined classification norms. High risk deviations are stringently monitored for closure and open items duly escalated.
- 6) Proper documentation is in place, stored and retained.
- 7) Tax calculations are done as per current tax laws, salary payments are in adherence to labour laws and internal policy, issuance of appropriate tax forms – Loan recoveries, interest charge, etc., are in order.
- 8) Process of Appointment – Induction – Performance and appraisal reviews, Trainings, Complaints etc., are in order.
- 9) Impact on account of cash outflow is accrued / reflected in appropriate heads.
- 10) Ensure strict adherence to the Code of Ethics, Whistle Blower Policy and Prevention of Sexual Harassment Policy.
- 11) Actuarial valuation of Gratuity, Leave Encashment (generally obtained by HR) has been duly obtained on record and the assumptions considered are reasonable. The Auditor should also verify whether the salary and employee data provided to the actuary are consistent with the data maintained by the Bank.
- 12) Where payroll processing is done through a specialised software, whether adequate IT controls are in place to ensure correctness of data input, validations, processing, output and appropriate accounting thereof in the accounting system of the Bank.
- 13) In case the HR aspect is subjected in internal or other audits, the Auditor would have to peruse the reports of such audits to identify any audit issues already flagged off.

7.08 While most of the issues stated above will not have a direct quantitative impact, indirectly they make a big impact on the employee motivation,

engagement, performance and productivity and hence, it is imperative that the Auditor reviews the process end to end. Any issues noted therein should be appropriately discussed for resolution and necessary reporting should be made in the LFAR.

7.09 Profit per employee / Business per employee figures needs to be stated in the Notes to Accounts by Banks. The Employee number and the methodology for allotting this number will have to be certified by the HR department.

7.10 In September 2020, the Code on Social Security, 2020 was passed by the Parliament. Though the effective date has not yet been notified, the Auditor would want to comment in the LFAR on the adequacy of the process followed by the Bank to quantify the impact of the said enactment on the overall employee cost of the Bank.

8

Large Corporate and Loan Syndication

Introduction

8.01 All corporates require large of funds by way of debt and equity for timely financial closure of their projects. Loan syndication most often occurs when a borrower requires an amount too large for a single lender to provide or when the loan is outside the scope of a lender's risk-exposure levels. Thus, multiple lenders form a syndicate to provide the borrower with the requested capital. The Bank which spearheads the process is called the "lead bank". The lead Bank carries out most of the due diligence. The Lead Bank in most of the cases is responsible for the initial transaction, fees, documentation, compliance reports and repayments throughout the duration of the loan, loan monitoring, and overall reporting for all lending parties. Hence, the lead bank has more responsibility as compared to other members of the syndication. Any laxity in any stage of the loan i.e. Sanctioning, Documentation, Disbursement, Monitoring by lead bank may increase the risk associated with the borrower for all syndicate members. Normally in Loan Syndication one agreement is entered between all members of the syndicate and the borrower. Though the lead banker is the single point for correspondence, other Banks / lenders have the right in proportion to their share in loan. The Lead Bank charges fees for the syndication arrangement which are normally higher than the normal loan processing fees.

8.02 The Auditor of the lead bank in the case of Loan Syndication should verify:

- Whether the bank has Board approved policy for business of Loan syndication. Whether this policy has been updated & reviewed annually.
- Whether the Bank has processes in place for loan syndication business.
- Whether the bank has underwritten any loan which it has syndicated; if yes whether the same has been considered as Contingent Liability.
- Whether the bank has collected fees in all cases of syndication.
- Whether Loan Syndication Department is adequately staffed having different skill sets as required to carry out due diligence.

- Whether the bank has passed on the relevant information promptly to other Banks.
- Whether meetings with all banks in the syndicate are held as per schedule and the minutes of the meeting are timely and properly prepared and circulated.
- Whether issues raised by member banks are replied in time and satisfactorily.
- Whether the correspondences are duly filed in order.

8.03 The Auditor of other banks (Member banks) should verify the following:

- Whether the bank has a Board approved policy for participation in a syndicate. Whether this policy has been updated and reviewed annually.
- Whether the bank has carried out its own due diligence on information provided by the Lead Bank and raised queries, if any to the Lead Bank and whether the same are resolved satisfactorily.
- Whether share of the bank is clearly mentioned in correspondence with Lead bank and other syndicate members.
- Whether the bank has put in place for loan system for Delivery of Bank Credit.

Micro, Small and Medium Enterprises Department

Introduction

9.01 Advances to the MSME Sector are categorised as Priority Sector Advances as per existing guidelines issued by RBI. The target for the MSME Sector advances is 7.5% of ANBC or credit equivalent amount of "Off Balance Sheet exposure", whichever is higher.

9.02 The categorisation of MSME was based on the limits of investment in plant and machinery and equipment till 30th June, 2020, *vide* Notification S.O.1642(E) dated September 9, 2006, as under:

Manufacturing Sector Enterprises	Investment in Plant & Machinery
Micro Enterprises	Does not exceed twenty five lakh rupees
Small Enterprises	More than twenty five lakh rupees but does not exceed five crore rupees
Medium Enterprises	More than five crore rupees but does not exceed ten crore rupees
Service Sector Enterprises	Investment in Equipment
Micro Enterprises	Does not exceed ten lakh rupees
Small Enterprises	More than ten lakh rupees but does not exceed two crore rupees
Medium Enterprises	More than two crore rupees but does not exceed five crore rupees

9.03 Considering that the Micro, Small and Medium Enterprises [MSME] sector is a significant contributor towards building up of a strong and stable national economy and considering that the present thresholds in MSME definition has created an apprehension among MSMEs of graduating out of the benefits of MSME and dampens the urge to grow, the Government of India *vide* notification No: S.O. 2119(E) dated 26.06.2020 published in the Gazette of India,

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Extraordinary, Part II, Section 3 Sub-Section (ii), has changed the definition criteria of MSME as under::

	Sector	Definition
A	Micro Enterprises	Investment in Plant & Machinery or Equipment does not exceed one crore rupees and annual turnover does not exceed five crores rupees.
B	Small Enterprises	Investment in Plant and Machinery or Equipment does not exceed ten crore rupees and annual turnover does not exceed fifty crore rupees.
C	Medium Enterprises	Investment in Plant and Machinery or Equipment does not exceed fifty crore rupees and annual turnover does not exceed two hundred and fifty crore rupees.

9.04 The revised definition as above is effective from 1st July, 2020. All existing enterprises and new enterprises are required to register by filing a memorandum known as “Udyam Registration” in the Udyam Registration Portal based on self declaration. Composite criterion of investment and turnover shall apply for classification of an enterprise as micro, small or medium. If an enterprise crosses the ceiling limits specified for its present category in either of the two criteria of investment or turnover, it will cease to exist in that category and be placed in the next higher category but no enterprise shall be placed in the lower category unless it goes below the ceiling limits specified for its present category in both the criteria of investment as well as turnover.

9.05 All units with Goods and Services Tax Identification Number (GSTIN) listed against the same Permanent Account Number (PAN) shall be collectively treated as one enterprise and the turnover and investment figures for all of such entities shall be seen together and only the aggregate values will be considered for categorizing units into micro, small or medium enterprise.

9.06 The calculation of investment in plant and machinery or equipment and turnover will be linked to the Income Tax Return (ITR) and GST Returns of the previous years with certain conditions.

9.07 RBI has issued circular on MSME Sector – Restructuring of Advances – vide RBI Circular No. RBI/2018-19/100 DBR.No.BP.BC.18/ 21.04.048/ 2018-19 dated January 1, 2019 on “Micro, Small and Medium Enterprises (MSME) sector – Restructuring of Advances”. One time relaxation given for Restructuring of

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MSME Standard Accounts without downgrading, subject to compliance of the following conditions:

1. Aggregate exposure (Fund Based/Non-Fund Based) of banks and NBFCs should not exceed Rs. 25 Crores as on 01.01.2019.
2. Borrower account should be a Standard Asset as on 01.01.2019 and till the date of implementation of the restructuring.
3. Borrower entity should be registered under GST on the date of implementation of restructuring, unless exempted.
4. Restructuring of borrower accounts to be implemented on or before 31.03.2020 subject to fulfilment of certain conditions.
5. Additional provision of 5% to be made and retained till the end of specified period or account demonstrating satisfactory performance.
6. Post restructuring, usual NPA norms to be applied.
7. Disclosure in Notes to Accounts required for MSME Restructured Accounts specifying the number of accounts and the amount.
8. If restructured account is downgraded as NPA as per IRAC norms, the same would be eligible for upgradation only if it demonstrates satisfactory performance (Not overdue for more than 30 days) during the specified period (1 year).

9.08 RBI has subsequently vide Notification dated February 11, 2020 extended the period for OTR relief to the MSME borrowers subject to the following conditions:

- a. Aggregate exposure (Fund based/Non Fund based) of all banks/ NBFC's should not have exceeded Rs. 25 Crs as on 01.01.2020.
- b. The borrower account should have been Standard as on 01.01.2020 till the date of restructuring.
- c. The borrower should have been registered with GST. This condition is not applicable to those entities which are exempt from registration under GST.
- d. Restructuring should have been implemented on or before 31.12.2020.

Also those borrowers who have availed relief under the Notification dated 01.01.2019 are ineligible to claim relief under the Notification dated 11.02.2020.

9.09 Banks have to create 5% additional provision in respect of accounts restructured in MSME OTR. Banks are required to put in place a Board approved policy on restructuring of such advances including viability assessment. Many times it is observed that in their eagerness to restructure an account bank may

even restructure a non-viable unit. Hence special attention is to be paid to the application of Board approved policy while restructuring of accounts.

9.10 The requirement of additional provision can be withdrawn only on satisfactory performance during specified period, that is there should be no payment which remains overdue for a period of more than 30 days or in case of OCC/ OD account the outstanding in the account shall not be more than sanctioned limit/ DP whichever is lower for more than 30 days for a period of 1 year from the commencement of the first payment of interest/ principal whichever is later

9.11 It must be ensured that the borrower meets the definition of MSME under MSME Act 2006 (as amended w.e.f.1st July 2020) and may not be required to obtain MSME Certificate to qualify for the scheme. In case of any doubt the Auditor should insist of CA Certificate that the borrower meets the definition of MSME under the Act. Additional disclosure is required to be made of the number and value of restructured accounts under this scheme.

9.12 RBI has subsequently *vide* Notification dated August 06, 2020 extended the period for OTR relief to the MSME borrowers subject to the following conditions:

- a. Aggregate exposure (Fund based/Non Fund based) of all banks/ NBFC's should not have exceeded Rs. 25 Crs as on 01.03.2020.
- b. The borrower account should have been 'Standard' as on 01.03.2020 till the date of restructuring.
- c. Restructuring should have been implemented on or before 31.03.2021.
- d. The borrower should have been registered with GST. This condition is not applicable to those entities which are exempt from registration under GST.
- e. Asset classification of borrowers classified as standard may be retained as such, whereas the accounts which may have slipped into NPA category between March 2, 2020 and date of implementation may be upgraded as 'standard asset', as on the date of implementation of the restructuring plan. The asset classification benefit will be available only if the restructuring is done in terms of the provisions of this circular.
- f. Banks have to create 5% additional provision in respect of accounts restructured in MSME OTR.

9.13 Also refer Circular No. 170/2020-21 dated June 24, 2020 issued by the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) regarding "Distressed Assets Fund - Subordinate Debt for Stressed MSMEs"

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scheme. As the credit facilities extended under the above scheme are backed by a guarantee from CGTMSE, as a special dispensation, RBI vide its circular RBI/2020-21/09 DoR.BP.BC.No.01/21.04.048/2020-21 dated July1, 2020 has decided to permit the banks to reckon the funds infused by the promoters in their MSME units through loans availed under the captioned scheme as equity/quasi equity from the promoters for debt-equity computation.

Preparation / Planning

9.14 Obtain the revised, updated MSME policy of the bank. Discuss the process of collecting information from MSME customers and record the same in Account Master of CBS. How is this process internally validated?

Conduct / Execution

9.15 Verify whether the process for identification of MSME account has been followed at branches / Controlling offices / CBS:

- Check the internal controls for recognition of MSME accounts and eligible MSME accounts for OTR.
- Check the controls for ensuring that once OTR is extended under 1st January, 2019 Circular the same account is not eligible for OTR relief under 11th February, 2020 circular of RBI.
- Check 2% interest subvention to all GST registered MSME Accounts.
- Check for restructured MSME accounts additional 5% provision (over and above provisions already held) is made at reporting date.
- Check for restructured MSME accounts disclosure required in financial statements for the number of accounts restructured and the amount.
- What is the process for arriving at deviations and correction of the same, if any.

Reporting / Conclusion

9.16 Based on audit issue appropriate certificate, report on compliance for MSME Advances in the Long Form Audit Report. Check whether appropriate disclosures are being made in the notes to accounts in the financial statements.

Rural and Agricultural Business Department

Introduction

10.01 The Rural & Agricultural business department focuses on lending under agriculture. The Department function revolves around Supervision, Policy & Strategy formulation for lending under priority sector with a focus of agriculture and other government schemes relating to farmers and weaker sections.

10.02 The Department is generally responsible for allocation, monitoring & compliances relating to priority or agricultural business across various sectors/ subsectors.

10.03 This Department is also responsible to keep abreast with RBI regulations with regard to Rural and Agricultural advances and to frame guidelines within the framework of RBI regulations and to issue internal circulars to the branches, Regional/Zonal/Circle offices of the bank and also monitor implementation of the same.

10.04 This Department also interacts and liaise with other agencies like NABARD, SLBCs, and local government authorities in the implementation of the schemes and reliefs.

10.05 This Department also maintains Day books for incurring administrative expenses relating to the functions of the department.

Audit Approach

1	Comparative Statement	I) Prepare a comparative chart of expenses as per Profit & Loss Account of current year & previous year and check in depth wherever variance is much higher than last year. Variance needs to be addressed. II) Verify to see that all records are upto date.
2	Expenses & Provisions Verification	Verification of Expenses and Provisions made thereof.
3	Scrutiny of Office Accounts	Verification of Office accounts - Scrutinizing Long Outstanding entries in office accounts.

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4	Closure of Previous Auditor's Report	Ensure adherence to the previous audit points, and MOC effects have been given.
5	Verification of Interest Subvention process	Verification of Interest Subvention process - Submission to RBI, Booking in Finacle, Receipts from RBI and distribution to branches. Verify and advice reversal of non- recoverable amount.
6	Interest Subvention Certificate	Verification of accuracy of Interest Subvention Certificate.
7	Non-achievement of priority sector targets	<p>Scheduled Commercial Banks having any shortfall in lending to priority sector shall be allocated amounts for contribution to the Rural Infrastructure Development Fund (RIDF) established with NABARD and other Funds with NABARD/NHB/SIDBI/ MUDRA Ltd. as decided by the Reserve Bank from time to time. The achievement will be arrived at the end of the financial year based on the average of priority sector target /sub-target achievement as at the end of each quarter.</p> <p>While computing priority sector target achievement, shortfall / excess lending for each quarter will be monitored separately. A simple average of all quarters will be arrived at and considered for computation of overall shortfall / excess at the end of the year. The same method will be followed for calculating the achievement of priority sector sub-targets. An Illustrative example is given in Annex of Master Directions No. RBI/FIDD/2016-17/33 FIDD.CO.Plan.1/04.09.01/ 2016-17 dated July 07, 2016 (Updated as on December 05, 2019) "Priority Sector lending – Target and Classification".</p> <p>The interest rates on banks' contribution to RIDF or any other Fund, tenure of deposits, etc. shall be fixed by RBI from time to time. The misclassifications reported by the Reserve</p>

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		Bank's Department of Banking Supervision would be adjusted/ reduced from the achievement of that year, to which the amount of declassification/ misclassification pertains, for allocation to various funds in subsequent years. Non-achievement of priority sector targets and sub-targets will be taken into account while granting regulatory clearances/approvals for various purposes.
8	Directions from Regulatory Authorities charged with Governance	To check various RBI and Government guidelines and actions taken by bank upon the same. Relevant board notes also to be checked.
9	Review Concurrent Audit Report	Review of Concurrent Audit Report.
10	Verification of various certificates	Various certificates issued by branch auditors to be verified and collated. Further some broad checks to be employed to ensure correctness of certificates.

11.01 One of the key risks faced by banks is the legal risk. The bank grants various types of credit facilities to its customers with or without underlying security, whether primary or collateral. The bank and the borrowers execute various documents related to such credit facilities including loan agreements, charge creation documents w.r.t. the securities which are hypothecated / pledged to the bank. The law department ensures that such documents relating to credit facilities are legally enforceable in court of law, are properly stamped & executed and thus, the law department defines SOPs related to execution of such documents including ensuring the enforceability of the documents.

11.02 The Bank obtains account opening forms duly executed from various deposit and demat account holders. The bank obtains various documents to legally validate (and protect its interest) a variety of transactions / activities undertaken by the bank such as Locker arrangements, Lease agreements, Borrowings, Remittances, Trade Finance transactions, Guarantees issued, Forward Contracts, Interest rate or Currency Swaps. The Bank's legal department which is usually located centrally, ensures pre-vetting of all documents used by the Bank in its borrowing, lending & investment/ treasury operations and in discharge of its various income/expense bearing activities.

11.03 The key document w.r.t. Law Department is the legal policy of the bank. It contains a detailed write-up on the roles, responsibilities and also the manner of execution / implementation. It contains or refers to various documentation to be obtained / executed for various funded and non-funded facilities sanctioned by the bank and the custody, storage of the same as well as the stamping requirements which could vary from State to State. Important documents are scanned and movements of original loan papers need to be tracked.

11.04 The legal policy should be subject to periodic review. The legal Department headed by the Chief Legal Officer is the original compiler and custodian of this policy. The legal team is assisted by various staff centrally as well as at decentralized zonal/Circle, regional or cluster levels. Banks have to ensure that the legal team is adequately staffed and vacancies if any, are promptly filled in by inducting competent resources.

11.05 One of the key functions of the legal team is to have a legal audit conducted for advances over a particular threshold. The threshold varies from Bank to Bank. This audit is done either pre-sanction or pre-disbursement of the loan amount.

11.06 The risk policy of the bank talks of legal risks and the primary role of protecting the bank from any legal risks rests with the legal department. The legal team works in co-ordination with the risk department in this regard.

11.07 Various legal compliances like reporting to CIBIL / CRILC needs to be done within the specified deadlines. These are centralised and also monitored parallelly with the compliance team.

11.08 At times during the credit sanction process, various legal issues crop up and the legal team is responsible for issuing opinions in that connection.

11.09 Banks have set processes wherein certain disbursements over a threshold cannot be made unless there is a legal clearance certificate.

11.10 The legal department conducts the title search of the mortgaged premises and ensures that the original title deeds are in order on record. The work is also outsourced to panel advocates. The empanelment of advocates for conducting outsourced work, the detailed due diligence to be done prior to empanelment is all conducted by the legal team. The legal team is also responsible for framing and monitoring the legal outsourcing policy.

11.11 Banks have cases of credit defaults and at various occasions, legal action needs to be initiated against the borrowers for recovery. All legal cases of the bank are handled and co-ordinated by the bank's legal team either internally or through support of the panel advocates.

11.12 Issuance of loan recall, recovery & securitization notices, newspaper advertisements in this connection, obtaining symbolic- physical possession, filing cases in Debt Recovery Tribunals or initiating insolvency proceedings in tribunal is handled either by the bank's recovery department, in case the bank has a separate department, but in which case the recovery department closely liaisons with and obtains guidance and support of the legal department wherever needed.

11.13 The legal team maintains a tracker of all legal cases court wise – date wise which is constantly updated post each case hearing. These updates have to be done timely. As best practice some Banks have an online legal tracker updated close to real time. Timelines are also prescribed for updating the case status post the case date.

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11.14 Bank should have a full-fledged legal department headed and manned by an experienced, expert legal resource. The entire team has to comprise of legal professionals who should be periodically trained and fully equipped to handle all legal challenges.

11.15 While the tracker for time barred debts is monitored at individual branches and also at cluster / regional / zonal/Circle level, in certain Banks, the legal team also monitors this tracker parallelly.

11.16 The Auditor needs to liaison with the legal team to get an updated status on all pending cases, filed by the bank or against the bank. This position has to be obtained with the amount in litigation and also whether the cases have been won or lost in earlier courts and appealed subsequently. Whether a lost case needs to be appealed further and whether the appeal timelines are met is also to be ensured by the legal team. The key discussion with the legal team is to quantify the amount of contingent liability & arrive at the provisioning requirement if any, thereon. The provisioning of the fees payable to advocates will also have to be arrived at based on the agreements entered with the respective advocates and discussions with the legal team.

11.17 The legal department also monitors non-credit related frauds committed by employees or third parties. Whenever a fraud is unearthed or reported an internal investigation is made by the bank through its legal department and also subsequent procedures of filing FIR against the accused, filing criminal cases and monitoring the same. The legal department also complies with provision required to be made against loss due to such frauds.

11.18 Banks also have a panel of valuers for conducting valuation of securities sanctioned / mortgaged to the Bank. The responsibility of appointment of valuers, fixing their appointment terms and conditions is also co-ordinated by the Bank's legal team.

11.19 The legal team is responsible for conducting a performance review of the efficiency and effectiveness of the empanelled advocates work. At times, the services of empanelled advocates are discontinued due to work quality and in all these decisions, the legal department is the key co-ordinator. The legal team is also subject to an internal audit review for efficiency and effectiveness.

11.20 The auditor should ensure:

- 1) The Bank has an updated legal policy in place which is reviewed periodically preferably annually.

- 2) Due diligence for empanelment of panel advocates is done. This panel is reviewed periodically with appropriate evaluation metrics framed. Further, the bank may at its discretion take legal assistance of any other legal counsel with due prior approval for the same for matters which may be unusual and / or critical in nature.
- 3) Documentation requirements for each loan facility is established. Documentation is reviewed and amended in view of changing regulations and learnings from various ongoing litigations.
- 4) Tracker of legal cases is maintained court wise, amount wise, stage wise. Delays, if any, are examined for root cause to ensure timely adherence in future.
- 5) Arrival at the contingent liabilities for court cases, provisioning for legal liability & Debits to profit and loss for legal fees is correctly done after due evaluation of the case success probabilities.
- 6) Adverse issues noted in legal audit if any are properly addressed.
- 7) An internal team should review the entire legal process starting from drafting of a plaint to the response / rejoinder there on. Compilation of best strategy practices or what went right or wrongs impacting the eventual case result could be learnings to be documented for future policy or tactical change incorporation. The same should be a part of a structured process.
- 8) Deviations, if any, from the legal policy are appropriately recorded, duly escalated, authorized and properly addressed.
- 9) Filing and custody of loan documents is in order.
- 10) Systematic track of legal opinions issued is maintained. Adverse court judgments / order obtained against these opinions should be reviewed for issuer competency or operational usage pursuant to disclaimers issued as a part of the opinion.
- 11) Legal risks are identified and gaps therein, especially high risks, are noted for remediation.
- 12) The Reserve Bank of India has directed the banks to undertake Legal Audit of title documents in respect of large value loan accounts (i.e., exposures above Rs. 5 crores) vide its circular 2012-13/524 -DBS.FrMC. BC.No.7/23.04.001/2012-13 dated June 07, 2013. Banks are required to devise the methodology for compliance of the said guidelines.

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- 13) Training should be an ongoing process to keep abreast with the latest developments and upgrade legal skillsets.
- 14) If any opinion / consultation is sought from an advocate (either on the panel of the bank or otherwise) the auditor should review / refer the same from the perspective of financial implications and / or compliance related aspects aligned thereto. The auditor may consider the legal opinions sought by the management as one obtained from 'Management's Expert' as referred to in 'SA 620 – Using work of an Auditor's Expert' and consider the same appropriately as per the said SA. It would be pertinent to note that the legal opinion / views as referred to by the auditor would not dilute the auditor's sole responsibility for the audit opinion expressed.

Credit Recovery Department

Introduction

12.01 The area of operation / function of the Credit Recovery Department is typically confined to the monitoring of ARBs (Asset Recovery Branches) with major thrust on the areas related to recovery of credit portfolio of the bank. The scope of the department may also include handling of recovery through various other mechanisms like NBAs (Non-Banking Assets, Selling of Assets to Asset Recovery Companies (ARCs) whereby upfront cash is realised or Security Receipts (SRs) may be received, Cases under Insolvency and Bankruptcy Code (IBC), One Time Settlement (OTS), upgradation of accounts, etc. The auditor needs to be critical in income recognition policies of the bank as regards the order of recovery and income recognition especially with respect to cases wherein the recovery is made in the form of Non-Banking Assets and sale of assets to ARCs.

Preparation / Planning

12.02 The auditor should get acquainted himself with the Recovery Policy of the bank and the guidelines of Reserve Bank of India as regards the accounting and income recognition thereto. The auditor needs to take into consideration the extent of automation of process related to accounting of recovery of credit portfolio of the bank while audit planning.

Conduct / Execution

12.03 Following aspects need to be checked by the Auditor:

- Verify the returns / data from Asset Recovery Branches (ARBs) under reporting of the departments.
- Verify the consistency in income recognition process as regards order of recovery and whether the same is in sync with the internal policy of the bank and is appropriately disclosed in notes on accounts.
- Verify whether income recognition is in compliance with extant RBI guidelines related to income recognition.
- Verify whether the non-performing accounts upgraded during the period under audit are upgraded in compliance with the extant RBI guidelines in this regard.

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- Verify whether the income is recognised against recovery especially through NBAs and SRs only to the extent of cash realisation and not to the extent of fair market value of NBAs / SRs as the same is yet to be realised.
- Review and verify as regards the possibility of the deterioration in the value of NBAs and / or requirement of provision for diminishing in the value of NBAs and the policy of the bank in this regard and the disclosure of the same in notes on accounts.
- Verify the accounts upgraded (from NPA to PA) during the period under audit with thrust on the source of funds and the compliance of upgradation norms as per the extant RBI guidelines.
- Verify the compliance with Insolvency and Bankruptcy Code w.r.t. the accounts under recovery under IBC mechanism.

Reporting / Conclusion

12.04 Check whether the appropriate disclosure of policy related to recovery especially in terms of order of recovery and NBAs / SRs is made in the 'notes on accounts'.

12.05 Based on adverse audit observations, appropriate reporting is to be ensured in LFAR and / or Audit Report.

Risk Management Department

13.01 Risk management is a key function in a Bank. Banks face various risks in their conduct of business. The Basel framework on capital adequacy ratio mandates banks to maintain minimum capital as per its risk weighted assets. Risk calculation is a key Banking activity. Some risks which the Bank faces are:

- 1) Operational risk
- 2) Credit risk
- 3) Liquidity risk
- 4) Market risk
- 5) Investment risk
- 6) Interest rate risk
- 7) Legal risk
- 8) Regulatory risk
- 9) Reputational risk
- 10) Financial risk
- 11) Money laundering risk
- 12) Technology risk
- 13) Product risk
- 14) Concentration risk
- 15) Country Risk

13.02 Banks have a risk department which is responsible for framing a risk policy. The risk policy contains detailed risk guidance on:

- 1) Risk identification – various risk scenarios, existing or emerging to which the bank could be exposed on an end to end activity, sub-activity basis.
- 2) Risk assessment – classification of identified risks based on their probability or likelihood and significance or impact into high, medium or low. The methodology for risk classification has to be objectively quantified. Alternate risks can also be classified into risk types.

- 3) Risk evaluation – mapping assessed risks based on current controls designed and in place to mitigate / remediate the risks. Evaluation of risk should also factor the impact on account of pandemic, floods and other natural calamities and Policy changes.

Sector wise risk of the advances portfolio based on the last five years average especially on the agriculture / priority / educational loan.

- 4) Risk monitoring – periodically reviewing the evaluated risks based on operating effectiveness of the controls to actually identify the status of residual risks or gaps. The Auditor is expected to ensure that controls are automated and pro-active. Reactive and manual controls should be pointed out for upgradation or stringent maker -checker.
- 5) Risk response – post risk evaluation, noting whether overall risks are within the risk appetite and transaction wise within defined risk tolerances. If risks are beyond the risk appetite, ensuring that they are appropriately responded by strengthening controls to minimize impact to below risk tolerance / appetite acceptable levels. Alternatively the bank could decide whether to avoid such transactions or get them insured or budget losses appropriately.
- 6) Risk communication – Banks have to ensure that activities have to be done right from the start. Hence, they need to sensitize their employees and make them risk aware and risk ready by proper training.

13.03 The risk policy of the Bank will have to be comprehensively compiled and periodically updated. Banks have a risk department headed by a Chief Risk Officer whose main responsibility is to ensure adherence to the risk policy in terms of identification, assessment, evaluation, response and communication. Banks have a risk review committee where key existing and emerging risks are discussed brainstormed from control perspective.

13.04 The Risk department is generally centralized with various decentralized support functionaries located zone, region or cluster wise as the case may be. The key aspect is that risk is treated as close to the scene of origination especially credit and money laundering risk.

13.05 The Auditor has to primarily ensure that the bank has a formal risk structure in place with a formally approved comprehensive risk policy. The Auditor should ensure that the Bank is in adherence to the policy. Deviations to the policy should have been duly monitored and captured for action.

13.06 The RBI *vide* its circulars have mandated risk based audit in banks. The Auditor should focus on high risk areas. Audit plan should be based on due risk

classification and audit time spent should be commensurate with the risk involved. The Auditor should ensure that there is a risk-based audit structure formally in place.

13.07 Calculation of Capital to Risk-weighted Assets (CRAR) Ratio and continuously monitoring the same to ensure that it is within the minimum regulatory requirement, is also a vital function of Risk Management Department.

Important points in relation to CRAR that should be noted are:

- 1) Banks are required to maintain a minimum Capital to Risk-weighted Assets Ratio (CRAR) of 9% on an on-going basis. In addition to this, outside the period of stress, banks are also required to maintain Capital Conversion Buffer (Comprised of Common Equity) at 2.50% of RWAs.
- 2) Credit Risk, Market Risk and Operational Risk together determine the amount of minimum eligible capital to be maintained by the bank as per the regulatory requirements.

$$\text{Total Capital (CRAR) (\%)} = \frac{\text{Eligible Total Capital}}{\text{Credit Risk RWA} + \text{Market Risk RWA} + \text{Operational Risk RWA}}$$

- 3) Minimum total capital (MTC) of 9% of total risk weighted assets (RWAs) is further divided into different components.

Sr. No.	Regulatory Capital	As % to RWAs
(i)	Minimum Common Equity Tier 1 Ratio	5.50%
(ii)	Capital Conservation Buffer	2.50%
(iii)	Minimum Common Equity Tier 1 Ratio plus Capital Conservation Buffer [(i)+(ii)]	8.00%
(iv)	Additional Tier 1 Capital	1.50%
(v)	Minimum Tier 1 Capital Ratio [(i) +(iv)]	7.00%
(vi)	Tier 2 Capital	2.00%
(vii)	Minimum Total Capital Ratio (MTC) [(v)+(vi)]	9.00%
(viii)	Minimum Total Capital Ratio plus Capital Conservation Buffer [(vii)+(ii)]	11.50%

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- 4) The Auditor should ensure that calculation of RWAs for each type of risks i.e. credit, market & operational has been done as per the detailed methodologies contained in the RBI Master Circular No. DBR.No.BP.BC.1/21.06.201/2015-16 dated 01st July, 2015 on Basel III Capital Regulations.
 - 5) Further, for the calculation of RWAs for credit risk, the auditor should ensure that for all the entities with unhedged foreign currency exposures and having ratio of likely loss/EBID(%) in excess of 75%, there is 25% increase in the risk weight as a part of Incremental capital requirement.
 - 6) For the calculation of RWAs for credit risk, the ratings assigned by the eligible external credit rating agencies (wherever available) are largely used while assigning risk weights for capital adequacy purposes. Accordingly, the auditor has to ensure that the latest external credit rating has been updated and used for this purpose.
 - 7) For the calculation of Market Risk also external credit ratings are used to determine the risk weight (%). Along with this, applicable RW (%) varies based on the residual maturity of the investment. Thus, the auditor has to ensure that for each investment correct external rating & residual maturity has been taken.
 - 8) Banks generally have investment in other bank's capital instruments such as bonds, equity shares etc. Risk weight (%) in these cases is based on the level of common equity Tier 1 capital (CET1) including applicable capital conservation buffer (CCB) (%) of the investee bank. In these cases, the auditor shall ensure that the level of CET1 & CCB has been taken as per reported in the latest quarterly results of the investee bank.
- 13.08 In addition to the above the Auditor has to verify that:
- 1) The bank has a formally defined risk appetite and risk tolerance levels are fixed transaction wise.
 - 2) Risk identification based on what can go wrong on an end to end activity wise basis is conducted considering the organization structure, functions and responsibilities. The bank should be maintaining a risk register for the same.
 - 3) Risk identification is an ongoing, periodic activity.
 - 4) Risk assessment or classification of risks into risk types or high-medium-low is comprehensively done.

- 5) Existing controls are mapped to risks.
- 6) Trainings on risk awareness is conducted amongst employees.
- 7) Gaps which are beyond risk appetite / risk tolerance are addressed. Timelines and the manner of addressal along with risk owner are identified. Open risk items should be duly tracked. Proper escalation mechanisms should be in place to highlight open items.
- 8) Risk policy is periodically updated and reviewed.
- 9) Minutes of Risk Committee Meetings are duly recorded on a timely manner.
- 10) Effectiveness of IT system/IT infrastructure including Management Information Systems.

13.09 Any risk deviations noted are to be appropriately discussed with the management or appropriate risk committee members and duly reported in the Long Form Audit Report as the case may be.

Frauds

13.10 While the primary responsibility for preventing frauds lies with banks themselves, the Reserve Bank of India (RBI) has been advising banks from time to time about the major fraud prone areas and the safeguards necessary for prevention of frauds. Banks are required to introduce necessary safeguards / preventive measures by way of appropriate procedures and internal checks so as to prevent/minimize occurrence of frauds and resultant financial loss to the banks.

13.11 The CEOs of the banks are supposed to provide singular focus on the "Fraud Prevention and Management Function" to enable, among others, effective investigation in fraud cases and prompt as well as accurate reporting of fraud cases to the appropriate regulatory and law enforcement authorities including RBI. Banks are required to frame their internal policy for fraud risk management and fraud investigation function with the approval of their respective Boards. The Auditor should refer SA 240, "The Auditor's Responsibilities relating to Fraud in an Audit of Financial Statements" in this regard.

Classification

13.12 Frauds are classified, mainly on the basis of the provisions of Indian Penal Code (IPC), as under:-

- a) Misappropriation and criminal breach of trust.

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- b) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
- c) Unauthorized credit facilities extended for reward or for illegal gratification.
- d) Cash shortages.
- e) Cheating and forgery.
- f) Fraudulent transactions involving foreign exchange
- g) Any other type of fraud not coming under the specific heads as above.

13.13 As regards cases under (d) and (f) above cash shortages resulting from negligence and fraudulent forex transactions involving irregularities / violation of regulations have also to be reported as fraud if the intention to cheat/defraud is suspected or proved.

13.14 Cases will be deemed to be fraud and reported in the following circumstances:

- a) Cases of cash shortage more than Rs. 10,000/-.
- b) Cases of cash shortage more than Rs. 5,000/- if detected by management / auditor/ inspecting officer and not reported on the day of occurrence by the persons handling cash.

Other points to be considered while reporting fraud are:

- a) Frauds involving forged instruments have to be reported only by the paying banker whereas collection of a genuine instrument fraudulently by a person who is not the true owner, the collecting bank, which is defrauded, will have to file fraud report with the RBI.
- b) Collection of an instrument where the amount has been credited before realization and subsequently the instrument is found to be fake/ forged and returned by the paying bank, the collecting bank is required to report the transaction as fraud with the RBI as they are at loss by parting the amount.
- c) Collection of an altered/fake cheque involving two or more branches of the same bank, the branch where the altered/fake cheque has been encashed is required to report the fraud to its H.O. for further reporting to RBI by the H.O.
- d) An altered/fake cheque having been paid/ encashed involving two or more branches of a bank under Core Banking Solution (CBS), the branch which released the payment is required to report the fraud to its H.O. for further reporting to RBI.

- e) Cases of theft, burglary, dacoity and robbery are not treated as fraud but are required to be reported separately to the Reserve Bank of India.
- f) Banks (other than foreign banks) having overseas branches/offices are required to report all frauds perpetrated at such branches/offices to RBI.

Reporting

Reporting of Frauds to RBI (FMR)

13.15 All frauds irrespective of the amount

- Fraud including in the subsidiaries and affiliates/joint ventures of the Banks perpetrated through those in misrepresentation, breach of trust, manipulation of books of account, fraudulent encashment of instruments like cheques, drafts and bills of exchange, unauthorised handling of securities charged to the bank, misfeasance, embezzlement, misappropriation of funds, conversion of property, cheating, shortages, irregularities, etc.
 - Cases under criminal proceedings initiated by central investigating agencies *suo moto* and/or where RBI has directed to treat the acts as frauds.
 - In all frauds irrespective of the amount, banks are required to send soft copy of the reports (FMR/B) to be reported through FMR application in XBRL system supplied to them within three weeks from the date of detection of fraud.
 - A monthly certificate, in prescribed format to be submitted by bank to CFMC, Bengaluru with a copy to the respective SSM of the bank within 7 days from the end of the month.
 - Banks are also required to furnish a Flash Report(FR) for frauds involving amounts of Rs.50 million and above within a week of such fraud being noticed.
 - Any further developments in fraud cases are to be reported through FMR update application in XBRL system.
- a) Frauds committed by unscrupulous borrowers.** Such frauds include:-
- Fraudulent discount of instruments or kite flying in clearing effects.
 - Fraudulent removal of pledged stocks/disposing of hypothecated stocks without the bank's knowledge/inflating the value of stocks in the stock statements and drawing excess bank finance.
 - Diversion of funds outside the borrowing units, lack of interest or criminal neglect on the part of borrowers, their partners, etc. leading to the unit becoming sick as also due to laxity in effective monitoring / supervision over

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the operations in borrowal accounts on the part of the bank functionaries rendering the advance difficult to recover.

- Banks are supposed to exercise due diligence while appraising the credit needs of all borrowers, borrower companies, partnership/ proprietorship concerns and their directors, partners and proprietors, etc. as also their associates who have defrauded the banks. Banks should ensure appraisal of credit proposal considering the genuine requirements of the working capital based upon the turnover achieved / turnover projected. Besides the borrower fraudsters, other third parties such as builders, vehicle/tractor dealers, warehouse/cold storage owners, etc. and professionals are also to be held accountable if they have played a vital role in credit sanction/disbursement or facilitated the perpetration of frauds. Banks are required to report to Indian Banks Association (IBA) the details of such third parties involved in frauds.

Most of the frauds in advances are perpetrated by the borrowers mainly due to the slackness in monitoring and control of borrower accounts.

b) Frauds in borrowal accounts having multiple banking arrangements (MBA)

- All banks under MBA arrangement are required to evolve a system of exchanging information on fraud committed by the borrower so as to take appropriate action including criminal action against the borrower.
- Banks are required to evolve an operating framework for tracking frauds and dealing with them.
- It is not necessary that the fraud may take place in all the banks which are the members of the consortium. However the information should be shared with the members of the consortium when the fraud takes place in one bank.
- The time taken to report the fraud also needs to be monitored.
- CRILC reported accounts can be checked regularly for its classification with other banks

Provisioning Pertaining to Fraud Accounts

13.16 Banks are required to prescribe a uniform provisioning norm in respect of all cases of fraud, as under:

- (a) The entire amount due to the bank (irrespective of the quantum of security held against such assets), or for which the bank is liable (including in case of deposit accounts), is to be provided for 100% or over a period not exceeding

four quarters commencing with the quarter in which the fraud has been detected;

- (b) However, where there has been delay, beyond the prescribed period, in reporting the fraud to the Reserve Bank, the entire provisioning is required to be made at once. In addition, the Reserve Bank of India may also initiate appropriate supervisory action where there has been a delay by the bank in reporting a fraud, or provisioning against therein.

Closure of fraud cases

13.17 Banks shall report to CFMC, RBI and the SSM (Senior Supervisory Manager) of RBI, the details of fraud cases of ₹0.1 million and above closed along with reasons for the closure after completing the process as given below.

13.18 Banks should close only such cases where the actions as stated below are complete and prior approval is obtained from the SSM:

- a) Case pending with CBI/Police/Court have been finally disposed off
- b) Staff accountability has been examined/ completed
- c) The amount involved in the fraud has been recovered or written off
- d) Insurance claim wherever applicable has been settled
- e) Bank has reviewed the systems and procedures and taken steps to avoid recurrence;
- f) Banks should also pursue vigorously with CBI for final disposal of pending fraud cases especially where the banks have completed staff side action, etc.

Reports to the Board

Reporting of fraud

13.19 Banks need to ensure that all frauds of Rs. 1.00 lakh and above are reported to their Boards promptly on their detection. Such reports should, among others, contain the failure on the part of the concerned branch officials and controlling authorities and consider initiation of appropriate action against the officials responsible for the fraud.

Information relating to frauds for each quarter end are to be placed before the Audit Committee of the Board of Directors. Further report on individual cases of attempted fraud involving an amount of Rs. 10 million and above is to be placed before the Audit Committee of its Board.

Quarterly Review of Frauds

13.20 Information relating to frauds are to be placed before the Audit Committee of the Board of Directors on quarterly basis ending March, June and September with statistical analysis. The Auditor is supposed to read the minutes of all such meetings and ensure the appropriate accounting and disclosure in the financial statements.

13.21 Banks are required to constitute a Special Committee consisting of CMD of public sector banks and MD in respect of SBI/its associates for monitoring and follow up of cases of frauds involving amounts of Rs. 1.00 crore and above exclusively. The main function of the committee would be to monitor and review all the frauds of Rs. 1.00 crore and above and to put in place, among others, measures as may be considered to prevent recurrence of frauds such as strengthening of internal controls etc.

Annual Review of Frauds

13.22 Banks are required to conduct an annual review of the frauds and place a note before the Board of Directors/Local Advisory Board for information. The review would take into account, among others, whether the systems in the bank are adequate to detect frauds once they have taken place within the shortest possible time.

Early Warning Signals (EWS) and Red Flagged Accounts (RFA)

13.23 A "Red Flagged Account" (RFA) is one where a suspicion of fraudulent activity is thrown up by the presence of one or more Early Warning Signals (EWS).

The threshold for EWS and RFA is an exposure of Rs. 50 crores or more at the level of a bank irrespective of the lending arrangement (whether solo banking, multiple banking or consortium). All accounts beyond Rs. 50 crores classified as RFA or 'Frauds' must also be reported on the CRILC data platform together with the dates on which the accounts were classified as such.

The FMG or any such designated committee shall classify the account as RFA and the details of RFA accounts shall be put up to the CMD/CEO every month.

In cases where the bank is the sole lender, the FMG will take a call on whether an account in which EWS are observed should be classified as RFA or not. This exercise should be completed as soon as possible and in any case within a month of the EWS being noticed. Further within a period of 6 months, banks should either lift the RFA status or classify the account as a fraud.

In case of multiple banking/consortium the overall time allowed for the entire exercise to be completed is six months from the date when the first member bank reported the account as RFA or Fraud on the CRILC platform.

Guidelines for Reporting Frauds to Police/CBI

13.24 While reporting the frauds, banks are required to ensure that, besides the necessity of recovering the amount expeditiously, the guilty persons do not go unpunished.

Private Sector Banks/Foreign banks (operating in India)

13.25 All Cases are required to be referred to State Police including:

- a) Cases of fraud involving an amount of Rs. 1.00 lakh and above committed by outsiders on their own and/or with the connivance of bank staff/officers.
- b) Cases of fraud involving amount exceeding Rs. 10,000/-committed by bank employees.
- c) Fraud cases involving amounts of Rs. 1.00 crore and above should also be reported to the Serious Fraud Investigation Office (SFIO), GOI, in FMR-format.

Public Sector Banks

13.26 Cases to be referred to CBI

- a) Cases of fraud involving amount of Rs. 3.00 crore and above upto Rs. 25 crore:
 - Where staff involvement is prima facie evident - CBI (Anti Corruption Branch).
 - Where staff involvement is prima facie not evident- CBI (Economic Offences Wing).
- b) All cases involving amount more than Rs. 25 crore but less than Rs. 50 crores - Banking Security and Fraud Cell (BSFC) of CBI,
- c) All cases involving amount more than Rs. 50 crores-Joint Director(Policy) CBI, HQ, New Delhi

13.27 Cases to be referred to Local Police

Fraud involving Rs. 1.00 Lakh and above but less than Rs. 3 Cores	Compliant to be filed with Regional Head of the bank to State CID/Economic Offences Wing of State concerned
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Below Rs. 1.00 Lakh but above Rs. 10,000/- (if committed by staff)	Local Police Station by the branch
Below Rs. 10,000/- involving bank officials	Reported to Regional Head of the bank to decide on further course of action.
Frauds involving forged instruments	By paying banker to Local Police
Fraudulent encashment of DD/TTs/Pay orders/ Cheques/ DWs, etc.	Local Police concerned
Collection of genuine instrument, but collected frequently by a person who is not the owner	Collecting bank to Local Police concerned
Payment of uncleared instrument which is found to be fake/forged and returned by the paying bank	Collecting Bank to Local Police
Collection/payment of altered/fake cheque involving 2 or more branches of the same bank	Branch where the cheque was encashed to the Local Police

Reporting of Cases of Theft, Burglary, Dacoity and Bank Robberies

13.28 In respect of cases of theft, burglary, needs to be done: and bank robberies the following:

- Occurrence of any bank robberies, dacoities, thefts and burglaries are required to be reported immediately by Fax/e-mail to
 - a) CFMC, Bengaluru
 - b) The SSM of the bank.
 - c) RO of DBS under whose jurisdiction the affected bank branch is located to enable the Regional Office to take up the issues regarding security arrangements in affected branch/es during the State Level Security Meetings with the concerned authorities.
 - d) The Security Adviser, Central Security Cell, Reserve Bank of India, Central Office Building, Mumbai - 400 001.
 - e) Ministry of Finance, Department of Financial Services Government of India, Jeevan Deep, Parliament Street, New Delhi-110 001.

- Banks are also required to submit a quarterly return to RBI electronically using the XBRL system within 15 days of the end of the quarter it relates.

13.29 The Auditor has to check the above and confirm whether the bank has complied with the above provisions.

Audit Methodology

13.30 The Auditor has to verify

- 1) That there is a fraud policy in place which is reviewed and updated at periodic intervals. This Fraud policy has been circulated on the bank Intranet and employees are sensitized of the fraud policy.
- 2) Periodic anti-fraud training and awareness sessions are in place.
- 3) Whistle Blower hotlines are in place.
- 4) Fraud risk scenarios are identified and current anti- fraud controls noted and mapped to fraud risks. Measures are put in place to prevent significant gaps.
- 5) The bank's zero tolerance policy for fraud or ethical violations are made known to all employees.
- 6) Swift dismissal / termination of employees found guilty of fraud is in place.
- 7) There are automated systems / surveillance systems to detect fraud and alerts.
- 8) Mechanisms of early detection and reporting of fraud incidents are in place.
- 9) Back ground screening checks for employee joining are in place.
- 10) There are periodic anti-fraud communications and care taken to prevent frauds / money laundering.
- 11) Auditor to examine the robustness of anti-fraud controls and staff accountability.
- 12) Reporting mechanisms to RBI are effectively in place.
- 13) Fraud is clearly identified. Policies for reporting on fund diversions, siphoning of funds and wilful defaults are in place.
- 14) Auditors should examine Action Taken Report (ATR) in respect of all red flagged accounts / fraud accounts.

If the Auditor notes adverse issues, the same have to be discussed at appropriate levels of the management. Necessary reporting will have to be done in the long form audit report or the main audit reports as the case may be.

Risk weights on advances accounts for which Documentation & Sanction has been completed but not opened in CBS

13.31 Risk weights on advances accounts not opened in CBS but for which sanction and documentation had been completed also forms part of risk weighted assets. Credit conversion factor of 50% is to be applied on term loans while 20% is to be provided for others. Risk weights on this are to be applied considering the rating of each borrower. These accounts do not form part of total exposure for purpose of risk evaluation as these are not opened in CBS but have the potential of adversely affecting the business as the documentation has been completed and the exposure is exercisable at the option of the borrower.

13.32 As per RBI instructions vide DBR.No.BP.BC.17/21.06.001/2019-20 consumer credit, including personal loans and credit card receivables but excluding educational loans, attracts a higher risk weight of 125 per cent or higher, if warranted by the external rating of the counterparty. The risk weight for consumer credit, including personal loans, excluding credit card receivables, is to 100%.

13.33 As per RBI instructions vide DoR.BP.BC.No.76/21.06.201/2019-20 in respect of National Credit Guarantee Trustee Company (NCGTC) the captioned scheme announced by the Government of India to extend guaranteed emergency credit line to MSME borrowers the Member Lending Institutions shall assign zero percent risk weight on the credit facilities extended under this scheme to the extent of guarantee coverage.

Vigilance

13.34 The Chief Vigilance Officers in the banks have been authorised to decide upon the existence of a vigilance angle in a particular case, at the time of registration of the complaint. Once a complaint has been registered as a vigilance case, it will have to be treated as such till its conclusion, irrespective of the outcome of the investigation.

13.35 Key functions of the Vigilance Department include the following:

- Handling of complaints received from various quarters, examining the matter from vigilance angle and advising competent authority to take suitable disciplinary action.
- Determination/examining of existence of vigilance angle based on the findings/lapses indicated in investigation reports, inspection reports, Special Reports, fraud reports, accountability reports on advances which have slipped to NPA, etc., and communicating the same to disciplinary authorities, through HR Wing, for further action as per procedure.

- Seeking advice of Central Vigilance Commission (CVC) as per the norms in respect of vigilance cases involving officials who come under the jurisdiction of CVC and communicating the advice to disciplinary authorities for further action.
- Conducting intensive examination of works/purchase contracts as per norms and ensuring implementation of CVC guidelines on tender procedures in the Bank.
- Finalising agreed list with CBI and preparation of list of Officers of Doubtful Integrity (ODI), and ensuring surveillance on such officials whose names appear in agreed list/ODI. Co-ordinating with CBI on all matters of vigilance investigations referred to them by the bank and providing assistance to CBI.
- Scrutiny of staff accountability reports in case of advances of large value.
- Ensuring implementation of guidelines of CVC, RBI and the Ministry in matters relating to Vigilance.
- Submitting board notes/ review notes to the Board of Directors, Committee of Directors, Audit Committee and Chairman and Managing Director in respect of vigilance matters and also various returns to CVC, RBI, CBI and Ministry.

13.36 Generally, vigilance angle could be perceptible in cases characterised by:

- (i) commission of criminal offences like demand and acceptance of illegal gratification, possession of disproportionate assets, forgery, cheating, abuse of official position with a view to obtaining pecuniary advantage for self or for any other person; or
- (ii) irregularities reflecting adversely on the integrity of the public servant; or
- (iii) lapses involving any of the following:
 - (a) gross or wilful negligence;
 - (b) recklessness;
 - (c) failure to report to competent authorities, exercise of discretion without or in excess of powers/jurisdiction;
 - (d) cause of undue loss or a concomitant gain to an individual or a set of individuals/a party or parties; and
 - (e) flagrant violation of systems and procedures.

13.37 In banking institutions risk-taking forms an integral part of business. Once a vigilance angle is evident, it becomes necessary to determine through an impartial investigation as to what went wrong and who is accountable for the same.

13.38 Information about corruption, malpractices or misconduct on the part of public servants may come to the CVO's notice through various sources, such as:

- (i) the complaints received from the public, or through the administrative Ministry, CBI and the CVC;
- (ii) departmental inspection reports and stock verification surveys;
- (iii) scrutiny of property returns and the transactions reported by the concerned employee under the Conduct Rules;
- (iv) audit reports;
- (v) press reports;
- (vi) reports of parliamentary committees etc. Information received verbally should be reduced to writing and dealt with similarly.

13.39 The vigilance department acts upon all such kind of complaints and conducts a detailed investigation. Periodic meetings are held with the respective committees and cases are discussed with the top Management of the Bank. The SCA is expected to read the minutes of the meetings and understand the complaints and the actions taken upon them by the CVC/vigilance department. The details of the individual cases should be ascertained and the same can be discussed with the CVO and his department by the SCA. It is essential that the SCA arrives at a proper judgement over the cases and concludes its proper accounting/ disclosure in the financial statements.

Risk management limits and monitoring

13.40 Risk is a function of probability and impact. Risk management is an important function in banks. Banks have a separate risk management department and a committee. The department is responsible for identifying key risks, assessing, evaluating, monitoring and responding to risks. The risk committee ensures that the risk oversight is adequate and effective. Design of automated Controls and its effective and efficient implementation and execution to pro-actively remediate and mitigate the risks is monitored on an ongoing manner.

13.41 One of the key aspects in risk monitoring is setting up limits and ensuring that these are not breached. These are tolerance levels within which the activities have to be conducted. Limits ensure control. Any breach in the

limits needs to be escalated, ratified and approved at appropriate levels. The limits are duly framed in respective policies and reviewed from time to time. Some limits are framed by the RBI itself while some limits are set up by Banks internally.

13.42 Limits are also in place for reporting purposes as transactions over a particular threshold need to be reported to either RBI, FIU, Income Tax authorities.

13.43 Banks have limits in place for various activities namely:

- 1) Advances – Single Borrower and Group Borrower exposure details – Priority Sector lending – Unsecured Advances – Minimum Provisioning – conduct of stock audits – obtaining end use and other certifications – obtaining second valuations.

Recovery of NPA advances is a major area for concentration and action. This requires constant follow up with legal and other support for expeditious settlement. Auction of the properties offered as security is to be attempted more vigorously.

- 2) Investments – Held to maturity securities / available for sale securities / non SLR securities – creation of investment fluctuation / depreciation reserve / investments made in government securities / venture capital fund.
- 3) Borrowing limits.
- 4) Transfers to statutory and other mandatory reserves.
- 5) Cash reserve ratio – Statutory liquidity ratio limits.
- 6) Overseas foreign currency borrowing limits including overdrafts in Nostro accounts adjusted in 5 days.
- 7) Limits under various AP-DIR circulars - Reporting in XOS- BEF statements.
- 8) Treasury – Open limits, aggregate gap limits, individual gap limits, counterparty limits, settlement limits, and currency limits.
- 9) Country risk only in respect of country where a bank net funded exposure is 1% or more of its total assets, the bank is required to formulate the CRM policy for dealing with that country risk problem.
- 10) Obtaining PAN for cash transactions over a determined threshold.
- 11) Remittances under liberalized remittance scheme (LRS).
- 12) Legal audit and verification of title deeds for loans over Rs. 5 Crores – conducting due diligence reporting.
- 13) RTGS transactions – Minimum amount should be over Rs. 2 lakhs.

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- 14) NEFT transactions have no limits. Earlier Banks had certain time restrictions but now RBI has instructed that these facilities be available 24 hours.
- 15) Parameters are in place for automated transaction monitoring and breach of these limits throws system alerts which are white washed or validated. Exceptions are reported in the Suspicious Transactions Report. Banks also have to report transactions in Cash transaction reports, Cross Border Wire Transfer Report, Counterfeit Currency reports, Non-Profit organization transaction reports.
- 16) Banks also have internal monitoring thresholds and any breach of these parameters is reported as exceptional transactions in Exception Reports which are generated and monitored daily.
- 17) Cash retention limits - Limits on amount of cash withdrawals at other than home branch with / without charges – Cash deposits other than home branches – ATM amount withdrawn per day.
- 18) Reporting under FATCA- CRS.
- 19) Limits for fraud reporting.
- 20) Annual information reporting.
- 21) Reporting to credit information companies.
- 22) Reporting to Central Repository of Information on Large Credits.

13.44 This list is not exhaustive and the auditor should look into various RBI – FEMA - CBDT Circulars / bank's internal policies for the list of limits to be monitored and reported.

13.45 The Auditor should primarily obtain a listing of all limits which the Bank is monitoring for internal control purposes or reporting purposes authority wise.

13.46 In the absence of such a list, the Auditor will have to primarily report the non- existence of such a list as an issue.

13.47 The Auditor should examine the process for compilation of this list and how these limits are monitored. An automated system should ideally be in place. Where the monitoring is done manually, stringent maker checker process controls should be in place which should operate effectively and efficiently at all times.

13.48 Deviations or discrepancies noted should be reported appropriately in the Long Form Audit Report or duly qualified in the accounts if necessary, as the case may be.

Central Audit and Inspection Department

Introduction

14.01 Audit Department in Banks is a combination of centralized function with some level of decentralization at the Cluster, Regional or Zonal level. The structure may vary from Bank to Bank. Banks have an audit manual, Audit policy or audit charter. The Audit department is usually headed by a Chief Audit Executive. Designations would vary from Bank to Bank. The primary function is to ensure that the audit function is handled smoothly, effectively & efficiently.

14.02 The functions are as under:

- 1) Scoping the audit – deciding who does what, how and when – maintaining an audit calendar – ensuring that the audit calendar is maintained as scheduled.
- 2) Ensuring that the statistical information and other inspection and audit related agenda of Audit Committee are properly framed. Minutes of the audit committee should record the proceeding details correctly.
- 3) Ensuring that the audit follows a risk based approach in accordance with RBI guidelines. Audit issues need to be approached from the angle of lack of control and supervision / fraud / potential weakness in the accounts / sector / system.
- 4) Closure of open audit issues. Tracking audit issues for closure.
- 5) Placing audit reports before the Audit committee/ Management Committees, as the case may be. Ensuring actions suggested by the audit committee are duly followed and closed.
- 6) Identification of branches to be subjected to concurrent/ revenue audit.
- 7) Undertake Risk-Based Internal Audit (RBIA) as per the framework as stipulated by Reserve Bank of India.
- 8) Appointment of concurrent auditors, deciding their scope, meeting the concurrent auditors, discussing their issues, conducting trainings if needed, and review of work of concurrent auditors. Ensuring that RBI guidelines on concurrent audit are adhered.

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- 9) Closely interacting with other departments like risk, compliance etc., to ensure these functions are effectively performing their duties.
- 10) Following up closures of stock audit issues.
- 11) Conducting some audits internally – Branch audits, functional audits like human resources, information technology, review of risks and compliance functions for effectiveness and efficiency, MIS reviews etc.
- 12) Conducting application audit of new software applications (Developed in house or vendor procured), updated versions of existing application software, modules, patches, programs before its release/implementation by using web-based Application Audit Package on the specific requests received by the concerned functional groups and follow up for closure of these audit reports.
- 13) Ensuring that the internal audit team is well equipped and trained and is kept abreast of circulars and regulatory directions as issued by the regulators from time to time.
- 14) Co-ordinating with RBI inspectors or statutory auditors whenever needed.
- 15) Ensuring that the audit function is automated and adopts the latest techniques and procedures.
- 16) Re-risk rating of branches, whenever a fraud is reported in between two RBIAAs.
- 17) Co-ordinating with the department dealing with frauds for de-risking.
- 18) Laying down parameters for risk-based audit. Deciding risk classification in co-ordination with Risk / Business department.
- 19) To attend to work relating to transfer, promotion, deputation and disciplinary matters of Inspecting Officers.
- 20) Laying internal metrics for evaluating efficiency and effectiveness of audit function and getting it validated externally – internally.
- 21) Close co-ordination with the Chairman of Audit Committee or similar functionary for ensuring effective audit oversight.
- 22) Ensuring that other audits like revenue audits, legal audits, information security audits, cyber security audits are duly conducted and the process gaps noted therein are resolved.
- 23) Ensuring that the audit policy, audit manual or audit charter is duly reviewed on an annual basis.

14.03 Audit function, over the years, has moved from the traditional transaction verification to the process driven risk-based audit. The focus is on doing things right from start. The key is to ensure that there are no gaps and gaps if any are closed within acceptable time frames. The Auditor should examine the system of concurrent / internal audit along with follow-up / compliance / remedial corrective action taken related thereto, with reference to the bank's internal policy related thereto.

Audit approach

14.04 The Statutory Central Auditor should ensure that the audit function is effectively discharging its duties and functions enumerated above. He needs to co-ordinate with the audit head and validate the audit process. The validation could be done by a combination of transaction and system-process checks. It is the statutory auditor who is validating the internal audit function for efficiency and effectiveness. Any shortcomings or gaps noted have to be effectively escalated to the audit committee and reported appropriately in the LFAR.

14.05 The Statutory Central Auditor may review the criteria set by the department for selection of branches for the purpose of concurrent / internal / audit. The Auditor shall ensure that selection of branches for the purpose of audit is done objectively and no branch that ought to have been covered (owing to its level of operation) under audit has been missed.

14.06 In addition to this, the Auditor shall ensure that special function wings/units such as Forex Department, Treasury Department, Fixed Asset Department etc. are also covered under the scope of Internal Audit with adequate attention being given in terms of factoring in the eligibility and qualification of the person carrying internal audit of these specialised branches.

14.07 The scope of Concurrent / internal audit reports is to be understood in detail to check whether there is any area that needs the attention of the auditor that has not been covered within the scope of the audit.

14.08 The statutory auditor will also go through the reports of Concurrent Auditors of key branches/ functions. He will also have to scrutinize the system audit reports, revenue audit reports, stock audit reports, internal inspection reports. The scope, frequency and quality will have to be looked into in depth and commented. The Auditor should review as to whether the short comings / adverse remarks by the stock auditor have been duly and promptly attended to and corrective measures have been taken.

14.09 The statutory auditor also goes through the RBI Inspection reports. These are sensitive, confidential reports for internal consumption and the Auditor should ensure these findings are noted for adherence. Such inspection reports

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provide various information on the control and management of the bank in addition to divergence in provisions made by the bank *vis-à-vis* provision required as per IRAC norms.

14.10 The focus is on systems, processes and a root cause analysis to find out what went wrong and what could be done that the error does not recur again.

14.11 The statutory auditor could attend audit committee meetings to get real-time grasp of how the meetings are held, issues discussed and resolved.

14.12 The SCA should review the scope of work assigned in the reporting format for the concurrent audit of branches and other departments at HO and to ensure that there is adequate coverage of the working of the branch / related department, if not than may be reported in Long Form Audit Report of the bank and may discuss with the respective department in the Head office and / or major observation with the Audit Committee.

14.13 The SCA should also go through the minutes of the Board and Management Committee meetings to understand and appreciate the policies of the bank and other information including credit sanction.

Credit Monitoring and Restructuring Department

Introduction

15.01 Credit Monitoring & Restructuring department (CMRD), as the name suggests is a credit monitoring hub of the entire bank. Like many other departments at HO, CMRD too does not carry any financial activity. The sanctioning and operations of credit takes place with the respective branches and designated departments.

15.02 This department is expected to keep close watch over the health of the credit portfolio and to ensure that funds lent are safe and bring returns and the lending is done as per internal policy guidelines and RBI guidelines.

15.03 In every bank monitoring policy is framed to equip the field functionaries with effective tools of monitoring so that various risks associated with the lending are identified and remedial measures initiated well in time so as to maintain quality asset.

15.04 The monitoring policy at the holistic level is an embodiment of the Bank's approach at making the systems and controls more effective so that credit risks are managed in a systematic and effective manner.

15.05 The monitoring policy is reviewed every year keeping in view inputs received from Branches/ROs/ZOs, experience gained and to update the regulatory requirements.

15.06 The CMRD also monitors the special mention accounts (SMA 1 & 2) above a certain limit. The overdue statements generated by the bank are closely monitored and necessarily followed up to the concerned department/ Branch or officer is done through this department.

15.07 Further in some banks, this department may be responsible for sanctioning of restructuring of advances. During the last few years in order to give relief to MSMEs RBI has introduced restructuring schemes for stressed MSMEs without a downgrade in asset classification and hence large number of MSME accounts were given the benefit of these schemes and restructured. Further, this department may also be responsible for calculation of the additional provision required for the restructured portfolio and sacrifice calculations.

Audit Approach

15.08 It may be observed that all the activities of the department are in the nature of controlling and compliance. This department is also responsible for implementation of the bank's policies w.r.t monitoring and restructuring. It is necessary that the Auditor familiarises himself with the functions of the department and draws up the audit plan accordingly.

Credit Monitoring

15.09 The CMRD is responsible to monitor the credit portfolio independently and interact with the Zones/ Regions and Branches for the follow up. In particular, this department performs the following functions:

- Closely monitoring the overall overdues statement generated by the bank, particularly overdues above certain limits.
- Review of High risk rated accounts and providing periodic review notes to MD&CEO in respect of accounts under monitoring.
- Review of "Quick Mortality Accounts" and placing review notes before the Board of Directors/Audit Committee.
- Review of statement of expired credit limits and progress report on renewal of credit limits periodically and placing a note before the higher authorities as per extant guidelines.
- Ghosh Committee Recommendation – advances showing sticky tendencies above a certain limit to be monitored.
- Stock Audit report review in respect of accounts under monitoring as a part of monitoring exercise.
- Review of adhoc credit facility not regularized.
- To monitor effective implementation of Credit Audit System in the Bank.

15.10 While undertaking supervision, monitoring and control over the credit portfolio, the auditor may be required to undertake certain tests with a different perspective and keeping in mind the overall materiality. Keeping in view the significance from the regulator's perspective following transactions may be selected for checking at the HO level:

1. Any account in the bank having exposure (funded and non-funded) which is more than Rs. 2000 crores across banking sectors.
2. Accounts against whom NCLT proceedings are initiated either by the bank, or any other financial creditors or the operational creditors.
3. List of SMA accounts having exposure of Rs. 50 crore and above.

4. Red Flagged Accounts refer RBI circular no. DBS.CO.CFMC. BC. No.007/23.04.001/2014-15 dated May 7, 2015 on "Framework for dealing with loan frauds".
5. Cases under vigilance or investigation for fraud. These are typically the ones not reported as fraud and hence not available with Fraud monitoring department.
6. List of upgraded accounts in the branch above Rs. 1 Crore.
7. Checking of Central Repository of Information on Large Credits (CRILC) reported accounts for classification with other banks.
8. Restructured project loans, by way of revision of DCCO beyond the time limits and retention of the 'standard' asset classification.
9. Large exposures on infrastructure and project funding, where there is considerable time lag from the date of sanction / financial closures / implementation to the date of commercial operation, effective / periodic monitoring of such accounts with reference to the progress of work / project implementation / government consents and approvals / capital required to be brought in by the promoter, etc.

It is necessary to keep the following developments in mind while conducting CMRD audit:

Market mechanism for Large Borrowers

15.11 Regarding the market mechanism for large borrowers the Auditor is required to bestow his attention on the following:

- Guidelines issued on August 25, 2016, effective from April 1, 2017.
- Build-up of high concentration of credit risk at the systemic level in the banking sector. While single and group exposure norms put a ceiling on the amount an entity can borrow from a single bank, there is no ceiling on the total bank borrowing by a corporate entity. This has resulted in banks collectively having very large exposures to some of the large corporates in India, particularly in power/ infrastructure, housing finance and steel sectors/ industries. As observed from the analysis, many large corporates are excessively leveraged and banking sector's aggregate exposure towards such companies is also excessively high. This poses a collective concentration risk to the banking sector, even when the single and group borrower exposures for each bank remain well within the prescribed exposure limits.

- Framework mitigates the risk posed to the banking system on account of large aggregate lending by the banking system to a single corporate as the single borrower exposure limit linked to a bank's Tier 1 capital may not by itself be sufficient to contain the risk the banking system is exposed to.

15.12 Key Aspects of this mechanism are discussed hereunder:

- **Aggregate Sanctioned Credit Limit (ASCL)** - The aggregate of the fund based credit limits sanctioned or outstanding, whichever is higher, to a borrower by the banking system. ASCL would also include unlisted privately placed debt with the banking system.
- **Specified Borrower:** A borrower having an ASCL of more than
 - Rs. 25,000 crore at any time during FY 2017-18.
 - Rs. 15,000 crore at any time during FY 2018-19.
 - Rs. 10,000 crore at any time from April 1, 2019 onwards.
- **Reference Date:** The date on which a borrower becomes a 'specified borrower'.
- **Normally permitted lending limit (NPLL):** 50 percent of the incremental funds raised by the specified borrower over and above its ASCL as on the reference date, in the financial years (FYs) succeeding the FY in which the reference date falls. For this purpose, any funds raised by way of equity shall be deemed to be part of the incremental funds raised by the specified borrower (from outside the banking system) in the given year.
- **Prudential Measures for NPLL:** From 2017-18 onwards, incremental exposure of the banking system to a specified borrower beyond NPLL shall be deemed to carry higher risk which shall be recognised by way of additional provisioning and higher risk weights as under:
 - Additional provisions of 3 percentage points over and above the applicable provision on the incremental exposure of the banking system in excess of NPLL, which shall be distributed in proportion to each bank's funded exposure to the specified borrower.
 - Additional Risk weight of 75 percentage points over and above the applicable risk weight for the exposure to the specified borrower. The resultant additional risk weighted exposure, in terms of risk weighted assets (RWA), shall be distributed in proportion to each bank's funded exposure to the specified borrower.

Mandatory Loan System for Delivery of Bank Credit

15.13 The Auditor should note the following:

- Draft Guidelines issued on June 11, 2018. Final Guidelines issued on December 5, 2018.
- Guidelines made effective from April 1, 2019.
- Banks provide working capital finance by way of cash credit/overdraft, working capital demand loan, purchase/discount of bills, bank guarantee, letter of credit, factoring, etc. Cash credit (CC) is by far the most popular mode of working capital financing.
- While CC has its benefits, it also poses several regulatory challenges such as perpetual roll overs, transmission of liquidity management from the borrowers to banks/RBI, hampering of smooth transmission of monetary policy, etc.

Key Aspects of the Draft:

15.14 The salient aspects of the draft guidelines are as under:

- **Minimum level of 'loan component' and Effective date:** In respect of borrowers having aggregate fund based working capital limit of Rs. 1500 million and above from the banking system, a minimum level of 'loan component' of 40 percent shall be effective from April 1, 2019. Accordingly, for such borrowers, the outstanding 'loan component' (Working Capital Loan) must be equal to at least 40 percent of the sanctioned fund based working capital limit, including ad hoc limits and TODs.
- **Sharing of Working Capital Finance:** All lenders in the consortium shall be individually and jointly responsible to make sure that at the aggregate level, the 'loan component' meets the above-mentioned requirements. Under Multiple Banking Arrangements (MBAs), each bank shall ensure adherence to these guidelines at individual bank level.
- **Amount and tenor of the loan:** The amount and tenor of the loan component may be fixed by banks in consultation with the borrowers, subject to the tenor being not less than seven days. Banks may decide to split the loan component into WCLs with different maturity periods as per the needs of the borrowers.
- **Repayment/Renewal/Rollover of Loan Component:** Banks/consortia/syndicates will have the discretion to stipulate repayment of the WCLs in instalments or by way of a "bullet" repayment, subject to IRAC norms.

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Banks may consider rollover of the WCLs at the request of the borrower, subject to compliance with the extant IRAC norms.

- **Risk weights for undrawn portion of cash credit limits:** Effective from April 1, 2019, the undrawn portion of cash credit/ overdraft limits sanctioned to the aforesaid large borrowers, irrespective of whether unconditionally cancellable or not, shall attract a credit conversion factor of 20 percent.
- **Effective Date:** The guidelines made effective from April 1, 2019 covering both existing as well as new relationships. The 40 percent loan component will be revised to 60 percent, with effect from July 1, 2019.

Restructuring of MSME Accounts

15.15 In order to give relief to stressed MSMEs the RBI has introduced one-time restructuring of MSME Accounts subject to conditions as mentioned in circular DBR.No.BP.BC.18/21.04.048/2018-19 dated 01st January, 2019. Validity of this scheme was till 31st March 2020.

15.16 On 11th February, 2020 RBI vide circular No. DOR.No.BP.BC.34/21.04.048/2019-20 the RBI decided to extend the validity of the above scheme till 31st December, 2020.

15.17 RBI Circular dated 11th February, 2020 clearly mentioned that accounts which have already been restructured in terms of the circular dated January 1, 2019 shall be ineligible for restructuring under circular dated 11th February, 2020.

15.18 Further, in view of the continued need to support the viable MSME entities on account of the fallout of Covid19, RBI vide circular No. DOR.No.BP.BC/4/ 21.04.048/2020-21 dated 6th August, 2020 the RBI has extended the restructuring scheme notified vide circular dated 11th February, 2020 to 31st March, 2021. Further, vide circular no. DOR.No.BP.BC/13/21.04.048/2020-21 dated 7 September 2020, RBI has also stipulated certain key ratios while finalizing the resolution plans in respect of eligible borrowers.

15.19 The Auditor should ensure that the accounts restructured as per the above-mentioned scheme satisfy all the conditions stipulated in the respective circulars issued by RBI. In addition to that it should be verified that no MSME account is restructured more than once under this Scheme.

Restructuring of Accounts

15.20 The following two calculations and working are integral parts of the department audit:

- Sacrifice calculations at the end of the period.

- Additional provisioning of the overall restructured portfolio.

These calculations are generally not being done by the CBS system of the Bank at branches level.

Other Aspects

15.21 The Auditor should also obtain copies of inspection and other internal audit reports and latest Long Form Audit Report of this Department which covers the efficiency of various functional operations.

15.22 Any deviations or discrepancies noted should be appropriately reported in the Long Form Audit Report and major observations need to be discussed with the management / respective committees in the Bank.

Consolidation and Balance Sheet Preparation

16.01 The preparation of the financial statements in case of a bank is significantly different as compared to the preparation of the financial statement of the companies. The Third Schedule to the Banking Regulation Act, 1949 has prescribed Form A (Format of Balance Sheet) and Form B (Format of Profit and Loss Account). These formats for the Balance Sheet and Profit & Loss account are prescribed as per Section 29 of the Banking Regulation Act, 1949.

16.02 The process of preparation of the financial statements is divided into following phases:

- A. Preparation of Standalone Financial Statements including consolidation of the Branch Accounts, Role of SBA and SCA.
- B. Preparation of Consolidated Financial Statements (including subsidiary, associates, joint venture), Role of SCA.

A. Standalone Financial Statements including Branch Consolidation

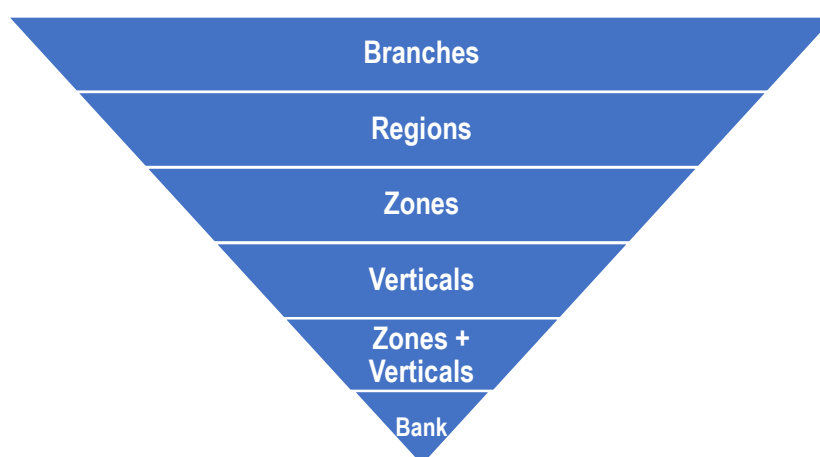
16.03 The preparation of the Standalone Financials of the Bank is primarily the consolidation of branch accounts and incorporation of various verticals/departments at the bank. The consolidation of branch accounts (audited and unaudited) is one of the important and sensitive aspect of the financial statements of a bank. Preparation of the consolidated financial statements of the bank (after consolidation of accounts of branches) is the responsibility of the bank's management. RBI *vide* its Circular No DBOD.No.BP.BC.72/21.04.018/2001-02 dated February 25, 2003 has issued guidelines to banks on consolidated accounting and other quantitative methods.

16.04 The following documents audited by the Statutory Branch Auditor are consolidated at the Bank level:

- Balance Sheet
- Profit and Loss Account
- LFAR (Long Form Audit Report)

- Ghosh Committee compliance checklist
- Jilani Committee compliance checklist
- Tax Audit report
- Various other reports like assets classification, fixed assets, bills payable, sundries, credit subventions, etc.

Process of consolidation



16.05 The consolidation process starts from the Branch level and the accounts of branches get consolidated at the respective regional office and those of all regional offices get consolidated at respective Zonal office and all zonal offices accounts get consolidated at Head Office. The procedures regarding consolidation of accounts vary from bank to bank. In case of private Banks, the consolidation process is centralized at the Head office since the systems and processes of accounting are centralised and there is no concept of mandatory branch audit by the Reserve bank of India.

16.06 All banks are on one or the other CBS application platform. However, the CBS application is implemented largely as a transaction recording software. As output, it can only give a Trial Balance. All financial Statements and reports as required by SBI Act, BR Act, BCA Act, RBI, SEBI and Companies Act are prepared with the help of another application where the data flows from various sources. The data from the CBS will flow without manual intervention. but that may not be true for the financial statements of Associates, Subsidiaries and Joint Ventures.

16.07 Bank managements generally follow the below under-mentioned process for the purpose of consolidation:

Step 1

Data for the Financial Statements as on 31st March

16.08 At the year-end i.e., 31st March, the bank provides the financial data to the statutory auditor in the form of various returns, Branch Balance Sheet, Profit and Loss Account for the purpose of the audit.

Step 2

Audit Adjustments through Memorandum of Changes (MOC)

16.09 There are two types of financial statements, Pre-MOC, i.e., the original data and Post-MOC, i.e., after giving the effect of accounting entries suggested by the Statutory Central Auditor (which is known as MOC). The effect of these MOCs are not fed in the live data but are recorded on a different software at appropriate consolidation level and are considered for the purpose of giving the financial impact in the closing financials.

16.10 Banks have varied mechanisms of posting the effects of the MOC's in the financial statements. e.g. in few banks all MOCs suggested at branches get consolidated and recorded at Controlling Offices (Regional / Zonal / Circle offices) and MOCs of Controlling Offices gets consolidated at the Head Office.

16.11 In this way, MOCs gets recorded in the parallel software e.g. ROSS, ADF at all levels of the bank. For making changes in the financial statements there must be a MOC approved by the SBA. Therefore, there will be a MOC for the difference between Pre-MOC financial statements and Post-MOC financial statements.

Accounting of MOC effect in live data

16.12 After the financial statements get approved and signed with all changes the MOCs gets accounted in live data. For example, the financial statements for the financial year 2019-20 gets approved and signed on 30th April, 2020, then on that day or on any other day with value date of 30th April, 2020, all MOCs will be accounted in the live data in CBS. Thus, if an account is marked as NPA by way of MOC during the audit, the same would be effected as NPA in the system from that day with date of NPA being the date as per the MOC suggested by the Auditor.

Step 3

Consolidation at Controlling Office (CO)-Regional Office/Zonal Office

16.13 *The process involves the following:*

1. Branches can be either audited branches or unaudited branches depending on the limits prescribed.
2. The branch financial statements are generated by the Information Technology department (ITD) or Central data Centre (CDC) and given to the branches in the respective folders. These are used for audit by the SBA. These statements once signed by the concerned bank official (with or without MOC) are submitted to the regional(RO) or Zonal office(ZO) for further processing. Where there are MOCs the financial statements will be signed as given by the ITD but will carry the effect of MOC in parallel to be consolidated at ZO.
3. Similarly, the RO/ZO standalone financial statement is prepared and consolidated like a branch. All RO/ZO are cost centres and SCA will be called upon to certify its financial statements.
4. These Controlling Office accounts get consolidated and adjustments, if any, are made at regional level. The Controlling Office is a cost centre and the auditor has to certify the financial statements of the Controlling Office in addition to the consolidation of the Branches under the relevant Controlling Office.

Audit Approach:

1. Statutory Central Auditor (SCA) for a CO must verify the completeness of the data uploaded by the branches into the system. However, this consolidation process is automated at most of the banks and the Auditor should verify the various controls adopted by the controlling office management to ensure the completeness.
2. SCA should obtain reasonable assurance and sufficient appropriate audit evidence of the adjustments made if any at the Controlling office level for the accounts which are audited by the Statutory Branch Auditor.
3. SCA should also reconcile and verify the effect of the Branch MOC's which are consolidated and effected at the CO office.
4. SCA may communicate to the SBAs, the requirements regarding process of consolidation for the current year, about the significant observations from the previous year's audit, quarterly reviews and additional precautions, modifications in Audit Program required considering the recent RBI Circulars. This communication can be circulated along with the closing instructions to SBAs.

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5. SCA should ensure on sample basis if all the documents as required by the respective banks have been taken at each level of consolidation i.e. appropriate flow of data along with the required documents.
6. SCAs are also required to verify the consolidation of various certificates/returns which are audited by the SBAs; the SCA should clearly bring out his/her responsibility while issuing the report at the CO level.

Consolidation Process at Head Office:

16.14 *The consolidation process is as under:*

At Head Office level all the Controlling office data is consolidated and further adjustments if any is made, ensuring the accuracy of the data uploaded at each stage of hierarchy. Further, the financial information from various other departments are also consolidated and incorporated in the Financial Statements like for e.g. Gratuity, Pension, Leave encashment, etc. are audited by the vertical auditor and are consolidated while preparing the financial statements.

Also various provisions such as Provision on Standard Assets, Restructured accounts, Stress sector provision are computed and provided at the Head office level.

Audit Approach to be followed by the Consolidating Auditor:

16.15 The consolidating Auditor should do the following:

1. Understand the various process and systems used by the bank for preparation and presentation of the financial statements.
2. Verify the various checks and controls placed by the bank to identify any unusual entries or any other difference.
3. Ensure the completeness as well as accuracy of the data at the whole Bank level. However, the responsibility of the consolidating auditor is to verify the accuracy of the data consolidated from the various returns/financial information which are audited by the auditor of various departments/verticals.
4. Obtain reasonable assurance and sufficient appropriate audit evidence of the adjustments made if any at the bank level.

16.16 The Consolidating Auditor should also examine the following key additional aspects:

- a. Check the effect of MOC from previous year is properly accounted.
- b. Reversal of interest on inter-branch balances and other similar items.

- c. Cancellation of transfers of assets among branches.
- d. Review the observations made by the SBAs in audit report and LFAR; however, such review is done by the respective auditors of controlling office. Where the SBA has made comment which should normally be reported through a MOC, the SCA is well advised to insist on MOC rather than make the changes based on the report. The MOC must come signed from the SBA who reported the deviation.
- e. Effect of Memorandum of Changes (MOC) if any made at Head office.
- f. Provision on Standard Assets, Fraud Provision and Other Provisions.
- g. Review of MOCs to ascertain whether there are systemic issues or deficiencies which need to be addressed by the management.

IT Controls

16.17 There is a significant and voluminous data involved during this whole process of consolidation. Consolidation being a system oriented process, the Auditor must verify if the IT controls of the bank are effective. The Auditor should also review the system audit report available with the Bank with respect to the system used for the purpose of preparation of the financial statement.

16.18 The application that is used for consolidation is mainly departmental and sometimes the ITD may not have full control over its daily functions. In many banks this could be an end user application like MS Excel or some simple addition software. It, therefore, requires higher level of vigilance on the part of SCA to ensure that the possibility of material misstatements are removed by testing vigorously.

Consolidation of Overseas Branches:

16.19 While consolidating the overseas branches the Auditor should examine the following aspects:

- a. Various reports of the overseas branches would be received in the local currencies of the reporting countries which need to be converted into the Indian currency.
- b. The effect of reinstatement of assets and liability which is given in Accounting standard 11, The Effects of Changes in Foreign Exchange Rates. RBI has also issued a circular for compliance of AS 11. DBOD.BP.BC.No.76/21.04.018/2005-06) dated April 5, 2006 and RBI/2016-17/281 DBR.BP.BC.No.61/ 21.04.018/2016-17 on Guidelines on compliance with Accounting Standard (AS) 11 [The Effects of Changes in Foreign Exchange Rates] by banks – Clarification dated April 18, 2017.

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- c. As per AS 11 (revised 2003), the method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise. For this purpose, foreign operations are classified as either "integral foreign operations" or "non-integral foreign operations".
- d. In terms of its Circular no DBOD.BP.BC.76/ 21.04.018/2004-05 dated March 15, 2005, the RBI has prescribed that with the issuance of the said circular, there should normally be no need for any Statutory Auditor for qualifying financial statements of a bank for non-compliance with Accounting Standard 11 (Revised 2003). Whenever specific difference in opinion arises among the Auditors, the Statutory Central Auditors would take a final view. Continuing difference, if any, could be sorted out in prior consultation with RBI, if necessary.
- e. The Auditor may also review the compliance with the applicable local laws and regulations of the concerned country by the overseas branches. The Auditor should also review the report given by the overseas branch auditor to identify the areas of concerns.
- f. The Auditor should also verify the process of translation from the foreign currency to the presentation currency and ensure that the consistent process have been followed by the bank over a period.
- g. The asset classification and provisioning on the loans are done as per the local laws of those respective branches; however the Auditor should ensure that the stricter norms have been followed by the bank at the time of consolidation.
- h. The Auditor should have issued audit instructions to the overseas branch Auditor for various compliances/control at the respective branches. The response needs to be considered and further information, if necessary should be sought.
- i. Many jurisdictions require the branches to report their financial statements under IFRS. In such cases the SCA will require iGAAP financial statements certified by the Auditor for the consolidation purposes.

Disclosure in Standalone Financial Statements:

16.20 The Consolidating Auditor is also required to verify various disclosures made in the Financial Statements as required under Master Circular no. RBI/2015-16/99 DBR.BP.BC No.23/21.04.018/2015-16 dated July 1, 2015 "Disclosure in Financial Statements - Notes to Accounts". The circular requires the bank to give various disclosures in Annual Accounts. Some of these

disclosures are audited and certified by the Auditor of various department/verticals. However, generally there are certain disclosures which are prepared and to be verified by the consolidating auditor e.g. Segment Reporting as per RBI Circular and Accounting Standard 17 and Earning Per Share as per Accounting Standard 20. The consolidating auditor should carefully review these disclosures and ensure their compliance as per the Master Circular or other circulars/notification issued from time to time. Further, the Auditor should carefully review the disclosure made for divergence in the asset classification and provisioning as required by RBI Circular no. RBI/2016-17/283 DBR.BP.BC.No.63/21.04.018/2016-17 dated April 18, 2017. RBI/2019-20/220 DOR.No.BP.BC.63/21.04.048/2019-20 dated April 17, 2020 has added 4 more disclosures which are required to be made in the "Notes to Accounts" for the year 2019-20 and 2020-21 relating to the COVID 19 Regulatory Package – Asset Classification and Provisioning.

B. Consolidated Financial Statement (including Subsidiary, Associates and Joint venture)

16.21 The PSB's and Private Sector Banks in India are listed on recognised stock exchange and are required to comply with the SEBI Regulations including Listing Obligations and Disclosure Requirements (LODR) as issued and amended on time to time basis.

16.22 As per Regulation 33 of SEBI LODR Regulations, the listed entities are required to prepare the standalone financial results and consolidated financial results shall be prepared as per Generally Accepted Accounting Principles in India. Further, a new sub-regulation was inserted under Regulation 33 of the SEBI LODR Regulations, which came into effect from April 01, 2019 requiring the entities to prepare consolidated financial statements on quarterly basis.

16.23 Consolidated Financial Statements (CFS) are presented for a group of entities under the control of a parent. A parent is an entity that has one or more subsidiaries. It may be noted that if a parent does not have subsidiary but has investment in associates and joint ventures, it will be required to prepare CFS. However, for the purpose of quarterly reporting under SEBI guidelines, CFS will not be necessary if the parent does not have subsidiary but has investments in associates and joint ventures. For this guidance note a parent would mean a Consolidating Bank.

Responsibility of a Bank

16.24 The responsibility for the preparation and presentation of CFS is that of the Bank. This responsibility, *inter alia*, includes:

1. Identifying components including financial information.

2. Identifying reportable segments.
3. Identifying related party transactions.

Responsibility of the Statutory Central Auditor

16.25 It is necessary for the Auditor to take into consideration the accounting standards relevant for the purpose of CFS. They are AS 21: Consolidated Financial Statements, AS 23: Accounting for Investments in Associates in Consolidated Financial Statements and AS 27: Financial Reporting of Interests in Joint Ventures. Further, careful consideration should be given by the Auditor of CFS to Other Matters paragraph, Emphasis of Matter paragraph, Modified Opinion in the report issued by the component auditors. The Auditor should also refer Guidance Note on Audit of Consolidated Financial Statements (Revised 2016) issued by ICAI for the guidance while auditing the CFS.

16.26 When the parent bank's auditor makes a reference to the auditor's report of the other auditors in the auditor's report on CFS, the latter should disclose clearly the magnitude of the portion of the financial statements audited by the other auditor(s) in "Other Matter" paragraph. This may be done by stating the rupee amounts or percentages of total assets and total revenue of subsidiary(ies) included in CFS not audited by the parent's auditor.

16.27 However, reference in the report of the auditor of CFS to the fact that part of the audit of the group was made by other auditor(s) is not to be construed as a modification of the opinion. With reference to the SEBI Circular no. CIR/CFD/CMD1/44/ 2019 dated March 29, 2019 the Auditor should also consider implications on reporting if some of the components are unaudited².

16.28 Generally, while conducting audit of a bank, SCA has a practice of issuing general instructions for the SBAs to facilitate easy consolidation of branch accounts. It would be appropriate to have a similar approach with respect to auditors of components, if the component auditors are different from the group auditor. This is especially important in case of "the other financial information" which is necessary for the purpose of consolidation and preparation of notes. It is advisable to make sufficient arrangements for co-ordination and efforts at the planning stage. In the present year the impact of COVID 19 related circulars and regulations will have a major role to play. These have to be communicated to SBA such that the SCA gets sufficient information to conclude.

² Attention in this regard is drawn to the Announcement on "Manner of Disclosure in the Auditor's Report of the Fact of Inclusion of Unaudited Financial Statements/ Information of Component/s in the Financial Statements Audited by the Principal Auditor(s)" issued by ICAI in February, 2014.

Audit of Consolidated Financial Statements

16.29 The Auditor should carefully review the following while auditing the consolidated Financial Statements:

- Accounting policy of the bank and its various components.
- Any subsidiaries, associates and joint ventures of the bank not consolidated under CFS.
- Changes in the shareholding that might have taken place since the last audit.

16.30 As far as possible the formats of the financial statements and cash flows used for the purpose of bank's individual financial reporting should be used for the CFS. In case the subsidiaries/joint venture accounts are prepared as per different regulation such as those issued by IRDA etc., the Auditor should be careful while converting the same into format prescribed by Banking Regulation Act. The Auditor, wherever possible, should obtain the "Fit-for-consolidation" financial statements duly certified by the respective Statutory Auditors of Subsidiaries/Joint Ventures.

16.31 The SCAs should examine that the CFS is prepared using uniform accounting policies for matters like transactions and other events in similar circumstances. If it is not practicable, that fact shall be disclosed together with the proportions of the items in the CFS to which the different accounting policies have been applied. For preparing the CFS using uniform accounting policies, the banks shall rely on a Statement of Adjustments for non-uniform accounting policies, furnished by the Statutory Auditors of the subsidiaries.

16.32 In cases where different entities in a group are governed by different accounting norms laid down by the concerned regulator for different businesses, the bank shall use for consolidation purposes the rules and regulatory requirements applicable to the banks in respect of like transactions and other events in similar circumstances. In situations where regulatory norms have not been prescribed by RBI, the norms as applicable according to the accounting standards may be followed.

16.33 The Standard on Auditing (SA) 580, "Written Representations" requires the auditor to obtain written representations from management and where appropriate those charged with governance. Such representations would include:

- Completeness of components included in the CFS.
- Identification of reportable segments for segment reporting.
- Identification of related parties and related party transactions for reporting.

Appropriateness and completeness of consolidation adjustments, including the elimination of intra-group transactions.

16.34 The valuation of investments in subsidiaries which are not consolidated and associates which are excluded under AS 23, 'Accounting for Investments in Associates in Consolidated Financial Statements', shall be as per the relevant valuation norms issued by the Reserve Bank of India. The valuation of investments in joint ventures shall be accounted for under the 'proportionate consolidation' method as per AS 27, 'Financial Reporting of Interests in Joint Ventures'. The banks may consider the provisions of the accounting standards relating to the exclusion of subsidiaries, associates or joint ventures from consolidation under specific circumstances. This aspect shall be examined by the Auditor.

Other Aspects

Head Office

16.35 Apart from examination of consolidation of branch returns, verification of capital and reserves, and verification of investments and provisioning in respect thereof, the Statutory Central Auditors also usually deal with the following items:

- Review of Internal/ Office accounts.
- Depreciation on assets like, premises, etc. where the recording of the relevant fixed assets is centralised at the head office.
- Employee benefits and provisions for certain employee costs, such as, bonus/ex-gratia in lieu of bonus, gratuity, leave encashment, pension and other retirement benefits.
- Provision for taxation.
- Provision for audit fee.
- Provisions to meet any other specific liabilities or contingencies the amount of which is material, for example, provision for revision in pay-scales of employees, provision for foreign exchange fluctuations, etc.
- Statutory Auditors of public sector banks (PSBs) shall also check that, the conditions attached to capital infusion by the Government have been complied with by the respective PSBs. In case of any non-compliance, the same may be suitably highlighted by the Statutory Auditors of PSBs in their Audit Report.
- Dividends.

Review of Internal/ Office accounts

16.36 The Reserve Bank of India has time and again emphasised the need for instituting proper control over the opening and operation of internal (office) accounts, in general, and of the sundry / suspense accounts. To curb frauds, malpractices, the opening of such internal accounts in the banks, as also their periodic reconciliation, should receive utmost attention of their Top Managements and be subjected to necessary checks in the form of concurrent audit, coverage under Long Form Audit Report, as also monitoring and review by the Audit Committee of the Board (ACB).

16.37 Post-migration to Core Banking Solutions(CBS), due to inherent nature of IT systems, certain practices were open to susceptible operations in opening and operating internal accounts that may prevent the system from slipping into NPA. Wherever NPA was inaccurately captured by the system, in almost all such cases, system-based identification of NPAs was bypassed in this manner.

16.38 Sometimes cases have been found where these internal accounts/branch GLs have been used for disbursing loan amount, parking Govt. funds, disguising customer's cash transactions, booking expenses such as telephone charges, ATM charges, service charge and interest reversals, etc. Similarly, there are instances of advances to customers/staff members have also been debited to such accounts.

16.39 Such transactions, though sometimes done inadvertently, amounts to violation of the extant regulatory instructions, and tantamount to manipulation of accounts

16.40 Auditors need to ensure that internal accounts are not allowed to be used unauthorised and proper checks are exercised before opening any such account, including adherence to the delegated powers in this regard.

16.41 The Auditor is expected to check the CGL or BGL which relates to Suspense, Sundry Debits, Sundry receivables, Inter-branch accounts, HO accounts which are parking accounts. The normal clearance is T+1 day. The SOP/Policy and rules of the bank will prescribe the permissible entries. That would need evaluation and tracing if the entries are pending for more than 90 days. Any entry pending for more than 90 days requires 100% provision.

Provisioning for Non-performing Assets

16.42 The prudential norms issued by the RBI prescribe the percentage of provision to be made in respect of advances classified under different categories, viz., standard, sub-standard, doubtful and loss assets. In this

context, the RBI has issued “Master Circular – Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances” (DBR.No.BP.BC.2/21.04.048/2015-16) dated July 1, 2015, *read with* updates thereafter. The primary responsibility for making adequate provisions for any diminution in the value of loan assets, investment or other assets is that of the bank management and the statutory auditors. The assessment made by the inspecting officer of the RBI is furnished to the bank to assist the bank management and the statutory auditors in taking a decision in regard to making adequate and necessary provisions in terms of prudential guidelines. It may be emphasised that the percentages prescribed by the RBI reflect the minimum proportion of an advance that a bank ought to provide for to comply with the guidelines. A bank can, at its discretion, make a higher provision than that required under the prudential guidelines. Further, the bank needs to ensure that the bank complies with the PCR (Provision Coverage Ratio) as prescribed by RBI.

Other Provisions at central office

1. Non-Performing Investments

Meaning of NPI

16.43 In respect of securities included in HTM/AFS/HFT Category where interest/ principal is in arrears:

- (i) Interest/ instalment (including maturity proceeds) is due and remains unpaid for more than 90 days.
- (ii) In case of preference shares where the fixed Dividend/ Maturity Proceeds is not paid and remains outstanding for more than 90 days.
- (iii) In the case of equity shares, in the event the investment in the shares of any company is valued at Re.1 per company on account of the non-availability of the latest balance sheet those equity shares would also be reckoned as NPI.
- (iv) If any credit facility availed by the issuer is NPA in the books of the bank, investment in any of the securities issued by the same issuer would also be treated as NPI and vice versa.
- (v) The investments in debentures / bonds, which are deemed to be in the nature of advance would also be subjected to NPI norms as applicable to investments.

2. Convergence of Foreign Subsidiaries/Branches Balance Sheet

16.44 The Balance Sheets of the respective branches and subsidiaries are drawn in the respective currencies hence for the purpose of the consolidation the

same needs to be converted to the INR.

1. In compliance with AS 11 (Revised), The Balance sheet items are converted to INR at the Closing Rates published by FEDAI.
2. The Profit and Loss account is converted on incremental basis for every quarter based on the average rate of the quarter published by FEDAI.

For example, if the expense for the period of June 2019 is 100\$, then the same needs to be converted at average rate for the quarter ended June 2019.

If the same expense for the period of September 2019 is 300\$, then the incremental 200\$ gets converted at average rate for the quarter ended September 2019.

Recognition of Certain Expenses

16.45 Certain expenses, such as the following, are usually recognised at the head office level (or at zonal or regional level):

- (a) Directors' fees, allowances and expenses
- (b) Insurance
- (c) Auditors' fees and expenses
- (d) GST, etc.

Audit Approach and Procedures

Directors' Fees, Allowances and Expenses

16.46 This item includes sitting fees and all other items of expenditure incurred in relation to directors. The daily allowance, hotel charges, conveyance charges, etc., though in the nature of reimbursement of expenses incurred, may be included under this head. Similar expenses of local Committee members may also be included under this head. Under the Companies Act, 2013 a director may receive remuneration by way of a fee for each meeting of the Board or a Committee attended by him. Local Committees are appointed by banks as advisory bodies in respect of the areas allotted to them. Their members are also paid fees or allowances.

16.47 The Auditor may check the sitting fees and allowances with reference to the articles of the banking company, agreements, minutes of the Board and Local Committees, etc. It may be noted that in the case of nationalised banks, the fees and the basis of reimbursement of travelling expenses are fixed by the Central Government in consultation with the RBI. Copies of the relevant orders may be examined in this behalf.

Insurance

16.48 This item includes insurance charges on bank's property. It also includes insurance premium paid to DICGC, etc., to the extent they are not recovered from the parties concerned.

16.49 Banks submit a Return on Total Insurable Deposits to RBI on a periodic basis. Insurance premium is payable on such deposits. The Auditor should check the basis of computation of insurable deposits and the insurance premium paid on same.

16.50 The DICGC guarantee fees payable by banks are based on the outstanding amount of priority sector advances covered by DICGC as on 31st March every year. The Auditor should check the basis of payment/provision for such guarantee fees.

Auditors' Fees and Expenses

16.51 This item includes the fees paid to the statutory auditors and auditors for professional services rendered and all expenses for performing their duties, even though they may be in the nature of reimbursement of expenses. If external auditors have been appointed by banks themselves for internal inspections and audits and other services, the expenses incurred in that context including fees incurred for such assignments may not be included under this head but shown under 'Other Expenditure'.

Accounting for GST

16.52 As per the GST Law, banks are eligible for 50% of the GST paid on the Purchase of input/capital goods and availment of services. Generally, accounting for GST Receivable is centralised. Entire GST paid for expenses / capital goods at the branch level is first debited to Profit & Loss Account. Then at the HO Level while preparing the consolidated Balance sheet for the Bank as a whole, 50% of eligible Input Tax Credit is recognised as asset (GST Receivable). However, the treatment for accounting GST can differ from Bank to Bank.

16.53 The Auditor needs to pay proper attention to the calculation done for transferring eligible ITC from Expense head to GST Receivable Account. It is also to be noted that GST paid on Inter-state supplies of goods or services (or both) between two branches of the same 100% GST is eligible.

Provision for Depreciation

16.54 As mentioned earlier, practices differ amongst banks with regard to accounting for fixed assets and provision for depreciation thereon. In case

these accounting aspects in respect of all or certain categories of fixed assets are centralised at the head office level, the Statutory Central Auditor should examine the same. The procedures to be followed by the Auditor in this respect would be similar to those discussed in Chapter 12, “Fixed Assets and Other Assets” of Section B of this Guidance Note at the branch level, except that the Statutory Central Auditor may request the respective branch auditors to examine the evidence of physical existence of fixed assets that, as per the records, are located at the branch or have been provided to employees for use (such as residential premises).

Provisions for Certain Employee Costs

16.55 Provisions for certain employee costs such as bonus/ex-gratia in lieu of bonus, and gratuity, leave encashment, pension and other retirement benefits are usually made at the head office level.

16.56 The Auditor should examine whether the liability for bonus is provided for in accordance with the Payment of Bonus Act, 1965 and/or agreement with the employees or award of competent authority.

16.57 The Auditor should examine whether provisions in respect of employee benefits are made in accordance with the requirements of Accounting Standard (AS) 15, “Employee Benefits”. The Auditor should particularly examine whether provision for leave encashment has been made by the bank. As per AS 15, employee benefits include all forms of consideration given by an enterprise in exchange for services rendered by employees. It includes short-term employee benefits such as wages, salaries and social security contributions and non-monetary benefits, post-employment benefits, other long-term employee benefits and termination benefits. The Auditor should examine the adequacy of the provisions made with reference to such documentary evidence such as reports of actuaries or certificates from the Life Insurance Companies, as appropriate under the facts and circumstances of the case.

16.58 In the case of employee benefits, the Master Circular on “Disclosure in Financial Statements – Notes to Accounts” (DBR.BP.BC No. 23/21.04.018/2015-16) dated July 1, 2015 issued by the RBI with reference to Accounting Standard 15, specifies that Banks may follow the disclosure requirements prescribed under AS 15 (Revised), ‘Employees Benefits’ issued by the ICAI.

Provision for Taxation

16.59 Provision for taxation relates to income-tax, (including corporate dividend tax). The Auditor must ensure compliance with AS 22, “Accounting for Taxes on Income”.

Income-tax

16.60 Some of the items which have an effect on the liability of a bank for income-tax and therefore, need to be specifically considered by the Auditor are discussed in the following paragraphs.

16.61 The Statutory Auditor should consider the impact of Income Computation and Disclosure Standards (ICDS) issued by CBDT while calculating provision of tax. The notification requires income computation and disclosure standards to be followed by all assessees, following mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head "Profit and gains of business or profession" or "Income from other sources".

Provision for Bad and Doubtful Debts

16.62 Section 36(1)(vii) of the Income-tax Act, 1961 deals with the allowability of bad debts and section 36(1)(viia) deals with the allowability of provision for bad and doubtful debts. According to section 36(1)(vii), bad debts written off are admissible deduction subject to the conditions prescribed under section 36(2), i.e.,—

- (i) no such deduction shall be allowed unless such debt or part thereof has been taken into account in computing the income of the assessee of the previous year in which the amount of such debt or part thereof is written off or of an earlier previous year, or represents money lent in the ordinary course of the business of banking or money-lending which is carried on by the assessee;
- (ii) if the amount ultimately recovered on any such debt or part of debt is less than the difference between the debt or part and the amount so deducted, the deficiency shall be deductible in the previous year in which the ultimate recovery is made;
- (iii) any such debt or part of the debt may be deducted if it has already been written off as irrecoverable in the accounts of an earlier previous year, but the Assessing Officer had not allowed it to be deducted on the ground that it had not been established to have become a bad debt in that year;
- (iv) where any such debt or part of debt is written off as irrecoverable in the accounts of the previous year and the Assessing Officer is satisfied that such debt or part became a bad debt in any earlier previous year not falling beyond a period of four previous years immediately preceding the previous year in which such debt or part is written off, the provisions of sub-section (6) of section 155 shall apply;

- (v) where such debt or part of debt relates to advances made by an assessee to which clause (viiia) of sub-section (1) applies, no such deduction shall be allowed unless the assessee has debited the amount of such debt or part of debt in that previous year to the provision for bad and doubtful debts account made under that clause.

16.63 The said deduction is limited to the amount by which the bad debts exceed the credit balance in the provision for bad and doubtful debts account made under section 36(1)(viiia). According to section 36(1)(viiia), a specified percentage of the total income and a specified percentage of the aggregate average advances made by the rural branches of the bank, both computed in the prescribed manner, is allowable as a deduction in respect of provision for bad and doubtful debts made by banks other than foreign banks.

16.64 A scheduled /non-scheduled bank has the option to claim a further deduction for an amount not exceeding the income derived from redemption of securities in accordance with a scheme framed by the Central Government. This is in addition to the deduction specified in paragraphs above with respect to section 36(1)(viiia). However, for the purpose of claiming this deduction, it is necessary that such income should be disclosed in the return of income under the head 'Profit and gains of business or profession'.

16.65 Section 36(1)(vii) requires the amount of any bad debt or part thereof to be written off as irrecoverable in the accounts of the assessee for the previous year. It is sufficient compliance of the section if the write off is done at Head Office level.

Special Reserve

16.66 Deduction in respect of a special reserve created and maintained by a banking company:

- (a) Section 36(1)(viii) provides for a deduction in respect of any special reserve created and maintained by a specified entity, which includes a banking company.
- (b) The quantum of deduction, however, should not exceed 20% of the profits derived from eligible business computed under the head "Profits and gains of business or profession" (before making any deduction under this clause) carried to such reserve account.
- (c) The eligible business, in case of a banking company, means the business of providing long-term finance for –
 - (i) Industrial or agricultural development or development of infrastructure facility in India; or

- (ii) Development of housing in India.
- (d) However, where the aggregate amount carried to such reserve account exceeds twice the amount of paid up share capital and general reserve, no deduction shall be allowed in respect of such excess.
- (e) The Reserve Bank of India has issued circular No.: DBOD. No.BP.BC.77/21.04.018/2013-14 dated December 20, 2013 for creation of deferred tax liability on special reserves created under section 36(1)(viii) and entire Special Reserves may be reckoned for the purpose computation of Tier-I Capital.

Interest on Non-Performing Accounts (NPAs)

16.67 According to section 43D, read with Rule 6EA of the Income-tax Rules, 1962, the income of a scheduled bank by way of interest in relation to such categories of bad or doubtful debts as may be prescribed having regard to the guidelines issued by the RBI in relation to such debts, shall be chargeable to tax only in the previous year in which it is credited to the Profit and Loss Account or in the year of actual receipt, whichever is earlier.

Transactions with Foreign Banks/Foreign branches of Indian banks

16.68 The applicability of any Double Taxation Avoidance Agreement(DTAA) is to be taken into account for the purpose of computation of tax in respect of transactions with foreign banks or foreign branches of Indian banks.

16.69 Similarly the applicability of Transfer Pricing Regulations is to be taken into account for the purpose of computation of tax in respect of international transactions with associated enterprises covered under section 92E of the Income-tax Act, 1961. Reference may also be made to the "Guidance Note on Report on International Transactions under section 92E of the Income-tax Act, 1961 (Transfer Pricing)" issued by ICAI.

16.70 In respect of any provision for bad and doubtful debts made by a foreign bank, an amount not exceeding 5% of the total income (computed before making any deduction under Chapter VI-A) is allowable as deduction.

Tax Refunds/Demands

16.71 Where an assessment order is received during the year, the Auditor should examine the assessment order and if any interest is determined on the amount of refund, the same should be considered as income. In case where the assessment results in fresh demand, the Auditor should consider the need for additional provisioning. Where an assessment order is received during the course of audit, the Auditor should examine the same and consider its impact,

if any, on the accounts under audit.

16.72 It is not prudent to recognise interest on possible refund which is not determined by any order from tax authorities.

Pending Proceedings

16.73 The Auditor should review the appellate orders received during the year and consider the need for any additional provision/reversal.

Method of Accounting

16.74 Many banks account for commission, exchange, brokerage, interest on bills, locker rent and other fees as income upon realisation. Section 145 of the Income-tax Act, 1961 provides, *inter alia*, that income chargeable under the head "Profits and Gains of Business and Profession" shall be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. Auditors of banks to which the Companies Act applies are required to follow the accrual basis of accounting. Further, accrual being a fundamental accounting assumption, the Auditor would need to consider modification/ reference to/ in the Auditor's Report wherever cash basis of accounting is followed.

Reversal of Earlier Year's Provision

16.75 It is possible that subsequent judicial pronouncements/ appellate orders may make the provisions of earlier years excessive.

16.76 As per Accounting Standard (AS) 29, "Provisions, Contingent liabilities and Contingent Assets", a provision should be recognised only when (a) an enterprise has a present obligation as a result of a past event, (b) it is possible that an outflow of resources embodying economic benefits will be required to settle the obligation, and (c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision should be recognised.

16.77 Only in rare cases like for example, a law suit, it may not be clear whether an enterprise has a present obligation. In such a case, an enterprise determines whether a present obligation exists at the balance sheet date by taking into account all available evidence. On the basis of such evidence, if it is more likely than not that a present obligation exists at the balance sheet date a provision is recognised (if other recognition criteria are also met). However, where it is more likely that no obligation exists at the balance sheet date, a contingent liability is disclosed unless the possibility of an outflow of resources embodying economic benefits is remote.

16.78 On the above considerations, if there is no requirement to retain a

provision, it can be reversed and the amount of liability is included in contingent liability. A suitable note on the following lines is recommended:

- (a) Provision for Income Tax is arrived at after due consideration of decisions of the Appellate authorities and advice of counsels; and
- (b) No provision is made for the disputed demands of Income tax keeping in view the judicial pronouncements and/or legal counsels' opinion.

Items Requiring Special Consideration

Tax Implications of Valuation of Investments

16.79 The RBI has issued various circulars on valuation of investments, according to which the difference between the market value/value as per yield to maturity method (YTM) will have to be provided in the books of accounts for certain types of investments. Various judicial decisions on the allowability of depreciation in valuation of investments, including implication of ICDS VIII, should be considered while provisioning.

Notional Gain/Loss on Foreign Exchange Translations

16.80 Banks are required to translate their foreign exchange balances / obligations in foreign currency as per FEDAI Guidelines. While recognising gains or loss for tax purposes the following decisions may be considered by the Auditor along with FEDAI Guidelines:

- The Madras High Court in the case of *Indian Overseas Bank Vs. Commissioner of Income-tax (1990) 183 ITR 200* has held that notional profits on conversion of foreign exchange forward contracts is not taxable.
- The Madras High Court in the case of *Commissioner of Income-tax Vs. Indian Overseas Bank (1985) 151 ITR 446* has held that notional loss on conversion of foreign exchange contracts is not tax deductible.

Carry forward of unabsorbed business loss and depreciation on amalgamation of a banking company with a banking institution

16.81 Section 72AA of the Income Tax Act, 1961 deals with Provisions relating to carry forward and set-off of accumulated loss and unabsorbed depreciation allowance in a Scheme of amalgamation of banking company in certain cases.

FATCA /CRS

16.82 Foreign Account Tax Compliance Act (known in short as FATCA) is a legislation to counter tax evasion in the United States of America (USA). FATCA was introduced by US Dept of Treasury (Treasury) and US Internal Revenue

Service (IRS) to encourage better tax compliance by preventing US persons from using banks and other financial organisations to avoid US taxation on their income and assets.

16.83 India and the USA have signed reciprocal version of model 1 IGA for FATCA on 9th July 2015. India signed the OECD's CRS (Common Reporting Standards) on 3rd June 2015. The IGA has 2 models – India has signed Model 1 IGA wherein banks will have to report information to the prescribed authority who in turn will submit information to the IRS.

16.84 In Model 1 IGA, the Foreign Financial Institutions (FFI) have to report all FATCA related information to their governmental agencies, which would then report the FATCA related information to the IRS. Some Model 1 IGAs are reciprocal, requiring the US to provide certain information about residents of the Model 1 country to the Model 1 country in exchange for the information that country provides to the USA. An FFI covered by a Model 1 IGA need not sign an FFI agreement but needs to register on the IRS's FATCA Registration Portal or file Form 8957.

16.85 Like FATCA, Common Reporting Standard (CRS) is a reciprocal exchange of information on financial accounts on an automatic basis with other countries/ non-sovereign territories so as to combat the menace of offshore tax evasion and avoidance and stashing of unaccounted money abroad.

16.86 India would be obligated to get its financial institutions to share financial account information of accountholders who are tax residents in any of these countries. Likewise, India would also get similar information through financial institutions of such treaty countries.

16.87 CBDT has notified Rule 114H for Due Diligence Requirement under FATCA; major requirements for the Bank are as under:

All the concerned financial institutions should register on the related e-filing portal of Income Tax Department as Reporting Financial Institution by submitting the requisite details. Thereafter, the reports can be submitted online by using the digital signature of the 'Designated Director' by either uploading the Form 61B or 'NIL' report.

16.88 As per RBI Circular RBI/2015-16/165 DBR.AML.BC.No.36/14.01.001 /2015-16, dated August 28, 2015, for the new accounts opened after September 1, 2015, the due diligence procedures specified in Rule 114H (4) and 114H (6) would be applicable.

Guidance Note on Audit of Banks (Revised 2021)

16.89 All the FIs have to submit reports online using the digital signature of the designated director by either uploading Form 61B or 'Nil Report' by September 10, 2015. The first reporting will be with respect to calendar year 2014 if an account has been identified as US reportable account consequent to completion of due- diligence procedures as laid down in Rule 114H. Therefore, the reasons for the 'Nil Report' should be captured as under:

a. *For pre-existing accounts*

Option 1: Due diligence procedure not completed.

Option 2: Due diligence procedure completed but no reportable US account identified.

b. *For new accounts*

Option 1: Alternative procedure invoked.

Option 2: Due diligence procedure as applicable to new accounts completed but no reportable US account identified.

16.90 All the regulated entities should take appropriate action for the implementation of due diligence and reporting requirements as laid down in the Rules and ensure compliance in a manner that lends itself to credible auditability including audit of the IT system which should be suitably upgraded to not only maintain the information required under the Rules but also to record and store the due diligence procedures. In due course, the detailed guidelines for carrying out audit of IT system for ascertaining the degree and level of compliance with due diligence procedures as laid down in the Rules will be issued.

16.91 The Statutory Auditor should verify whether the Bank has put a process in place for complying with guidelines under FATCA/CRS and submitted reports as required by FATCA.

16.92 The Supreme Court passed an interim order on September 03, 2020 w.r.t. the Writ Petition filed by Gajendra Sharma, stating that 'the accounts which were not declared NPA till 31.08.2020 shall not be declared NPA till further orders.' The SCA may refer to guidance given in para 11.370 of Chapter 11 "Reporting for Advances" of Section B of this Guidance Note in this regard. If a bank has not classified any account as NPA subsequent to August 31, 2020, which otherwise would have been classified as NPA, the SCA should review the functional working of CBS in terms of compliance made by the bank in terms of the said interim order of Supreme Court.

Government Business Department

Introduction

17.01 The basic scope of work of Government business carried out by banks is given in RBI Master Circular no. RBI/2020-21/03 DGBA.GBD.No.2/31.12.010/2020-21 dated July 01, 2020 on “Conduct of Government Business by Agency Banks – Payment of Agency Commission”.

Government transactions eligible for agency commission

17.02 Transactions relating to the following government business undertaken by agency banks are eligible for agency commission:

- a. Revenue receipts and payments on behalf of the Central/State Government;
- b. Pension payments in respect of Central / State Governments;
- c. Any other item of work specifically advised by Reserve Bank as eligible for agency commission.

17.03 Short term/long term borrowings of State Governments raised directly from financial institutions and banks are not eligible for agency commission as these transactions are not considered to be in the nature of general banking business. Reserve Bank pays the agency banks separate remuneration as agreed upon for acting as agents for management of public debt. Transactions arising out of Letters of Credit opened by banks on behalf of Ministries/Departments etc. do not qualify for agency commission.

17.04 Whenever agency banks collect stamp duty through physical mode or e-mode (challan based), they are eligible for payment of agency commission, provided the agency banks do not collect any charges from the members of public or receive remuneration from the State Government for doing this work.

17.05 If the agency bank is engaged by the State Government as Franking Vendor and it collects stamp duty from the public for franking the documents, it will not be eligible for agency commission since the State Government is paying commission to it as Franking Vendor. However, the agency bank which-collects the stamp duty paid by the Franking Vendor for credit to the Treasury through challan in physical or e-mode for purchase of the franking bar, would be eligible for agency commission since it is a regular payment of Stamp Duty as stated above.

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17.06 All agency banks while claiming Turnover Commission (ToC) should certify that no claim of ToC is made on ineligible transactions.

17.07 Agency banks paying their own tax liabilities through their own branches or through authorised branches of State Bank of India or offices of Reserve Bank of India wherever they do not have their own authorised direct tax collection branch should indicate the same separately in the scroll. Such transactions will not be eligible for payment of agency commission. Banks should furnish a certificate to the effect that own tax liabilities (TDS, Corporation Tax, etc.) paid by them have been excluded while claiming agency commission.

Rates for agency commission

17.08 As per the agency bank agreement, RBI pays agency commission at rates determined by it. The rates applicable with effect from July 1, 2019 are as under:

Sr. No.		Type of Transaction	Unit	Revised Rate
a.	(i)	Receipts - Physical mode	Per transaction	Rs. 40/-
	(ii)	Receipts - e-mode	Per transaction	Rs. 9/-
b.		Pension Payments	Per transaction	Rs. 75/-
c.		Payments other than Pension	Per Rs. 100 turnover	6.5 paise

In this context, the 'Receipts-e-mode transactions' indicated against Sr. No. a.(ii) in the above table refer to those transactions involving remittance of funds from the remitter's bank account through internet banking as well as such transactions which do not involve physical receipt of cash /instruments.

17.09 Agency banks would be eligible to claim agency commission for pension transactions at the rate of Rs. 75/- per transaction only when the entire work relating to disbursement of pension including pension calculation is attended to by them. If the work relating to pension calculations, etc., is attended to by the concerned Government Department / Treasury and the bank branches are required only to credit the amount of pension to the pensioners' accounts maintained with them by a single debit to Government Account, such transaction is to be categorised under 'other than pension payment' and would be eligible for payment of agency commission @ 6.5 paise per Rs.100/- turnover w.e.f. July 1, 2019.

17.10 With reference to the implementation of Goods and Service Tax (GST) regime, it is advised that a single Common Portal Identification Number (CPIN), processed successfully leading to generation of a Challan Identification Number (CIN), under GST payment process, may be treated as a single transaction, even if multiple major head/sub major head/minor head of accounts are credited. This means that CGST, SGST, IGST and Cess etc. paid through a single challan would constitute a single transaction. Thus, all such records clubbed under a single challan i.e., CPIN have to be treated as a single transaction for the purpose of claiming agency commission effective July 1, 2017

17.11 Similarly, in case of transactions not covered under GST, it is emphasised that a single challan (electronic or physical) should be treated as single transaction only and not multiple transactions, even if the challan contains multiple major head/sub major head/minor head of accounts that will get credited. Therefore, records clubbed under a single challan processed successfully have to be treated as a single transaction for the purpose of claiming agency commission

17.12 Turnover commission is payable to an agency bank at the full rate provided the transactions are handled by the bank at all stages. Where, however, the work is shared between two banks, the turnover commission is shared between the banks in the proportion of 75:25. Thus, broadly, the turnover commission is payable to the agency banks as detailed below:

- a. At the full rate, in cases where the transactions are handled by the bank at all stages, i.e., up to the stage of dispatch of scrolls and challans / cheques to the Pay and Accounts Offices, and treasuries/sub-treasuries.
- b. At 75% of the applicable rate, where the dealing branch is required to account for the transaction by passing on the scrolls and documents to the local/nearest branch of Reserve Bank of India or any agency bank conducting government business.
- c. At 25% of the applicable rate, in the case of agency branch which received the scrolls and documents from dealing branches of other banks and is responsible for the account of these transactions and dispatching of the scrolls and documents to the Pay and Accounts Offices, Treasuries, etc.

17.13 The number of transactions eligible for payment of agency commission should not exceed 14 per pensioner per year. This includes one monthly credit for payment of net pension and a maximum of two per year for payment of arrears on account of increase in dearness relief, if applicable. Cases involving payment of arrears on account of late start/restart of pension qualifies as a single transaction for claiming of agency commission. In other words, any payment of

arrears on account of late start/restart of pension should be treated as a single credit transaction and not as separate monthly credits.

Claiming agency commission

17.14 Agency banks are required to submit their claims for agency commission in the prescribed format to Central Accounts Section (CAS) Nagpur in respect of Central government transactions and the respective Regional Office of Reserve Bank of India for State Government transactions. The revised formats for claiming agency commission claims for all agency banks and separate and distinctive set of certificates to be signed by the branch officials and Chartered Accountants or Cost Accountants are given in Annexure-2, 2-A and 2-B respectively to the said RBI Master Circular dated July 01 2020. These certificates would be in addition to the usual Certificate from ED / CGM (in charge of government business) to the effect that there are no pension arrears to be credited / delays in crediting regular pension / arrears thereof.

17.15 Where the External Auditor is also the Concurrent Auditor / Statutory Auditor, claims can be certified by such Concurrent Auditor / Statutory Auditor. The auditor's certificate should, inter-alia, state that:

- a. 'receipt' and 'pension payment transactions' as also the agency commission claims for 'payments other than pension payments' indicated in the agency commission claim application submitted to the RBI are tallied with the records maintained at the concerned branch/es of the agency bank; and
- b. the agency commission claims made in respect of volume (number) based transactions viz. 'receipt' and 'pension payment transactions' have been claimed only once and the same stands excluded while arriving at value based transactions in respect of 'payments other than pension payments'.

17.16 In addition to this, agency banks are required to ensure that the agency bank's internal inspectors / auditors verify the agency commission claims submitted by their branches and confirm their accuracy during the course of their inspection / audit.

17.17 Agency banks are required to ensure that agency commission claims submitted to the Regional Offices of Reserve Bank of India / Central Accounts Section, Nagpur in the prescribed format are accurate. Agency banks may also alert their branches concerned to ensure that agency commission claims submitted to our Regional Offices are accurate. Such erroneous claims, if certified by the Internal / Concurrent Auditors, will defeat the very purpose of making such requirement an essential condition for making quarterly claims.

Deduction of TDS on Agency Commission

17.18 The Central Board of Direct Taxes (CBDT) has clarified that 'tax would not be required to be deducted by RBI on the turnover commission paid or credited by it to agency banks for transacting general banking business of the Central Government and State Governments'. However, agency commission would be taxable in the hands of the banks concerned as it is part of the bank's income.

Penal interest for wrong claims

17.19 Agency banks will be liable to pay penal interest at Bank Rate as notified by the Reserve Bank of India plus 2% for any wrong claims of agency commission settled.

Preparation / Planning

17.20 The Auditor has to do the following:

- Obtain Government Business Policy of the Bank
- Check Accounting policy whether it is on accrual or cash basis and accordingly plan the work

17.21 Discuss the process of execution of Government Business through authorised branches, recording of transactions in CBS system, reconciliation with respective Government Departments for various schemes. Some examples listed below:

Government Deposit Scheme	E-Kisan Vikas Patra Scheme, 2014 Sovereign Gold Bonds Public Provident Fund (PPF) Senior Citizen Savings Scheme 2004 Sukanya Samriddhi Accounts 2014 RBI Bonds
Taxes	Collection of Direct taxes (CBDT) Goods and Services Tax Collection of State Taxes
Pension Payments to Government / Ministries / Departments / others	Central/Civil Freedom Fighters Pension Railway Telecom & Postal Defence

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Other Schemes	Pension Payment to State Governments National Pension System (NPS) Treasury/Sub Treasury Business e-Stamping e-Biz Services to Civil/Non-Civil Ministries Atal Pension Yojana EPFO Collection ESIC Collection PFMS-Public Fund Management System NTRP (Non-Tax Receipt Portal) Gold Monetization Scheme, 2015
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Conduct / Execution

17.22 The Auditor is required to do the following:

- Verify whether Income from Government Business is accounted properly

This can be done by taking the data dump of the government transactions and analysing them to confirm that the GL/BGL contains the GB transactions, that the claim is arrived at automatically by the system – if not then the transactions in claim amount and the transactions in the GL/BGL match, that only those transactions which can be claimed have been selected, that the bank has a system to verify the amount of receipt with the amount of claim.

Any analytical tool will help in filtering the transactions on which agency commission can be received. For all transactions there will be a tag or flag which will determine whether there is any claim to be made.
- Check income reconciliation, follow up for recovery
- Check Tax Collection and Payment to Government Treasury in timely manner
- Check the internal controls for receipt / payments

Reporting / Conclusion

17.23 Based on audit, issue appropriate certificate, report on compliance for Government Business. Check whether appropriate disclosures are being made in financial statements.

Consolidation of LFARs for the Bank

Introduction

18.01 The financial statements of the banks generally signed within 45 days of the year end. However, RBI has given time up to June 30 for the submission of LFAR. Hence usually, formal consolidation process starts after the Financial statements of the Bank are signed and delivered.

18.02 The consolidation takes place based on Long Form Audit Reports submitted by the Statutory Branch Auditors in respect of branches/offices and the information / explanations and other data provided by the management, for Audited/Un-audited branches and departments. Hence analyzing of the data is required at the time of conducting the Financial audit at the zonal/ regional level audit and not just during LFAR consolidation process. It is often noted that branch LFAR may have given certain comments on the borrower account or some process in the Branch that may need attention in the main audit report issued by the auditors during financial audit. If analysis of branch LFAR is deferred, there may be a probability of missing on such comments.

18.03 It is the responsibility of the consolidating auditor to highlight the significant observations therein and summarise the issues after considering the information provided by the Bank, wherever required. All statistical data needs to be incorporated as provided by the Bank. Further the Auditor is expected to consider the compliance report of the Bank on LFAR for the previous year.

18.04 The SCA should ensure that the intent of the comments specified by SBAs in Branch LFAR is factored in while consolidating the Branch LFARs and accordingly may consider to keep the same intact wherever need be. Further, the SCA should review the major observations by SBAs including those which are likely to have a systemic impact though have been reported at few branches. The SCA may opt to conduct testing of such instances as reported by SBAs, to identify impact of the same on the consolidated LFAR of the Bank.

18.05 At the start of the audit of the Financial Statements, the Statutory Central Auditors need to communicate to Branch auditors and Departmental Auditors specifically to provide the data in structured format for the purpose of consolidation. The consolidated LFAR need not give the entire details reported

under the annexures. The Auditor may determine the materiality of the amounts to be reported in LFAR. However, the said data is required to be compiled bank-wide and submitted to the management.

Setting Reporting Materiality

18.06 The overall objective is to design and carry out our audit procedures in order to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether due to fraud or error.

18.07 Materiality is set for the financial statements should represent the maximum cumulative numerical misstatement in an account balance, class of transactions or other disclosure that the auditor would regard as not influencing the decisions of users of those financial statements. The materiality for reporting may be categorised into the following two types:

(i) Specific Transaction Materiality

18.08 These transactions are selected for reporting irrespective of the materiality due to their sensitive nature such as:

1. Any standard account in the branch having exposure (funded and non-funded) which is more than 50 crore across bank.
2. Accounts against whom NCLT proceedings are initiated either by Bank, any other financial creditors or the operational creditors.
3. SMA accounts above 5 crore.
4. Red Flagged Accounts.

The above list is indicative one.

(ii) The overall materiality limits

18.09 Having determined specific materiality it is necessary to determine a level of overall materiality which will be used when assessing the risk of reporting. The use of overall materiality is intended to reduce the risk of inappropriate audit report.

18.10 Unlike financial statement materiality (which is dependent on the perceptions of users) this materiality is affected by risk of misreporting.

18.11 Hence as a part of setting up of overall materiality limits, any uncorrected observations affecting the financial statement above certain amount, that may be decided by the Statutory Central Auditors (all observations put together by individual auditor at unit level). The combined impact needs to be assessed and reported in LFAR.

The Reporting

18.12 The RBI has issued thoroughly revamped format of LFAR vide Circular No. DOS.CO.PPG./SEC.01/11.01.005/2020-21 dated September 05, 2020. Though the mandate and scope of the audit will be as per the revised format, if the SCA feels the need of any material additions, etc., the SCA may have the same effected by giving specific justification and with the prior intimation of the bank's Audit Committee of Board (ACB).

18.13 The compilation of the questions is done on the basis of information provided by the Statutory Branch Auditors. However, as mentioned above, the specific information or the annexures that may be required by the consolidating auditor to ensure the adequacy of reporting, will have to be decided and called for during communicating to the Statutory Branch Auditors as required by SA 600. The illustrative list of Annexures that may be required could be as under:

- i. Instances of quick mortality cases.
- ii. Instances of disagreement of Asset Classification with Bank, i.e., divergences observed at branch level.
- iii. Instances of an account wherein auto-marking through CBS was not effected.
- iv. Instances of evergreening of Accounts.
- v. Accounts where excess over sanctioned limits are allowed.
- vi. Branches where limits were disbursed without complying with the terms and conditions of sanction.
- vii. Branches with deficiencies in documentation/inadequate insurance cover.
- viii. Branches where periodic balance confirmation / acknowledgement of debt not obtained.
- ix. Branches having accounts where review / renewal is pending.
- x. Branches where stock / book debt statements and other periodical operational & financial statements not obtained.
- xi. Branches where audited accounts not on record for advances to non-corporate with limit over Rs. 10 lakh (or any other limit as decided by the bank internally).
- xii. Branches where stock audit report is not obtained at prescribed interval.
- xiii. Short reviewed for period beyond six months.

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- xiv. Comments on major accounts (standard accounts having outstanding exceeding Rs. 10 crore).
- xv. Quarterly/half yearly statements not obtained.
- xvi. Break up of outstanding entries in Nostro reconciliation as of 31.03.20YY.
- xvii. Rate of interest charged less than prescribed rate decided by the bank.
- xviii. Deficiencies noticed in appraisal, monitoring and supervision.
- xix. Details of accounts where the relevant controlling authority of the bank has authorised legal action for recovery of advances.
- xx. List of overdue / matured term deposits.
- xxi. Major / adverse comments / issues not addressed by the branch arising out reports from previous auditors, concurrent auditors, stock or internal auditors or special audit or inspection report of RBI.
- xxii. Whether identification and classification of advances as standard/sub-standard/doubtful/ loss assets is as per RBI circular and instructions as per CO. If not, then details of accounts where there are deviations.
- xxiii. Guarantees involved / expired but not adjusted / reversed.
- xxiv. Outstanding amount of letter of credit / buyers credit.
- xxv. Cash holding/ cash held exceeds retention limit.
- xxvi. Details of cases where physical verification of securities not done as per laid down procedure.
- xxvii. Details of NPA accounts where valuation report is not obtained.
- xxviii. Detail of items for more than three years in bills payable / sundry deposit etc.
- xxix. List of the accounts (with outstanding in excess of Rs. 10.00 crore), which have been downgraded regarding their classification as non-performing asset or standard asset during the year.
- xxx. List of the accounts (with outstanding in excess of Rs. 10.00 crore), which have been upgraded regarding their classification as non-performing asset or standard asset during the year.
- xxxi. List of recoveries and their appropriation against interest and principal accounts settled/ written off/ closed during the year.
- xxxii. List of new borrower accounts transferred to the branch during the year.

The above list is indicative one.

18.14 There are separate formats (part of LFAR) for following specific branches which need to be consolidated in respect of:

- Dealing in Foreign Exchange Transactions
- Dealing in clearing house operations, normally referred to as service Branches.
- Dealing in NPAs such as Asset Recovery Management Branches.

There is an Annexure III specified in the circular on Long Form Audit Report – Review to be obtained by the Branch Auditors from branches dealing in large advances / asset recovery branches.

Introduction

19.01 The SCAs have to issue various Special Purpose Reports and Certificates at Head Office level. The Appointment letter normally contains the exhaustive list of all such Reports and Certificates which are required to be certified by the SCA's. These are to be verified and certified by the SCAs to ensure their correctness and accuracy. RBI regularly updates the various lists of certificates to be issued by SCAs. Many of these certificates are prepared by consolidating the certificates issued by SBAs for the respective branches/ROs/Zonal offices/Accounting units etc. and SCAs for the respective head office departments allocated at the time of appointment.

Regulatory Requirements

19.02 The Reserve Bank of India *vide* its Master Direction No: DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 Dated July 01, 2016 (updated July 03, 2017) on "Frauds- Classification and Reporting by commercial banks and select FIs, issued guidelines for classification of frauds and reporting of frauds to RBI, Central Office as well as the concerned regional office of the Department of Banking Supervision / Financial Conglomerate Monitoring Division (FCMD) at Central Office under whose jurisdiction the bank's Head Office/branch is situated. The reporting requirements for various categories of frauds based on financial exposure are specified in the aforesaid Master Directions.

19.03 While issuing a special purpose report or certificate, the auditors should bear in mind the recommendations made in the Guidance Note on Reports or Certificates for Special Purposes (Revised 2016) issued by the Institute of Chartered Accountants of India (ICAI).

Audit Approach

19.04 At the time of accepting the Audit, issuing engagement letter, preparing audit program, maintaining adequate working papers, the SCAs should appropriately comply with the requirements of Guidance Note on Reports or Certificates for Special Purposes (Revised 2016) issued by the Institute of Chartered Accountants of India (ICAI). Readers may also refer

covering report for certificates as prescribed in Annexure A “Illustrative Format of Covering Report for various Certificates issued by SCAs” of this Chapter.

19.05 Initially before commencement of the year end audit process, SCAs should ask the bank’s management to prepare a complete list of all the certificates to be issued as part of the audit based on RBI’s directions.

19.06 Based on the allocation of work/departments amongst joint auditors, various SCA should be assigned the responsibility of verifying and certifying the certificate to be submitted.

19.07 Depending on the centralization of operations at the bank, certificate to be issued at central office should be separated from the certificates to be issued based on consolidation process from various branches.

19.08 SCA should draft clear and adequate communication and instruction for SBAs (which would form part of the annual closing instructions from bank’s management to SBAs). Instructions should cover the requirements of the certificate, areas and extent of verification, inclusions and exclusions if any and in some cases draft of the format in which the certificates have to be issued. This ensures compliance of SA 600, “Using the Work of Another Auditor”.

19.09 SCA should be more careful while issuing certificates based on consolidation at branches/ROs/ZO/AU etc. The SCAs should understand and verify the process for consolidation of certificates received from various branches/ROs/ZO and head office departments with respect to the contents of consolidated certificates to be issued at head office level. In some cases such a consolidation may be happening manually and not through the bank’s CBS/IT system. All the returns submitted by unaudited branches to various higher authorities should be cross verified.

19.10 Wherever possible SCAs should reconcile or tally the closing balance of the return/ certificate with the General Ledger Heads in the Trial Balance or other relevant returns of the Bank as at the year end. This will be important for semi-automatic or manual returns. For system generated returns without manual intervention, it should still be ensured that they tally with the year-end figures, though detailed verification may not be warranted.

Responsibility of the Management

19.11 The correctness in preparation of various certificates is the responsibility of the management of the banks including designing, implementing and maintaining internal control relevant to the preparation and presentation of various certificates. Management is also responsible for compliance with all the provisions of RBI and other regulatory guidelines. The responsibility of the SCAs is to verify and report on the status of correctness of the same through the necessary checks carried out during the audit. The

results of the verification carried out by the SCAs on test check basis and their comments thereon would be given in a separate report.

Audit Approach and Procedures

19.12 The format of certificates required to be issued by the SBAs and SCAs are devised by the Bank, RBI and other authorities who are the users of these certificates. The prescribed formats are required to be filled in by the banks for reporting on compliance.

19.13 The SCA shall obtain a confirmation from the management whether it has received the various reports / certificates from all the branches, regional/ zonal offices, etc. and also whether it has prepared the status report as applicable to the Head Office level. The SCA shall obtain a list of the branches, regional/ zonal offices which have not submitted the prescribed report. Such a list would help the SCA to have a broad idea as to the extent of compliance.

19.14 The SCA should maintain proper documentation about the information received, audit process carried out, extent of checking, observations and findings.

19.15 The SCA should obtain and review a copy of these reports / certificates so prepared / compiled and submitted to them by the bank. Such a review would help the auditors identify areas which are susceptible to fraud/ malpractices. The results of such a review / checking may also require the auditor to re-consider the nature, timing and extent of the procedures adopted by him for carrying out the audit as well as his audit findings.

19.16 The SCA may also request the management to provide a list of branches which had been subject to a concurrent audit/ inspection by the in-house inspection department or the inspectors from the RBI. SCA may, if considered necessary, select some such branches and review the comments of the concurrent auditors/ inspectors on the status of implementation of the recommendations. This would help to identify any common cause of concern among the bank branches.

19.17 Some of the certificates to be issued by the SCAs are technical and the Auditor may have to reply on the work done by other experts or representation from the management. In such cases the SCA should be clear in mentioning any scope limitations and necessary disclaimers in the certificate. The Auditor may also consider modifying his opinion paragraph (issue a negative assurance rather than a reasonable or absolute assurance on the work done by him). SCAs are also required to keep the requirements of UDIN while issuing such certificates.

19.18 The certificates should clearly state the records checked, to what extent they have been checked and what has been checked.

Annexure A

Illustrative Format of Covering Report for various Certificates issued by SCAs

Independent Auditor's Certificate for various certificates issued during the Statutory Audit of [Name of the Bank] for the Financial year 2020 – 2021.

1. This Certificate is issued in accordance with the terms of our agreement dated [date of Engagement Letter].
2. The accompanying Statement contains various certificates issued by us during the Statutory Audit of [Name of the Bank] for the Financial year 2020 – 2021, listed in Annexure [Name], which we have been initialled for identification purposes only.

Managements' Responsibility for the Statement

3. The preparation of the accompanying Statement is the responsibility of the Management of the Bank. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and presentation of the Statement, and applying an appropriate basis of preparation; and making estimates that are reasonable in the circumstances.
4. The Management is also responsible for ensuring that the Bank complies with the requirements of the Equity Listing Agreement and for providing all relevant information to the Securities and Exchange Board of India.

Auditor's Responsibility

5. Pursuant to the requirements of the various RBI guidelines, our responsibility is to express reasonable assurance in the form of an opinion based on our audit and examination of books and records on test check basis, as to whether the [Name of the Bank] has undertaken only those activities that have been specifically permitted by the RBI and has complied with the specified terms and conditions.
6. We have audited the financial statements of [Name of the Bank] for the Financial year 2020 – 2021, on which we issued an unmodified audit opinion vide our reports dated [date of Audit Report]. Our audit of these financial statements was conducted in accordance with the Standards on Auditing and other applicable authoritative pronouncements issued by the Institute of Chartered Accountants of India. Those Standards require that we

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plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

7. We conducted our examination of the Statements/Certificates given in Annexure [Name], in accordance with the Guidance Note on Reports or Certificates for Special Purposes issued by the Institute of Chartered Accountants of India. The Guidance Note requires that we comply with the ethical requirements of the Code of Ethics issued by the Institute of Chartered Accountants of India.

8. We have complied with the relevant applicable requirements of the Standard on Quality Control (SQC) 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

Opinion

9. Based on our examination as above, and the information and explanations given to us, we report that the Statement in Annexure [Name] is in agreement with the books of account and other records of [Name of the Bank] for the Financial year 2020 – 2021 as produced to us for our examination, and the information thereof is prepared, in all material respects, in accordance with the applicable criteria.

Restriction on Use

10. This certificate has been prepared at the request of the [Name of the Bank] solely with reference to our appointment letter, for the purpose of onward compilation of various certificates and disclosure requirements for [Name of the Bank] as a whole. It should not be used by any other person or for any other purpose. Accordingly, we do not accept or assume any liability or any duty of care or for any other purpose or to any other party to whom it is shown or into whose hands it may come without our prior consent in writing.

For
Chartered Accountants
Firm's Registration Number:

Partner / Proprietor
Membership Number
UDIN

Place:

Date:

**Section B –
Bank Branch Audit**

Practical Guide for Statutory Branch Auditors performing Bank Branch Audit for the First Time

1.01 The banking industry is the backbone of any economy as it is essential for the sustainable socio-economic growth and financial stability in the economy. There are different types of banking institutions operating in India. These are as follows:

- (a) Commercial Banks
- (b) Regional Rural Banks
- (c) Co-operative Banks
- (d) Development Banks (more commonly known as 'Term-Lending Institutions')
- (e) Foreign Banks
- (f) Payment Banks
- (g) Small Finance Banks
- (h) EXIM Bank

1.02 All these banks have their unique features and perform various functions / activities subject to complying with the RBI guidelines issued from time to time. Section 6 of the Banking Regulation Act, 1949, lists down the forms of business in which banking companies may engage. The text of Section 6 of the Banking Regulation Act, 1949 has been reproduced in **Appendix I** of Section B (Available on ICAI website) of the Guidance Note on Audit of Banks (2021 Edition). Of these banks, commercial banks are the most wide spread banking institutions in India. Commercial banks offer a number of products and services to the general public and other segments of the economy. Two of the main functions of commercial banks are (1) accepting deposits and (2) granting advances. In addition to their main banking activities, commercial banks also undertake certain eligible Para Banking activities which are governed by the RBI guidelines on Para Banking activities.

1.03 The functioning of banking industry in India is regulated by the Reserve Bank of India (RBI) which is the Central Bank of our country. RBI is responsible

for the development and supervision of the constituents of the Indian financial system (which comprises banks and non-banking financial institutions) as well as for determining, in conjunction with the Central Government, the monetary and credit policies keeping pace with the need of the hour. Important functions of RBI are issuance of currency; regulation of currency issue; acting as banker to the central and state governments; and acting as banker to commercial and other types of banks including term-lending institutions. Besides, RBI has also been entrusted with the responsibility of regulating the activities of commercial and other banks. No bank can commence the business of banking or open new branches without obtaining licence from RBI. The RBI also has the power to inspect any bank.

1.04 The provisions regarding the financial statements of banks are governed by the Banking Regulation Act, 1949. The Third Schedule to the aforesaid Act, prescribes the forms of balance sheet and profit and loss account in case of banks. Readers may refer **Appendix II** of Section B (Available on ICAI website) of the Guidance Note on Audit of Banks (2021 Edition) for text of the third schedule to the Banking Regulation Act, 1949. Further, in case of banking companies, the requirements of the Companies Act, 2013, relating to the balance sheet, profit and loss account and cash flow statement of a company, in so far as they are not inconsistent with the Banking Regulation Act, 1949, also apply to the financial statements, as the case may be, of a banking company. It may be noted that this provision does not apply to Nationalised Banks, State Bank of India, its Subsidiaries and Regional Rural Banks (RRBs). The provisions regarding audit of Nationalised Banks are governed by the Banking Regulation Act, 1949 and the RBI Guidelines. The provisions regarding audit of Banking Companies are governed by the Banking Regulation Act, 1949, RBI Guidelines and the provisions of the Companies Act, 2013.

Pre-commencement of Audit

Co-ordination with Branch Management

1.05 Now a days typically, Statutory Branch Auditors (SBAs), are given limited time within which they have to undertake the audit of branches allotted to them. Co-ordination between the auditor and the branch management is essential for an effective audit and timely completion with the highest audit quality. An NOC from the previous auditor should be obtained and kept on record by the SBA. It is advisable that immediately after accepting the appointment, the SBA should send a formal communication to the branch management/HO accepting his appointment and other declarations and undertakings so required. Further, the SBA should also specify the books, records, and other information that he would require in the course of his audit. Such a communication would

enable the branch management to keep the requisite documents, information, etc., ready.

1.06 The SBA needs to plan the work properly prior to commencement of audit. The SBA needs to issue the audit engagement letter in accordance with Standard on Auditing (SA) 210, "Agreeing the Terms of Audit Engagements" and the requirement letter which will contain the details or information needed to conduct the audit. The SBA needs to obtain basic information about the size of the branch and nature of the activities carried out at the branch, to find out whether the branch is a normal branch or specialised branch such as forex or service branch. If the branch is a normal branch, then based on size of the branch, the SBA should organise his audit team and finalise the audit plan. If it is specialised branch, composition of persons in the audit team should be thoroughly acquainted with the rules and regulations governing such specialised branch. The audit team needs to have a basic knowledge about the Reserve Bank of India's regulations and circulars governing the specialized branch and when the appointment is made well before the year end, it is advisable to complete the entire non-financial verification like documentation, sanctioning terms, review of the supervision and monitoring terms, review of the concurrent/internal audit and inspection reports before the year-end.

Engagement and Quality Control Standards

1.07 The auditor/audit firm should establish a system of quality control designed to provide reasonable assurance that the auditor/firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm or engagement partner(s) are appropriate in the circumstances and will survive the test of any regulatory, legal or other action that may arise in future. This system of quality control should consist of policies designed to achieve its objectives and the procedures necessary to implement and monitor compliance with those policies. The nature of the policies and procedures developed by individual or firms to comply with SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements" will greatly depend on various factors such as the size, maturity, geographical location, type of work handled and other operating characteristics.

1.08 The ICAI has issued various Engagement and Quality Control Standards applicable to an audit of financial statements which are mandatorily to be followed by all practitioners. Understanding of the concepts in these Engagement Standards would help the SBA in discharging his duties in a diligent way.

1.09 In the present scenario of Statutory Bank Branch Audit, the most important aspect is proper planning. Documentation of the Audit Plan is a must. The SBA must have sound and complete knowledge of the business of the Bank.

1.10 The Auditor needs to study the following:

1. **Appointment Letter** – It is necessary to read the Appointment Letter carefully and duly consider all the terms and conditions mentioned therein, that are required to be followed during the process of the audit. The letter of appointment sent by banks to Statutory Branch Auditors typically contains the following:

- Appointment under the Banking Regulation Act, 1949, and the underlying duties and responsibilities of the SBA.
- Particulars of branch(s) to be audited and of the region/zone to which the branch reports.
- Particulars of Statutory Central Auditors (SCAs).
- Particulars of previous auditors.
- Guidelines for conducting audit of branches, completion of audit, eligible audit fees and reimbursement of expenses etc.
- Procedural requirements to be complied with in accepting the assignment, e.g., letter of acceptance, declaration of indebtedness, declaration of fidelity and secrecy, other undertaking by the firm/SBA, specimen signatures, etc.
- Scope of work - Besides the statutory audit under the provisions of the Banking Regulation Act, 1949, the SBA is also required to verify certain other areas and issue various reports and certificates like LFAR, Tax Audit Report, certificates for cash verification on odd dates, Ghosh & Jilani reports etc.
- The SBA needs to note compliance with relevant and applicable Engagement and Quality Control Standards issued by the ICAI.
- The Appointment letter mentions a list of documents/working papers which the RBI may require to be handed over. Such documents have to be carefully maintained with all details as to be self-explanatory.

2. **RBI Guidelines and Circulars** – SBA must read and study RBI Circulars, master directions, notification and the Banking Regulation Act, 1949.

3. **Bank's Closing Circular – Along** with the appointment letter, Banks also issue closing guidelines. This Circular covers the process and policies followed by Bank. Basic understanding of these circulars is necessary.
4. The SBA also needs to have a basic knowledge of allied applicable laws to carry out an effective audit. For example: Indian Contract Act 1872, Negotiable Instruments Act 1881, relevant Stamp Acts, etc.

Steps for audit of advances and NPA related matters

1.11 The SBA should document the criteria for test check which he has chosen for verification of advances. SBA should prepare / suitably create check-list to verify advances which are selected for verification. Based on RBI guidelines the Auditor should see that Sanctioning, Disbursement, Review / renewal and monitoring of advances is being done properly. If there are deviations, the Auditor should report the same. The Auditor should select appropriate sample from all categories of advances so that they truly represent the entire population and carry out appropriate test checks.

1.12 The SBA should study the latest Income Recognition and Asset classification (IRAC) guidelines of RBI. The Auditor should also check whether the Bank has correctly classified the advances into performing and non-performing categories. Appropriate test checks should be carried out regarding classification of advances. The Auditor should appropriately deal with the deviations in classification and accordingly, Memorandum of changes should be issued if required. The SBA should report all deficiencies noted by him in the Long Form Audit Report.

1.13 The RBI is now insisting on checking of Central repository of Information on Large Credits (CRILC) for advances over Rs. 5 Crore, which maintains history of the borrowers from inception. Banks have to update this every time the borrower moves into or out of default. This history card will give a snap shot of the borrower's behaviour and is generally maintained with Zonal authorities.

1.14 Similarly for advances less than Rs. 5 Crore, the RBI maintain Central Fraud Registry (CFR) which holds all the data regarding frauds reported by banks in India. This allows the bank to decide whether the borrower is eligible before processing the sanction.

Steps for audit related to Cash and Housekeeping Matters

1.15 The SBA should check internal controls on custody of cash and see that the cash management policy of the bank is strictly followed. The SBA should

physically check cash at the branch and at the ATM attached to branch. The SBA should examine rotation of duties of key management at branch for effective operations. The SBA should examine the limit for cash holding and what cash actually held by branch throughout the year.

Steps for audit related to Financial Statements

1.16 The SBA should apply basic audit principles and carry out checking of the Financial Statements. The SBA may apply analytical procedures such as ratio analysis, comparative analysis to find out material misstatements, if any in the financial statements. Based on the audit process carried out by audit team and after examination of the final financial statements, the auditor should frame his audit opinion.

Steps for compiling the Main report & LFAR etc.

1.17 The SBA should also ensure that their audit report complies with the requirements of SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements", SA 705 (Revised), "Modifications to the Opinion in the Independent Auditor's Report" and SA 706 (Revised), "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report". Based on the audit process carried out the Auditor should report his findings in the Audit Reports. The illustrative formats of auditor's report are given in **Appendices III and IV** of Section B (Available on ICAI website) of the Guidance Note on Audit of Banks (2021 Edition) as follows:

Appendix III - Illustrative Format of Report of the Branch Auditor of a Nationalised Bank

Appendix IV - Illustrative Format of Report of the Branch Auditor of a Banking Company

1.18 Besides the main audit report, the terms of appointment of auditors of public sector banks, private sector banks and foreign banks (as well as their branches), require the auditors to also furnish a Long Form Audit Report (LFAR) to the management. While planning the audit, the Auditor must cover all aspects on which reporting is to be done in his main report and also in the LFAR. The matters to be dealt with by auditors in LFAR have been specified by the RBI. Latest revision to LFAR by RBI has been made in September 2020 and are to be applied for audits of financial year 2020-21 and onwards. For matters which are reported in the Main Report and LFAR, the Auditor should have necessary and appropriate audit documentation to evidence the findings made. If the Auditor

intends to issue modified opinion, reasons for such modified opinion need to be mentioned. For the benefit of the members Illustrative Format of Engagement Letter to be sent to the Appointing Authority of the Nationalised Bank by Branch Auditor, Illustrative Format of Engagement Letter to be sent to the Appointing Authority of the Nationalised Bank by Branch Auditor - Separate only for Audit of Internal financial controls over financial reporting, Written Representation Letter, Abbreviations used in the Banking Industry, Illustrative Bank Branch Audit Programme for the Year ended March 31, 2021, Typical reasons for the divergence observed in asset classification (large accounts) by banks vis-à-vis supervisory assessment made by RBI during Supervisory Cycle 2019-20 (FY 2018-19), and Advisory for Statutory Bank Branch Auditors w.r.t. Specific Considerations while conducting Distance Audit / Remote Audit / Online Audit of Bank Branch under current Covid-19 situation issued on May 6, 2020 are given in **Appendices V to XI** of Section B (Available on ICAI website) of the Guidance Note on Audit of Banks (2021 Edition). These are as under:

- Appendix V** - Illustrative Format of Engagement Letter to be sent to the Appointing Authority of the Nationalised Bank by Branch Auditor.
- Appendix VI** - Illustrative Format of Engagement Letter to be sent to the Appointing Authority of the Nationalised Bank by Branch Auditor (Separate only for Audit of Internal financial controls over financial reporting).
- Appendix VII** - Illustrative Format of Written Representation Letter to be obtained from the Branch Management.
- Appendix VIII** - Suggested Abbreviations used in the Banking Industry.
- Appendix IX** - Illustrative Bank Branch Audit Programme for the Year ended March 31, 2021.
- Appendix X** - Typical reasons for the divergence observed in asset classification (large accounts) by banks vis-à-vis supervisory assessment made by RBI during Supervisory Cycle 2019-20 (FY 2018-19)
- Appendix XI** - Advisory for Statutory Bank Branch Auditors w.r.t. Specific Considerations while conducting Distance Audit / Remote Audit / Online Audit of Bank Branch under current Covid-19 situation issued on May 6, 2020.

Special Audit Considerations in Foreign Banks

1.19 Audit of foreign banks operating in India, poses unique challenges compared to local banks in India. Foreign banks have different operating models compared to local banks, and to a limited extent, they also operate in a different regulatory environment.

1.20 Foreign banks generally operate in India through branches and do not have a separate legal entity existence in India. Some are set up as an Indian subsidiaries of the foreign bank. However, the RBI regulates their functioning in India, with regard to scale and nature of business they undertake in India.

1.21 Auditors of foreign bank will have to modify their audit procedures so as to take care of the operational structure and operations of these banks. Some of the important elements related to foreign banks which may have a bearing on the audit plan and procedure are:

- Management structure.
- More centralised operational functions.
- Core banking software used globally.
- Requirement for compliance with foreign legal and regulatory requirements.
- Cross border flow and processing of data.
- Complex treasury operations and cross border forex deals.
- Operational processes.

Bank Branch Audit Planning

Appointment of Auditors

2.01 The ICAI invites applications from CAs to be empanelled for carrying out the Bank / Bank branch audit for nationalised banks. After due verification of details submitted, approved list of CAs is submitted to the Reserve Bank of India (RBI). The RBI circulates this list to banks for appointment of their auditors. Banks Check with CA firms about their willingness and then confirm their appointments. Once the appointment of statutory auditors is done, the final list is submitted by all the nationalised banks for RBI's approval.

Understanding the Business of Bank

2.02 The Auditor should understand the nature of activities carried out at the bank branch. The Auditor should consider requirements of SA 315 "Identifying and assessing the risks of Material Misstatement through understanding the entity and its environment". Besides the core business of banks of accepting deposits and sanctioning advances, newer Banking products are being periodically introduced by the banking industry. The Auditor should have complete knowledge about the basics of the core business of banks and these products offered at the branches. The Auditor should study the financial implication of all the products offered at the branches. The types of facilities provided to borrowers and the Standard Operating Procedures (SOP) should be studied. Before commencing the audit, the Auditor should also have a basic understanding of the core banking solution (CBS) used by the bank. Authority levels should be understood. Based on the features of the products, the Auditor should draw up a suitable audit plan to verify the transactions of the activities being provided by the Bank. Risk Assessment is to be carried out based on clear understanding of the business profile of the Bank.

2.03 The Auditor should find out the role and responsibilities of the branch officials and the internal controls in operation. Most of the Banks have converted their branches as Customer facing point of Contact and Sales and, almost all processing / decision making is centralised. Depending on the functions being carried out at the branch, the Auditor should design his audit plan and the extent of verification.

2.04 The Auditor must also have a thorough understanding of the RBI guidelines, prudential norms and master directions and be updated with the various recent circulars and instructions issued by the RBI.

Audit Planning

2.05 The Auditor should plan the audit keeping in mind the requirements of SA 300 "Planning an Audit of Financial Statements". The Auditor should document the audit plan and conduct a preliminary enquiry to know the nature, size and category of bank branch to be audited. The Auditor should work out an overall audit strategy for execution of the audit within the time limits.

2.06 The Auditor needs to assess the risk involved in branch being audited. Depending on the nature of transactions executed at branch, the audit plan should be designed. General branches will have one set of audit plan and specialised branches will have different audit plans based on the nature of transactions executed at branch, such as treasury branches, forex branches, service / clearing branches. The category of the branch to be audited will also determine the overall plan and the various checks to be applied for audit e.g., Large or mid Corporate, retail branch, rural or agricultural branch, etc.

2.07 The Auditor should assess the resource requirements for audit to be completed within the stipulated timelines. Based on the volume and nature of transactions executed at branch staff will be deployed. Audit team needs to be updated with banking law and regulations and RBI Guidelines.

2.08 Detailed requirement letter seeking information regarding branch should be sent by the Auditor to branch management so that necessary information is received during the planning stage and accordingly proper audit plans can be made. The Auditor should call for previous year's inspection/ concurrent and other important reports so that beforehand the Auditor may aware of the past key issues. The Auditor should also look at the previous year/period's reports of the previous statutory auditor and its compliance status. A study of the previous year's LFAR will also help in gaining an understanding of the issues at the branch.

2.09 All Public Sector Banks come out with closing instructions for bank's management and auditors at branches. The Auditor should design the audit plan and audit procedures and the extent of checking keeping the bank's closing guideline/instructions. Many banks also have a practice of organising a meeting of the Statutory Central Auditor and the branch auditors wherein insights are

shared and areas of importance are highlighted. The overall audit plan should also consider the important aspect from this.

2.10 The Auditor should document in the Audit plan Direction, Supervision and review strategies.

Audit procedures /understanding forms and content of financial statements/reporting

2.11 Before carrying out the audit at the branches, the Auditor should carefully make a list of all the annual returns/financial statements and certificates to be verified and certified as part of the branch audit. Understanding the underlying requirements of the annual statements to be certified would help the Auditor in designing the plan and audit procedures to be carried out.

2.12 The Auditor should carry out analytical and substantive audit procedures to verify true and fair view of the financial statements. Due to stringent timelines set by the Bank, along with appropriate test checks carried out, analytical procedures will be useful tools to find material misstatement, if any, in the financial statements. The Auditor should set materiality level in accordance with SA 320, "Materiality in Planning and Performing an Audit" and carry out substantive audit procedures for all material transactions.

2.13 Various closing forms and certificates are to be certified by the statutory auditors. Understanding the objective of such forms and certificates is very essential. The Auditor should read relevant circulars and guidelines of the RBI before verifying the forms and certificates and should understand the process followed in making such forms / certificates.

2.14 Final audit report and Long form Audit Report are two documents that are issued by the statutory auditor to the bank management. During the course of audit, the Auditor should note down the observations, which he had come across and which require attention of the management and various points need to be reported in Long Form Audit Report. While carrying out audit of each area simultaneously the Auditor should make replies for questions in Long Form Audit Report.

2.15 It is also important that the branch auditor complies with all the pre-audit formalities (like appointment letter, NOC from previous auditor, engagement letter etc.) immediately on receipt of confirmation from the bank and before the commencement of actual audit at the branch.

Audit Documentation in Bank Branch Audit

Audit Documentation in Bank Branch Audit

3.01 SA 230, "Audit Documentation" requires the auditor to duly prepare and maintain audit documentation for an audit of financial statements. Bank Audit is no exception and auditors need to collect all the documentary evidences while carrying out an audit. The nature and purpose of audit documentation has been explained in SA 230.

3.02 Various SAs also lay down the documentation that should be maintained by an auditor which should be ensured. The Auditor should ensure that the audit documentation meets the requirements of SA 230 and the specific documentation requirements of other relevant SAs and other regulatory requirements.

3.03 The Auditor should prepare the audit plans and make a note of the checks that will be carried out by him during the audit process. He should note the queries raised by him and how the same have been resolved, nature of issues that have arisen and the documents obtained for the same, and significant matters which have come across. Audit documentation must ensure that it provides sufficient evidence of the auditor's basis for a conclusion about the true and fair view of the financial statements of the branches, certificate issued, and his observations mentioned in the LFAR. Further, audit documentation must also ensure satisfactory evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

3.04 The Auditor should prepare audit documentation on a real time basis while conducting the audit. Audit documentation may be recorded on paper or on electronic or other media which can be easily retrieved as and when required. Audit documentation should be self-explanatory and should not require external help for interpretation. Examples of audit documentation include: Audit plan and programs (assigning responsibility of conduct, review and final authorization), working papers and Analysis, Issue-Memorandum, Summaries of significant matters, Letters of confirmations and representations, Checklists, Correspondences (including e-mail) concerning significant matters.

3.05 An Illustrative list of documents to be maintained in the bank branch audit file is given below-

- Appointment formalities, including appointment letter, NOC from previous

auditor, engagement letter etc.

- Latest RBI Master Directions / Circulars, other material for conducting the audit.
- Closing Guidelines / Circular issued by the Bank.
- Summary of the relevant provisions of the RBI master directions, IRAC norms, closing circular used at the branch.
- Details branch audit plan and program as per SA 230.
- Understanding of Powers and responsibilities at various levels in the branch.
- Summary of the accounting policies, observations from previous audits, inspection reports, concurrent audits etc. and how the Auditor has verified their satisfactory compliances
- Audit procedures adopted and determination of materiality levels. Understanding of the internal controls, IT system Controls.
- Audit working papers and issue trackers. How the issues raised during audit were concluded.
- Financial Statements of the previous year and current year.
- Management certified Trial Balance for the year.
- Various Audit reports such as internal inspection report, concurrent audit reports, previous year statutory audit report.
- Statement of advances with classification along with various fields duly filled such as security, sanction limits, date of sanction / renewal, outstanding balance etc.
- Specific representation, notes and working papers received by the bank's management on sensitive or significant audit issues or accounts.
- List of latest and updated stock and security statements, valuation and inspection reports.
- List of documents verified and minutes of meeting with the bank's management.
- Copies of supporting documents that are verified and confirmations obtained during the audit.
- Outstanding items of assets / liabilities.
- Proof of various securities, cash and other assets physically verified during the audit.
- Other Bank / RBI balance confirmation.
- Management Representation Letter.
- Various other Audit documents / evidence considered in audit process.

4

Overview of Standards on Auditing

4.01 Effective implementation of Standards on Auditing (SAs) is essential to ensure quality in bank branch audit as in the case of any other audit engagement. While it is true that the degree of depth in application of SAs to various sizes of the branch will vary materially, it is necessary that the Auditor must have on its records evidence that he has carried the audit as per the applicable SAs.

4.02 In order to facilitate compliance of these SAs, every audit file must contain the list of these SAs and remarks of signatory against each whether the standard is applied. This will inculcate necessary discipline among the staff members and even the signatories of the audit statements.

4.03 Let us understand the overall structure of the standards on auditing. The entire structure of SAs is divided as under:

SAs are applicable to all audit engagements. SAs are categorised as under:

- | | | |
|----|--|------------------|
| 1. | General principles & Responsibilities | SA 200 to SA 299 |
| 2. | Risk assessment & Response to the assessed risks | SA 300 to SA 499 |
| 3. | Audit Evidence | SA 500 to SA 599 |
| 4. | Using the Work of Others | SA 600 to SA 699 |
| 5. | Audit conclusions & Reporting | SA 700 to SA 799 |
| 6. | Specialised Areas | SA 800 to SA 899 |

4.04 It is necessary to keep a list of SAs in the audit documentation file to ensure their compliance. The brief on each SAs is given below which can be utilised as a reference checklist for each audit/ assignment undertaken.

SA - No.	Name of SA	Scope and Objective	Remark of Auditor
SA-200	Overall Objectives of the Independent Auditor and the	This SA establishes the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with SAs. Specifically, it sets out the overall objectives of the independent auditor,	

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	Conduct of an Audit in Accordance with Standards on Auditing	<p>and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority and structure of the SAs, and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the SAs.</p> <p>In conducting an audit of financial statements, the overall objectives of the auditor are:</p> <ul style="list-style-type: none"> (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and (b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings. 	
SA-210	Agreeing the Terms of Audit Engagements	<p>This SA deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance. This includes establishing that certain preconditions for an audit, responsibility for which rests with management and, where appropriate, those charged with governance, are present.</p> <p>The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be</p>	

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		<p>performed has been agreed, through:</p> <ul style="list-style-type: none"> (a) Establishing whether the preconditions for an audit are present; and (b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement. 	
SA-220	Quality Control for an Audit of Financial Statements	<p>This SA deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements. It also addresses, where applicable, the responsibilities of the engagement quality control reviewer.</p> <p>The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:</p> <ul style="list-style-type: none"> (a) The audit complies with professional standards and regulatory and legal requirements; and (b) The auditor's report issued is appropriate in the circumstances. 	
SA-230	Audit Documentation	<p>This SA deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements.</p> <p>The objective of the auditor is to prepare documentation that provides:</p> <ul style="list-style-type: none"> (a) A sufficient and appropriate record of the basis for the auditor's report; and (b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements. 	

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SA-240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements	<p>This SA deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Specifically, it expands on how SA 315 and SA 330 are to be applied in relation to risks of material misstatement due to fraud.</p> <p>The objectives of the auditor are:</p> <ul style="list-style-type: none"> (a) To identify and assess the risks of material misstatement in the financial statements due to fraud; (b) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and (c) To respond appropriately to identified or suspected fraud. 	
SA-250	Consideration of Laws and Regulations in an Audit of Financial Statements	<p>This SA deals with the auditor's responsibility to consider laws and regulations when performing an audit of financial statements.</p> <p>The objectives of the auditor are:</p> <ul style="list-style-type: none"> (a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements; (b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and 	

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		(c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.	
SA-260 (Revised)	Communication with Those Charged with Governance	<p>This SA deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements.</p> <p>The objectives of the auditor are:</p> <ul style="list-style-type: none"> (a) To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit; (b) To obtain from those charged with governance information relevant to the audit; (c) To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and (d) To promote effective two-way communication between the auditor and those charged with governance. 	
SA-265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	<p>This SA deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements.</p> <p>The objective of the auditor is to communicate appropriately to those</p>	

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		charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.	
SA-299 (Revised)	Joint Audit of Financial Statements	<p>This SA lays down the principles for effective conduct of joint audit to achieve the overall objectives of the auditor as laid down in SA 200. This SA deals with the special considerations in carrying out audit by joint auditors. Accordingly, in addition to the requirements enunciated in this Standard, the joint auditors also need to comply with all the relevant requirements of other applicable SAs.</p> <p>The objectives of this Standard are:</p> <ul style="list-style-type: none"> (a) To lay down broad principles for the joint auditors in conducting the joint audit. (b) To provide a uniform approach to the process of joint audit. (c) To identify the distinct areas of work and coverage thereof by each joint auditor. (d) To identify individual responsibility and joint responsibility of the joint auditors in relation to audit. 	
SA-300	Planning an Audit of Financial Statements	<p>This SA deals with the auditor's responsibility to plan an audit of financial statements. This SA is framed in the context of recurring audits. Additional considerations in initial audit engagements are separately identified.</p> <p>The objective of the auditor is to plan the audit so that it will be performed in an effective manner.</p>	

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SA-315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment	<p>This SA deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control.</p> <p>The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.</p>	
SA-320	Materiality in Planning and Performing an Audit	<p>This SA deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements.</p> <p>The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.</p>	
SA-330	The Auditor's Responses to Assessed Risks	<p>This SA deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with SA 315.</p> <p>The objective of the auditor is to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.</p>	

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SA-402	Audit Considerations Relating to an Entity Using a Service Organization	<p>This SA deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations.</p> <p>The objectives of the user auditor, when the user entity uses the services of a service organisation, are:</p> <ul style="list-style-type: none"> • To obtain an understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement; and • To design and perform audit procedures responsive to those risks. 	
SA-450	Evaluation of Misstatements Identified during the Audit	<p>This SA deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.</p> <p>The objective of the auditor is to evaluate:</p> <ol style="list-style-type: none"> (a) The effect of identified misstatements on the audit; and (b) The effect of uncorrected misstatements, if any, on the financial statements. 	
SA-500	Audit Evidence	<p>This SA explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which</p>	

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		<p>to base the auditor's opinion.</p> <p>The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.</p>	
SA-501	Audit Evidence-Specific Considerations for Selected Items	<p>This SA deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence in accordance with SA 330, SA 500 and other relevant SAs, w.r.t. certain aspects of inventory, litigation and claims involving the entity, and segment information in an audit of financial statements.</p> <p>The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the:</p> <ul style="list-style-type: none"> (a) Existence and condition of inventory; (b) Completeness of litigation and claims involving the entity; and (c) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework. 	
SA-505	External Confirmations	<p>This SA deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 330 and SA 500.</p> <p>The objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence.</p>	

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SA-510	Initial Audit Engagements- Opening Balances	<p>This SA deals with the auditor's responsibilities relating to opening balances when conducting an initial audit engagement.</p> <p>In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:</p> <ul style="list-style-type: none"> (a) Opening balances contain misstatements that materially affect the current period's financial statements; and (b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework. 	
SA-520	Analytical Procedures	<p>This SA deals with the auditor's use of analytical procedures as substantive procedures, and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.</p> <p>The objectives of the auditor are:</p> <ul style="list-style-type: none"> (a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and (b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity. 	

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SA-530	Audit Sampling	<p>This SA applies when the auditor has decided to use audit sampling in performing audit procedures. It deals with the auditor's use of statistical and non-statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from the sample.</p> <p>The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.</p>	
SA-540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	<p>This SA deals with the auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how SA 315, SA 330 and other relevant SAs are to be applied in relation to accounting estimates.</p> <p>The objective of the auditor is to obtain sufficient appropriate audit evidence whether in the context of the applicable financial reporting framework:</p> <ul style="list-style-type: none"> (a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable; and (b) related disclosures in the financial statements are adequate. 	
SA-550	Related Parties	<p>This SA deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements. Specifically, it expands on how SA 315, SA 330 and SA 240 are to</p>	

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		<p>be applied in relation to risks of material misstatement associated with related party relationships and transactions.</p> <p>The objectives of the auditor are:</p> <p>(a) Irrespective of whether the applicable financial reporting framework establishes related party requirements, to obtain an understanding of related party relationships and transactions sufficient to be able:</p> <p>(i) To recognise fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and</p> <p>(ii) To conclude whether the financial statements, insofar as they are affected by those relationships and transactions:</p> <p>a. Achieve a true and fair presentation (for fair presentation frameworks); or</p> <p>b. Are not misleading (for compliance frameworks); and</p> <p>(b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted</p>	
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		for and disclosed in the financial statements in accordance with the framework.	
SA-560	Subsequent Events	<p>This SA deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements.</p> <p>The objectives of the auditor are to:</p> <ul style="list-style-type: none"> (a) Obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements; and (b) Respond appropriately to facts that become known to the auditor after the date of the auditor's report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report. 	
SA-570 (Revised)	Going Concern	<p>This SA deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report.</p> <p>The objectives of the auditor are:</p> <ul style="list-style-type: none"> (a) To obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements; (b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related 	

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		<p>to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and</p> <p>(c) To report in accordance with this SA.</p>	
SA-580	Written Representations	<p>This SA deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance.</p> <p>The objectives of the auditor are:</p> <p>(a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;</p> <p>(b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and</p> <p>(c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.</p>	

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SA-600	Using the Work of Another Auditor	This SA establishes standards to be applied in situations where the principal auditor, reporting on the financial information of an entity, uses the work of other auditor w.r.t. financial information of components included in the financial information of the entity.	
SA-610 (Revised)	Using the Work of Internal Auditors	<p>This SA deals with the external auditor's responsibilities if using the work of internal auditors. This includes (a) using the work of the internal audit function in obtaining audit evidence and (b) using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor.</p> <p>The objectives of the external auditor, where the entity has an internal audit function and the external auditor expects to use the work of the function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor, or to use internal auditors to provide direct assistance, are:</p> <p>(a) To determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent;</p> <p>and having made that determination:</p> <p>(b) If using the work of the internal audit function, to determine whether that work is adequate for the purposes of the audit; and</p> <p>(c) If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.</p>	

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SA-620	Using the Work of an Auditor's Expert	<p>This SA deals with the auditor's responsibilities regarding the use of an individual or organisation's work in a field of expertise other than accounting or auditing, when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence.</p> <p>The objectives of the auditor are:</p> <ul style="list-style-type: none"> (a) To determine whether to use the work of an auditor's expert; and (b) If using the work of an auditor's expert, to determine whether that work is adequate for the auditor's purposes. 	
SA-700 (Revised)	Forming an Opinion and Reporting on Financial Statements	<p>This SA deals with the auditor's responsibility to form an opinion on the financial statements. It also deals with the form and content of the auditor's report issued as a result of an audit of financial statements.</p> <p>The objectives of the auditor are:</p> <ul style="list-style-type: none"> (a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and (b) To express clearly that opinion through a written report. 	
SA - 701	Communicating Key Audit matters in the Independent Auditor's report	<p>This SA deals with the auditor's responsibility to communicate key audit matters in the auditor's report. It is intended to address both the auditor's judgment as to what to communicate in the auditor's report and the form and content of such communication.</p> <p>The objectives of the auditor are to determine key audit matters and, having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report.</p>	

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SA-705 (Revised)	Modifications to the Opinion in the Independent Auditor's Report	<p>This SA deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700(Revised), the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary. This SA also deals with how the form and content of the auditor's report is affected when the auditor expresses a modified opinion.</p> <p>The objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that is necessary when:</p> <ul style="list-style-type: none"> (a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement. 	
SA-706 (Revised)	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report	<p>This SA deals with additional communication in the auditor's report when the auditor considers it necessary to:</p> <ul style="list-style-type: none"> (a) Draw users' attention to a matter or matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements; or (b) Draw users' attention to any matter or matters other than those presented or disclosed in the 	

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		<p>financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.</p> <p>The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:</p> <p>(a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or</p> <p>(b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.</p>	
SA-710	Comparative Information- Corresponding Figures and Comparative Financial Statements	<p>This SA deals with the auditor's responsibilities regarding comparative information in an audit of financial statements.</p> <p>The objectives of the auditor are:</p> <p>(a) To obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and</p> <p>(b) To report in accordance with the auditor's reporting responsibilities.</p>	

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SA-720 (Revised)	The Auditor's Responsibilities Relating to Other Information	<p>This SA deals with the auditor's responsibilities relating to other information, whether financial or non-financial information (other than financial statements and the auditor's report thereon), included in an entity's annual report.</p> <p>The objectives of the auditor, having read the other information, are:</p> <ul style="list-style-type: none"> (a) To consider whether there is a material inconsistency between the other information and the financial statements; (b) To consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit; (c) To respond appropriately when the auditor identifies that such material inconsistencies appear to exist, or when the auditor otherwise becomes aware that other information appears to be materially misstated; and (d) To report in accordance with this SA. 	
SA-800	Special Considerations-Audit of Financial Statements Prepared in Accordance with Special Purpose Frameworks	<p>This SA deals with special considerations in the application of SAs in the 100-700 series to an audit of financial statements prepared in accordance with a special purpose framework.</p> <p>The objective of the auditor, when applying SAs in an audit of financial statements prepared in accordance with a special purpose framework, is to address appropriately the special considerations that are relevant to:</p> <ul style="list-style-type: none"> (a) The acceptance of the 	

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		<p>engagement;</p> <p>(b) The planning and performance of that engagement; and</p> <p>(c) Forming an opinion and reporting on the financial statements but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.</p>	
SA-805	Special Considerations-Audit of Single Financial Statements and specific Elements, Accounts or Items of a Financial Statement	<p>This SA deals with special considerations in the application of SAs in the 100-700 series to an audit of a single financial statement or of a specific element, account or item of a financial statement.</p> <p>The objective of the auditor, when applying SAs in an audit of a single financial statement or of a specific element, account or item of a financial statement, is to address appropriately the special considerations that are relevant to:</p> <p>(a) The acceptance of the engagement;</p> <p>(b) The planning and performance of that engagement; and</p> <p>(c) Forming an opinion and reporting on the single financial statement or on the specific element, account or item of a financial statement but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.</p>	
SA-810	Engagements to report on Summary Financial Statements	<p>This SA deals with the auditor's responsibilities when undertaking an engagement to report on summary financial statements derived from financial statements audited in accordance with SAs by that same auditor.</p>	

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		<p>The objectives of the auditor are to:</p> <ul style="list-style-type: none">(a) Determine whether it is appropriate to accept the engagement to report on summary financial statements;(b) Form an opinion on the summary financial statements based on an evaluation of the conclusions drawn from the evidence obtained; and(c) Express clearly that opinion through a written report that also describes the basis for that opinion.	
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Compliance with the SAs should be taken care of, while executing the audit as well as reporting.

5

Special Considerations in a CBS Environment

Introduction

5.01 The face of Banking Industry is changing rapidly. What banking is today is quite different from what it was in the years gone by. Rapid strides in technological advancements, different payment systems, integration of Aadhaar for cardless transactions are changing the way of banking. However, in recent times there have been few instances of manipulating the banking system for unlawful gains and frauds.

Responsibilities of Branch Auditors

5.02 Generally, the branch auditors do not have access to the overall IT policy, processes, controls and accounting procedures implemented by the bank. Moreover, the branch auditors confront following practical issues at fully computerised branches:

- Accounting manual, entries, calculations and framework is built in computerised accounting systems.
- Critical IT and manual controls are centralised at HO level.
- Limited access to periodical MIS, exception reports, NPA related reports generated by the system.
- Documentation of critical processes performed for accounting and book keeping (IT and Manual).
- Access to primary records and entry level transactions.
- Difficulty in audit sampling due to huge population of data.
- Hard copies of transactions.
- Independent IT Audit at branches, etc.
- Staff ignorance about various aspects of the IT infrastructure at the Branch.

5.03 Overall review of IT environment and of the computerised accounting system has to be taken up at the central level. The management plays a more proactive role to ensure that the computerised accounting systems are working properly and effectively. It is for the Statutory Central Auditor to review whether

the management is performing this role effectively. The roles and responsibilities of bank, and the branch auditors are enumerated in the following paragraphs.

Role and responsibilities of the Bank

5.04 Considering the importance of IT systems in the preparation and presentation of financial statement, it is imperative that the bank should share detailed information about the following key aspects relating to IT environment of the bank with the central/branch auditor at regular intervals:

- Overall IT Policy, structure and environment of the bank's IT system and changes/developments, if any, thereto. The Bank is also required to put in place a cyber security framework as mandated by RBI vide Circular no. DBS.CO/CSITE/BC.11/33.01.001/2015-16 dated June 2, 2016 and any amendments thereto.
- Data processing and data interface under various systems.
- Data integrity and data security.
- Business Continuity Plans and Disaster Recovery Plans.
- Accounting manual and critical accounting entries (including month-end and year-end) and the processes and involvement of IT systems.
- Controls over key aspects, such as, account codes and mapping thereof, use of various account heads including other assets and other liabilities, asset classification, income recognition, expense booking, overdue identification, month-end and year-end procedures, valuation and re-valuation of various items of the financial statements, KYC, AML, etc.
- Controls and recording of various e-banking and internet banking products and channels.
- Manual processing of key transactions.
- MIS reports being generated and the periodicity thereof.
- Hard copies being generated and the periodicity thereof.
- Process of generating information related to various disclosures in the financial statements and the involvement of the IT systems.
- Major exception reports and the process of generation thereof along with logic embedded in generation of such reports.
- Major IT related issues (including frauds and failures) faced and resolved/unresolved during the year, such as, data/system corruption,

system break-down, etc., having a bearing on the preparation and presentation of financial statements.

- Significant observations of internal auditors, concurrent auditors, system auditors, RBI inspection, internal inspection, etc., related to computerised accounting and overall IT systems.
- Customer complaints related to mistakes in transactions (interest application, balances, etc.).
- In order to ensure that the technology deployed to operate the payment system/s authorised is/are being operated in a safe, secure, sound and efficient manner and as per the process flow submitted by the bank for which authorisation has been issued; banks are required to get a System audit done by a firm of Chartered Accountants. The auditor conducting the System Audit should also be a Certified Information System Auditor (CISA) and registered with the ISACA. The scope of the System audit would include evaluation of the hardware structure, operating systems and critical applications, security and controls in place, including access controls on key applications, disaster recovery plans, training of personnel managing systems and applications, documentation, etc. The system auditor is also required to comment on the deviations, if any, in the processes followed from the process flow submitted to RBI while seeking authorisation.¹
- Compliance documentation with RBI IT and Security directives and guidelines.

Role and responsibilities of branch auditors

5.05 Based on the guidance and information received from the Statutory Central Auditor / Bank, the branch auditors need to ensure that:

- Their roles and responsibilities are clearly understood and implemented.
- To the extent possible, data analysis tools are used for better and effective audit.
- Test of controls and substantive checking of sample transactions are carried out at the branch level and, where considered necessary, the results are shared with the Statutory Central Auditors.
- Data review and analysis through CBS is carried out.

¹ Refer RBI circular No. DPSS.AD.No./ 1206/02.27.005/2009-2010 dated 7th December, 2009 on "System Audit of the Payment Systems operated under the PSS Act, 2007".

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- Significant observations having bearing on the true and fair view are reported to the Statutory Central Auditors.
- Any other limitations on audit which are required to be reported to the Statutory Central Auditors are reported in a timely manner.

NPA Identification through System (RBI Guidelines)

5.06 The RBI had come out with the following Guidelines for NPA identification.

- Various instances have been observed wherein Banks are still found to be resorting to manual identification of NPA and also over-riding the system generated asset classification by manual intervention. Several gaps have been observed in automated processes for NPA identification, income recognition, provisioning and generation of related returns.
- In order to ensure the completeness and integrity of the automated Asset Classification (classification of advances/investments as NPA/NPI and their upgradation), Provisioning calculation and Income Recognition processes, RBI vide circular no. RBI/2020-21/37 Ref. No. DoS.CO.PPG./SEC.03/11.01.005/2020-21, dated September 14, 2020, advised banks to put in place / upgrade their systems to system based asset classification on an ongoing exercise for both down gradation and up-gradation of accounts.
- As per this circular banks should ensure that the asset classification status is updated as part of day end process. Banks should also be able to generate classification status report at any given point of time with actual date of classification of assets as NPAs/NPIs.
- Banks shall not resort to manual intervention / over-ride in the System based asset classification process. In any exceptional circumstance where manual intervention is required to override the System classification, it must have at least two level authorisation.
- Day end process and manual interventions are generally at branch level operations; branch auditor to ensure compliance of the said circular.

Auditors should note that the above Circular is applicable from June 2021.

Data Analytics on CBS MIS Reports

5.07 In terms of Chapter VIII of Master Directions no. RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016-17, "Master Directions on Frauds – Classification and Reporting by commercial banks and select FIs" dated July 1, 2016 (updated as on July 03, 2017), bank should track Early Warning Signals (Annex-II of Master Directions) by integrating with the credit monitoring process

in the bank so that it becomes a continuous activity and also acts as a trigger for any possible credit impairment in the loan accounts, given the interplay between credit risks and fraud risks.

5.08 Among the illustrative 42 EWS, the most prominent ones are, suspicious related party transactions and financial and stock statement manipulations are posed to high credit and fraud risks.

5.09 Further, the auditor should bring it to the notice of the top management and if necessary to the Audit Committee of the Board (ACB) for appropriate action such instances of EWS.

I. Related party transactions pose a big threat to credit risks and fraud risks. As system preventive controls or manual maker and checker controls are weak in banking with respect to controlling borrowers suspicious related party transactions, auditors have carryout substantive analytical procedures using tools like spreadsheet to rule out material misstatements due to fraud or error.

Data analytics can be used on the CBS MIS reports, borrowers financials and stock statements for assessing credit and or fraud risks.

Spreadsheet can be used as an audit documentation tool in support of compliance to various auditing standards viz. SA 230, SA 240, SA 315, SA 300, SA 520, etc., spreadsheet functions like sort, filter, sumif, vlookup, pivot can be used for audit documentation.

II. Financial Statement and Stock Statement manipulations for enhanced loan eligibility

Following are control weaknesses in CBS

- a. DP calculated on the basis of manual returns is entered in the CBS. Except for maximum sanctioned limit/DP no other application control on quality of returns.
- b. There is a lack of independent application systems to assess the quality of stock statements and periodical returns.
- c. Validation controls are weak with respect to DP limits.
- d. Controls around validation of borrowers' financial statement are weak.
- e. Audited Financial statements content is entered into spreadsheet template as a part of CMA data for critical ratio analysis related to liquidity, profitability, and other ratios. Application controls for analysis of financial statements are weak.

III. Wrong IRAC classifications by banks are significant audit risks.

Following are control weaknesses in CBS:

- a. Basis of IRAC classification is dependent on fields such as Loan Sanction Date, Period of Loan, Rate of interest, moratorium, nature of facility, priority sector, terms of re-schedulement, etc., which are at times updated manually at the branch and not through Centralised / automated process.
- b. Periodic validation of IRAC classification, especially in case of Doubtful or Loss Assets wherein at times it is observed that the same is not system driven and updated manually at the branch.

Audit in a CIS environment

Assessment of Inherent and Control Risks

5.10 The nature of banking operations is such that the auditors may not be able to reduce the audit risk to an acceptable low level by the performance of substantive procedures alone. It may be so on account of following factors:

- The extensive use of IT and EFT systems, which means that much of the audit evidence is available only in electronic form and is produced by the bank's own IT systems.
- The high volume of transactions processed by banks, which makes reliance on substantive procedures alone impracticable.
- The geographic spread of banks' operations.
- Complex trading transactions (Highly inter connected and automated systems such as card, mobile banking and payment systems).
- The susceptibility of the financial statements to frauds and auditor's responses as per SA 240.

5.11 In most situations, the auditors' ability to reduce audit risk to an acceptably low level would be affected by the internal control systems established by the management that allow the auditors to be able to assess the level of inherent and control risks as less than high. The auditors obtain sufficient appropriate audit evidence to assess the level of inherent and control risks.

5.12 The auditor's procedures would need to be adapted as circumstances warrant and in respect of each account, different procedures may be necessary.

5.13 The principal objective of the auditor in undertaking an audit in a CIS environment is to evaluate the effectiveness of controls. In simple words, controls are those policies and procedures which the organisation implements to minimise the events and circumstances whose occurrence could result in a loss / misstatement. There are mainly four types of controls:

A. *Deterrent controls* - Deterrent controls are designed to deter people, internal

as well as external, from doing undesirable activities. For example, written policies including the punitive measures may deter people from doing undesired activities.

- B. *Preventive Controls* - Preventive controls prevent the cause of exposure from occurring or at least minimise the probability of unlawful event taking place. For example, security controls at various levels like hardware, software, application software, database, network, etc.
- C. *Detective Controls* - When a cause of exposure has occurred, detective controls report its existence in an effort to arrest the damage further or minimise the extent of the damage. Thus, detective controls limit the losses if an unlawful event has occurred. Review processes in place at a Branch are examples of detective controls.
- D. *Corrective Controls* - Corrective controls are designed to recover from a loss situation. For example, 'business continuity planning' is a corrective control. Without corrective controls in place, the bank has risk of loss of business and other losses due to its inability to recover essential IT based services, information and other resources after the disaster has taken place.

5.14 The Auditor should obtain a preliminary understanding of the IT environment and various controls put in place by the management, including entity-level controls and then test and evaluate whether the controls are operating effectively. The Auditor should discuss the methodology adopted by the bank in implementing controls and their monitoring with the Head of the IT department and the Head of the audit department. These discussions will enable the auditor to get a view on the manner in which the bank has implemented controls. Based on these discussions, the auditor could interact with the various officials of the bank to determine whether they are sensitised to the control expectations of the management considering the technology deployed. If this sensitisation level is low, the auditor may need to perform more extensive audit procedures.

Security Control Aspects

5.15 The key security control aspects that an auditor needs to address when undertaking audit in a computerised bank include:

- Ensure that authorised, accurate and complete data is made available for processing.
- Ensure that in case of interruption due to power, mechanical or processing failures, the system restarts without distorting the completion of the entries and records.

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- Verify whether “access controls” assigned to the staff-working match with the responsibilities as per manual. It is important for the auditor to ensure that access and authorisation rights given to employees are appropriate.
- Verify that segregation of duties is ensured while granting system access to users and that the user activities are monitored by performing an activities log review.
- Verify that changes made in the parameters or user levels are authenticated.
- Verify that charges calculated manually for accounts when function is not regulated through parameters are properly accounted for and authorised.
- Verify that exceptional transaction reports are being authorised and verified on daily basis by the concerned officials. It is important for the auditor to understand the nature of exception and its impact on financials.
- Verify that the account master and balance cannot be modified / amended / altered except by the authorised personnel.
- Verify that all the general ledger accounts codes authorised by Head Office are in existence in the system.
- Verify that balance in general ledger tallies with the balance in subsidiary book.

Risks arising out of CBS environment

Credit Risk

5.16 Generally, the bank's credit risk is not increased by the mere fact that a loan is originated through an e-banking channel. However, the bank should ensure that additional precautions are in place when originating and approving loans electronically including assuring management information systems' effectiveness by preparing a track of the performance of portfolios originated through e-banking channels. The following aspects of on-line loan origination and approval tend to make risk management of the lending process more challenging:

- Verifying the customer's ID for on-line credit applications and executing an enforceable contract;
- Monitoring and controlling the growth, pricing, and on-going credit quality of loans originated through e-banking channels;

- Monitoring and oversight of third-parties operations doing business as agents or on behalf of the banks;
- Valuing collateral and perfecting liens over a potentially wider geographic area; and
- Collecting loans from individuals over a potentially wider geographic area.

If not properly managed, these aspects can significantly increase the credit risk.

Compliance/ Legal Risk

5.17 Compliance and legal issues arise out of the rapid growth in usage of e-banking services and the differences between the electronic and paper-based processes. E-banking is a new delivery channel where the laws and rules governing the electronic delivery of certain financial products or services may be ambiguous or still evolving. Specific regulatory and legal challenges include:

- Uncertainty over the legal jurisdictions applicable to the transaction taking place through e-banking.
- Delivery of credit and deposit related disclosures/notices as required by law or regulation.
- Retention of required compliance documentation for on-line advertising, applications, statements, disclosures, notices.
- Establishment of legally binding electronic agreements.

5.18 Banks offering e-banking services, both informational and transactional, assume a higher level of compliance risk because of the changing nature of the technology, the speed at which errors can be replicated, and the frequency of regulatory changes to address e-banking issues. The potential for violations is further heightened by the need to ensure consistency between paper and electronic advertisements, disclosures and notices.

Reputational Risk

5.19 The rise of the sophisticated cyber-crime has become one of the fastest growing security and reputational risks to banks. The cyber-crime landscape features malware exploits that can routinely evade traditional security controls. The reactive attack and penetration approaches of the past may no longer be sufficient to deal effectively with that level of ingenuity of cyber-attacks and are being replaced with new forms of cyber intelligence capable of enhancing traditional security programs. Adding a layer of complexity to the issue is the rise

of social networking, online communications, and online financial transactions. The bank has a significant role to play in identifying and addressing this risk thereby safeguarding its reputation and instilling the confidence in its customers.

Audit through CBS

5.20 With the adoption of CBS by banks, realignment in the conventional audit methodology has also become inevitable. Audit is required to be conducted through the system. In various aspects, the automated controls in the CBS system are also required to be reviewed and verified.

What is CBS?

5.21 The core banking system is the set of basic software components that manage the services provided by a bank to its customers through its branches (branch network). The bank's customers can make their transactions from any branch, ATM, Service Outlets, Internet, Phone at their disposal. The CBS is based on Service Oriented Architecture (SOA). It helps banks to reduce risk that can result from manual data entry and out of date information. It also helps banks to improve Service Delivery quality and time to its customer. The software is accessed from different branches of bank via communication lines like telephones, satellite, internet, etc.

5.22 Core Banking Solution [CBS] works on a concept of Centralized Database and Processing. Transactions take place at various geographical locations which get recorded and processed at a Centralized Server. Updating of Database is on Real Time Basis. Due to the Centralization of Transaction Processing, issue of Out of Date Information is eliminated. All the users connected to CBS will be able to get up to date information. CBS also enhances the quality of Reporting and strengthens Access Control.

5.23 Under CBS data is stored in centralized servers at Data Centre. This effectively means that all operations at the connected branches, back offices are carried out through servers at Data Centre including transactions through other delivery channels like ATMs, Internet Banking, Phone Banking.

5.24 Under CBS, the branches, back offices are defined as SOL (i.e. Service Outlets) where each SOL functions as a service window. The CBS is capable of processing any transaction from any branch location connected to CBS. It can be equated with single window operations at airline counters or railway reservation counters wherein all the services can be obtained at one place. Hence, under CBS customer is now a customer of the bank and not merely a customer of a branch of the Bank. This has facilitated "Any-where, Anytime Banking" convenience for the customer.

5.25 From Bank's perspective, control over the application and processes has been entrusted at Data Center Level. In addition to it, CBS also makes available effective MIS on real-time basis. It enables generation of all periodical returns centrally.

5.26 There are various CBS developed by various software companies available in the market. Few widely used CBS are (a) FINACLE, (b) BaNCS and (c) FlexCube. An Illustrative List of Special Purpose / Exception Reports in CBS is given as Annexure to this Chapter.

5.27 The Branch auditor should call for reports, if any, of the CBS environment in use at the Branch. Further, the auditor should also consider interaction of various other IT systems with the CBS and review whether the flow of data between various systems is seamless and without any manual intervention.

Annexure**Illustrative List of Special Purpose / Exception Reports in CBS**

The following indicative list of reports will benefit SCAs and SBAs (if shared in advance) while undertaking the audit in a fully computerised environment:

Advances

Sr. No.	Report
i.	Advances Snapshot covering all important parameters
ii.	Accounts with overdue in excess of 90 Days and are classified as Standard Assets
iii.	List of LCs devolved during the period / year and current status of account
iv.	List of BGs invoked during the period / year and current status of account
v.	Standalone Non Fund Based Limits granted to customers
vi.	List of SMA / Watch list / Probable NPA/Weak account accounts as on the last date of Audit period
vii.	Backdated updation of stock and book debt statements (Difference between Date of updation in CBS and Date of Stock Statement updated)
viii.	List of accounts wherein the facility is not renewed / reviewed
ix.	List of accounts slipped to NPA during the current period
x.	List of accounts wherein there is an amendment in Date of NPA
xi.	List of accounts written off during the period / year
xii.	List of Accounts upgraded (along with date of upgrade and the overdues on the date of upgrade)
xiii.	Quick Mortality (NPA within 1 year of Advance)
xiv.	List of NPA Accounts with Security Valuation not carried out within the prescribed period
xv.	List of accounts wherein re-phasing (Change in EMI, Tenor, Moratorium period) is carried out in CBS (excluding re-phasing due to change in the reference rate)
xvi.	Loan / OD against FD with no linkage to FD (i.e. Security)
xvii.	Loan to Minor (Excluding Non individual accounts and excluding Education, Loan/OD against Deposit cases)

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Sr. No.	Report
xviii.	Loans below the benchmark rate (as applicable in each bank)
xix.	Loans above the maximum lending rate (as applicable in each bank)
xx.	Loans where disbursement is made in Cash (Threshold limit may be prescribed)
xxi.	Credit transactions in CC / OD / Loan Accounts with Value Date (Back Date) without Value Date (Back Date) at Debit Leg.
xxii.	Advance accounts where effective interest rate is Zero.
xxiii.	CC Accounts with primary security is "Nil"
xxiv.	Multiple TODs / Ad hoc Sanctions for a customer.
xxv.	Non delinking of Ad hoc facility sanctioned on expiry
xxvi.	Multiple Customer IDs having common PAN
xxvii.	Red Flagged Accounts since more than 6 months

Profit & Loss

Sr. No.	Report
i.	Manual debit to Interest Income and Other Income Account
ii.	Manual credits to Interest Income and Other Income Account
iii.	Manual debit to Interest Expense Account
iv.	Interest pegging marked as "Y" for loans sanctioned at variable rate i.e. w.r.t. benchmark rates (pegging may freeze the interest rate at the respective time).

Foreign Exchange, Internal Controls and Systems

Sr. No.	Report
i.	Bills under LC devolved and not crystallized. / Bills under LC devolved wherein the crystallization account is office account / not of customer.
ii.	Export Bills discounted / purchased and outstanding beyond due dates.
iii.	Packing Credits Accounts outstanding beyond due dates / Running Packing Credit accounts with age of un-utilized orders is more than 365 days.
iv.	Resident Customers having Non Resident Account (under same or multiple customer master)

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v.	NRE Account Holder having Resident Savings Account (under same or multiple customer master)
vi.	FDs / RDs with aggregate balance at customer master level in excess of Rs. 20,000 and closed one / all FDs / RDs in cash
vii.	Cash Payments from Office Accounts in excess of Rs. 10,000
viii.	Non Senior Citizen customers (based on DOB) with Senior Citizen Interest Table code
ix.	Preferential Interest Rate applicable to staff applied in non staff deposit (Refer the policy of bank w.r.t. extending facility to ex-staff and relatives of staff / ex-staff)
x.	List of Outstanding Office Accounts entries (Pointing type accounts)
xi.	Accounts with invalid PAN (No. of digits, structure, constitution code mapping with 4 th Digit)
xii.	List of Foreign Exchange transactions with Exchange Rates beyond the card rate / Maximum-Minimum Rate during the period

Capital Adequacy

Sr. No.	Report
i.	Accounts above threshold limit wherein External Credit Rating is not obtained / updated
ii.	Bank Guarantees and LC Expired and not reversed.
iii.	Accounts with mismatch in Constitution code and BASEL Mapping

The above list of reports is indicative only. There are various other reports that can be generated. However, the generation of reports requires in-depth review of bank's systems, processes and gaps. The reports can be made more effective through continuation review and update mechanism.

6

Cash

6.01 The primary check for cash is to carry out verification of the balance of cash on hand. Wherever feasible, the Auditor should visit the branch at the close of business on the last working day of the year or before the commencement of business hours on the next day for carrying out physical verification of cash. If, for any reason, the auditor is unable to do so, he should carry out the physical verification of cash as close to the balance sheet date as possible, at the time of audit and also reconcile with the cash register/balance in CBS.

6.02 The physical verification should be evidenced through working paper indicating the denominations and the number of currency notes. The auditor should ensure that the physical verification of cash includes physical verification of cash on hand, cash at ATM and cash at CDM (Cash Deposit Machines) and the reconciliation of the same with the GL balances of the respective GL heads. The counting sheet should be counter signed by the Cashier and the Branch manager.

6.03 In some banks, the branch deposits a large portion of its cash balance with the RBI or the State Bank of India or any other bank on the closing day and in such cases, the auditor should request the branch to provide sufficient appropriate evidence for the same and also ensure that the same is effected in the books of accounts and is not appearing as a bank reconciliation item.

6.04 Besides the physical verification, if there are instructions or certifications specific to the bank, the same needs to be complied with. Following specific questions w.r.t. cash need to be addressed in LFAR.

- (a) Does the system ensure that cash maintained is in effective joint custody of two or more officials, as per the instructions of the controlling authorities of the bank?
- (b) 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?

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- (c) (i) Does the branch generally maintain / carry cash balances, which vary significantly from the limits fixed by the controlling authorities of the bank?
- (ii) Does the figure of the balance in the branch books in respect of cash with its ATM(s) tally with the amounts of balances with the respective ATMs, based on the year end scrolls generated by the ATMs? If there is any difference, same should be reported.
- (d) Whether the insurance cover available with the branch adequately meets the requirement to cover the cash-in hand and cash-in transit?

Balances with Reserve Bank of India, State Bank of India and Other Banks (For Branches with Treasury Operations)

7.01 In most of the branches, there will be no bank account. Hence this section does not require any reporting. However, in case there is a bank account balance, following steps need to be taken for the audit.

- (i) Examine that no debit for charges or credit for interest is outstanding and all the items which ought to have been taken to books of accounts for the year have been considered. This should be particularly observed when the bills collected, etc., are credited with net amount and entries for commission, etc., are not made separately in the statement of account.
- (ii) Examine that no cheque sent or received in clearing is outstanding. As per the practice prevalent among banks, any cheque returned unpaid are accounted for on the same day on which they were sent for clearing or on the following day.
- (iii) Examine that all bills or outstanding cheques sent for collection and outstanding as on the closing date have been credited subsequently.
- (iv) The auditor should also examine the large transactions in inter-bank accounts, particularly towards the year-end, to ensure that no transactions have been put through for window-dressing.
- (v) In respect of balances in deposit accounts, original deposit receipts should be examined in addition to confirmation certificates obtained from banks in respect of outstanding deposits. The auditor should also ensure that interest on such deposits has been recorded on time proportion basis and interest has been recorded till the closing day.
- (vi) The balances with banks outside India should also be verified in the manner described above. These balances should be converted into Indian currency at the exchange rates prevailing on the balance sheet date.
- (vii) Increasingly banks are automating the process of reconciliation with other banks. In case of system process, the auditor should understand the system, system controls and manual controls.

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- (viii) The auditor should review the bank reconciliation statement (whether automated or manual) and undertake age-wise and entry-wise analysis of the same and verify if any effect to un-responded entries is required to be given and / or provision related thereto is required.

7.02 Besides the requisite audit checks as specified above, in respect of branches where bank balances are maintained, following LFAR issues need to be addressed:

- a) Were balance confirmation certificates obtained in respect of outstanding balances as at the year-end and whether the aforesaid balances have been reconciled? The nature and extent of differences should be reported.
- Balance confirmation certificates to be obtained in respect of outstanding balances as at the year end as well as at the end of the month.
 - Obtain the Bank Reconciliation Statement for the above referred period.
 - If the reconciliation is not carried out or carried out incorrectly the same to be reported.
 - If any difference is observed, then report the amount, nature of difference and period since when the amount is lying in the reconciliation statement.
- b) Observations on the reconciliation statements may be reported in the following manner:
- (i) Cash transactions remaining un-responded (give details)
 - (ii) Revenue items requiring adjustments/write-off (give details)
 - (iii) Other credit and debit entries originated in the statements provided by RBI/other banks, remaining un-responded for more than 15 days.
 - (iv) Where the branch maintains an account with the RBI, the following additional matter may be reported:

Entries originated prior to, but communicated / recorded after, the year end in relation to currency chest operations at the branch/other link branches, involving deposits into / withdrawals from the currency chest attached to such branches (Give details)
- c) In case, any matter deserves special attention of the management, the same may be reported.

Money at Call and Short Notice

8.01 Generally, this activity is handled in the Treasury Department of the bank. In view of the same, such types of transactions do not appear in the Branch Books. However, the Auditor should confirm that no such transactions are appearing in the Branch Trial Balance. The RBI statement provided to the Treasury Branch mentions the branch code against each of the entries and in turn the treasury department provides the same to the branch and asks the branch to respond for passing the appropriate accounting entry in the books of accounts. The auditor should check the communication between the branch and the treasury branch and ascertain that any entry pertaining to the branch is appropriately identified and passed in the books of accounts.

8.02 If there are such types of transactions, obtain the instructions/guidelines laid down by the Controlling Authorities of the bank and examine the compliance thereof.

8.03 The Auditor is required to report on following points for the said activity in Long Form Audit Report:

- a) Has the branch kept money-at-call and short notice during the year?
- b) Has the year-end balance been duly confirmed and reconciled?
- c) Has interest accrued up to the year-end been properly recorded?
- d) Whether instructions/guidelines, if any, laid down by the controlling authorities of the bank have been complied with?

9

Investments (For Branches Outside India)

9.01 This area is looked after by Treasury Department of the bank. Hence, such types of transactions do not appear in Branch Books. However, the auditor should confirm that no Investments are appearing in the Branch Trial Balance. However, in case of Branches outside India, the Investment activity is carried out at branch level as well.

9.02 If investments are appearing in the branch trial balance, physical verification and reconciliation with the books should be conducted and reported accordingly. Also verify investment balance confirmation of counter party (Investee) with balance appearing in Branch Books.

Reporting in Long Form Audit Report

9.03 For Branches outside India

- a) In respect of purchase and sale of investments, has the branch acted within its delegated authority, having regard to the instructions/ guidelines in this behalf issued by the controlling authorities of the bank?
- b) Have the investments held by the branch whether on its own account or on behalf of the Head Office / other branches been made available for physical verification? Where the investments are not in the possession of the branch, whether evidences with regard to their physical verification have been produced?
- c) Is the mode of valuation of investments in accordance with the RBI guidelines or the norms prescribed by the relevant regulatory authority of the country in which the branch is located whichever are more stringent?
- d) Whether there are any matured or overdue investments which have not been encashed and / or has not been serviced? If so, give details?

9.04 The questions in LFAR are self-explanatory and no specific guidance is provided here. However, the Auditor may refer to Chapter 5 "Treasury Operations" given in the Section A of this Guidance Note.

Introduction

10.01 Agriculture has always been the backbone of the Indian economy despite sustained progress in industrial and service(s) sector. It still contributes around 14 per cent of the GVA (Gross Value Added) and provides employment opportunities to around 42 per cent of the population (Source: National Council of Applied Economic Research, Delhi). Indian agriculture has been the source of raw materials to many of our leading industries like cotton, jute textile industries, sugar, flour mills, vanaspati, oil mills etc. Besides, many industries like handloom weaving, rice-dehusking etc. depend indirectly on agriculture.

10.02 Agricultural credit is considered as one of the most basic inputs for conducting all agricultural development programmes. In India there is immense need for proper agricultural credit as the economic condition of Indian farmers generally is of subsistence.

10.03 With a view to ensure wider spread of agricultural credit, the Government adopted the institutional credit approach through various agencies like co-operatives, commercial banks, regional rural banks etc. to provide adequate credit to farmers, at a cheaper rate of interest. The long term and short term credit needs of these institutions are also being met by National Bank for Agriculture and Rural Development (NABARD). It has the objective of promoting the health and the strength of the credit institutions which are in the forefront of the delivery system namely, cooperatives, commercial banks and regional rural banks. It is, in brief, an institution for the purpose of refinance; with the complementary work of directing, inspecting and supervising the credit- flows for agricultural and rural development.

10.04 The evolution of institutional credit to agriculture could broadly be classified into four distinct phases –

- i. 1904-1969 (predominance of co-operatives and setting up of RBI)
- ii. 1969-1975 [nationalization of commercial banks and setting up of Regional Rural Banks (RRBs)]
- iii. 1975 - 1990 (setting up of NABARD)
- iv. 1991 onwards (Financial Sector Reforms): The genesis of institutional involvement in the sphere of agricultural credit could be traced back to the

enactment of the Cooperative Societies Act in 1904. The establishment of the RBI in 1935 reinforced the process of institutional development for agricultural credit.

10.05 The Government has increasingly begun to tap institutional finance from banks and other term lending institutions for financing various developmental programmes in view of the need to supplement plan financing. Banks have also played a pivotal role in this regard. However, credit should be utilized in a prudent manner to maximize returns and spread the benefit over wider sections of the population.

10.06 The State Level Bankers' Committee ('SLBC'), constituted by the Reserve Bank of India under the Lead Bank Scheme periodically takes up the review performance and monitors progress under special schemes. At the District level the District Consultative Committee with the Chief Executive Officer of Zilla Panchayat as chairperson and representatives of financial institutions and Heads of Government departments at the district level as members monitors the implementation of government sponsored schemes & Service Area Credit Plans. At the block level, Block Level Bankers' Committee chaired by Lead District Manager with bank managers and departmental heads of government at block level as members periodically reviews the implementation of government sponsored schemes & Service Area Credit Plans and sorts out problems encountered in the implementation of various programmes. In order to select and prioritise the works for loan assistance from NABARD under Rural Infrastructure Development Fund (RIDF) Scheme, launched in 1995-96, a Cabinet Sub-Committee on RIDF has been constituted under the chairmanship of the Minister for Public Works. There is also a High Power Committee chaired by the Additional Chief Secretary and Development Commissioner for reviewing the implementation of RIDF projects. These policy measures have resulted in an increase in the share of institutional credit of the rural households.

Priority Sector Lending (PSL)

10.07 The RBI has classified lending to the agriculture and allied activities under Priority Sector Lending. Commercial banks are guided by priority sector lending policy of providing credit to various deserving sectors/sections including agriculture and allied activities.

10.08 With a view to regulate and encourage the flow of agricultural credit by all scheduled Commercial Banks, the RBI from time to time, issues a number of guidelines /instructions/directives to banks on Priority Sector Lending.

10.09 Priority Sector Lending programme has been an integral part of the banking policy in India. This scheme is intended to give loans to the important

sectors of the economy (agriculture, small scale industries etc.) in such a way to ensure maximum credit flow to the last man in the last village of the country through a strong banking network. Priority sector lending in its present form was introduced in 1980, when it was also made applicable to private sector banks and a sub-target was stipulated for lending to the "weaker" sections of the society within the priority sector.

Meaning – Priority Sector & Priority sector advances

10.10 Priority sector refers to those sectors of the economy which may not get timely and adequate credit in the absence of this special dispensation. Priority sector advances are small value loans to farmers for agriculture and allied activities, micro and small enterprises, poor people for housing, students for education and other low income groups and weaker sections.

10.11 In terms of RBI Master Direction- RBI/FIDD/2020-21/72 Master Directions FIDD.CO.Plan.BC.5/04.09.01/2020-21 dated September 04, 2020 "Master Direction-Priority Sector Lending Targets and Classification", the categories under priority sector are as follows:

- (i) Agriculture
- (ii) Micro, Small and Medium Enterprises
- (iii) Export Credit
- (iv) Education
- (v) Housing
- (vi) Social Infrastructure
- (vii) Renewable Energy
- (viii) Others

10.12 The targets and sub-targets for agriculture set under priority sector lending for all scheduled commercial banks operating in India are furnished below for domestic scheduled commercial banks and foreign banks with 20 branches and above:

Agriculture	<p>18 per cent of Adjusted Net Bank Credit (ANBC) or Credit Equivalent Amount of Off-Balance Sheet Exposure (CEOBE), whichever is higher, out of which a target of 10% is prescribed for Small and Marginal Farmers (SMFs).</p> <p>Additionally, domestic banks are directed to ensure that the overall lending to non-corporate farmers does not fall below the system-wide average of the last three years</p>
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	<p>achievement. The applicable target for lending to the non-corporate farmers for FY 2020-21 will be 12.14% of ANBC or CEOBE whichever is higher. All efforts should be made by banks to reach the level of 13.5% of ANBC (erstwhile target for direct lending to agriculture sector).</p> <p>Guidelines issued by RBI for Priority Sector lending by Small Finance Banks are different and these should be noted separately.</p>
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Computation of Adjusted Net Bank Credit (ANBC)

10.13 The Table below presents the computation of adjusted net bank credit:

Bank Credit in India [As prescribed in item No.VI of Form 'A' under Section 42 (2) of the RBI Act, 1934].	I
Bills rediscounted with RBI and other approved Financial Institutions.	II
Net Bank Credit (NBC)*	III (I - II)
Outstanding deposits under RIDF and other eligible funds with NABARD, NHB, SIDBI and MUDRA Ltd. on account of priority sector shortfall + outstanding PSLCs.	IV
Eligible amount for exemptions on issuance of long-term bonds for infrastructure and affordable housing as per circular DBOD.BP.BC.No.25/08.12.014/2014-15 dated July 15, 2014.	V
Eligible advances extended in India against the incremental FCNR (B)/NRE deposits, qualifying for exemption from CRR/SLR requirements, as per guidelines.	VI
Investments made by public sector banks in the Recapitalization Bonds floated by Government of India.	VII
Other investments eligible to be treated as priority sector (e.g. investments in securitised assets).	VIII
Face value of securities acquired and kept under HTM category under the TLTRO 2.0 (Press Release 2019-2020/2237 dated April 17, 2020 read with Q.11 of FAQ and SLF-MF- Press Release 2019-2020/2276 dated April 27, 2020 and also Extended Regulatory Benefits under SLFMF Scheme vide Press Release 2019-2020/2294 dated April 30, 2020.	IX

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Bonds/debentures in Non-SLR categories under HTM category.	X
ANBC	III+IV- (V+VI+VII)+ VIII-IX+X
<p>* For the purpose of priority sector computation only. Banks should not deduct / net any amount like provisions, accrued interest, etc. from NBC.</p> <p>A. If a bank opts to subtract prudential write off at Corporate/Head Office level while reporting Bank Credit as above, bank credit to priority sector and all other sub-sectors so written off should also be subtracted category wise from priority sector and sub-target achievement.</p> <p>B. All types of investments or any other items which are treated as eligible for classification under priority sector target/sub-target achievement should also form part of Adjusted Net Bank Credit.</p>	

Agriculture Credit

10.14 Lending to agriculture sector has been defined to include:

- (i) Farm Credit-Individual farmers (which will include short-term crop loans and medium/long-term credit to farmers).
- (ii) Farm credit-Corporate farmers, Farmer producer Organisations (FPOs)/(FPC) Companies of Individual Farmers, Partnership firms and Co-operatives of farmers engaged in Agriculture and Allied Activities.
- (iii) Agriculture Infrastructure.
- (iv) Ancillary Services.
- (v) Small and Marginal Farmers (SMFs).
- (vi) Lending by banks to NBFCs and MFIs for on-lending in agriculture.

10.15 A list of eligible activities under the above sub-categories is indicated below:

(i) Farm Credit

Loans to individual farmers [including Self Help Groups (SHGs) or Joint Liability Groups (JLGs), i.e. groups of individual farmers, provided banks maintain disaggregated data of such loans] and proprietorship firms of farmers, directly engaged in Agriculture and Allied Activities, viz., dairy, fishery, animal husbandry, poultry, bee-keeping and sericulture. This will include:

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- a. Crop loans to farmers, which will include traditional/non-traditional plantations and horticulture, and, loans for allied activities.
 - b. Medium and long-term loans to farmers for agriculture and allied activities (e.g. purchase of agricultural implements and machinery, and developmental loans for allied activities).
 - c. Loans for pre and post-harvest activities, viz., spraying, harvesting, grading and transporting of their own farm produce.
 - d. Loans to distressed farmers indebted to non-institutional lenders.
 - e. Loans to farmers under the Kisan Credit Card Scheme.
 - f. Loans to small and marginal farmers for purchase of land for agricultural purposes.
 - g. Loans against pledge/hypothecation of agricultural produce (including warehouse receipt) for a period not exceeding 12 months subject to a limit up to Rs. 50 lakh.
 - h. Loans to farmers for installation of stand-alone Solar Agriculture Pumps and for solarisation of grid connected Agriculture Pumps.
 - i. Loans to farmers for installation of solar power plants on barren/fallow land or in stilt fashion on agriculture land owned by farmer.
- (ii) Loans to corporate farmers, farmers' producer organizations/companies of individual farmers, partnership firms and co-operatives of farmers directly engaged in Agriculture and Allied Activities, up to an aggregate limit of Rs. 2 crore per borrower entity for the following activities.
- a. Crop loans to farmers which will include traditional/non-traditional plantations and horticulture, and loans for allied activities.
 - b. Medium and long-term loans to farmers for agriculture and allied activities (e.g. purchase of agricultural implements and machinery, and developmental loans for allied activities).
 - c. Loans for pre and post-harvest activities, viz., spraying, harvesting, grading and transporting of their own farm produce.
 - d. Loans up to Rs. 50 lakh against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months.
 - e. Loans up to Rs. 5 crore per borrowing entity to FPOs/FPCs undertaking farming with assured marketing of their produce at a pre-determined price.

(iii) Agriculture Infrastructure

For the following loans, an aggregate sanctioned limit of Rs. 100 crore per borrower from the banking system, will apply.

- a. Loans for construction of storage facilities (warehouses, market yards, godowns and silos) including cold storage units/ cold storage chains designed to store agriculture produce/products, irrespective of their location.
- b. Soil conservation and watershed development.
- c. Plant tissue culture and agri bio-technology, seed production, production of bio-pesticides, bio-fertilizer, and vermi composting.
- d. Loans for construction of oil extraction/ processing units for production of bio-fuels, their storage and distribution infrastructure along with loans to entrepreneurs for setting up Compressed Bio Gas (CBG) plants.

(iv) Ancillary Services

- a. Loans up to Rs. 5 crore to co-operative societies of farmers for purchase of the produce of members.
- b. Loans for setting up of Agri-clinics and Agri-business centres.
- c. Loans for Food and Agro-processing up to an aggregate sanctioned limit of Rs. 100 crore per borrower from the banking system (Indicative list of permissible activities is given in Annex-III to the Master direction).
- d. Loans to Custom Service Units managed by individuals, institutions or organizations which maintain a fleet of tractors, bulldozers, well-boring equipment, threshers, combines, etc., and undertake farm work for farmers on contract basis.
- e. Bank loans to Primary Agricultural Credit Societies (PACS), Farmers' Service Societies (FSS) and Large-sized Adivasi Multi-Purpose Societies (LAMPS) for on-lending to agriculture.
- f. Loans sanctioned by banks to MFIs for on-lending to agriculture sector as per the conditions specified.
- g. Loans sanctioned by banks to registered NBFCs (other than MFIs) as per conditions specified.
- h. Outstanding deposits under RIDF and other eligible funds with NABARD on account of priority sector shortfall.
- i. Loans up to Rs. 50 crore to Start-ups, as per definition of Ministry of Commerce and Industry, Govt. of India that is engaged in agriculture and allied services.

(v) Small and Marginal Farmers (SMFs)

For the purpose of computation of achievement of the sub-target, Small & Marginal Farmers will include the following:

- a. Farmers with landholding of up to 1 hectare (Marginal Farmers).
- b. Farmers with a landholding of more than 1 hectare and up to 2 hectares (Small Farmers).
- c. Landless agricultural labourers, tenant farmers, oral lessees and share-croppers, whose share of landholding is within the limits prescribed for small and marginal farmers.
- d. Loans to Self Help Groups (SHGs) or Joint Liability Groups (JLGs), i.e. groups of individuals Small and Marginal farmers directly engaged in Agriculture and Allied Activities, provided banks maintain disaggregated data of such loans.
- e. Loans up to Rs. 2 lakh to individuals solely engaged in Allied activities without any accompanying land holding criteria.
- f. Loans to FPOs/FPC of individual farmers, and co-operatives of farmers directly engaged in Agriculture and Allied Activities, where the land-holding share of SMFs is not less than 75 percent, subject to loan limits prescribed above.

(vi) Lending by banks to NBFCs and MFIs for on-lending in agriculture

- (a) Bank credit extended to registered NBFC-MFIs and other MFIs (Societies, Trusts etc.) which are members of RBI recognised SRO for the sector, for on-lending to individuals and also to members of SHGs/ JLGs will be eligible for categorisation as priority sector advance under respective categories of agriculture subject to conditions specified.
- (b) Bank credit to registered NBFCs (other than MFIs) towards on-lending for 'Term lending' component under agriculture will be allowed up to Rs. 10 lakh per borrower subject to conditions specified.

Kisan Credit Card (KCC)

10.16 The salient features of the kisan credit card scheme areas under:

- a. In terms of RBI Circular No. RPCD.FSD. BC.No. 77/05.05.09/2011-12 dated 11th May, 2012 on "Revised Kisan Credit Card (KCC) Scheme", revised scheme for issue of Kisan Credit card was introduced by RBI, which was subsequently modified vide various circulars. The Latest circular issued by RBI on the subject is Master Circular No. RBI/2018-19/10

FIDD.CO.FSD.BC. No. 6/05.05.010/2018-19 dated July 04, 2018 "Kisan Credit Card (KCC) Scheme" and KCC scheme for Animal Husbandry and Fisheries vide RBI/2018-19/112 FIDD.Co.FSD.BC.12/05.05.010/2018-19 dated February 04, 2019.

- b. The scheme aims at providing adequate and timely credit support under single window to the farmers for their cultivation and other needs as indicated below:
 - Short term credit limits.
 - i. To meet the short-term credit requirement for cultivation of crops.
 - ii. Post-harvest expenses.
 - iii. Produce marketing loan.
 - iv. Consumption requirement of farmer household.
 - v. Working capital for maintenance of farm assets and activities allied to agriculture.
 - Long term Credit Limit:
Investment credit requirement for agriculture and allied activities.
- c. It may be noted that KCC is not a type of loan, but is a channel for granting either short term or long term agricultural finance to:
 - i. Farmers both individuals and joint borrowers who are owner cultivators;
 - ii. Tenant farmers, oral lessees and share croppers;
 - iii. Self Help Groups(SHG) or Joint Liability Groups (JLGs) of farmers including tenant farmers, share croppers etc.
- d. Master Circular No. RBI/2018-19/10 FIDD.CO.FSD.BC.No. 6/ 05.05.010/2018-19 dated July 04, 2018 "Kisan Credit Card (KCC) Scheme", throws more light on the following macro topics:
 - i. Eligibility for KCC.
 - ii. Fixation of credit limit / loan amount for:
 - All farmers other than marginal farmers.
 - For Marginal Farmers.
 - iii. How Disbursement takes place.
 - iv. Issue of Electronic Kisan Credit Cards.
 - v. Validity/Renewal.
 - vi. Rate of Interest (ROI).
 - vii. Repayment Period.
 - viii. Security and Margin.

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S.No.	KCC limit	Primary security	Collateral security	Margin
1.	Up to Rs.1.6 Lakh	Hypothecation of crops	Nil	Nil
2.	Up to Rs.3 Lakhs with tie-up for recovery	Hypothecation of crops	Nil	Banks to decide
3.	Above Rs.1.6 lakh in case of non-tie up and Rs.3 lakh in case of tie-up advances	Hypothecation of crops	Collateral required eg land.	Banks to decide

ix. Other features like simple documentation.

x. Classification of account as NPA.

The extant prudential norms on income recognition, asset-classification and provisioning will apply for loans granted under the KCC Scheme.

xi. Delivery Channels - Technical features:

- Issue of cards
- Type of card
- Delivery channels
- Mobile banking / Other channels

10.17 Interest Application

- Unlike normal loans, the interest on agricultural advances is not charged at monthly rests but is charged as per the instructions contained in circulars RPCD.No.CPFS.BC. 60/PS.165-85 dated June 06, 1985 and RPCD.No. PLFS.BC.129/05.02.27/97-98 dated June 29, 1998.
- Interest on current dues i.e. crop loans and instalments not fallen due in respect of term loans in respect of direct agricultural advances should not be compounded.
- The RBI *vide* its circular no. DBOD No. Dir. BC. 25/13.03.00/2002-03 dated September 19, 2002 had advised the banks that instructions regarding charging of interest on monthly rests shall not be applicable to agricultural advances and banks shall continue to follow the existing practice of charging/compounding of interest on agricultural advances linked to crop seasons.

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Examples of Interest application according to crop seasons and for other activities:

Crop Season	Kharif	Rabi
Disbursement Period	April 01 to Sept 30	Oct 01 to March 31
Interest Application Date	Due date fixed for repayment	Due date fixed for repayment
Compounding from date	After due date	After due date
Penal Interest	From date the loan becomes overdue	From date the loan becomes overdue

	Allied Activities	
	Dairy, Poultry	Goat Rearing, Piggery
Repayment	Quarterly	Half Yearly / Yearly
Interest Application	Quarterly	Half Yearly / Yearly
Interest application date	Quarter end	Half Year end / Year end
Compounding Frequency	Quarterly	Half Yearly / Yearly
Compounding from date	After Quarter end	After Half Year end / Year end
Penal Interest	If overdue, after Quarter end	If overdue after half year /year end.

Interest Subvention

10.18 Public / Private Sector Scheduled Commercial Banks (in respect of loans given by the rural and semi urban branches) are eligible under the scheme. On a loan given at 7 per cent interest, subvention of 2 per cent p.a. is allowed to Banks on their own funds used for short term crop loans up to Rs.3.00 lakh per farmer. Short term credit, thus made available at 7 per cent p.a. to farmers, is considered for interest subvention. This is calculated on the crop loan amount from the date of its disbursement/ drawl up to the date of actual repayment of the crop loan by the farmer or up to the due date of the loan fixed by the banks, whichever is earlier, subject to a maximum period of one year.

10.19 From 2011-12, additional interest subvention of 3% to those farmers, who repay their short term crop loans promptly and on or before the due date. Farmers, who promptly repay their crop loans as per the repayment schedule fixed by the banks, are offered loans at an effective interest rate of 7% - 3% i.e. 4% p.a.

10.20 The RBI vide its circular no. RBI/2018-19/137 FIDD.CO.FSD.BC.No.15/05.02.001/2018-19 dated March 07, 2019 has specified continuation of the interest subvention scheme for 2018-19 and 2019-20 on the terms and conditions approved in the guidelines. Aadhaar linkage was also made mandatory for availing short-term crop loans in 2018-19 and 2019-20.

10.21 The RBI vide its circular no. RBI/2019-20/166 FIDD.CO.FSD. BC. No.1785/05.02.001/2019-20 dated February 26, 2020 has stated that all Short Term Crop Loans eligible for Interest Subvention (IS) and Prompt Repayment Incentive (PRI) benefit are extended only through KCC w.e.f. April 1, 2020. The existing Short Term Crop Loans which are not extended through KCC shall be converted to KCC loans by March 31, 2020.

10.22 The RBI vide Circular No. RBI/2019-20/48 FIDD. CO. FSD. BC. No. 10/05.02.001/ 2019-20 dated August 26, 2019 on "Interest Subvention Scheme for Kisan Credit Card to Fisheries and Animal Husbandry Farmers (AHDF). During the Years 2018-19 and 2019-20", has decided to extend interest subvention for KCC facility to Animal Husbandry farmers and Fisheries Subject to maximum limit of Rs.2 Lakhs for KCC of AHDF within the overall limit of Rs.3 Lakh per farmer with priority given to KCC of crop loans.

10.23 RBI vide Circular RBI/2019-20/250 FIDD.CO.FSD. BC.No. 25/05.02.001/2019-20 dated June 4, 2020 has provided 2% IS and 3% PRI to farmers for the extended period of repayment up to August 31, 2020 or date of repayment, whichever is earlier.

10.24 Additional subvention to short term crop loans also affected by natural calamity. Further, as notified by the Government of India (Subject to inclusion in the Interest Subvention Scheme on short term crop loans) from time to time, to provide relief to farmers availing short term crop loans and affected by a natural calamity, an interest subvention of 2 percent per annum shall be made available to banks for the first year on the restructured loan amount. Such restructured loans shall attract normal rate of interest from the second year onwards.

10.25 However in case of severe natural calamities, ISS of 2% will be made available to banks for the first three years/entire period (subject to a maximum of 5 years).

Interest subvention scheme to post harvest loans

10.26 Scheme extended to small and marginal farmers (having Kisan Credit Card) for a further period up to six months, post-harvest, against negotiable warehouse receipt for keeping their produce in warehouses. To discourage distress sale by farmers and to encourage them to store their produce in

warehouses against warehouse receipts of warehouse accredited with Warehousing Development Regulatory Authority (WDRA).

10.27 Auditors have to submit certificate of Interest Subvention along with annual accounts of the branch audited by them.

10.28 Further, all short term crop loans processed in 2018-19 are required to be brought on ISS portal / DBT platform. Banks are advised to capture and submit category wise data of beneficiaries under the scheme and report the same on ISS portal individual farmer wise once it is launched to settle the claims arising from 2018-19 onwards.

10.29 Audit Procedure

1. For details of short term crop loans qualifying for subvention, obtain information in Format I and Format II submitted by the Branch to HO or submitted by Bank to RBI (Refer to Annexure 1 and Annexure 2).
2. The Auditor has to verify that the book credit entries are not passed for the purpose of availing the interest subvention.
3. Obtain list of eligible borrowers with interest rate charged to the account.
4. Obtain the working sheet of interest subvention and verify the same.
5. Verify that the interest is first credited to the account and then a claim is made for reimbursement for 3% prompt repayment subvention.
6. Verify the following for cases verified:
 - a) How the limit of 3 Lakh per borrower is verified for claim purposes.
 - b) Only cases where prompt repayment has been received are given the benefit of interest subvention of 3%.
7. Inquire about any rejection made in earlier year's claims and reasons thereof and whether proper accounting done for the same in branch books.

10.30 As per RBI circular, the Auditor needs to certify the correctness of the claim and hence substantive testing needs to be carried out for examinations.

10.31 As per the extant RBI guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops. The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Banker's Committee in each State depending upon the duration of crops raised by an agriculturist.

State Level Banker's Committee (SLBC)

10.32 Agriculture finance is supervised and monitored by State Level Banker's Committee ('SLBC') and its decisions are implemented by all banking sector having branches in the state. Every state has its own SLBC and guidelines have been issued to banks to develop agricultural finance.

10.33 The SLBC is an inter-institutional forum for co-ordination and joint implementation of development programmes and policies by all the financial institutions operating in a state. Although SLBC is envisaged as a bankers' forum, Government officials are also included. The Lead Bank is designated as 'Convener Bank'. The State Level Banker's Committee meets once in a quarter.

10.34 The SLBC of the respective State decides the crop season for each crop, which effectively means the period up to harvesting of the crop raised and the banks of the respective State have to adhere with the crop season as decided by the SLBC of that respective State. Hence, practically it may occur that same crop may have different harvesting season in different States as decided by the respective SLBC of those States. In these cases, the Auditor needs to verify whether the banks have the requisite mechanism to map the crop season(s) vis-à-vis the crop season(s) as defined by the SLBC of each State as any discrepancies may have a direct impact on identification of NPAs. The Auditors are advised to refer to the guidelines issued by SLBC of the State wherein the branch under the audit is located.

RBI Clarification to the Maharashtra SLBC

10.35 Loan may be treated as NPA immediately on completion of two crop seasons / one crop season (as the case may be, depending on the duration of the crops) after the repayment due date. Two crop seasons after the due date should refer to only those two consecutive crop seasons in which the farmer usually undertakes crop production.

10.36 The crop season for each crop, means the period up to harvesting of the crops raised. The asset classification norms assume that there is normal crop yield during the season for which credit is extended. Hence, immediately after consecutive two harvest seasons (as per the cultivation pattern followed by the farmer borrower) from repayment due date, the account is to be identified as NPA as per the revised guidelines. In case the yield is affected by natural calamities as declared by the State Government, the loan accounts should be restructured / rescheduled.

Example of NPA identification

10.37 NPA in Agricultural advances

- i. A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons.

A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops, would be treated as "short duration" crops.

The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made applicable to agricultural term loans availed of by him.

The above norms should be made applicable only to Farm Credit extended to agricultural activities as listed at Annex 2 of the Circular no.RBI/2015-16/101 DBR.No.BP.BC2/21.04.048/2015-16 dated July 1, 2015. An extract of the list of these items is furnished in the Annex - 2 of the circular. In respect of agricultural loans, other than those specified in the Annex - 2 of the circular and term loans given to non-agriculturists, identification of NPAs would be done on the same basis as non-agricultural advances, which, at present, is the 90 days delinquency norm.

- ii. Where natural calamities impair the repaying capacity of agricultural borrowers for the purposes specified in Annex - 2 of the circular, banks may decide on their own as a relief measure conversion of the short-term production loan into a term loan or re-scheduling of the repayment period; and the sanctioning of fresh short-term loan, subject to guidelines as detailed below.
- iii. In such cases of conversion or re-scheduling, the term loan as well as fresh short-term loan may be treated as current dues and need not be classified as NPA. The asset classification of these loans would thereafter be governed by the revised terms and conditions and would be treated as NPA if interest and/or instalment of principal remains overdue for two crop seasons for short duration crops and for one crop season for long duration crops. For the purpose of these guidelines, "long duration" crops would be

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crops with crop season longer than one year and crops, which are not 'long duration' would be treated as 'short duration' crops.

- iv. While fixing the repayment schedule in case of rural housing advances granted to agriculturists under Indira Awas Yojana and Golden Jubilee Rural Housing Finance Scheme, banks should ensure that the interest/instalment payable on such advances are linked to crop cycles.

10.38 Example of NPA identification for various types of crop loans is given as follows.

S.No.	Particulars	Short Term	Crops	Long Term	Crops
		Kharif	Rabi	Sugarcane	Banana
1	Sanction date	1 st April 2018 to 30 th September, 2018	1 st October 2018 to 31 st March, 2019	1 st October, 2017	1 st July, 2017
2	Harvesting time	September, 2018	March, 2019	December, 2018	September, 2018
3	Repayment due date	31 st December, 2018	30 th June, 2019	31 st March, 2019	31 st December, 2018
4	Interest subvention @ 3%	Available up to date of repayment subject to maximum repayment due date.(subject to 1 year)	Available up to date of repayment subject to maximum repayment due date. (subject to 1 year)		
5	Date of irregularity	31 st December, 2018	30 th June, 2019	31 st March, 2019	31 st December, 2018
Multiple/ double cropping pattern					
6	First crop season end date	30 th June, 2019	31 st December, 2019	NA	NA
7	Second crop season	31 st December,	30 th June, 2020	NA	NA

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	end date	2019			
8	Date of NPA	31 st December, 2019	30 th June, 2020	NA	NA
Single/ mono cropping pattern					
9	First crop season end date	31 st December, 2019	30 th June, 2020	31 st March 2021	31 st December 2020
10	Second crop season end date	31 st December 2020	30 th June, 2021	NA	NA
11	Date of NPA	31 st December 2020	30 th June, 2021	31 st March 2021	31 st December 2020

The illustration given above is for guidance only and the facts may be verified with reference to each case in hand.

Allied Activity (Instalment)				
Type	Dairy	Goat Rearing	Piggery	Poultry
	(equated quarterly instalment with moratorium period, first instalment is due on Sept 30, 2018)	(equated half yearly / yearly instalment considering moratorium period of six months first instalment is due on June 30, 2019)	(equated half yearly / yearly instalment considering moratorium period of six months first instalment is due on June 30, 2019)	(equated quarterly instalment with moratorium period, first instalment is due on Sept 30, 2018)
Loan Disbursed	1-Jun-18	1-Jul-18	1-Jul-18	1-Jun-18
Due Date	30-Sep-18	30-Jun-19	30-Jun-19	30-Sep-18
Overdue Date	1-Oct-18	1-Jul-19	1-Jul-19	1-Oct-18
Compounding	1-Oct-18	1-Jul-19	1-Jul-19	1-Oct-18
NPA turning date	31-Dec-18	30-Sep-19	30-Sep-19	31-Dec-18
Remark	After 90 days overdue	After 90 days overdue	After 90 days overdue	After 90 days overdue

Investment Credit (Instalment)	
Type	Investment Credit - Minor Irrigation system to a farmer cultivating cotton
Loan Disbursed	1-Jun-18
Due Date	31-Mar-19
Overdue Date	1-Apr-19
Compounding	1-Apr-19
NPA turning date	31-Mar-20
Remarks	After two crop seasons. First crop season will end at March 2019 and the other will end at March 2020

Key Points in Auditing Agriculture Advances

10.39 The audit approach for agriculture advances has to be on similar lines as that of other advances. The following is a summary of Key aspects in the audit of Agricultural Advances:

- a. Sanctioned amount of agriculture loans should be as per scale of finance applicable to the land under cultivation and the crop being cultivated. Further, appropriate security should be obtained as per the guidelines framed by the bank.
- b. Auditors should verify that the agricultural credit is extended only after obtaining 'No dues/ No objection certificates' from the existing credit agencies in the area of finance.
- c. Disbursement of agricultural finance is required to be carried out in various 'stages' based on the requirements of farming activity. This needs to be ensured strictly. In some cases, the expenditure is incurred by the farmer from his/her own sources or by raising loans from non-institutional lenders and subsequently banks are requested to reimburse the same. In such cases, the Auditors have to carefully verify the facts from the documents/evidences available on record. Under all situations, Auditors should verify that the bank holds documents evidencing the utilisation of loans for agricultural activities.
- d. For crop loans, primary security is normally the standing crops under cultivation, as such pre and post sanction visits by the officers of bank, who are experts in agriculture finance and adequate documentation of visit report is a key control.

- e. While verifying the security offered for agricultural loans, it is to be confirmed that the security is legally enforceable. Standing crops and agricultural machinery and implements are secured by a hypothecation charge, while the agricultural land is secured by a mortgage charge. Auditors have to ensure that amongst others, the following have been duly taken on record by the banks:
- Copy of the land revenue extracts, with bank charges recorded.
 - Land Tax Assessment and payment receipt.
 - Copy of record with sub registrar (wherever applicable).
 - Original copies of the title deeds.
 - Search of title deeds and Legal opinion from the advocate on the Bank's approved panel.
 - Valuation of land from a valuer on the Bank's approved panel.
- f. Loans granted to farmers against the security of NSC, KVP or Fixed Deposits of Banks, which have been utilised for agricultural purposes, is allowed to be classified under the category of finance to agriculture under priority sector in Schedule 9. However, Auditors should carefully verify the loan documents and other supporting documents to ensure that non-agricultural loans are not classified as Agricultural Finance.
- g. Agricultural advances are required to be serviced through realisation of sale proceeds of crop. Auditors should be sceptical about the nature and timing of credits coming in to service the agricultural loans and ensure that they are from genuine sources.

Agricultural Advances Affected by Natural Calamities

10.40 RBI Master Direction no. RBI/FIDD/2018-19/64 FIDD.CO.FSD.BC No.9/05.10.001/2018-19 dated October 17, 2018 on "Reserve Bank of India (Relief Measures by Banks in Areas Affected by Natural Calamities) Directions, 2018 deals elaborately with classification and income recognition issues due to impairment caused by natural calamities. Banks may decide on their own relief measures, viz., conversion of the short term production loan into a term loan or re-scheduling of the repayment period and the sanctioning of fresh short-term loan, subject to the guidelines contained in RBI Master Circular No. RBI/15-16/101 DBR.No.BP.BC.2/ 21.04.048/2015-16 dated July 1, 2015 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances" and directions contained in RBI Master Direction no. RBI/FIDD/2018-19/64 FIDD.CO.FSD.BC No.9/05.10.001/2018-19 dated October 17, 2018 on "Reserve Bank of India (Relief Measures by Banks in Areas Affected by Natural Calamities) Directions, 2018". In such cases the NPA

classification would be governed by such rescheduled terms. Asset classification of remaining amount (if any), not restructured, continue to be governed by original terms and conditions.

10.41 Additional finance granted due to natural calamities treated as standard assets, will be governed by the terms and conditions of its sanction. Different dues from the borrower (e.g. current dues, dues which are not restructured etc.) will be classified under different asset classification norms. This is an accepted departure from the basic principle of IRAC norms, i.e. NPA should be borrower-wise and not facility-wise.

10.42 In such cases of conversion or re-scheduling, the term loan as well as fresh short-term loan may be treated as current dues and need not be classified as NPA. The said benefit of restructuring of assets would not be available for Short-term Crop Loans if the said loan was overdue at the time of occurrence of natural calamity and for Long-term Credits if the borrower has wilfully defaulted in repayment of loan in earlier years. The asset classification of these loans would thereafter be governed by the revised terms and conditions and would be treated as NPA if interest and/or instalment of principal remain overdue for two crop seasons for short duration crops and for one crop season for long duration crops. For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" would be treated as "short duration" crops.

10.43 In case of receipt of claim of crop insurance, the insurance proceeds shall ideally compensate the losses. Under the Prime Minister Fasal Bima Yojana (PMFBY), all Seasonal Agricultural Operations (SAO) loans for notified crops in notified areas are to be compulsorily provided insurance cover for all stages of the crop cycle including post-harvest risks in specified instances. There are further ancillary measures prescribed by RBI for providing relief in terms of relaxation on KYC norms, providing access to banking services, etc.

Collateral Free Agricultural Loans

10.44 RBI vide notification No FIDD.CO.FSD.BC.No.13/05.05.010/2018-19 dated February 7, 2019 on "Credit Flow to Agriculture - Collateral free Agricultural Loans", has increased the collateral free limit for Agricultural Loans from Rs.1 Lac to Rs.1.60 Lac. (Refer earlier circular RPCD.PLFS.BC.No 85/05.04.02/2009-10 dated June 18, 2010).

Agricultural Debt Relief / Waiver Schemes

10.45 There are various State and Central Government debt waiver / relief schemes which are implemented for providing relief to the affected agriculture

borrowers. An Auditor is advised to go through the schemes so declared and implemented by State / Central Government for providing agricultural debt relief / waiver as the case may be and consider the same in terms of eligible loans under the scheme, amount of relief / waiver provided, asset classification norms and accounting.

Audit Procedure

10.46 The audit procedure involve the following steps:

1. Obtain the copy of relevant schemes and bank's circular in this regard.
2. Obtain list of eligible borrowers with outstanding balance.
3. Check the claim amount statement submitted to RO/ZO for claiming the same.
4. Check the accounting entries passed for the credit of eligible amount in the account of the borrower.
5. Verify the accounting of interest and other charges to be borne by the lending institution as per the scheme.
6. Ensure reporting requirement as per closing instructions of the bank.
7. Obtain written representation from the management about the scheme and its applicability including cutoff amount and period of loan disbursed.

10.47 Other Important points are as under:

- i) Here Land holding being the deciding criterion for an Agricultural Loan to an individual farmer, a company whose objects are farming etc., shall not qualify for agriculture loans in that category, if it is not a farm producer company and none of its directors hold land.
- ii) Loans given for the purchase of vehicles like Balero, Maruti VAN, Bikes and some other two wheelers and four wheelers shall come under commercial vehicle Loan category. For purchase of Tractors loan can be given as agriculture term loan.
- iii) Loans to fishermen for purchase of trawlers/ boats etc. can be considered.
- iv) SHG and JLGs where farmers are members of the Group, qualify to take Agricultural Loans. Further loans are categorised according to the activities carried out by the Groups and purpose for which the loans are taken.
- v) If term deposits are given by farmers to the Primary Agricultural Societies which are deposited in Banks, the Societies qualify for Loans against the deposits. The primary Agricultural Society can back to back, give loans to its member farmers.

Annexure 1

Format I

Claim for 2% Interest Subvention on Short-term Crop Loans/ Post-harvest credit against negotiable warehouse receipts/ Loans restructured due to NC/ Loans restructured due to Severe NC, up to Rs. 3 lakh for the year 2018-19 / 2019-20.

Name of the Bank: _____

Statement for the half year / year ended on
September 20/ March 20/ Additional Claim

	*Total short term production credit at 7% p.a		Amount of total subvention claimed (Rs. in actuals)
	No. of accounts (in thousands)	Amount Disbursed / drawn (Rs. lakh)	
Loans up to Rs.3 lakh			

Category-wise claim for 2% Interest Subvention for 2018-19 / 2019-20 for All India except North East region

	*Total short term production credit at 7% p.a. for All India except North East region								
	General			SC			ST		
	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. In actual)	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. In actual)	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. In actual)
Loans up to Rs.3 lakh									

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Category-wise claim for 2% Interest Subvention for 2018-19 /
2019-20 for North East region

	*Total short term production credit at 7% p.a. for North East region								
	General			SC			ST		
	No. of accounts (in thousand)	Amount Disburs ed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. in actuals)	No. of accounts (in thousand)	Amount Disburs ed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. in actuals)	No. of accounts (in thousand)	Amount Disburs ed/ drawn (Rs. lakh)	Amount of subvent- ion claimed (Rs. in actuals)
Loans up to Rs.3 lakh									

- i) We certify having disbursed the above loans at 7% p.a. up to Rs. 3 lakh by way of short-term production credit to the farmers during the year 2018-19 / 2019-20.

Sd/-

Authorised Signatory of the Bank

- ii) (Statutory auditor certifying the correctness of the subvention claim)

Sd/

Seal and Signature of Auditor

Date:

(This claim format needs to be duly certified by the Statutory Auditors with the Firm Registration Number and Membership Number of all Signatories)

* May be modified suitably for post-harvest credit against negotiable warehouse receipts/ Loans restructured due to NC/ Loans restructured due to severe NC.

Annexure 2**Format II**

One - time Claim for Additional 3 per cent
Subvention for timely repayment of Short-term Crop
Loans / Loans restructured due to Severe NC, up to
Rs.3 lakh disbursed in 2018-19 / 2019-20

Name of the Bank: _____

	*Total short term production credit at 7% p.a		*Total short term production credit which were repaid in time		Amount of additional subvention claimed @ 3% (Rs. in actuals)
	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	No. of accounts (in thousands)	Amount disbursed drawn (Rs. lakh)	
Loans up to Rs.3 lakh					

Category-wise one-time claim for additional 3% Subvention for 2018-19 /
2019-20 for All India except North East region

	*Total short term production credit which were repaid in time for All India except North East region								
	Geneal			SC			ST		
	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. In actuals)	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. In actuals)	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. In actuals)
Loans up to Rs.3 lakh									

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Category-wise one-time claim for additional 3% Subvention for 2018-19 / 2019-20 for North East region

	*Total short term production credit which were repaid in time for North East region								
	General			SC			ST		
	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. in actuals)	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. in actuals)	No. of accounts (in thousands)	Amount Disbursed/ drawn (Rs. lakh)	Amount of subvention claimed (Rs. in actuals)
Loans up to Rs.3 lakh									

- i) We certify that the above loans for which the claim is being made were repaid in time and the benefit of additional 3 percent incentive subvention has already been passed on to the account holders, thereby bringing down the interest rate for such farmers to 4 per cent per annum for short term production credit / Loans restructured due to Severe NC, up to Rs. 3 lakh disbursed during 2018-19 / 2019-20 for these farmers.

Sd/-

Authorised Signatory of the Bank

- ii) (Statutory Auditor certifying the correctness of the subvention claim)

Sd/-

Seal and Signature of Auditor

Date:

(This claim format needs to be duly certified by the Statutory Auditors with the Firm Registration Number and Membership Number of all Signatories)

*May be modified suitably for Loans restructured due to severe NC.

Reporting for Advances

Introduction

11.01 Lending constitutes a major activity of a bank besides the investment function. The core business of banks is accepting deposits for onward lending. Advances, generally, constitute the largest item on the assets side of the balance sheet of a bank and are major source of its income.

11.02 Audit of advances is one of the most important areas covered by auditors in bank audit. It is necessary that auditors have adequate knowledge of the banking industry and its regulations. Auditors must be aware of various functional areas of the bank/branches, its processes, procedures, systems and prevailing internal controls with regard to advances.

11.03 Advances generally comprise of:

- a) Money lent by bank to its customers including interest accrued and due
- b) Debit balances in depositor accounts
- c) Inter-Bank Participation Certificates.

11.04 Every bank has its credit policy approved by its board of directors which is updated at regular intervals. The credit policy is in line with applicable RBI guidelines, relevant laws and regulations. Auditors must acquaint themselves with the credit policy of the bank and the advances portfolio composition.

Type of Advances and Nature of Security

Types of Advances

Fund Based and Non-Fund Based Credit Facilities

11.05 In Fund based credit facilities, there is an actual outflow of funds from the bank to the borrower, whereas non-fund based facilities, do not involve outflow of bank's funds. Typical fund based facilities are term loans, cash credits and overdrafts while non-fund based facilities are letters of credit, bank guarantees, letter of comfort/undertaking, etc. Non-fund based facility may turn into a fund based facility on due date, if not paid by the borrower, for e.g. devolvement of bills under LC, invocation of Bank Guarantee, etc.

Fund Based Facilities

Cash Credit

11.06 Cash credit facility is provided to entities (borrowers) engaged in manufacturing and / or trading activities to enable them meet the gap in their working capital requirements. This facility is repayable on demand. The cash credit facility is generally granted against security of stocks of goods (net of trade creditors), standing crops, bills / book debts representing genuine sales (restricted to pre-defined age of such book debts).

11.07 A cheque book is issued to the borrower for withdrawal of money against the limit sanctioned. The withdrawals are permitted to the extent, lower of drawing power or sanctioned limit. This is a revolving facility and is, generally, reviewed and renewed annually or on other intervals as per Bank policy. The Bank performs a periodical review of the borrower based on his credit assessment.

11.08 Cash credit advances are generally on 'floating' interest rate basis. The rate is reset periodically, depending upon changes in the bank's base rate (MCLR – Marginal Cost of fund based Lending Rate) / spread in relation to the borrower class and his risk perception.

Working Capital Demand Loan (WCDL)

11.09 WCDL is granted for a fixed period on expiry of which it has to be liquidated, renewed or rolled over. WCDL is generally granted to meet the working capital requirement gap and is considered as a part of working capital facility. Depending on the sanction terms, repayment of WCDL can either be in the form of instalments spread over the loan tenure or an end of tenure bullet payment. It has to be ensured that there is actual repayment at the end of the loan tenure by fund flows and not just a renewal by roll-over which could tantamount to ever-greening.

11.10 As per RBI Circular dated December 05, 2018 Guidelines on Loan System for Delivery of Bank Credit for FY 2020-21, In respect of borrowers having aggregate fund based working capital limit (WCL) of Rs. 1500 million and above from the banking system, a minimum level of 'loan component' of 60 percent is prescribed. Accordingly, for such borrowers, the outstanding 'loan component' (Working Capital Loan) must be equal to at least 60 per cent of the sanctioned fund based working capital limit, including ad hoc limits and TODs. Hence, for such borrowers, drawings up to 60 per cent of the total fund based working capital limits shall only be allowed from the 'loan component'. Drawings in excess of the minimum 'loan component' threshold may be allowed in the form of cash credit facility.

11.11 The amount and tenor of the loan component may be fixed by banks in consultation with the borrowers, subject to the tenor being not less than seven days. Banks may decide to split the loan component into WCLs with different maturity periods as per the needs of the borrowers.

Guidelines on Loan System for Delivery of Bank Credit

11.12 The RBI issued circular RBI/2018-19/87 DBR.BP.BC.No.12/21.04.048/2018-19 dated December 05, 2018, specified minimum level of loan component as follows:

- a. In respect of borrowers having aggregate fund based working capital limit of ₹1500 million and above from the banking system, a minimum level of 'loan component' of 40 percent shall be effective from April 01, 2019. Accordingly, for such borrowers, the outstanding 'loan component' (Working Capital Loan) must be equal to at least 40 percent of the sanctioned fund based working capital limit, including ad hoc limits and TODs.
- b. All lenders in the consortium shall be individually and jointly responsible to make sure that at the aggregate level, the 'loan component' meets the above mentioned requirements. Under Multiple Banking Arrangements (MBAs), each bank shall ensure adherence to these guidelines at individual bank level.
- c. The amount and tenor of the loan component may be fixed by banks in consultation with the borrowers, subject to the tenor being not less than seven days. Banks may decide to split the loan component into WCLs with different maturity periods as per the needs of the borrowers.
- d. Banks/consortia/syndicates will have the discretion to stipulate repayment of the WCLs in instalments or by way of a "bullet" repayment, subject to IRAC norms. Banks may consider rollover of the WCLs at the request of the borrower, subject to compliance with the extant IRAC norms.
- e. The guidelines will be effective from April 1, 2019 covering both existing as well as new relationships. The 40 percent loan component will be revised to 60 percent, with effect from July 1, 2019.

Repayment/Renewal/Rollover of Loan Component

11.13 Banks/consortia/syndicates will have the discretion to stipulate repayment of the WCLs in installments or by way of a "bullet" repayment, subject to IRAC norms. Banks may consider rollover of the WCLs at the request of the borrower, subject to compliance with the extant IRAC norms.

Risk weights for undrawn portion of cash credit limits

11.14 Effective from April 1, 2019, the undrawn portion of cash credit/overdraft limits sanctioned to the aforesaid large borrowers, irrespective of

whether unconditionally cancellable or not, shall attract a credit conversion factor of 20 per cent.

Term Loans

11.15 Term loans are generally extended for the following purposes:

- setting up of plants, acquisition of fixed assets like land and building, plant and machinery, furniture, vehicles, implements, houses, consumer durables, etc.
- meeting expenses on education/medical treatment of self/dependants.
- meeting other personal expenses.
- Travel – Vehicle - Housing purchase and renovation.
- meeting deficit in net working capital requirements as assessed by the bank.
- Marketing / Launching / Branding etc.

11.16 Banks may give general purpose loans also i.e. without stipulating any end-use of funds, on the strength of a suitable security, or even without security based on the borrower's credit worthiness. Bank's policy provides guidance and documentation to be obtained for end use of funds in such cases which has to be ensured.

11.17 Term loans are repayable in instalments spread over a period of time excluding the moratorium period, if granted. The moratorium period is assessed by the lender based on future cash flows and borrower requirements. If the borrower defaults in compliance with terms and conditions, the bank has the right to demand repayment of the entire loan outstanding, before due date. In few cases, there are terms for increase in interest rate as stipulated in sanction terms and conditions. The amount, periodicity of repayment, last draw down date and other terms and conditions are fixed at the time of sanction and duly recorded in the loan documents. The amount and periodicity may be uniform throughout the life of the loan, or either or both of them may differ from instalment to instalment. Besides, repayment schedule may either be drawn only for the principal amount in which case periodic interest has to be paid by the borrower separately as and when due, or a schedule may be fixed with 'equated monthly instalments' which also includes amount of interest likely to be applied to the account during its entire tenure at the rate of interest applicable at the time of sanction/documentation/first disbursement. The disbursal may happen in one tranche or more than one tranche as per the borrower requirements.

11.18 The interest rate for loans may be on 'fixed' terms' in which event, the rate contracted originally holds good during the entire loan currency, or it may be on 'variable' terms; where the rate may undergo changes at unspecified periods on happening of certain events as outlined in the loan agreement. This aspect is a subject matter of negotiation between the bank and the borrower. Interest is charged on reducing balance method at monthly rests.

Foreign Currency Loans (FCL)

11.19 Banks are authorised to lend in foreign currency. These loans are sanctioned as per the EXIM Policy and guidelines issued by RBI from time to time. FCL may be in nature of Term loans or Working Capital loans. These loans may be issued independently or through conversion of rupee term/working capital loan to FCL for a stipulated period as per RBI guidelines.

Overdrafts

11.20 The overdraft facility may be either secured or clean (i.e., without security) and does not generally carry a fixed repayment schedule. The most common form of security for an overdraft arrangement is term deposit receipts. Overdrafts may also be granted against other securities like immovable properties, life insurance policies, shares, bonds, NSCs, Kisan Vikas Patra, Indira Vikas Patra, etc. In case of term deposit receipts, care is taken to lien mark the deposit in the system and also on physical fixed deposit receipt (not on fixed deposit advice). Fixed deposits are generally for specific period and need to be renewed on maturity. Care should be taken to ensure that interest rate spread between overdraft and fixed deposit is maintained. The bank has to update lien mark on the new fixed deposit. The bank has to ensure that proper margin i.e. security value and loan amount is kept while sanctioning the overdraft and at all times during the loan pendency.

Bills

11.21 Finance against bills is meant to finance the actual sale transactions and can be in any of the under mentioned form:

- Purchase of bills if these are payable 'on demand'.
- Discounting of bills if these are usance (or time) bills.
- Advance against bills under collection from the drawee, whether sent for realisation through the bank or sent directly by the drawer to the drawees.

11.22 Bills may be either 'documentary', i.e., accompanied by original documents of title to goods, or 'clean', i.e., without original documents of title to goods. In case of documentary bills, the bank releases documents of title to the drawee only against payment (in case of demand bills purchased) or against

acceptance (in case of usance bills discounted). On release of documents of title after acceptance of usance bills, these assume the nature of clean bills. The bills may be domestic (denominated in rupee for domestic trade) or foreign (denominated in foreign currency for import/export).

11.23 A unique facility under this head is advances against bills drawn on public sector undertakings / government departments which do not accept bills. In such cases, pre-receipted challans are submitted by the borrower to the bank as an evidence for availing finance thereagainst (a pre-receipted challan establishes genuine movement of goods and ensures usage of bank funds for sanctioned purposes only). This facility is commonly known in the banking sector as 'government bills facility' or 'supply bills facility'. The purchase / discounting of bills may be either under or without a letter of credit. In case of dishonour of bills, banks have the right to recover the amount from the drawer with penalty, additional interest, etc.

11.24 RBI has issued guidelines for regulation of discounting and rediscounting of bills (Ref. Master Circular No. DBR.No.Dir.BC.10/13.03.00/2015-16, dated July 01, 2015, "Loans and Advances-Statutory and other Restrictions").

Exports

Export Credit

11.25 Exporters are granted facilities in the form of cash credit and bills only. These facilities are in form of 'pre-shipment credit' and 'post-shipment credit'. All types of advances sanctioned to finance the production cycle – i.e. from procurement of raw materials to bringing them to the port for despatch fall under 'pre-shipment credit' category. It also includes financing of working capital expenses towards rendering of services. The advance is given based on individual order obtained, or sanctioned as an Export Packing Credit (EPC) limit and amounts disbursed on submission of individual orders; in the latter case, EPC becomes a running account. The exporter usually adjusts the account by drawing bills of exchange on the foreign buyer, which are discounted by the bank under the letter of credit and the proceeds collected from the foreign bank. The post-shipment credit relates to financing of bills raised on the overseas buyer upon shipment of goods/ services. Export credit advance may be granted in Indian Rupees or a designated foreign currency. In the latter case, the loan is disbursed in a foreign currency. Export credit is granted at concessional rates of interest. Pre-shipment credit has to be liquidated out of export proceeds only and cannot be adjusted out of rupee funds (except where raw materials required for processing exceed the FOB contract value, in which case the excess advance

has to be repaid maximum within 30 days from the date of advance). Export proceeds have normally to be received within 9 months from the shipment date. This period can be extended in genuine cases, with the bank's approval or RBI approval, as permitted under FEMA Guidelines and operating instructions issued by the RBI from time to time.

11.26 Pre-shipment credit granted in a foreign currency is called 'Packing Credit in Foreign Currency' (PCFC) advance and has to be repaid out of export bills discounted under the Export Bills Rediscounting (EBR) scheme or out of export proceeds. Each bank designates a few select branches to handle PCFC and EBR transactions. The Rupee Export credit is also allowed to be shared between export order holders and manufacturer of the goods to be exported. Similarly, banks may extend PCFC to the manufacturer on the basis of disclaimer from the export order holder through his bank. PCFC granted to the manufacturer can be repaid by transfer of foreign currency from the export order holder by availing of PCFC or by discounting of bills. It should be ensured that no double financing is involved in the transaction and the total period of packing credit is limited to actual cycle of production of exported goods (Ref. Para 5.12 of the Master Circular No. DBR No.DIR.BC.14/04.02.002/2015-16 dated July 1, 2015, "Rupee/Foreign Currency Export Credit and Customer Service to Exporter"). PCFC may be made available to both the supplier of EOU/EPZ/SEZ unit and the receiver of EOU / EPZ / SEZ unit and PCFC for supplier EOU / EPZ / SEZ unit will be for supply of raw material/components of goods which will be further processed and finally exported by receiver EOU / EPZ / SEZ unit. The PCFC extended to the supplier EOU/EPZ/SEZ unit will have to be liquidated by receipt of foreign exchange from the receiver EOU/EPZ/SEZ unit, for which purpose, the receiver EOU/EPZ/SEZ unit may avail of PCFC. The stipulation regarding liquidation of PCFC by payment in foreign exchange will be met in such cases not by negotiation of export documents but by transfer of foreign exchange from the banker of the receiver EOU/EPZ/SEZ unit to the banker of supplier EOU/EPZ/SEZ unit. Thus, there will not normally be any post-shipment credit in the transaction from the supplier EOU/EPZ/ SEZ unit's point of view. In all such cases, it has to be ensured by banks that there is no double financing for the same transaction. The PCFC to receiver EOU/EPZ/SEZ unit will be liquidated by discounting of export bills or by receipt of export proceeds as per Master Circular DBR No.DIR.BC.14/04.02.002/2015-16 dated July 01, 2015, on "Rupee/Foreign Currency Export Credit and Customer Service to Exporter". In this context, attention is invited to RBI's Circular No DIR.BC.14/04.02.002/2015-16 dated July 01, 2015 on "Rupee/Foreign Currency Export Credit and Customer Service to Exporter."

Imports

Trade Credit – Buyer's Credit

11.27 This facility is provided by Banks (foreign/overseas branches of Indian banks), financial institutions, foreign equity holder(s) located outside India and financial institutions in IFSCs located in India, to importers of capital goods and raw material in India. The same is given against BG/SBLC issued by Indian bank, on behalf of their Indian importer customers, to enable them to receive such credit. The BG/SBLC issued by the Indian bank is duly recorded as a "contingent liability" in its books.

Detailed guidelines for the same are provided in paragraph 23.13 in the Chapter 23 of 'Audit of Foreign Exchange Business' of Section B of this Guidance Note.'

Entries of inward and outward remittances are to be recorded in the books of accounts (NOSTRO Mirror Account) of the Indian bank.

Nature of Security

11.28 Types of securities commonly accepted by banks for granting different kinds of credit facilities are examined in greater details in this section. Security can be in any form i.e. tangible or intangible, movable or immovable. Further, it is classified into two types namely, primary and collateral securities.

Primary and Collateral Securities

11.29 'Primary Security' refers to the security offered by the borrower for bank finance or the one against which credit is extended by the bank. Primary security is the principal security for an advance. A collateral security is an additional security.

Mode of Creation of Security

11.30 Depending on the nature of the advance, creation of security may be in the form of a mortgage, pledge, hypothecation, assignment, set-off, or lien.

Mortgage

11.31 Mortgage is defined under section 58 of the Transfer of Property Act, 1882, as "the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to a pecuniary liability".

11.32 Mortgages are of several kinds but the most important ones are the Registered Mortgage and the Equitable Mortgage. A Registered Mortgage is effected by a registered instrument called the 'Mortgage Deed' signed by the

mortgagor. It registers the property to the mortgagee as a security. Equitable mortgage, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof. The government mandates registration of all types of mortgages with Central Registry of Securitisation Asset Reconstruction and Security Interest of India (CERSAI) which should be strictly followed by banks.

Pledge

11.33 A pledge is defined under section 172 of the Indian Contract Act, 1872, as "the bailment of goods as security for payment of a debt or performance of a promise." A pledge involves bailment or delivery of goods by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance. The legal ownership of the goods remains with the pledger while the lending banker gets certain defined interest in the goods. The pledge of goods constitutes a specific (or fixed) charge. In a pledge, the bank has all the liabilities and responsibilities of a bailee of goods. The bank may be held responsible for not carrying out their obligations as bailee.

Hypothecation

11.34 The term 'hypothecation' in commercial parlance refers to the creation of an equitable charge (i.e., a charge created not by an express enactment but by equity and reason), in favour of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower. Neither ownership nor possession is transferred to the bank. However, the borrower holds the physical possession of the goods as an agent/trustee of the bank. The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker based on which the drawing power of the borrower is fixed.

Assignment

11.35 Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favour of another person. Only actionable claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment. An assignment gives the assignee absolute right over the moneys/debts assigned to him. The transfer of debt, right or property is subject to all the liabilities and equity to which the transferor was subject on the date of transfer. In other words, the assignee cannot get a better title than that of the assignor.

Set-off

11.36 Set-off is a statutory right of a creditor to adjust, wholly or partly, the debit balance in the debtor's account against any credit balance lying in another account of the debtor. A lending bank has the right of set-off in the absence of an agreement, express or implied, to the contrary with the borrower. The right of set-off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and in the same right (i.e., the capacity of the account holder in both the accounts should be the same). For the purposes of set-off, all bank branches are treated as one single entity. The right of set-off can also be exercised in respect of time-barred debts.

Lien

11.37 Lien is creation of a legal charge with the owner's consent, which gives the lender a legal right to seize and dispose / liquidate the asset under lien.

Types of Securities

11.38 The characteristics of a good security from the view point of the lending bank are marketability, easy ascertainability, stability of value, clean title, realisability and transferability/transportability.

11.39 The most common types of securities accepted by banks are the following.

Fixed and Floating Charges

11.40 A fixed charge (also called 'specific charge') is a charge on some specific and ascertained assets. The creator of the charge (i.e., the borrower) cannot deal with the asset without the specific consent of the holder of the charge (i.e., the lender). A floating charge, is an equitable charge on the assets, present and future. A floating charge attaches to assets whose condition varies from time to time in the ordinary course of business (e.g., work-in-process). A floating charge crystallises (i.e., becomes a fixed charge) when money becomes repayable and the holder of the charge (i.e., lender) takes necessary steps for enforcement of the security.

Personal Security of Guarantor

11.41 The personal security of guarantor comprises a third party guarantee for payment of loan outstanding, in the event of borrower's default. No charge is created on the guarantor's movable or immovable assets.

Margin

11.42 Margin on loans is upfront payment by the borrower towards the purpose of sanctioned loan. Banks provide finance after keeping suitable margin, depending on its risk perception. Margin is deducted from the asset value to take care of any downward fluctuations in the asset's market value. Generally, margin is prescribed in every sanction letter in terms of percentage of security value, as per bank's credit policy. For certain loans such as advances against gold ornaments and jewellery, RBI has defined the limits on the loan to value.

Stock Exchange Securities and Other Instruments

11.43 Stock Exchange securities include shares, debentures and bonds which are traded on stock exchanges. These securities are easily marketable; the market value is readily ascertainable; it is easy to ascertain the title of the depositor; and they are easy to pledge. Banks have policy for shares against which they provide loans and periodically re-assess the eligible share as security for lending. Banks also advance against instruments as gilt-edged securities, National Savings Certificates, Kisan Vikas Patras, Indira Vikas Patras, Gold Bonds, etc. Banks are not allowed to provide loans to companies for buy back of shares / securities. Banks are also not allowed to provide loans against security of its own shares.

11.44 These securities are usually in the possession of the bank. Wherever the shares are held as security by a bank (as primary or collateral security), banks are required to have them transferred in their own names if the loan amount exceeds the RBI prescribed ceiling). The ceiling is different for shares in dematerialised form and in physical form. In other cases, (i.e., where the loan amount does not exceed the prescribed ceiling), banks accept the aforesaid securities subject to following conditions:

- (a) in the case of physical shares, they are accompanied by blank transfer deeds duly signed by the person in whose name they are registered; in case of shares held in dematerialised form, authorisation slips should be obtained from the borrower and passed on to the relevant depository participant who immediately marks those shares as pledged; or
- (b) the bank holds a general power of attorney from the person in whose name they are registered.

11.45 If the person in whose name the securities are registered is other than the borrower, the bank has to particularly satisfy itself that the person has a good title to the security. The bank also obtains a letter of renunciation from the person in whose name the securities are registered.

11.46 In the case of advances against bearer securities (Kisan Vikas Patras/ Indira Vikas Patras), banks obtain independent/direct confirmation of the genuineness of the certificates from the issuing authorities. After obtaining such confirmation, bank possession is sufficient.

11.47 In case of government paper and inscribed stock, banks should get them registered in their own name while accepting them as security.

11.48 Before accepting shares as security, the lending bank has to ensure that provisions of section 19 of the Banking Regulation Act, 1949 are not contravened except otherwise specifically permitted by RBI regulations. This section prohibits a banking company from holding shares in any company, whether as pledge, mortgagee or absolute owner, of an amount exceeding thirty per cent of the paid up share capital of that company or thirty per cent of its own paid-up share capital and reserves, whichever is less.

Goods

11.49 Goods constitute a significant proportion of the securities taken by banks. They are either stock-in-trade of its trading customers or finished products of manufacturers. Raw materials, work-in-process, etc., are also accepted as security. Banks should have a system in place to ensure that the security in terms of stock offered by borrower is as per bank policy.

11.50 Goods may be either hypothecated to, or pledged with, the bank. As mentioned earlier, in case of hypothecation of goods, banks obtain periodic statements from the borrowers (monthly/quarterly), declaring quantity and value of the goods basis which the borrowers drawing power is fixed. The officers of the lending bank pay regular visits to borrower godowns or factories to inspect and check the correctness of records maintained by the borrowers basis which, the periodic statements are prepared by them. They also check value of the goods in stock with reference to sale bills, market quotations, etc. In the case of large advances, inventory is subject to inspection and verification (stock audit) by external agency at stipulated intervals. The Auditor may go through the same for determining the existence and adequacy of security and also to determine irregularity in the account, if any.

11.51 Stock registers are maintained by godown keepers of the lending bank in respect of goods pledged with the bank. Godowns are regularly inspected by the inspectors and other bank officers. When goods are brought into the godown, the godown keeper has to satisfy himself, by appropriate test checks, regarding the quantity and quality of goods. Banks have to exercise care to ensure that frauds are not perpetrated against them by pledging packages not containing the specified goods and later on holding them

responsible for the goods supposed to have been pledged as per the documents.

11.52 The goods are insured against fire and other risks involved and the insurance policies are either in the name of, or endorsed in favour of, the bank. In case the borrower is a company, the bank has to ensure registration of charge with the Registrar of Companies.

Documents of Title to Goods

11.53 A document of title to goods is a negotiable or quasi-negotiable instrument. According to section 2(4) of the Sale of Goods Act, 1930, a document of title is any document used in the ordinary course of business as proof of the possession or control of goods, or authorising or purporting to authorise, either by endorsement or by delivery, the possessor of the document to transfer or receive the goods represented thereby.

11.54 Documents of title include:

- Bill of lading
- Railway receipt
- Transporter's receipt
- Dock warrant
- Warehouse-keeper's certificate
- Wharfinger's receipt
- Warrant or order for delivery of goods

Before being pledged with the bank, these documents have to be appropriately endorsed in bank's favour.

Gold Ornaments and Bullion

11.55 Gold ornaments are accepted by banks as security on the basis of assessor's certificate regarding the content, purity, weight and value thereof. Valuation, keeps on changing as a result of market fluctuations. Loans are given only on the basis of gold content of ornaments, without considering gold making charges. RBI, vide Master Circular No. DBR.No.Dir.BC.10/13.03.00/2015-16 on Loans and Advances-Statutory and Other Restrictions dated July 1, 2015, directed banks to give preference to hallmarked jewellery for granting advances. RBI vide Circular No. DBOD.BP.BC.No.86/21.01.023/2013-14 on "Lending against Gold Jewellery" dated January 20, 2014 read with Master Circular No. DBR.No.Dir.BC.10/13.03.00/2015-16 on

Loans and Advances-Statutory and Other Restrictions dated July 1, 2015, issued guidance in respect of "Advances against Gold Ornaments and Jewellery for purpose of Medical Expenses and Meeting Unforeseen Liabilities". In this context, attention is invited to RBI's Circular No. DBOD.No.BP.79/21.04.048/2013-14 on "Non-Agriculture Loans against Gold Ornaments and Jewellery" dated December 30, 2013 read with circular no. RBI/2014-15/142 DBOD.No.BP.BC.27/21.04.048/ 2014-15 dated July 22, 2014 and Master Circular No. DBR.No.Dir.BC.10/ 13.03.00/2015-16 on Loans and Advances-Statutory and Other Restrictions dated July 1, 2015 containing guidelines on bullet repayment of loans extended against pledge of gold ornaments and jewellery for other than agricultural purposes.

Life Insurance Policies

11.56 Life insurance policies have to be assigned in bank's favour and such assignment has to be registered with the insurer. The surrender value of the policy is the basis of valuation.

Plantations

11.57 Advances are made to agriculturists such as tea gardeners to finance their growing crops. When the produce is harvested, processed and sold, the money is repaid to the bank.

11.58 The basis of calculating the amount of the advance is the estimated crop of the season. This depends upon the area under cultivation, expected yield, etc. Separate advances are made for each season's crop.

11.59 The crop to be produced is hypothecated to the bank. Generally, fixed assets of the plantation are also mortgaged with the bank as collateral security. Finance is taken from the bank to incur expenditure on the crop. The amount of the advance increases as the crop grows.

Immovable Property

11.60 Before advancing money on mortgage of immovable property, the lending bank has to satisfy itself that the borrower has a clear and unencumbered title to the property that is marketable and adequately insured. Banks ascertain whether the property in question has already been mortgaged to any other financial institution and if so, details of charges already created on the property. In respect of advances to public companies against mortgage of a block of assets, it is essential that provisions of section 180(1)(a) of the Companies Act, 2013 are duly considered.

Third Party Guarantees

11.61 Advances covered by third party personal guarantees (except banks and government) in addition to borrower's personal security are not classified as 'secured' advances and are classified as 'unsecured' advances.

11.62 The guarantee bond executed by the guarantor in favour of the bank may be in bank's own prescribed form or otherwise. Such bonds are generally executed by holding companies, overseas customers, overseas principals, insurance companies, etc. A letter of continuity is also obtained from the guarantor.

Banker's General Lien

11.63 A lending bank also has a general lien under law. A lien represents the right of retaining the goods/securities unless a debt due by a debtor is paid to the creditor (retainer), provided there is no agreement, express or implied, to the contrary. A lien is a statutory right, which does not require any separate agreement. Under section 171 of the Indian Contract Act, 1872, a banker may, in the absence of an agreement to the contrary, retain as security for a general balance of account, any goods and securities bailed to him. This is called banker's general lien.

11.64 Two conditions necessary for creating such lien are:

- (a) Securities must be placed in a banker's hand by his customers; and
- (b) Securities are not specifically appropriated.

11.65 Securities over which a banker has general lien are credit balance in any other account, bonds and coupons deposited for collection, securities allowed to remain in banker's hands after repayment of a secured advance, etc.

11.66 Securities on which a banker does not have a general lien are securities deposited for safe custody, money deposited or earmarked for a specific purpose, documents executed for a special purpose, etc. Lien is applicable even in respect of the borrower's obligations as a surety. The banker's right of general lien over the security is not barred by the law of limitation and can be exercised in case of unenforceable or time-barred debts also.

11.67 'Negative lien' refers to an undertaking given by the borrower to the bank that no charge such as lien, pledge, hypothecation, or mortgage, over his immovable and moveable properties and assets including uncalled capital will be created without bank's prior permission. Negative lien relates to goods, securities, etc., not in Bank's possession. Negative lien does not require registration with Registrar of Companies or similar authorities.

Statutory Restrictions

Advances against Bank's own Shares

11.68 In terms of Section 20(1) of the Banking Regulation Act 1949, a bank cannot grant any loan or advance against the security of its own shares.

Advances to Bank's Directors

11.69 Section 20(1) of Banking Regulation Act, 1949 lays down restrictions on loans and advances to directors and firms in which they hold substantial interest.

11.70 Banks are prohibited from entering into any commitment for granting any loans or advances to or on behalf of any of its directors, or any firm in which any of its directors is interested as partner, manager, employee or guarantor, or any company (not being a subsidiary of the banking company or a company registered under Section 8 of the Companies Act, 2013 or a Government company) of which, or the subsidiary or the holding company of which any of the directors of the bank is a director, managing agent, manager, employee or guarantor or in which he holds substantial interest, or any individual in respect of whom any of its directors is a partner or guarantor. Certain exemptions are given in the aforesaid Master Circular in this regard.

11.71 For the above purpose, the term 'loans and advances' shall not include:

- (a) Loans or advances against Government securities, life insurance policies or fixed deposit.
- (b) Loans or advances to Agricultural Finance Corporation Ltd.
- (c) such loans or advances as can be made by a banking company to any of its directors (who immediately prior to becoming a director, was an employee of the banking company) in his capacity as an employee of that banking company and on terms and conditions as would have been applicable to him as an employee of that banking company, if he had not become a director of the banking company. Banking company includes every bank to which provisions of Section 20 of Banking Regulation Act, 1949 apply.
- (d) such loans or advances granted by the banking company to its Chairman and Chief Executive Officer, who was not an employee of the banking company immediately prior to his appointment as Chairman/Managing Director/CEO, for the purpose of purchasing a car, personal computer, furniture or constructing/ acquiring a house for his personal use and festival advance, with prior approval of RBI and on such stipulated terms and conditions.

- (e) Such loans or advances granted by a banking company to its whole time director for the purpose of purchasing furniture, car, personal computer or constructing/acquiring house for personal use, festival advance with RBI prior approval and on such stipulated terms and conditions.
- (f) Call loans made by banking companies to one another.
- (g) Facilities like bills purchased/discounted (whether documentary or clean and sight or usance and whether on D/A basis or D/P basis), purchase of cheques, other non-fund based facilities like acceptance/co-acceptance of bills, opening of L/Cs and issue of guarantees, purchase of debentures from third parties, etc.
- (h) Line of credit/overdraft facility extended by settlement bankers to National Securities Clearing Corporation Ltd.(NSCCL)/ Clearing Corporation of India Ltd. (CCIL) to facilitate smooth settlement.
- (i) Credit limit granted under credit card facility provided by a bank to its directors to the extent the credit limit so granted is determined applying the same criteria as applied by it in normal conduct of credit card business.

11.72 Purchase of or discount of bills from directors and their concerns, which is in the nature of clean accommodation, is reckoned as 'loans and advances' for purposes of Section 20 of the Banking Regulation Act, 1949.

Restrictions on Power to Remit Debts

11.73 Section 20A of the Banking Regulation Act, 1949 stipulates that notwithstanding anything to the contrary contained in Section 180 of the Companies Act, 2013, a banking company shall not, except with RBI's prior approval, remit, in whole or in part, any debt due to it by -

- any of its directors, or
- any firm or company in which any of its directors is interested as director, partner, managing agent or guarantor, or
- any individual, if any of its directors is his partner or guarantor.

Any remission made in contravention of the above provisions shall be void and shall have no effect.

Restriction on Holding Shares in Companies

11.74 As per Section 19(2) of Banking Regulation Act, 1949, banks should not hold shares in any company except as provided in sub-section (1) whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30 per cent of the paid-up share capital of that company or 30 per cent of its own paid-up share

capital and reserves, whichever is less, except otherwise specifically permitted by RBI regulations.

11.75 In terms of Section 19(3) of the Banking Regulation Act, 1949, banks should not hold shares whether as pledgee, mortgagee or absolute owner, in any company in the management of which any managing director or manager of the bank is in any manner concerned or interested.

11.76 While granting loans and advances against shares, provisions of Sections 19(2) and 19(3) should be strictly observed, except otherwise specifically permitted by RBI regulations.

Restrictions on Credit to Companies for Buy-back of their Securities

11.77 As per Section 68 of the Companies Act, 2013, companies are permitted to purchase their own shares or other specified securities out of their:

- Free reserves.
- Securities premium account.
- Proceeds of any shares or other specified securities.

subject to compliance of various conditions specified in sub-section (2) of section 68 of Companies Act, 2013. Therefore, banks should not provide loans to companies for buy-back of shares/securities.

Regulatory Restrictions

Granting Loans and Advances to relatives of Directors

11.78 Without prior approval of the Board or its knowledge, no loans and advances should be granted to relatives of bank's Chairman/Managing Director or other Directors, Directors (including Chairman/Managing Director) of other banks and their relatives, Directors of Scheduled Co-operative Banks and their relatives, Directors of Subsidiaries/Trustees of Mutual Funds/Venture Capital Funds set up by the financing banks or other banks. However, banks may grant loan or advance to or on behalf of spouses of their Directors in cases where the spouse has his/her own independent source of income arising out of his/her employment or profession and the facility so granted is based on standard procedures and norms for assessing the borrower creditworthiness. Such facility should be extended on commercial terms. Accordingly, Banks should not grant loans and advances without approval of the Board of Directors/Management Committee aggregating Rupees twenty five lakhs and above to –

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- a. directors (including the Chairman/Managing Director) of other banks.
- b. any firm in which any of the directors of other banks is interested as a partner or guarantor.
- c. any company in which any of the directors of other banks holds substantial interest or is interested as a director or as a guarantor.
- d. any relative other than spouse and minor/dependent children of their own Chairmen/Managing Directors or other Directors.
- e. any relative other than spouse and minor/dependent children of the Chairman/Managing Director or other directors of other banks.
- f. any firm in which any of the relatives other than spouse and minor/dependent children as mentioned in (d) & (e) above is interested as a partner or guarantor.
- g. any company in which any of the relatives other than spouse and minor / dependent children as mentioned in (d) & (e) above hold substantial interest or is interested as a director or as a guarantor.

Restrictions on Grant of Loans and Advances to Officers and the Relatives of Senior Officers of Banks

11.79 No officer or any Committee comprising, *inter alia*, an officer as member, shall, while exercising powers of sanction of any credit facility, sanction any credit facility to his/her relative. Such a facility shall ordinarily be sanctioned only by the next higher sanctioning authority. Credit facilities sanctioned to senior officers of the financing bank should be reported to the Board. Loans and advances and award of contracts to relatives of senior officers of the bank or proposals for credit facilities to the relatives of senior officers of the bank sanctioned by the appropriate authority should be reported to the Board. Further, when a credit facility is sanctioned by an authority, other than the Board, to:

- any firm in which any of the relatives of any senior officer of the financing bank holds substantial interest, or is interested as a partner or guarantor; or
- any company in which any of the relatives of any senior officer of the financing bank holds substantial interest, or is interested as a director or as a guarantor, such transaction should also be reported to the Board.

Credit facility will not include loans and advances such as housing loans, car advances, consumption loans, etc., granted to an officer of the bank under any scheme applicable generally to bank employees.

Restriction on Advances against Sensitive Commodities under Selective Credit Control (SCC)

11.80 To prevent speculative holding of essential commodities with the help of bank credit and the resultant rise in their prices, in exercise of powers conferred by Sections 21 & 35A of the Banking Regulation Act, 1949, RBI, issues, from time to time, directives to all commercial banks, stipulating specific restrictions on bank advances against specified sensitive commodities.

The Auditor should be updated as to which commodities are under selection credit control during the audit period under review.

Restriction on payment of commission to staff members including officers

11.81 Section 10(1)(b)(ii) of Banking Regulation Act, 1934, stipulates that a banking company shall not employ or continue employment of any person whose remuneration or part of whose remuneration takes the form of commission or a share in the profits of the company. Clause (b) of Section 10(1)(b)(ii) permits payment of commission to any person who is employed only otherwise than as a regular staff. Therefore, banks should not pay commission to staff members and officers for recovery of loans.

Restrictions on offering incentives on any banking products

11.82 Banks are not permitted to offer any banking products, including online remittance schemes etc., with prizes /lottery/free trips (in India and/or abroad), etc. or any other incentives having an element of chance, except inexpensive gifts costing less than Rs. 250/-, as such products involve non-transparency in the pricing mechanism. Such products, if offered, by banks are considered as violation of extant guidelines and banks concerned are liable for penal action.

Restrictions on Other Loans and Advances

Loans and Advances against Shares, Debentures and Bonds

11.83 Banks are required to strictly observe regulatory restrictions on grant of loans and advances against shares, debentures and bonds as detailed in Master Circular no. RBI /2015-16/95 DBR.No.Dir.BC. 10/13.03.00/2015-16 dated July 01, 2015 on "Loans and Advances – Statutory and Other Restrictions". The restrictions on loans and advances against shares and debentures, are:

- (a) No loans to be granted against partly paid shares.
- (b) No loans to be granted to partnership/proprietorship concerns against the primary security of shares and debentures.

11.84 RBI's Master Circular No. RBI/2015-16/95 DBR. No. Dir. BC. 10/13.03.00/2015-16 "Loans and Advances - Statutory and Other Restrictions" contains guidelines for granting Loan and Advances against Shares, Debentures and Bonds as follows:

Advances to individuals

11.85 Banks may grant advances against security of shares, debentures or bonds to individuals subject to following conditions:

- (i) **Amount of advance:** Loans against security of shares, debentures and bonds should not exceed Rs. 10 lakhs per individual if the securities are held in physical form and Rs. 20 lakhs per individual if securities are held in dematerialised form. Auditors should note updated limits from time to time.
- (ii) **Margin:** Banks should maintain a minimum margin of 50 per cent of the market value of equity shares / convertible debentures held in physical form. In case of shares / convertible debentures held in dematerialised form, a minimum margin of 25 per cent should be maintained. These are minimum margin stipulations and banks may stipulate higher margins for shares whether held in physical or dematerialized form. Margin requirements for advances against preference shares / nonconvertible debentures and bonds may be determined by banks themselves.
- (iii) **Lending policy:** Each bank should formulate with their Board of Directors, approval, a Loan Policy for grant of advances to individuals against shares / debentures / bonds keeping in view RBI guidelines. Banks should obtain a declaration from the borrower indicating the extent of loans availed of by him from other banks as input for credit evaluation. It would also be necessary to ensure that such accommodation from different banks is not obtained against shares of a single company or a group of companies. As a prudential measure, each bank may also consider laying down appropriate aggregate sub-limits of such advances.

Advances to Share and Stock Brokers/ Commodity Brokers

11.86 (i) Banks and their subsidiaries are not permitted to finance 'Badla' transactions. Banks can grant advances only to SEBI registered share and stock brokers complying with capital adequacy norms prescribed by SEBI / Stock Exchanges. This would be towards need based overdraft facilities / line of credit against shares and debentures held by them as stock in trade. A careful assessment of need based requirements for such finance should be made taking into account the borrower's financial position, operations on his own account and on behalf of clients, income earned, average turnover

period of stocks and shares and the extent to which broker's funds are required to be involved in business operations. Banks may also grant working capital facilities to such stock brokers to meet cash flow gap between delivery and payment for DVP transactions undertaken on behalf of institutional clients viz. FIs, FII, mutual funds and banks, duration of such a facility will be short and based on an assessment of financing requirements keeping in view cash flow gaps, the broker's funds required to be deployed for the transaction and overall financial position of the broker. Utilization has to be monitored based on individual transactions.

Banks may institute adequate safeguards and monitoring mechanisms. A uniform margin of 50 per cent is required to be applied on all advances/financing of IPOs/ issue of guarantees on behalf of share and stockbrokers. A minimum cash margin of 25 per cent (within the 50% margin) shall be maintained in respect of guarantees issued by banks for capital market operations. The above minimum margin will also apply to guarantees issued by banks on behalf of commodity brokers in favour of commodity exchanges viz. National Commodity and Derivatives Exchange (NCDEX), Multi Commodity Exchange of India Ltd. (MCX) and National Multi Commodity Exchange of India Ltd. (NMCEIL), in lieu of margin requirements as per commodity exchange regulations. These margin requirements will also be applicable in respect of bank finance to stock brokers by way of temporary overdrafts for DVP transactions. Banks may issue guarantees on behalf of share and stock brokers/commodity brokers in favour of stock exchanges in lieu of security deposit to the extent it is acceptable in form of bank guarantee as laid down by stock exchanges. Banks may also issue guarantees in lieu of margin requirements as per stock exchange regulations.

- (ii) The requirement relating to transfer of shares in bank's name in respect of shares held in physical form mentioned at Sl. No. (ix) of Paragraph 2.3.1.14 of Master Circular on Loans and Advances would not apply in respect of advances granted to share and stock brokers provided such shares are held as security for a period not exceeding nine months. In case of dematerialised shares, the depository system provides a facility for pledging and banks may avail this facility. In such cases, there will not be a need to transfer the shares in the bank's name irrespective of the period of holding. The share and stock brokers are free to substitute shares pledged by them as and when necessary. In case of a default in the account, the bank should exercise the option to get the shares transferred in its name.

Bank finance for market makers

11.87 Necessary guidelines for the same as stated in the Master Circular to be noted wherever applicable cases exist in the Branch.

Financing of Initial Public Offerings (IPOs)

11.88 Banks should ensure that no advances exceed Rs. 10 lakhs to any individual against security of shares, convertible bonds, convertible debentures, units of equity oriented mutual funds and PSU bonds for subscribing to IPOs. Banks should not extend any credit or financing to Corporates for investment in other companies' IPOs and to NBFCs for further lending to individuals for IPOs.

Bank Finance to assist employees to buy shares of their own companies

11.89 (i) Banks may extend finance to employees for purchasing shares of their own companies under Employees Stock Option Plan (ESOP)/ reserved by way of employees' quota under IPO to the extent of 90% of the purchase price of the shares or Rs. 20 Lakhs, whichever is less. Banks are not allowed to extend advances including advances to their employees/ Employees' Trusts set up by them for purposes of purchasing their own banks' share under ESOPs/IPOs or from the secondary market irrespective of whether the advances are secured or unsecured. Follow-on Public Offers (FPOs) will also be included under IPO.

(ii) Banks should obtain declaration from the borrower indicating details of loan/advances availed against shares and other securities specified above, from any other bank/s to ensure compliance with the prescribed ceilings.

Advances to other borrowers against shares / debentures / bonds

11.90 (i) The question of granting advances against primary security of shares and debenture including promoters' shares to industrial, corporate or other borrowers should not normally arise except for secured loans granted towards working capital or for other productive purposes other than NBFCs. In such cases, Banks should accept shares only in dematerialised form. Banks may accept shares of promoters only in dematerialized form wherever demat facility is available.

(ii) Banks may obtain collateral security of shares and debentures by way of margin for a temporary period of one year from borrowers other than NBFCs in the course of setting up of new projects or expansion of existing business or for purposes of raising additional working capital. Banks have to satisfy themselves regarding the capacity of the borrower to raise the required funds and to repay the advance within the stipulated period.

Bank Loans for Financing Promoters Contribution

11.91 The promoters' contribution towards the equity capital of a company should come from their own resources and bank's should not normally grant advances to take up shares of other companies. However, banks are permitted to extend loans to corporate against security of shares (as far as possible in dematerialised form) held by them to meet promoters' contribution to equity of new companies in anticipation of raising resources subject to terms and conditions detailed in the loan policy of the bank, in addition to general guidelines given in para 2.3.1.14 of the Master Circular no. RBI/2015-16 /95 DBR. No. Dir. BC. 10/13.03.00/ 2015-16 dated July 1, 2015 on Loans and Advances – Statutory and Other restrictions.

- i) Margin and loan repayment period may be determined by the banks.
- ii) Loans sanctioned to a corporate against security of shares (as far as possible, demat shares) for meeting promoters' contribution to the equity of new companies in anticipation of raising resources, should be treated as bank's investments in shares coming under the ceiling of 40 percent of the bank's net worth as on March 31 of the previous year prescribed for the bank's total exposure including both fund and non-fund based exposure to capital market in all forms. These loans will be subject to individual/group of borrowers exposure norms and statutory limit on shareholding in companies, detailed in Master Circular no. RBI/2015-16/70 DBR.No.Dir.BC.12/ 13.03.00/2015-16 dated July 1, 2015 on Exposure Norms.
- iii) Banks may extend financial assistance to Indian companies for acquisition of equity in overseas joint ventures / wholly owned subsidiaries or in other overseas companies, new or existing, as strategic investment, in terms of a Board approved policy, duly incorporated in the bank's loan policy. Such policy should include overall limit on such financing, terms and conditions of eligibility of borrowers, security, margin, etc. The finance would be subject to compliance with the statutory requirements under Section 19(2) of the Banking Regulation Act, 1949.
- iv) Restriction on grant of bank advances for financing promoters' contribution towards equity capital would also extend to bank finance to activities related to acquisitions like payment of non-compete fee, etc. These restrictions would also apply to bank finance to such activities by overseas branches / subsidiaries of Indian banks.
- v) With the approval of the Board of Directors, banks should formulate internal guidelines with appropriate safeguards for this purpose.

- vi) Under refinance scheme of Export-Import Bank of India, banks may sanction term loans on merits to eligible Indian promoters for acquisition of equity in overseas joint ventures / wholly owned subsidiaries, provided the term loans are approved by EXIM Bank for refinance.

Advances against Units of Mutual Funds

11.92 While granting advances against units of mutual funds, banks should adhere to the following guidelines:

- i) Units should be listed in Stock Exchanges or repurchase facility for the Units of mutual fund should be available at the time of lending.
- ii) Units should have completed the minimum lock-in-period stipulated in the relevant scheme.
- iii) Amount of advance should be linked to the Net Asset Value (NAV) / repurchase price or market value, whichever is less and not to face value.
- iv) Advance against units of mutual funds (except units of exclusively debt oriented funds) would attract quantum and margin requirements as applicable to advance against shares and debentures. However, the quantum and margin requirement for loans/ advances to individuals against units of exclusively debt-oriented mutual funds may be decided by individual banks themselves in accordance with their loan policy.
- v) Advances should be purpose oriented, taking into account the credit requirement of the investor. Advances should not be granted for subscribing to or boosting up the sales of another scheme of mutual funds or for purchase of shares/ debentures/ bonds etc.

For exposure norms w.r.t. advances against units of Mutual Funds, refer to Para 4.6 of the Master Circular No. RBI/2015-16/70 DBR.No.Dir.BC.12/13.03.00/2015-16 dated July 1, 2015 "Exposure Norms".

Margin Trading

11.93 Banks may extend finance to stockbrokers for margin trading. The Board of each bank should formulate detailed guidelines for lending for margin trading, subject to the following parameters:

- (a) Finance extended for margin trading should be within the overall ceiling of 40% of net worth prescribed for capital market exposure.
- (b) Minimum margin of 50 per cent to be maintained on the funds lent for margin trading.
- (c) Shares purchased with margin trading to be in dematerialised mode under pledge to the lending bank. Bank to put in place an appropriate system for monitoring and maintaining the margin of 50% on an ongoing basis.

- (d) Bank's Board should prescribe necessary safeguards to ensure that no "nexus" develops between inter-connected stock broking entities/ stockbrokers and the bank in respect of margin trading. Margin trading should be spread out by the bank among a reasonable number of stockbrokers and stock broking entities.

11.94 The Audit Committee of the Board should periodically monitor bank's exposure by way of financing for margin trading and ensure that Board guidelines, subject to the above parameters, are complied. Banks should disclose the total finance extended for margin trading in "Notes on Account" to their Balance Sheet.

Financing for Acquisition of Equity in Overseas Companies

11.95 Banks may extend financial assistance to Indian companies for acquisition of equity in overseas joint ventures / wholly owned subsidiaries or in other overseas companies, new or existing, as strategic investment, in terms of a Board approved policy, duly incorporated in the bank's loan policy. Such policy should include overall limit on such financing, terms and conditions of eligibility of borrowers, security, margin, etc. While the Board may frame its own guidelines and safeguards for such lending, such acquisition(s) should be beneficial to the company and the country. The finance would be subject to compliance with the statutory requirements under Section 19(2) of the Banking Regulation Act, 1949.

Refinance Scheme of Export Import Bank of India

11.96 Under the refinance scheme of Export Import Bank of India (EXIM Bank), banks may sanction term loans on merits to eligible Indian promoters for acquisition of equity in overseas joint ventures / wholly owned subsidiaries, provided that term loans are approved by the EXIM Bank for refinance.

Arbitrage Operations

11.97 Banks should not undertake arbitrage operations themselves or extend credit facilities directly or indirectly to stockbrokers for arbitrage operations in Stock Exchanges. While banks are permitted to acquire shares from the secondary market, they should ensure that no sale transaction is undertaken without holding the shares in their investment accounts.

General guidelines applicable to advances against shares / debentures / bonds

11.98 Statutory provisions regarding grant of advances against shares contained in Sections 19(2) and (3) and 20(1) (a) of the Banking Regulation Act, 1949 should be strictly observed. Shares held in dematerialised form should also be included for the purpose of determining limits under Section 19(2) and 19(3).

11.99 While considering grant of advances against shares / debentures banks must follow normal procedures for sanction, appraisal and post sanction follow-up.

11.100 Advances against primary security of shares / debentures / bonds should be kept distinct and separate and not combined with any other advance.

11.101 Banks should satisfy themselves about the marketability/ reliability of the shares / debentures and the net worth and working of the company whose shares / debentures / bonds are offered as security.

11.102 Shares/ debentures/ bonds should be valued at prevailing market prices when they are lodged as security for advances.

11.103 Banks should exercise particular care when advances are sought against large blocks of shares by a borrower or a group of borrowers. It should be ensured that advances against shares are not used to enable the borrower to acquire or retain a controlling interest in the company/ companies or to facilitate or retain inter-corporate investments.

11.104 No advance shall be granted against partly paid shares.

11.105 No loans to be granted to partnership/ proprietorship concerns against primary security of shares and debentures.

11.106 Whenever the limit/limits of advances granted to a borrower exceed Rupees Ten lakhs, it should be ensured that the said shares / debentures / bonds are transferred in the bank's name and that the bank has exclusive and unconditional voting rights in respect of such shares. For this purpose the aggregate of limits against shares / debentures / bonds granted by a bank at all its offices to a single borrower should be taken into account.

11.107 Where securities are held in dematerialised form, the requirement relating to transfer of shares in bank's name will not apply and banks may take their own decision in this regard.

11.108 Banks should, however, avail of the facility provided in the depository system for pledging securities held in dematerialised form under which the securities pledged by the borrower get blocked in favour of the lending bank. In case of default by the borrower and on the bank exercising the option of invocation of pledge, the shares and debentures get transferred in the bank's name immediately.

11.109 Banks may take their own decision in regard to exercise of voting rights and may prescribe procedures for this purpose.

11.110 Banks should ensure that the scrip lodged with them as security are not

stolen / duplicate / fake / benami. Any irregularities coming to their notice should be reported immediately to the RBI.

11.111 Banks operating in India should not be a party to transactions such as making advances or issuing back-up guarantees favouring other banks for extending credit to clients of Indian nationality / origin by some of their overseas branches, to enable borrowers to make investments in shares and debentures / bonds of Indian companies.

11.112 A uniform 50 per cent margin shall apply on all advances against shares/financing of IPOs/issue of Guarantees. A minimum 25 per cent cash margin (within margin of 50 per cent) shall be maintained in respect of guarantees issued by banks for capital market operations. These margin requirements will also apply in respect of bank finance to stock brokers by way of temporary overdrafts for DVP transactions.

Advances against Fixed Deposit Receipts issued by Other Banks

11.113 Instances have come to light where fake term deposit receipts, purported to have been issued by some banks, were used for obtaining advances from other banks. RBI has hence, advised banks to desist from sanctioning advances against FDRs, or other term deposits of other banks.

Advances to Agents/Intermediaries Based on Consideration of Deposit Mobilisation

11.114 Banks should desist being part to unethical practices of raising of resources through agents/intermediaries to meet credit needs of existing/prospective borrowers or from granting loans to intermediaries, based on consideration of deposit mobilisation, who may not require funds for genuine business requirements.

Loans Against Certificate of Deposits (CDs)

11.115 Banks cannot grant loans against CDs. Banks are also not permitted to buy-back their own CDs before maturity. However, these restrictions on lending and buy back in respect of CDs held by mutual funds have been relaxed.

11.116 While granting such loans to mutual funds, banks should keep in view provisions of Paragraph 44(2) of the SEBI (Mutual Funds) Regulations, 1996. Further, such finance, if extended to equity-oriented mutual funds, will form part of banks' capital market exposure.

Finance for and Loans/Advances against Indian Depository Receipts (IDRs)

11.117 Banks are not permitted to grant any loan / advance for subscription to Indian Depository Receipts (IDRs). No loans/ advances can be granted against security / collateral of IDRs issued in India.

Bank Finance to Non-Banking Financial Companies (NBFCs)

11.118 RBI, vide Master Circular No. DBR.BP.BC.No.5/21.04.172/ 2015-16 on Bank Finance to Non-Banking Financial Companies (NBFCs) dated July 1, 2015 states:

- a) Ceiling on bank credit linked to Net Owned Fund (NOF) of NBFCs has been withdrawn in respect of all NBFCs statutorily registered with RBI and engaged in principal business of asset financing, loan, factoring and investment activities. Accordingly, banks may extend need based working capital facilities and term loans to all NBFCs registered with RBI and engaged in infrastructure financing, equipment leasing, hire-purchase, loan, factoring and investment activities.
- b) Banks may finance NBFCs against second hand assets financed by them.
- c) Banks may formulate suitable loan policy with the approval of their Boards of Directors within RBI prudential guidelines and exposure norms to extend various kinds of credit facilities to NBFCs subject to the condition that the activities as indicated in the Master Circular are not financed by them.

11.119 In respect of NBFCs not required to be registered with RBI, viz.:

- i) Insurance Companies registered under Section 3 of the Insurance Act, 1938;
- ii) Nidhi Companies notified under Section 406 of the Companies Act, 2013;
- iii) Chit Fund Companies carrying on Chit Fund business as their principal business as per Explanation to Clause (vii) of Section 45-I(bb) of the Reserve Bank of India Act, 1934;
- iv) Stock Broking Companies / Merchant Banking Companies registered under Section 12 of the Securities and Exchange Board of India Act, 1992; and
- v) Housing Finance Companies being regulated by the National Housing Bank (NHB) which have been exempted from the requirement of registration by RBI], banks may take their credit decisions based on usual factors like purpose of credit, nature and quality of underlying assets, repayment capacity of borrowers, risk perception, etc.

11.120 Banks are prohibited from providing credit for the following NBFC activities:

- (i) Bills discounted/rediscounted by NBFCs, except for rediscounting of bills discounted by NBFCs arising from sale of –
 - (a) commercial vehicles (including light commercial vehicles), and
 - (b) two-wheeler and three-wheeler vehicles, subject to following conditions:
 - bills should have been drawn by the manufacturers on dealers only.
 - bills should represent genuine sale transactions as may be ascertained from the chassis/engine numbers.
 - before rediscounting the bills, banks should satisfy themselves about the *bona fides* and track record of the NBFCs discounting the bills.
- (ii) Investments of NBFCs both of current and long term nature, in any company/entity by way of shares, debentures, etc. However, Stock Broking Companies may be provided need-based credit against shares and debentures held by them as stock-in-trade.
- (iii) Unsecured loans/inter-corporate deposits by NBFCs to/in any company.
- (iv) All types of loans/advances by NBFCs to their subsidiaries, group companies/entities.
- (v) Finance to NBFCs for further lending to individuals for subscribing to Initial Public Offerings (IPOs) and for purchase of shares from secondary market.

Bank Finance to Residuary Non-Banking Companies (RNBCs)

11.121 Residuary Non-Banking Companies (RNBCs) are required to be mandatorily registered with RBI. In respect of such companies, bank finance would be restricted to their Net Owned Fund (NOF). The NOF computation will be as per definition given in explanation to Section 45-IA of RBI Act, 1934.

Other Prohibition on Bank Finance to NBFCs

Bridge loans / interim finance to NBFCs

11.122 Banks should not grant bridge loans of any nature, or interim finance against capital / debenture issues and / or in form of loans of a bridging nature pending raising of long-term funds from the market by way of capital, deposits, etc. to all categories of Non-Banking Financial Companies, i.e., equipment leasing and hire-purchase finance companies, loan and investment companies and also Residuary Non-Banking Companies (RNBCs).

11.123 Banks should strictly follow these instructions and ensure that they are not circumvented in any manner whatsoever by purport and / or intent by sanction of credit under a different nomenclature like unsecured negotiable notes, floating rate interest bonds, etc., as also short-term loans, repayment of which is proposed / expected to be made out of funds to be or likely to be mobilised from external / other sources and not out of surplus generated by use of the asset(s).

Advances against collateral security of shares to NBFCs

11.124 Shares and debentures cannot be accepted as collateral securities for secured loans granted to NBFCs borrowers for any purpose.

Restriction on Guarantees for placement of funds with NBFCs

11.125 Banks should not execute guarantees covering inter-company deposits / loans thereby guaranteeing refund of deposits / loans accepted by NBFCs / firms from other NBFCs / firms. The restriction would cover all types of deposits / loans irrespective of their source, including deposits / loans received by NBFCs from trusts and other institutions. Guarantees should not be issued for purposes of indirectly enabling placement of deposits with NBFCs.

Bank Finance to Equipment Leasing Companies

11.126 Banks should not enter into lease agreements departmentally with equipment leasing companies as well as other Non-Banking Financial Companies engaged in equipment leasing.

Bank Finance to Factoring Companies

11.127 Necessary guidelines given in the master circular should be noted in applicable cases if any in branches.

Restrictions regarding investments made by banks in securities/ instruments issued by NBFCs

11.128 Banks should not invest in Zero Coupon Bonds (ZCBs) issued by NBFCs unless the issuer NBFC builds up sinking fund for all accrued interest and keeps it invested in liquid investments / securities (Government bonds).

11.129 Banks are permitted to invest in Non-Convertible Debentures (NCDs) with original or initial maturity up to one year issued by NBFCs. While investing in such instruments banks should be guided by the extant prudential guidelines in force, ensure that the issuer has disclosed the purpose for which the NCDs are being issued in the disclosure document and such purposes are eligible for bank finance.

Advances Against NR(E) and FCNR(B) Deposits

11.130 Grant of advance against NR(E) and FCNR(B) deposits would be subject to guidelines issued under Foreign Exchange Management Act, 1999.

Advances Against Bullion/Primary Gold

11.131 Banks are prohibited from granting any advance against bullion/primary gold. However, specially minted gold coins sold by banks are not treated as “bullion” or “primary gold” and hence are acceptable as security up to 50 gms per customer. Such loans may be covered under the policy framed by the bank’s Board, in terms of RBI circular DBOD.No. BC. 138/21.01.023/94 dated November 22, 1994. Where advances have been granted against gold coins it should be ensured that end use of funds is for approved, non-speculative purposes. Banks should desist from granting advances to silver bullion dealers which are likely to be utilised for speculative purposes.

Loans for Acquisition of KVPs

11.132 Banks should ensure that no loans are sanctioned for acquisition of/investing in Small Savings Instruments including Kisan Vikas Patras.

Advances against Gold Ornaments and Jewellery

11.133 RBI vide Master Circular No. RBI/2015-16/95 DBR.No.Dir.BC.10/13.03.00/2015-16 dated July 1, 2015 on “Loans and Advances – Statutory and Other Restrictions” states that hallmarking of gold jewellery ensures quality of gold used in the jewellery as to carat fineness and purity. Hence, granting of advances against security of such hallmarked jewellery is safer and easier. Preferential treatment is given to loans against hallmarked jewellery as it is also in the long-term interest of consumer, lenders and industry. Based on gold purity and content, bank decides on margin and rates of interest.

Loan to Value Ratio for Loan against Gold Ornaments and Jewellery

11.134 RBI vide Master Circular No. RBI/2015-16/95 DBR.No.Dir.BC.10/13.03.00/2015-16 dated July 1, 2015 on “Loans and Advances – Statutory and Other Restrictions” provides that loans (including bullet repayment loans) sanctioned by banks against pledge of gold ornaments and jewellery for non-agricultural purposes should not exceed 75 per cent of the value of gold ornaments and jewellery. The RBI issued circular DoR.No.BP.BC/6/21.04.048/2020-21 dated August 06, 2020, wherein the permissible loan to value ratio (LTV) for loans against pledge of gold ornaments and jewellery for non-agricultural purposes was increased from 75% to 90%, to enable the borrowers to tide over their temporary liquidity mismatches on account of COVID 19. The said enhanced LTV is applicable up to March 31,

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2021 and fresh loans which are sanctioned subsequently, i.e., from April 01, 2021 onwards shall attract LTV ratio of 75%.

11.135 In order to standardize the valuation and make it more transparent to the borrower, gold ornaments and jewellery accepted as security / collateral will have to be valued at the average of the closing price of 22 carat gold for the preceding 30 days as quoted by the India Bullion and Jewellers Association Ltd. [Formerly known as the Bombay Bullion Association Ltd. (BBA)]. If the gold is of purity less than 22 carats, bank should translate the collateral into 22 carat and value the exact grams of the collateral.

11.136 Loans extended against pledge of gold ornaments and jewellery other than for agricultural purposes, where both interest and principal are due for payment at maturity of the loan will be subject to following conditions:

- (i) Banks, as per their Board approved policy, may decide upon the ceiling with regard to the quantum of loan that may be granted against pledge of gold jewellery and ornaments for non-agricultural end uses.
- (ii) Period of the loan shall not exceed 12 months from sanction date.
- (iii) Interest will be charged at monthly rests and recognized on accrual basis if the account is a 'standard' account. This will also apply to existing loans.
- (iv) Such loans shall also be governed by other extant norms pertaining to income recognition, asset classification and provisioning which shall be applicable once the principal and interest become overdue.

Gold (Metal) Loans

11.137 Nominated banks can extend Gold (Metal) Loans to exporters of jewellery who are customers of other scheduled commercial banks, by accepting stand-by letter of credit or bank guarantee issued by their bankers in favour of the nominated banks subject to authorised banks' own norms for lending and other conditions stipulated by RBI. Banks may also extend the facility to domestic jewellery manufacturers, subject to the conditions specified by RBI's Master Circular RBI/2015-16/95 DBR.No.Dir.BC.10/13.03.00/2015-16 dated July 1, 2015 on "Loans and Advances - Statutory and Other restrictions".

11.138 Nominated banks may continue to extend Gold (Metal) Loans to jewellery exporters subject to following conditions:

- Exposure assumed by the nominated bank extending the Gold (Metal) Loan against stand-by LC / BG of another bank will be deemed as an exposure on the guaranteeing bank and attract appropriate risk weight as per extant guidelines.

- The transaction should be on back-to-back basis i.e. nominated banks should extend Gold (Metal) Loan directly to the customer of a non-nominated bank, against the stand-by LC / BG issued by the latter.
- Gold (Metal) Loans should not involve any direct or indirect liability of the borrowing entity towards foreign suppliers of gold.
- Banks may calculate their exposure and compliance with prudential norms daily by converting into Rupee the gold quantity by crossing London AM fixing for Gold / US Dollar rate with the rupee-dollar reference rate announced by RBI.

11.139 Banks should recognise overall risks in extending Gold (Metal) Loans and in extending SBLC / BG. Banks should lay down appropriate risk management / lending policy in this regard and comply with Ghosh Committee recommendations and other internal requirements relating to acceptance of guarantees of other banks to obviate possibility of frauds.

11.140 Nominated banks are not permitted to enter into any tie up arrangements for retailing of gold / gold coins with any other entity including non-banking financial companies / co-operative banks / non-nominated banks.

Loans and advances to Micro and Small Enterprises (MSEs)

11.141 RBI has issued Master Directions on Lending to Micro, Small and Medium Enterprises (MSME) sector vide Master Directions no. FIDD. MSME and NFS.12/06.02.31/2017-18 dated July 24, 2017 (updated April 25, 2018), in which definition of MSME and common guidelines/instructions for lending to MSME section are given.

Working Capital Finance to Information Technology and Software Industry

11.142 Following the recommendations of the "National Taskforce on Information Technology and Software Development", the RBI has framed guidelines for extending working capital to the said industry. Banks are free to modify the guidelines based on their own experience without reference to the RBI to achieve the purpose of the guidelines in letter and spirit.

11.143 Salient features of these guidelines are as under:

- (i) Banks may consider sanction of working capital limits based on track record of the promoter's group affiliation, composition of the management team, their work experience and infrastructure.
- (ii) For borrowers with working capital limits of up to Rs 2 crore, assessment may be made at 20 per cent of the projected turnover. In other cases, banks may consider assessment of MPBF based on monthly cash budget

system. For borrowers enjoying working capital limits of Rs 10 crore and above from the banking system, guidelines regarding the loan system would be applicable.

- (iii) Banks may obtain collateral security wherever available. First/ second charge on current assets, if available, may be obtained.
- (iv) Rate of interest as prescribed for general category of borrowers may be levied. Concessional rate of interest as applicable to pre-shipment/post-shipment credit may be levied.
- (v) Banks may evolve tailor-made follow up system for such advances. Banks could obtain quarterly statements of cash flows to monitor operations. In case the sanction was not made based on cash budgets, they can devise a reporting system, deemed fit.

Guidelines for bank finance for PSU disinvestments of Government of India

11.144 In terms of RBI circular DBOD No. Dir.BC.90/13.07.05/98 dated August 28, 1998, the promoters' contribution towards equity capital of a company should come from their own resources and bank should not normally grant advances to take up shares of other companies. Banks should ensure that advances against shares are not used to enable the borrower to acquire or retain a controlling interest in the company/companies or to facilitate or retain inter-corporate investment.

11.145 The instructions of the 1998 circular would not apply in the case of bank finance to the successful bidders under the PSU disinvestment program of the Government, subject to the following:

- Banks' proposals for financing the successful bidders in PSU disinvestment programme should be approved by their Board of Directors.
- Bank finance should be for acquisition of shares of PSU under a disinvestment programme approved by Government of India, including the secondary stage mandatory open offer, wherever applicable and not for subsequent acquisition of PSU shares. Bank finance should be made available only for prospective disinvestments by Government of India.
- Companies, including promoters, to which bank finance is to be extended, should have adequate net worth and an excellent track record of servicing loans availed from the banking system.
- Amount of bank finance provided should be reasonable with reference to the banks' size, its net worth, business and risk profile.

11.146 In case the advances against PSU disinvestment is secured by shares of the disinvested PSUs or any other shares, banks should follow RBI's extant guidelines on capital market exposures on margin, ceiling on overall exposure to the capital market, risk management and internal control systems, surveillance and monitoring by the Audit Committee of the Board, valuation and disclosure, etc. In this regard, banks may be guided by the Master Circular no. RBI /2015-16/70 DBR.No.Dir.BC.12 /13.03.00/2015-16 dated July 1, 2015 on "Exposure Norms".

Stipulation of lock-in period for shares

11.147 Banks may extend finance to the successful bidders even though the shares of the disinvested company acquired/ to be acquired by the successful bidder are subjected to a lock-in period/ other such restrictions which affect their liquidity, subject to fulfilment of following conditions:

- (a) Documentation between Government of India and the successful bidder should contain a specific provision permitting the pledgee to liquidate the shares during lock-in period that may be prescribed in respect of such disinvestments, in case of shortfall in margin requirements or default by the borrower.
- (b) If the documentation does not contain such a specific provision, the borrower (successful bidder) should obtain waiver from the Government for disposal of shares acquired under PSU disinvestment program during the lock-in period.

11.148 As per the terms and conditions of PSU disinvestments by Government of India, the pledgee bank will not be allowed to invoke the pledge during the first year of lock-in period. During the second and third year of the lock-in period, in case of inability of the borrower to restore the margin prescribed for the purpose by way of additional security or non-performance of the payment obligations as per the repayment schedule agreed upon between the bank and the borrower, the bank would have the right to invoke the pledge. The pledgee bank's right to invoke the pledge during the second and third years of the lock-in period, would be subject to documentation terms and conditions between Government and the successful bidder, which cast certain responsibilities on the pledgee banks.

11.149 The RBI has clarified that the concerned bank must make a proper appraisal and exercise due caution about creditworthiness of the borrower and the financial viability of the proposal. The bank must satisfy itself that the proposed documentation, relating to the disposal of shares pledged with the bank, are fully acceptable and do not involve unacceptable risks.

11.150 In terms of IECD Circular No. 10/ 08.12.01/ 2000- 2001 dated 8th January 2001, banks are precluded from financing investments of NBFCs in other companies and inter-corporate loans / deposits to/ in other companies.

11.151 Special Purpose Vehicles (SPVs) which comply with the following conditions would not be treated as investment companies and hence not as NBFCs:

- a) They function as holding companies, special purpose vehicles, etc., with not less than 90 per cent of their total assets as investment in securities held for the purpose of holding ownership stake.
- b) They do not trade in these securities except for block sale.
- c) They do not undertake any other financial activities.
- d) They do not hold/accept public deposits.

Financing Housing Projects

11.152 Master Circular No.DBR.No.DIR.BC.13/ 08.12.001/2015-16 dated July 1, 2015 on "Housing Finance" provides guidance in respect of housing finance provided by banks. Banks could deploy funds under housing finance allocation in any of the following three categories as per norms provided in the Master Circular:

- Direct finance.
- Indirect finance.
- Investment in bonds of NHB/HUDCO, or combination thereof.

11.153 The Master Circular contains guidelines, including conditions wherein a bank cannot extend credit for housing purposes. These conditions are as follows:

- (i) In case of *lending to housing intermediary agencies*, banks should ensure compliance with National Housing Board (NHB) guidelines, in terms of which, a housing finance company's total borrowings, by way of deposits, issue of debentures/ bonds, loans and advances from banks or from financial institutions including any loans obtained from NHB, should not exceed 16 times its net owned funds (i.e., paid up capital and free reserves less accumulated balance of loss, deferred revenue expenditure and intangible assets).
- (ii) Banks are not permitted to extend fund and non-fund based facilities to private builders for acquisition of land even as part of a housing project.

- (iii) Banks cannot grant finance for construction of buildings meant purely for Government/Semi-Government offices, including Municipal and Panchayat offices. However, banks may grant loans for activities refinanced by institutions like NABARD.
- (iv) *Projects undertaken by public sector entities* which are not corporate bodies (i.e., public sector undertakings not registered under Companies Act or which are not Corporations established under the relevant statute) cannot be financed by banks.
- (v) In terms of Delhi high court's orders, banks cannot grant loans in respect of:
- Properties falling under unauthorised colonies unless and until they are regularised and development and other charges paid.
 - Properties meant for residential use but which the applicant intends to use commercially and declares so while applying for the loan.

Loan to Value (LTV) ratio

11.154 To prevent excessive leveraging, LTV ratio and risk weight and standard as set provisioning in respect of individual housing loans have been prescribed. RBI Vide Circular No. RBI/2016-2017/317 DBR.BP.BC.No.72/08.12.015/2016-17 dated June 7, 2017 "Individual Housing Loans: Rationalisation of Risk –Weights and Loan to Value (LTV) Ratios" revised LTV ratios is applicable for all loans sanctioned post June 7, 2017 are as under:

Category of loan	LTV ratio (%)	Risk Weight (%)
Up to Rs. 30 lakh	≤ 80	35
	> 80 and ≤ 90	50
Above Rs. 30 lakh and up to Rs. 75 lakh	≤ 80	35
	> 80 and ≤ 90	50
Above Rs. 75 lakh	≤ 75	50

11.155 Following LTV ratios, Risk Weights and Standard Asset Provision set out in circular DBR.BP.BC.No.44/08.12.015/ 2015-16 dated October 8, 2015 "Individual Housing Loans: Rationalisation of Risk-Weights and LTV Ratios", shall continue to apply to loans sanctioned up to June 6, 2017.

Category of loan	LTV ratio (%)	Risk Weight (%)
Up to Rs. 30 lakh	≤ 80	35
	> 80 and ≤ 90	50
Above Rs. 30 lakh and up to Rs. 75 lakh	≤ 75	35
	> 75 and ≤ 80	50
Above Rs. 75 lakh	≤ 75	75

11.156 The LTV ratio should not exceed the prescribed ceiling in all fresh cases of sanction. In case the LTV ratio is currently above the ceiling prescribed for any reason, efforts should be made to bring it within limits.

Waiver of EMI in case of regular payment of home loans

11.157 Some banks have introduced certain incentives to home loans to borrowers who have been making regular payment of EMI/dues. As per this feature, the borrower gets waiver of some EMI amount either at the end of the loan or on some periodical basis. The Auditor needs to ensure that the bank has made sufficient provision for future waiver of EMI in the books in the books.

Innovative Housing Loan Products – Upfront Disbursal of Housing Loans

11.158 Some banks have introduced certain innovative Housing Loan Schemes in association with developers / builders, e.g. upfront disbursal of sanctioned individual housing loans to the builders without linking the disbursals to various stages of construction of housing project, interest / EMI on the housing loan availed of by the individual borrower being serviced by the builders during the construction period / specified period, etc. This might include signing of tripartite agreements between the bank, the builder and the buyer of the housing unit.

11.159 These loan products are popularly known by various names like 80:20, 75:25 Schemes. Such housing loan products are likely to expose the banks as well as their home loan borrowers to additional risks e.g. in case of disputes between individual borrowers and developers / builders, default / delayed payment of interest / EMI by the developer / builder during the agreed period on behalf of the borrower, non-completion of the project on time, etc. Further, any delayed payments by developers / builders on behalf of individual borrowers to banks may lead to lower credit rating / scoring of such borrowers by credit information companies (CICs) as information about servicing of loans gets passed on to the CICs on a regular basis. In cases where bank loans are also disbursed upfront on behalf of their individual borrowers in a lump-sum to builders / developers without any linkage to stages of construction, banks run disproportionately higher exposures with concomitant risks of diversion of funds.

11.160 In view of the higher risks associated with such lump-sum disbursal of sanctioned housing loans and customer suitability issues, banks are advised that disbursal of housing loans sanctioned to individuals should be closely linked to the stages of construction of the housing project / houses and upfront disbursal should not be made in cases of incomplete / under-construction / green field housing projects.

11.161 Banks while introducing any kind of product should consider customer suitability and appropriateness issues and also ensure that the borrowers / customers are made fully aware of risks and liabilities under such products.

Retail loans

11.162 Banks generally provide various retail advances namely:

- Home loans and loans against property.
- Vehicle loans.
- Personal loans.
- Consumer durable loans.
- Credit cards.

11.163 Loans are either sourced through direct selling agents or bank's own branches. Banks have a credit policy which defines process to be followed for sanction and disbursement of loan and various documents required.

11.164 The credit assessment process is not as detailed and followed in corporate loans. Bank generally collects following documents:

- Completely filled loan application form with customers' signature.
- Income proof like salary slip, financial statement, Income tax returns, Bank statement.
- Photograph.
- Business continuity proof (e.g. Shops and Establishment Act, any other govt. certificate for doing business).
- Residence proof.
- Identification proof.
- Contact Point – Mobile No. of applicants is mandatory.
- Age proof.
- PAN Card.

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

11.166 As a part of loan sanction process, bank runs CIBIL score and only if CIBIL score is above a specific number, the bank considers further sanction.

11.167 Bank also conducts field investigations on the proposed customer which generally involve residential and office visits. Few banks also have a process of Fraud Containment Unit (FCU) screening of selected sample files. At the FCU, an official screens through the genuineness and authenticity of the documents for traces of fraud.

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

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

Financing Infrastructure Projects

11.170 RBI has revised the definition of 'infrastructure Lending' vide Master Circular no. "RBI/2015-16 /95 DBR.No.Dir.BC.10/13.03.00/2015-16 dated July 1, 2015 on Loans and Advances – Statutory and Other Restrictions read with Circular No. RBI/2012 13/297/DBOD.BP.BC.No 58/08.12.014/ 2012-13 dated November 20, 2012 on "Second Quarter Review of Monetary Policy 2012-13 - Definition of 'Infrastructure Lending". The RBI has periodically added certain sectors as infrastructure lending from time to time.

11.171 The revised definition of 'infrastructure lending' is effective from the circular date. Exposure of banks to projects under sub-sectors included under previous definition of infrastructure, but not included in the revised definition, will continue to get benefits under 'infrastructure lending' for such exposures till completion of the projects. However, any fresh lending to these sub-sectors from the circular date will not qualify as 'infrastructure lending'.

11.172 The definition of Infrastructure Lending includes credit facility extended by Lenders (i.e., Banks and Selected AIFIs) to a borrower for exposure in various infrastructure sub-sectors as per paragraph 2.3.7.2 of Master Circular no. RBI/2015-16/95 DBR.No.Dir.BC.10/13.03.00/2015-16 dated July 1, 2015 on Loans and Advances- Statutory and Other Restrictions, read with Circular No. DBOD.BP.BC.No.66/08.12.2014/2013-14 on "Financing of Infrastructure – Definition of 'Infrastructure Lending'" dated November 25, 2013.

11.173 Banks/FIs are free to finance technically feasible, financially viable and bankable projects undertaken by public and private sector undertakings subject to following conditions:

- i. Amount sanctioned should be within overall ceiling of prudential exposure norms prescribed by RBI for infrastructure financing.
- ii. Banks/ FIs should have the requisite expertise for appraising technical feasibility, financial viability and bankability of projects, with particular reference to risk and sensitivity analysis.
- iii. In respect of projects undertaken by public sector units, such term loans should not be in lieu of or to substitute budgetary resources envisaged for the project. The term loan could supplement budgetary resources if such supplementing was contemplated in the project design. Banks/FIs are, advised to follow the above instructions scrupulously, even while making investment in bonds of sick State PSUs as part of rehabilitation effort.
- iv. Banks may lend to SPVs in the private sector, registered under Companies Act for directly undertaking infrastructure projects which are financially viable and not for acting as mere financial intermediaries. Banks may ensure that bankruptcy or financial difficulties of the parent/ sponsor should not affect the financial health of the SPV.
- v. In few cases where completion of the project gets delayed, RBI *vide* its Master Circular No. RBI/2015-16/101 DBR.No.BP.BC. 2/21.04.048/2015-16 dated July 1, 2015 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances" provides detailed guideline on classification and provision for project loans. RBI *vide* Circular No. RBI/2016-17/122 DBR.No.BP.BC.34 /21.04.132/2016-17 dated November 10, 2016 on "Schemes for Stressed Assets – Revisions" provides guidelines for project companies where change of ownership happen/ are happening after date of commencement of commercial operation ('DCCO').
- vi. The Auditor should obtain a list of all outstanding project loans of the bank. Details should also include information about original DCCO and revision of DCCO, if any. The Auditor should verify that the revision of the project DCCO is based on technical and financial study and is approved by competent authority. The Auditor should also verify the revision in DCCO, and check whether the same is permissible under extent RBI guidelines. The Auditor should apply professional judgment and skepticism while evaluating/ accessing and concluding on compliance of the said guidelines for deferment of DCCO and retaining standard/standard restructured classification. To verify compliance, the Auditor shall obtain documentary

evidences like legal documents for Court cases, Lead engineers report/ Review note/ consortium meeting minutes specifying the event that is beyond promoter's control etc., as the case may be.

- vii. The RBI has issued a mail box clarification on assessment and revision in project cost. The clarification provides guidance on classification of loan in case revision of project cost is above a certain percentage of original project cost. The Auditor should ensure compliance with this clarification.

Types of Financing by Banks

- 11.174 (i) In order to meet financial requirements of infrastructure projects, banks may extend credit facility by way of working capital finance, term loan, project loan, subscription to bonds and debentures/ preference shares/ equity shares acquired as a part of the project finance package which is treated as "deemed advance" and any other form of funded or non-funded facility.
- (ii) Take-out Financing - Banks may be guided by the instructions regarding take-out finance as per Circular No.DBOD.BP.BC.144/21.04.048/2000 dated February 29, 2000.
- (iii) Inter-institutional Guarantees: Banks are permitted to issue guarantees favouring other lending institutions in respect of infrastructure projects, provided the bank issuing the guarantee takes a funded share in the project at least to the extent of 5 per cent of the project cost and undertakes normal credit appraisal, monitoring and follow-up of the project.
- (iv) Financing promoter's equity: In terms of Circular No.DBOD.Dir.BC.90/13.07.05/98 dated August 28, 1998 - Banks are advised that promoters' contribution towards equity capital of a company should come from their own resources and Banks should not normally grant advances to take up shares of other companies. However, under certain circumstances, an exception may be made to this policy for financing acquisition of promoters' shares in an existing company, engaged in implementing or operating an infrastructure project in India.

11.175 Conditions, subject to which an exception may be made, are as follows:

- Bank finance would be only for acquisition of shares of existing companies providing infrastructure facilities. Further, acquisition of such shares should be in respect of companies where existing foreign promoters (and/ or domestic joint promoters) voluntarily propose to disinvest majority shares in compliance with SEBI guidelines, where applicable.
- Companies to which loans are extended should, *inter alia*, have a satisfactory net worth.

- Company financed and promoters/ directors of such companies should not be a defaulter to banks/ FIs.
- Bank finance should be restricted to 50% of the finance required for acquiring promoter's stake in the company being acquired.
- Finance extended should be against security of the assets of the borrowing company or the assets of the company acquired and not against the shares of that company or the company being acquired. Shares of the Borrower Company / Company being acquired may be accepted as additional security and not as primary security. Security charged to the banks should be marketable.
- Banks should ensure maintenance of stipulated margins at all times.
- Tenor of the bank loans may not be longer than seven years. However, the Boards of banks can make an exception in specific cases, where necessary, for financial viability of the project.
- Financing to be subject to compliance with statutory requirements under Section 19(2) of the Banking Regulation Act, 1949.
- Financing of acquisition of equity shares by promoters should be within the regulatory ceiling of 40 per cent of their net worth as on March 31 of the previous year for the aggregate exposure of the banks to the capital markets in all forms (fund and non-fund based).
- Proposal for bank finance should have the approval of the Board.

System of Base Rate and Interest Rate/ Marginal Cost of Funds based Lending Rate (MCLR)

11.176 The RBI *vide* DBR.Dir.No.85/13.03.00/ 2015-16 dated March 03, 2016 (Updated as on February 26, 2020) on "Reserve Bank of India (Interest Rate on Advances) Directions, 2016" requires banks to freely determine lending rates on the advances as per their Board approved policy subject to the guidelines contained in the circular. The Base Rate system was operational between July 1, 2010 and March 31, 2016 aimed at enhancing transparency in lending rates of banks and enabling better assessment of transmission of monetary policy.

- All rupee loans sanctioned and credit limits renewed w.e.f. April 1, 2016 will be priced with reference to Marginal Cost of Funds based Lending Rate (MCLR) which will be the internal benchmark for such purposes. The Auditor should verify whether new loans sanctioned and credit limits renewed post April 1, 2016 are under the new MCLR regime.

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- MCLR will comprise of marginal cost of funds, negative carry on account of CRR, Operating costs and Tenor premium.
- All new floating rate personal or retail loans and floating rate loans extended by banks to Micro and Small Enterprises from October 01, 2019 and floating rate loans to Medium Enterprises from April 01, 2020 shall be benchmarked to one of the following:
 - RBI policy repo rate
 - GOI 3months Treasury bill yields published by FBIL.
 - GOI 6 months Treasury bill yields published by the FBIL
 - Any other benchmark market interest rate published by the FBIL.
- Banks may offer such external benchmarked loans to other types of borrowers as well.
- Banks to adopt uniform external benchmark within a loan category.

Spread

11.177

- (i) Banks should have a Board approved policy delineating components of spread charged to a customer. Price differentiation should be consistent with bank's credit pricing policy.
- (ii) Bank's internal pricing policy must spell the rationale for, and range of, the spread in case of a given category of borrower, as also, delegation of powers in respect of loan pricing. Rationale of the policy should be available for supervisory review.
- (iii) The spread charged to an existing borrower should not be increased except on account of deterioration in the credit risk profile of the customer or change in the tenor premium. Any such decision regarding change in spread on account of change in credit risk profile should be supported by a full-fledged risk profile review of the customer. Change in tenor premium should not be 'borrower specific' or 'loan class specific' and should be uniform for all types of loans for a given residual tenor.
- (iv) Guidelines contained in sub-paragraph (iii) above are not applicable to loans under consortium/ multiple banking arrangements.

Accounting and Auditing Aspects

Balance Sheet Disclosure

11.178 The Third Schedule to the Banking Regulation Act, 1949 requires classification of advances made by a bank from three different angles, viz.,

nature of advance, nature and extent of security, and place of making advance (i.e. whether in India or outside India). Accordingly, advances are classified in Schedule 9 to the balance sheet as follows:

- A. (i) Bills purchased and discounted
- (ii) Cash Credits, Overdrafts and Loans repayable on demand
- (iii) Term loans
- B. (i) Secured by tangible assets
- (ii) Covered by bank/government guarantees
- (iii) Unsecured
- C. I. Advances in India
 - (i) Priority sectors
 - (ii) Public sector
 - (iii) Banks
 - (iv) Others
- II. Advances outside India
 - (i) Due from banks
 - (ii) Due from others
 - (iii) Bills purchased and discounted
 - (iv) Syndicated loans
 - (v) Others

Classification Based on Nature of Advance

11.179 Different classifications are as follows:

- (a) In classification under section 'A', all outstandings – in India as well as outside India – less provisions made, will be classified under three heads.
- (b) Outstandings in credit card operations should be shown as part of advances under the head 'cash credits, overdrafts and loans repayable on demand'.
- (c) Term loans will be loans not repayable on demand and would include overdue instalments.
- (d) All interest bearing loans and advances granted by the bank to its employees should be shown as part of advances.

Classification Based on Nature and Extent of Security

11.180 Different classifications are as follows:

- (a) All advances or part of advances, which are secured² by tangible assets, whether in India or outside India, should be shown under the heading 'Secured by tangible assets'. Advances against book debts may be included under the head 'Secured by Tangible Assets', and presented in Schedule 9 (Advances) as follows:

"B Secured by Tangible Assets" (includes advances against book debt)

- (b) Advances in India and outside India to the extent they are covered by guarantees of Indian and foreign governments and Indian and foreign banks and DICGC and ECGC are to be included under the head 'advances – covered by bank/government guarantees'.
- (c) Unsecured advances will include advances not classified under (i) & (ii) of section B.

Classification based on Place of Making Advances

- 11.181
- a) Advances to sectors, classified as priority sectors according to the instructions of the RBI, are to be classified under the head 'priority sectors'. Such advances should be excluded from, 'Advances to Public Sector'.
 - b) Advances to Central and State Governments and other government undertakings including government companies and corporations which are, according to the statutes, to be treated as public sector companies, are to be included in the category 'Public Sector'.
 - c) All advances to the banking sector including co-operative banks will come under the head 'Banks'.
 - d) All remaining advances will be included under the residual head 'Others'; typically this category will include non-priority advances to the private, joint and co-operative sectors.

Audit Approach and Procedures

11.182 Advances generally constitute major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. Audit of advances requires major attention from the auditors. In carrying out audit

² A 'secured advance', according to section 5(n) of the Banking Regulation Act, 1949 means an advance made on the security of assets the market value of which is not at any time less than the amount of such advance.

of advances, the Auditor is primarily concerned with obtaining evidence about the following:

- a) Amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.
- b) Advances represent amount due to the bank.
- c) Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.
- d) There are no unrecorded advances.
- e) The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.
- f) Advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
- g) Appropriate provisions towards advances is made as per the RBI norms, Accounting Standards and Generally Accepted Accounting Practices.

11.183 The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

- examining the validity of the recorded amounts;
- examining loan documentation and its vetting by the legal department;
- reviewing the operation of the accounts especially of accounts held and operated with other banks;
- examining the existence, enforceability and valuation of the security from time to time especially for loans given on a standalone basis;
- checking compliance with RBI norms including appropriate classification and provisioning;
- carrying out appropriate analytical procedures; and
- procedure for loan balance confirmations.

11.184 In carrying out substantive procedures, the Auditor should examine all large advances while other advances may be examined on sampling basis. The accounts identified to be problem accounts need to be examined in detail unless the amount involved is insignificant. The auditor should obtain list of SMA 1 and SMA 2 borrowers from the bank and the same should also be considered for selection of problematic accounts. The extent of sample checking would depend on auditor's assessment of efficacy of internal controls.

What constitutes a 'large advance' needs to be determined in the context of volume of operations of the branch. As a general rule, an advance may be considered to be a large advance if the year-end balance is in excess of 10% of outstanding aggregate balance of fund based and non-fund based advances of the branch or Rs.10 crores, whichever is less. The said threshold has been derived from the revised LFAR prescribed by RBI for the Branch audits from the year 2020-2021.

11.185 Advances which are sanctioned during the year or which are adversely commented by RBI inspection team, concurrent auditors, bank's internal inspection, etc., should, generally, be included in audit sample. Besides this new advances sanctioned during the year should be included on selective basis in the sample.

11.186 In nutshell, the Auditor at branch may keep following in mind to plan comprehensive coverage of advances and for selection of sample.

1. **Obtain top 10 exposure accounts:** It may be advisable for a branch auditor to visit the branch and ask the list of top 10 accounts/ exposures along with all the details such as status and security etc. before starting of the audit.
2. **Obtain the list of stressed accounts:** Stressed accounts include accounts classified as SMA 1 or SMA 2 of projects where implementation is delayed. The banks monitor stressed accounts on daily basis. Accounts that generally have overdue beyond 60 days or likely to slip to NPA at the quarter end are termed as stressed account (some banks may use different terminology). It is advisable to obtain a list of stressed accounts at least 15 days ahead of the closing date i.e. say stressed account list as on 15th March. This will provide the Auditor a ready list of such accounts. The auditor then can scrutinize (based on materiality) whether the account has slipped or if not whether has been kept standard by unusual transaction that cannot be termed as business transaction. RBI through its circulars has time and again emphasized that stray credits at the quarter end need not qualify to keep account standard. We need to really assess whether the account is inherently weak. If so the same may have to be downgraded. As regards the partial recovery in overdue account (qualifying the criteria for classification of an account as NPA), such account cannot be upgraded unless overdue portion is recovered in entirety. As regards subsequent credit (after the date of balance sheet), the same will not improvise the classification of an advance.

3. **Obtain list of restructured accounts:** Restructured account portfolio requires separate additional provisioning. It is necessary to obtain the list of such accounts and ensure that the restructure is as per RBI directives.
4. **Obtain list of unsecured exposures above Rs. 1 Crore:** Unsecured exposure has significant impact on the bank, if it slips to NPA. Many times such accounts are reviewed in the traditional manner. These require close monitoring not only from the perspective of financial parameters of the prudential guidelines but also non-financial parameters that give signals of possible ill health. Banking industry (especially PSUs) has faced severe damages on account non-identification of such non-financial parameters.
5. **Early mortality cases:** Any advance slippage to NPA within 12 months of its sanction is called early mortality case. Early mortality cases invoke penalty to the sanctioning authorities. This will have to be checked to understand the reason for such happening to avoid such cases in future and also to find out whether there are any cases classified as performing on some untenable ground to push it beyond early mortality.
6. List of accounts upgraded during the year or previous years.
7. List of accounts rated adversely as per Bank's internal ratings.
8. List of accounts where adverse issues have been noted in previous audits.

Evaluation of Internal Controls over Advances

11.187 The Auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, *inter alia*, the following:

- Bank should make an advance only after satisfying itself as to the credit worthiness of the borrower by doing KYC compliance, proper credit appraisal etc. and after obtaining sanction from the appropriate authorities of the bank. The sanction for an advance should specify, among other things, the limit of borrowing, nature of security, margin to be kept, interest, terms of repayment etc. It needs to be ensured that loans sanctioned are as per the Loan Policy of the bank and adhere to regulatory (RBI) norms unless a specific exemption is taken in this regard.
- All necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- Compliance with terms of sanction and end use of funds should be ensured.

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- Sufficient margin specified in the sanction letter should be kept against securities taken to cover for any decline in the value thereof. Availability of sufficient margin needs to be ensured at regular intervals.
- Controls over custody and storage of documents and their removal for verification.
- If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and effective control of such securities be retained as a part of documentation.
- All securities requiring registration should be registered in the name of the bank or accompanied by documents sufficient to give clear title to the bank.
- In the case of goods in possession of the bank, contents of the packages should be test checked at the time of receipt. The godown should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.
- Surprise checks should be made in respect of hypothecated goods not in physical possession of the bank.
- Drawing Power Register should be updated every month to record value of securities hypothecated. These entries should be separately checked by an independent officer.
- Accounts should be kept within the drawing power and the sanctioned limit.
- All accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to notice of the controlling authority regularly.
- Operation of each advance account should be reviewed at least once a year, and at more frequent intervals in case of large advances.

Consideration of Drawing Power/Limits in respect of stocks hypothecated

11.188 In respect of credit facilities against hypothecation of stocks (inventories) being the primary security, Bank's system of appraisal for determining the maximum permissible finance to borrowers and fixing of limits, *inter alia*, should take into consideration the level of sundry creditors. The sanction is expected to be in tune with the appraisal so made. While sanctioning such credit facility, the bank is expected to stipulate in the documents, that for computing the Drawing Power, the value of declared stocks is to be considered only net of the stipulated margin; and that declared stocks shall not cover the borrower's liability outstanding in form of sundry creditors for goods or covered by LCs/ guarantees/ co-acceptances or Buyer's Credit availed for procurement of

material. The bank should also insist on such information from borrowers. In case of consortium accounts, drawing power calculation and allocation made by the Lead Bank is binding on all Member Banks.

11.189 The RBI has issued guidelines on treatment of unpaid stocks while arriving at the drawing power available in borrower accounts. The thrust of the guidelines is avoidance of double financing on unpaid stocks, if such stocks are taken as eligible for computation of drawing power.

11.190 The matter having been re-examined by RBI vide directive No. IEC.D.No.32/08.10.01/92-93 dated 28th April, 1993, banks were advised as regards the treatment of unpaid stocks while arriving at the drawing power available in the borrower accounts, wherein the thrust is avoidance of the double finance on the unpaid stock, if such stocks are taken as eligible for computation of drawing power. Thus, it would be unrealistic to assume that the composition of the stock items, the level of stock held and the portion of unpaid stock considered at the time of appraisal would be static and should be presumed to be at the same level for subsequent period. For the said reason, the drawing power needs to be recomputed based on variations, not only in composition and level of stock but also in the unpaid portion of stocks before the stipulated margin is applied as per the sanction terms of working capital finance.

11.191 The Auditor should review the bank policy for any inherent weakness in the credit system, where the stringency in appraisal, is relaxed while sanctioning the advances, having consequential effect on monitoring and supervision, and may have effect on the classification status of the borrower, where the drawing power falls short of the outstanding.

11.192 Banks usually consider credit facilities by way of hypothecation of stocks and a charge on the sundry debtors. The Drawing Power is required to be computed net of the stipulated margin, based on and applied to the total eligible current assets comprising of:

- Net Value of Stock as stated above; and
- Net Value of Debtors (i.e., eligible Trade Debtors Less Bills Discounted with Bank). The bank usually prescribes conditions as to what comprise of "eligible trade debtors", and stipulates the period for debts being considered as current and good on which the margin is computed.

11.193 For purposes of classification of advances, computation of drawing power based on realistic value of hypothecated stocks (net of unpaid for stocks, whether covered by Buyer's Credit, LCs/ Guarantees/ Co-acceptances or otherwise) and margin as stipulated, is vital, particularly in cases of default, and in border-line cases where health status of borrowers may be in question, to gauge slippages.

11.194 Due care is required to be exercised by the auditor in case of

- Documents retained in original at centralised offices where these are not available at the branches that are advised of drawing power limits; and
- consortium advances, where bank, not being the leader, gets related figures of drawing power from the leader bank, without related evidence of computation or appropriateness of drawing power.

The Auditor needs to look into this aspect to verify that there is no slippage of the account into NPA classification.

11.195 These days most of the banks have their 'advances' statements generated through the system. The Auditor should ensure that the fields which system copies from last year are the same and he should take extra care in relation with the date of NPA and date of becoming doubtful asset as these facts have great bearing on the provisioning. The auditor should obtain audit trail from the bank to verify whether there are any changes or not.

Examination of Loan Documents

11.196 Documents relating to advances would be affected by the legal status of the borrower and the nature of security. Thus, where the borrower is a company, loan documents would include certificate of incorporation, memorandum and articles of association, certificate of commencement of business (in the case of public limited companies), resolution of board of directors, and special resolution of shareholders [in cases covered by section 180 (1)(c) of the Companies Act, 2013, etc. Where the borrower is a partnership firm, loan documents would include copy of partnership deed. Where the security is in the form of mortgage, apart from mortgage deed (in the case of English Mortgage) or letter of intent to create mortgage (in the case of Equitable Mortgage), the evidence of registration of the charge with the Registrar of Companies would also form part of loan documentation if the borrower is a company. Each bank has its own set of rules regarding the documents to be obtained from various types of borrowers and in respect of different kinds of securities. Formats of many of the documents are also prescribed. The Auditor should evaluate the adequacy of loan documents in the context of the rules framed by the bank in this regard.

Centralisation and location of original loan documents at Loan Processing Centres

11.197 Of late, there is an increasing propensity in banks to process loans and advances, including appraisal, sanction, documentation, initial disbursements, etc., at Loan Processing Centres/Offices (by whatever name called) and to execute and physically hold all the documents at such locations, that may not be in very close proximity to the branch, where the borrower accounts are

maintained/serviced. The Branch places reliance only on the sanction letters, on the presumption that all required legal and documentation formalities are correct and complete at the centralized location.

11.198 In the absence of the original documents (or even authenticated copies thereof) on an updated basis, the Auditor would need to request the management for the files identified for examination by him. The Statutory Branch Auditor must be satisfied on the authenticity and terms of the sanction (in case the sanction letters are only computer generated but not authenticated), the completeness of the records, duly updated, for all accounts where the sanction was so conveyed; and further whether the number of accounts and amounts recorded at such centres tally with the corresponding data at the branch. It needs to be confirmed whether there are any cheques held by such centres that remain unbanked affecting the borrower account balance. Reference must also be made to any adverse observations in the related monitoring/supervisory report on the documentation aspects at the centralized location.

Review of Operation of Account

11.199 The Auditor should review the operation of the advance accounts. In doing so, an intelligent scrutiny of the operation of the account should be carried out to see that the limit is not exceeded; that the account is not becoming stagnant; that the customer is not drawing against deposits which are not free from lien; that the account is not window-dressed by running down overdrafts at the year end and again drawing further advances in the new year, etc. The Audit procedure should be able to highlight disbursements from pre/freshly sanctioned limits made either to the same borrower or to group entities near the repayment dates of critical dues.

11.200 The Auditor should also examine whether there is a healthy turnover in the account. It should be seen that the frequency and the amounts of credits in the account are commensurate with the sanctioned limit and the nature and volume of business of the borrower. Any unusual items in the account should be carefully examined by the auditor. If the auditor's review indicates any unhealthy trends, the account should be further examined. The auditor's examination should also cover transactions in the post-balance sheet date period. Large transactions in major accounts particularly as at the year-end may be looked into, to identify any irregularities in these accounts. A written note/explanation may be obtained from the management as regards any major irregularities which may have a bearing on his report.

11.201 The Auditor may also review the following to assess recoverability of advances:

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- (a) Periodic statements submitted by the borrowers indicating the extent of compliance with terms and conditions.
- (b) Latest financial statements of borrowers.
- (c) Reports on inspection of security.
- (d) Auditors' reports in the case of borrowers enjoying aggregate credit limits of Rs. 10 lakh (or as approved by Board of Directors of respective banks) or above for working capital from the banking system.

11.202 The Auditor should verify that interest is being charged on all performing accounts regularly and should compare the rate of interest with the agreement, sanction letter and credit rating reports where rate of interest is linked to credit rating. In case the interest rate is revised based on changes in PLR/BPLR/Base Rate of the bank, it needs to be ensured that the rate of interest to be charged from the borrower is suitably revised as and when there are changes in PLR/BPLR/Base Rate. Calculation of interest should be test-checked. The auditor should examine that interest not received on any account, which is a non-performing asset as per RBI guidelines. It may be noted that interest accrued but not due on advances does not form part of advances.

11.203 Penal interest on delayed submission of stock statements, non-creation of security, overdrawn accounts etc., needs to be charged as per sanctioned terms and norms of the bank. Compliance of the same should be checked in detail by the auditors.

11.204 In case of advances covered by guarantees of DICGC/ECGC/CGTS, in case of default the auditor should examine whether appropriate steps are taken for lodging of claims for guarantees in accordance with applicable procedure. The claims declined by DICGC/ECGC/CGTS should not be considered as recoverable while calculating provisions against the respective advances.

11.205 In respect of consortium advances, the Auditor should examine:

- (a) Compliance with limits stipulated by consortium in lending moneys to the borrower;
- (b) Bank's monitoring of securities like stocks, etc., in its custody/charge; and
- (c) Follow-up with lead bank on pending issues.

11.206 The auditor should examine whether the bank has correctly classified the inter-bank participation certificates. In the case of participations on risk-sharing basis, the auditor should examine whether any loss has devolved on the bank as on the balance sheet date and, if so, whether adequate provision in respect of such loss is made.

Verification of Security against Advances

11.207 An advance is treated as secured to the extent of the value of the security on the reporting date. If a part of the advance is covered by the value of the security as at the date of the balance sheet, that part only should be classified as secured; the remaining amount should be classified as unsecured.

11.208 Following points are relevant for classifying advances based on security:

- (a) Government guarantees include guarantees of Central/State Governments and advances guaranteed by Central/State Government owned corporations, financial institutions like IDBI, IFCI, ICICI, State Financial Corporations, State Industrial Development Corporations, ECGC, DICGC, CGTS, etc.
- (b) Advances covered by bank guarantees include advances guaranteed against any negotiable instrument, payment of which is guaranteed by a bank.
- (c) Advances covered by bank/government guarantees should be included in unsecured advances to the extent the outstanding in these advances exceed the amount of related guarantees.
- (d) While classifying advances as secured, the primary security should be applied first and for residual balance, if any, value of collateral security should be taken into account. If the advance is still not fully covered, then, to the extent of bank/government guarantees available, the advance should be classified as 'covered by bank/government guarantee'. Balance, if any, remaining after the above classification, should be classified as 'unsecured'.
- (e) There may be situations where more than one facility is granted to a single borrower and a facility is secured, apart from primary and collateral securities relating specifically to that facility, by the residual value of primary security relating to any other credit facility (or facilities) granted to the borrower. In such a case, in the event of shortfall in the value of primary security in such a credit facility, the residual value of primary security of the other facility (or facilities, as the case may be) may be applied first to the shortfall and the value of collateral securities should be applied next.
- (f) In case of common collateral security for advances granted to more than one borrower, if there is a shortfall in value of primary security in any one or more of the borrower accounts, the value of collateral security may be applied proportionately to the shortfall in each borrower account.

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- (g) Advances covered by ECGC/DICGC, CGTS guarantees should be treated as covered by guarantees to the extent of guarantee cover available. The amount already received from DICGC/ECGC/CGTS and kept in sundry creditors account pending adjustment should be deducted from advances.
- (h) An account which is fully secured but the margin which is lower than that stipulated by the bank should nevertheless be treated as fully secured for purposes of balance sheet presentation.
- (i) All documentary bills under delivery-against-payment terms (i.e., covered by RR/Airway Bill/Bill of lading) for which the documents are with the bank as on the balance sheet date should be classified as 'secured'.
- (j) Documentary bills under delivery-against-acceptance terms which remain unaccepted at close of 31st March (i.e., for which documents of title are with the bank on this date) should be classified as secured. All accepted bills should be classified as 'unsecured' unless collaterally secured.
- (k) Cheques purchased including self-cheques (i.e., where the drawer and payee are one and the same) should be treated as unsecured.
- (l) Advances against supply bills, unless collaterally secured, should be classified as unsecured even if they have been accepted by the drawees.
- (m) 'Security' means tangible security properly discharged to the bank and will not include intangible securities like guarantees (including State government guarantees), comfort letters, etc. Moreover, rights, licenses, authorisations, etc., charged to banks as collateral in respect of projects (including infrastructure projects) financed by them, should not be reckoned as tangible security (Ref Master Circular No. RBI/2015-16/99DBR.BP.BC.No.23/21.04.018/2015-16 dated July 1 2015 on Disclosure in Financial Statements- Notes to Accounts).

11.209 In examining whether an advance is secured and, if so, to what extent, the auditor is concerned with determining:

- (a) whether security is legally enforceable, i.e., whether necessary legal formalities regarding documentation, registration, etc., are complied with;
- (b) whether security is in effective control of the bank; and
- (c) to what extent the value of the security, assessed realistically, covers amount outstanding in the advance.

11.210 The Auditor should examine the following aspects in respect of advances classified as 'secured':

- (a) Documents executed are complete and in force.

- (b) Where documents are not renewed, limitation period has not expired.
- (c) Evidence is available to the market value of the security.
- (d) Evidence is available that:
 - i. hypothecated/pledged goods are the property of the borrowers and are not old/obsolete or otherwise unsaleable;
 - ii. advances against book debts of borrowers are related to their current debts and not old/doubtful debts; and
 - iii. Stocks hypothecated/pledged are paid stocks owned by the borrower.
- (e) In case of companies, charge is appropriately registered with the Registrar of Companies and a certificate of registration of charge or other evidence of registration is held.
- (f) Borrowers are regular in furnishing requisite information regarding value of security lodged with the bank.
- (g) In respect of second charge being available in respect of certain assets, the amount of the lender(s) enjoying the first charge on such asset be worked out and only the residuary value, if any, available for second charge holders, be considered.

Stock Exchange Securities and Other Securities

11.211 The Auditor should verify stock exchange securities and their market value in the same manner as in the case of investments. The Auditor should examine whether the securities have been registered or assigned in favour of the bank, wherever required and verify the same with Demat Statement.

11.212 A quoted security may not have frequent transactions on the stock exchange and the quotation included in the official quotations may be that of a very old transaction. In such a case, the auditor should satisfy himself as to the market value by scrutiny of balance sheet, etc., of the company concerned, particularly, if the amount of advance made against such security is large.

11.213 Banks do not generally make advances against partly paid securities. If, however, any such shares are accepted by the bank as security and these are registered in the name of the bank, the auditor should examine whether the issuing company has called up any amount on such securities and, if so, whether the amount has been paid in time by the borrower/bank.

Goods

11.214 In respect of hypothecated goods, the auditor should check the quantity and value of goods hypothecated with reference to the statement received from

the borrower. He should also examine the reasonableness of valuation. Letter of hypothecation should also be examined by the auditor. If the value of the goods is higher than the amount mentioned in the letter of hypothecation, the bank's security is only to the extent of the latter. The Auditor should also verify that the Bank has system of maintenance of proper register in this regard and a system of scrutiny of stock/book debt statement furnished by the borrower.

11.215 The auditor should also check the nature of goods hypothecated/pledged. If the goods are of perishable nature, it will not have a market value. In case of goods/book debts, movable assets hypothecated, auditor should also examine whether the Bank has system in place for periodical inspection of such goods/debts/assets and records of borrowers by its own officer or by external agencies like firm of Chartered Accountants. Whether proper register is maintained in this regard and timely action is taken whenever there is an adverse remark in the inspection report. The Auditor should also check that there is adequate insurance cover in respect of goods /assets hypothecated and there is a bankers' clause in the policy.

11.216 In respect of goods pledged with the bank, the auditor should check the statement received from the borrower regarding the quantity and value of goods pledged by him. He should test check the godown registers and valuation of goods. If there is any outstanding delivery order against the goods as on the balance sheet date, the same should be deducted from the total quantity in hand in ascertaining the value of the goods constituting the security. The auditor may also examine the key movement register to verify movement of goods inwards and/or outwards.

11.217 Sometimes, goods are in possession of third parties, such as clearing and forwarding agents, transporters, brokers, warehouse-keepers, etc. If these parties have given an undertaking to the bank that they will hand over the goods or sale proceeds thereof to the bank only, i.e., they have 'attorned' to the bank the advances made against such goods should be considered as secured. In such cases, certificates should be obtained by the bank from such third parties regarding quantities on hand on balance sheet date. The valuation of such goods should be checked by the auditor. In case the borrower is a company, the auditor should examine the certificate of registration of charge on the goods hypothecated with the Registrar of Companies. It may be mentioned that in case of pledge of goods, registration of charge is not necessary.

Gold Ornaments and Bullion

11.218 The auditor may inspect and weigh (on a test basis) the ornaments on the closing date. He should also see the assayer's certificate regarding the net gold content of the ornaments and their valuation. Valuation should also be

checked with reference to the current market price of gold. In context to the valuation, attention is also invited to the valuation norms as given in the RBI circular no. DBOD.No.BP.BC.27/21.04.048/2014-15 on "Loans against Gold Ornaments and Jewellery for Non-Agricultural End-uses" dated July 22, 2014. Read with Master Circular no. RBI/2015-16/95 DBR.No.Dir.BC.10 /13.03.00 /2015-16 dated July 01, 2015 on Loan and Advances – Statutory and Other Restrictions.

11.219 In respect of gold and silver bars, the auditor should inspect the bars on a test basis and see that the mint seals are intact. The weights mentioned on the bars may generally be accepted as correct.

Life Insurance Policies

11.220 The Auditor should inspect the policies and see whether they are assigned to the bank and whether such assignment has been registered with the insurer. The Auditor should also examine whether premium has been paid on the policies and whether they are in force. Certificate regarding surrender value obtained from the insurer should be examined. The auditor should particularly see that if such surrender value is subject to payment of certain *premia*, the amount of such *premia* has been deducted from the surrender value.

11.221 It should be verified whether policies are assignable in bank's favour. In certain types of policies where assignment to third party are restricted, due care has to be taken while considering it as a security.

Bank's Own Deposit Certificates

11.222 The Auditor should inspect such certificates and examine whether they have been properly discharged and whether lien of the bank is noted on the face of the certificates, in the relevant register of the bank and in CBS master data.

Hire-purchase Documents

11.223 These advances may be classified as secured against the hypothecation of goods. Where there is no hypothecation, the advance will be classified as unsecured.

Plantations

11.224 These advances are classified as secured against the crop and/or the fixed assets (*viz.*, mortgage of land) of the plantation. The auditor should examine the agreement and the title deeds. Regarding the estimate of the crop, he may examine the record of the garden for the last few years. He should also ascertain whether the crop is properly insured against natural calamities and other disasters such as hail, etc.

11.225 The Auditor should keep in mind that where moratorium is available for payment of interest in such plantation projects, the payment of interest becomes due only after the moratorium or gestation period is over. In such a case the account will become NPA in case interest is not recovered after the due date after moratorium period, if specifically mentioned in the sanction letter.

Immovable Property

11.226 The Auditor should inspect title deeds, solicitor's/advocate's opinion taken by the bank in respect thereof, and the mortgage deed. For valuation, he may rely on the report of the architect or valuer (which should be taken at least once in three years) after carrying out appropriate audit procedures to satisfy himself about the adequacy of the work of the architect/valuer for this purpose³. He should also examine the insurance policies.

11.227 In some cases, banks make advances against immovable properties where the title deeds are not in the name of the borrower. For example, an advance may be given against the security of a flat in a co-operative group housing society, the title deeds of which may not be in the name of the borrower. In such cases, the auditor should examine the evidence regarding the right or interest of the borrower in the property mortgaged, e.g., power of attorney, share certificate of co-operative group housing society, 'no objection certificate' from the society/lessor (in the case of leasehold properties) for offering the property as security, etc.

11.228 In case the bank has accepted third party property as a security, the owner of the property should also execute guarantee bond in bank's favour. The mortgage value in bank's favour should be equal/in excess of the loan amount covered by such mortgage.

Reliance on / review of other reports

11.229 The auditor should take into account the adverse comments, if any, on advances appearing in the following:

- Previous years audit reports.
- Latest internal inspection reports of bank officials.
- Reserve Bank's latest inspection Report/Asset Quality Review/ Risk Based Supervision report.
- Concurrent /internal audit report.
- Report on verification of security.

³ Reference may be made in this regard to SA 620, "Using the Work of an Auditor's Expert".

- Any other internal reports specially related to particular accounts.
- Manager's charge-handing-over report when incumbent is changed.

11.230 The above reports should be reviewed in detail. Statutory Central Auditor's(SCAs) must review the Annual Financial Inspection report of RBI relating to the bank and should check whether variations in provisions, etc., reported by RBI have been properly considered by the bank management. SCAs should consider the issues emerging from recent RBI inspections and obtain an understanding of changes made by the banks pursuant to the inspection process to enhance their identification of NPAs. Further audit procedures should be suitably re-designed after considering such issues.

Third Party Guarantees

11.231 The Auditor should examine guarantee bonds and demand promissory notes in order to verify the third party liability. The Auditor should satisfy that the guarantee is in force as at the date of the balance sheet. In the absence of a provision to the contrary, a guarantee terminates by revocation or upon death of the surety. The surety is also discharged (unless there is a specific covenant to the contrary) if the creditor arranges with the principal debtor for compromise, or agrees to give time or agrees not to sue him, without consulting the surety. If any variation is made in the terms of the contract between the principal debtor and the creditor without the surety's consent, it discharges the surety as to transactions subsequent to the variation. The guarantee forms used by banks normally seek to ensure the continuing obligation of the guarantor in spite of these contingencies. If such clause is absent then the Auditor has to see if the acknowledgement to debt from the borrower as well as guarantor is obtained by the Bank.

Verification of Bills Purchased and Discounted

11.232 The Auditor should familiarise with the guidelines issued by RBI and the policies framed by the bank regarding discounting and rediscounting of bills and the Auditor should ascertain that the policy framed by the bank conforms to RBI requirements.

11.233 Bills purchased and discounted have to be shown separately in the balance sheet as part of 'advances'. Further, under the head 'advances outside India' in the balance sheet, bills purchased and discounted outside India have to be shown separately. This category will include bills covering export of goods, bills discounted by foreign branches of the bank and payable in their respective countries, etc.

11.234 Banks purchase or discount bills of exchange drawn or endorsed by

their customers. The bank credits the amount of the bill to its customer after deducting the discount. The total amount of such bills is shown as an asset in the balance sheet.

11.235 In certain eligible cases, the bills purchased or discounted by the bank may be rediscounted by it with the RBI/IDBI/SIDBI. Such bills would not be included under advance but would constitute a contingent liability.

11.236 Bills purchased and discounted by the bank are generally drawn on outstation parties and are, therefore, sent by the bank to its branches or agents for collection immediately after their receipt. They are generally not in the possession of the bank on the closing date. The auditor therefore has to rely upon the Register of Bills Purchased and Discounted and the party-wise Register of Bills maintained by the bank. The auditor should examine these registers and satisfy himself that:

- (a) All outstanding bills have been taken in the balance sheet;
- (b) All details, including nature of the bills and documents, are mentioned in the register and that the bills have been correctly classified;
- (c) Bills purchased or discounted from different parties are in accordance with the agreements with them and total of outstanding bills of each party is not in excess of the sanctioned limit; and
- (d) Bills are not overdue. If there are any overdue bills, the Auditor should ascertain the reasons for the delay and the action taken by the bank.

11.237 The Auditor should examine whether registers of bills purchased and discounted are properly maintained and the transactions are recorded therein correctly. He should examine whether bills and documents accompanying the bills are properly endorsed and assigned in favour of the bank. In checking the bills, it should be ensured that the bills are held along with the documents of title. In case of documentary bills, it should be examined whether related RRs/TRs are held along with the invoices/ hundies / bills and that these have not been parted with. Wherever such RRs/TRs are not held on record, the fact should be duly considered by the auditor and the Auditor should also examine the bills collected subsequent to year-end to obtain assurance regarding completeness and validity of recorded bill amounts.

Other Aspects

11.238 Sometimes, a customer is sanctioned a cash credit limit at one branch but is authorised to utilise such overall limit at a number of other branches also, for each of which a sub-limit is fixed. In such a case, the determination of status of the account as NPA or otherwise should be determined at the limit-sanctioning

branch with reference to the overall sanctioned limit/drawing power, and not by each of the other branches where a sub-limit has been fixed. The Auditor of the limit-sanctioning branch should examine whether it receives particulars of all transactions in the account at sub-limit branches and whether status of the account has been determined considering the total position of operation of the account at all concerned branches. As far as sub-limit branches are concerned, they should follow classification adopted by the limit-sanctioning branch.

11.239 The Auditor should examine that advances made by a banking company otherwise than in the course of banking business, such as, prepaid expenses, advance for purchase of assets, etc., are not included under 'advances' but is included under 'other assets'.

11.240 The amount of advances in India and those outside India are to be shown separately in the balance sheet. This classification will depend as to where the advance was actually made and not where it has been utilised. Generally speaking, figures of Indian branches will be shown as advances in India and figures of foreign branches as advances outside India.

11.241 The Auditor should examine whether any loan has been granted in violation of statutory limitations in section 20 of the Banking Regulations Act, 1949. If any such loan is granted the report will have to be drafted with suitable qualifications, as the transaction is ultra vires.

11.242 It may also be examined whether the bank has a system of ensuring end use of the funds granted compared with the purpose of sanction.

Drawing Power Consideration

11.243 Working capital borrower account, drawing power calculated from stock statement older than 3 months has to be considered as "irregular" (overdue). If such "irregular" account continues for 90 days, it has to be classified as NPA, even though the account is otherwise operated regularly.

11.244 Stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinized in detail.

11.245 The audited Annual Report submitted by the borrower should be scrutinized properly. Monthly stock statement of the month for which the audited accounts are prepared and submitted should be compared and the reasons for deviations, if any, should be ascertained.

11.246 It needs to be examined whether the drawing power is calculated as per the extant guidelines formulated by the bank, which should also be in line with RBI guidelines/directives. Special consideration should be given to proper reporting of sundry creditors for purposes of calculating drawing power.

11.247 Stock audit should be carried out by the bank for all accounts having funded exposure over Rs.5 crores. The Auditors can also conduct or recommend for conduct of stock audit in other cases if situation warrants the same. Branches should obtain stock audit reports from lead bank or any other member, as decided in consortium in cases where the Bank is not the leader of the consortium of working capital. The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power.

11.248 Drawing power needs to be verified carefully in case of working capital advances to entities engaged in construction business. Valuation of work in progress should be calculated properly and consistently. It should be examined whether mobilization advance being received by the contractors is reduced while calculating drawing power. In respect of certain businesses such as diamond merchants and jewellers, the Auditor should exercise due caution while verifying realisable value of precious metals, diamonds, jewellery etc. The Auditor may also consider obtaining assistance of an expert in case circumstances so warrant.

11.249 In case of consortium accounts, the drawing power calculation and allocation is made by the Lead Bank and is binding on the Member Banks.

Lending under Consortium Arrangement / Multiple Banking Arrangements

11.250 In order to strengthen the information sharing system among banks in respect of borrowers enjoying credit facilities from multiple banks, banks are required to obtain regular certification by a professional, preferably a Company Secretary, Chartered Accountant or Cost Accountant regarding compliance of various statutory prescriptions that are in vogue, as per specimen given in Annexure III (Part I and II), to RBI Circular No. DBOD.No. BP.BC.110/08.12.001/ 2008-09 dated February 10, 2009 on "Lending under Consortium Arrangement / Multiple Banking Arrangements" Read with Master Circular no. RBI/2015-16/95 DBR.No.Dir.BC.10/13.03.00/2015-16 dated July 01, 2015 on Loan and Advances – Statutory and Other Restrictions.

11.251 Accounts under consortium arrangements may, notwithstanding their classification as Standard, due to servicing thereof, may nonetheless be intrinsically weak or even be NPA in other participating bank(s), including on the basis of the certificate/report as aforesaid. The Auditor should consider this aspect and classify the account appropriately based on facts and circumstances, particularly based on any serious adverse remarks/comments in the certificate issued pursuant to the RBI circular.

11.252 The Auditor should check compliance with RBI guidelines on unhedged foreign currency exposure. Self-declaration from the client or Independent auditors' certificate of foreign currency exposure should be obtained by the Bank. Such declaration/certificate can be cross checked with computation of standard asset provisioning.

11.253 The bank should ensure that correct, sensitized and vetted data is duly and timely captured so that analytics could be run intelligently through the system to make data predictions to generate foresights on trends, patterns that show incipient sickness. Pro-active monitoring of the Early Warning Signals (EWS) as per Annex II of RBI Master Direction No. RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 dated July 01, 2016 (Updated as on July 03, 2017) on Fraud – Classification and Reporting by commercial bank and select FIs should be ensured. These (EWS) should be used as indicators for Red Flagged accounts (RFA). The Auditors should comment on the prevalence of the (EWS) - (RFA) system and its operational efficiency and effectiveness.

11.254 The Auditors should comment on the frequency and periodicity of trainings given to Branch officials on knowledge and skill up-gradation especially on usage of technology and other advanced developments on appraisal, risk, controls and gap mitigation loan and cyber frauds.

Non fund based facilities

11.255 Non-fund based facilities are letters of credit, bank guarantees, letter of comfort/undertaking, etc. Non-fund based facility may turn into a fund based facility on due date, if not paid by the borrower, for e.g. devolvement of bills under Letters of Credit, invocation of Bank Guarantee, etc. As on the date of a sanction and original booking they do not involve an outflow of funds.

11.256 Letter of credit: A Letter of Credit (LC) is a promise by a banker to honour the payments to be made by its customer (the buyer or importer) to the seller or exporter. This type of payment facility is generally used in international trade. In this type of facility, at the request of the buyer, his banker opens an LC, which is sent to the seller. Based on such LC, the seller despatches the goods and then sends the bills and other documents through his banker to the buyer's banker, which has opened the LC, to make payment of the bill. The buyer then makes the payment and routes it through his banker to the seller's banker. In case the buyer fails to make the payment (also known as devolvement of LC), the buyer's banker, which has opened the LC, is liable to make the payment to the seller. RBI has mandated banks not to discount bills drawn under LCs or otherwise for beneficiaries, who are not their regular clients.

11.257 Bank Guarantee: A bank guarantee is a written contract given by a

bank on behalf of customer. By issuing this guarantee, a bank takes responsibility for payment of a sum of money in case, it is not paid by the customer on whose behalf the guarantee has been issued. In return, a bank gets some commission for issuing the guarantee. Anyone can apply for a bank guarantee, if his or her company has obligations towards a third party for which funds need to be blocked in order to guarantee that his or her company fulfils its obligation (For example carrying out certain works, payment of debt, etc.) In case of any changes or cancellation during the transaction process, bank guarantee remains valid until the customer duly releases bank from its liability. In the situations where customer fails to pay the money, bank must pay the amount within 3 working days. This payment can also be refused by bank if claim is found unlawful. Guarantees are of two types—financial guarantee, wherein the guarantor (the bank) promises to pay the stated amount to the beneficiary, if the person for whom the guarantee is given, fails to pay the same (also referred to as invoking the guarantee); performance guarantee, wherein the guarantor promises to pay the beneficiary a stated sum of amount, if the person for whom the guarantee is given, fails to perform, as expected, in a given period of time. Banks are generally discouraged from issuing performance guarantees. Guarantee transaction usually comprises two independent but related components— one is the guarantee issued by the banker (of the buyer) to the beneficiary (i.e., seller) and the other is a counter guarantee given by the buyer to his banker, who has issued the guarantee.

11.258 Generally, guarantees should not be issued on behalf of customers, who do not enjoy credit facilities with the bank. Since guarantees invoked could get converted into funded advance to a borrower, banks should not encourage borrowers to over extend their commitments solely on the basis of guarantees. Guarantees could be for specific transaction (called specific guarantee) or it could be for multiple transactions within a specific time frame (called continuing guarantees). Guarantees should generally be for short durations; in any case, it should not have a maturity period of more than 10 years. Unsecured Guarantees to a particular borrower should generally not exceed 10% of the total exposure. Banks should also not concentrate its unsecured guarantees to a particular borrower or a group. The Ghosh Committee has recommended certain precautions to be taken by banks while issuing guarantees. Guarantees are generally issued by keeping margins, either in the form of cash/term deposit or some other security. In case of guarantees issued on behalf of share and stock brokers, the RBI has advised that banks should obtain a minimum margin of 50% (with 25% being cash margin). RBI has laid restrictions on guarantees of inter-company deposits/loans and inter institutional guarantees. In the above mentioned circular, the RBI has also given extensive guidelines on issue of guarantees on behalf of exporters and importers.

11.259 *Co-Acceptance of Bills:-* In this type of facility, the seller despatches the goods and raises the bill on the buyer. The buyer accepts the bill and then it is co-accepted by buyer's banker. The seller's banker then discounts this bill. This type of facility is often used by customers to float accommodation bills (i.e., bills which are not supported by genuine sale and purchase of goods) and hence auditors should be careful while examining such bills.

11.260 Non fund based facilities are recorded in the Books of accounts as a contra item appearing on both sides of the Trial Balance. In the balance sheet they appear under the prescribed schedule.

11.261 The Auditor should ensure that:

- 1) There is a proper procedure for sanctioning non fund based facilities and these facilities are duly monitored and are within the sanctioned limits. Any outstanding beyond sanctioned amount is a deviation and should be promptly reported.

Banks do not issue these facilities especially Guarantees for walk-in customers even with 100% cash margins. Necessary KYC checks and a due sanction should be in place for issuance of these facilities.

- 2) There is a proper procedure for recording these amounts in the books of accounts through serial numbers or other appropriate methods.
- 3) Necessary margins as prescribed in the sanction letter have been duly collected. These margins are duly lien marked and not allowed to be withdrawn during pendency of the facility.
- 4) They have been issued in the prescribed standard format. Care should be taken to note the formats for issuance of Letters of Comfort / Undertaking.
- 5) They have been issued under proper authority. Banks have a schedule of powers for sanction of various facilities and it should be noted that these facilities are sanctioned under proper delegated authority levels.
- 6) They have been duly disclosed in the financials under appropriate prescribed heads in the prescribed manner. Some Banks disclose these facilities as Net of margins while some disclose this at Gross. The Auditor should ensure that whatever practice is followed by banks is consistent as per their policy and is duly disclosed in the financial statements.
- 7) The bank has proper policies, procedures, manuals which could also be a part of their credit manual that describes in detail how these facilities are to be sanctioned, disbursed, documented, monitored, accounted and cancelled. The auditor should ensure due compliance with these policies, procedures and manuals.

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- 8) If these facilities are devolved / invoked, then they would be funded advances. Appropriate removal from “non fund based advances” should be done to avoid duplicate disclosure as both funded and non funded advances.
- 9) The underlying documents should be kept under proper control and custody.
- 10) Where a number of guarantees / Letters of credit issued have been invoked/ devolved, the auditor would have to consider the probability of invocation / devolvement of the guarantees / letters of credit on their due dates and consider making appropriate provisioning thereon as of current date.
- 11) On expiry of their term and if no letter of invocation / devolvement has been received and if the original Guarantee has been received back, there would be no liability due on these Guarantees / Letters of credit, these would have to be removed from the books of account.

Different banks have different practices in this regard especially for Guarantees. In case of Guarantees some Banks wait for receipt of the original guarantee back from the issuer before cancelling the liability from the books. In such cases the auditor should also note whether there is a timely system of sending letters to the issuers asking for return of the original guarantees immediately post the expiry date.

11.262 For Guarantees issued to Governments, specific rules apply and the Auditor should ensure that these are followed.

- 1) The Auditor should ensure proper classification of guarantees in to performance or financial as they carry separate risk weights.
- 2) The Auditor should note that the RBI has issued Master Circular No. RBI/2015-16/76 DBR.No.Dir.BC.11/ 13.03.00/2015-16 dated July 01, 2015 on Guaranteed and Co-acceptances. RBI also keeps on issuing guidelines/ circulars from time to time, which should be noted for compliance. RBI vide circular no. RBI/2017-18/139 A. P. (DIR Series) circular no. 20 dated March 13, 2018 on “Discontinuance of Letters of Undertaking (LoUs) and Letters of Comfort (LoCs) for Trade Credits” has also advised the AD Category-I banks to discontinue the practice of issuance of LoUs / LoCs for Trade Credits for imports into India with immediate effect.
- 3) Non fund based advances are prone to frauds as can be seen in recent times and due care needs to be taken while verifying these facilities.
- 4) These facilities are duly reviewed and renewed as per procedures

prescribed in the same manner and alongside funded advances.

- 5) Care should be taken to ensure that the bank does not issue letters on behalf of their customers to 3rd parties which are in the form of a Comfort / Undertaking and may need classification as a non fund based Liability. Necessary procedures framed by the bank in this regard should be verified including the awareness, training and sensitization thereof.
- 6) The internal controls designed and in operation over the process from start to end from the sanction to the cancellation should be verified in depth on a standalone basis. Any gaps noted in the control process should be promptly reported.

Since these are specialized operational areas, Staff with necessary, relevant experience with training are only posted to handle Guarantee / Letters of Credit transactions. Controls over job rotations and mandatory leaves to these staff should be verified and reported.

- 7) The LFAR contains specific questions needing reporting on non fund based facilities. The auditor should note the requirements of the LFAR while planning and conducting the audit.
- 8) Non fund based facilities should be duly considered for all reporting and calculation purposes as prescribed in appropriate guidelines.
- 9) These facilities earn a fee based income for Banks. Banks have different methods for booking fee based income especially in case of Guarantees. Some do it up-front either monthly or quarterly. The Auditor should ensure there is consistency in the methodology followed for booking of income in accordance with prescribed policy at prescribed rates.

Banks should also ensure to collect processing fees on sanction, review and renewal of these facilities at prescribed rates.

- 10) There may be cases where the main non funded limit may be sanctioned at one branch and sub limits may be sanctioned at another branch. In such cases, appropriate monitoring should be done in the same manner as is done for sanctioned advances in similar situations.

For consortium accounts, monitoring and follow-up including obtaining of relevant information would be the same as would be done in the case of a funded facility.

- 11) In some Banks especially Foreign Banks, non fund based facilities constitute a significant portion of their book size and at times even exceed their funded facilities.

- 12) Forward Contracts, Swaps – Currency or Interest Rate are also non fund based facilities which are also duly sanctioned, monitored, disclosed and transacted as per policies and guidelines. Necessary details therein have been disclosed in appropriate section of this Guidance Note.

Selection of accounts

11.263 The Auditor should obtain a list or breakup of all advance accounts as at the yearend. This should be obtained facility wise – security wise – sanction date and amount wise. In accordance with RBI guidelines contained in the LFAR, the Auditor has to mandatorily comment on all advances in respect of which the outstanding amount is in excess of 10% of outstanding aggregate balance of fund based and non-fund based advances of the branch or Rs.10 crores, whichever is less. Apart from these accounts mandatorily to be considered for reporting, the auditor should also select advance accounts for each type – Each of Unsecured, Educational, Housing, Vehicle, Personal, Loan against FD, Loan against Shares, Loan against property, Loans granted against other securities. Besides loans accounts cash credit accounts, overdraft against property, bills discounting / purchase accounts should be selected for verification a mix of both - new sanctions in the current year 2020-2021 and sanctions of previous years. The sampling should be based on the Standards on Auditing (SA) 530, Audit Sampling issued by the ICAI.

11.264 All the accounts falling within the threshold should be scrutinized in depth end to end keeping in mind the reporting requirements of the LFAR. Selection has to be done in a manner that each distinct and unique type of credit facility is verified and reported. Adverse issues noted on verification to be discussed with the Branch, Branch responses obtained and appropriate reporting to be made in the LFAR.

11.265 The format of reporting for advances below Rs.10 Crores is not specified. The auditor may report the same in the format he feels appropriate ensuring that adverse issues noted are brought out for corrective action. It should be noted that finding gaps in process is the key. The transactional errors noted is the outcome of a weakness in the process and the process will need strengthening to ensure that such transactional errors are minimized if not zeroed.

11.266 The LFAR specifies the format (given below) in which the auditor has to obtain data from the Branch for large advances. The compilation has to be done by the Branch. The Auditor has to review on a test check basis whether the data keyed into the system is correct.

11.267 While giving his observations, the Auditor has not only to go through all

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the points filled in by the Branch but also through all the loan correspondence files of the borrower. The process of appraisal, sanction, disbursement, documentation, monitoring, review or renewal, follow-up, classification as SMA-NPA will have to be independently verified for such accounts. Audit comments should not be simply based on the data submitted by the Branch. Independent verification and assessment is essential.

11.268 The Long Form Audit Report (LFAR) for Large / Irregular / Critical Advance Accounts (To be obtained by the Branch Auditors from branches dealing in large advances/asset recovery branches) is as under –

Sr. No.	Items / Particulars	Details
1.	Name of the Borrower	
2.	Address	
3.	Nature of business/activity	
4.	Total exposure of the branch to the borrower	
	(a) Fund Based (Rs. in crore)	
	(b) Non-Fund Based (Rs. in crore)	
5.	Name of Proprietor / Partners / Directors (As Applicable)	
6.	Name of the Chief Executive, if any	
7.	Asset Classification by the branch	
	(a) as on the date of current audit	
	(b) as on the date of previous Balance Sheet	
8.	Asset Classification by the branch auditor	
	(a) as on the date of current audit	
	(b) as on the date of previous Balance Sheet	
9.	Are there any adverse features pointed out in relation to asset classification by RBI inspection or any other audit	
10.	Date on which the asset was first classified as NPA (where applicable)	
11.	Facilities sanctioned	

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Date of Sanction	Nature of facilities	Limit (Rs. in crore)	Prime Security	Collateral Security	Margin %	Balance outstanding at the year-end	
						Current Year	Previous Year
Sr. No.	Items / Particulars					Details	
12.	Whether the facility is a consortium facility or a facility made on multiple bank basis						
13.	If Consortium-						
	(a) names of participating banks with their respective shares						
	(b) name of the Lead Bank in Consortium						
14.	If on multiple banking basis, names of other Banks						
15.	Has the branch classified the facility under the Credit Rating norms in accordance with the guidelines of the controlling authorities of the bank						
16.	(a) Details of verification of primary security and evidence thereof						
	(b) Details of valuation and evidence thereof						

Date of Verification	Nature of Security	Value	Valuation done by
Insured for Rs. _____ (expiring on _____)			

Sr. No.	Items / Particulars	Details
17.	(a) Details of verification of collateral security and evidence thereof	

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	(b) Details of valuation and evidence thereof	
18.	Give details of the Guarantee in respect of the facility	
	(a) Central Government Guarantee	
	(b) State Government Guarantee	
	(c) Bank Guarantee or Financial Institution Guarantee	
	(d) Corporate / Personal / Other Guarantee	
	Provide the date, validity and value of the above Guarantees.	
19.	Compliance with the terms and conditions of the sanction	

Terms and Conditions			Compliance
(i)	Primary Security		
	a)	Charge on primary security	
	b)	Mortgage of fixed assets	
	c)	Registration of charges with Registrar of Companies	
	d)	Insurance with date of validity of Policy	
(ii)	Collateral Security		
	a)	Charge on collateral security	
	b)	Mortgage of fixed assets	
	c)	Registration of charges with Registrar of Companies	
	d)	Insurance with date of validity of Policy	
(iii)	Guarantees - Existence and execution of valid Guarantees.		

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(iv)	Asset coverage to the branch based upon the arrangement (i.e., consortium or multiple-bank basis)	
(v)	Others	
	(a) Submission of Stock Statements / Quarterly Information Statements and other Information Statements	
	(b) Last inspection of the unit by the branch officials: Give the date and details of errors/omissions noticed	
	(c) In case of consortium advances, whether copies of documents executed by the company favouring the consortium are available	
	(d) Any other area of non-compliance with the terms and conditions of sanction	
20.	Key financial indicators of the borrower for the last two years and projections for the current year	

Indicators	Audited Year ended 31 st March	Audited Year ended 31 st March	Projections for Current Year
Turnover			
Increase in turnover % over previous year			
Profit before depreciation, interest and tax			
Less: Interest			
Net Cash Profit before tax			
Less: Depreciation			
Less: Tax			
Net Profit after Depreciation and Tax			

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Net Profit to Turnover Ratio			
Capital (Paid-up)			
Reserves			
Net Worth			
Turnover to Capital Employed Ratio (The term capital employed means the sum of Net Worth and Long Term Liabilities)			
Current Ratio			
Stock Turnover Ratio			
Total Outstanding Liabilities / total Net Worth Ratio			
In case of listed companies, market value of Share?			
(a) High (b) Low (c) Closing			
Earnings Per Share			
Whether the accounts were audited? If yes, up to what date; and are there any audit Qualifications			

21.	Observations on the operations in the account	
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Particulars	Excess over drawing power	Excess over limit
1. No of occasions on which the balance exceeded the drawing power/sanctioned limit (give details)		
Reasons for excess drawings, if any		

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Whether excess drawing were reported to the Controlling Authority and approved		
	Debit Summation (Rs. in crore)	Credit Summation (Rs. in crore)
2. Total summation in the account during the year Less : Interest Balance		

Sr. No.	Items / Particulars	Details
22.	Adverse observations in other audit reports / Inspection Reports / Concurrent Auditor's Report / Stock Audit Report / Special Audit Report or RBI inspection with regard to :	
	(a) Documentation	
	(b) Operations	
	(c) Security/Guarantee	
	(d) Others	
23.	Branch Manager's overview of the account and its operations	
24.	(a) In case the borrower has been identified / classified as NPA during the year, whether any unrealised income including income accrued in the previous year has been accounted as income, contrary to the income recognition norms.	
	(b) Whether any action has been initiated towards recovery in respect of accounts identified / classified as NPA.	

11. 269 An Illustrative list for Basis of Selection of Advance Accounts in case of Bank Branch Audit is given as Annexure to this Chapter.

Bank Branch Audit

Procedure for Sanction, Documentation, Disbursement, and Supervision

11.270 Each bank has its own procedures for sanctioning, disbursal, documentation, supervision and renewal of advances. The procedures are stated in the Credit policy which is generally updated at annual intervals. The auditor should obtain the last updated credit policy and circulars issued post the credit policy. The Auditor should ensure that the credit policy is in sync with RBI Master Circulars especially the one on "Loan and Advances – Statutory and Other Restrictions".

Sanction

Loan Application

11.271 Initiation of process of sanction of advance is on receipt of a formal request from the applicant. The request may be in the form of a standard format (Loan Application Form) of the bank or in the form of a letter in which case the Bank requests the intending borrower to furnish the standard format duly filled in. All applications are entered in a "loan applications received register" (the exact nomenclature may vary from bank to bank). The required supporting documents are to be furnished along with the application. The Bank should ensure that the documents are obtained from respective borrowers as per the Loan policy of the Bank.

Credit Appraisal

11.272 The proposal is evaluated in the context of the directions of the RBI including prudential exposure limits and the bank's own credit policy and risk management guidelines. The primary purpose is to ascertain the cash flows and the repayment capacity of the borrower to repay the loan within the stipulated timelines that would be prescribed. The proposal is mainly appraised to find the Default Risk or the possibility of the borrower not repaying the loan amount that would be sanctioned or disbursed, either in full or in part. This process entails conducting a detailed SWOT – (Strengths – Weakness – Opportunity Threat) analysis of the borrower. Besides, the proposal is appraised on the following parameters to ensure technical feasibility, economic viability and commercial acceptability (the degree of scrutiny depends largely on the amount of the advance):

- Performance of the unit *vis-a-vis* other similar units.
- Conduct of its accounts with the lenders.

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- Experience, competence and profile of the management of the unit.
- Guarantees and collateral securities offered.
- Trend and ratio analysis to see that the unit's growth is healthy, financials are sound, liquidity is comfortable and the promoters have a reasonable stake in the unit.
- Availability of inputs for production – right time and price.
- Market condition – fast changing tastes and preferences.
- Technology in use – factoring in obsolescence in technology.
- Unit's capability to achieve the projected operating and performance levels and to service the debt.
- Applicability of norms/benchmarks relating to scale of finance, e.g., Nayak Committee recommendations for SSI units, scale of finance fixed by the bank for agricultural finance to be extended in the local area, etc.
- CIBIL, RBI List of defaulter, Credit and confidential reports from other banks. These are to be checked from respective websites.
- Various disclosure/notices issued by the government/government authorities such as with regard to shell companies, defunct companies, directors of these types of companies, etc.
- Latest Government. policy about particular industry / locational restriction, etc.
- In the current complex scenario both internally and externally – VUCA world as some describe it for an environment characterized by Volatility, Uncertainty, Complexity and Ambiguity, assessment of cash flows over longer term period is a challenge. The auditor should exercise greater diligence while reviewing the appraisal process for such long tenor advances.
- Diligence will be higher if the units are resorting to funding for the first time ever or with the bank. In case of existing facilities for renewal – review, there is a past performance or availability of data to base credit decisions. For new units, validating the projections or estimated will need deeper scrutiny.
- Banks generally have a Turn Around Time (TAT) for disposing off loan applications – i.e. the time from receipt of Loan application to its rejection or sanction. Causes for rejection also have to be noted in a Loan Rejection Register or similarly named Register, The cases of appraisals have to be within TAT. Deviations from TAT are monitored for process efficiency.

Sanctioning Authority

11.273 If the official concerned finds the proposal acceptable, a detailed appraisal note is submitted along with necessary supporting documents with recommendations to the authority having powers to sanction it. Each official who has been vested with powers to sanction advances has a monetary ceiling up to which he/she can sanction advances to the specified kind of borrowers (like individuals, partnerships, companies, etc.) and/or for the specified activities (like agriculture, industry, professional education, business, etc.) and / or for the type of facility (term loan, overdraft, cash credit, etc.). Such powers are properly documented and circulated by the bank to all its offices by way of delegation of powers. The officials at the branch can sanction only those advances, which fall within their delegated powers. For advances, which require to be sanctioned by higher authorities, the branch has to carry out the appraisal and send the proposal along with its recommendations to its controlling office for necessary sanction. As and when the advance is sanctioned by the competent authority (which could be an official, a committee of officials or the Board of Directors of the bank, depending on the amount involved), the fact of sanction along with detailed terms and conditions of the sanction are communicated by the controlling office to the branch.

11.274 The auditor should ensure that all issues noted in the credit appraisal process have been duly factored while preparing the Sanction Note and the sanction letter and no significant issue is missed out. Clarifications on any issues noted in the appraisal process should be duly documented. The Auditor has to ensure that the sanctioning is done within the powers of the competent authority. Any deviation noted will have to be reported appropriately.

11.275 Processing fees as applicable should be collected as per the bank's policy before the disbursement. Banks have a practice of debiting Cash Credit accounts for processing fees. While this is in order for existing accounts, for new facilities sanctioned, the same should be collected separately up-front rather than being a part of disbursement.

Documentation and Disbursement

11.276 After the sanction of the advance, the branch communicates the terms and conditions of the sanction to the applicant and obtains its consent for the arrangement. Thereafter, the documents as prescribed by the bank are obtained, charges created and, the bank's charge over the unit's assets noted with the authorities concerned, e.g., Registrar of Companies, Road Transport Authority, Insurance Company, Land Records Authority, CERSAI, etc. In the case of an advance to a partnership firm, while the account is opened in the trade name of the firm, the security documents are got executed from the

partners in both their individual capacity (i.e., without mentioning the name of the firm or affixing the stamp of the firm) and in their capacity as partners of the firm. This is to ensure that the advance may be recovered from the assets of the firm as well as from the individual assets of the partners. The bank generally records the sanction details and stipulation in the system. In many cases, the system is updated for pre-sanction, pre-disbursement documents for each loan. The document discrepancy report then acts as a check for documents received and pending for monitoring purposes.

11.277 After the above formalities have been completed, the advance is released in the following manner:

- Term loans (granted generally for acquisition of fixed assets, etc.) are disbursed on the basis of quotations/ proforma invoices obtained by the borrower from the vendors and submitted to the bank either along with the application or later. In case of large projects, the schedule and status of completion of projects have also to be seen. Banks generally stipulate a stated percentage of the cost to be met by the borrower from his own funds. Once the borrower provides his contribution to the bank, the branch debits the Term Loan account with the balance amount and pays the amount to the vendor directly along with a letter stating the purpose of the funds. The term loan may be released in one or more instalments. As and when the asset is received by the borrower, the bank officials inspect it, record the particulars in their books, and obtain copies of the final invoices for their record from the borrower.
- There may be instances where, on business considerations, the borrower has already acquired the asset. In such a case, he submits the documentary evidence to the branch and seeks reimbursement to the extent permissible. The branch officials inspect the asset and verify the books of account of the borrower and, if satisfied, credit the eligible amount to the borrower's account (current / cash credit, as desired by the borrower) by debiting his term loan account.
- Cash credit advances are released on the basis of drawing power calculated as per the stock statements submitted by the borrower as per the periodicity laid down in the terms of sanction. The branch officials verify the stock statements and calculate the 'drawing power' based on the security held by the borrower and the margin prescribed in the sanction. In case of consortium accounts, the drawing power calculation and allocation is made by the Lead Bank and is binding on the Member Banks (Circular No. C&I/Circular/2014-15/689 dated 29 September 2014 issued by the Indian Banks Association). This 'drawing power' is noted in the system in

respect of Cash Credit accounts and is a guide to the official concerned while authorising debits to the account.

- The procedures of many banks require the branch manager to periodically submit a certificate to the controlling authority (i.e., regional or zonal office) that all disbursements during the relevant period have been made only after completion of the necessary formalities.
- Banks also require submission of End-Use certificates from Chartered Accountants. Some banks have a format in which the same is to be issued. It should be ensured that certificates are issued in the prescribed format. In all other cases, it should be ensured that the certificate is as per the requirements of the ICAI guidelines on special purpose certification.
- Central Registry of Securitisation Asset Reconstruction and Security Interest of India (CERSAI) - The Auditor needs to keep abreast of the mandatory requirements related to registration of mortgages and compliance thereof by the lender bank, as applicable to the various forms of securities offered as security for the advances.
- The Auditor has to ensure that all sanction terms and conditions have been complied with. Pending sanction terms should be waived off by the appropriate sanctioning authority or a time frame, post disbursal for their obtention, be approved. In no case, the disbursal should take place without a formally approved waiver.
- Banks should maintain an updated tracker of all sanction terms still not complied with. If the due dates for their obtention is breached, causes for the same should be noted for closure.

Monitoring and Supervision

11.278 The primary purpose of monitoring and supervision is to ensure that there is no diversion or siphoning of funds. Any adverse features has to be pro-actively tracked using technology to the fullest. Annex II of RBI Master Direction No. RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 dated July 01, 2016 (Updated as on July 03, 2017) on "Fraud – Classification and Reporting by commercial bank and select FIs" gives indicators for Early Warning Signals (EWS) which have to be followed up for possible Red Flagging.

11.279 Banks have to ensure that EWS are tacked through system, pro-actively so that early signs of liquidity problems are known and followed up with the borrower for possible re-structuring or rehabilitation to preserve the economic value of the account and avoid it to slip into a NPA.

11.280 The following are the procedures usually adopted by banks for

monitoring and supervision of advances after disbursement:

- Regular inspection of the borrower's assets and books. The main purposes of inspection are as follows:
 - To ensure that the amounts disbursed have been utilised for purposes for which the advance was sought.
 - To check that the borrower has not acquired / disposed of any asset without the consent / knowledge of the bank, depending upon the terms of the advance. Acquisition of fixed assets from working capital funds may amount to diversion of short-term funds which, from the viewpoint of the bankers, is not a sign of financial prudence.
 - To cross-check the figures declared in the stock statements with the books maintained by the borrower (including excise and other statutory records, as applicable) as well as to physically verify the stock items, to the extent possible.
 - To check that the unit has been working on projected levels particularly in the areas of sales and production and the general working of the unit is satisfactory.
 - To ensure that the borrower has not availed of finance against stocks for which it has itself not made the payment.
 - To ensure that the borrower has not availed of unauthorised finance from any other lender.
 - To ensure that the borrower has not defaulted on payment of Statutory Liabilities.
 - To ensure that the borrower has not made any investment in, or advances to, its associates without the bank's approval, if such approval is required as per the terms of the loan or otherwise diverted the funds.
 - To check that there is a regular turnover of stocks and the unit does not carry any obsolete, unusable stocks. Generally, banks place a limit on the age of stocks which are eligible for bank finance; the items older than such limit are not financed. Similarly, in the case of book debts, debts outstanding beyond a specified period are also not eligible for bank finance. Also to check sundry creditors for goods.
 - To ensure that the borrower continues to be engaged in the activity for which the loan has been granted.

- Periodic review of the progress in implementation of the project (to note whether project timelines given at the time of processing loan are being adhered to. If there are delays, it may hamper the project completion and may affect servicing of loan). Generally, in large and complex projects, banks appoint lead engineering agency to who provide the status of the project periodically.
- Review of the conduct of the account.
- Obtaining and scrutinising stock statements.
- Obtaining other relevant financial data periodically and analysis of the data. Banks obtain information at monthly / quarterly / half yearly / yearly intervals about on the levels of sales, production, profit, cash accruals, break up of assets and liabilities, cash flows etc. The analysis covers the following points:
 - Comparison of the data with the projections contained in the appraisal note to find out the deviations, the reasons thereof, and the corrective action to be taken, wherever necessary.
 - Comparison of the unit's performance, on an on-going basis, with other similar units.
 - Ratio analysis based on the provisional data submitted by the unit to find out the liquidity and solvency position and any diversion of short-term resources towards long term uses.
 - Observing the credits to the account.
- Whenever the above analysis indicates weaknesses in operations, or the need for additional documentation or security, a dialogue is held with the borrower, with consequent follow-up.

11.281 RBI, *vide* its circular no. DBS.CO.PPD.BC.No. 5 /11.01.005/2010-11 dated January 14, 2011 on "End Use of Funds - Monitoring", has advised banks to evaluate and strengthen the efficacy of the existing machinery in the banks for post-sanction inspection by the bank officers, supervision and follow-up of advances. There needs to be a proper process of stock audit of the borrowers. Effective monitoring of the end use of funds lent is of critical importance in safeguarding a bank's interest. Further, this would also act as a deterrent for borrowers to misuse the credit facilities sanctioned, and in the process, help build a healthy credit culture in the Indian banking system.

Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair recovery of lenders – Framework for revitalisation of distressed assets

11.282 The RBI has issued guidelines for classification of standard assets into three sub-categories, viz., SMA-0, SMA-1 and SMA2 in order to recognise the financial distress in any performing asset at an early stage, besides regulatory compliances like forming of Joint Lender's Forum, reporting to CRILC, etc. for specified categories of Special Mention Accounts (SMA). In case the bank does not follow the said regulatory compliances, such accounts are subjected to accelerated provisions.

LFAR in respect of Advances for Bank Branches

11.283 Vide its circular no. DOS.CO.PPG./SEC.01/11.01.005/2020-21 dated 5th September 2020, the RBI has come up with a revised LFAR applicable for audits of F.Y. 2020-2021 and onwards. Various new clauses have been included for reporting by the auditors. Annex II of the said circular deals with the LFAR for bank branches. The auditor should refer to the Technical Guide on Revised Formats of Long Form Audit Report for clause by clause analysis of the same.

RBI Guidelines on Income Recognition, Asset Classification, Provisioning and Other Related Matters

11.284 In its report submitted in 1992, the Committee on Financial System set up by the RBI under the Chairmanship of Mr. M. Narasimham made several recommendations concerning accounts of banks. The Committee recommended that a policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Likewise, the classification of assets should be done on the basis of objective criteria which would ensure a uniform and consistent application of norms. As regards provisioning, the Committee recommended that provisions should be made on the basis of classification of assets under different categories. Vide its Circular No. BP.BC.129/21.04.043-92 dated April 27, 1992, the Reserve Bank issued guidelines to be followed by all scheduled commercial banks (excluding regional rural banks) for income recognition, asset classification, provisioning and other related matters. These guidelines (commonly referred to as 'prudential guidelines' or 'prudential norms') have since been modified in several respects through various circulars of the Reserve Bank. The latest Master Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 was issued on July 1, 2015 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances'. The salient points of the guidelines as presently in force are discussed in the following paragraphs.

Regulatory Guidelines vis-a-vis Audit Approach and Reporting

A. Has the branch identified and classified advances into standard/substandard/doubtful/loss assets through the computer system without manual intervention (in line with the norms prescribed by the Reserve Bank of India) (The auditor may refer to the relevant H.O. instructions for identification of NPAs and Classification of Advances).

The auditor needs to review and comment as to whether such identification & classification through the computer system, without manual intervention?

Relevant Provision

11.285 The guidelines require banks to classify their advances into four broad categories for the purpose of provisioning as follows:

(a) Standard assets:

A standard asset is one which is not a non-performing asset and does not carry more than normal banking risk attached to the business.

As per RBI Circular RBI/2018-19/ 203 DBR.No.BP.BC.45/21.04.048/2018-19 dated June 7, 2019 on Prudential Framework for Resolution of Stressed Assets, the banks shall recognise incipient stress in loan accounts, immediately on default, by classifying such assets as special mention accounts (SMA) as per the following categories:

SMA Sub-categories	Basis of Classification
	Principal or Interest payment or any other amount wholly or partly overdue between
SMA-0	1-30 days
SMA-1	31-60 days
SMA-2	61-90 days

In the case of revolving credit facilities like cash credit, the SMA sub-categories will be as follows:

SMA Sub-categories	Basis of Classification
	Outstanding balance remains continuously in excess of the sanctioned limit or drawing power, whichever is lower, for a period of
SMA-1	31-60 days
SMA-2	61-90 days

Lenders shall report credit information, including classification of an account as SMA to Central Repository of Information on Large Credits (CRILC), on all borrowers having aggregate exposure of Rs. 50 Millions (5 Crores) and above with them on monthly basis. Further the lenders shall submit a weekly report on instances of defaults of all borrowers having aggregate exposure of Rs. 50 Millions (5 Crores) and above on close of business on every Friday.

Such classification also serves to be useful for bank officers monitoring as well as audit perspective to check the transactions and methods of keeping these standard at the balance sheet date

(b) Sub-standard assets:

A sub-standard asset is one which has remained NPA for a period less than or equal to 12 months. Such an asset will have well defined credit weaknesses that jeopardize the liquidation of the debt and are characterized by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

(c) Doubtful assets:

An asset is classified as doubtful if it has remained in the sub-standard category for a period of 12 months. Such an asset has all the inherent weaknesses as in a substandard asset and an added characteristic that the weaknesses make the collection or liquidation in full highly improbable or questionable.

(d) Loss assets:

A loss asset is one which has been identified as wholly irrecoverable either by:

- (a) the bank; or
- (b) the internal or external auditors; or
- (c) the RBI inspectors.

but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

Classification Norms relating to NPAs

Criteria for Classification of Various Types of Credit Facilities

11.286 A Cash Credit / Overdraft account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the principal

operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period, these accounts should also be treated as 'out of order'. Further, any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.

11.287 The following criteria are to be applied for determining the status of various types of credit facilities:

- (a) **Term Loans:** A term loan is treated as a non-performing asset (NPA) if interest and/or instalment of principal remain overdue for a period of more than 90 days. Thus, in case of term loans wherein there is no amount overdue (i.e., the ledger balance is less than ideal drawing power), such accounts will not be marked as NPA as the criteria for marking a Term Loan account as NPA is not based on the concept of servicing of interest but is based on the overdue concept. However, as per Para 2.1.3 of Master Circular No. RBI/2015-16/101DBR.No.BP.BC.2/ 21.04.048/2015-16 was issued on July 1, 2015 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances', in case of term loans, wherein only interest is due, the interest due and charged during any quarter is not serviced in 90 days from the end of the quarter, such account will be treated as NPA.
- (b) **Cash Credits and Overdrafts:** A cash credit or overdraft account is treated as NPA if it remains out of order as indicated above.
- (c) **Bills Purchased and Discounted:** Bills purchased and discounted are treated as NPA if they remain overdue and unpaid for a period of more than 90 days.
- (d) **Securitisation:** The asset is to be treated as NPA if the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated February 1, 2006.
- (e) **Agricultural Advances:** A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons and, a loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.
- (f) **Credit Card Accounts:** credit card account will be treated as non-performing asset if the minimum amount due, as mentioned in the statement, is not paid fully within 90 days from the payment due date mentioned in the

statement as per Circular DBR.No.BP.BC.30/21.04.048/2015-16 dated July 16 2015 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances – Credit Card Accounts". It is further suggested by RBI that banks should follow this uniform method of determining over-due status for credit card accounts while reporting to credit information companies (CIC) and for the purpose of levying of penal charges, viz., late payment charges, etc., if any.

11.288 As per the guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops. The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made applicable to agricultural term loans availed of by him.

11.289 The above norms should be made applicable to all direct agricultural advances as listed in the Master Direction no. RBI/FIDD /2020-21/72 Master Direction FIDD.CO.Plan. BC.5/04.09.01/2020-21 dated September 04, 2020 on "Lending to Priority Sector-Target and Classification". In respect of all other agricultural loans, identification of NPAs would be done on the same basis as non-agricultural advances, which, at present, is the 90 days delinquency norm.

Temporary Deficiencies

11.290 The classification of an asset as NPA should be based on the record of recovery. Bank should not classify an advance account as NPA merely due to the existence of some deficiencies which are temporary in nature such as non-availability of adequate drawing power based on the latest available stock statement, balance outstanding exceeding the limit temporarily, non-submission of stock statements and non-renewal of the limits on the due date, etc. In the matter of classification of accounts with temporary deficiencies, banks have to follow the following guidelines:

- (a) Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets, since current assets are first appropriated in times of distress. Drawing Power (DP) is required to be arrived at based on current stock statement. Proper computation of drawing power (as per Bank's policy) is imperative as the advances are to be checked with reference thereto. The Auditor should review the Bank's policy for treatment of creditor's balances for computation of DP. The auditor should factor in other considerations in the drawing power calculations, such as (i) comparison of the level of stock and books debts assumed at the time of assessment if the reduction of trade creditors is

limited to the extent of excess over the level of trade creditors assumed at the time of assessment; (ii) excess of other Sundry Creditors (i.e., other than trade creditors) over the level assumed at the time of assessment (as suggested in Annexure to IBA Circular No.: C&I/Circular/2014-15/689 dated September 29, 2014. Thus, if the bank is having a policy of considering trade creditors to the extent of excess over the level of trade creditors assumed at the time of assessment, the auditor will reciprocally review and verify the level of stock and book debts assumed at the time of assessment. Further, the Auditor will refer and review the methodology adopted by the bank in the calculation of MPBF (as regards netting off of trade creditors against stock and book debts) based on the level of stock, book debts and trade creditors. Further, the term 'paid stock' denotes value of stock as reduced by trade creditors at gross level. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. In case of consortium accounts, the drawing power calculation and allocation is made by the Lead Bank and is binding on the Member Banks (circular No. C&I/Circular/2014-15/689 dated 29 September 2014 issued by the Indian Banks Association).

- (b) The outstanding in the account based on drawing power calculated from stock statements older than three months is deemed as irregular.
- (c) A working capital borrowing account will become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days even though the unit may be working or the borrower's financial position is satisfactory.
- (d) Regular and ad hoc credit limits need to be reviewed/ regularised not later than three months from the due date/date of ad hoc sanction. In case of constraints such as non-availability of financial statements and other data from the borrowers, the branch should furnish evidence to show that renewal/ review of credit limits is underway and would be completed soon. In any case, delay beyond six months is not considered desirable as a general discipline. Hence, an account where the regular/ adhoc credit limits have not been reviewed/ renewed within 180 days from the due date/ date of adhoc sanction will be treated as NPA. It would be pertinent to note that the counting of 180 days would be required to be done from the date of original due date for renewal and not from the date of expiry of short reviews / technical reviews. The RBI issued circular RBI/2020-21/27 DoS.CO.PPG.BC.1/11.01.005/2020-21 dated August 21, 2020 on Ad-hoc/Short Review/Renewal of Credit Facilities, advising banks to follow the instructions related thereto in letter and spirit.

Regularisation Near About Balance Sheet date

11.291 The asset classification of borrower accounts where a solitary or a few credits are recorded before the balance sheet date should be handled with care and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA. In other genuine cases, the banks must furnish satisfactory evidence to the satisfaction of the auditor about the manner of regularisation of the account to eliminate doubts on their performing status.

Cheque bounce

11.292 In case the account is regularised by making payment through cheque, the Auditor should review the actual realisation of cheques to assess the NPA classification. In case, the cheque is bounced, same should not be considered as credit in the Advance account for assessing the NPA classification.

Asset Classification to be Borrower-wise not Facility-wise

11.293 All facilities granted to a borrower and investment made in securities issued by the borrower will have to be treated as NPA / Non-Performing Investments (NPI), once any or a part of the facility / investment has become irregular, except in case of preference shares wherein if the same are marked as NPI, the rest of the exposures are not required to be considered as Non-Performing.

11.294 In case debits arising out of devolvement of letters of credit or invoked guarantees are parked in a separate account, the balance outstanding in that account also should be treated as a part of the borrower's principal operating account for the purpose of application of prudential norms on income recognition, asset classification and provisioning. The following provisions are given in the master circular in this regard:

- (i) The bills discounted under LC favouring a borrower may not be classified as a non-performing advance (NPA), when any other facility granted to the borrower is classified as NPA. However, in case documents under LC are not accepted on presentation or the payment under the LC is not made on the due date by the LC issuing bank for any reason and the borrower does not immediately make good the amount disbursed as a result of discounting of concerned bills, the outstanding bills discounted will immediately be classified as NPA with effect from the date when the other facilities had been classified as NPA. Further, in case of bill discounted under LC, if the payment under the LC is not made on the due date by the LC issuing bank for any reason, unless the amount is immediately made good by the borrower, the Auditor needs to review the availability of security in the light of the straight away classification norms specified.

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

receivable remaining unpaid for 90 days, in addition to reversing the crystallised receivable from Profit and Loss Account as stipulated above, the positive MTM pertaining to future receivables may also be reversed from Profit and Loss Account to another account styled as 'Suspense Account – Positive MTM'. The subsequent positive changes in the MTM value may be credited to the 'Suspense Account – Positive MTM', not to P&L Account. The subsequent decline in MTM value may be adjusted against the balance in 'Suspense Account – Positive MTM'. If the balance in this account is not sufficient, the remaining amount may be debited to the P&L Account. On payment of the overdues in cash, the balance in the 'Suspense Account-Crystallised Receivables' may be transferred to the 'Profit and Loss Account', to the extent payment is received.

- (vii) If the bank has other derivative exposures on the borrower, it follows that the MTMs of other derivative exposures should also be dealt with / accounted for in the manner outlined, subsequent to the crystallised/settlement amount in respect of a particular derivative transaction being treated as NPA.
- (viii) Since the legal position regarding bilateral netting is not unambiguously clear, receivables and payables from/to the same counterparty including that relating to a single derivative contract should not be netted.
- (ix) Similarly, in case a fund-based credit facility extended to a borrower is classified as NPA, the MTMs of all the derivative exposures should be treated in the manner discussed above.

Non-Financial Parameters

11.295 Normally NPA assessment is done based on record of recovery of dues in advances account. However, there are many other non-financial parameters which also should be considered while assessing classification of NPA account such as:

- Inherent weakness in account.
- Non-achievement of DCCO.
- Failure to comply with key restructuring conditions.
- Erosion in value of security.

Advances to Primary Agricultural Credit Society (PACS) Farmers Service Society (FSS) ceded to Commercial Banks

11.296 In case of advances granted under the on-lending system, however, only the particular credit facility granted to PACSs or FSSs, which is in default for

a period of two crop seasons in case of short duration crops and one crop season in case of long duration crops, as the case may be, after it has become due will be classified as NPA and not all the credit facilities sanctioned subject to such conditions as specified in the RBI's Master Circular no. RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 on "Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances" dated July 1, 2015. The other direct loans and advances, if any, granted by the bank to the member borrower of a PACS/ FSS outside the on-lending arrangement will become NPA even if one of the credit facilities granted to the same borrower becomes NPA.

Erosion in Value of Securities/ Frauds Committed by Borrowers

11.297 In respect of accounts where there are potential threats for recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers, such accounts need not go through the stages of asset classification. In such cases, the asset should be straightaway classified as doubtful or loss asset, as appropriate. Further consequences are:

- (i) Erosion in the value of securities by more than 50% of the value assessed by the bank or accepted by RBI inspection team at the time of last inspection, as the case may be, would be considered as "significant", requiring the asset to be classified as doubtful straightaway and provided for adequately.
- (ii) In case of secured loan, if the realisable value of security as assessed by bank/approved valuers/RBI is less than 10% of the outstanding in the borrower accounts, the existence of the security should be ignored and the asset should be classified as loss asset and accordingly fully provided for.
- (iii) Provisioning norms in respect of all cases of fraud:
 - a. The entire amount due to the bank (irrespective of the quantum of security held against such assets), or for which the bank is liable (including in case of deposit accounts), is to be provided for over a period not exceeding four quarters commencing with the quarter in which the fraud has been detected.
 - b. However, where there has been delay, beyond the prescribed period, in reporting the fraud to the Reserve Bank, the entire provisioning is required to be made at once. In addition, the Reserve Bank of India may also initiate appropriate supervisory action where there has been a delay by the bank in reporting a fraud, or provisioning there against.

- c. Where the bank chooses to provide for the fraud over two to four quarters and this results in the full provisioning being made in more than one financial year, banks should debit 'other reserves' [i.e., reserves other than the one created in terms of Section 17(2) of the Banking Regulation Act 1949] by the amount remaining un-provided at the end of the financial year by credit to provisions. However, banks should proportionately reverse the debits to 'other reserves' and complete the provisioning by debiting profit and loss account, in the subsequent quarters of the next financial year.

Government Guaranteed Advances

11.298 The credit facilities backed by guarantees of Central Government though overdue may be treated as NPA only when the government repudiates its guarantee, when invoked. This exemption from classification of Central Government guaranteed advances as NPA is not for the purpose of recognition of income and thus, in such instances the income would be required to be recognized on cash basis. In case of State Government guaranteed loans, this exemption will not be available and such account will be NPA if interest / principal / other dues remain overdue for more than 90 days.

Advances under Consortium

11.299 Consortium advances should be based on the record of recovery of the respective individual member banks and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account should be treated as not serviced in the books of the other member banks and therefore, an NPA.

11.300 Banks participating in the consortium, therefore, need to arrange to get their share of recovery transferred from the lead bank or to get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

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

11.301 Advances against Term Deposits, NSCs eligible for surrender, KVP/IVP and life policies need not be treated as NPAs, provided adequate margin is available in the accounts. Advance against gold ornaments, government securities and all other securities are not covered by this exemption and should be classified as NPA as per the extant IRAC norms. However, in respect of Jewel Loans taken for Agricultural Purposes, the classification has to be continued in accordance with Crop Seasons only.

Agricultural Advances Affected by Natural Calamities

11.302 Master Direction FIDD.CO.FSD.BC No.9/05.10.001/2018-19 dated October 17, 2018 on Master Direction – Reserve Bank of India (Relief Measures by Banks in Areas affected by Natural Calamities) Directions 2018 – SCBs” deals elaborately with the classification and income recognition issues due to impairment caused by natural calamities. Banks may decide on their own relief measures, viz., conversion of the short term production loan into a term loan or rescheduling of the repayment period and the sanctioning of fresh short-term loan, subject to the guidelines contained in RBI’s Master Circular. In such cases the NPA classification would be governed by such rescheduled terms. The Auditors are advised to obtain the latest decisions of State Level Banking Committee (SLBC) and the minutes of the SLBC meeting will be accessible in website.

11.303 In such cases of conversion or re-scheduling, the term loan as well as fresh short-term loan may be treated as current dues and need not be classified as NPA. The asset classification of these loans would thereafter be governed by the revised terms and conditions and would be treated as NPA if interest and/or instalment of principal remain overdue for two crop seasons for short duration crops and for one crop season for long duration crops. For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" would be treated as "short duration" crops.

11.304 While fixing the repayment schedule in case of rural housing advances granted to agriculturist under Indira Awas Yojana and Golden Jubilee Rural Housing Finance Scheme, banks should ensure that the interest/ instalment payable on such advances are linked to crop cycles.

Advances Granted Under Rehabilitation Packages Approved by BIFR/Term Lending Institutions

11.305 In respect of advances under rehabilitation package approved by BIFR/term lending institutions, the provision should continue to be made in respect of dues to the bank on the existing credit facilities as per their classification as sub-standard or doubtful asset. This classification cannot be upgraded by the bank unless the package of renegotiated terms has worked satisfactorily for a period of one year. As regards the additional facilities sanctioned as per package finalised by BIFR and/or term lending institutions, the income recognition, asset classification norms would apply after a period of one year from the date of disbursement.

Transactions Involving Transfer of Assets through Direct Assignment of Cash Flows and the Underlying Securities

11.306 **Originating Bank:** The asset classification and provisioning rules in respect of the exposure representing the Minimum Retention Requirement (MRR) of the Originator of the asset would be as under:

- a) The originating bank may maintain a consolidated account of the amount representing MRR if the loans transferred are retail loans. In such a case, the consolidated amount receivable in amortisation of the MRR and its periodicity should be clearly established and the overdue status of the MRR should be determined with reference to repayment of such amount. Alternatively, the originating bank may continue to maintain borrower-wise accounts for the proportionate amounts retained in respect of those accounts. In such a case, the overdue status of the individual loan accounts should be determined with reference to repayment received in each account.
- b) In the case of transfer of a pool of loans other than retail loans, the originator should maintain borrower-wise accounts for the proportionate amounts retained in respect of each loan. In such a case, the overdue status of the individual loan accounts should be determined with reference to repayment received in each account.
- c) If the originating bank acts as a servicing agent of the assignee bank for the loans transferred, it would know the overdue status of loans transferred which should form the basis of classification of the entire MRR/individual loans representing MRR as NPA in the books of the originating bank, depending upon the method of accounting followed as explained in para (a) and (b) above.

11.307 **Purchasing Bank:** In purchases of pools of both retail and non-retail loans, income recognition, asset classification and provisioning norms for the purchasing bank will be applicable based on individual obligors and not based on portfolio. Banks should not apply the asset classification, income recognition and provisioning norms at portfolio level, as such treatment is likely to weaken the credit supervision due to its inability to detect and address weaknesses in individual accounts in a timely manner. If the purchasing bank is not maintaining the individual obligor-wise accounts for the portfolio of loans purchased, it should have an alternative mechanism to ensure application of prudential norms on individual obligor basis, especially the classification of the amounts corresponding to the obligors which need to be treated as NPAs as per existing prudential norms. One such mechanism could be to seek monthly statements containing account-wise details from the servicing agent to facilitate classification of the portfolio into different asset classification categories. Such details should

be certified by the authorized officials of the servicing agent. Bank's concurrent auditors, internal auditors and statutory auditors should also conduct requisite checks of these portfolios with reference to the basic records maintained by the servicing agent. The servicing agreement should provide for such verifications by the auditors of the purchasing bank. All relevant information and audit reports should be available for verification by the Inspecting Officials of RBI during the Annual Financial Inspections of the purchasing banks.

11.308 The above guidelines prescribed for Originating Bank and Purchasing Bank do not apply to the following:

- (a) Transfer of loan accounts of borrowers by a bank to other bank/FIs/NBFCs and vice versa, at the request/instance of borrower.
- (b) Inter-bank participations.
- (c) Trading in bonds.
- (d) Sale of entire portfolio of assets consequent upon a decision to exit the line of business completely. Such a decision should have the approval of Board of Directors of the bank.
- (e) Consortium and syndication arrangements and arrangement under Corporate Debt Restructuring mechanism.
- (f) Any other arrangement/transactions, specifically exempted by the Reserve Bank of India.

Post Shipment Supplier's Credit

11.309 In respect of post-shipment credit extended by the banks covering export of goods to countries for which the ECGC cover is available, EXIM Bank has introduced a guarantee-cum-refinance programme whereby, in the event of default, EXIM Bank will pay the guaranteed amount to the bank within a period of 30 days from the day the bank invokes the guarantee after the exporter has filed claim with ECGC.

11.310 Accordingly, where the credit extended by banks are guaranteed by EXIM Bank, the extent to which payment has been received from EXIM bank on guarantee the advance may not be treated as NPA.

Takeout Finance

11.311 Takeout finance is the product emerging in the context of the funding of long-term infrastructure projects. Under such an arrangement, the bank or financial institution financing infrastructure projects will have an arrangement with any financial institution for transferring to the latter the outstanding in respect of such financing in their books on a predetermined basis. In view of the time-lag

involved in taking-over, the possibility of a default in the meantime cannot be ruled out. The norms of asset classification will have to be followed by the concerned bank/financial institution in whose books the account stands as balance sheet item as on the relevant date. If the lending institution observes that the asset has turned NPA on the basis of the record of recovery, it should be classified accordingly. The lending institution should not recognise income on accrual basis and account for the same only when it is paid by the borrower/taking over institution (if the arrangement so provides). The lending institution should also make provisions against any asset turning into NPA pending its takeover by the taking over institution. As and when the asset is taken over by the taking over institution, the corresponding provisions could be reversed. However, the taking over institution, on taking over such assets, should make provisions treating the account as NPA from the actual date of it becoming NPA even though the account was not in its books as on that date.

Export Project Finance

11.312 Where the actual importer has paid the dues to the bank abroad and the proceeds have not been made good to the bank granting finance due to any political reasons, such account need not be classified as NPA if the bank is able to establish through documentary evidence that the importer has cleared the dues in full by payment received to the credit of account of exporter maintained in such country. The account will, however, have to be considered as NPA if at the end of one year from the date the amount was deposited by the importer in the bank abroad, the amount has not still been remitted to the bank.

Net Worth of Borrower/Guarantor or Availability of Security

11.313 Since income recognition is based on recoveries, net worth of borrower/guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise, except to the extent provided in Para 4.2.9 of the Master Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 was issued on July 1, 2015 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances'. Likewise, the availability of security and/or guarantee is not relevant for determining whether an account is an NPA or not.

Project Finance Under Moratorium Period

11.314 In the case of bank finance given for industrial projects or for agricultural plantations etc., where moratorium is available for payment of interest, payment of interest becomes due after the moratorium or gestation period is over, and not on the date of debit of interest. Therefore, such amounts of interest do not become overdue and hence the accounts do not become NPA, with reference to

the date of debit of interest. They become overdue after due date for payment of interest as per the terms of sanction and consequently NPA norms would apply to those advances from that due date.

Advances to Staff

11.315 Interest bearing staff advances as a banker should be included as part of advances portfolio of the bank. In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from first due date onwards. Such loans/advances should be classified as NPA only when there is a default in repayment of instalment of principal or payment of interest on the respective due dates. The staff advances by a bank as an employer and not as a banker are required to be included under the sub-head 'Others' under the schedule of Other Assets.

Partial Credit Enhancement to Corporate Bonds

11.316 In a waterfall mechanism, credit enhancement (CE) gets drawn only in a contingent situation of cash flow shortfall for servicing a debt / bond etc., and not in the normal course of business. Hence, such an event is indicative of financial distress of the project. Keeping this aspect in view, a drawn tranche of the contingent PCE facility will be required to be repaid within 30 days from the date of its draw (due date). The facility will be treated as NPA if it remains outstanding for 90 days or more from the due date and provided for as per the usual asset classification and provisioning norms. In that event, the bank's other facilities to the borrower will also be classified as NPA as per extant guidelines.

NPA Management

11.317 The RBI has issued Master Circular dated July 1, 2015 on "Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances". The Circular stresses the importance of effective mechanism and availability of granular data on NPA management in the banks and provides as follows:

- Asset quality of banks is one of the most important indicators of their financial health. However, it has been observed that existing MIS on the early warning systems of asset quality, needed improvement. Banks are, therefore, advised that they should review their existing IT and MIS framework and put in place a robust MIS mechanism for early detection of signs of distress at individual account level as well as at segment level (asset class, industry, geographic, size, etc.). Such early warning signals should be used for putting in place an effective preventive asset quality management framework, including a transparent restructuring mechanism

for viable accounts under distress within the prevailing regulatory framework, for preserving the economic value of those entities in all segments.

- The banks' IT and MIS system should be robust and be able to generate reliable and quality information with regard to their asset quality for effective decision making. There should be no inconsistencies between information furnished under regulatory/statutory reporting and the banks' own MIS reporting. Banks are also advised to have system generated segment-wise information on non-performing assets and restructured assets which may include data on the opening balances, additions, reductions, (upgradations, actual recoveries, write-offs etc.) closing balances, provisions held, technical write-offs, etc.
- The RBI issued circular RBI/2020-21/37 DoS.CO.PPG./SEC.03/11.01.005/2020-21 dated September 14, 2020 on 'Automation of Income Recognition, Asset Classification and Provisioning processes in banks' with reference to earlier circular DBS.CO.PPD.No.1950/11.01.005/2011-12 dated August 04, 2011 and have advised the banks to put in place / upgrade their systems to ensure completeness and integrity of automated asset classification, provisioning calculation and income recognition process by June 30, 2021 in compliance with the extant guidelines issued vide the circular.

Audit Procedures and Reporting

- The point requires the Auditor to verify and comment whether the identification and classification of advances into standard/substandard/doubtful/loss assets have been done in compliance with the RBI Master Circular No. RBI/2015-16/101, DBR.No.BP.BC.2/21.04.048/2015-16 dated July 01, 2015 "Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances" in conjunction with H.O's instructions for identification of NPAs and Classification of Advances.
- The Auditor should verify as to whether the bank has a system of ongoing identification and classification of advances through CBS without manual intervention and its accuracy in crystallising date of NPA. In case of accounts identified as NPA by the auditor, the auditor needs to review the reasons of non-identification of such accounts through CBS as regards the effectiveness of the existing auto-identification and marking system in the CBS.
- The Auditor should verify the deposit account having debit balances due to charging of service charges/interest time to time and pending for

recovery since long. Verify whether, prudential norms on Income Recognition, Asset Classification and Provisioning have been followed. If there is any deviation to RBI circular and HO instructions same should be commented and MOC should be given if required.

- The Auditor should also review the quality and correctness of master data of loans accounts updated in Core Banking Software. Check parameters viz. instalment amount, tenure of loan, moratorium period, interest rate, interest flags, limits setup, due date of first instalment and instalment amount. In case of errors in master data configuration, various advances related reports, statement of overdue accounts will not be generated correctly software. Such reports, if relied upon, lead to incorrect identification of NPAs. In view of the same, the Auditor should take utmost care while verifying the compliance of NPA norms.
- The Auditors should review and compare the date of NPA of loans accounts mentioned in current year statements with that of previous year. Normally there should not be change of date of NPA unless it is suggested by previous auditor in MOC or by RBI Inspectors. Any change other than these, should be reviewed closely and reasons for such change should be ascertained.
- If an account is identified as NPA either by the bank or by the auditors, the crystallisation of date of NPA needs to be carefully reviewed / verified, which needs to be date of NPA after completion of requisite number days of default (e.g. 91st day in case of continuously overdrawn CC/OD Accounts). The said date of NPA need not be confined to the current financial year but can be of earlier date too. However, in such circumstances, the Auditor should also verify the reasons for such accounts being not marked as NPA earlier through system.
- Whenever an incorrect master data related to interest or EMI or tenure of advance, is rectified by the bank, the effects of the same should be given as per the original terms of sanction and not prospectively as the prospective effects of such rectifications in certain cases (wherein the amounts due for repayment had been incorrectly considered on lower side as compared to the terms of sanction) may amount to restructuring of an advance. Further, the Auditor needs review and consider the instances of non-charging of penal interest, bank charges, processing fees on the due dates and its effects of NPA classification.
- In case of advances upgraded during the year, the Auditor needs to review such upgradation in the light of criteria's specified for upgradation of NPA accounts, considering the possibility of incorrect upgradation of

account on the basis of partial recoveries made in the account wherein the overdue portion is not extinguished in entirety, recoveries made in the account subsequent to the cut-off date, (i.e., date of financial statements) and non-identification of NPAs on on-going basis resulting in an account being considered as standard though overdue portion of such unidentified NPAs is not recovered in entirety.

- The Auditor needs to ensure that each customer of the bank is tagged under one single Customer ID / Unique Customer Identification Code (UCIC) in respect of all its accounts, including those in which credit facilities are granted, irrespective of their location, to enable the bank, (subject to the relaxations/exceptions for the time being applicable to any account/facility), to accord the same NPA classification status to the customer/borrower, based on the most adverse classification determined for any of its account/ facility. The NPA classification of a group entity as such does not automatically extend to other related / group entities, where the classification would have to be judged based on independently, i.e., at the entity level and not at a group level, unless there is a diversion of funds.
- The Auditor should also comment if the banks' IT and MIS system are robust and able to identify and generate reliable and quality information with regard to their asset quality for effective decision making without any manual intervention. There should be no inconsistencies between information furnished under regulatory/statutory reporting and the banks' own MIS reporting.

Other NPA related aspects

Income Recognition

On Advances Granted

11.318 Banks recognise income (such as interest, fees and commission) on accrual basis, i.e., as it is earned. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection. In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognise income on non-performing assets until it is actually realised.

11.319 If any advance including bills purchased and discounted, becomes NPA, the entire interest accrued and credited to the income account in the past periods should be reversed if the same is not realised. Interest for the current year if recognised till the date of identification but not realised should also be reversed. Further,

- i. Interest income on advances against term deposits, NSCs, IVPs, KVPs and life policies may be taken to income account on the due date, provided adequate margin is available in the accounts.
- ii. Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit.
- iii. If Government guaranteed advances become NPA (subject to what is stated hereunder in respect of Central Govt. guaranteed accounts), the interest on such advances should not be taken to income account unless the interest has been realised.

Credit facilities backed by guarantee of the Central Government, though overdue, may be treated as NPA only when the Government repudiates its guarantee when invoked. Thus, where the guarantee is not invoked/repudiated, the related account cannot be classified as NPA and by implication, the advance is to be treated as "Standard" for the purpose of provisioning. This exemption from classification of such Central Government guaranteed advances as NPA is not for the purpose of recognition of income; income is to be recognized only based on realisations made.

Reversal of Income

11.320 If any advance, including bills purchased and discounted, becomes NPA, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also. In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected. Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognised as income in the previous year(s).

On Leased Assets

11.321 The finance charge component of finance income (as defined in AS 19 – Leases) on the leased asset which has accrued and was credited to income account before the asset became non-performing, and remaining unrealised, should be reversed or provided for in the current accounting period.

On Take-out Finance

11.322 In the case of take-out finance, if based on record of recovery, the account is classified by the lending bank as NPA, it should not recognise

income unless realised from the borrower/taking-over institution (if the arrangement so provides).

On Partial Recoveries in NPAs (Appropriation of recoveries in NPAs)

11.323 In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner. The appropriate policy to be followed is to recognise income as per AS 9 when certainty attaches to realisation and accordingly amount reversed/de-recognised or not recognised in the past should be accounted.

11.324 Interest partly/fully realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.

Memorandum Account

11.325 When an account turns NPA, banks should reverse the interest already charged and not collected by debiting Profit and Loss account, and stop further application of interest. However, banks may continue to record such accrued interest in a memorandum account in their books for control purposes. For the purpose of computing Gross Advances, interest recorded in the memorandum account should not be taken into account.

Treatment of interest suspense account

11.326 Amounts held in "interest suspense Account should not be reckoned as part of provisions. Amounts lying in this account should be deducted from the relative advances and thereafter, provisioning as per the norms, should be made on the balances after such deduction.

Guidelines on Restructuring of Advances by Banks

11.327 The RBI, vide its Master Circular No.DBR.No.BP.BC.2/21.04.048/2015-16 dated July 1, 2015 issued guidelines on prudential norms on Income Recognition, Assets Classification and Provisioning pertaining to Advances. The Guidelines also contain the organisational framework for restructuring of advances under consortium/ multiple banking/ syndication arrangements, i.e., the CDR mechanism.

11.328 In line with the recommendation of the Working Group under the Chairmanship of Shri B. Mahapatra, to review the existing prudential guidelines on restructuring of advances by banks/financial institutions, the extant incentive for quick implementation of restructuring package and asset classification

benefits (Paragraph 20.2.1 & 20.2.2 of Master Circular No. RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 was issued on July 1, 2015 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances') available on restructuring on fulfilling the conditions will however, be withdrawn for all restructurings effective from April 1, 2015 with the exception of provisions related to changes in DCCO in respect of infrastructure as well as non-infrastructure project loans. It implies that with effect from April 1, 2015, a standard account on restructuring (for reasons other than change in Date of Commencement of Commercial Operations (DCCO)) would be immediately classified as sub-standard on restructuring as also the non-performing assets, upon restructuring, would continue to have the same asset classification as prior to restructuring and slip into further lower asset classification categories as per the extant asset classification norms with reference to the pre-restructuring repayment schedule.

Key Concepts

11.329 Key concepts used in these Guidelines are defined in Annex – 5 to the RBI's Master Circular no. RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances" dated July 1, 2015.

Eligibility criteria for restructuring of advances

11.330 Banks may restructure the accounts classified under 'standard', 'sub-standard' and 'doubtful' categories. Banks cannot reschedule / restructure / renegotiate borrowal accounts with retrospective effect. While a restructuring proposal is under consideration, the usual asset classification norms would continue to apply. The process of re- classification of an asset should not stop merely because restructuring proposal is under consideration. The asset classification status as on the date of approval of the restructured package by the competent authority would be relevant to decide the asset classification status of the account after restructuring/ rescheduling/ renegotiation. In case there is undue delay in sanctioning a restructuring package and in the meantime the asset classification status of the account undergoes deterioration, it would be a matter of supervisory concern.

11.331 Normally, restructuring cannot take place unless alteration / changes in the original loan agreement are made with the formal consent / application of the debtor. However, the process of restructuring can be initiated by the bank in deserving cases subject to customer agreeing to the terms and conditions.

11.332 No account will be taken up for restructuring by the banks unless the financial viability is established and there is a reasonable certainty of repayment from the borrower, as per the terms of restructuring package. Any restructuring

done without looking into cash flows of the borrower and assessing the viability of the projects / activity financed by banks would be treated as an attempt at ever greening a weak credit facility and would invite supervisory concerns / action. Banks should accelerate the recovery measures in respect of such accounts. The viability should be determined by the banks based on the acceptable viability benchmarks determined by them, which may be applied on a case-by-case basis, depending on merits of each case. Illustratively, the parameters may include the following:

- Return on Capital Employed
- Debt Service Coverage Ratio
- Gap between the Internal Rate of Return
- Cost of Funds
- Provision required in lieu of the diminution in the fair value of the restructured advance.

11.333 The borrowers indulging in frauds and malfeasance will continue to remain ineligible for restructuring. Banks may review the reasons for classification of the borrowers as wilful defaulters, especially in old cases where the manner of classification of a borrower as a wilful defaulter was not transparent, and satisfy itself that the borrower is in a position to rectify the wilful default.

11.334 Following are the erstwhile types of Restructuring mechanisms.

- i. Joint Lenders Forum (JLF) and Corrective Action Plan (CAP).
- ii. Strategic Debt Restructuring (SDR).
- iii. Scheme for Sustainable structuring of Stressed Assets (S4A).
- iv. Corporate Debt Restructuring (CDR) Mechanism.

11.335 With issuance of circular no. RBI/2018-19/203 DBR. No.BP.BC.45/21.04.048/2018-19 on Prudential Framework for Resolution of Stressed Assets dated June 07, 2019 and circular no. RBI/2017-18/131 DBR.No.BP.BC.101/21.04.048/2017-18 on Resolution of Stressed Assets – Revised Framework dated February 12, 2018, the extant instructions on resolution of stressed assets such as Framework for Revitalising Distressed Assets, Corporate Debt Restructuring Scheme, Flexible Structuring of Existing Long Term Project Loans, Strategic Debt Restructuring Scheme (SDR), Change in Ownership outside SDR, and Scheme for Sustainable Structuring of Stressed Assets (S4A) stand withdrawn with immediate effect. Accordingly, the Joint Lenders' Forum (JLF) as mandatory institutional mechanism for resolution of stressed accounts was discontinued.

Resolution of Stressed Assets – Revised Framework w.e.f. February 12, 2018

11.336 The RBI issued Circular no. RBI/2017-18/131 DBR.No.BP.BC.101/21.04.048/2017-18 dated February 12, 2018 on “Resolution of Stressed Assets – Revised Framework”, wherein the existing provisions w.r.t. stress assets have been revised in entirety with discontinuation of various enabling provisions for retention of class of assets (under Corrective Action Plan (CAP), Strategic Debt Restructuring (SDR), Scheme for Sustainable Structuring of Stressed Assets (S4A). All accounts including the one where any of the schemes have been invoked but not yet implemented, shall be governed by revised framework.

11.337 RBI had put a comma for restructuring by discontinuing special regulatory treatment for asset classification from 31 March 2015. However, the introduction / continuation of schemes like CAP, SDR, S4A, etc. allowed banks to keep accounts standard after restructuring. With the new guidelines issued on February 12, 2018, the RBI has overhauled the restructuring framework by discontinuing prevalent restructuring schemes like CAP, SDR, S4A, etc. The new framework goes one step ahead as it aims at resolution of stressed asset and not just restructuring. With the enactment of Insolvency and Bankruptcy Code, 2016 (IBC), the process of resolution in case of failure of restructuring can be expedited.

Prudential Framework for Resolution of Stressed Assets – Revised Framework w.e.f. June 07, 2019

11.338 The earlier circular related to revised framework for Resolution of Stressed Assets was replaced vide circular no. RBI/2018-19/203 DBR.No.BP.BC.45/21.04.048/2018-19 dated June 07, 2019 for ‘Prudential Framework for Resolution for Stressed Assets’. The purpose of these guidelines is to provide framework for early recognition, reporting and time bound resolution of stressed assets.

11.339 These directions are issued without prejudice to issuance of specific directions, from time to time, by the Reserve Bank to banks, in terms of the provisions of Section 35AA of the Banking Regulation Act, 1949, for initiation of insolvency proceedings against specific borrowers under the Insolvency and Bankruptcy Code, 2016 (IBC). It has provided a framework for resolution of stressed assets as follows:

I. Early Identification and reporting of stress

Lenders shall recognise incipient stress in loan accounts, immediately on default by classifying such assets as per special mention accounts (SMA) as per following categories.

Guidance Note on Audit of Banks (Revised 2021)

SMA Sub-categories	Basis of Classification Principal or Interest payment or any other amount wholly or partly overdue between
SMA-0	1-30 days
SMA-1	31-60 days
SMA-2	61-90 days

In the case of revolving credit facilities like cash credit, the SMA sub-categories will be as follows:

SMA Sub-categories	Basis of Classification Outstanding balance remains continuously in excess of the sanctioned limit or drawing power, whichever is lower, for a period of
SMA-1	31-60 days
SMA-2	61-90 days

II. Implementation of Resolution Plan

All lenders must put Board Approved Policy for resolution of stressed assets, including timelines for resolution. It is expected that the lenders initiate the process of implementing Resolution Plan even before a default. Once default is reported, "Review Period" of 30 days starts, wherein lenders may decide on resolution strategy and may choose to initiate legal proceedings for insolvency or recovery. If RP is to be implemented, all lenders to sign Inter Creditor Agreement (ICA) during the Review Period. Decision to be taken as agreed by lenders representing 75% by value of total outstanding credit facilities (FB+NFB) and 60% of lenders by number.

In case of accounts with aggregate exposure above a threshold with the lenders, on or after the reference date, the resolution plan must be implemented within 180 days from end of review period

Aggregate exposure of the borrower to lenders	Reference Date
Rs. 20 Billion (2000 Crores) and Above	Date of these directions
Rs. 15 Billion (1500 Crores) and above but less than Rs. 20 Billion (2000 Crores)	January 1, 2020
Less than Rs. 15 Billion (1500 Crores)	To be announced in due course

III. Implementation conditions of Resolution Plan

For 1 billion (100 Cr) and above exposure – Independent Credit Evaluation (ICE) of the residual debt by Credit Rating Agencies (CRAs) specifically authorised by RBI for this purpose.

For 5 billion (500 Cr) and above exposure – Two such Independent Credit Evaluation (ICE) of the residual debt by Credit Rating Agencies (CRAs) specifically authorised by RBI for this purpose.

RP is implemented if the following conditions are to be met:

- i. RP Not involving Restructuring / Change in Ownership shall be deemed to be implemented only if the borrower is not in default with any of the lenders as on 180th day from the end of Review Period.
- ii. RP involving Restructuring / Change in Ownership shall be deemed to be implemented only if following conditions are met:
 - a. All related documentation, creation of security/charge / perfection of security are completed by the lenders.
 - b. New Capital Structure and changes in terms of conditions of the existing loans gets duly reflected in the books of the lenders and borrower.
 - c. Borrower is not in default with any of the lenders.

IV. Delayed implementation of Resolution Plan

Additional provision required when viable RP is not implemented as follows:

Timeline for implementation of viable RP	Additional Provision as % of total outstanding
180 days from the end of review period	20%
365 days from the commencement of Review Period	15%

An additional provision is to be made over and above the higher of following (max 100% of outstanding):

- a. Provisions already held.
- b. Provisions required to be made as per asset classification status of the borrower account.

V. Prudential Norms

Restructuring is an act in which a lender, for economic or legal reasons relating to the borrower's financial difficulty, grants concessions to the borrower.

Restructuring may involve modification of terms of the advances / securities, which would generally include, among others, alteration of payment period / payable amount / the amount of instalments / rate of interest; roll over of credit facilities; sanction of additional credit facility/ release of additional funds for an account in default to aid curing of default / enhancement of existing credit limits; compromise settlements where time for payment of settlement amount exceeds three months.

11.340 A non exhaustive indicative list of “financial difficulty” (Based on Basel Committee Guidelines) is as follows:

- i. Borrower not in default, but it is probable that the borrower will default on any of its exposures in foreseeable future without the concession.
- ii. Borrowers outstanding securities have been delisted.
- iii. Actual performance vs estimates, cash flows to be assessed insufficient to service all of its loans or debt securities.
- iv. Borrowers credit facilities are NPA.
- v. Borrowers existing exposures are categorised as exposures that have already evidenced difficulty in borrowers’ ability to repay in accordance with banks internal credit rating system.

Asset Classification

11.341 On restructuring the account will be downgraded from Standard to Substandard. NPAs will remain in same category.

Upgradation

11.342 Only when all the outstanding loan / facilities in the account demonstrate ‘satisfactory performance’ during the period from the date of implementation of RP up to the date by which at least 10% of the sum of outstanding principal debt as per RP and interest capitalisation sanctioned as a part of the restructuring, if any is repaid (provided that account cannot be upgraded before one year from the commencement of the first payment of interest or principal, whichever is later, on the credit facility with longest period of moratorium under the terms of RP).

11.343 In addition to the satisfactory performance, in case of aggregate exposure of Rs. 1 Billion and above, external credit rating of investment grade should be BBB - or better and in case of aggregate exposure of Rs. 5 Billion and above, two such external credit ratings of investment grade should be BBB- or better

11.344 On failure to demonstrate satisfactory performance during the

monitoring period, asset classification upgrade is subjected to fresh restructuring / change of ownership framework as per IBC and additional provision of 15% for such accounts should be made at the end of review period.

Provisioning Norms

11.345 Accounts restructured under the revised framework shall attract provisioning as per the asset classification category as laid out in the Master Circular no. RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 on Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated July 1, 2015. The circular further provides guidelines for Supervisory Review and related to Disclosures.

11.346 Accounts restructured under earlier framework in which accounts are continued to be classified as standard post restructuring, if satisfactory performance after the specified period is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to pre-restructuring schedule.

Upgradation of Loan Accounts Classified as NPAs

11.347

- (i) If arrears of interest and principal are paid by the borrower in the case of loan accounts classified as NPAs, the account should no longer be treated as non-performing and may be classified as 'standard' accounts. Upgradation is allowed only if the account reaches "no over dues" status. This should not be misunderstood with "overdues brought within 90 days". Upgradation of a restructured/ rescheduled/CDR accounts is governed by the restructuring / rescheduling /CDR norms. Further, in case of borrowers wherein the bank has multiple exposures, it would be pertinent to note that the 'no overdue' status needs to be achieved w.r.t. all exposures of the bank as on the date of upgradation of the account.
- (ii) The Auditor has to verify that any upgrading of accounts classified as 'Sub-Standard' or 'Doubtful' category wherein restructuring / rephasing of principal or interest has taken place should be upgraded to the 'Standard Asset' category only after a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms, subject to satisfactory performance during the period. The total amount becoming due during this period of one year should be recovered and there should be no over dues to make it eligible for upgradation. If the amount which has become due during this one year

period is on a lower side *vis a vis* total amount outstanding, the other aspects of the account, *viz* financial performance, availability of security, operations in account, etc., should be reviewed in detail and only if found satisfactory, the account should be upgraded.

- (iii) Recovery in an advance which was rescheduled cannot give the advance a better classification than the previous one. NPA accounts can be upgraded to performing accounts, provided all overdues are adjusted.
- (iv) Upgradation within the NPA category is not permitted i.e. a Doubtful account cannot be made sub-standard even if the overdue are reduced to less than 12 months.

Relief for MSME borrowers registered under GST

11.348 The RBI issued Circular no. RBI/2017-18/129 DBR.No.BP.BC.100/21.04.048/2017-18 dated February 07, 2018 on "Relief for MSME Borrowers registered under Goods and Services Tax (GST)", The Auditors need to be vigilant as regards the applicability of the said circular and eligibility of the borrower. This circular applies only to borrowers which are classified as micro, small and medium enterprise under the MSMED Act, 2006. The exposure of banks to such borrowers would be classified as standard assets subject to conditions specified in the circular:

1. The borrower is registered under the GST regime as on January 31, 2018.
2. The aggregate exposure including non-fund-based facilities of banks and NBFCs, to the borrower does not exceed Rs. 25 crores as on January 31, 2018.

Thus, the overall exposure of the borrower (including that of multiple banking/ consortium banking) as on January 31, 2018 should not exceed Rs. 25 crores, i.e. the overall exposure of the borrower to banks and NBFCs combined should not exceed the cap of Rs. 25 crores. Further, it is to be noted that as per RBI Master Circular no. RBI /2015-16/70 DBR.No.Dir.BC.12 /13.03.00/2015-16 on "Exposure Norms", – 'exposure' shall include credit exposure (funded and non-funded credit limits) and investment exposure (including underwriting and similar commitments). The sanctioned limits or outstanding, whichever are higher, shall be reckoned for arriving at the exposure limit. However, in the case of fully drawn term loans, where there is no scope for re-drawl of any portion of the sanctioned limit, banks may reckon the outstanding as the exposure.

3. The borrower's account should be standard account as on August 31, 2017.

It would be pertinent to note that some banks may be following a system of marking of accounts as NPA in the system as at quarter-end instead of marking the accounts on on-going basis. However, the borrower account needs to be tested for classification purpose as on August 31, 2017 and in case such account is a NPA account as per the extant of IRAC norms specified by RBI as on August 31, 2017, irrespective of the account being marked or not by the bank, such accounts will not be eligible for relief granted by this circular.

4. The amount from the borrower, overdue as on September 01, 2017 and payments from the borrower due between September 01, 2017 and January 31, 2018 are paid not later than 180 days from their respective original due date.

As per para 2.3 of Master Circular No. RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 was issued on July 1, 2015 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances' – 'any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank'. Thus, the extension period of 180 days granted for the repayment of the overdue amount as on September 01, 2017 as well as the amounts due between the specified period is restricted to the extent of 180 days from the respective 'due date'. Further, the email dated April 03, 2018 from DBR, Reserve Bank of India, Central Office states thus: – "It is clarified that CC/OD limits are part of the aggregate exposure to the borrower. OD/CC accounts which become 'out of order' as per para 2.2 of our Master Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 was issued on July 1, 2015 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances' between September 01, 2017 and January 31, 2018 may continue to be classified as standard provided the irregularity in the account is removed within a period not exceeding 90 days from the original date of the account becoming 'out of order'.

5. A provision of 5% shall be made against such exposures which are not classified as NPA (due to the relaxation as provided above), which otherwise would have been classified as NPA as per usual IRAC norms (of accounts overdue beyond 90 days period).
6. The additional time provided is for the purpose of asset classification only and not for income recognition.

Thus, if an account is otherwise eligible to be classified as NPA as per usual IRAC norms (of accounts overdue beyond 90 days period) but is classified as PA

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based on the above-mentioned relaxation granted, the income is required to be recognised on realisation basis and not on accrual basis.

11.349 Further RBI has issued Circular no. RBI/2017-18/186 DBR.No.BP.BC.108/ 21.04.048/ 2017-18 dated June 06, 2018 for Encouraging Formalisation of MSME sector. This circular is in continuity with Circular no. RBI/2017-18/129 DBR.No.BP.BC.100/21.0 4.048/2017-18 dated February 07, 2018 on MSME borrowers registered under the Goods and Services Tax (GST); thus, the Auditor needs to be vigilant as regards the applicability of both these circulars and eligibility of the borrowers. This circular applies only to borrowers which are classified as micro, small and medium enterprise under the MSMED Act, 2006. The exposure of banks to such borrowers would be classified as standard assets subject to conditions specified in the circular as detailed below:

- i. The aggregate exposure, including non-fund based facilities, of banks and NBFCs to the borrower does not exceed ₹ 250 million as on May 31, 2018.
- ii. The borrower's account was 'standard' as on August 31, 2017.
- iii. The payments due from the borrower as on September 1, 2017 and falling due thereafter up to December 31, 2018 were/are paid not later than 180 days from their original due date.
- iv. In respect of dues payable by GST-registered MSMEs from January 1, 2019 onwards, the 180 days past due criterion shall be aligned to the extant IRAC norms in a phased manner, as given below. However, for MSMEs that are not registered under GST as on December 31, 2018, the asset classification in respect of dues payable from January 1, 2019 onwards shall immediately revert to the extant IRAC norms.

Period during which any payment falls due	Time Permitted
September 01, 2017 – December 31, 2018	180 days
January 01, 2019 – February 28, 2019	150 days
March 01, 2019 – April 30, 2019	120 days
May 01, 2019 onwards	90 days

- v. The other terms and conditions of the circular dated February 07, 2018 remain unchanged.

11.350 The RBI issued Circular no. RBI/2018-19/100 DBR.No.BP.BC.18/ 21.04.048/2018-19) dated January 01, 2019 on "Micro, Small and Medium Enterprises (MSME) sector – Restructuring of Advances", permitting one-time restructuring of existing loans of MSMEs classified as 'Standard' without a

downgrade in asset classification subject to certain conditions. The said circular is issued with reference to the earlier circulars related to MSME borrowers issued on February 07, 2018 and June 06, 2018. The one-time restructuring as stated above is subject to conditions specified in the circular as detailed below:

- i. The aggregate exposure, including non-fund based facilities, of banks and NBFCs to the borrower, does not exceed Rs. 25 crores as on January 01, 2019.
- ii. The borrower's account (can be in default but is standard as on January 01, 2019 and continues to be standard asset till the date of implementation of the restructuring.
- iii. The borrower is registered under GST as on the date of implementation of restructuring. However, this condition will not apply to MSMEs which are exempt from GST registration. The condition of exemption should be determined on the basis of exemption limit obtaining as on January 01, 2019
- iv. The restructuring of the borrower account is implemented on or before March 31, 2020. A restructuring would be treated as implemented if the following conditions are met:
 - a. All related documentation including execution of necessary agreements between lenders and borrowers / creation of security charges / perfection of securities are completed by all lenders; and,
 - b. The new capital structure and / or changes in the terms and conditions of existing loans gets duly reflected in books of all lenders and the borrower.
- v. A provision of 5% in addition to the provision already held shall be made w.r.t. the accounts restructured under these instructions. Such provision can be reversed at the end of specified period subject to the account demonstrating satisfactory performance during the specified period.

'Specified Period' means a period of one year from the commencement of the first payment of interest or principal, whichever is later, on the credit facility with longest period of moratorium under the terms of restructuring package. 'Satisfactory Performance' means no payment (interest and/or principal) shall remain overdue for a period of more than 30 days. In case of cash credit / overdraft account, satisfactory performance means that the outstanding in the account shall not be more than the sanctioned limit or drawing power, whichever is lower, for a period of more than 30 days.

- vi. Subsequent to the restructuring, NPA Classification of these accounts shall be as per extant IRAC norms.
- vii. Appropriate disclosure in the financial statements under 'Notes on Accounts' related to MSME restructured accounts under these instructions would be required specifying number of accounts restructured and amount.
- viii. All other instructions applicable to restructuring of loans to MSME borrowers shall continue to be applicable.

11.351 The RBI has further clarified that the accounts classified as NPA can be restructured, however, the extant asset classification norms governing restructuring of NPAs continues to apply. As a general rule, barring the above one-time exception, any MSME account, which is restructured must be downgraded to NPA upon restructuring and will slip into progressively lower asset classification and higher provisioning requirements as per extant IRAC norms. Such an account may be considered for upgradation to 'standard' only if it demonstrates satisfactory performance during the specified period.

MSME Sector – Restructuring of Advances

Circular dated February 11, 2020

11.352 The RBI issued circular RBI/2019-20/160 DOR.No.BP.BC.34/21.04.048/2019-20 dated February 11, 2020 in continuation of earlier circular RBI/2018 - 19/100 DBR.No.BP.BC.18/ 21.04.048/2018-19) dated January 01, 2019 extending the one-time restructuring of MSME advances classified as 'standard' without a downgrade in the asset classification with the following amended conditions:

- i. The aggregate exposure, including non-fund based facilities, of banks and NBFCs to the borrower does not exceed ₹ 25 crores as on January 01, 2020.
- ii. The borrower's account can be in default but is standard as on January 01, 2020 and continues to be standard asset till the date of implementation of the restructuring.
- iii. The borrower is registered under GST as on the date of implementation of restructuring. However, this condition will not apply to MSMEs which are exempt from GST registration. The condition of exemption should be determined on the basis of exemption limit obtaining as on January 01, 2020.
- iv. The restructuring of the borrower account is implemented on or before December 31, 2020.

Circular dated August 06, 2020

11.353 The RBI issued circular RBI/2020-21/17 DOR.No.BP.BC /4/ 21.04.048/2020-21 dated August 06, 2020 in continuation of earlier circular RBI/2019-20/160 DOR.No.BP.BC.34/21.04.048/2019-20 dated February 11, 2020 extending the one-time restructuring of MSME advances classified as 'standard' without a downgrade in the asset classification and aligning the guidelines with the Resolution Framework for COVID19 – related Stress announced for other advances, with following amended conditions:

- i. The aggregate exposure, including non-fund based facilities, of banks and NBFCs to the borrower does not exceed Rs. 25 crores as on March 01, 2020.
- ii. The borrower's account is standard as on March 01, 2020. In case the account slips into NPA category between March 02, 2020 and date of implementation of restructuring plan, the asset classification of borrowers would be reinstated to standard provided restructuring is done as per provisions of this circular.
- iii. The borrower is registered under GST as on the date of implementation of restructuring. However, this condition will not apply to MSMEs which are exempt from GST registration. The condition of exemption should be determined on the basis of exemption limit obtaining as on March 01, 2020.
- iv. The restructuring of the borrower account is implemented on or before March 31, 2021.
- v. For the accounts restructured under these guidelines, the banks shall maintain additional provision of 5% over and above the provision already held by them.

COVID19 Regulatory Package

COVID19 Regulatory Package dated March 27, 2020

11.354 The RBI issued COVID19 Regulatory package vide Circular RBI/2019-20/186 DOR.No.BP.BC.47/21.04.048/2019-20 dated March 27, 2020 granting relief to borrowers as follows:

- i. Term Loans: In respect of all term loans (including agricultural term loans, retail and crop loans), all commercial banks (including regional rural banks, small finance banks and local area banks), co-operative banks, all-India Financial Institutions, and NBFCs (including housing finance companies), lending institutions are permitted to grant a moratorium of three months on payment of all instalments falling due between March 1,

2020 and May 31, 2020. The repayment schedule for such loans as also the residual tenor, will be shifted across the board by three months after the moratorium period. Interest shall continue to accrue on the outstanding portion of the term loans during the moratorium period. The Instalments will include the following payments falling due from March 1, 2020 to May 31, 2020: (i) principal and/or interest components; (ii) bullet repayments; (iii) Equated Monthly instalments; (iv) credit card dues. It would be pertinent to note that the repayment schedule of the loans is permitted to shift only to the extent of period equivalent to moratorium period.

- ii. Working Capital Facilities: In respect of working capital facilities sanctioned in the form of cash credit/overdraft (CC/OD), lending institutions are permitted to defer the recovery of interest applied in respect of all such facilities during the period from March 1, 2020 up to May 31, 2020 (deferment). The accumulated accrued interest shall be recovered immediately after the completion of this period.
- iii. Other facilities like LCBD, Bill Discounting, etc.: The captioned RBI circular does not grant any relief to other facilities like LCBD and Bill Discounting as both are neither in the form of Term Loan nor in the form of Cash Credit / Overdraft facilities.
- iv. Investments: The captioned RBI circular does not grant any relief to Investment portfolio of the bank.
- v. Easing of Working Capital Finance: In respect of working capital facilities sanctioned in the form of CC/OD to borrowers facing stress on account of the economic fallout of the pandemic, lending institutions may recalculate the 'drawing power' by reducing the margins and/or by reassessing the working capital cycle. This relief shall be available in respect of all such changes effected up to May 31, 2020 and shall be contingent on the lending institutions satisfying themselves that the same is necessitated on account of the economic fallout from COVID 19. Further, accounts provided relief under these instructions shall be subject to subsequent supervisory review with regard to their justifiability on account of the economic fallout from COVID-19.

The circular grants discretion to the lending institutions regarding reduction in margin and reassessment of working capital cycle, during the period up to May 31, 2020. The bank's board approved policy will need to prescribe the manner of implementing this requirement. The said relief will have limited impact to the extent of change in method of calculation of drawing power to the extent of reduction in margin and relaxation in consideration of working capital cycle.

- vi. Classification as Special Mention Account (SMA) and Non-Performing Asset (NPA): The relief granted by banks to the borrower as specified and permitted under the said circular, will not be considered as concession or change in terms and conditions of loan agreements due to financial difficulty of the borrower under Paragraph 2 of the Annex to the Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019 dated June 7, 2019 ('Prudential Framework'). Consequently, such a measure, by itself, shall not result in asset classification downgrade. Thus, any relief granted over and above that specified in the said circular may result in asset classification downgrade.
- vii: The said circular did not distinguish between Standard Accounts and Non-Performing Accounts and thus, the benefit of relaxation as provided under this circular would be available across classifications of assets.

COVID 19 Regulatory Package – Asset Classification and Provisioning dated April 17, 2020

11.355 The RBI circular RBI/2019-20/220 DOR.No.BP.BC. 63/21.04.048/2019-20 dated April 17, 2020 on COVID 19 Regulatory Package on Asset Classification and Provisioning, granted relief as under:

- i. Term Loans: In respect of Term Loan accounts classified as standard as on February 29, 2020, even if overdue, the moratorium period, wherever granted, shall be excluded by the lending institutions from the number of days past-due for the purpose of asset classification under the IRAC norms. The circular granted relief to the term loan accounts availing moratorium benefit, to the extent of moratorium period granted, by excluding the same while calculating the delinquency for asset classification. Thus, in case if a term loan account has not opted for the moratorium period, the benefit of the exclusion of the period between March 01, 2020 to May 31, 2020 in calculation of delinquency for asset classification would not be available.
- ii. Working Capital Facilities: In respect of working capital facilities sanctioned in the form of cash credit/overdraft ('CC/OD'), the Regulatory Package permitted the recovery of interest applied during the period from March 1, 2020 up to May 31, 2020 to be deferred ('deferment period'). Such deferment period, wherever granted in respect of all facilities classified as standard, including SMA, as on February 29, 2020, shall be excluded for the determination of out of order status. The circular granted relief from testing a CC/OD account for determination of 'out of order' status during the intervening period of March 01, 2020 and May 31, 2020.

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Thus, an account which was standard as on February 29, 2020 (i.e., not out of order status) would remain standard (or in other words in same category as standard or SMA) till May 31, 2020.

- iii. It would be pertinent to note that the circular does not prohibit upgradation of accounts during the intervening period. Thus, in case a NPA is regularised during the intervening period based on the revised terms of repayment and / or interest due, the said account is eligible for upgradation.
- iv. Provisioning
 - a. Term Loans

In case of Term Loans, wherein the benefit of moratorium period has been availed and such moratorium period has also been granted for the purpose of calculating the delinquency related to asset classification, on such accounts, a general provision of 10% would be required to be made to the extent of total outstanding in the loan accounts in phased-wise manner as follows:

- (i) Quarter ended March 31, 2020 – not less than 5 per cent
- (ii) Quarter ending June 30, 2020 – not less than 5 per cent

The said provision would be applicable only in cases wherein such accounts would otherwise (i.e., without availing the benefit related to asset classification) have been marked as NPA and the said provisioning requirement will not apply to the accounts which otherwise would have continued to be under standard category. The following table includes illustrative examples to clarify further:

(Presumption: the account is standard account as at February 29, 2020 and has availed a moratorium period for payment of EMIs for a period of 3 months (March 01, 2020 to May 31, 2020):

Instalment overdue since	Provision required	Provision required for the quarter
December 15, 2019	Yes	March, 2020 – 5% June, 2020 – 5%
January 01, 2020	Yes	March, 2020 – 5% June, 2020 – 5%
January 15, 2020	Yes	June, 2020 – 10%
February 29, 2020	Yes	June, 2020 – 10%

b. Working Capital Facilities

In case of working capital facilities wherein the benefit of exclusion of period of March 01, 2020 to May 31, 2020 is availed, a general provision of 10% would be required to be made to the extent of total outstanding in the loan accounts in phased-wise manner as follows:

(i) Quarter ended March 31, 2020 – not less than 5 per cent

(ii) Quarter ending June 30, 2020 – not less than 5 per cent

The said provision would be applicable only in the cases wherein such accounts would otherwise (i.e., without availing the benefit related to 'out of order') have been marked as NPA and the said provisioning requirement will not apply to the accounts which otherwise would have continued to be under standard category.

c. The above provisions may be adjusted against the actual provisioning requirements for slippages from the accounts reckoned for such provisions. The residual provisions at the end of the financial year can be written back or adjusted against the provisions required for all other accounts.

d. The above provisions shall not be reckoned for arriving at net the NPAs till they are adjusted against the actual provisioning requirements as specified earlier. Further, till such adjustments, these provisions shall not be netted from gross advances but shown separately in the balance sheet as appropriate.

e. The said provision is required to be made to the extent of the balance outstanding in the account wherein such benefit is availed and thus is not required to be made borrower-wise.

v. As regards the accounts which have been marked as NPA as at February 29, 2020, the asset classification norms based on subsequent aging would continue as per usual asset classification. Thus, the relaxation specified in this circular is limited to the extent the borrower accounts which were standard as at February 29, 2020 and not otherwise.

vi. It would be pertinent to note that the said circular specifies as regards maintenance of status quo of account classification as at February 29, 2020 up to May 31, 2020 but that does not preclude upgradation of an NPA account on account of extinction of delinquencies in the said account due to which the account was classified as NPA (e.g.: In case of term loan account, borrower has repaid the overdue amount to the fullest extent).

- vii. The circular provides for the disclosure and reporting requirements related to the assets which have availed the asset classification benefit as per the extant relaxation under this circular.

11.356 The RBI issued circular RBI/2019-20/244 DOR.No.BP.BC.71/21.04.048/2019-20 dated May 23, 2020 on COVID 19 Regulatory Package thereby further extending the benefit provided vide earlier circular RBI/2019-20/220 DOR.No.BP.BC. 63/21.04.048/2019-20 dated April 17, 2020 on COVID 19 Regulatory Package - Asset Classification and Provisioning, granting relief w.r.t. Asset Classification and Provisioning as follows:

- i. Term Loans: The specified lending institutions were permitted to extend the moratorium by another three months, i.e., from June 01, 2020 to August 31, 2020 on payment of all instalments in respect of term loans (including agricultural term loans, retail and crop loans) and accordingly residual tenor of repayment shifted across the board. Interest continued to accrue on the outstanding portion of term loans during the moratorium period.
- ii. Working Capital Finance: The lending institutions were permitted deferment of another three months, from June 01, 2020 to August 31, 2020 on recovery of interest applied. Further, the lending institutions were permitted at their discretion, to convert accumulated interest for deferment period up to August 31, 2020 into a funded interest term loan (FITL), which shall be repayable not later than March 31, 2021.
- iii. Easing of Working Capital Finance: The relief earlier granted to working capital facilities sanctioned in the form of CC/OD to borrowers facing stress on account of the economic fallout of the pandemic, lending institutions was extended by permitting to recalculate the 'drawing power' by reducing the margins till August 31, 2020 and wherein temporary enhancement of in drawing power is considered the margins to be restored to original levels by March 31, 2021 and/or review of the working capital sanctioned limits up to March 31, 2021, based on a reassessment of working capital cycle.
- iv. The conversion of accumulated interest into FITL as permitted under this circular was not to be treated as concession granted due to financial difficulty of the borrower and consequently will not result in asset classification downgrade, thereby granting relief in the form of retention of class of asset to such accounts.
- v. Further relief was granted –as under:
 - a. In respect of accounts classified as standard as on February 29,

2020, even if overdue, the moratorium period, wherever granted in respect of term loans, shall be excluded by the lending institutions from the number of days past-due for the purpose of asset classification under the IRAC norms. The asset classification for such accounts shall be determined on the basis of revised due dates and the revised repayment schedule;

- b. in respect of working capital facilities sanctioned in the form of cash credit/overdraft ("CC/OD"), where the account is classified as standard, including SMA, as on February 29, 2020, the deferment period, wherever granted in terms of the circular shall be excluded for the determination of out of order status.

COVID19 Regulatory Package – Review of Resolution Timelines under the Prudential Framework on Resolution of Stressed Assets

11.357 The RBI issued circular RBI/2019-20/219 DOR.No.BP.BC.62/21.04.048/2019-20 dated April 17, 2020 on COVID 19 Regulatory Package - Review of Resolution Timelines under the Prudential Framework on Resolution of Stressed Assets as follows:

The relief was granted in the form of extension of timelines under the Prudential Framework on Resolution of Stressed Assets dated June 07, 2019 –

As per para 11 of the Prudential Framework, lenders are required to implement a resolution plan in respect of entities in default within 180 days from the end of Review Period of 30 days. The relaxation was given as follows:

- a. In respect of accounts which were within the Review Period as on March 1, 2020, the period from March 1, 2020 to May 31, 2020 shall be excluded from the calculation of the 30-day timeline for the Review Period. In respect of all such accounts, the residual review period shall resume from June 1, 2020, upon expiry of which the lenders shall have the usual 180 days for resolution.
- b. In respect of accounts where the review period was over, but the 180-day resolution period had not expired as on March 1, 2020, the timeline for resolution shall get extended by 90 days from the date on which the 180-day period was originally set to expire.

11.358 Accordingly, the requirement of making additional provisions specified in Paragraph 17 of the Prudential Framework shall be triggered as and when the extended resolution period, as stated above, expires.

11.359 The lending institutions shall make relevant disclosures in respect of accounts where the resolution period was extended in the 'Notes to Accounts'

while preparing their financial statements for the half year ending September 30, 2020 as well as the financial years FY2020 and FY2021.

11.360 The RBI issued Circular RBI/2019-20/245 DOR.No.BP.BC.72/21.04.048/ 2019-20 dated May 23, 2020 on COVID 19 Regulatory Package - Review of Resolution Timelines under the Prudential Framework on Resolution of Stressed Assets, thereby further extending the benefit provided vide earlier circular RBI/2019-20/219 DOR.No.BP.BC.62/21.04.048/2019-20 dated April 17, 2020 as follows:

- a. In respect of accounts which were within the Review Period as on March 1, 2020, the period from March 1, 2020 to August 31, 2020 shall be excluded from the calculation of the 30-day timeline for the Review Period. In respect of all such accounts, the residual Review Period shall resume from September 1, 2020, upon expiry of which the lenders shall have the usual 180 days for resolution.
- b. In respect of accounts where the Review Period was over, but the 180-day resolution period had not expired as on March 1, 2020, the timeline for resolution shall get extended by 180 days from the date on which the 180-day period was originally set to expire.

Resolution Framework for COVID19 related Stress

11.361 The RBI issued circular RBI/2020-21/16 DOR.No.BP.BC/3/ 21.04.048/2020-21 dated August 06, 2020 providing window under Prudential Framework to enable lenders to implement a resolution plan in respect of eligible corporate exposures without change in ownership and personal loans, while classifying such exposures as standard, subject to certain conditions. The resolution under this facility was to be extended only to borrowers having stress on account of Covid19 and the lending institutions requiring to assess the viability of resolution plan subject to laid out prudential boundaries. Further, the lending institutions are required to frame Board approved policies pertaining to implementation of viable resolution plans for eligible borrowers under this framework and also lay down the due diligence considerations to be followed to establish the necessity of implementing a resolution plan w.r.t. the concerned borrower. The reference date for outstanding amount of debt for resolution would be March 01, 2020.

11.362 The following accounts are not eligible for resolution plan under this framework:

- i. MSME borrowers whose aggregate exposure to lending institutions collectively, is Rs. 25 crore or less as on March 1, 2020;

- ii. Farm credit as listed in Paragraph 6.1 of Master Direction FIDD.CO.Plan.1/04.09.01/2016-17 dated July 7, 2016 (as updated) or other relevant instructions as applicable to specific category of lending institutions;
- iii. Loans to Primary Agricultural Credit Societies (PACS), Farmers' Service Societies (FSS) and Large-sized Adivasi Multi- Purpose Societies (LAMPS) for on-lending to agriculture;
- iv. Exposures of lending institutions to financial service providers
- v. Exposures of lending institutions to Central and State Governments; Local Government bodies and body corporates established by an Act of Parliament or State Legislature;
- vi. Exposures of housing finance companies where the account has been rescheduled in terms of para 2(1)(zc)(ii) of the Master Circular - The Housing Finance Companies (NHB) Directions, 2010 after March 1, 2020, unless a resolution plan under this framework has been invoked by other lending institutions.

11.363 Resolution of Stress in Personal Loans

- i. Eligibility:
 - a. The personal loans which are standard but not in default for more than 30 days as on March 01, 2020, i.e., accounts which are standard but not under SMA1 or SMA2 category as on March 01, 2020.
 - b. The date of invocation is the date on which both borrower and lender agree to proceed with a resolution plan under this framework. The eligible accounts should be classified as 'Standard' till the date of invocation of resolution under this framework.
- ii. The resolution can be invoked up to December 31, 2020 and must be implemented within 90 days from the date of invocation.
- iii. The resolution plan may include:
 - a. Re-scheduling of payments
 - b. Conversion of any interest accrued or to be accrued into another credit facility (FITL)
 - c. Granting of moratorium based on assessment of income streams of borrower, subject to maximum of two years and accordingly overall tenor modified commensurately. Moratorium if granted shall come into force immediately upon implementation of the resolution plan.
- iv. The resolution plan shall be deemed to be implemented if all the following

conditions are met:

- a. all related documentation, including execution of necessary agreements between lending institutions and borrower and collaterals provided, if any, are completed by the lenders concerned in consonance with the resolution plan being implemented;
 - b. the changes in the terms of conditions of the loans get duly reflected in the books of the lending institutions; and,
 - c. borrower is not in default with the lending institution as per the revised terms.
- v. Any resolution plan implemented in breach of these stipulated timeline shall be governed by Prudential Framework, as if the resolution process was never invoked under this Framework.

11.364 Resolution of Other Exposures

i. Eligibility:

- a. All the eligible exposures which are not personal loan, and are standard but not in default for more than 30 days as on March 01, 2020, i.e., accounts which are standard but not under SMA1 or SMA2 category as on March 01, 2020.
- b. The date of invocation is the date on which both borrower and lender agree to proceed with a resolution plan under this Framework. The eligible accounts should be classified as 'Standard' till date of invocation of resolution under this framework.
- c. In case of multiple lending exposures to borrower, the resolution process would be considered as invoked if
 - (1) lending institutions representing 75 per cent by value of the total outstanding credit facilities (fund based as well non-fund based), and
 - (2) not less than 60 per cent of lending institutions by number agree to invoke the same.

failing to which, the invocation will be treated as lapsed.

- ii. The resolution can be invoked up to December 31, 2020 and must be implemented within 180 days from the date of invocation.
- iii. In cases involving multiple lending institutions, where the resolution process is invoked and consequently a resolution plan has to be implemented, ICA shall be required to be signed by all lending institutions within 30 days from the date of invocation, failing to which, the invocation will be treated as lapsed.

- iv. Any resolution plan implemented in breach within the stipulated timeline shall be fully governed by Prudential Framework, as if the resolution process was never invoked under this Framework.

- v. Expert Committee:

The RBI constituted an Expert Committee to recommend a list of financial parameters which, in their opinion would be required to be factored into the assumptions that go into each resolution plan, and the sector specific benchmark ranges for such parameters. The parameters shall inter alia cover aspects related to leverage, liquidity, debt serviceability etc.

The Expert Committee submitted list of financial parameters (vide report dated September 04, 2020) and sector-specific desirable ranges for such parameters to RBI which in turn notified the Financial Parameters vide circular RBI/2020-21/34 DOR.No.BP.BC/13/21.04.048/2020-21 dated September 07, 2020.

This Expert Committee has the responsibility of vetting the resolution plans to be implemented under this window in respect of all accounts where the aggregate exposure of the lending institutions at the time of invocation of the resolution process is Rs. 1500 crore and above. The Committee would check and verify that all the processes have been followed by the parties concerned as desired without interfering with the commercial judgments exercised by the lenders.

- vi. Permitted features of Resolution Plan
 - a. Involving any action as provided in Paragraph 13 of the 'Prudential Framework' permitted except compromise settlement.
 - b. Resolution Plan may include sanctioning of additional credit facilities.
 - c. Extension of residual tenor of loan allowed, with or without moratorium, by a period not more than two years and moratorium if granted to come in force with immediate effect upon implementation of resolution plan.
 - d. The revised assumptions that go into the plan shall, at the minimum, factor in the financial parameters decided by the Expert Committee and the ranges for such parameters, as notified by RBI.
 - e. Conversion of a portion of debt into equity or other marketable, non-convertible debt securities issued by borrower permitted subject to fulfilment of conditions specified thereto.
- vii. If the aggregate exposure of the lending institutions at the time of

invocation of plan is Rs. 100 crores and above, and independent credit evaluation (ICE) by any one credit rating agency (CRA) authorised by RBI under Prudential Framework would be required.

11.365 Asset Classification and Provisioning

- i. If a resolution plan is implemented in adherence to the provisions of this facility, the asset classification of borrowers' accounts classified as Standard may be retained as such upon implementation, whereas the borrowers' accounts which may have slipped into NPA between invocation and implementation may be upgraded as Standard, as on the date of implementation of the plan.
- ii. In respect of personal loans where a resolution plan is implemented under this facility, the lending institutions shall keep provisions from the date of implementation, which are higher of the provisions held as per the extant IRAC norms immediately before implementation, or 10 percent of the renegotiated debt exposure of the lending institution post implementation (residual debt).
- iii. In other cases where a resolution plan is implemented under this facility, the lending institutions, which had signed the ICA within 30 days of invocation, shall keep provisions from the date of implementation, which are higher of the provisions held as per the extant IRAC norms immediately before implementation, or 10 percent of the total debt, including the debt securities issued in terms of clause 30, held by the ICA signatories post-implementation of the plan (residual debt).
- iv. If, lending institutions did not sign the ICA within 30 days of invocation, they shall, immediately upon the expiry of 30 days, keep provision of 20 per cent of the debt on their books as on this date (carrying debt), or the provision required as per extant IRAC norms, whichever is higher. Even in cases where the invocation lapses on account of the thresholds for ICA signing not being met, such lending institutions which had earlier agreed for invocation but did not sign the ICA shall also be required to hold 20 percent provisions on their carrying debt.
- v. Additional provision, if any, maintained by lending institutions in terms of Circular DOR.No.BP.BC.63/21.04.048/2019-20 dated April 17, 2020 in respect of such borrowers, to the extent not already reversed, may be utilised for meeting the provision requirements in all cases under this facility.
- vi. Any additional provision maintained in terms of Paragraph 17 of the Prudential Framework, wherever applicable, may be reversed at the time of

invocation of the resolution plan under this facility. However, if the plan is not implemented within 180 days from invocation, provision as per the Prudential Framework shall be required to be maintained, as if a resolution process was never invoked under this window.

11.366 Reversal of Provisions

- i. In case of personal loans resolved under this facility, half of the above provision may be written back upon the borrower paying at least 20 per cent of the residual debt without slipping into NPA post implementation of the plan, and the remaining half may be written back upon the borrower paying another 10 per cent of the residual debt without slipping into NPA subsequently.
- ii. In case of resolution of other exposures, the provision maintained by the ICA signatories may be reversed as prescribed in clause 44. However, in respect of the non-ICA signatories while half of the provision may be reversed upon repayment of 20 percent of the carrying debt, the other half may be reversed upon repayment of another 10 per cent of the carrying debt, subject to the required IRAC provisions being maintained.

11.367 Post-implementation Performance

- i. For personal loans, after implementation of the resolution plan in terms of this facility, the subsequent asset classification will be governed by the criteria laid out in the Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated July 1, 2015.
- ii. In respect of exposures other than personal loans, any default by the borrower with any of the signatories to the ICA during the monitoring period shall trigger a Review Period of 30 days. 'Monitoring period', for this purpose, is defined as the period starting from the date of implementation of the resolution plan till the borrower pays 10 per cent of the residual debt, subject to a minimum of one year from the commencement of the first payment of interest or principal (whichever is later) on the credit facility with longest period of moratorium.
- iii. If the borrower is in default with any of the signatories to the ICA at the end of the Review Period, the asset classification of the borrower with all lending institutions, including those who did not sign the ICA, shall be downgraded to NPA from the date of implementation of the resolution plan or the date from which the borrower had been classified as NPA before implementation of the plan, whichever is earlier.
- iv. In all cases, further upgradation shall be subject to implementation of a fresh restructuring under the Prudential Framework.

- v. Upon completion of the monitoring period without being classified as NPA, the asset classification norms will revert to the criteria laid out in the Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated July 1, 2015.
- vi. The provision required to be maintained under this window, to the extent not already reversed, shall be available for: (i) the provisioning requirements when any of the accounts, where a resolution plan had been implemented, is subsequently classified as NPA; as well as, (ii) the additional provisioning requirements on account of Paragraph 17 of the Prudential Framework, as and when the Prudential Framework becomes applicable in respect of the particular account.

11.368 Disclosure and Credit Reporting

- i. Lending institutions publishing quarterly statements shall, at the minimum, make disclosures as per the format prescribed in Format-A to the circular in their financial statements for the quarters ending March 31, 2021, June 30, 2021 and September 30, 2021. Such lending institutions shall also make disclosures in the format prescribed in Format-B to the circular every half-year, i.e., in the financial statements as on September 30 and March 31, starting from the half-year ending September 30, 2021 till all exposures on which resolution plan was implemented are either fully extinguished or completely slips into NPA, whichever is earlier.
- ii. Lending institutions required to publish only annual financial statements shall make the required disclosures in their annual financial statements, along with other prescribed disclosures.
- iii. The credit reporting by the lending institutions in respect of borrowers where the resolution plan is implemented under this facility shall reflect the "restructured" status of the account if the resolution plan involves renegotiations that would be classified as restructuring under the Prudential Framework. The credit history of the borrowers shall consequently be governed by the respective policies of the credit information companies as applicable to accounts that are restructured.

11.369 The RBI published FAQs on Resolution Framework for Covid-19 on October 13, 2020 related stress clarifying certain aspects related thereto.

- i. The resolution plan may include:
 - a. Re-scheduling of payments

- b. Conversion of any interest accrued or to be accrued into another credit facility (FITL)
 - c. Granting of moratorium based on assessment of income streams of borrower, subject to maximum of two years and accordingly overall tenor modified commensurately. The moratorium period if granted shall come into force immediately upon implementation of the resolution plan.
- ii. The resolution plan shall be deemed to be implemented if all the specified conditions herein below are met:
 - a. all related documentation, including execution of necessary agreements between lending institutions and borrower and collaterals provided, if any, are completed by the lenders concerned in consonance with the resolution plan being implemented;
 - b. the changes in the terms of conditions of the loans get duly reflected in the books of the lending institutions; and,
 - c. borrower is not in default with the lending institution as per the revised terms.
- iii. Any resolution plan implemented in breach of these stipulated timeline shall be governed by Prudential Framework.

Supreme Court Order dated September 03, 2020

11.370 The Supreme Court passed an interim order on September 03, 2020 in the Writ Petition filed by Gajendra Sharma, stating that 'the accounts which were not declared NPA till 31.08.2020 shall not be declared NPA till further orders'. In view of the said interim order if a bank has not classified any account as NPA subsequent to August 31, 2020, which otherwise would have been classified as NPA, the Auditor should ensure that

- 1. The Auditor shall make a suitable reference in the audit report as prescribed in Standards on Auditing, to the disclosure made by the bank along with reference to the said interim order of Supreme Court in financial statements.
- 2. In the accounts which are not marked as NPA by a bank, (which otherwise would have been required to be marked as NPA as per IRAC norms), the income recognition and provisions norms would be continued to be applied as if such accounts are marked as NPA, i.e. income on such account would be recognised on cash basis and a provision would also be made, as would have required to be made had this account been marked as NPA.

Provisioning for Loans and Advances

11.371 The RBI's Master Circular no. RBI/2015-16/101 DBR.No.BP.BC. 2/ 21.04.048/2015-16 dated July 1, 2015 on Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to advances contains the principles to be followed by the bank in calculating the provisions required for the NPAs in conformity with the prudential norms. The circular also requires the bank to take into consideration aspects such as time lag between an account becoming an NPA, its recognition as such, realisation of security and the erosion over time in the value of security charged to the bank, while calculating the required amount of provision. The specific requirements of the Master Circular in respect of provisioning are as follows:

(a) Loss assets

The entire amount should be written off. If the assets are permitted to remain in the books for any reason, 100 per cent of the outstanding should be provided for.

(b) Doubtful assets

11.372 The provisioning for doubtful assets under loans and advances is as under:

- (i) Full provision to the extent of the unsecured portion should be made. In doing so, the realisable value of the security available, to which the bank has a valid recourse, should be determined on a realistic basis. The Auditor should verify whether that security is considered based on the latest information available with the bank. Also check if DICGC/ECGC cover is taken into account.
- (ii) In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 25 to 100 per cent of secured portion depending upon the period for which the asset has remained doubtful. In case the advance covered by CGTSI guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per the extant guidelines on provisioning for non-performing advances.

<i>Period for which the advance has been considered as doubtful</i>	<i>% of provision on secured portion</i>
Up to 1 year	25
More than 1 year and up to 3 years	40
More than three years	100

Valuation of Security: With a view to bringing down divergence arising out of difference in assessment of the value of security, in cases of NPAs with balance of Rs. 5 crore and above, stock audit at annual intervals by external agencies appointed as per the guidelines approved by the Board is mandatory in order to enhance the reliability on stock valuation. Collaterals, such as immovable properties charged in favour of the bank are required to be got valued once in three years by valuers appointed as per the guidelines approved by the Board of Directors.

(c) Sub-standard assets

11.373 A general provision of 15 per cent on total outstanding should be made without making any allowance for DICGC/ECGC cover and securities available. Unsecured exposures, which are identified, as sub-standard would attract an additional provision of 10 per cent (i.e., total 25 per cent of total outstanding). However, in view of certain safeguards such as escrow accounts available in respect of infrastructure lending, infrastructure loan accounts which are classified as sub-standard will attract a provisioning of 20 per cent instead of the aforesaid prescription of 25 per cent. To avail of this benefit of lower provisioning, the banks should have in place an appropriate mechanism to escrow the cash flows and also have a clear and legal first claim on these cash flows. 'Unsecured exposure' is defined as an exposure (including all funded and non-funded exposures) where realisable value of the tangible security properly charged to the bank, as assessed by bank/approved valuers/RBI inspectors, is not more than 10 per cent, *ab initio*, of the outstanding exposure. 'Security' means tangible security properly discharged to the bank and will not include intangible securities like guarantees (including State Government guarantees), comfort letters, etc.

In order to enhance transparency and ensure correct reflection of the unsecured advances in Schedule 9 of the banks' balance sheet, the following RBI requirements are applicable from the financial year 2009-10 onwards:

- a) For determining the amount of unsecured advances for reflecting in schedule 9 of the published balance sheet, the rights, licenses, authorisations, etc., charged to the banks as collateral in respect of projects (including infrastructure projects) financed by them, should not be reckoned as tangible security. Hence such advances shall be reckoned as unsecured.
- b) However, banks may treat annuities under Build-Operate-Transfer (BOT) model in respect of road / highway projects and toll collection rights, where there are provisions to compensate the project sponsor if a certain level of traffic is not achieved, as tangible securities subject to the condition that

banks' right to receive annuities and toll collection rights is legally enforceable and irrevocable.

- c) It is noticed that most of the infrastructure projects, especially road/highway projects are user-charge based, for which the Planning Commission has published Model Concession Agreements (MCAs). These have been adopted by various Ministries and State Governments for their respective Public-Private Partnership (PPP) projects and they provide adequate comfort to the lenders regarding security of their debt. In view of the above features, in case of PPP projects, the debts due to the lenders may be considered as secured to the extent assured by the project authority in terms of the Concession Agreement, subject to the following conditions:
- i) User charges / toll / tariff payments are kept in an escrow account where senior lenders have priority over withdrawals by the concessionaire;
 - ii) There is sufficient risk mitigation, such as pre-determined increase in user charges or increase in concession period, in case project revenues are lower than anticipated;
 - iii) The lenders have a right of substitution in case of concessionaire default;
 - iv) The lenders have a right to trigger termination in case of default in debt service; and
 - v) Upon termination, the Project Authority has an obligation of (i) compulsory buy-out and (ii) repayment of debt due in a pre-determined manner.

In all such cases, banks must satisfy themselves about the legal enforceability of the provisions of the tripartite agreement and factor in their past experience with such contracts.

- d) Banks should also disclose the total amount of advances for which intangible securities such as charge over the rights, licenses, authority, etc., have been taken as also the estimated value of such intangible collateral. The disclosure may be made under a separate head in "Notes to Accounts". This would differentiate such loans from other entirely unsecured loans.

As per the existing instructions of RBI, in the Balance Sheet of the banks, the amounts comprising debtors (though not tangible assets), charged as security are grouped as secured by tangible assets and disclosure is made with a

remark in parenthesis in the Schedule 9, without any quantification of the advances covered by security of debtors. The amounts comprising the intangibles as per the RBI's Master Circular no. RBI/2015-16/101 DBR. No. BP.BC.2/21.04.048/2015-16 on Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances will need to be culled out of the secured exposures and quantified to be reflected as unsecured advances; which would also require corresponding reclassification of advances for the earlier year. More importantly, in case of NPAs, the unsecured portion would attract a higher provision, when segregated from the secured portion.

(d) Standard Assets

11.374 The bank is required to make a general provision for standard assets at the following rates for the funded outstanding on global loan portfolio basis. The general provision towards standard assets as per Master Circular is as follows:

- a) Farm Credit to Agricultural and Small and Micro Enterprises (SMEs) sectors - 0.25%.
- b) Advances to Commercial Real Estate (CRE) sector – 1.00%.
- c) Advances to Commercial Real Estate – Residential Housing Sector (CRE - RH) at 0.75 per cent.

For this purpose, CRE-RH would consist of loans to builders/developers for residential housing projects (except for captive consumption) under CRE segment. Such projects should ordinarily not include non-residential commercial real estate. However, integrated housing projects comprising of some commercial space (e.g. shopping complex, school, etc.) can also be classified under CRE-RH, provided the commercial area in the residential housing project does not exceed 10% of the total Floor Space Index (FSI) of the project. In case the FSI of the commercial area in the predominantly residential housing complex exceeds the ceiling of 10%, the project loans should be classified as CRE and not CRE-RH.

- d) Housing loans extended at teaser rates– 2.00%- The provisioning on these assets would revert to 0.40 per cent after 1 year from the date on which the rates are reset at higher rates if the accounts remain 'standard'.
- e) In terms of RBI Circular No. RBI/2016-17/317-DBR.BP.BC.No. 72/08.12.015/2016-17 dated June 07, 2017 on "Individual Housing Loans: Rationalisation of Risk-Weights and Loan to Value (LTV) Ratios", the bank should make standard asset provision of 0.25% on individual housing loan sanctioned on or after June 07, 2017. In respect of individual housing loan sanctioned before that date provisions @ 0.40% is required to be made on

standard assets in terms of Circular No. RBI/2015-16/200 DBR.BP.BC.No.44/ 08.12.015/ 2015-16 dated October 08, 2015 on "Individual Housing Loans: Rationalisation of Risk-Weights and LTV Ratios".

- f) Restructured accounts classified as standard advances will attract a higher provision (as prescribed from time to time) in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract the prescribed higher provision for the period covering moratorium and two years thereafter.

Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a higher provision (as prescribed from time to time) in the first year from the date of upgradation.

11.375 As per para 17.4.1 of Master Circular No. RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 issued on July 1, 2015 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances', with effect from April 1, 2016 provision on new restructured standard accounts would be made at 5 per cent.

All other loans and advances not included in (a), (b), (c), (d) and (e) above - 0.40%.

11.376 It is clarified that the Medium Enterprises will attract 0.40% standard asset provisioning. The RBI issued circular RBI/2020-2021/10 FIDD.MSME & NFS.BC.No.3/06.02.31/2020-21 dated July 02, 2020 specifying the criteria for classification of enterprises into micro, small and medium enterprise with reference to notification by Government of India through Gazette Notification S.O. 2119 (E) dated June 26, 2020, as regards new criteria for classifying the enterprises as Micro, Small and Medium enterprises w.e.f. July 01, 2020. Further, the RBI has issued clarifications as regards new definition of the terms Micro Enterprises, Small Enterprises, and Medium Enterprises vide circular RBI/2020-2021/26 FIDD.MSME & NFS.BC.No.4/06.02.31/2020-21 dated August 21, 2020.

11.377 While the provisions on individual portfolios are required to be calculated at the rates applicable to them, the excess or shortfall in the provisioning, *vis-a-vis* the position as on any previous date, should be determined on an aggregate basis. If the provisions required to be held on an aggregate basis are less than the provisions held as on November 15, 2008, the provisions rendered surplus should not be reversed to profit and loss account but should continue to be maintained at the level, existed as on November 15, 2008. In case of shortfall determined on aggregate basis, the balance should be provided for by debit to profit and loss account.

11.378 The provisions on standard assets should not be reckoned for arriving at net NPAs. The provisions towards Standard Assets need not be netted from gross advances but included as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions - Others' in Schedule 5 of the balance sheet.

11.379 Banks shall make additional provision of 2% (in addition to country risk provision that is applicable to all overseas exposures) against standard assets representing all exposures to the step-down subsidiaries of Indian companies, to cover the additional risk arising from complexity in the structure, location of different intermediary entities in different jurisdictions exposing the Indian company, and hence the bank, to greater political and regulatory risk. All the step-down subsidiaries, including the intermediate ones, must be wholly owned subsidiaries of the immediate parent company or its entire shares shall be jointly held by the immediate parent company and the Indian parent company and / or its wholly owned subsidiary. The immediate parent should, wholly or jointly with Indian parent company and / or its wholly owned subsidiary, have control over the step-down subsidiary.

11.380 A high level of unhedged foreign currency exposures of the entities can increase the probability of default in times of high currency volatility. Hence, banks are required to estimate the risk of unhedged position of their borrowers as per the instructions contained in RBI circular no. RBI/2013-14/448 DBOD.No.BP.BC.85/21.06.200/2013-14 dated January 15, 2014 on "Capital and Provisioning Requirements for Exposures to entities with Unhedged Foreign Currency Exposure" and circular no. RBI/2013-14/620 DBOD.No.BP.BC.116/21.06.200/2013-14 dated June 3, 2014 on "Capital and Provisioning Requirements for Exposures to entities with Unhedged Foreign Currency Exposure-Clarifications" and make incremental provisions on their exposures to such entities:

Likely Loss / EBID (%)	Incremental Provisioning Requirement on the total credit exposures over and above extant standard asset provisioning
Up to 15 per cent	0
More than 15 per cent and up to 30 per cent	20 bps
More than 30 per cent and up to 50 per cent	40 bps
More than 50 per cent and up to 75 per cent	60 bps
More than 75 per cent	80 bps

Unhedged Foreign Currency Exposure of Corporates

11.381 To ensure that each bank has a policy that explicitly recognises and takes account of risks arising out of foreign exchange exposure of their clients, foreign currency loans above US\$ 10 million, or such lower limits as may be deemed appropriate *vis-à-vis* the banks' portfolios of such exposures, should be extended by banks only on the basis of a well laid out policy of their Boards with regard to hedging of such foreign currency loans. Further, the policy for hedging, to be framed by their Boards, may consider, as appropriate for convenience, excluding the following:

- Where forex loans are extended to finance exports, banks may not insist on hedging but assure themselves that such customers have uncovered receivables to cover the loan amount.
- Where the forex loans are extended for meeting forex expenditure.

11.382 Banks may also consider stipulating a limit on unhedged position of corporates on the basis of bank's Board approved policy. In this context, attention of the readers is also invited to RBI's Circular No. DBOD.No.BP.BC.85/ 21.06.200/2013-14 on "Capital and Provisioning Requirements for Exposures to entities with Unhedged Foreign Currency Exposure" dated January 15, 2014 and clarification DBOD.No.BP.BC.116/ 21.06.200/2013-14 dated June 3, 2014 on "Capital and Provisioning Requirements for Exposures to entities with Unhedged Foreign Currency Exposure-Clarifications" providing requirements for exposures to entities with unhedged foreign currency exposure.

11.383 The Auditor while carrying out the audit of the Unhedged Foreign Currency Exposure (UFCE) should ensure that the Bank has:-

- Obtained the UFCE information from all its branches (including foreign branches) in respect of large borrowers.
- Obtained a certificate in respect of UFCE from entities on a quarterly basis on self-certification basis, which has preferably been internally audited by the entity concerned. However, at least on an annual basis, UFCE information should be audited and certified by the statutory auditors of the entity for its authenticity.
- Computed "Capital and Provisioning Requirements for Exposures to entities with UFCE" at least on a quarterly basis, as per the applicable RBI guidelines.

Provisioning requirements for derivative exposures

11.384 Credit exposures computed as per the current marked to market value of the contract, arising on account of the interest rate and foreign exchange derivative transactions, and gold, shall also attract provisioning requirement as applicable to the loan assets in the 'standard' category, of the concerned counterparties. All conditions applicable for treatment of the provisions for standard assets would also apply to the aforesaid provisions for derivative and gold exposures.

Provisioning Norms for Leased Assets

11.385

- i) Substandard assets
 - a) 15 per cent of the sum of the net investment in the lease and the unrealised portion of finance income net of finance charge component. The terms 'net investment in the lease', 'finance income' and 'finance charge' are as defined in 'AS 19 Leases' issued by the ICAI.
 - b) Unsecured lease exposures which are identified as 'substandard' would attract additional provision of 10 per cent, i.e., a total of 25 per cent.
- ii) Doubtful assets
- iii) Loss assets

Provisioning norms for aforesaid clause (ii) & (iii) are same as applicable to Advances.

Accounting and Provisioning Norms for Equipment Leasing Activity

11.386 While the accounting and provisioning norms discussed above shall also apply in respect of equipment leasing activities the bank should follow AS 19 on "Leases" issued by ICAI in accounting for lease transactions.

Advances Guaranteed by ECGC

11.387 In the case of advances guaranteed by ECGC, provision should be made only for the balance in excess of the amount of such guarantee. Further, while arriving at the provision required to be made for doubtful assets, realisable value of the securities should first be deducted from the outstanding balance in respect of the amount guaranteed by these Corporations and then provision should be made (For examples on calculation of the provision, refer the Master Circular no. RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-

16 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, dated July 1, 2015).

Advance covered by guarantees of Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) or Credit Risk Guarantee Fund Trust for Low Income Housing (CRGFTLIH)

11.388 In case the advance covered by CGTMSE or CRGFTLIH guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per the extant guidelines on provisioning for non- performing advances. For illustrative examples of provisioning in case of advances covered by CGTSL guarantee, refer Paragraph 5.9.5 of the Master Circular No. on Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances, dated July 1, 2015.

Divergences reported by RBI

11.389 After statutory audit, RBI conducts annual financial inspection of banks. Auditors may go through the divergence reported by RBI, if any, in terms of classification as well as provisioning and whether the same divergence has been appropriately addressed /clarified, by Banks. Accordingly, the Auditor would be well advised to consider these aspects while take final view on classification /provisioning of such accounts.

Reserve for Exchange Rate Fluctuations Account (RERFA)

11.390 When exchange rate movements of Indian rupee turn adverse, the outstanding amount of foreign currency denominated loans (where actual disbursement was made in Indian Rupee) which become overdue goes up correspondingly, with its attendant implications of provisioning requirements. Such assets should not normally be revalued. In case such assets need to be revalued as per requirement of accounting practices or for any other requirement, the following procedure may be adopted:

- The loss on revaluation of assets has to be booked in the bank's profit and loss account.
- Besides the provisioning requirement as per Asset Classification, banks should treat the full amount of the Revaluation Gain relating to the corresponding assets, if any, on account of Foreign Exchange Fluctuation as provision against the particular assets.

Provisioning For Country Risk

11.391 Banks are required to make provisions, with effect from the year

ending 31 March 2003, on the net funded country exposures on a graded scale ranging from 0.25 to 100 per cent according to the risk categories mentioned below. To begin with, banks are required to make provisions as per the following schedule:

Risk Category	ECGC Classification	Provisioning requirement (per cent)
Insignificant	A1	0.25
Low	A2	0.25
Moderate	B1	5
High	B2	20
Very high	C1	25
Restricted	C2	100
Off-credit	D	100

11.392 Banks are required to make provision for country risk in respect of a country where its net funded exposure is one per cent or more of its total assets. The provision for country risk shall be in addition to the provisions required to be held according to the asset classification status of the asset. In the case of 'loss assets' and 'doubtful assets', provision held, including provision held for country risk, may not exceed 100% of the outstanding. Banks may not make any provision for 'home country' exposures i.e. exposure to India. The exposures of foreign branches of Indian banks to the host country should be included. Foreign banks shall compute the country exposures of their Indian branches and shall hold appropriate provisions in their Indian books. However, their exposures to India will be excluded. Banks may make a lower level of provisioning (say 25% of the requirement) in respect of short-term exposures (i.e., exposures with contractual maturity of less than 180 days).

11.393 Provisioning norms for sale of financial assets to Securitisation Company (SC) / Reconstruction company (RC) –

- (i) When a bank / FI sells its financial assets to SC/ RC, on transfer the same will be removed from its books.
- (ii) If the sale of financial assets to SC/RC, is at a price below the net book value (NBV) (i.e., book value less provisions held), the shortfall should be debited to the profit and loss account of that year. Banks can also use countercyclical / floating provisions for meeting any shortfall on sale of

NPAs i.e., when the sale is at a price below the net book value (NBV).

However, for assets sold on or after February 26, 2014 and up to March 31, 2015, as an incentive for early sale of NPAs, banks can spread over any shortfall, if the sale value is lower than the NBV, over a period of two years. This facility of spreading over the shortfall will be subject to necessary disclosures in the Notes to Account in Annual Financial Statements of the banks. The RBI vide Notification dated May 21, 2015 had decided to extend this dispensation for assets sold on or after March 31, 2015 and up to March 31, 2016.

Further RBI has vide notification RBI/2015-16/423 DBR.No.BP.BC.102 /21.04.048/2015-16 dated June 13, 2016 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances – Spread Over of Shortfall on Sale of NPAs to SCs/RCS" has decided to extend the dispensation of amortising the shortfall up to March 31, 2017. However, for the assets sold from the period April 1, 2016 to March 31, 2017, banks will be allowed to amortise the shortfall over a period of only four quarter from the quarter in which the sale took place.

Further, where a bank chooses to make the necessary provisions over more than one quarter and this results in the full provisioning remaining to be made as on the close of a financial year, banks should debit 'other reserves' [i.e., reserves other than the one created in terms of Section 17(2) of the Banking Regulation Act 1949] by the amount remaining un-provided at the end of the financial year, by credit to specific provisions. However, banks should proportionately reverse the debits to 'other reserves' and complete the provisioning by debiting profit and loss account, in the subsequent quarters of the next financial year.

Banks shall make suitable disclosures in the 'Notes to Accounts' with regard to the quantum of provision made during the year to meet the shortfall in sale of NPAs to SCs/RCS and the quantum of unamortised provision debited to 'other reserves' as at the end of the year.

- (iii) For assets sold on or after February 26, 2014, banks can reverse the excess provision on sale of NPAs, if the sale value is for a value higher than the NBV, to its profit and loss account in the year the amounts are received. However, banks can reverse excess provision arising out of sale of NPAs only when the cash received (by way of initial consideration and / or redemption of SRs / PTCs) is higher than the net book value (NBV) of the asset. Further, reversal of excess provision will be limited to the extent to which cash received exceeds the NBV of the asset. With regard to assets sold before February 26, 2014, excess provision, on

account of sale value being higher than NBV, should not be reversed but should be utilized to meet the shortfall/ loss on account of sale of other financial assets to SC/RC.

- (iv) When banks/ FIs invest in the security receipts/ pass-through certificates issued by SC/RC in respect of the financial assets sold by them to the SC/RC, the sale shall be recognised in the books of the banks / FIs at the lower of:
- the redemption value of the security receipts/ pass-through certificates; and
 - the NBV of the financial asset.

The above investment should be carried in the books of the bank / FI at the price as determined above until its sale or realization, and on such sale or realization, the loss or gain must be dealt with in the same manner as at (ii) and (iii) above.

11.394 All instruments received by banks/FIs from SC/RC as sale consideration for financial assets sold to them and also other instruments issued by SC/ RC in which banks/ FIs invest will be in the nature of non SLR securities. Accordingly, the valuation, classification and other norms applicable to investment in non-SLR instruments prescribed by RBI from time to time would be applicable to bank's/ FI's investment in debentures/ bonds/ security receipts/PTCs issued by SC/ RC. However, if any of the above instruments issued by SC/RC is limited to the actual realisation of the financial assets assigned to the instruments in the concerned scheme the bank/ FI shall reckon the Net Asset Value (NAV), obtained from SC/RC from time to time, for valuation of such investments.

11.395 Investments of banks and FIs in debentures/ bonds/ security receipts/PTCs issued by a SC/RC will constitute exposure on the SC/RC. As only a few SC/RC are being set up now, banks'/ FIs' exposure on SC/RC through their investments in debentures/ bonds/security receipts/PTCs issued by the SC/ RC may go beyond their prudential exposure ceiling. In view of the extra ordinary nature of such event, banks/ FIs will be allowed, in the initial years, to exceed prudential exposure ceiling on a case-to-case basis. Banks/ FIs, which sell their financial assets to a SC/ RC, shall be required to make the disclosures in the Notes on Accounts in their Balance sheets. For guidelines on the presentation of the disclosures, refer Para 6.6 of the Master Circular no. RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/ 2015-16 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances.

Write-off of NPAs

11.396 Banks without forgoing the right of recovery, may prudentially write off non-performing advances and claim tax benefits as applicable, by evolving appropriate methodology in consultation with their auditors / tax consultants. Subsequent recoveries in such accounts should be offered for tax as per the rules. Banks may write-off advances at Head Office level, even though the advances are still outstanding in the branch books. At the branch level, provision requirement as per classification norms shall be made and in respect of loss assets 100 per cent provision shall be made.

Readers may refer Chapter 25 "Recovery of Non-Performing Assets by Asset Recovery Branches" of Section B of this Guidance Note for Guidelines on Sale/Purchase of NPAs.

Audited Financial Statements in case of Bank Borrowers

11.397 The RBI *vide* Circular no. DBOD.No. CAS(COD)BC.146/27-77 dated December 22, 1977 had prescribed that all borrowers having credit limit of Rs.10 lakh and above from the banking system should get their annual accounts audited by chartered accountants. Further the RBI *vide* circular DBOD.No.BP.BC.33/21.04.018/2002-03 dated October 21, 2002 on "Certification of Borrower's Account by Chartered Accountants" has authorised the Board of Directors of banks to fix a suitable cut off limit with reference to the borrowing entity's overall exposure on the banking system, over which audit of accounts of borrower by chartered accountants would be mandatory.

Projects under Implementation

11.398 For all projects financed by the FIs/ banks after 28th May 2002, the date of completion of the project should be clearly spelt out at the time of financial closure of the project.

Project Loans

11.399 There are occasions when the completion of projects is delayed for legal and other extraneous reasons like delays in Government approvals etc. All these factors, which are beyond the control of the promoters, may lead to delay in project implementation and involve restructuring/rescheduling of loans by banks. Accordingly, the following asset classification norms would apply to the project loans before commencement of commercial operations. These guidelines will, however, not be applicable to restructuring of advances classified as Commercial Real Estate exposures; Advances classified as Capital Market exposure; and Consumer and Personal Advances which will continue to be dealt with in terms of the extant provisions. For this purpose, all project loans have been divided into the following two categories:

- a. Project loans for infrastructure sector.
- b. Project loans for non-infrastructure sector.

'Project loan' would mean any term loan which has been extended for the purpose of setting up of an economic venture. Banks must fix a date of Commencement of Commercial Operations (DCCO) for all project loans at the time of sanction of the loan / financial closure (in the case of multiple banking or consortium arrangements).

Project Loans for Infrastructure Sector

11.400

- (i) A loan for an infrastructure project will be classified as NPA during any time before commencement of commercial operations as per record of recovery (90 days overdue), unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (v) below.
- (ii) A loan for an infrastructure project will be classified as NPA if it fails to commence commercial operations within two years from the original DCCO, even if it is regular as per record of recovery, unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (v) below.
- (iii) If a project loan classified as 'standard asset' is restructured any time during the period up to two years from the original date of commencement of commercial operations (DCCO), in accordance with the provisions of Part B of this Master Circular, it can be retained as a standard asset if the fresh DCCO is fixed within the following limits, and further provided the account continues to be serviced as per the restructured terms.
 - (a) Infrastructure Projects involving court cases
Up to another 2 years (beyond the existing extended period of 2 years i.e. total extension of 4 years), in case the reason for extension of date of commencement of production is arbitration proceedings or a court case.
 - (b) Infrastructure Projects delayed for other reasons beyond the control of promoters
Up to another 1 year (beyond the existing extended period of 2 years i.e. total extension of 3 years), in other than court cases.
- (iv) It is re-iterated that the dispensation is subject to adherence to the provisions regarding restructuring of accounts as contained in the Master Circular which would *inter alia* require that the application for restructuring

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should be received before the expiry of period of two years from the original DCCO and when the account is still standard as per record of recovery.

The other conditions applicable would be:

- a. In cases where there is moratorium for payment of interest, banks should not book income on accrual basis beyond two years from the original DCCO, considering the high risk involved in such restructured accounts.
- b. Banks should maintain provisions on such accounts as long as these are classified as standard assets as under:

Particulars	Provisioning Requirement
If the revised DCCO is within two years from the original DCCO prescribed at the time of financial closure	0.40 per cent
If the DCCO is extended beyond two years and up to four years or three years from the original DCCO, as the case may be, depending upon the reasons for such delay	Project loans restructured with effect from June 1, 2013: 5.00 per cent – From the date of such restructuring till the revised DCCO or 2 years from the date of restructuring, whichever is later.

- (v) For the purpose of these guidelines, mere extension of DCCO would not be considered as restructuring, if the revised DCCO falls within the period of two years from the original DCCO. In such cases the consequential shift in repayment period by equal or shorter duration (including the start date and end date of revised repayment schedule) than the extension of DCCO would also not be considered as restructuring provided all other terms and conditions of the loan remain unchanged.
- (vi) In case of infrastructure projects under implementation, where the appointed date (as defined in the concession agreement) is shifted due to the inability of the Concession Authority to comply with the requisite conditions, change in date of commencement of commercial operations (DCCO) need not be treated as 'restructuring', subject to following conditions:

- a. The project is an infrastructure project under public private partnership model awarded by a public authority.
- b. The loan disbursement is yet to begin.
- c. The revised date of commencement of commercial operations is documented by way of a supplementary agreement between the borrower and lender.
- d. Project viability has been reassessed and sanction from appropriate authority has been obtained at the time of supplementary agreement.

Project Loans for Non-Infrastructure Sector

- 11.401 (i) A loan for a non-infrastructure project will be classified as NPA during any time before commencement of commercial operations as per the record of recovery (90 days overdue), unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (iv) below.
- (ii) A loan for a non-infrastructure project will be classified as NPA if it fails to commence commercial operations within one year from the original DCCO, even if is regular as per record of recovery, unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (iv) below.
- (iii) In case of non-infrastructure projects, if the delay in commencement of commercial operations extends beyond the period of one year from the date of completion as determined at the time of financial closure, banks can prescribe a fresh DCCO, and retain the "standard" classification by undertaking restructuring of accounts in accordance with the provisions contained in this Master Circular, provided the fresh DCCO does not extend beyond a period of two years from the original DCCO. This would among others also imply that the restructuring application is received before the expiry of one year from the original DCCO, and when the account is still "standard" as per the record of recovery.

The other conditions applicable would be:

- a. In cases where there is moratorium for payment of interest, banks should not book income on accrual basis beyond one year from the original DCCO, considering the high risk involved in such restructured accounts.
- b. Banks should maintain provisions on such accounts as long as these are classified as standard assets as under:

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Particulars	Provisioning Requirement
If the revised DCCO is within one year from the original DCCO prescribed at the time of financial closure	0.40 per cent
If the DCCO is extended beyond one year and up to two years from the original DCCO prescribed at the time of financial closure	Project loans restructured with effect from June 1, 2013: 5.00 per cent – From the date of restructuring for 2 years.

- (iv) For this purpose, mere extension of DCCO would not be considered as restructuring, if the revised DCCO falls within the period of two years from the original DCCO. In such cases the consequential shift in repayment period by equal or shorter duration (including the start date and end date of revised repayment schedule) than the extension of DCCO would also not be considered as restructuring provided all other terms and conditions of the loan remain unchanged.

Project Loans in Commercial Real Estate (CRE) Sector

11.402 The project loans to CRE sector should be identified on the basis of instructions issued vide circulars DBOD.BP.BC.No.42/08.12.015/2009-10 dated September 9, 2009 and DBOD.BP.BC. No.104/08.12.015/2012-13 dated June 21, 2013.

11.403 The RBI vide circular RBI/2019-20/158 DOR.No.BP.BC.33/ 21.04.048 /2019-20 dated February 07, 2020 harmonised the guidelines for deferment of date of DCCO for projects in non-infrastructure and commercial real estate (CRE) sectors. Accordingly, revised guidelines for deferment of DCCO for CRE projects were issued as follows:

- (i) Revisions of the date of DCCO and consequential shift in repayment schedule for equal or shorter duration (including the start date and end date of revised repayment schedule) will not be treated as restructuring provided that:
- The revised DCCO falls within the period of one year from the original DCCO stipulated at the time of financial closure for CRE projects; and
 - All other terms and conditions of the loan remain unchanged.
- (ii) In case of CRE projects delayed for reasons beyond the control of promoter(s), banks may restructure them by way of revision of DCCO up to another one year (beyond the one-year period quoted at paragraph i (a) above) and retain the 'standard' asset classification if the account continues

to be serviced as per the revised terms and conditions under the restructuring.

- (iii) Banks while restructuring such CRE project loans under instructions at (ii) above will have to ensure that the revised repayment schedule is extended only by a period equal to or shorter than the extension in DCCO.
- (iv) Banks may fund cost overruns that arise on account of extension of DCCO (within the limits at (i) and (ii) above), subject to the instructions issued vide circular DBOD.No.BP.BC.33/21.04.048/2014-15 dated August 14, 2014 and the mailbox clarification dated April 20, 2016.
- (v) It is re-iterated that a loan for a project may be classified as NPA during any time before commencement of commercial operations as per the record of recovery (90 days overdue). It is further re-iterated that the dispensation at (ii) above is subject to the condition that the application for restructuring should be received before the expiry of period mentioned at paragraph (i) (a) above and when the account is still standard as per record of recovery.
- (vi) At the time of extending DCCO, Boards of banks should satisfy themselves about the viability of the project and the restructuring plan.
- (vii) All other aspects related to restructuring, income recognition, asset classification, provisioning as applicable for projects under implementation shall continue to apply.
- (viii) Banks shall ensure that all provisions of the Real Estate (Regulation and Development) Act, 2016 are complied with.

Change in Ownership

- 11.404 (i) In order to facilitate revival of the projects stalled primarily due to inadequacies of the current promoters, if a change in ownership takes place any time during the periods quoted in paragraphs 4.2.15.3 of the Master Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 was issued on July 1, 2015 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances" or before the original DCCO, banks may permit extension of the DCCO of the project up to two years in addition to the periods quoted at paragraph 4.2.15.3 of the aforesaid circular as the case may be, without any change in asset classification of the account subject to the conditions stipulated in the following paragraphs. Banks may also consequentially shift/extend repayment schedule, if required, by an equal or shorter duration.
- (ii) In cases where change in ownership and extension of DCCO (as indicated in paragraph 4.2.15.5 (i) of the aforesaid circular) takes place before the

original DCCO, and if the project fails to commence commercial operations by the extended DCCO, the project will be eligible for further extension of DCCO in terms of guidelines quoted at Paragraph 4.2.15.3 of the aforesaid circular. Similarly, where change in ownership and extension of DCCO takes place during the period quoted in Paragraph 4.2.15.3 (i) of the aforesaid circular, the account may still be restructured by extension of DCCO in terms of guidelines quoted at Paragraph 4.2.15.3 (ii) of the aforesaid circular, without classifying the account as non-performing asset.

- (iii) The provisions of Paragraphs 4.2.15.4 (i) and 4.2.15.4 (ii) of the aforesaid circular are subject to the following conditions:
- a. Banks should establish that implementation of the project is stalled/affected primarily due to inadequacies of the current promoters/management and with a change in ownership there is a very high probability of commencement of commercial operations by the project within the extended period.
 - b. The project in consideration should be taken-over/acquired by a new promoter/promoter group with sufficient expertise in the field of operation. If the acquisition is being carried out by a special purpose vehicle (domestic or overseas), the bank should be able to clearly demonstrate that the acquiring entity is part of a new promoter group with sufficient expertise in the field of operation.
 - c. The new promoters should own at least 51 per cent of the paid up equity capital of stake in the acquired project. If the new promoter is a non-resident, and in sectors where the ceiling on foreign investment is less than 51 per cent, the new promoter should own atleast 26 per cent of the paid up equity capital or up to applicable foreign investment limit, whichever is higher, provided banks are satisfied that with this equity stake the new non-resident promoter controls the management of the project.
 - d. Viability of the project should be established to the satisfaction of the banks.
 - e. Intra-group business restructuring/mergers/acquisitions and/or takeover/acquisition of the project by other entities/subsidiaries/associates etc. (domestic as well as overseas), belonging to the existing promoter/promoter group will not qualify for this facility. The banks should clearly establish that the acquirer does not belong to the existing promoter group.
 - f. Asset classification of the account as on the 'reference date' would

continue during the extended period. For this purpose, the 'reference date' would be the date of execution of preliminary binding agreement between the parties to the transaction, provided the acquisition/takeover of ownership as per the provisions of law/regulations governing such acquisition/takeover is completed within a period of 90 days from the date of execution of preliminary binding agreement. During the intervening period, the usual asset classification norms would continue to apply. If the change in ownership is not completed within 90 days from the preliminary binding agreement, the 'reference date' would be the effective date of acquisition/takeover as per the provisions of law/regulations governing such acquisition/ takeover.

- g. The new owners/promoters are expected to demonstrate their commitment by bringing in substantial portion of additional monies required to complete the project within the extended time period. As such, treatment of financing of cost overruns for the project shall be subject to the guidelines prescribed in paragraph 13 of the circular. Financing of cost overrun beyond the ceiling prescribed in paragraph 13 of the circular would be treated as an event of restructuring even if the extension of DCCO is within the limits prescribed above.
 - h. While considering the extension of DCCO (up to an additional period of 2 years) for the benefits envisaged hereinabove, banks shall make sure that the repayment schedule does not extend beyond 85 per cent of the economic life/concession period of the project.
 - i. This facility would be available to a project only once and will not be available during subsequent change in ownership, if any.
- (iv) Loans covered under this guideline would attract provisioning as per the extant provisioning norms depending upon their asset classification status.

Other Issues

- 11.405 (i) All other aspects of restructuring of project loans before commencement of commercial operations would be governed by the provisions of Part B of Master Circular no. RBI/2015-16/101 DBR.No.BP.BC.2/ 21.04.048/2015-16 on Prudential norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances. Restructuring of project loans after commencement of commercial operations will also be governed by these instructions.
- (ii) Any change in the repayment schedule of a project loan caused due to an increase in the project outlay on account of increase in scope and size of the project, would not be treated as restructuring if:

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- (a) The increase in scope and size of the project takes place before commencement of commercial operations of the existing project;
 - (b) The rise in cost excluding any cost-overflow in respect of the original project is 25 per cent or more of the original outlay;
 - (c) The bank re-assesses the viability of the project before approving the enhancement of scope and fixing a fresh DCCO; and
 - (d) On re-rating, (if already rated) the new rating is not below the previous rating by more than one notch.
- (iii) Multiple revisions of the DCCO and consequential shift in repayment schedule for equal or shorter duration (including the start date and end date of revised repayment schedule) will be treated as a single event of restructuring provided that the revised DCCO is fixed within the respective time limits stipulated at Paragraphs 4.2.15.3 (iii) and 4.2.15.4 (iii) of the Master Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 on "Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances", dated July 1, 2015 and all other terms and conditions of the loan remained unchanged.
- (iv) Banks, if deemed fit, may extend DCCO beyond the respective time limits stipulated at Paragraphs 4.2.15.3 (iii) and 4.2.15.4 (iii) of the Master Circular No. RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 on "Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances", dated July 1, 2015; however, in that case, banks will not be able to retain the 'standard' asset classification status of such loan accounts.
- (v) In all the above cases of restructuring where regulatory forbearance has been extended, the Boards of banks should satisfy themselves about the viability of the project and the restructuring plan.
- (vi) The RBI vide Circular No. RBI/2014-15/182 DBOB. No.BP.BC.33/21.04.048/2014-15 dated August 14, 2014 on "Prudential Norms on Income Recognition, Assets Classification and Provisioning Pertaining to Advances – Project under Implementation" (read with Master Circular no. RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 dated July 01, 2015 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances), mentions that banks have represented to RBI that in respect of funding of cost overruns, which may arise on account of extension of DCCO within the above (i.e.; two years and one year for infrastructure and non-infrastructure projects respectively from original DCCO date with other terms and conditions remain

unchanged), time limits may be allowed without treating the loans as restructured.

- (vii) In cases where banks have specifically sanctioned a 'standby facility' at the time of initial financial closure to fund cost overruns, they may fund cost overruns as per the agreed terms and conditions.
- (viii) Where the initial financial closure does not envisage such financing of cost overruns, based on the representations from banks, it has been decided to allow banks to fund cost overruns, which may arise on account of extension of DCCO within the time limits quoted at Paragraph (i) above, without treating the loans as 'restructured asset' subject to the following conditions:
 - (a) Banks may fund additional 'Interest during Construction', which may arise on account of delay in completion of a project.
 - (b) Other cost overruns (excluding Interest during Construction) up to a maximum of 10 per cent of the original project cost.
 - (c) Debt equity ratio as agreed at the time of initial financial closure should remain unchanged subsequent to funding cost overruns or improve in favour of the lenders and the revised Debt Service Coverage Ratio should be acceptable to the lenders.
 - (d) Disbursement of funds for cost overruns should start only after the Sponsors/Promoters bring in their share of funding of the cost overruns.
 - (e) All other terms and conditions of the loan should remain unchanged or enhanced in favour of the lenders.

Flexible structuring of Long Term Project Loans to Infrastructure and Core Industries

- 11.406(i) In view of the challenges faced by Banks, the RBI has clarified in Circular no. DBOD.No.BP.BC.24/21.04.132/2014-15 on Flexible Structuring of Long Term Project Loans to Infrastructure and Core Industries dated July 15, 2014 (read with Master Circular no. RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 dated July 01, 2015 on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances), that it has no objection to banks' to fix longer amortisation period for loans to projects in infrastructure and core industries sectors, say 25 years, based on the economic life or concession period of the project, with periodic refinancing, say every 5 years. For details refer to the circular.
- (ii) The RBI has further clarified in circular no. DBR.No.BP.BC.53/21.04.132/2014-15 dated December 15, 2014 on "Flexible Structuring of

Existing Long Term Project Loans to Infrastructure and Core Industries” that the flexible structuring of existing loans will be allowed in addition to new loans as per the norms given in the circular.

- (iii) For detailed guidelines on the Flexible structuring of Long Term Project Loans, refer para 10 and 11 of the Master Circular DBR.No.BP.BC.2/ 21.04.048/ 2015-16 on “Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances”.

Income recognition

- 11.407 (i) Banks may recognise income on accrual basis in respect of the projects under implementation, which are classified as ‘standard’.
- (ii) Banks should not recognise income on accrual basis in respect of the projects under implementation which are classified as a ‘substandard’ asset. Banks may recognise income in such accounts only on realisation on cash basis. Consequently, banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognised as income in the previous year(s). As regards the regulatory treatment of ‘funded interest’ recognised as income and ‘conversion into equity, debentures or any other instrument’ banks should adopt the following:
 - a) **Funded Interest:** Income recognition in respect of the NPAs, regardless of whether these are or are not subjected to restructuring/ rescheduling/ renegotiation of terms of the loan agreement, should be done strictly on cash basis, only on realisation and not if the amount of interest overdue has been funded. If, however, the amount of funded interest is recognised as income, a provision for an equal amount should also be made simultaneously. In other words, any funding of interest in respect of NPAs, if recognised as income, should be fully provided for.
 - b) **Conversion into equity, debentures or any other instrument:** The amount outstanding converted into other instruments would normally comprise principal and the interest components. If the amount of interest dues is converted into equity or any other instrument, and income is recognised in consequence, full provision should be made for the amount of income so recognised to offset the effect of such income recognition. Such provision would be in addition to the amount of provision that may be necessary for the depreciation in the value of the equity or other instruments, as per the investment valuation norms. However, if the conversion of interest is into equity which is quoted, interest income can be recognised at market value of equity,

as on the date of conversion, not exceeding the amount of interest converted to equity. Such equity must thereafter be classified in the "available for sale" category and valued at lower of cost or market value. In case of conversion of principal and /or interest in respect of NPAs into debentures, such debentures should be treated as NPA, *ab initio*, in the same asset classification as was applicable to loan just before conversion and provision made as per norms. This norm would also apply to zero coupon bonds or other instruments which seek to defer the liability of the issuer. On such debentures, income should be recognised only on realization basis. The income in respect of unrealised interest which is converted into debentures or any other fixed maturity instrument should be recognized only on redemption of such instrument. Subject to the above, the equity shares or other instruments arising from conversion of the principal amount of loan would also be subject to the usual prudential valuation norms as applicable to such instruments.

Provisioning norms on restructured advances

Normal provisions

11.408

- (i) Banks will hold provision against the restructured advances as per the extant provisioning norms.
- (ii) Restructured accounts classified as standard advances will attract a higher provision (as prescribed from time to time) in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract the prescribed higher provision for the period covering moratorium and two years thereafter.
- (iii) Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a higher provision (as prescribed from time to time) in the first year from the date of upgradation.
- (iv) The above-mentioned higher provision on restructured standard advances (2.75 per cent as prescribed vide circular dated November 26, 2012) would increase to 5 per cent in respect of new restructured standard accounts (flow) with effect from June 1, 2013 and increase to 5% by FY: 2015-16 in a phased manner for the stock of restructured standard accounts as on May 31, 2013.

Provision for diminution in the fair value of restructured advances-

- 11.409 (i) Reduction in the rate of interest and/or rescheduling of the repayment

of principal amount, as part of the restructuring, will result in diminution in the fair value of the advance. Such diminution in value is an economic loss for the bank and will have impact on the bank's market value of equity. It is, therefore, necessary for banks to measure such diminution in the fair value of the advance and make provisions for it by debit to Profit and Loss Account. Such provision should be held in addition to the provisions as per existing provisioning norms and in an account distinct from that for normal provisions.

For this purpose, the erosion in the fair value of the advance should be computed as the difference between the fair value of the loan before and after restructuring. Fair value of the loan before restructuring will be computed as the present value of cash flows representing the interest at the existing rate charged on the advance before restructuring and the principal, discounted at a rate equal to the bank's BPLR or Base Rate⁴ (whichever is applicable to the borrower) as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring. Fair value of the loan after restructuring will be computed as the present value of cash flows representing the interest at the rate charged on the advance on restructuring and the principal, discounted at a rate equal to the bank's BPLR or base rate (whichever is applicable to the borrower) as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring.

The above formula moderates the swing in the diminution of present value of loans with the interest rate cycle and will have to be followed consistently by banks in future. Further, it is reiterated that the provisions required as above arise due to the action of the banks resulting in change in contractual terms of the loan upon restructuring which are in the nature of financial concessions. These provisions are distinct from the provisions which are linked to the asset classification of the account classified as NPA and reflect the impairment due to deterioration in the credit quality of the loan. Thus, the two types of the provisions are not substitute for each other.

- ii) There could be divergences in the calculation of diminution of fair value of accounts by banks. For example, divergences could occur if banks do not appropriately factor in the term premium on account of elongation of repayment period on restructuring. In such a case the term premium used

⁴ This change has been introduced as a result of the introduction of Base Rate System w.e.f. July 1, 2010 vide circular DBOD.No.Dir.BC.88/13.03.00/2009-10 dated April 9, 2010 on 'Guidelines on the Base Rate'.

while calculating the present value of cash flows after restructuring would be higher than the term premium used while calculating the present value of cash flows before restructuring.

Further, the amount of principal converted into debt/equity instruments on restructuring would need to be held under AFS and valued as per usual valuation norms. Since these instruments are getting marked to market, the erosion in fair value gets captured on such valuation. Therefore, for the purpose of arriving at the erosion in the fair value, the NPV calculation of the portion of principal not converted into debt/equity has to be carried out separately. However, the total sacrifice involved for the bank would be NPV of the above portion plus valuation loss on account of conversion into debt/equity instruments.

The Auditor should therefore verify that the bank has correctly captured diminution in fair value of restructured accounts as it will have a bearing not only on the provisioning required to be made by them but also on the amount of sacrifice required from the promoters.

The Auditors should also verify that there is no any effort on the part of banks to artificially reduce the net present value of cash flows by resorting to any sort of financial engineering. The Auditor should also verify that there is a proper mechanism in place of checks and balances to ensure accurate calculation of erosion in the fair value of restructured accounts.

11.410 In the case of working capital facilities, the diminution in the fair value of the cash credit / overdraft component may be computed as indicated in para 17.4.2 (i) of Master Circular No. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/2015-16 issued on July 1, 2015 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances", reckoning the higher of the outstanding amount or the limit sanctioned as the principal amount and taking the tenor of the advance as one year. The term premium in the discount factor would be as applicable for one year. The fair value of the term loan components (Working Capital Term Loan and Funded Interest Term Loan) would be computed as per actual cash flows and taking the term premium in the discount factor as applicable for the maturity of the respective term loan components.

11.411 If any security is taken in lieu of the diminution in the fair value of the advance, it should be valued at Re.1/- till maturity of the security. This will ensure that the effect of charging off the economic sacrifice to the Profit and Loss account is not negated.

11.412 The diminution in the fair value may be re-computed on each balance

sheet date till satisfactory completion of all repayment obligations and full repayment of the outstanding in the account, so as to capture the changes in the fair value on account of changes in BPLR or base rate (whichever is applicable to the borrower), term premium and the credit category of the borrower. Consequently, banks may provide for the shortfall in the provision or reverse the amount of excess provision held in the distinct account.

11.413 If due to lack of expertise / appropriate infrastructure, a bank finds it difficult to ensure computation of diminution in the fair value of advances, as an alternative to the methodology prescribed above for computing the amount of diminution in the fair value, the bank has the option of notionally computing the amount of diminution in the fair value and providing therefor, at five percent of the total exposure, in respect of all restructured accounts where the total dues to bank(s) are less than rupees one crore. The total provisions required against an account (normal provisions plus provisions in lieu of diminution in the fair value of the advance) are capped at 100 per cent of the outstanding debt amount.

Risk-Weights

11.414 The RBI circular also provides that:

- a. Restructured housing loans should be risk weighted with an additional risk weight of 25 percentage points.
- b. With a view to reflecting a higher element of inherent risk which may be latent in entities whose obligations have been subjected to restructuring / rescheduling either by banks on their own or along with other bankers / creditors, the unrated standard / performing claims on corporates should be assigned a higher risk weight of 125 per cent until satisfactory performance under the revised payment schedule has been established for one year from the date when the first payment of interest / principal falls due under the revised schedule.
- c. For details on risk weights, Master Circular RBI/2015-16/58 DBR.No.BP.BC.1/21.06.201/ 2015-16 dated July 1, 2015 on 'Basel III Capital Regulations' may be referred.

Prudential Norms for Conversion of Principal into Debt / Equity

Asset classification norms

11.415 A part of the outstanding, principal amount can be converted into debt or equity instruments as part of restructuring. The debt / equity instruments so created will be classified in the same asset classification category in which the restructured advance has been classified. Further movement in the asset classification of these instruments would also be determined based on the subsequent asset classification of the restructured advance.

Income recognition norms

Standard Accounts

11.416 In the case of restructured accounts classified as 'standard', the income, if any, generated by these instruments may be recognised on accrual basis.

Non- Performing Accounts

11.417 In the case of restructured accounts classified as non-performing assets, the income, if any, generated by these instruments may be recognised only on cash basis.

Valuation and provisioning norms

11.418 These instruments should be held under AFS and valued as per usual valuation norms. Equity classified as standard asset should be valued either at market value, if quoted, or at break-up value, if not quoted (without considering the revaluation reserve, if any) which is to be ascertained from the company's latest balance sheet. In case the latest balance sheet is not available, the shares are to be valued at Re. 1. Equity instrument classified as NPA should be valued at market value, if quoted, and in case where equity is not quoted, it should be valued at Re. 1. Depreciation on these instruments should not be offset against the appreciation in any other securities held under the AFS category.

Prudential Norms for Conversion of Unpaid Interest into 'Funded Interest Term Loan' (FITL), Debt or Equity Instruments

Asset classification norms

11.419 The FITL / debt or equity instrument created by conversion of unpaid interest will be classified in the same asset classification category in which the restructured advance has been classified. Further movement in the asset classification of FITL / debt or equity instruments would also be determined based on the subsequent asset classification of the restructured advance.

Income recognition norms

11.420 The income, if any, generated by these instruments may be recognised on accrual basis, if these instruments are classified as 'standard', and on cash basis in the cases where these have been classified as a non-performing asset.

11.421 The unrealised income represented by FITL / Debt or equity instrument should have a corresponding credit in an account styled as "Sundry Liabilities Account (Interest Capitalization)".

11.422 In the case of conversion of unrealised interest income into equity,

which is quoted, interest income can be recognized after the account is upgraded to standard category at market value of equity, on the date of such upgradation, not exceeding the amount of interest converted into equity.

11.423 Only on repayment in case of FITL or sale / redemption proceeds of the debt / equity instruments, the amount received will be recognized in the P&L Account, while simultaneously reducing the balance in the "Sundry Liabilities Account (Interest Capitalisation)".

Valuation and Provisioning norms

11.424 Valuation and provisioning norms would be as referred above. The depreciation, if any, on valuation may be charged to the Sundry Liabilities (Interest Capitalisation) Account.

Introduction

B. Whether the branch is following the system of classification the accounts into SMA-0, SMA-1, and SMA-2. Whether the auditor disagrees with the branch classification of advances into standard (Including SMA-0, SMA-1, SMA-2) /substandard/doubtful/ loss assets, the details of such advances with reasons should be given. Also indicate whether required changes have been incorporated/ suggested in the Memorandum of Changes.

Audit Procedures and Reporting

11.425

- (i) The auditor should obtain a listing of NPA classification obtained from the system. If the same does not tally then a reconciliation should be obtained.
- (ii) If auditor does not agree with classification given by branch, he should give necessary details along with reasons for the same.
- (iii) This point also requires the Auditor to indicate whether suitable changes have been incorporated in Memorandum of Changes as well.

C. Have you come across cases where the relevant Controlling Authority of the bank has authorized legal action for recovery of advances or recalling of advances but no such action was taken by the branch? If so, give details of such cases.

Audit Procedures and Reporting:

11.426 The Auditor should ask for the list of cases from the management, where approval for legal action for recovery of advances has been obtained from controlling authority of bank. The Auditor should verify these cases and comment

where branch has not taken any legal action so far or taken with delay. Reasons for delay should be ascertained.

D. Whether the branch has reported accounts restructured or rephased during the year to Controlling Authority of the bank?

Audit Procedures and Reporting:

11.427 The Auditor should verify reporting of the accounts restructured or rephased during the year, to the controlling authority of the bank.

E. Have appropriate claims for credit guarantee (ECGC and Others), if any, been duly lodged and settled? Give details of claims rejected? (As per the given table)

Particulars	Number		Amount (Rs)
Claims as at the beginning of the year (Give year-wise details)	-----	N.A.	-----
Further claims lodged during the year	-----	N.A.	-----
Total A			
Amounts representing :			
(a) claims accepted/settled	-----		-----
(b) claims rejected			
Total B			
Balance as at the year-end (
A-B	-----	N.A.	-----

Whether the rejection is appropriately considered while determining the provisioning requirements.

Audit Procedures and Reporting:

11.428 (i) The Auditor should verify that there is process of identifying the cases, where claims are required to be lodged for credit guarantee (like ECGC and others)

(ii) The Auditor should verify, whether in a required case, branch has taken step for lodging the claims and same have been lodged.

- (iii) The Auditor should obtain the numbers of accounts with outstanding balance relating to credit guarantee claims (like ECGC and any other claims). He should furnish year-wise breakup of number of account with amount in prescribed format for claims as at beginning of the year, claims lodged, accepted /settled/ rejected during the year and balance at year end.
- (iv) In cases where claims have been rejected, the Auditor should verify and comment whether the rejection is appropriately considered while determining the provisioning requirements.

F. In respect of non-performing assets, has the branch obtained valuation reports from approved valuers for the immovables charged to the bank, once in three years, unless the circumstances warrant a shorter duration?

Relevant Provision

11.429 Valuation reports should be obtained from empanelled valuers. The bank should have a system of prior tracking of cases where the period of 3 years is expiring

11.430 According to the guidelines; the provisioning for doubtful assets under loans and advances is as under:

- (i) Full provision to the extent of the unsecured portion should be made. In doing so, the realizable value of the security available, to which the bank has a valid recourse, should be determined on a realistic basis. The Auditor should verify whether the security is considered based on the latest information available with the bank. Check if DICGC/ECGC cover is also taken into account.
- (ii) In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 25 to 100 per cent of secured portion depending upon the period for which the asset has remained doubtful. In case the advance covered by CGTMSE / CRGFTLIH / CGTSI guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per the extant guidelines on provisioning for non-performing advances.

Period for which the advance has been considered as doubtful	% of provision on secured portion
Up to 1 year	25
More than 1 year and up to 3 years	40
More than three years	100

Note on valuation of Security: With a view to bringing down divergence arising out of difference in assessment of the value of security, in cases of NPAs with balance of Rs. 5 crore and above, stock audit at annual intervals by external agencies appointed as per the guidelines approved by the Board is mandatory in order to enhance the reliability on stock valuation. Collaterals, such as immovable properties charged in favour of the bank are required to be got valued once in three years by valuers appointed as per the guidelines approved by the Board of Directors.

Audit Procedures and Reporting

- 11.431 (i) The Auditor should verify and comment whether, in case of NPA accounts, branch has obtained approved valuer report for fixed assets charged to bank once in three years or shorter duration as prescribed by the bank. If there is any deviation same should be commented upon.
- (ii) The Auditor should also verify and comment on compliance of Notes given at the end of clause 5.3 of prudential norms master circular dated July 1, 2014 for stock audit and valuation of collaterals by external agencies in case of NPAs with balance of Rs. 5 crore and above.

G. In the cases examined by you has the branch complied with the Recovery Policy prescribed by the controlling authorities of the bank with respect to compromise/settlement and write-off cases? Details of the cases of compromise/settlement and write-off cases involving write-offs/ waivers in excess of Rs.50.00 lakhs may be given.

11.432 Audit Procedures and Reporting

- (i) The Auditor should verify the cases of compromise/settlement and write off during the year. The Auditor should verify that prescribed policy of the bank for compromise/settlement and write off is followed by the branch. Approval from designated authority has been obtained as per policy in all cases.
- (ii) The Auditor should obtain the details of all cases of compromise/ settlement and write off cases involving write off/waiver in excess of Rs. 50 lacs and submit along with report.

Renewal/ Enhancement/ Re-scheduling/ Balance Confirmation

Renewal

11.433 WCDL is granted for a fixed period on the expiry of which it has to be liquidated, renewed or rolled over. Depending on the terms of sanction the repayment of WCDL can either be in the form of instalments spread over the tenure of the facility or bullet payment at the end of the tenure of the loan. WCDL is generally granted to meet the gap in working capital requirement and

considered as a part of working capital facility at the time of renewal or roll over.

Each bank has its own procedures for sanctioning, disbursal, supervision and renewal of advances. Following is the common process across banks w.r.t. advances.

Renewal of Advances

11.434 Working capital advances are generally granted for one year at a time and require renewal if the borrower wants to continue the facility beyond that period at the same level, reduced level or increased level, depending upon the borrower's needs, its financial ratios, the bank's perception of risk and so on. Loans repayable over a period of time in instalments are not renewed. However, some banks have a system of reviewing these loans from time to time primarily with the objective of risk evaluation and interest rate resetting. The procedure described above for sanction of advances is also followed, to the extent applicable, for renewal of advances already granted to an applicant.

11.435 The RBI guidelines require banks to renew the advances within 6 months of the expiry of the limit. Hence no working capital limit can remain without being reviewed for more than 18 months. It should be ensured that the latest audited balance sheet, various compliance proofs should be on bank's record. Further the various monitoring reports such as inspections, stock audit and operations in the account should be taken cognisance of during renewal.

Non-renewal sometimes may appear to be administrative delay but it may not be so. Hence stricter compliances should be ensured.

Long Form Audit Report

11.436 The auditor has to comment on various specific issues as mentioned in the Long Form Audit Report of the bank. While evaluating the efficacy of internal controls over advances, the auditor should particularly examine those aspects on which he is required to comment in his long form audit report. Thus, he should examine, *inter alia*, whether the loan applications are complete and in prescribed form; procedural instructions regarding grant/ renewal/enhancement of facilities have been complied with; sanctions are within delegated authority and disbursements are as per terms of the sanction; documentation is complete; and supervision is timely, effective and as per prescribed guidelines. The auditor can gather the requisite evidence by examining relevant documents (such as loan application forms, supporting documentation, sanctions, security documents, etc.) and by obtaining information and explanations from the branch management in appropriate cases. The auditors must familiarise themselves with those issues and guidance relating to the same and should cover the same during the regular course of audit of advances.

Enhancement

11.437 At the time of renewal of working capital facilities, the borrower may ask for increase in the existing facilities, which is called enhancement. All the other process is similar to that of renewal of working capital facilities, except the exposure is higher than the earlier sanction.

Rescheduling / Restructuring

Retail Assets

11.438 The retail assets in various banks at present form a significant part of their portfolio. As there are large numbers of accounts in these cases, the same poses a challenge for the auditors. The classification and provisioning towards the same should, however, be done as in case of other assets.

11.439 There may be a large number of accounts under retail assets, which have been restructured/rescheduled during the respective years including repetitive rephasements. The process of the bank to report / record all such rescheduling / restructuring needs to be reviewed and adequacy of the same should be checked. In case of restructuring of consumer and personal advances, the same should immediately be treated as NPA. The accounts are treated as restructured when the bank, for economic or legal reasons relating to borrower's financial difficulty, grants to the borrower concessions that the bank would otherwise not consider. The HO of the bank should instruct properly to branches in this regard.

Restructuring of cases

11.440 RBI has given guidelines for treatment of restructured accounts in part B of the Master Circular no. RBI/2015-16/101 DBR. No. BP. BC. 2/ 21. 04. 048 / 2015-16 on Prudential Norms on Income Recognition, Assets Classification and Provisioning Pertaining to Advances dated July 1, 2015.

11.441 RBI has given guidelines for early recognition of financial distress whereby Joint Lenders Forum (JLF) will give a Corrective Action Plan (CAP) in part C of the Master Circular no. RBI/2015-16/101 DBR. No. BP. BC. 2/ 21. 04. 048 / 2015-16 on Prudential Norms on Income Recognition, Assets Classification and Provisioning Pertaining to Advances dated July 1, 2015.

11.442 RBI has given flexible restructuring scheme in Circular no. DBOD.No.BP.BC.24/ 21.04.132/2014-15 dated July 15, 2014 on "Flexible Structuring of Long Term Project Loans to Infrastructure and Core Industries".

11.443 RBI has given SDR restructuring scheme in Circular no.

DBR.BP.BC.No.101/ 21.04.132/2014-15 dated June 8, 2015 on "Strategic Debt Restructuring Scheme".

11.444 RBI has given outside SDR restructuring scheme in Circular no. DBR.BP.BC.No.41/ 21.04.048/2015-16 dated September 24, 2015 on "Prudential Norms on Change in Ownership of Borrowing Entities (Outside Strategic Debt Restructuring Scheme)".

11.445 RBI has given S4A Scheme for sustainable structuring of stressed assets in Circular no. DBR.No.BP.BC.103/21.04.132/2015-16 dated June 13, 2016 on "Scheme for Sustainable Structuring of Stressed Assets".

11.446 RBI has issued circular no. DBR.No.BP.BC.101/21.04.048/2017-18 dated February 12, 2018 regarding Resolution of Stressed Assets – Revised Framework, and subsequently issued circular no. DBR.No.BP.BC.45/ 21.04.048/2018-19 dated June 7, 2019 regarding Prudential Framework for Resolution of Stressed Assets, whereby the extant instructions on resolution of stressed assets such as Framework for Revitalising Distressed Assets, Corporate Debt Restructuring Scheme, Flexible Structuring of Existing Long Term Project Loans, Strategic Debt Restructuring Scheme (SDR), Change in Ownership outside SDR, and Scheme for Sustainable Structuring of Stressed Assets (S4A) stand withdrawn with immediate effect. Accordingly, the Joint Lenders' Forum (JLF) as mandatory institutional mechanism for resolution of stressed accounts also stands discontinued.

11.447 Once the bank receives an application/proposal in respect of an account for restructuring, it implies that the account is intrinsically weak. Thereby during the time the account remains pending for restructuring, the auditors need to take a view whether provision needs to be made in respect of such accounts pending approval for restructuring.

11.448 Existing loans to MSMEs classified as 'standard' may be restructured without a downgrade in the asset classification, subject to the following conditions:

- i. The aggregate exposure, including non-fund based facilities, of banks and NBFCs to the borrower does not exceed Rs. 25 crore as on March 1, 2020.
- ii. The borrower's account was a 'standard asset' as on March 1, 2020.
- iii. The restructuring of the borrower account is implemented by March 31, 2021.
- iv. The borrowing entity is GST-registered on the date of implementation of the restructuring.
- v. Asset classification of borrowers classified as standard may be retained as

such, whereas the accounts which may have slipped into NPA category between March 2, 2020 and date of implementation of resolution plan may be upgraded as 'standard asset', as on the date of implementation of the restructuring plan.

- vi. For accounts restructured under these guidelines, banks shall maintain additional provision of 5% over and above the provision already held by them.

[Reference: RBI notification DOR.No.BP .BC/4/21.04.048/2020-21 dated August 6, 2020]

11.449 Vide Paragraphs 4 & 7 of RBI notification DOR.No.BP.BC.71/21.04.048/2019-20 dated May 23, 2020, In respect of working capital facilities sanctioned in the form of CC/OD to borrowers facing stress on account of the economic fallout of the pandemic, banks may, as a one- time measure,

- (i) recalculate the 'drawing power' by reducing the margins till August 31, 2020. However, in all such cases where such a temporary enhancement in drawing power is considered, the margins shall be restored to the original levels by March 31, 2021; and/or,
- (ii) review the working capital sanctioned limits up to March 31, 2021, based on a reassessment of the working capital cycle.

The above measures shall be contingent on the banks satisfying themselves that the same is required on account of the economic fallout from COVID-19. Further, accounts provided relief under these instructions shall be subject to subsequent supervisory review with regard to their justifiability. Banks may, accordingly, put in place a Board approved policy to implement the above measures.

Funding of Interest

11.450 In addition, the auditor should also consider the fact that during the course of restructuring/rescheduling in any manner, the interest element, in addition to the principal may also be rescheduled by the bank. This rescheduling of interest may be with or without sacrifice. In some cases future interest may also be funded apart from the principal. In such cases, the Auditor should examine whether the RBI's requirements with regard to provisioning for sacrifice have been complied with by the bank. In case of interest sacrifice, the model prescribed by RBI includes calculation and provisioning for sacrifice on future interest as well. The Auditor should examine the terms of funding of interest and if the same is in the nature of moratorium for payment of interest, then the interest would become due only after the moratorium period is over. The funded interest cannot be recognised as income if the account is treated as NPA.

11.451 In respect of working capital facilities sanctioned in the form of cash credit/overdraft ("CC/OD"), banks are permitted to allow a deferment from March 1, 2020 to August 31, 2020, on recovery of interest applied in respect of all such facilities. Banks are permitted, at their discretion, to convert the accumulated interest for the deferment period up to August 31, 2020, into a funded interest term loan (FITL) which shall be repayable not later than March 31, 2021. The conversion of accumulated interest into FITL are permitted to the borrowers to specifically tide over economic fallout from COVID-19 and not be treated as concessions granted due to financial difficulty of the borrower [Reference: Paragraphs 3 & 7 of RBI notification DOR.No.BP.BC.71/21.04.048/2019-20 dated May 23, 2020].

Sacrifice of interest

11.452 In respect of sacrifice of interest, the Auditor should examine the following questions:

- (a) Whether interest sacrifice involved in the amount of interest has been provided for by debit to Profit and Loss account and held in a distinct account.
- (b) Whether sacrifice is recomputed on each balance sheet date till satisfactory completion of all repayment obligations and full repayment of the outstanding in the account, so as to capture the changes in the fair value on account of changes in BPLR/ Base Rate, term premium and the credit category of the borrower and the consequent shortfall in provision or reversal of the amount of excess provision has been held in the distinct account.
- (c) Whether in the event any security taken against interest sacrifice, the same has been valued at Re.1/- till maturity of the security. As per RBI norms, the interest sacrifice in all the restructured cases needs to be worked out including for Working Capital Loans. In the case of working capital facilities, the diminution in the fair value of the cash credit /overdraft component may be computed reckoning the higher of the outstanding amount or the limit sanctioned as the principal amount and taking the tenor of the advance as one year. The term premium in the discount factor would be as applicable for one year. The fair value of the term loan components (Working Capital Term Loan and Funded Interest Term Loan) would be computed as per actual cash flows and taking the term premium in the discount factor as applicable for the maturity of the respective term loan components. The process of identifying such interest sacrifice in case of working capital loans needs to be looked into in details.

In case the bank has agreed to convert existing/future exposure to the borrower in to Funded Interest Term Loan, such interest should be parked under sundry liabilities and should not be reckoned as income.

Balance Confirmation

Examining the Validity of Recorded Amounts

11.453 The Auditor should ascertain the status of balancing of subsidiary ledgers relating to advances. The total of balances in the subsidiary ledgers should agree with the control accounts in the General Ledger. The Auditor should also tally the total of the statement of advances with the balances as per general ledger/ subsidiary ledgers. He should also cross-check the balances of the advances selected for examination as listed in the statement of advances with the balances in the relevant advance accounts in the subsidiary ledgers. Banks often obtain balance confirmation statements from borrowers periodically. Such statements have a dual advantage in preventing disputes by the customer and extending the period of limitation by reference to the date of confirmation. Wherever available, such confirmations may be seen.

Borrowing Arrangements

Nature of Borrowing Arrangements

11.454 The following paragraphs explain the different ways in which a banking arrangement can be tied up by a borrower.

Sole Banking

11.455 In this arrangement, the borrower obtains credit from a single bank. This is the simplest form of tie-up and is operationally convenient for both the lender and the borrower. Most of the banking tie-ups in India are of this type because the quantum of bank finance in an individual case is usually small. Depending on the nature and extent of credit facility offered, the lending bank itself may stipulate that the borrower will not avail of finance from another bank.

Consortium Arrangement

11.456 In this type of arrangement, the number of lending banks is more than one. The lending banks form a formal consortium. Salient features of the arrangement are:

- The consortium has a formal leader, called the 'lead bank' (normally though not necessarily, the bank with the largest exposure).
- The consortium frames and adopts its rules within the RBI framework for

conducting its business with the borrower.

- There is a common set of loan documents, which is obtained by the lead bank on behalf of other participating banks also.
- The lead bank is responsible for overall monitoring.
- The member banks of the consortium have rights over the security in an agreed proportion.
- The borrower maintains direct business relationship with all member banks of the consortium.
- Minutes of the consortium meetings are circulated amongst the members.
- Banks should exchange information about the conduct of the borrowers' accounts with other banks at least at quarterly intervals.

Multiple Banking

11.457 In this type of arrangement, there is no formal arrangement amongst the lending banks. Each of them has its set of loan documents, securities and mode of lending, independent of other lending banks. The borrower has to deal with each of the banks separately.

11.458 The RBI, *vide* its Circular No. DBOD No. BP. BC.46/ 08.12.001/2008-09 dated September 19, 2008 on "Lending under Consortium Arrangement/Multiple Banking Arrangements", encourages the banks to strengthen their information back-up about the borrowers enjoying credit facilities from multiple banks as under:

- (i) At the time of granting fresh facilities, banks may obtain declaration from the borrowers about the credit facilities already enjoyed by them from other banks, as prescribed in the RBI Circular No. DBOD.No.BP.BC.94 /08.12.001/2008-09 dated December 08, 2008 on "Lending under Consortium Arrangement/Multiple Banking Arrangements". In the case of existing lenders, all the banks may seek a declaration from their existing borrowers availing sanctioned limits of Rs.5.00 crores and above or wherever, it is in their knowledge that their borrowers are availing credit facilities from other banks, and introduce a system of exchange of information with other banks as indicated above.
- (ii) Subsequently, banks should exchange information about the conduct of the borrowers' accounts with other banks at least at quarterly intervals.
- (iii) Obtain Diligence Report by a professional at regular intervals, regarding compliance of various statutory prescriptions that are in vogue, as per specimen given in the RBI Circular.

Prudential Exposure Norms

Prudential Exposure Limits

11.459 With a view to achieve a better risk management and avoidance of concentration of credit risk, the RBI from time to time, prescribes, limits on exposure of a bank to individual borrowers and groups of borrowers in India. The Master Circular No. RBI/2015-16/70 DBR.No.Dir.BC.12/13.03.00/ 2015-16 dated July 1, 2015 on "Exposure Norms", lays down the ceiling on credit exposure to individual/group borrowers in relation to bank's capital fund as defined under capital adequacy standards (Tier-I and Tier-II Capital). Further the RBI has issued Circular no. DBR.No.BP.BC.43/21.01.003/2018-19 dated June 03, 2019 and Circular no. DOR.No.BP.BC.43 /21.01.003/2019-20 dated March 23, 2020 on "Large Exposures Framework (LEF)".

Single and Group Borrower Limits

11.460 *Large Exposure Limits- Single Counterparty:* The sum of all the exposure values of a bank to a single counterparty must not be higher than 20 per cent of the bank's available eligible Tier I capital base at all times. In exceptional cases, the Board of banks may allow an additional 5 per cent exposure of the bank's available eligible capital base. Banks shall lay down a Board approved policy in this regard.

11.461 *Groups of Connected Counterparties:* The sum of all the exposure values of a bank to a group of connected counterparties must not be higher than 25 per cent of the bank's available eligible Tier I capital base at all times.

11.462 *Exposures to NBFCs: Single NBFC:* Banks' exposures to a single NBFC will be restricted to 15 per cent% of their eligible Tier I capital base.

11.463 *Group of connected NBFCs or group of connected counterparties having NBFCs in the group:* banks' exposure will be restricted to 25 per cent of their Tier I Capital. Where the bank has exceeded the above referred prudential exposure limit, the same should be appropriately disclosed in the "Notes to Accounts" to the Balance Sheet.

11.464 With effect from June 03, 2019, In order to capture exposures and concentration risk more accurately and to align the above instructions with international norms, the following amendments have been incorporated in the above mentioned instructions:

- i) Exclusion of entities connected with the Sovereign from the definition of group of connected counterparties.

- ii) Introduction of economic interdependence criteria in definition of connected counterparties.
- iii) Mandatory application of look-through approach (LTA) in determination of relevant counterparties in case of collective investment undertakings, securitisation vehicles and other structures.

Disinvestment Programme of the Government of India

11.465 On account of banks' financing of acquisition of PSU shares under the Government of India disinvestment programmes, if any bank, is likely to exceed the regulatory ceiling of single / group borrower limit, RBI will consider relaxation on specific requests from banks in the single/group credit exposure norms on a case by case basis, provided that the bank's total exposure to the borrower, net of its exposure due to acquisition of PSU shares under the Government of India disinvestment programme, should be within the prudential single/group borrower exposure ceiling prescribed by RBI.

Sector Specific Limit

11.466 Apart from limiting the exposures to an individual or a borrower group as indicated above, banks may also consider fixing internal limits for aggregate commitments to specific sectors, e.g. textiles, jute, tea, etc., so that the exposures are evenly spread over various sectors. These limits could be fixed by the banks having regard to the performance of different sectors and the risks perceived. The limits so fixed may be reviewed periodically and revised, as necessary.

Bills Purchased/Discounted under Letter of Credit(LC)

11.467 In cases where the bills discounting/purchasing/negotiating bank and LC issuing bank are different entities, bills purchased/ discounted/ negotiated under LC (where payment to the beneficiary is not "under reserve") should be treated as an exposure on LC issuing bank and not on borrower. In the case of negotiations "under reserve", the exposure will be treated as an exposure on the borrower. However, in cases where the bills discounting/purchasing/ negotiating bank and LC issuing bank are part of the same bank, i.e. where LC is issued by the Head Office or branch of the same bank, then the exposure should be taken on the third party/borrower and not on the LC issuing bank.

Lending for Real Estate

11.468 Banks are required to frame comprehensive prudential norms relating to the ceiling on the total amount of real estate loans, single/group exposure limits for such loans, margins, security, repayment schedule and availability of supplementary finance and the policy should be approved by the banks' Boards.

The disbursements in case of these loans should be made only after the borrower has obtained requisite clearances from the government authorities.

11.469 The RBI has also required that the banks' Boards may also consider incorporation of aspects relating to adherence to National Building Code (NBC) in their policies on exposure to real estate. The information regarding the NBC can be accessed from the website of Bureau of Indian Standards (www.bis.org.in). Banks should also adopt the National Disaster Management Authority (NDMA) guidelines and suitably incorporate them as part of their loan policies, procedures and documentation.

Financing of Joint Ventures

11.470 Banks are allowed to extend credit/non-credit facilities (viz. letters of credit and guarantees) to Indian Joint Ventures/Wholly-owned Subsidiaries abroad and step-down subsidiaries which are wholly owned by the overseas subsidiaries of Indian corporates. Banks are also permitted to provide at their discretion, buyer's credit/acceptance finance to overseas parties for facilitating export of goods and services from India. The above exposure will, however, be subject to a limit of 20 percent of banks' unimpaired capital funds (Tier I and Tier II capital) and would be subject to the conditions laid down in this regard in the Master Circular no. RBI/2015-16 /95 DBR.No.Dir.BC.10/13.03.00/2015-16 on 'Loans and Advances – Statutory and Other Restrictions' dated July 1, 2015.

Limits on Banks' Exposure to Capital Markets

Statutory limit on shareholding in companies

11.471 No banking company is permitted to hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30 per cent of the paid-up share capital of that company or 30 per cent of its own paid-up share capital and reserves, whichever is less, except as provided in sub-section (1) of Section 19 of the Banking Regulation Act, 1949. Shares held in demat form should also be included for the purpose of determining the exposure limit. This is an aggregate holding limit for each company.

Regulatory Limit

A. Solo Basis

11.472 The aggregate exposure of a bank to the capital markets in all forms (both fund based and non-fund based) should not exceed 40 per cent of its net worth as on March 31 of the previous year. Within this overall ceiling, the bank's direct investment in shares, convertible bonds / debentures, units of equity-oriented mutual funds and all exposures to Venture Capital Funds (VCFs) [both registered and unregistered] should not exceed 20 per cent of its net worth.

B. Consolidated Basis

11.473 The aggregate exposure of a consolidated bank to capital markets (both fund based and non-fund based) should not exceed 40 per cent of its consolidated net worth as on March 31 of the previous year. Within this overall ceiling, the aggregate direct exposure by way of the consolidated bank's investment in shares, convertible bonds/debentures, units of equity-oriented mutual funds and all exposures to VCFs [both registered and unregistered] should not exceed 20 per cent of its consolidated net worth⁵.

Sectoral Distribution

11.474 Advances are required to be classified, *inter alia*, into those in India and those outside India, with further sub-classification under each category. One such sub-classification that merits discussion from an Auditor's perspective is advances in India to priority sectors.

11.475 Priority sector advances include:

- Advances for agriculture and other allied activities – However, RBI, *vide* its circular no. RPCD.CO.Plan.BC. 51 /04.09.01/2010-11 dated February 2, 2011 on "Classification of loans against gold jewellery" clarifies that loans sanctioned to NBFCs for on-lending to individuals or other entities against gold jewellery, are not eligible for classification under agriculture sector. Similarly, investments made by banks in securitised assets originated by NBFCs, where the underlying assets are loans against gold jewellery, and purchase/assignment of gold loan portfolio from NBFCs are also not eligible for classification under agriculture sector.
- RBI *vide* its master circular no RBI/2018-19/02 FIDD.FID.BC.No.02/12.01.033/ 2020-21 dated July 01, 2020 has provided details on SHG-Bank linkage Programme. In order to enable the banks to report their SHG lending without difficulty, it was decided that the banks should report their lending to SHGs and for on-lending to SHGs/members of SHGs under the new segment, *viz.* 'Advances to SHGs' irrespective of the purposes for which the loan have been disbursed members of SHGs. Lending to SHGs should be included by the banks as part of their lending to the weaker sections (under priority section).
- Advances to minority communities.

⁵ Attention of the readers is drawn to Master Circular of RBI, DBR.No.Dir.BC.12/13.03.00/2015-16 dated 1 July 2015 "Exposure Norms", for components of capital exposure, exclusions, method of computation of capital exposure for the purpose and Intra-day limits.

- Advances to micro/small/medium scale enterprises⁶.
- Advances to small road transport operators.
- Advances to retail traders and small business enterprises.
- Advances to professionals and self-employed.
- Advances sanctioned to State sponsored organisations for scheduled castes/scheduled tribes.
- Educational loans up to the prescribed limit – RBI, *vide* its circular no. RPCD.SME & NFS.BC.No. 69/06.12.05 /2009-10 dated April 12, 2010 on “Collateral Free Loans - Educational Loan Scheme”, clarified that banks must not, mandatorily, obtain collateral security in the case of educational loans up to Rs. 4 lakh.
- Housing loans up to prescribed limits⁷.
- Funds provided to RRBs.
- Micro credit⁸.
- Any other priority sector advances, such as SEPUP (Self-Employment Programme for Urban Poor), PMRY (Prime Minister's Rozgar Yojana), SEEU (Self-Employment Scheme for Educated Unemployed Youth) SGSY (Swarna jayanti Gram swaraj Swarozgar Yojana)⁹, SJSRY (Swarna jayanti Sahakari Rozgar Yojana).

11.476 Priority sector advances generally carry an interest rate, which is lower than the normal rate of interest on lending to other sectors. These advances are also known as DRI advances, i.e., advances on which differential rate of interest is applicable. Under the Reserve Bank of India's guidelines, a specified proportion of the total advances of banks are to be made to priority sectors

⁶ The RBI has issued a master Direction no. RBI/FIDD/2017-18/56 FIDD.MSME & NFS. 12/06.02.31/2017-18 on “Lending to Micro, Small and Medium Enterprises (MSME) Sector” dated July 24, 2017 (updated as on April 25, 2018). Also refer circular no. RPCD.SME & NFS.BC.No.79/06.02.31/2009-10 dated May 6, 2010 on “Working Group to Review the Credit Guarantee Scheme for Micro and Small Enterprises (MSEs) – Collateral free loans to MSEs”.

⁷ Attention is also invited to circular no. DBOD.No.BP.BC. 69 /08.12.001/2010-11 dated December 23, 2010 on “Housing Loans by Commercial Banks – LTV Ratio, Risk Weight and Provisioning”, circular no. RPCD.MSME & NFS.BC.No. 30 /06.11.01/ 2012-13 dated September 18, 2012 on “Scheme of 1% interest subvention on housing loans up to Rs. 15 lakh” and Master circular no. DBR. No.DIR.BC.13/08.12.001/2015-16 dated July 1, 2015 on “Housing Finance”.

⁸ The RBI has issued a master circular no. RPCD.MFFI.BC.No. 05/12.01.001/2010-11 dated July 1, 2010 on “Micro Credit”.

⁹ Attention is the readers is drawn to master circular No. FIDD.CO.Plan.BC.04/04.09.01/2015-16 dated July 1, 2015 on “Priority Sector Lending - Special Programmes – Swarna jayanti Gram Swarozgar Yojana (SGSY)” and Circular No. RPCD.GSSD.BC.No.30 /09.01.01/2010 -11 dated December 15, 2010 on “Swarna jayanti Gram Swarozgar Yojana (SGSY) - Group Life Insurance Scheme”.

necessarily. Depending upon the nature and type of facilities extended, the bank may get subsidy from the Government to fully or partly offset the shortfall in interest rate and/or get indemnified for bad debts for the whole or a portion of such advances.

11.477 RBI has issued guidelines for the targets and sub-targets set under priority sector lending for all scheduled commercial banks operating in India. For detailed information on the guidelines, refer RBI Direction no. RBI/FIDD/2016-17/33 Master Direction FIDD.CO.Plan.1/04.09.01/2016-17 dated July 07, 2016 (Updated as on December 05, 2019) on "Priority Sector Lending – Targets and Classification".

11.478 Government of India vide Notification dated February 04, 2016 has specified "Dealing in Priority Sector Lending Certificates (PSLCs) in accordance with the Guidelines issued by Reserve Bank of India" as a form of business under Section 6 (1)(o) of the Banking Regulation Act, 1949. The purpose of PSLCs is to enable banks to achieve the priority sector lending target and sub-targets by purchase of these instruments in the event of shortfall and at the same time incentivize the surplus banks; thereby enhancing lending to the categories under priority sector. Refer RBI circular NO. FIDD.CO.Plan.BC.23/04.09.01/2015-16 dated April 07, 2016 on "Priority Sector Lending Certificates" for detailed guidelines on PSLCs.

Recovery mechanisms

11.479 This topic has been prepared with the sole intention of helping the auditors who are doing the audit of Asset Reconstruction Management Branches (ARMB) or any other branch which have one or more of the non-performing assets (NPA) of a Bank or an Institution, understand the usual legal recovery options available in a broad manner. This note is not intended to provide a detailed insight to such options but only to provide a quick and an overall perspective in a simple and brief manner. In this topic, the term "Bank" also stands for Financial Institutions.

11.480 An account declared as NPA by a Bank warrants that the Bank take steps for recovery of the outstanding dues. Such steps can involve steps like rescheduling, re-phasing or restructuring of the outstanding loans. However, with the spurt in the NPA levels across the banking sector, the Reserve Bank of India – in departure to earlier guidelines – has issued revised guidelines from time to time which usually makes it mandatory for Banks to declare an account as NPA irrespective of the fact that the account could have been/ or is restructured.

11.481 This topic provides an insight to the following measures that a Bank initiates once an account has been classified as NPA:

1. Recovery using the provisions of the SARFAESI Act, 2002.
2. Recovery using the provisions of the Recovery of Debt dues to Banks and Financial Institutions Act, 1993.
3. Recovery using the Lok Adalats.
4. Recovery using the provisions of the Insolvency and Bankruptcy Code (IBC).

1. Recovery using the provisions of the SARFAESI Act, 2002

11.482 The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI) empowers Banks / Financial Institutions to recover their Non-Performing Assets (NPA) without the intervention of the Court.

11.483 The provisions of this Act are applicable only for NPA loans in the following circumstances:

- Contractual dues is above Rs. One Lakh (Rs. 1.00 lakh).
- The default must have occurred i.e. account should have become NPA as per RBI norms.
- Securities are available in the loan account by way of hypothecation or mortgage or assignment.
- The security charges to the Bank must be specific, clear and available to the Bank. It must be duly and effectively charged to the bank and therefore, enforceable if the borrower fails to pay in response to notice.
- The securities available are enforceable in nature – agricultural land, aircrafts and vessels are not covered under the Act.
- Amount due is more than 20 per cent of the principal amount and interest thereon.
- There is a single lender for an account or a secured asset or 60 per cent of the lenders in a consortium structured consent for action.

11.484 The Act provides three alternative methods for recovery of non-performing assets, namely: -

- a. Securitisation
- b. Asset Reconstruction
- c. Enforcement of Security without the intervention of the Court

a. Securitisation

It refers to the process of drawing and converting of loans and other financial assets into marketable securities worth selling to the investors. In other words, it involves repackaging of less liquid assets into saleable securities. The securitization company takes over the mortgaged assets of the borrower and is entitled to adopt the following steps:

- Getting hold of financial assets from bank.
- Creating funds from eligible institutional buyers by dint of issuing security receipts to acquire the financial assets.
- Fund raising in any legal way.
- Financial asset acquisition along with taking over the mortgaged assets (such as building, land etc.).

Asset Reconstruction Companies (ARC) – which can do the above – have been created as a result of this Act.

b. Asset Reconstruction

It refers to conversion of non-performing assets into performing assets. There are multiple steps to reconstruct asset. The point to be noted in this context is that the reconstruction must be done in accordance with the SARFAESI Act and RBI regulations.

c. Enforcement of Security without the intervention of the Court

The Act empowers the Bank/ ARC:

- To issue demand notice (Section 13 (2)) to the defaulting borrower and guarantor, calling upon them to discharge their dues in full within 60 days from the date of the notice.
- To give notice to any person who has acquired any of the secured assets from the borrower to surrender the same to the Bank.
- To ask any debtor of the borrower to pay any sum due or becoming due to the borrower.

11.485 If on receipt of demand notice, the borrower makes any representation or raises any objection, the Authorised Officer shall consider such representation or objection carefully and if he comes to the conclusion that such representation or objection is not acceptable or tenable, he shall communicate the reasons for non-acceptance within one week of receipt of such representation or objection.

11.486 A borrower / guarantor aggrieved by the action of the Bank can file an appeal with DRT and then with DRAT, but not with any civil court. The borrower / guarantor has to deposit 50 per cent of the dues before an appeal with DRAT.

11.487 If the borrower fails to comply with the notice, the Bank may take recourse to one or more of the following measures:

- Take possession of the security
- Sale or lease or assign the right over the security
- Manage the same or appoint any person to manage the same

Concluding remarks

11.488 Recovery action under this route is very popular as it does not entail a Court administered mechanism and therefore is much faster and often cost effective. Action under SARFAESI provisions must adhere to the provisions of the Limitation Act though SARFAESI action itself is not considered to be an action tenable under Limitation Act and hence a separate suit must be filed in the Court to adhere to the provisions of the Limitation Act by the Bank.

2. Recovery through the Recovery of Debt dues to Banks and Financial Institutions Act, 1993

11.489 This Act was enacted in 1993 to facilitate speedy recovery of loans due to Banks and Institutions that were until then in the domain of Civil Courts. Debt Recovery Tribunals (DRTs) were created as a result of this Act. The main objective and role of DRT is the recovery of dues from borrowers payable to banks and financial institutions. The Tribunals power is limited to settle cases regarding the restoration of the unpaid amount from NPAs as declared by the banks under the RBI guidelines. The Tribunal has all the powers vested with the District Court. The Tribunal also has a Recovery officer who guides in executing the recovery Certificates as passed by the Presiding Officers.

Applicability of the Act

11.490 The Act applies to the following cases:

- Where the amount of debt due is not less than Rs. 20,00,000/-.
- When the original application for recovery of debts is filed only by Banks and Financial Institutions.

Composition of DRT

11.491 DRT is controlled over by a Presiding Officer, who is qualified to be a District Judge and is appointed by notification by Central Government. The

Central Government may also authorise another presiding officer of a DRT other than discharging the function of a presiding officer of a DRT.

Documents Required

11.492 Every application should be furnished by a paper book (called Original application or OA in short), by the affected Bank containing details such as:

- A statement showing details of the debt due from a borrower and the circumstances under which such debt has become due.
- Any documents relied upon by the Bank and those mentioned in the application by the Bank.
- Details including crossed Bank Draft or Indian Postal Order representing the application fee.
- Index of the documents produced.

DRT Application contents

11.493

- Particulars of debt.
- Particulars of security interest.
- Estimated value of security.
- If estimated value is less than the amount due then details of other assets owned by debtor.
- Application to DRT seeking an order to disclose the other properties owned by debtor.
- The application must be accompanied by true copies all documents relied upon to substantiate the claim.
- Documents include statement of account or entry duly certified.

Procedure at Filing the Case in DRT

11.494 The following procedures are to be followed at the time of filing the case in the debt recovery tribunal.

- The Recovery Application, in the prescribed format, should be submitted with the DRT within the specified time (as applicable under the Limitation Act).
- Recovery Application should contain the description of all relevant documents and securities charged to the Bank.
- Interim reliefs such as the injunction against properties, attachment before

judgement, the appointment of Receiver, Recovery Certificate for admitted dues should be appealed as a rule.

- Account Extracts to be provided and certified as per the provisions of Bankers Books Evidence Act and be annexed to the Recovery Application.

Procedure after Filing the Case in DRT

11.495 The following procedures are to be followed after filing the case in debt recovery tribunal.

- If the Recovery Application filed is satisfied in all respects, DRT will issue a serial number and summons to borrowers or guarantors called defendants.
- Serving of warrant for quick disposal of the case and the Branch/Advocate should get to see that summons are served within one month.
- If the summons is served on the defendants, proceedings commence with evidence by way of affidavits filed by the bank followed by cross-examination of Bank's witnesses and vice versa followed by arguments ending up in Recovery Certificates in respect of the Bank.
- Evidence by way of affidavits as preceding, clarifications or reports excepted by the DRT should be filed.

Execution of Recovery Certificate

11.496 The Presiding Officer finally grants Recovery Certificate and sends it to Recovery Officer (R.O.) for execution. On receipt of the Recovery certificate, the RO can issue the notice to Certificate Debtors, giving 15 days for payment of the amount stated in the Recovery Certificate.

11.497 If the defendant neglects to pay the amount, the RO will proceed to recover the amount by any one or more of the methods, which are listed below:

- Attachment and sale of Movable or Immovable Property of the defendant.
- Arrest and Detention of the defaulter.
- Appointment of Receiver.

After full recovery of bank dues, the application is closed by the RO.

Appeal Against Recovery Officer

11.498 The appeal against an order of RO to DRT can be requested within 30 days from the date of order. The Tribunal has to resolve the claim within six months. An appeal against the judgment of DRT can be made within 45 days to DRAT (Debt Recovery Appellate Tribunal).

Concluding remarks

11.499 Banks resort to DRT as it is considered to be a legally tenable action and therefore satisfies the condition of the Limitation Act. It is common for Banks to simultaneously initiate action under SARFAESI and this Act. Having said that, SARFAESI led resolution is usually faster than DRT led action. However, as mentioned earlier, SARFAESI action applies for eligible securities clearly charged to the Bank. In cases, where recovery from secured assets are not enough to cover the dues of the Bank, the Bank needs to get additional assets charged to recover its balance amount. Such attachment happens through the DRT platform.

3. Recovery using the Lok Adalats

11.500 Lok Adalat is a process of administering justice in a cost free and speedy manner without resorting to Courts. It is established under the Legal Services Authority Act, 1987. Under the provisions of the Act, States have constituted Legal Services Authorities at High Court, District and at Taluka level. Under such Authorities, Courts are organising Lok Adalats in their respective areas.

11.501 Lok Adalat settles the dispute through assuagement and compromise. Lok Adalat acknowledges the cases pending in the civil courts within their purview which could be settled by conciliation.

11.502 There are several advantages in utilising the forum of Lok Adalats:

- No court fees payable when cases are referred to it.
- It can take cognizance of existing suits and look into fresh disputes as well.
- If no settlement is arrived, parties can continue their legal proceedings in civil courts.
- Every award by Lok Adalat shall be deemed to be a decree passed by Civil Court and is binding on the parties and execution proceeding can be filed accordingly.
- No appeal lies against the decree passed by Lok Adalats as the matter settles through negotiation and mutual consent.

Types of Lok Adalat

11.503 Various kinds of Lok Adalats are as under:

- Continuous Lok Adalat

This type of Lok Adalat is organized for a number of days continuously.

- **Daily Lok Adalat**

As the name suggests, these are held every day.

- **Mobile Lok Adalat**

These are the utility vans which are set up in different areas to resolve petty issues.

- **Mega Lok Adalat**

This is held on a single day at State level, in all the courts of the state.

- **National level Lok Adalats**

These are held at regular intervals throughout the country. The pending cases are disposed of in huge numbers.

- **Permanent Lok Adalats**

The other type of Lok Adalat is the Permanent Lok Adalat, organized under Section 22-B of The Legal Services Authorities Act, 1987. Permanent Lok Adalats have been set up as permanent bodies with a Chairman and two members for providing compulsory pre-litigation mechanism.

Applicability

11.504 If any of the party involved in a dispute, prior to approaching the court, files a grievance to the legal service authority of the state, the case is taken by the Lok Adalats. This is the pre-litigation stage.

Cases already pending before any court can also be referred to the Lok Adalats if both the parties consent to it.

Process involved

11.505 Briefly stated, the procedure followed by the Lok Adalats is as under:

- After referring the case, the Lok Adalat tries to communicate with the parties. They might invite the disputing parties for a meeting or communicate with them in writing or orally. In this stage, the factual information is discussed and if any one-party desires to keep the information confidential from another party, it can be done.
- Suggestions are invited from both the parties to settle the case.
- When the Lok Adalat believes that there are elements of settlement of the

dispute and that the terms might be acceptable by the parties, it is informed to the parties for observation and modifications and accordingly, the dispute is resolved.

- If the case is referred by a court then the award granted by Lok Adalat mentions a clause regarding refund of court fee to the parties.
- The members of Lok Adalat ensure that the issue is settled by mutual consent and that there is no element of coercion or force.

Concluding remarks

11.506 Lok Adalats are low cost and speedy platform for recovery and Banks do use this platform especially for settlement of cases where the amount involved is low and protracted legal battle is uneconomical and not viable in relation to the amount involved.

4. Recovery through the Insolvency and Bankruptcy Code (IBC)

11.507 The Insolvency and Bankruptcy Code was first introduced in 2016 and subsequently amended in 2019. The Code provides a time-bound process for resolving insolvency in companies and among individuals. Insolvency is a situation where individuals or companies are unable to repay their outstanding debt.

Applicability

11.508 The Insolvency and Bankruptcy code at present can only be triggered if there is a minimum default of Rs 1 lakh. This process can be triggered by way of filing an application before the National Company Law Tribunal (NCLT). The process can be initiated by two classes of creditors which would include financial creditors and operational creditors. For the application to be admitted, the creditor will have to show that a requisite default is ascertainable.

11.509 Another important aspect that has to be seen in respect of Insolvency and Bankruptcy Code (IBC) is that at present only companies (both private and public limited company) and Limited Liability Partnerships (LLP) can be considered as defaulting corporate debtors. This code also contains provisions in respect of individual insolvency, but these provisions have not been notified. Therefore cases relating to unpaid debts against individuals and partnership firms would fall outside the purview of this Code.

11.510 As soon as the matter is admitted by the NCLT, it proceeds with the

appointment of an Interim Resolution Professional (IRP) who takes over the management of the defaulting debtor. The Resolution Professional may then be continued or removed, contingent on the wishes of the Committee of Creditors (COC). The role of the Resolution Professional primarily entails making on efforts to ensure that the defaulting debtor should as far as possible continue to operate as a going concern. All efforts will be made to ensure that maximum realization of debts can take place as a consequence of the Corporate Insolvency Resolution Process (CIRP) process.

Corporate Insolvency Resolution Process (CIRP)

11.511 The CIRP may include necessary steps to revive the company such as raising fresh funds for operation, looking for new buyer to sell the company as going concern. The outstanding debts may be satisfied by way of another person submitting a Resolution plan to take over the company and pay off the remaining debts. In the event a resolution plan is not submitted or not approved by the COC, the CIRP process is deemed to have failed. In such a situation the liquidation proceedings would then commence subject to the order of the tribunal.

Timeline

11.512 The Code states that the insolvency resolution process must be completed within 180 days, extendable by a period of up to 90 days. In the light of the recent amendment to the code, for conducting the entire process a time period of 330 days has been specified.

Facilitating Institutions

11.513 The Code creates various institutions to facilitate resolution of insolvency. These are as follows:

- *Insolvency Professionals:* A specialised cadre of licensed professionals are being created. These professionals will administer the resolution process, manage the assets of the debtor, and provide information for creditors to assist them in decision making.
- *Insolvency Professional Agencies:* The insolvency professionals will be registered with insolvency professional agencies. The agencies conduct examinations to certify the insolvency professionals and enforce a code of conduct for their performance.
- *Information Utilities:* Creditors will report financial information of the debt

owed to them by the debtor. Such information will include records of debt, liabilities and defaults.

- *Adjudicating authorities:* The proceedings of the resolution process will be adjudicated by the National Company Law Tribunal (NCLT), for companies; and the Debt Recovery Tribunal (DRT), for individuals. The duties of the authorities will include approval to initiate the resolution process, appoint the insolvency professional, and approve the final decision of creditors.
- *Insolvency and Bankruptcy Board:* The Board will regulate insolvency professionals, insolvency professional agencies and information utilities set up under the Code. The Board will consist of representatives of Reserve Bank of India, and the Ministries of Finance, Corporate Affairs and Law.

Procedure to resolve insolvency

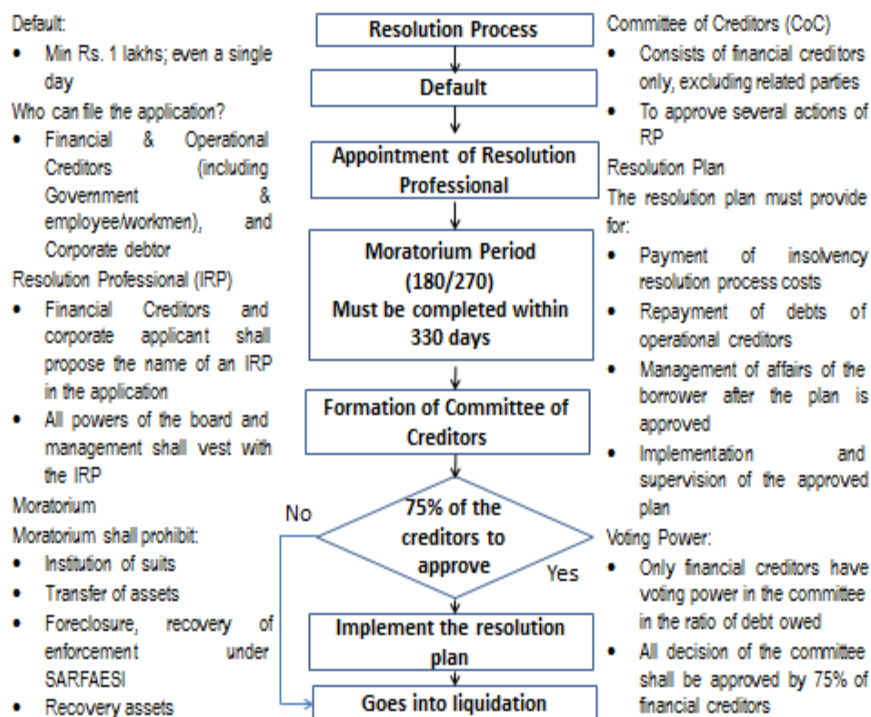
11.514 The Code contains the following steps to resolve insolvency:

- *Initiation:* When a default occurs, the resolution process may be initiated by the debtor or creditor. The insolvency professional administers the process. The insolvency professional provides financial information of the debtor from the information utilities to the creditor and manage the debtor's assets.
- *Decision to resolve insolvency:* A committee consisting of the financial creditors who lent money to the debtor will be formed by the insolvency professional. The creditors committee will take a decision regarding the future of the outstanding debt owed to them. They may choose to revive the debt owed to them by changing the repayment schedule, or sell (liquidate) the assets of the debtor to repay the debts owed to them.
- *Liquidation:* If the debtor goes into liquidation, an insolvency professional administers the liquidation process. Proceeds from the sale of the debtor's assets are distributed in the following order of precedence: i) insolvency resolution costs, including the remuneration to the insolvency professional, ii) secured creditors, whose loans are backed by collateral, dues to workers, other employees, iii) unsecured creditors, iv) dues to government, v) priority shareholders and vi) equity shareholders.

Corporate Insolvency Process

11.515 The following flowchart describes the insolvency process:

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Concluding remarks

11.516 The IBC platform is relatively new but the processes are fast settling in the Code has been challenged on various grounds and courts have clarified these issues and as a result the Code has been made more robust. In the days to come, resolution through IBC mechanism is bound to pick up even more widely especially for the bigger ticket exposures of Banks.

Role of Statutory Auditor

11.517 The role of the statutory auditor is as under:

- The Auditor should review the updated policies of the Bank framed for handling recoveries through this mechanism
- The rationale for transfer of cases to either of the aforesaid legal mediums should be documented.
- Listing of cases pending in each of the forums and the updated status should be obtained. Automated MIS trackers to be in place to ensure adherence to timelines is scrupulously maintained.
- Review of these processes by an internal audit team should be done. Issues

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raised by audit, if any should be followed up for understanding the gaps and initiating remedial action.

- Empanelment process for enrolment of Advocates or other professionals should be examined.
- Key is to adhere to timelines stipulated in the policy. Delays, if any, in adhering to the timelines needs to be reviewed and set right.
- During the pandemic, courts have not been functioning and cancellations / extensions of court hearing procedures have happened delaying the judicial process. Auditors should review the operational procedures to ensure that necessary tracking and follow-up mechanism is in place and operating effectively.

Annexure

**Illustrative list for Basis of Selection of
Advance Accounts in case of
Bank Branch Audit**

The list given for Bank Branch Auditors is only illustrative in nature. Members are expected to exercise their professional judgment while using this list depending upon facts and circumstances of each case.

Basis of selection of Advances accounts to be examined by Branch Auditor	No. of Accounts
1. All Large accounts (excess of 10% of outstanding aggregate balance of fund based and non-fund based advances of the branch or Rs.10 crores, whichever is less).	
2. Accounts wherein process under IBC is mandated but not initiated by branch	
3. Borrowers wherein process of IBC initiated by any of the creditors including bank	
4. NPA accounts upgraded to Standard during the year.	
5. Advances where Restructuring Proposals/ requests are pending approval/disposal at year end.	
6. Accounts Restructured in the earlier years to determine their year-end status, if in default or not classified as per RBI norms.	
7. Accounts Restructured during the year to determine their year-end classification.	
8. Restructured advances with moratorium of Interest where interest is accrued contrary to RBI applicable norms.	
9. FITL cases arising out of Restructuring where corresponding provisions are held in "Sundry Liabilities Account (Interest Capitalization)".	
10. Advances accounts where there is an initiation of proceedings involving Investigation, vigilance, enquiry and those where fraud is reported.	

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11. Staff Advances – where the persons have ceased to be employees of the Bank; and accounts in default.	
12. BIFR cases classified as Standard.	
13. SSI/SME cases under rehabilitation as at the year end.	
14. Standard advances in litigation.	
15. Central Government guaranteed cases which are Standard non-performing.	
16. Standard accounts where there is Interest Suspense/ Unapplied Interest.	
17. Advances in the list of wilful defaulters of the RBI.	
18. Cases where one time settlement (OTS) has been sought; and those in which OTS was accepted but there is default in compliance.	
19. Advances subject to re-financing.	
20. Accounts which are not renewed regularly or adhoc not regularised for more than 180 days	
21. Accounts which are classified as NPAs and also upgraded during the year	
22. Accounts which are reported to CRILC during the year	
23. Fresh NPAs identified by the Branch.	
24. NPA cases where the assessed realizable value of the securities has a significant shortfall – 50% or more.	
25. NPA cases where the realizable value of the security as assessed by the Bank/approved valuers /RBI is less than 10% of the outstanding.	
26. Standard Accounts with temporary deficiencies as per Para 4.2.4 of Master Circular on Advances.	
27. Quick Mortality Cases.	
28. Advances comprising frauds detected (Para 4.2.9.(ii) of the IRAC Master Circular dated 1.7.2015).	
29. Other Accounts, not covered above, with adverse comments in the existing/latest Reports (as per Para 1 of Annexure I to the initial letter to Branch).	
30. Comments on accounts as per latest RBI AFI Report	

Fixed Assets and Other Assets

Fixed Assets

Introduction

12.01 This Chapter deals with Fixed Assets and Other Assets. Fixed assets include movable and immovable property. Fixed assets comprise premises and other fixed assets such as furniture and fixtures, motor vehicles, office equipment, computers, printers, UPS, generators, intangible assets such as application software and other computer software, etc.

Purchase of Fixed Assets

12.02 In most banks, the fixed assets are generally purchased by the head office or regional or zonal offices. Statutory Branch Auditor (SBA) has to ascertain the procedure followed by the bank and plan the audit accordingly. Also, the banks generally prefer to centralise the function of obtaining insurance and obtain a comprehensive policy for assets at numerous locations (to avail the benefit of rebate on bulk business). Fixed assets, particularly furniture and fixture, consumer durables, etc. are provided by banks to the staff and the account for the same is maintained at the office where the employee is posted.

12.03 The Auditor has to verify whether the original invoices (or copy of original invoices) of the purchase including the purchases during the year are at the Branch Office and also required approval are in place as per approval matrix. The Auditor should make specific inquiries and also review open purchase orders, to ensure completeness of purchases recorded for the year. It has been observed that an asset is already delivered to the branch but in the absence of invoice for same, accounting is not done. In case of sales /disposal of assets done during the year, the relevant note and the process of the disposal including the accounting entries are to be verified by the Auditor.

Maintenance of Records

12.04 In most of the banks the maintenance of records is centralised at HO. In recent times, some of the banks have installed Fixed Asset Management Software and the information relating to purchase, sale of fixed assets and depreciation thereon (in some cases) is accounted for with the help of such software. SBA has to ascertain the procedures followed and audit accordingly.

Physical Verification of Fixed Assets

12.05 The SBA has to physically verify the assets at the branch particularly those acquired during the year and reconcile with the fixed asset management system (manual or electronic). The SBA is to ensure that assets provided to employees working in that branch are properly accounted.

Balance Sheet Disclosure

Disclosure of Assets

12.06 The Third Schedule to the Banking Regulation Act, 1949 requires fixed assets to be classified into two categories in the balance sheet, viz., Premises and Other Fixed Assets. Though not specifically mentioned under the Banking Regulation Act, 1949, the assets taken on lease and intangible assets should be shown separately for proper classification and disclosure and also to comply with the requirements of the Accounting Standards (ASs) issued by the Institute of Chartered Accountants of India (ICAI).

12.07 As per the Notes and Instructions for compilation of balance sheet, issued by the RBI, premises wholly or partly owned by the banking company for the purpose of business including residential premises should be shown under the head, 'Premises'. Furniture and fixtures, motor vehicles, office equipment, computers and all other fixed assets except premises should be shown under the head 'Other Fixed Assets'. An immovable property acquired by the bank in satisfaction of debts due should be included under the head 'fixed assets' only, if it is held by the bank for its own use.

Reduction or Revaluation of Fixed Assets

12.08 Generally reduction or revaluation of fixed assets (if any) will be dealt at the Head Office level. The SBA has limited role to play. The Notes and Instructions for Compilation of Balance Sheet, issued by the RBI, require that where sums have been written-off on reduction of capital or revaluation of assets, every balance sheet after the first balance sheet subsequent to the reduction or revaluation should show the revised figures for a period of five years with the date and amount of revision made. In case any assets are appearing in the branch balance sheet, the SBA has to ensure that above instructions are followed.

Depreciation on Fixed Assets

12.09 Rates of depreciation on fixed assets have not been prescribed by the Banking Regulation Act, 1949. The provisions of the Schedule II to the

Companies Act, 2013, should, therefore, be kept in mind in this respect especially in so far as the banking companies are concerned. Depreciation on Computers and Software forming an integral part of Computer Hardware, in and outside India is provided on Straight Line Method at the rate of 33.33 per cent p.a., as per the guidelines of RBI. The SBA has to examine and ensure that the HO policy on depreciation is correctly followed. The auditor should be careful regarding the date of recording the fixed asset in the books of accounts and commencement of depreciation which should be from the date, the asset is put to use.

Other Assets

Disclosure of Other assets

12.10 The following items broadly are to be disclosed under the head 'Other Assets':

- Inter-office adjustments (net)
- Stationery and stamps
- Interest accrued
- Non-banking assets acquired in satisfaction of claims
- Tax paid in advance/tax deducted at source
- Others

12.11 All loans and advances given to staff, which are non-interest bearing should be included in item 'Others' under 'Other Assets' and should not be reflected as 'Advances'.

Audit Approach and Procedures

Fixed Assets

Audit of Fixed Assets

12.12 While carrying out the audit of fixed assets, the Auditor is concerned, primarily, with obtaining evidence about their ownership, existence and valuation. For this purpose, the Auditor should review the system of internal controls relating to fixed assets, particularly the following:

- Control over expenditures incurred on fixed assets acquired or self-constructed.
- Accountability and utilisation controls.
- Information controls for ensuring availability of reliable information about fixed assets.

Accounting of Fixed Assets

12.13 The SBA should ascertain whether the accounts in respect of fixed assets are maintained at the branch or centrally. Similarly, the auditor should ascertain the location of documents of title or other documents evidencing ownership of various items of fixed assets. The procedures described in the following paragraphs would be relevant only to the extent the accounts and documents of title, etc., relating to fixed assets are maintained at the branch.

12.14 Where the acquisition, disposal, etc., of fixed assets take place at branches / other offices, but accounting of fixed assets is done at the head office, the SBA should examine whether acquisitions, disposals, etc. effected at the branch during the year have been properly communicated to the head office. The SBA should also bring this to the notice of Statutory Central Auditor (SCA).

12.15 In cases where, for any reason acquisition of fixed asset is shown in suspense account then the branch cannot classify the asset in the Balance Sheet under this head unless the asset is put to use or ready for use, as the case may be, and all internal formalities are completed. A long-standing suspense entry of this type should be properly dealt with by the auditor and may need to be escalated to the statutory central auditors if the amount involved is material.

Premises

12.16 *Verification of accounting for Premises:* The Auditor should verify the opening balance of premises with reference to schedule of fixed assets, ledger or fixed assets register. Acquisition of new premises should be verified with reference to authorisation, title deeds, record of payment, etc. Self-constructed fixed assets should be verified with reference to authorisation from appropriate authority and documents such as, contractors' bills, work order records, record of payments and completion certificate. The Auditor should also examine whether the balances as per the fixed assets register reconcile with those as per the ledger and the final statements.

12.17 As per the AS-10 (Revised), "Property, Plant & Equipment", the banks can adopt the policy to follow Cost Model or Revaluation Model for Premises or any other class of Property, Plant & Equipment (PPE). The Auditor should inquire about the policy followed by the bank and verify the accounting treatment more specifically with reference to revaluation model. The Auditor should also check the impairment, if any, by applying the principles laid down in Accounting Standard (AS) 28, "Impairment of Assets".

12.18 *Leasehold Premises:* In the case of leasehold premises, capitalisation and amortisation of lease premium, if any, should be examined. Any improvements to leasehold premises should be amortised over their balance residual life. It would be appropriate to segregate the cost/value of the land from the building/superstructures to ensure that depreciation/amortisation is appropriately considered in case of leasehold premises.

12.19 *Capital Work-in-progress (CWIP):* In case of property under construction, it should be seen that they are shown under a separate heading, e.g., 'premises under construction'. Advances to contractors may be shown as a separate item under the head 'fixed assets' or under the head 'Other Assets'. It should be verified that where the branch has obtained the licence to commence business and is ready for use then the same is not shown as "premises under construction". In such cases even if all the bills/ documents from the contractors/suppliers are not received, at the year end, an estimate of the expenditure thereon should be made and capitalised on a provisional basis. The Auditor should obtain ageing report of CWIP and inquire about old balances outstanding as CWIP.

12.20 *Holding of Immovable Property:* The Auditor should specifically keep in mind the provisions of section 9 of the Banking Regulation Act, 1949, which prohibits a banking company from holding any immovable property, howsoever acquired (i.e., whether acquired by way of satisfaction of claims or otherwise), for a period exceeding seven years from the date of acquisition, except such as is required for its own use.

12.21 The Auditor should specifically examine that no immovable properties other than those required for the own use of the bank have been included in fixed assets (own use would cover use by employees of the bank, e.g., residential premises provided to employees). The SBA should also obtain a written representation to the above effect from the branch management.

Other Fixed Assets

12.22 *Other Fixed Assets:* The procedures discussed above regarding premises also apply, to the extent relevant, to verification of other fixed assets. In respect of movable fixed assets, the Auditor should pay particular attention to the system of recording the movements as well as other controls over such fixed assets. The Policy regarding verification of fixed assets at premises, if any, should be noted.

12.23 For assets used by the branch officials at their residences; the Auditor should obtain confirmation from the respective staff member. In case of discrepancies, the SBA should ensure that the same has been properly dealt in

the books of account and adequate provision in respect of any damaged assets has been made.

12.24 *Operating Software:* Banks incur substantial expenditure on computer hardware and software. Computer hardware and operating software being an integral part of the hardware, qualifies the definition of plant and equipment as given in AS 10 (Revised), "Property, Plant and Equipment". Expenditure incurred on acquisition and installation of the hardware and operating software should be capitalised in accordance with the principles laid down in AS 10 (Revised) and depreciated over the remaining useful life of the hardware. Since these are susceptible to faster technical obsolescence; useful life of the asset should not be for a period of more than three years.

12.25 *Application Software:* Application software is not an integral part of the related hardware and is treated as an intangible asset. Accordingly, the same should be accounted for as per Accounting Standard (AS 26), "Intangible Assets". In estimating the useful life of application software, the rapid pace of changes in software as also the need for periodic modification/ upgradation of software to cater to changes in nature of transactions, information needs etc. need special consideration. The software can be acquired from outside or developed in-house. During the stage of development, the same needs to be accounted in accordance with AS 26, while capitalising the same due consideration be given to para 44 of the said standard. The software to be capitalised on the date of asset put to use.

12.26 While conducting the audit of intangible assets, the Auditor should also consider the guidelines issued by RBI by way of Circular No.DBOD.No.BP.BC.82/21.04.018/2003-04, dated April 30, 2004 on "Guidelines on compliance with Accounting Standards (AS) by banks".

Transfer of assets between branches

12.27 Fixed assets like furniture, office equipment, etc., are transferred from one branch to another. The Auditor should examine whether accumulated depreciation in respect of such assets is also transferred. It may be noted that the consolidated accounts of the bank would not be affected by such transfers. In recent times, the fixed asset management software is in use. The Auditor has to examine the reasonableness of the internal controls with respect to recording such inter branch transfer of assets. The SBA may notice more of such transactions during this year due to mergers of banks.

Classification of Fixed Assets

12.28 SBA should examine whether fixed assets have been properly classified. Fixed assets of similar nature only should be grouped together. For

example, items like safe deposit vaults should not be clubbed together with the office equipment or the theft alarm system of the bank.

Sale / Disposal / Scrapping of Fixed Assets:

12.29 Usually, these decisions are taken at HO or Regional or Zonal offices, branch will not have authority to make these type of decisions. In case of any sale / disposal / scrapping of assets happen during the year, the SBA has to examine whether there is adequate control system in place and also should verify the records, receipts and value of the transactions. In case of heavy values see whether proper authorisation is obtained from HO. Accounting for original cost, accumulated depreciation, sale value and profit/loss on sale of the asset to be verified. The SBA should ensure that proper taxes like GST are collected wherever it is applicable on sale or disposal of assets. Due consideration to be given to AS10 while accounting for the De-recognition of the fixed asset.

Capitalisation of Expenditure

12.30 The auditor should examine whether any expenditure incurred on a fixed asset after it has been brought to its working condition for its intended use, has been dealt with properly. According to AS 10 (Revised), "Property, Plant & Equipment", such expenditure should be added to the book value of the fixed asset concerned only if it increases the future benefits from the asset beyond its previously assessed standard of performance.

Use of Depreciated Assets

12.31 At times, though depreciation has been fully provided on certain types of assets, they still continue to be in use. In such cases the Auditor should verify whether the bank's policy in this regard has been followed.

Leased Assets

12.32 RBI/2015-16/30 DBR.No.FSD.BC.19/24.01.001/2015-16 dated July 01, 2015 on Para- banking activities consolidates all the instructions/guidelines issued to banks till June 30, 2014 on para-banking activities. The aforesaid circular also provides guidelines on Equipment Leasing in para no. 8 of the circular dealing with methodology, exposure, accounting and prudential norms to be followed by banks undertaking leasing activity. The auditor, in respect of leased assets, should also have regard to the requirements of AS 19, "Leases". Assets given on Lease need to be separately shown in the same manner as other assets.

Impairment of Assets

12.33 These activities are done at HO level and branch has no role to play. In case bank feels to do the exercise on impairment of assets, the same should be done as per AS 28, "Impairment of Assets". The standard prescribes the procedure that an enterprise should apply to ensure that its assets are carried at not more than their recoverable amount.

12.34 RBI's circular on compliance with Accounting Standards, issued in April 2004 states as follows in respect of AS 28:

- The Standard would not apply to investments, inventories and financial assets such as loans and advances and may generally be applicable to banks in so far as it relates to fixed assets.
- Banks may also take into account the following specific factors while complying with the Standard:
 - Paragraphs 7 and 8 of the Standard have clearly listed the triggers which may indicate impairment of the value of assets. Hence, banks may be guided by these in determining the circumstances when the Standard is applicable to banks and how frequently the assets covered by the Standard need to be reviewed to measure impairment.
 - In addition to the assets of banks which are specifically identified above, viz., financial assets, inventories, investment, loans and advances etc., to which the Standard does not apply, the Standard would apply to financial lease assets and non-banking assets acquired in settlement of claims only when the indications of impairment of the entity are evident.

12.35 During the year if impairment of assets has taken place with respect to any of the assets at the branch, the SBA has to verify that the procedures as stated in AS 28 is duly followed by the branch. The Auditor should also inquire about assets which are not in use for long period and whether any impairment provision to be done on same considering recoverable value of those assets.

Other Assets

12.36 Other assets include Inter-office Adjustments, Interest Accrued, Tax Payments, Stationery and Stamps among other items. SBA may carry out the audit of various items appearing under the head 'Other Assets' in the following manner.

Inter-Office Adjustments

12.37 Inter Office Adjustments/Inter Branch Account is dealt separately in Chapter 20, "Inter Branch/Office Accounts" of Section B of this Guidance Note. In CBS environment these days in most of the banks interoffice adjustments/ inter branch reconciliation are carried out by the system automatically on a real time basis.

Interest Accrued

12.38 The main components of this item are interest accrued but not due on investments and advances and, interest due but not collected on investments. As banks normally debit the borrower's account with interest due on the borrower's repayment cycle date, there would usually be an amount of interest accrued but not due on advances on balance sheet date. On the other hand, interest on government securities, debentures, bonds, etc., which accrues from day to day should be calculated and brought into account, in so far as it has accrued on the date of the balance sheet.

12.39 The auditor should examine whether the interest has been accrued on the entire loans and advances portfolio of the bank. Special consideration should be given to the overdue bills purchased/ discounted. Several times the interest accrued on such advances is manually computed by the Branch and the auditors should check the workings thoroughly so as to avoid any income leakages. As far as possible, the detailed breakup of the loan portfolio and the interest accrual should be obtained and the same should agree with the general ledger balance. This would ensure completeness of the interest accrual of advances. The Auditor should also examine the interest accrued on advances by re-computing it on a test check basis by referring to the loan parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc., from the loan agreements. This would ensure the completeness of the interest accrual on advances. In the current banking scenario, the interest accrual setup is automated system driven for most banks and the auditor should verify the in-built logic and controls of the system.

Tax Paid in Advance/Tax Deducted at Source

12.40 Generally, this item is dealt at the head office only and would, therefore, not appear in the balance sheet of a branch, except that tax deducted at source on fixed deposits and other products/services if handled at the branch level. The procedures to be followed by the SBA for verification of tax deducted at source by the branch would be similar to those in an audit of other types of entities. The SBA needs to examine whether the certificates for such tax deducted at source is collected by the branch and the original copy is

sent to the Head Office along with the transfer of such Tax Deducted at Source (TDS) amount to Head Office on periodic basis as defined.

Stationery and Stamps

12.41 Internal controls over stationery of security items (like term deposit receipts, drafts, pay orders, cheque books, traveller's cheques, gift cheques, tokens, etc.) assume special significance in the case of banks as their loss or misuse could eventually lead to misappropriation of the most valuable physical asset of a bank, viz., cash. The SBA should study and evaluate the existence, effectiveness and continuity of internal controls over these items in the normal course of his audit.

12.42 *Valuation of Stationery and Stamps:* As per RBI instructions, the item "Stationery and Stamps" should include only exceptional items of expenditure on stationery like, bulk purchase of security paper, loose leaf or other ledgers, etc., which are shown as quasi-asset to be written off over a period of time. The valuation of such items is suggested to be at cost without any element of escalation/appreciation. In other words, the normal expenditure on stationery may be treated as an expense in the profit and loss account, while unusually heavy expenditure may be treated as an asset to be written off based on issue/consumption. At the branch level, the expenditure on latter category may not appear since a considerable part of the stationery is supplied to branches by the head office.

12.43 *Physical Verification of Stationery and Stamps:* The auditor should physically verify the stationery and stamps on hand as at the year-end, especially stationery of security items. Any shortage should be inquired into as it could expose the bank to a potential loss from misuse. The auditor should examine whether the cost of stationery and stamps consumed during the year has been properly charged to the profit and loss account for the year in the context of the accounting policy/instructions from the head office regarding treatment of cost of stationery and stamps.

Non-Banking Assets Acquired in Satisfaction of Claims

12.44 This heading includes those immovable properties/tangible assets, which the bank has acquired in satisfaction of debts due or its other claims and is being held with the intention of being disposed of. As stated in para 12.20 above, the banking company can't hold any immovable property for any period exceeding seven years. The RBI has the power to extend the aforesaid period in a particular case up to another five years. During this period, the bank may deal or trade in

any such property for the purpose of facilitating the disposal thereof. The above provisions will not apply for those assets which the bank intends to use for its own purpose.

12.45 *Valuation and Verification:* At the date of acquisition, the assets should be recorded at the amount lower of the net book value of the advance or net realisable value of asset acquired. At each balance sheet date, net realisable value of such assets may be re-assessed and necessary adjustments may be made.

12.46 The auditor should verify such assets with reference to the relevant documentary evidence, e.g., terms of settlement with the party, order of the Court or the award of arbitration, etc. The auditor should verify that the ownership of the property is legally vested in the bank's name by verifying the Encumbrance Certificate (EC) of the property. If there is any dispute or other claim about the property, the auditor should examine whether the recording of the asset is appropriate or not. In case the dispute arises subsequently, the auditor should examine whether a provision for liability or disclosure of a contingent liability is appropriate, keeping in view the requirements of AS 29 "Provisions, Contingent Liabilities and Contingent Assets".

12.47 If an immovable property is obtained as satisfaction for a claim then a Suitable display at the premises of the immovable property is to be made by the bank stating that it is the property of the Bank with a view to avoid trespass and illegal occupation of the premises by any other person/s.

12.48 Since, most of these activities are centralised at banks, branch will have limited role of facilitating the process.

Others

12.49 This is the residual heading, which will include items not specifically covered under other sub-heads, e.g., claims which have not been received, debit items representing additions to assets or reductions in liabilities which have not been adjusted for technical reasons or want of particulars, etc., receivables on account of government business, prepaid expenses, Accrued income other than interest (e.g., dividend declared but not received) may also be included under this head. The audit procedures relating to some of the major items included under this head are discussed below.

12.50 *Non-Interest Bearing Staff Advances:* The auditor should examine non-interest bearing staff advances with reference to the relevant documentation and the bank's policy in this regard. The availability, enforceability and valuation of security, if any, should also be examined. It

needs to be examined whether the same relates to employees on the roll of the bank on the date of the preparation of financial statements.

12.51 *Festival and Other Advances:* Banks grant unsecured advances to staff like festival/drought relief/housing advances etc. due to the employer-employee relationship where normally lien is marked on the terminal benefits of the employee; but advances against FDRs and other securities etc. are also given. While a distinction needs to be made between advances given by the bank as an "employer" and as "banker", the RBI's latest applicable circular needs to be kept in view as regards disclosure requirement of advances in the latter category i.e. as banker.

12.52 *Security Deposits:* Security deposits with various authorities (e.g., on account of telephone, electricity, etc.) and with others (e.g., deposits in respect of premises taken on rent) should be examined with reference to documents containing relevant terms and conditions, and receipts obtained from the parties concerned. The auditor should verify that the deposits have not become due as per the terms and conditions. If it is so, then the recoverability of the same needs to be looked into in detail and appropriate provision should be suggested against the amount where recovery is in doubt.

12.53 *Suspense Account:* 'Suspense' account is another item included under 'other assets'. Ideally, where accounts are maintained properly and on a timely basis, suspense account may not arise. However, in a practical situation, suspense account is often used to temporarily record certain items such as the following:

- (i) amounts temporarily recorded under this head till determination of the precise nature thereof or pending transfer thereof to the appropriate head of account;
- (ii) debit balances arising from payment of interest warrants/ dividend warrants pending reconciliation of amounts deposited by the company concerned with the bank and the payment made by various branches on this account;
- (iii) amounts representing losses on account of frauds awaiting adjustment.

12.54 *Process of Creation of Suspense Accounts:* The Auditor should study the process of creation of suspense accounts, who is authorized to post and reverse entries in these accounts especially, the necessity of posting these entries, controls over monitoring of ageing and reversal of entries therein. Auditors should also ensure that multiplicity of accounts and unnecessary accounts are not opened as suspense accounts. RBI has also suggested a quick audit of entries in Suspense Account and the status thereof to be

reported in terms of RBI Circular No. DBOD.BP.BC.4/ 21.04.018/2003-04 dated 19 July, 2003 "Guidelines on netting off of old and small value entries - Clearing Differences".

12.55 Unusual items in Suspense Accounts: The Auditor should pay special attention to any unusual items in suspense account since these are prone to fraud risk. The Auditor should obtain the management policy for provision/write off for old outstanding items. He should obtain from the management, details of old outstanding entries/age-wise balances along with narrations in suspense account. The Auditor should verify the process of the bank to ensure expeditious clearance of items debited to suspense account and whether the same is actually happening. Also, to verify the reasons for delay in adjusting the entries, if any. Where the outstanding balances comprised in suspense account require a provision/write-off, the Auditor should examine whether the necessary provision has been made/written off. All items of more than 90 days in suspense accounts need special attention of the Auditor. The Auditor has to certify all the suspense account entries through a separate certificate in the annual closing sets. If there are any intangible items, the same should be specifically reviewed for their recoverability. In case any of them are under investigation, the same should be reviewed in detail, status taken and accordingly be reported including if any provision needs to be made in this regard.

12.56 The Auditor has also to verify whether any particular office account is used for allowing debits to accommodate temporary overdrafts without appropriate disclosures. This tantamount to a fraudulent practice and the bank has to put in place suitable internal controls to avoid opening and operating of such office account heads. Since, suspense account not monitored properly may lead to frauds, the SBA has to make proper verification and also report the same to the SCA.

12.57 The auditor should review the system at the Bank for clearance of items debited to Suspense Account and the time taken for the same. Outstanding entries in excess of 90 days needs to be scrutinized in detail and the reasons for delay in adjusting the entries may be ascertained. Any old balances which are not expected to be recovered should be provided for.

12.58 *Prepaid Expenses*: The Auditor should verify prepaid expenses in the same manner as in the case of other entities and examine whether the basis of allocation of expenditure to different periods is reasonable. The Auditor should particularly examine whether the allocation of discounting and rediscounting

charges paid by the bank to different accounting periods is in consonance with the accounting policy followed for the bank as a whole. Timely apportionment of entries from prepaid accounts as per Bank policy should be ensured.

12.59 Miscellaneous Debit Balances on Government Account: Miscellaneous debit balances on government account in respect of pension, public provident funds, compulsory deposit scheme payments, etc., for which the branch obtains reimbursement from the government through a designated branch, are also included under the head 'others'. In many cases, the accounting for this is outside the core banking solution and needs the special attention of the Auditor. The Auditor should review the ageing statements pertaining to these items and should particularly examine the recoverability of old outstanding items. The Auditor should also examine whether claims for reimbursement have been lodged by the branch in accordance with the relevant guidelines, terms and conditions. The net balances of the amount recoverable at the Head Office level should also be taken along with age-wise analysis of the same. Outstanding balances without any confirmation or proper justification should be provided for /written off as the case may be in the accounts.

Borrowings and Deposits

Borrowings

13.01 Borrowings is usually handled as a centralised activity. In case of exception borrowing happens at few designated branches authorised in this behalf by the head office/ controlling authority either generally or specifically in respect of a particular borrowing. Mostly, borrowings are handled by the Treasury Branches and form part of the Balance Sheet of the Treasury Branch and hence, does not figure in the balance sheets of most branches of the bank.

13.02 RBI, Export-Import Bank of India (EXIM Bank), National Bank for Agriculture and Rural Development (NABARD) and Small Industries Development Bank of India (SIDBI) are the major agencies providing refinance to banks, generally for loans extended to specified sectors. Borrowings from RBI include refinance obtained by the bank from the RBI. Similarly, borrowings from other banks include refinance obtained by the bank from commercial banks, co-operative banks, etc. Refinance obtained by the bank from EXIM Bank, NABARD, SIDBI and other similar institutions and agencies are to be included under 'Borrowings from other institutions and agencies'. This head will also include the bank's liability against participation certificates on non-risk sharing basis issued by it to participating banks.

Deposits and Types

13.03 Deposits represent the most important source of funds for banks. Deposits are received from a large number of constituents, generally in small amounts.

13.04 Deposits accepted by banks are primarily of two types – those repayable on demand (demand deposits) and those repayable after a fixed term (term deposits), though in this case also subject to certain conditions, the deposits may be repaid prematurely at the request of the depositor.

Demand Deposits

13.05 Current account and Savings account are the most common form of demand deposits.

Current Bank Deposits

13.06 Current accounts can be opened in the names of individuals, associations of persons, corporate bodies, trusts, societies, etc., i.e., for all

kinds of customers. The operations in current accounts opened in joint names may be joint, single, by either holder or by surviving holder, depending on the mode of operation chosen by the account holders. The salient features of this type of accounts are:

- There is no restriction on the withdrawal or deposit of money or number of transactions by the account holder at any one time.
- Some guidelines are prescribed by the bank for maintaining a minimum balance, which differ from bank to bank. Bank also charges a penalty for non-maintenance of minimum balance, as per internal policy.
- No interest is generally payable on this deposit except where it may be specifically permitted by the bank / RBI.

Savings Bank Deposits

13.07 Savings accounts are generally in the names of individuals– either singly or jointly and HUF, and sometimes, in the names of institutions which are specifically approved by the RBI for maintaining savings bank accounts with banks (Trusts, Educational Institutes etc). In terms of RBI's guidelines, no bank can open a savings bank account for government departments, municipal corporations, municipal committees, any political party, or any trade, business or professional concern, whether such concern is a proprietary or a partnership firm or a company or an association.

13.08 The salient features of this type of accounts are:

- Banks place restrictions on the maintenance of minimum balance (separate for accounts with cheque book facility and those without cheque book facility), amount of funds that can be withdrawn by the account holder at any point of time. Beyond this cut-off level, banks require the depositors to give notice of a specified period for withdrawal of the amount.
- Banks also place restrictions on the number of withdrawals from the account during a stated period of time, usually one year. For the number of withdrawals beyond this number, banks have the right to levy service charges. The intention behind putting this restriction is to ensure that the savings bank accounts (on which the account holder is entitled to payment of interest) are used to promote genuine savings and are not used as substitutes for current accounts.
- Rate of interest has been largely deregulated and is on discretion of individual banks subject to uniformity for balance up to Rs.1 Lakh and differential rate for balance exceeding Rs. 1 Lakh. Banks pay interest at

quarterly or shorter intervals on daily outstanding balances. Depending on the practice adopted by each bank provision for the balance period up to the year-end may be made at branches/Head Office.

- With effect from April 1, 2015, while levying charges for non-maintenance of minimum balance in savings bank accounts, banks shall adhere to the following additional guidelines:
 - (i) In the event of a default in maintenance of minimum balance / average minimum balance as agreed to between the bank and customer, the bank should notify the customer clearly by SMS / email / letter etc. that in the event of the minimum balance not being restored in the account within a month from the date of notice, penal charges will be applicable.
 - (ii) In case the minimum balance is not restored within a reasonable period, which shall not be less than one month from the date of notice of shortfall, penal charges may be recovered under intimation to the account holder.
 - (iii) The policy on penal charges to be so levied may be decided with the approval of Board of the bank.
 - (iv) The penal charges should be directly proportionate to the extent of shortfall observed. In other words, the charges should be a fixed percentage levied on the amount of difference between the actual balance maintained and the minimum balance as agreed upon at the time of opening of account. A suitable slab structure for recovery of charges may be finalized.
 - (v) It should be ensured that the balance in the savings account does not turn into negative balance solely on account of levy of charges for non-maintenance of minimum balance.

13.09 In the case of both current and savings bank accounts, if there are no operations on the account by the account holder during a prescribed period (such period may vary from bank to bank), such accounts are identified as 'dormant' or 'inoperative' accounts and may be transferred to a separate GL code. Further, transactions and even in some banks the viewing rights in these accounts are allowed only with authority of the official designated by the bank for this purpose.

Term Deposits

13.10 Term deposits (known by different nomenclature in different banks) are repayable after a specified period of time. The minimum period of these deposits, at present, is 7 days. The salient features of this kind of deposits are given below:

- Interest is payable at periodic intervals to the depositors or as per their instructions.
- In case a depositor so desires, the periodic interest can be reinvested in fresh term deposits. Such schemes are generally called 'reinvestment plans'. In this case, the interest payable is compounded at the specified intervals and the resultant maturity value is indicated on the deposit receipt at the time of issuing the receipt. The head offices of banks issue maturity value charts for the guidance of their branches from time to time.

13.11 Recurring deposit accounts are an important variant of term deposit. In a recurring deposit, a specified sum is deposited at regular intervals, generally once a month, for a pre-determined period. On the expiry of this period, the maturity proceeds, which are known at the time of opening the account, are repaid to the depositors or as per their instructions. No recurring deposit is accepted under FCNR(B) Scheme. Some of the banks are offering fixed / flexible recurring deposit accounts in recent times where the customer chooses amount of deposit each time based on their convenience.

13.12 Cash Certificates and Certificates of Deposit (CD), in demat form or otherwise, are two other variants of term deposits. Cash certificates are issued at discounted value, e.g., a certificate with face value of Rs. 100 and term of 5 years may be issued at, say, Rs. 49. The certificates of deposit are short-term negotiable money market instruments and are issued in only dematerialised form or as a Usance Promissory Note. However, according to the Depositories Act, 1996, investors have the option to seek certificate in physical form. Further, issuance of CDs will attract stamp duty. In this regard, the RBI has issued Master Direction No. RBI/FMRD/2016-17/32 FMRD. Master Direction No. 2/2016-17 dated July 07, 2016 on "Money Market Instruments: Call/Notice Money Market, Commercial Paper, Certificates of Deposit and Non-Convertible Debentures (original maturity up to one year)" (which include Certificate of Deposit). CDs may be issued at a discount on face value. The rate of interest thereon is negotiable with the depositor and may vary on a daily basis. The maturity period of CDs issued by banks should not be less than 7 days and not more than one year. Banks are allowed to issue CDs on floating rate basis provided the methodology of compiling the floating rate is objective, transparent and market-based. The issuing bank/FI is free to determine the discount / coupon rate. The interest rate on floating rate CDs would have to be reset periodically in accordance with a pre-determined formula that indicates the spread over a transparent benchmark. CDs can be issued in Demat or in physical form, and in the latter case must be issued on security paper stationery, in denomination of Rs. 1 lakh (for a single subscriber) or in multiple of Rs 1 lakh and without the benefits of repatriation if issued to NRI. Other than for NRIs, CDs are transferrable by endorsement and delivery.

13.13 There is no grace period for repayment of CDs. If maturity date happens to be on holiday it should be paid on the immediately preceding working day. Banks may, therefore, so fix the period of deposit that the maturity date does not coincide with a holiday to avoid loss of discount / interest rate. All OTC trades in CDs shall be reported within 15 minutes of the trade on the FIMMDA reporting platform.

13.14 In respect of term deposits, banks issue Deposit Receipts. These receipts are not negotiable, and therefore, deposits cannot be transferred without the consent of the bank. Certificates of deposits are, however, transferable. CDs held in physical form are transferable by endorsement and delivery. CDs in dematerialised form can be transferred as per the procedure applicable to other demat securities. There is no lock-in period for CDs. Banks / FIs cannot grant loans against CDs. Furthermore, premature buyback is not permitted and no loans can be taken against CDs. However, the Reserve Bank may relax these restrictions for temporary periods through a separate notification.

13.15 Banks normally allow repayment of the deposits before the due date; however, the rate of interest paid to the depositor in case of premature repayment is as per the rate applicable to the period for which the deposit have actually run which may be less than the rate contracted initially. Premature penalty may also be levied by the bank as per its policy in this regard.

Issues to be considered by the Auditor

13.16 Following are the important issues in respect of different categories of accounts which an Auditor must consider.

(a) FCNR (B) Accounts

Foreign Currency Non-Resident (FCNR) Accounts are the accounts, as the name suggests opened by Non-Resident Indians in form of fixed deposit only.

Further, RBI, *vide* its Master Direction-Reserve Bank of India(Interest rate on Deposits) Direction, 2016 dated March 03, 2016provides guidance on the interest rates on deposits held in FCNR(B) accounts. The Circular further prohibit banks to:

- (i) accept or renew a deposit over five years;
- (ii) discriminate in the matter of rate of interest paid on the deposits, between one deposit and another accepted on the same date and for the same maturity, Except for difference on account of tenor of deposits and size of deposits.

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Further, the interest rates on all deposits, with floating rate deposits shall be within the ceiling of swap rates for the respective currency/maturity and interest reset period shall be six months.

The interest rate ceiling on FCNR(B) deposits shall be as under:

Period of deposit	Ceiling rate
1 year to less than 3 years	LIBOR/ Swap plus 200 basis points
3 years and above up to and including 5 years	LIBOR/ Swap plus 300 basis points

The LIBOR / Swap rates quoted/displayed by Foreign Exchange Dealers Association of India (FEDAI) shall be used as the reference for arriving at the interest rates on FCNR(B) deposits.

Interest shall be calculated on the basis of 360 days to a year and paid at intervals of 180 days each and thereafter for the remaining actual number of days. Depositor may also receive interest on maturity with compounding effect.

(b) Resident Foreign Currency (RFC) Accounts

The returning Indians can have their foreign currency accounts or NRE accounts to be converted into RFC.

(c) Export Earners Foreign Currency (EEFC) accounts

- Exporters having good track record and a unit located in SEZ entitled to open foreign currency account with banks with following features.
- Non-interest bearing current account.
- No credit facilities against the security of the balances.
- Hundred per cent of export earnings can be credited to this account.
- Amount is credited in a calendar month is to be utilised for authorised purposes by the end of next calendar month except the amount set-aside for forward commitments. Any balance left unutilised needs to be converted into Indian Rupees for credit to rupee account of exporter.

(d) Diamond Dollar Accounts

This account may be opened with the permission from RBI to transact business in USD.

Firms and companies dealing in purchase/sale of rough or cut diamonds/precious metal jewellery with track record of at least 2 years and average annual turnover of Rs.3 crores or above during preceding 3 licencing years.

(e) *Non-resident (NRO and NRE) Bank Accounts*

NRE account may be opened by Non-resident Indians (NRIs) and persons of Indian Origin (PIOs), whereas NRO account may be opened by all non-residents.

The accounts may be maintained in form of savings, current, recurring or fixed deposit and are denominated in Indian Rupees.

The RBI, *vide* its Master Direction No. RBI/DBR/2015-16/19 Master Direction DBR. Dir. No.84/13.03.00/2015-16 dated March 03, 2016 (updated as on February 22, 2019) on Reserve Bank of India (Interest Rate on Deposits) Directions, 2016 provides guidance on the interest rates on rupee deposits held in Domestic, Ordinary Non-Resident (NRO) and Non-Resident (External) (NRE) Accounts.

(f) *Special Non-Resident Rupee Account (SNRR)*

Any non-resident having business interest in India may open SNRR account for the purpose of putting through bona fide transactions in rupee as specified under A.P.(DIR series) Circular no.09 dated Nov.22, 2019. The account shall not carry any interest and the maximum period shall not exceed seven years except in some specified cases.

Unclaimed Deposits/ Inoperative Accounts

13.17 As per RBI Circular no. DBOD No. Leg.BC.34/ 09.07.005/2008-09 dated August 22, 2008 on "Unclaimed Deposits/inoperative accounts in Banks", a bank is required to make an annual review of accounts in which there are no operations (i.e. no credit or debit other than crediting of periodic interest or debiting of service charges) for more than one year. A savings/ current account should be treated as inoperative/ dormant if there are no transactions in the account for over a period of two years. In case any reply is given by the account holder giving the reasons for not operating the account, banks should continue classifying the same as an operative account for one more year within which period the account holder may be requested to operate the account. However, in case the account holder still does not operate the same during the extended period, banks should classify the same as inoperative account after the expiry of the extended period. If a Fixed Deposit Receipt matures and proceeds are unpaid, the amount left unclaimed with the

bank will attract savings bank rate of interest. Further no penal charges are to be levied for non-maintenance of minimum balances in any inoperative account w.e.f. May 06, 2014(RBI/2013-14/580 DBOD.DIR.BC.No.109/ 13/03 /00/2013-14).

13.18 In terms of Foreign Exchange Management (Crystallization of Inoperative Foreign Currency Deposits) Regulations, 2014 and vide Notification No. FEMA 10A/2014-RB dated March 21, 2014; and as per Clause 2.7 of the RBI Master Circular DBOD.No.Dir.BC.14/13.03.00/2014-15 dated July 01, 2014 "Master Circular of Instructions Relating to Deposits held in FCNR(B) Accounts", inoperative deposits having a fixed term and those with no fixed term maturity after the expiry of a three month notice, upon completion of three years, will get crystallized into Rupees.

Depositor Education and Awareness Fund (DEAF) Scheme 2014

13.19 The Reserve Bank of India vide its circular no. DBOD.No.DEAF Cell. BC. 101/ 30.01.002/2013-14 dated March 21, 2014 issued "The Depositor Education and Awareness Fund Scheme, 2014 - Section 26A of Banking Regulation Act, 1949" laying down certain guidelines with respect to the said fund. Under the provisions of Section 26A of the Banking Regulation Act, 1949 the amount to the credit of any account including savings, term, recurring, current or any other deposit, cash credit account, loan accounts after due appropriation by the bank, outstanding TT, DD, Sundry deposit accounts, clearing adjustments, unreconciled credit balance in ATM, undrawn balance in prepaid card etc in India with any bank which has not been operated upon for a period of ten years or any deposit or any amount remaining unclaimed for more than ten years shall be credited to the Fund, within a period of three months from the expiry of the said period of ten years. . The depositor would, however, be entitled to claim from the bank the deposit or any other unclaimed amount or operate the account after the expiry of ten years, even after such amount has been transferred to the Fund. The bank would be liable to pay the amount to the depositor/claimant and claim refund of such amount from the Fund.

13.20 Normally the list of the dormant accounts is generated by the system itself and the branch is required to follow up with the account holders. The System identifies dormant accounts at the Branches and transfers the balances ageing more than 10 years to the DEAF usually through the RBI current account maintained at the Treasury Branch. The auditors should check all such balances which have been dormant more than 10 years and not transferred to the DEAF and make the necessary rectifications at the Branches. Various returns are required to be submitted to RBI in this regard, which are also required to be verified by the auditors.

13.21 As per RBI/2013-14/614 DBOD.No.DEAF Cell.BC.114/30.01.002/2013-14 all such unclaimed liabilities (where amount due has been transferred to DEAF) may be reflected as "Contingent Liability – Others-items for which the bank is contingently liable" under Schedule 12 of the annual financial statements. Banks are also required to disclose the amounts transferred to DEAF under the notes to accounts.

Reserve Bank of India (Gold Monetization Scheme) Direction, 2015

13.22 The RBI issued Master Direction No.DBR.IBD.No.45/23.67.003/2015-16 dated October 22, 2015 (Updated as on August 16, 2019) on "Gold Monetisation Scheme, 2015" to all Scheduled Commercial Banks that decide to implement the Scheme (*excluding Regional Rural Banks*), requiring such banks that decide to implement the Scheme (Designated Bank), to formulate a comprehensive policy with approval of their respective boards.

13.23 The Gold Monetization Scheme, 2015 (GMS) which includes the Revamped Gold Deposit Scheme (R-GDS) and Revamped Gold Metal Loan Scheme (R-GML) was intended to mobilise gold held by households and institutions to facilitate its use for productive purposes, and to reduce country's reliance on the import of gold.

13.24 Designated Banks are authorised to accept deposits, the principal and interest of which, under the scheme, shall be denominated in gold and the interest will start accruing from the date of conversion of gold deposited into tradable gold bars after refinement or 30 days after receipt of gold, whichever is earlier. Such deposits can be accepted from eligible persons, viz., Resident Indians [Individuals, HUFs, Proprietorship & Partnership firms, Trusts including Mutual Funds/Exchange Traded Funds registered under SEBI (Mutual Fund) Regulations, Companies, charitable institutions, Central Government, State Government or any other entity owned by Central Government or State Government]. Joint deposits of two or more eligible depositors can be made on the same basis as other joint deposit accounts and with nomination facility.

13.25 The minimum deposit at any one time shall be 30 grams of raw gold with no maximum limit with two types of gold deposit scheme i.e. Short term Bank deposit (STBD) and Medium and Long term Government Deposit (MLTGD). The broad features of the Gold Monetisation Scheme are summarised and given as at Annexure to this Chapter.

Know Your Customer Requirements (KYC)

13.26 The Reserve Bank of India vide its master direction dated February 25, 2016 and updated up to April 20, 2020 on "Master Direction-Know Your

Customer (KYC) Direction, 2016” has laid down certain guidelines to prevent banks from being used, intentionally or unintentionally, by criminal elements for money laundering or terrorist financing activities. The guidelines prescribed in this circular, popularly known as KYC guidelines; also enable banks to know/understand their customers and their financial dealings better which in turn help them manage their risks prudently.

13.27 These guidelines contain detailed requirements for banks in respect of customer acceptance policy, customer identification procedures, monitoring of transactions and risk management. The auditor should also keep in mind the reporting requirements under LFAR format while verifying the area.

Data Integrity and modifications

13.28 The Auditor need to verify the control processes to ensure that the customer accounts opened in system are properly updated in the relevant module in CBS and errors, if any are identified and rectified. Further any subsequent changes in customer accounts, should be properly authorised and control process should exist for their verification. Auditor may pick some cases on sample basis to verify correctness of above data updated in CBS system and any periodic changes in the same.

Audit Approach and Procedures

Borrowings

13.29 Borrowings from RBI, other banks/financial institutions, etc., should be verified by the auditor with reference to confirmation certificates and other supporting documents such as, application form, sanction letter, agreements, interest rate, security, correspondence, etc. Audit evidence in the form of external confirmations received directly by the Auditor from appropriate confirming parties / lenders may assist the auditor in obtaining audit evidence that the auditor requires to respond to significant risks of material misstatement. The Auditor is required to comply with the requirements of Standard on Auditing (SA) 505, “External Confirmations” which contains guidance on designing and performing external confirmation procedures to obtain relevant and reliable audit evidence.

13.30 The Auditor should also examine whether a clear distinction has been made between ‘rediscount’ and ‘refinance’ for disclosure of the amount under the above head since rediscount does not figure under this head.

13.31 The Auditor should examine whether borrowings of money at call and short notice are properly authorised. The rate of interest paid/payable on, as well as duration of such borrowings should also be examined by the auditor. In case of borrowing through bonds and debentures, generally banks appoint the

registrar for maintenance of records of borrowing such as bond holders etc. The Auditor can obtain the balance confirmation from registrar of the bonds including other parameters of borrowing at each period end.

Deposits

13.32 In carrying out audit of deposits and liabilities, the Auditor is primarily concerned with obtaining reasonable assurance that all known liabilities are recorded and stated at appropriate amounts.

13.33 The Auditor may verify various types of deposits in the following manner.

Current Accounts and Savings Bank Account

13.34 The Auditor should verify if any difference exist from legacy system of control and subsidiary ledgers.

13.35 The Auditor should examine whether the debit balances in current accounts are not netted out on the liabilities side but are appropriately included under the head 'Advances'.

13.36 Inoperative accounts are a high risk area of frauds in banks. While examining current accounts, the Auditor should specifically cover in his sample some of the inoperative accounts revived / closed during the year. The Auditor should also ascertain whether inoperative accounts are 'revived' only with proper authority. For this purpose, the Auditor should identify cases where there has been a significant reduction in balances compared to the previous year and examine the authorisation for withdrawals. Ratio analysis and comparatives can be used to select / identify such variation.

13.37 As per RBI/2020-21/20 DOR.No.BP.BC/7/21.04.048/2020-21 dated August 06, 2020 banks have been instructed not to open current accounts for customer who have availed credit facilities in form CC/OD from the banking system. In other cases of credit facilities current account may be opened for facility less than Rs.5 crores and in other cases only lenders can open current account and other banks may open collection accounts, as per specified criteria,

13.38 The Auditor has to verify whether the savings accounts are opened for only eligible entities for savings purposes and not for Business purposes.

Term Deposits

13.39 While evaluating the internal controls over term deposits, the Auditor should specifically examine whether the deposit receipts and cash certificates are issued serially and all of them are accounted for in the registers. The auditor should also satisfy himself that there is a proper control over the

unused forms of deposit receipts and cash certificates to prevent their misuse.

13.40 As stated earlier, the rate of interest on Certificates of Deposits (CDs) is negotiable with the depositor. This area is quite sensitive. The auditor should bear this fact in mind while examining the efficacy of prescribed internal controls with regard to rates of interest on CDs.

13.41 Term deposits from banks are usually (though not necessarily) in round figures. Any odd balances in term deposits should therefore be selected by the auditor for verification on a sample basis.

13.42 In case of Bulk Deposits (Rupees one crore and above for scheduled commercial banks and Rs.15 lakhs for RRBs) the interest rate would be obtained by the branch from the Treasury division. The Auditor to verify all such cases to verify correctness of rates been offered.

13.43 In case of for closure of deposit test check to be made whether the mandated foreclosure penalty has been deducted from the applicable Interest rate payable.

Deposits Designated in Foreign Currencies

13.44 In the case of deposits designated in a foreign currency, e.g., foreign currency non-resident deposits, the Auditor should examine whether they have been converted into Indian rupees at the rate notified in this behalf by the head office. The Auditor should also examine whether any resultant increase or decrease has been taken to the profit and loss account. It may also be seen that interest on deposits has been paid on the basis of 360 days in a year:

- i) For deposits up to one year, at the applicable rate without any compounding effect.
- ii) In respect of deposits for more than 1 year, the interest on FCNR (B) deposits should be calculated at intervals of 180 days each and thereafter for remaining actual number of days, till normal maturity.

13.45 Further, in case of conversion of FCNR (B) deposits into NRE deposits or vice versa before maturity has been subjected to the provisions relating to premature withdrawal.

Other Non-resident Deposits

13.46 Only eligible credits are made to the NRE account and only legitimate dues of the accountholder are credited to NRO accounts.

Debits to NRE and NRO accounts to be verified for any violation of applicable

guidelines.

In case of Premature of NRE deposit, before 1 year, no interest to be paid for such deposits as per RBI guidelines.

It is also to be verified whether any customer is holding both non-resident and resident account at the same point of time, which may not be permissible.

Summary of NRE, FCNR(B) and NRO Accounts

Particulars	Non-Resident (External) Rupee Account Scheme [NRE Account]	Foreign Currency (Non-Resident) Account (Banks) Scheme [FCNR (B) Account]	Non-Resident Ordinary Rupee Account Scheme [NRO Account]
(1)	(2)	(3)	(4)
Who can open an account	NRIs and PIOs Individual/entities of Pakistan and Bangladesh shall requires prior approval of the Reserve Bank of India		Any person resident outside India for putting through bonafide transactions in rupees. Individuals/ entities of Pakistan nationality/ origin and entities of Bangladesh origin require the prior approval of the Reserve Bank of India. A Citizen of Bangladesh/ Pakistan belonging to minority communities in those countries i.e. Hindus, Sikhs, Buddhists, Jains, Parsis and Christians residing in India and who has been granted LTV or whose application for LTV is under consideration, can open only one NRO account with an AD bank subject to the conditions mentioned in Notification No. FEMA

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			5(R)/2016-RB dated April 01, 2016, as updated from time to time. Post Offices in India may maintain savings bank accounts in the names of persons resident outside India and allow operations on these accounts subject to the same terms and conditions as are applicable to NRO accounts maintained with an authorised dealer/ authorised bank.
Joint account	May be held jointly in the names of two or more NRIs/ PIOs. NRIs/ PIOs can hold jointly with a resident relative on 'former or survivor' basis (relative as defined in Companies Act, 2013). The resident relative can operate the account as a Power of Attorney holder during the life time of the NRI/ PIO account holder except closure and remittance back of funds to the depositor.		May be held jointly in the names of two or more NRIs/ PIOs. May be held jointly with residents on 'former or survivor' basis.
Currency	Indian Rupees	Any permitted currency i.e. a foreign currency which is freely convertible	Indian Rupees
Type of Account	Savings, Current, Recurring, Fixed Deposit	Term Deposit only	Savings, Current, Recurring, Fixed Deposit
Period for fixed deposits	From one to three years, However,	For terms not less than 1 year and not more than 5	As applicable to resident accounts.

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	banks are allowed to accept NRE deposits above three years from their Asset-Liability point of view	years	
Permissible Credits	<p>Credits permitted to this account are inward remittance from outside India, interest accruing on the account, interest on investment, transfer from other NRE/ FCNR(B) accounts, maturity proceeds of investments (if such investments were made from this account or through inward remittance).</p> <p>Current income like rent, dividend, pension, interest etc. will be construed as a permissible credit to the NRE account.</p> <p>Care: Only those credits which have not lost repatriable character</p>		<p>Inward remittances from outside India, legitimate dues in India and transfers from other NRO accounts are permissible credits to NRO account.</p> <p>Rupee gift/ loan made by a resident to a NRI/ PIO relative within the limits prescribed under the Liberalised Remittance Scheme may be credited to the latter's NRO account.</p>
Permissible Debits	<p>Permissible debits are local disbursements, remittance outside India, transfer to other NRE/ FCNR(B) accounts and investments in India.</p>		<p>The account can be debited for the purpose of local payments, transfers to other NRO accounts or remittance of current income abroad.</p> <p>Apart from these, balances in the NRO account cannot be repatriated abroad except by NRIs and PIOs up to USD 1 million, subject to conditions specified in Foreign Exchange Management (Remittance of Assets) Regulations, 2016.</p> <p>Funds can be transferred to</p>

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		NRE account within this USD 1 Million facility.
Repatriability	Repatriable	<p>Not repatriable except for all current income.</p> <p>Balances in an NRO account of NRIs/ PIOs are remittable up to USD 1 (one) million per financial year (April-March) along with their other eligible assets subject to payment of due tax appropriately certified as per law.</p>
Taxability	Income earned in the accounts is exempt from income tax and balances exempt from wealth tax	Taxable subject to withholding tax.
Loans in India	<p>AD can sanction loans in India to the account holder/ third parties without any limit, subject to usual margin requirements. These loans cannot be repatriated outside India and can be used in India only for the purposes specified in the regulations.</p> <p>In case of loans sanctioned to a third party, there should be no direct or indirect foreign exchange consideration for the non-resident depositor agreeing to pledge his deposits to enable the resident individual/ firm/ company to obtain such facilities.</p> <p>In case of the loan sanctioned to the account holder, it can be repaid either by adjusting the deposits or through inward remittances from outside India through banking channels or out of balances held in</p>	<p>Loans against the deposits can be granted in India to the account holder or third party subject to usual norms and margin requirement. The loan amount cannot be used for relending, carrying on agricultural/ plantation activities or investment in real estate.</p> <p>The term "loan" shall include all types of fund based/ non-fund based facilities.</p>

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	<p>the NRO account of the account holder. <i>In case of a POA holder, confirmation from the original depositor must be obtained.</i></p> <p>The facility for premature withdrawal of deposits will not be available where loans against such deposits are availed of.</p> <p>The term "loan" shall include all types of fund based/ non-fund based facilities.</p>	
Loans outside India	<p>Authorised Dealers may allow their branches/ correspondents outside India to grant loans to or in favour of non-resident depositor or to third parties at the request of depositor for bona fide purpose against the security of funds held in the NRE/ FCNR (B) accounts in India, subject to usual margin requirements.</p> <p>The term "loan" shall include all types of fund based/ non-fund based facilities</p>	Not permitted
Rate of Interest	As per guidelines issued by the regulating Department	
Operations by Power of Attorney in favour of a resident	<p>Operations in the account in terms of Power of Attorney is restricted to withdrawals for permissible local payments or remittance to the account holder himself through normal banking channels, but he cannot close the account.</p>	<p>Operations in the account in terms of Power of Attorney is restricted to withdrawals for permissible local payments in rupees, remittance of current income to the account holder outside India or remittance to the account holder himself through normal banking channels. While making remittances, the limits and</p>

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			conditions of repatriability will apply.
Change in residential status from Non-resident to resident	NRE accounts should be designated as resident accounts or the funds held in these accounts may be transferred to the RFC accounts, at the option of the account holder, immediately upon the return of the account holder to India for taking up employment or on change in the residential status.	On change in residential status, FCNR (B) deposits may be allowed to continue till maturity at the contracted rate of interest, if so desired by the account holder. Authorised dealers should convert the FCNR(B) deposits on maturity into resident rupee deposit accounts or RFC account (if the depositor is eligible to open RFC account), at the option of the account holder.	NRO accounts may be designated as resident accounts on the return of the account holder to India for any purpose indicating his intention to stay in India for an uncertain period. Likewise, when a resident Indian becomes a person resident outside India, his existing resident account should be designated as NRO account

Summary of EEFC, RFC(D) and RFC Accounts

Particulars	Exchange Earners Foreign Currency (EEFC) Account	Resident Foreign Currency (Domestic) [RFC(D)] Account	Resident Foreign Currency (RFC) Account
Who can open the account	Exchange Earners	Individuals	Individuals
Joint	Jointly with eligible	Jointly with any person eligible to	Same as EEFC

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Particulars	Exchange Earners Foreign Currency (EEFC) Account	Resident Foreign Currency (Domestic) [RFC(D)] Account	Resident Foreign Currency (RFC) Account
account	<p>persons;</p> <p align="center">or</p> <p>With resident relative(s) on former or survivor' basis.</p> <p>Relative as defined under Companies Act, 2013 (viz. members of HUF, spouse, parents, step-parents, son, step-son, daughter-in-law, daughter, son-in-law, brother/sister, step-brother/ step-sister)</p> <p>Relative joint account holder cannot operate the account during the life time of the account holder</p>	open the account	
Type of Account	Current only	Current only	Current/ savings/ term deposits
Interest	Non-interest earning	Non-interest earning	De-regulated (As decided by the AD bank)
Permitted Credits	<p>1) 100% of foreign exchange received on account of export transactions.</p> <p>2) advance remittance received by an exporter towards export of goods or services</p> <p>3) Repayment of loans</p>	<p>1) Foreign exchange received as payment/ service/ gift/ honorarium while on visit abroad or from a non-resident who is on a visit to India</p>	<p>1) Foreign exchange received by him as super-annuation/ other monetary benefits from overseas employer</p> <p>2) Foreign</p>

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Particulars	Exchange Earners Foreign Currency (EEFC) Account	Resident Foreign Currency (Domestic) [RFC(D)] Account	Resident Foreign Currency (RFC) Account
	<p>given to foreign importers</p> <p>4) Disinvestment proceeds on conversion of ADR/ GDR</p> <p>5) professional earnings like director's/ consultancy/ lecture fees, honorarium and similar other earnings received by a professional by rendering services in his individual capacity</p> <p>6) Interest earned on the funds held in the account</p> <p>7) Re-credit of unutilised foreign currency earlier withdrawn from the account</p> <p>8) Payments received in foreign exchange by an Indian startup arising out of sales/ export made by the startup or its overseas subsidiaries</p>	<p>2) Unspent amount of foreign exchange acquired from AD for travel abroad</p> <p>3) Gift from close relative</p> <p>4) Earning through export of goods/ services, royalty</p> <p>5) Disinvestment proceed on conversion of shares into ADR/ GDR</p> <p>6) Foreign exchange received as earnings of LIC claims/ maturity/ surrendered value settled in forex from an Indian insurance company</p>	<p>exchange realised on conversion of the assets referred to in Section 6(4) of FEMA 1999</p> <p>3) Gift/ inheritance received from a person referred to in Section 6(4) of FEMA 1999</p> <p>4) Foreign exchange acquired before July 8, 1947 or any income arising on it held outside India with RBI permission</p> <p>5) Foreign exchange received as earnings of LIC claims/ maturity/ surrendered value settled in forex from an Indian insurance company</p> <p>6) Balances in NRE/ FCNR (B)</p>

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Particulars	Exchange Earners Foreign Currency (EEFC) Account	Resident Foreign Currency (Domestic) [RFC(D)] Account	Resident Foreign Currency (RFC) Account
			accounts on change in residential status
Permitted Debits	1) Any permissible current or capital account transaction 2) Cost of goods purchased 3) Customs duty 4) Trade related loans and advances. The amount received in one calendar month should be utilized before end of next calendar month except what is earmarked towards future liability due for payment in a near future.	Can be used for any permissible current/capital account transactions.	No restrictions on utilisation in/ outside India.

Difference between SNRR Account and NRO Account

Feature	SNRR Account	NRO Account
Who can open	Any person resident outside India, having a business interest in India for putting through bona fide transactions in rupees. Opening of SNRR accounts by Pakistan and Bangladesh nationals and entities incorporated in	Any person resident outside India for putting through bona fide transactions in rupees. Individuals/ entities of Pakistan nationality/ origin and entities of Bangladesh origin require the prior approval of the Reserve Bank of India. However, a citizen of

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	Pakistan and Bangladesh requires prior approval of Reserve Bank.	Bangladesh/Pakistan belonging to minority communities in those countries i.e. Hindus, Sikhs, Buddhists, Jains, Parsis and Christians residing in India and who has been granted LTV or whose application for LTV is under consideration, can open one NRO account with an AD bank subject to the conditions mentioned in Notification No. FEMA 5(R)/2016-RB dated April 01, 2016, as updated from time to time.
Type of Account	Non-interest bearing	Current, Savings, Recurring or Fixed Deposit; Rate of interest – as per guidelines issued by Department of Regulation.
Permissible Transactions	Debits and credits specific/incidental to the business proposed to be done by the account holder	Credits: Inward remittances, legitimate dues in India, transfers from other NRO accounts and any amount received in accordance with the Rules/Regulations/Directions under FEMA, 1999. Debits: Local payments, transfer to other NRO accounts, remittance of current income, settlement of charges on International Credit Cards.
Tenure	Concurrent to the tenure of the contract / period of operation / the business of the account holder and in no case should exceed seven years, other than with approval of the Reserve	No such restrictions on tenure.

	Bank. Restriction of seven years is not applicable to SNRR accounts opened for the purposes stated at sub. paragraphs (i) to (v) of paragraph 1 of Schedule 4 of FEMA 5(R).	
Repatriability	Repatriable	Not repatriable except for current income; and remittances by NRIs/ PIOs up to USD 1 million per financial year in accordance with the provisions of FEMA 13(R).

Interest Accrued But Not Due

13.47 The auditor should examine that interest accrued but not due on deposits is not included under the relevant deposits but is shown under the head 'other liabilities and provisions'.

Inoperative Accounts

13.48 Internal controls over inoperative accounts, is imperative. A response to the letter addressed to the Branch will assist the auditor to take a view on the system of dealing with inoperative Accounts. Attention needs to be sharply focused on debits/withdrawals to ascertain whether these are unauthorised. In testing the debits, attention should be specially paid to large and repetitive debits out of otherwise dormant accounts.

Computer generated exception reports will also reveal the status of the inoperative accounts.

The activation of the account to be made active only after the specific request from the customer and there should be operation in the account on the day of the activation.

The Auditor may verify the existence of Audit log for cheque returns due to account dormancy and subsequent activation. The Auditor also to verify that the system should not allow the withdrawal in inoperative accounts through overrides.

The Auditor may verify whether there is a practice in the bank to intimate the customers once the account has become dormant through letter/ SMS/ E-mails

and suitable advice.

Window-dressing

13.49 There are several ways in which the deposits of a bank may be inflated for purposes of balance sheet presentation. For example, some of the constituents may be allowed overdraft on or around the date of the balance sheet, the overdrawn amounts may be placed as deposits with the bank, and further advances may be given on the security of the deposit receipts, thus inflating deposits as well as advances. The transactions may be reversed immediately after the close of the year. Where the Auditor comes across transactions, which indicate the possibility of window-dressing, he may report the same in his long form audit report. In appropriate cases, the auditor should consider making a suitable qualification in his main audit report also.

The Auditor has to verify whether the unavailed portion of the credit facilities (Overdraft, cash credit) are used to boost the loans and deposit at the end quarter/ Half year/Annual and reversed on the next day which might tantamount to window dressing. If so the same to be suitable comments in the Audit report/ LFAR.

The Auditor has to verify whether cheques/ Bills are purchased/Discounted to boost the loan and deposits at the end quarter/ Half year/Annual and reversed on the next day which might tantamount to window dressing. If so the same to be suitable commented in the Audit report/ LFAR.

The Auditor has to verify whether the debits are made in suspense account/ sundries receivable account with an offset credit in current account at the end of the quarter and then reversed on the next day to validate the element of window dressing.

LFAR Reporting

13.50 Reporting on deposits shall be as under:

- a) 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.
 - Refer to the process of the bank for identification of dormant/inoperative accounts.
 - Refer the process for control over inactive/dormant accounts by restricting access and other control procedures.

- Check the process of identifying DEAF accounts and transfer the same to RBI, as per process.
 - Sample check the control process is working and identify discrepancies. Properly report the same.
- b) After the balance sheet date and till the date of audit, whether there have been any unusual large movements (whether increase or decrease) in the aggregate deposits held at the year-end? If so, obtain the clarifications from the branch and give your comments thereon.
- Take the GL abstract on balance sheet date and date of audit and check for variations in the figures of deposits and loans.
 - Check the variations for any unusual movements, if any and identify the specific accounts resulting in this movement.
 - Obtain reasons and report accordingly after considering response of the management.
- c) Whether the scheme of automatic renewal of deposits applies to FCNR(B) deposits? Where such deposits have been renewed, report whether the branch has satisfied itself as to the 'non-resident status' of the depositor and whether the renewal is made as per the applicable regulatory guidelines and the original receipts / soft copy have been dispatched.
- Check for bank policy for renewal of FCNR(B) accounts and system parameters for automatic renewal marked in FCNR(B) accounts.
 - Check the process of obtaining documents at the time of renewal of FCNR(B) accounts including verification of the process of continuation of account holder in non-resident status.
 - Check the bank's policy of printing and dispatch of original receipts and control over them. Test check sample cases to form an opinion about the efficacy of the process.
- d) Is the branch complying with the regulations on minimum balance requirement and levy of charges on non-maintenance of minimum balance in individual savings accounts?
- Check the bank policy for minimum balance maintenance and intimation to customer for non-maintenance of the same.
 - Check in sample cases levy of charges with intimation given by the bank.
 - Check for any charges levied in inoperative/dormant accounts by the bank.

13.51 Implementation of KYCAML guidelines

- Whether the branch has adequate systems and processes, as required, to ensure adherence to KYC/AML guidelines towards prevention of money laundering and terrorist financing.
- Whether the branch followed the KYC/AML guidelines based on the test check carried out by the branch auditors.

13.52 Management Information System

- 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?

Annexure

Features of the Gold Monetization Scheme

The Broad features of the Gold Monetization Scheme are summarised in the following Table:

Acceptance of Deposits and Interest accretion	<ol style="list-style-type: none"> 1. Deposits under the scheme are to be made at the <ol style="list-style-type: none"> a. Collection and Purity Testing Centre (CPTC) -the collection and assaying centres certified by the Bureau of Indian Standards (BIS) and notified by the Central Government for the purpose of handling gold deposited and redeemed under the Scheme, or b. designated bank branches, where, at their discretion, banks may accept the deposit of gold. 2. Minimum Deposits -With no maximum limit for deposit, the minimum deposit at any one time shall be raw gold (bars, coins, jewellery, excluding stones and other metals) equivalent to 30 grams of gold (of 995 fineness only). 3. Assaying of Gold - All gold deposited under the scheme, whether tendered at the CPTC or designated bank branches, shall, (except standard good delivery gold accepted at the designated branches), be assayed at CPTC for fire assaying. 4. Interest on such deposits accrues from the date of conversion of gold deposited into tradable gold bars after refinement or 30 days after the receipt of gold at the CPTC or the bank's designated branch, as the case may be, whichever is earlier. 5. Gold deposited to be treated as an item in safe custody - Between the date of acceptance of the gold and till commencement of the date of accretion of interest, the gold deposited shall be treated as an item in safe custody held by the designated bank.
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Valuation	<p>On the day the gold deposited starts accruing interest, the designated banks shall translate the gold liabilities and assets into Indian Rupees*. The prevalent custom duty for import of gold will be added to the above value to arrive at the final value of gold. This methodology will also be followed for valuation of gold at any subsequent valuation date(s) and for the conversion of gold into Indian Rupees under the Scheme.</p> <p><i>(*by crossing the London AM fixing for Gold / USD rate with the Rupee-US Dollar reference rate announced by RBI on that day)</i></p>
Reporting to RBI	<p>The designated banks will be required to submit a monthly report on GMS to the RBI in the prescribed format.</p> <p>However, as per RBI Circular No. DGBA GAD No 2294/15.04.001/2016-17 dated March 6, 2017, in order to have uniformity in reporting, reconciliation and accounting, agency banks may report the Gold Monetisation Scheme transactions i.e., receipt, payment, penalty, interest, commission for mobilisation, handing charges, etc., directly through the government account maintained for the purpose at Central Accounts Section, Reserve Bank of India, Nagpur, on a daily basis.</p>
Opening of Gold Deposit Account <i>(opened with a designated bank under the Scheme and denominated in grams of gold)</i>	<p>Customer identification criteria as applicable to any other deposit accounts (KYC norms), shall apply and non-customers can open a gold deposit account with zero balance at any time prior to tendering gold at the CPTC.</p> <p>The designated banks will credit/record the STBD or MLTGD, as the case may be (with the amount of 995 fineness gold as indicated in the advice received from CPTC), after 30 days of receipt of gold at the CPTC, regardless of whether the depositor submits the receipt for issuance of the deposit certificate or not.</p> <p><u>Tendering of gold to CPTC</u></p> <p>Before tendering the raw gold to a CPTC, the depositor shall indicate the name of the designated bank with whom he</p>

	<p>would like to place the deposit.</p> <p>After assaying the gold, the CPTC will issue a receipt signed by authorised signatories of the centre showing the standard gold of 995 fineness on behalf of the designated bank indicated by the depositor. Simultaneously, the CPTC will also send an advice to the designated bank regarding the acceptance of deposit.</p> <p><u>Fee to CPTC</u></p> <p>If in agreement with result of the fire assay test, the customer will exercise his option to deposit the gold with the bank and the fee charged by the CPTC will be borne by the bank. In case of any disagreement with the fire assay result, the customer will have the option to take back the melted gold after paying a nominal fee to the centre.</p> <p><u>Documentation</u></p> <p>Standard documentation (designed by IBA including application form for tendering raw gold to the assaying centers, the description of the physical appearance/ characteristics of gold, recording of the results of XRF by the assaying centre, customer's consent for melting the gold for fire-assaying and for making the final deposit, the final receipt to be issued to the depositor), are to be made known and available to the CPTCs and to the depositor upfront and should include all the terms and conditions of the Scheme including the schedule of charges.</p> <p>-----</p> <p><i>(The 995 fineness equivalent amount of gold as determined by the CPTC will be final and any difference in quantity or quality found after issuance of the receipt by the CPTC including at the level of the refinery due to refinement or any other reason shall be settled among the three parties viz., the CPTC, the refiner and the designated bank in accordance with the terms of the tripartite agreement to be</i></p>
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	<i>entered into.)</i>
Types of deposits	<ol style="list-style-type: none"> 1. Short Term Bank Deposit (STBD). 2. Medium and Long Term Government Deposit (MLTGD).
Short Term Bank Deposit (STBD)	<p>Duration - for a short term period of 1-3 years (<i>with a roll over in multiples of one year</i>), to be treated by banks as their on-balance sheet liability; the duration being subject to such minimum lock-in period and penalties, if any, as may be determined by the banks as per their laid down policy.</p> <p>Interest-banks are free to fix the interest rates; and the interest shall be credited in the deposit accounts on the respective due dates and will be withdrawable periodically or at maturity as per the terms of the deposit.</p> <p>Redemption of principal and interest at maturity will, at the option of the depositor be either in Indian Rupee equivalent of the deposited gold and accrued interest based on the price of gold prevailing at the time of redemption, or in gold. The option in this regard shall be made in writing by the depositor at the time of making the deposit and shall be irrevocable:</p> <p>Premature redemption, if any, shall be in Indian Rupee equivalent or gold at the discretion of the designated bank.</p> <p>Imports permitted by designated banks for redemption</p> <p>The designated banks other than the nominated banks shall be eligible to import gold only for redemption of the gold deposits mobilised under the STBD.</p> <p><i>(Nominated bank – A Scheduled Commercial Bank authorized by RBI to import gold in terms of RBI circular A.P.(DIR Series) Circular No.79 dated February 18, 2015)</i></p> <p>CRR and SLR</p> <p>CRR and SLR requirements apply (as per instructions of RBI) from the date of credit of the amount to the deposit account. However, the stock of gold held by banks in their books will be an eligible asset for meeting the SLR requirement in terms of RBI Master Circular - Cash Reserve</p>

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	<p>Ratio (CRR) and Statutory Liquidity Ratio (SLR) dated 1st July 2015.</p> <p><u>End use</u></p> <p>In respect of gold mobilised under the STBD, the designated banks may:</p> <ul style="list-style-type: none"> ○ sell the gold to MMTC for minting India Gold Coins (IGC), to jewellers and to other designated banks participating in GMS; or ○ lend the gold under the GML scheme to MMTC for minting India Gold Coins (IGC) and to jewellers.
Medium and Long Term Government Deposit (MLTGD)	<p>Deposits shall be accepted by the designated banks on behalf of the Central Government <i>and shall constitute the liability of Central Government; the receipts issued by the Collection and Purity Testing Centre (CPTC) -the collection and assaying centres certified by the Bureau of Indian Standards (BIS) and notified by the Central Government for the purpose of handling gold deposited and redeemed under the Scheme, and the deposit certificate issued by the designated banks shall clearly state this.</i></p> <p><i>Accordingly, such deposits shall not be reflected in the balance sheet of the designated banks. Reserve Bank of India will maintain the Gold Deposit Accounts denominated in gold in the name of the designated banks that will in turn hold sub-accounts of individual depositors.</i></p> <p>Control over the gold deposited - The designated banks will hold the gold deposited on behalf of Central Government until it is transferred to such person as may be determined by the Central Government.</p> <p>The gold received under MLTGD will be auctioned by the agencies notified by Government and the sale proceeds will be credited to Government's account held with RBI.</p> <p>The details of auctioning and the accounting procedure will be notified by Government of India.</p> <p>Duration - the deposit can be made for a medium term period of 5-7 years or a long term period of 12-15 years or for such period as may be decided from time to time by the</p>

	<p>Central Government (<i>The designated banks may allow whole or part premature withdrawal of the deposit subject to such minimum lock-in period and penalties, if any, as determined by the Central Government</i>).</p> <p>Redemption of the deposit including interest accrued - Redemption will be only in Indian Rupee equivalent of the value of the gold and accumulated interest as per the price of gold prevailing at the time of redemption.</p> <p>However, as per RBI Circular No. DGBA.GBD.No.1007/15.04.001/2017-18 dated October 17, 2017.</p> <ul style="list-style-type: none"> - Reimbursement of payments made by banks, relating to Medium and Long Term Government Deposit (MLTGD), will be made by Central Account Section (CAS), Nagpur, RBI. - Accordingly, banks are advised to pay immediately the interest amount already due to the depositors and to take note that, in future, payment of interest to the depositors is to be made on the due dates. After making payments, the banks may raise a claim to Government through RBI (CAS, Nagpur). <p><u>End Use:</u></p> <p>Gold accepted under MLTGD will be auctioned by MMTC or any other agency authorized by the Central Government and the sale proceeds credited to the Central Government's account with RBI.</p> <p>The entities participating in the auction may include RBI, MMTC, banks and any other entities notified by the Central Government in this regard.</p> <p>Gold purchased by designated bank under the auction may be utilized by them and they may :</p> <ul style="list-style-type: none"> o sell the gold to MMTC for minting India Gold Coins (IGC), to jewellers and to other designated banks participating in GMS; or o lend the gold under the Gold Metal Loan (GML) Scheme to MMTC for minting India Gold Coins (IGC) and to
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	jewellers.
Tripartite agreement between the designated banks, refiners and CPTCs	<p>The designated bank shall enter into a legally binding tripartite agreement with the refiners and CPTCs with whom they tie up under the Scheme; the refiners being refineries accredited by the National Accreditation Board for Testing and Calibration Laboratories(NABL) and notified by the Central Government for the purpose of handling gold deposited and redeemed under GMS.</p> <p>The agreement shall cover the nature of services to be provided, standards of service, arrangements regarding movement of gold, payment of fees and rights and obligations of the parties.</p>
Transfer of gold to the Refiners	<p>The CPTCs will transfer the gold to the refiners as per the terms and conditions set out in the tripartite agreement.</p> <p>The refined gold may, at the option of the designated bank, be kept in the vaults maintained by the refiners or at the branch itself.</p> <p>For the services provided by the refiners, the designated banks will pay a fee as decided mutually.</p> <p>The refiners shall not collect any charge from the depositor.</p>
Oversight over the CPTCs and Refineries	<ol style="list-style-type: none"> 1. The Central Government: <ul style="list-style-type: none"> • in consultation with BIS, NABL, RBI and IBA, may put in place appropriate supervisory mechanism over the CPTCs and the refiners so as to ensure observance of the standards set out for these centres by Government (BIS and NABL). • may take appropriate action including levy of penalties against the non-compliant CPTCs and refiners. • may put in place appropriate grievance redress mechanism regarding any depositor's complaints against the CPTCs. 2. Complaints against the designated banks regarding any discrepancy in issuance of receipts and deposit certificates, redemption of deposits, payment of interest will be handled first by the bank's grievance redress

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	process and then by the Banking Ombudsman of RBI.
Risk management	<p>The designated banks should put in place suitable risk management mechanisms including appropriate limits to manage the risk arising from gold price movements in respect of their net exposure to gold.</p> <p>The designated banks are allowed to access the International Exchanges, London Bullion Market Association or make use of Over-the-counter contracts to hedge exposures to bullion prices subject to the guidelines issued by RBI.</p>

Other Liabilities

Bills Payable

14.01 Bills payable represent instruments issued by the branch against moneys received from customers, which are to be paid to the customer or as per his order (usually at a different branch). These include demand drafts, telegraphic transfers, mail transfers, traveller's cheques, pay-orders, banker's cheques and similar instruments issued by the bank but not presented for payment till the balance sheet date.

14.02 The important aspect to look for in 'bills payable' is; whether there are material movements in the older balances. The reasonableness of such transactions must be verified.

Inter-office Adjustments

14.03 The balance in inter-office adjustments account, if in credit, is to be shown under this head.

14.04 Inter-office transactions mostly take place at branches. The balances can be debit balance or credit balances in the balance sheet of the branches. Branches have a number of transactions amounting to large sums with the other branches and controlling office and hence it becomes very important to monitor the same. It is the responsibility of the bank to reconcile their transactions on a daily basis and keep a track on un-reconciled transactions.

14.05 The bank should first segregate the credit entries outstanding for more than 5 years in the inter-office account and transfer them to a separate Blocked Account which should be shown under 'Other Liabilities & Provisions - Others'.

14.06 While arriving at the net amount of inter-office transactions for inclusion here, the aggregate amount of Blocked Account should be excluded and only the amount representing the remaining credit entries should be netted against debit entries. Only net position of inter-office accounts, inland as well as foreign, should be shown here. For arriving at the net balance of inter-office adjustments all connected inter-office accounts should be aggregated and the net balance only will be shown, representing mostly items in transit and unadjusted items.

14.07 Following are the major transactions which occur between branches and Head office:

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- a. Issue of remittance instruments like drafts/TTs/MTs on other branches.
- b. Payment of remittance instruments like drafts/TTs/MTs drawn by other branches.
- c. Payment to / receipts from other branches of the proceeds of instruments received/sent for collection /realization/clearing.
- d. Payments made under LCs of other branches.
- e. Cash sent to/received from other branches.
- f. Payment of instruments like gift cheques/ banker's cheques/ interest warrants/ dividend warrants/repurchase warrants/refund warrants / traveller's cheques, etc. which are paid by the branch on behalf of other branches which have received the amount for payment of these instruments from the customers concerned.
- g. Head office interest receivable and payable by the branches.
- h. Profit/loss transferred by the branch to head office.
- i. Government receipts and payments handled by the branch either as the nodal branch or as an agent of the nodal branch.
- j. Operations by the authorised branches on the bank's NOSTRO accounts.
- k. Foreign exchange transactions entered into by the branch for which it has to deal with the nodal forex department of the bank for exchange of rupees with foreign currency.
- l. Deposits into and withdrawal of money, by branches into currency chest maintained by another branch.
- m. Gold Banking Transactions at the branch on behalf of nodal branches.
- n. Transactions through NEFT, RTGS, NACH, UPI, etc.
- o. ATM transactions of the customer either at ATM linked with other branches or with merchant establishments.
- p. Internet based transactions other than inter-account transfers with the same branch.
- q. Credit card related transactions of the customers.
- r. Control Accounts of Indian Branches maintained with Overseas Branches of the bank.
- s. Capital Funds with the Overseas Branches.

- t. Head Office balances with the overseas branches including subordinated debt lent to the overseas branches.
- u. GST transactions advises to Nodal branches where GST remittance is made where GST is remitted on behalf of other branches within their fold.

14.08 Following are the most common types of errors observed in inter branch transactions.

- Wrong identification of the nature of transaction.
- Recording of particulars in incorrect fields.
- Wrong accounting of bank charges, commission, etc.
- Errors in writing the amounts.
- Incorrect branch code numbers.
- Incorrect schedule numbers.
- Recording the same transaction twice.
- Difference between the closing and opening balances in successive daily statements.
- Squaring off the transaction by same amount without checking the transactions.
- Forced matched transactions.

14.09 Banks generally have a separate department to deal with the process of reconciliation of inter branch transactions. Hence reconciliation is not a responsibility at the branch level. As all the Banks are on CBS and hence the inter branch entries are reconciled and adjusted by the system on a regular basis; but the Auditor has to scrutinise the old credit entries and check the nature of such entries and confirm whether the same should remain in branch books or should be transferred to Head Office as per the policy of the Bank. It is also observed that sometimes there are system generated entries posted under this head. The Auditor in such cases should ascertain the details of such entries and find out if the necessary ticket has been raised by the branch with the IT department for an appropriate resolution.

Interest Accrued

14.10 Interest due and payable and interest accrued but not due on deposits and borrowings are to be shown under this head. The interest accrued in accordance with the terms of the various types of deposits and borrowings are considered under this head. Such interest is not to be clubbed with the figures

of deposits and borrowings shown under the head 'Deposits and Borrowings'.

Further it includes provisioning of interest on Matured Term Deposits.

Interest accruing on all deposits, whether payment is due or not, should be treated as a liability.

Rebate on bills discounted

14.11 The bank collects interest in advance on usance bills discounted normally ranging over a period of 90 to 180 days. Interest collected by the branch is credited to 'Rebate on bills Discounted'. The system calculates the interest daily and debit the head. Sometimes the balance outstanding under this head is not matching with the balance of loan outstanding under 'Bills Negotiated under LC' or Bill purchased and discounting.

Where due to merger of the branches, the interest was not reversed on timely basis or period of bills was not correctly entered in the system, the auditor should review the outstanding balance of rebate on bills discounted account, balance of loan under bills discounting and unexpired period of bills outstanding. The branch can provide a report of outstanding interest on each bill.

Others (Including Provisions)

14.12 At branch level, this includes only the expense provisions at the branch.

14.13 Besides the above items, the following are other important items usually included under this head:

- (a) Collections in respect of suit-filed accounts. These are not adjusted against advances till final settlement (However, for the purpose of provisioning against non-performing advances, such credit balances are taken into account for ascertaining net outstanding).
- (b) Collection of income-tax on behalf of the Government.
- (c) Collection from DICGC. These are carried till final realisation/write-off of the concerned advance account.
- (d) Provisions for frauds. These are ultimately adjusted by way of a write-off.
- (e) Insurance claims received in respect of frauds. These are retained separately till final write-off in respect of fraud.
- (f) Provision for gratuity, pension and other staff benefits.
- (g) Provision for bank's share in the expenses of the Banking Services Recruitment Board.

- (h) Provision for audit fees.
- (i) Unamortized interest income on the bills purchased/ discounted.
- (j) Only pure deposits are to be disclosed under the head 'deposits' and hence all surplus provisions for bad and doubtful debts contingency funds, secret reserves, etc. which are not netted off against the relative assets should be brought under the head 'Others' (including provisions).

It may be noted that many of the items to be disclosed under this head are accounted for at the head office level and would not therefore form part of balance sheet of a branch.

LFAR REPORTING

Bill Payable, Sundry Deposits, etc.

14.14 The number of items and the aggregate amount of outstanding items pending for one year or more be obtained from the Branch and reported under appropriate heads. Give details thereof

Year	No. of items	Amount (Rs.)	Remarks

The Auditor should obtain the details of outstanding entries and match the same with GL balances and report in the prescribed format.

14.15 Does your test check indicate any unusual items or material withdrawals or debits in these accounts? If so, give details thereof.

As mentioned above, the balances under this head are susceptible to higher risks if movement in the old balances is seen. The Auditor should check if the transactions are genuine.

On sample basis auditor shall conduct scrutiny of such accounts to verify that whether the transactions in accounts are of the purpose for which account is opened. Any outlier/ unusual transaction should be inquired and reported. If MoC is required, the same should be passed.

Contingent Liabilities and Bills for Collection

Introduction

15.01 The term 'contingent liabilities' can take two forms. On the one hand, a contingent liability refers to possible obligations arising from past transactions or other events or conditions, the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise. On the other hand, a contingent liability may also take the form of a present obligation that arises from past events or transactions but is not recognised due to the fact that either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a reliable estimate of the amount of the obligation cannot be made. Thus, contingent liabilities may or may not crystallise into actual liabilities. If they do become actual liabilities, they give rise to a loss or an expense. The uncertainty as to whether there will be any obligation differentiates a contingent liability from a liability that has crystallised. Contingent liabilities should also be distinguished from those contingencies which are likely to result in an obligation on the entity (i.e., the obligation is not merely possible but probable) and which, therefore, requires creation of a provision in the financial statements (*Members may refer to Accounting Standard (AS) 29, "Provisions, Contingent Liabilities and Contingent Assets"*).

15.02 The Reserve Bank of India (RBI), has been issuing directions/guidelines from time to time to cover the key aspects relating to Contingent Liabilities in the banks; and reference may, in particular, be made to the following circulars /Master Directions issued by the Reserve Bank of India.

- (i) RBI/2015-16/76 DBR .No. Dir. BC.11/13.03.00/2015-16 dated July 1, 2015 -issued to all commercial banks (excluding RRBs) - Master Circular - Guarantees and Co-acceptances.

This is a statutory directive issued by the RBI in exercise of the powers conferred by the Banking Regulation Act, 1949 and covers directions to the commercial banks in the matter of conduct of guarantee business, including prescriptions to be followed while issuing guarantees, restrictions placed on

certain types of guarantees, precautions to be taken to avoid the risk of frauds etc.

- (ii) RBI/FED/2018-19/67 FED Master Direction No.5/2018-19 dated March 26, 2019 - External Commercial Borrowings, Trade Credits and Structured Obligations (updated as on August 08, 2019) – which covers certain guidelines and restrictions on guarantees being issued on certain types of borrowings, including ECBs and Trade Credits.
- (iii) RBI/2017-18/139 A.P. (DIR Series) Circular No. 20 dated March 13, 2018 on Discontinuation of Letter of Undertaking (LOUs) and Letter of Comfort (LOCs) for Trade credit- issued to all Authorised Dealers Category-I Banks.
- (iv) RBI/2013-14/614 DBOD.No.DEAF Cell.BC.114/30.01.002/2013-14 dated May 27, 2014 - The Depositor Education and Awareness Fund Scheme, 2014 –Section 26A of Banking Regulation Act, 1949- Operational Guidelines.

Letter of Credit, Bank Guarantees and Letters of Comfort, Letter of Undertaking¹⁰

15.03 Letters of Credit, Bank Guarantees and Letters of Comfort, Letter of Undertaking are contingent liabilities, which need to be disclosed as off Balance Sheet items. The procedure for verification of these items is discussed under Chapter 11, "Reporting for Advances" of Section B of this Guidance Note.

Letters of Credit:

15.04 Letters of credit (LCs) are documents under which the bank agrees to meet the obligations of its customers (usually for purchases/imports).

15.05 Letters of credit are normally issued on certain terms, conditions and stipulations, against guarantees of the customers and may be with/without security/margin as permitted by the laid down policy of the bank. Generally the Bank retains, as a percentage of the value of the LC, a cash margin or holds lien marked Term Deposit Receipt(s) or marks a lien on the account of the customers, to enable it to appropriate the same in the event of a default by the customer in honouring its commitment to the bank. Upon honouring the commitment and making payment to the other bank/party, the amount is debited to the bank's customer and treated as an advance; and the related margin/security is released/ adjusted depending upon the conditions of the LC.

¹⁰ The Reserve Bank of India has issued circular no. RBI/2017-18/139 A. P. (DIR Series) circular no. 20 dated March 13, 2018 on "Discontinuance of Letters of Undertaking (LoUs) and Letters of Comfort (LoCs) for Trade Credits", to discontinue the practice of issuance of LoUs/ LoCs for Trade Credits for imports into India by AD Category –I banks with immediate effect.

15.06 Such Letters of credit may be:

- i. Clean;
- ii. documentary - where bills drawn are accompanied by documents of title to goods;
- iii. revocable - entirely at the pleasure of the bank at any time prior to shipment of goods;
- iv. irrevocable or confirmed;
- v. for single transaction or bill-covering purchases/ imports;
- vi. "revolving" to cover a series of transactions within certain limits/value, sometimes restrictions being placed on the limit of each bill.

Guarantees

15.07 Guarantees are issued on behalf of customers as part of the agency functions of the bank, and for which the bank charges commission. There is no outlay of the bank's funds till there is a default on the part of the bank's customer, giving rise to a claim from any claimant/beneficiary in whose favour guarantee is issued.

15.08 Guarantees issued may be specific to particular transactions or a series of transactions involving assumption of obligations up to certain monetary limits. Guarantees are issued for certain specified time limits and have a claim obligation within the currency/ tenure/ validity period of the guarantee and a specified time limit within which claims can be made by the claimant/beneficiary.

15.09 Such obligations are assumed by issuance of a guarantee document which is expected to be issued only on security paper stationery, kept under dual control, and normally signed on behalf of the bank, only by the authorised signatories; and the bank normally obtains as security, either a cash margin, generally based on a percentage of the obligation, or holds lien marked fixed deposits and in some cases, the bank marks a lien on the account of the customer, where the laid down policy so permits. It also obtains counter-guarantee of a third party, to be invoked in case the obligation devolves.

15.10 Entries are imperative in the guarantee register/records for each guarantee issued.

15.11 The entries are expected to be reversed upon expiry of the guarantee/claim period and when effectively the obligations of the bank cease. The management is duty bound to ensure that no contingent liability is carried in the books/records of the bank where the obligations under the guarantee have ceased, whether or not the original guarantee documents are formally returned to the bank for cancellation.

15.12 It is imperative for the Auditor that internal control for recording of guarantees is looked into, to ensure that entries are made immediately upon assumption of guarantee obligations.

Letter of Comfort (LoC) / Letter of Undertaking (LoU)

15.13 Banks agree to accept/ discharge the customers' contracted liability on due dates and assume obligations and give undertakings/assurance through execution of documents in the form of Letters of Comfort or Letters of Undertaking. The distinction between these needs to be understood.

15.14 Letter of Comfort (LoC) in banking parlance is referred to a document which is provided by a person, typically an affiliate (such as the holding / parent company) of the borrower ("LoC Provider") assuring the financial soundness of the borrower to repay its debt(s) and applies generally to obligations between branches or subsidiaries of the bank. These require lower provisioning under the Basel III Norms.

15.15 Letter of Undertaking (LoU), involves a contract to perform the stated promise, or to discharge the liability, of a third person in case of his default and is used in inter-bank obligations. Obligations comprising Letters of Undertaking (LOUs), normally used for trade credits, are disclosed in the Notes in the manner required (by RBI), in foreign currency and Rupee equivalent, that should be at the year-end rates of exchange.

15.16 These attract higher provisioning under the Basel III Norms.

Liability on Partly Paid Investments

15.17 The Investments Portfolio is generally handled at the Head Office and if the bank holds any partly paid Investments (shares, debentures, etc.), the Auditor concerned to whom the related work is allocated, needs to examine the related books and records to verify the amount comprising the contingent liability by way of uncalled /unpaid amounts in respect of the investments that are not fully paid up; and ensure that the Management has made appropriate disclosure thereof as at the year end, in the Balance Sheet of the Bank.

Liability on Account of Outstanding Forward Exchange Contracts and Derivatives Contract

15.18 All branches which undertake foreign exchange business (i.e., those which are authorised foreign exchange dealers) usually enter into forward exchange contracts. The amount of forward exchange contracts, which are outstanding on the balance sheet date, is to be shown under this head. The treasury of the bank enters into Over The Counter (OTC) derivatives

contracts like Interest Rate Swap, Cross currency Swaps, etc. Similarly, the Bank may also be transacting in derivative contracts including forward exchange contracts on exchanges, which are known as Exchange Traded derivatives. The notional amount of these contracts should be disclosed either separately or under this head as separate sub head. The Auditor should verify that notional value of that leg of the contract where the bank is under obligation to deliver is only considered as liability and therefore receivable leg of the contract should not be included in the liability.

15.19 The general principles to be observed for forward foreign exchange contracts are covered in detail in "Master Direction - Risk Management and Inter-Bank Dealings" RBI/FMRD/2016-17/31 FMRD Master Direction No. 1/2016-17 dated July 5, 2016 (updated as on September 1, 2020).

Guarantees Given on Behalf of Constituents

15.20 The amount of all guarantees outstanding on the balance sheet is to be shown under the above head after deducting therefrom any cash margin.

15.21 The guarantees may include those that have expired, where the claim period has expired and where the obligations have ceased. Where the bank's obligations have legally ceased, these cannot be included on the ground that the related guarantee documents have not been formally returned to the bank and that this verification needs to be done at the branch level by the auditor. The Auditors need to be satisfied that appropriate instructions have been issued by management to the branches to ensure due care in compiling and disclosing this information.

Acceptances, Endorsements and Other Obligations

15.22 This item includes the following balances:

- (a) Letters of credit opened by the bank on behalf of its customers.
- (b) Letters of Comfort issued by the bank on behalf of its customers for availing buyers' credit facilities.
- (c) Bills drawn by the bank's customers and accepted or endorsed by the bank (to provide security to the payees) whether drawn under letters of credit or letters of comfort.

15.23 The total of all outstanding letters of credit as reduced by the cash margin and after deducting the payments made for the bills negotiated under them should be included in the balance sheet. In case of revolving credit, the maximum permissible limit of letters of credit that may remain outstanding at any point of time as reduced by the cash margin should be shown. If the

transactions against which the letter of credit was opened have been completed and the liability has been marked off in the books of the bank, no amount should be shown as contingent liability on this account.

Other Acceptances and Endorsements

15.24 Sometimes, a customer of the bank may issue a usance bill payable to his creditor and drawn on the bank. The bank, on accepting such a bill, becomes liable to pay it on maturity. In turn, it has to recover this amount from its customer.

15.25 The Auditor should verify whether the management has disclosed as a contingent liability, the total of all outstanding acceptances and endorsements at the end of the year, as reduced by the cash margin.

Other Items for Which the Bank is Contingently Liable

15.26 As per the Notes and Instructions for compilation given by RBI vide its circular DBOD.No.BP.BC.78/C.686/1991-92 dated February 6, 1992, under this head are to be included such items as arrears of unpaid dividend on cumulative preference shares, bills re-discounted, commitments under underwriting contracts, estimated amounts of contracts remaining to be executed on capital account, disputed tax liabilities, credit enhancement in respect of securitised loans to which the assignee or the special purpose vehicle has recourse, etc.

15.27 Underwriting involves an agreement by the bank to subscribe to the shares or debentures or issue of other similar securities which remain unsubscribed in a public issue, in consideration of underwriting commission. It also includes commitment made to participate in the venture capital fund or private equity fund or AIF or similar funds, which has not been called up till the Balance Sheet date.

15.28 Rediscounting is generally done with the RBI, or other financial institutions or, in the case of foreign bills, with foreign banks. If the drawer dishonours the bill, the re-discounting bank has a right to proceed against the bank as an endorser of the bill. On the due date(s), the rediscounting entries are reversed, including in respect of the dishonour of the bills.

15.29 Tax demands, which have been disputed are in the nature of contingent liability should be disclosed, unless the same is considered as "remote" as per *Accounting Standard (AS) 29, "Provisions, Contingent Liabilities and Contingent Assets"*). Where an application for rectification of mistake has been made by the entity, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of tax is for a certain amount and the dispute relates to only a part and not the whole of the

amount, only such part amount should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure as per provisions of Accounting Standard (AS) 29, "Provisions, Contingent Liabilities and Contingent Assets".

15.30 The liability involved in cases lodged against the bank in various courts including consumer dispute redressal forums, Banking Ombudsman as per Reserve Bank of India and any other Authority are in the nature of contingent liability and should be disclosed.

Depositor Education and Awareness Fund:

15.31 As per RBI Circular No. RBI/2013-14/ 614 DBOD.No.DEAF Cell.BC.114/ 30.01.002/ 2013-14 dated May 27, 2014 on "The Depositor Education and Awareness Fund Scheme, 2014 –Section 26A of Banking Regulation Act, 1949- Operational Guidelines", all such unclaimed liabilities (where amount due has been transferred to DEAF) may be reflected as "Contingent Liability – Others, items for which the bank is contingently liable" under Schedule 12 of the annual financial statements.

15.32 Since the amounts could be claimed by the depositors together with interest to be compensated by the DEAF, it is appropriate to include the same as a contingent liability, by indicating that the claims, if any, are fully recoverable from the said Fund.

Bills for Collection

15.33 Bills held by a bank for collection on behalf of its customers are to be shown by way of a footnote to the balance sheet.

15.34 These bills are generally *hundies* or bills of exchange accompanied by documents of title to goods. Frequently, no bills of exchange are actually drawn; the bank is asked to present invoices and documents of title with instructions to collect the amount thereof from the party in whose name the invoice has been made. The documents of title enclosed with the bills for collection are usually not assigned to the bank.

15.35 Bills for collection do not involve an outlay of the bank's funds and Bank has no financial liability in respect of such bills, the proceeds of which are to be credited to the customer's account if and when collected. The banks earn commission for rendering service relating to collection of bills for their customers. Bills not collected are normally returned to the customers, and only current outstanding bills as at the year end are to be shown as 'bills for collection' in the financial statements of the branches where such activity takes place. Thus, in the normal course, such bills are expected to collect on behalf of customers in a time

bound manner, and entries in respect thereof in the records cannot remain outstanding for long periods of time, beyond their normal dates of collection. Reasons for unwarranted retention of entries and their inclusion /disclosure in the Notes, need to be enquired into, to ensure that the aggregate amount of such bills is not overstated

15.36 A bank may get bills for collection from -

- (a) its customers, drawn on outstation parties; or
- (b) its other branches or other outstation banks or parties, drawn on local parties.

15.37 On receipt of the bills drawn on outstation parties, the bank forwards them to its branch or other correspondent at the place where they are to be collected. Such bills are called Outward Bills for Collection.

15.38 Bills received by the bank from its outstation branches and agents, etc. for collection are called Inward Bills for Collection.

15.39 It may be noted that if a bill is received by one branch of the bank from a customer and sent by it to another branch of the bank for collection, the same will be shown as an Outward Bill at the first branch and as an Inward Bill at the other branch. In the consolidated balance sheet of the bank, however, all such bills should be shown only once. Therefore, Inward Bills for Collection are excluded from the balance sheet of each branch.

Co-acceptance of Bills

15.40 In its Master Circular No. RBI/2015-16/76 DBR. No. Dir. BC.11/13.03.00/2015-16 dated July 1, 2015 on "Guarantees and Co-acceptances", the RBI had reiterated the need for the banks to be cautious while co-accepting bills of their customers and discounting the same so as to avoid loss to banks arising on account of frauds perpetrated in the guise of bills. The circular requires the banks, *inter alia*, not to extend their co-acceptances to house bills/ accommodation bills drawn by group concerns on one another. In the circular, the RBI had also listed a number of safeguards to be undertaken by banks while co-accepting bills.

Audit Approach and Procedures

Contingent Liabilities

15.41 In respect of contingent liabilities, the Auditor is primarily concerned with seeking reasonable assurance that all contingent liabilities are identified, accounted and properly valued. To this end, the auditor should, generally follow the audit procedures given below:

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- (a) The Auditor should verify whether there exists a system whereby the non-fund based facilities are extended only to their regular constituents, etc. in line with the Bank's laid down policy.
- (b) The Auditor should ascertain whether there are adequate internal controls to ensure that transactions giving rise to contingent liabilities are executed only by persons authorised to do so and in accordance with the laid down procedures.
- (c) The Auditor should also examine whether in case of LCs for import of goods, as required by the abovementioned Master Circular on guarantees and co-acceptances, the payment to the overseas suppliers is made on the basis of shipping documents and after ensuring that the said documents are in strict conformity with the terms of LCs.
- (d) Ascertain whether the accounting system of the bank provides for maintenance of adequate records in respect of such obligations and whether the internal controls ensure that contingent liabilities are properly identified and recorded.
- (e) The Auditor should perform substantive audit tests to establish the completeness of the recorded obligations. Such tests include confirmation procedures as well as examination of relevant records in appropriate cases.
- (f) The Auditor should review the reasonableness of the year-end amount of contingent liabilities in the light of previous experience and knowledge of the current year's activities.
- (g) The Auditor should review whether comfort letters issued by the bank have been considered for disclosure of contingent liabilities.
- (h) The Auditor should ascertain the process followed to restate the contingent liabilities denominated in foreign currency into the reporting currency as at the Balance Sheet date. It is preferable to have automation in this regard to the extent possible.
- (i) While testing the adequacy of internal control procedure, the Auditor should test whether there exist a proper system of numbering of such transactions for performing completeness test and whether there exists a proper system over recording of such transactions in straight through processing(STP). In case the straight through processing has not been implemented or controls over straight through processing is not adequate, the auditor should perform such additional procedure including the as may be appropriate in the circumstances so that the risk of material misstatement is adequately addressed.

With banks using a variety of different programs for different needs, ensuring all of the systems involved in the STP process work together and transfer information accurately and smoothly without delay is often the biggest challenge when implementing STP. Depending on the information being relayed, many different programs may be required to help transfer the data and information correctly. Gaps in integrating all of those different programs to work together in one seamless structure can result in Risk of Misstatement and Frauds.

In whichever branch SWIFT is installed, existence and adequacy of the internal control system and procedures need to be kept in view. It needs to be emphasised that for a fraud to be perpetrated in SWIFT messages/transactions, one would have to play the role of all four—maker, checker, verifier and the receiver of the transactional message from its origination to conclusion, which would be in breach of internal control system. Control systems would be robust where the outward messages, expected to be in pre-serially numbered and sequentially arranged forms on special stationery, are independently handled and authenticated at each stage before being transmitted under the signatures of the authorised officials. Similarly the laid down controls/procedure need to be strictly followed for the inward SWIFT messages. It needs to be ensured that the messages are linked to the CBS system; and at frequent short intervals, the related transactions and their closure need to be checked, particularly overdue entries outstanding in the accounts of the customers. The verification of such transactions and balances should also be extensively covered by Internal Inspection and concurrent audit.

SWIFT

Founded in 1973 as a member-owned cooperative society, initially with 239 banks in 15 countries, and called Society for Worldwide Inter-bank Financial Telecommunications (SWIFT), it considerably expanded its spread and operations, to provide services not only to banks, but Brokerage Institutes and Trading Houses, Securities Dealers, Asset Management Companies, Clearing Houses, Depositories, Exchanges, Corporate Business Houses, Treasury Market Participants and Service Providers, Foreign Exchange and Money Brokers.

Recognised for its core business as a vast messaging network SWIFT is used by banks and other financial institutions, to quickly, accurately, and securely send and receive information and instructions through a standardized system of codes, and has attained, and holds, a dominant position in the global processing of transactional messages for its

members. In consideration of a one-time joining fee plus annual support charges, which vary by member classes, and for usage of services, SWIFT assigns to each such member, a unique code of 8, (going on to 11) characters (interchangeably called the Bank Identifier Code (BIC), SWIFT code, SWIFT ID, or ISO 9362 code). The characters represent the institution, country, location/city for the first 8 characters and the last three are used by the banks/institutions at their option to identify their branches etc.

- (j) The Auditor should also examine whether the bank has given any guarantees in respect of any trade credit (buyer's credit or seller's credit)¹¹. The period of guarantees is co-terminus with the period of credit reckoned from the date of shipment. The Auditor also needs to examine as to whether contingent liability in respect of trade credits includes any amounts actually arranged and received by the Bank from other banks in its NOSTRO Account(s) overseas, to discharge the financial commitment/obligation (of the Bank's customer in India), in favour of such customer's overseas suppliers. The amounts so received are of the nature of funded obligations and intrinsically not of the nature of Contingent obligations. On behalf of the Bank's customer in India, guarantees provided to the customer's overseas supplier for imports into India, where no funds are transferred in discharge of the (customer's) liability, the same is of the nature of a contingent liability; and the contingent liability would cease on actual payment on the due date.
- (k) The Auditor should verify whether the bank has extended any non-fund facility or additional/*ad hoc* credit facilities to persons other than its regular customers. In such cases, the Auditor should examine the existence of concurrence of existing bankers of such borrowers and enquire regarding financial position of those customers. The auditor should also verify whether the required margin as per the sanction letter is invariably kept by the branch.
- (l) If the bank is using separate application for communicating, transacting, executing any co-acceptance / guarantees, the Auditor should verify the interface controls in respect of these applications and CBS. If the system-based interface is not available and manual intervention is involved then the Auditor should verify the controls put in place by the bank for confirming completeness and correctness of transactions.

¹¹ In terms of the Circular No. RBI/2004/34 A.P. (Dir. Series) Circular no. 60 dated January 31, 2004 "External Commercial Borrowings (ECB)", any trade credit extended for a period of three years and above comes under the category of external commercial borrowings.

- (m) The Auditor may also perform analytical procedure by analysing the commission/fee earned from these transaction *vis a vis* aggregate transactions during the period.
- (n) The Auditor should obtain representation from the management that:
 - (i) all off-balance sheet transactions have been accounted in the books of accounts as and when such transaction has taken place;
 - (ii) all off balance sheet transactions have been entered into after following due procedure laid down;
 - (iii) all off balance sheet transactions are supported by the underlying documents;
 - (iv) all year end contingent liabilities have been disclosed;
 - (v) the disclosed contingent liabilities do not include any crystallised liabilities which are of the nature of loss/ expense and which, therefore, require creation of a provision/adjustment in the financial statements;
 - (vi) the estimated amounts of financial effect of the contingent liabilities are based on the best estimates in terms of Accounting Standard 29, including consideration of the possibility of any reimbursement;
 - (vii) in case of guarantees issued on behalf of the bank's directors, the bank has taken appropriate steps to ensure that adequate and effective arrangements have been made so that the commitments would be met out of the party's own resources and that the bank will not be called upon to grant any loan or advances to meet the liability consequent upon the invocation of the said guarantee(s) and that no violation of section 20 of the Banking Regulation Act, 1949 has arisen on account of such guarantee; and
 - (viii) such contingent liabilities which have not been disclosed on account of the fact that the possibility of their outcome is remote include the management's justification for reaching such a decision in respect of those contingent liabilities.

15.42 The specific procedures to be employed by the Auditor to verify various items of contingent liabilities are discussed in the following paragraphs.

Claims Against the Bank Not Acknowledged as Debts

15.43 Information relating to claims against the Bank is recorded at each Branch as also at the Head Office. Such information would include claims made by staff (particularly those under suspension/dismissal), constituents

(e.g. for dishonour of cheques, frauds in customers' accounts due to negligence etc.), and any other matters in litigation which are contested by the bank but not acknowledged as a liability. Such claims may arise from Govt. bodies/authorities/others either under a statute or through litigation/arbitration etc. At the Head Office, the Legal Department would have a record of such claims, both originating at the Branches as well as at the Head Office.

15.44 The Auditor concerned should seek information from the management as to the year end status of claims outstanding against the branch/ bank, that are not acknowledged as debts. To begin with, an enquiry needs to be made as to the reasons for deletion during the year, of any such outstanding claims which were disclosed as at the previous year end, to ensure that the deletion thereof was justified based on facts and evidence. At the Head Office, reference needs to be made to the minutes of the Board/Committees, the records maintained by the Legal Department, relating to matters in litigation/arbitration, particularly those relating to notices served on the Bank by the Central/State Government and local authorities/bodies. A review of subsequent events would also provide evidence about completeness and valuation of claims. Based on the circumstances of each case and available evidence, the auditor should verify whether the item is likely to remain a claim against the bank not acknowledged as debt or it is likely to be a liability requiring provisioning. The auditor may ask the Bank for an opinion from legal experts in respect of crystallisation of claim against the Bank. The Auditor should use professional judgement to determine as to whether a claim needs to be provided or can be regarded as a contingent liability.

Liability on Account of Outstanding Forward Exchange Contracts and Derivatives Contracts

15.45 *Forward Exchange Contract:* The Auditor may verify the outstanding forward exchange contracts with the statement of outstanding forward exchange contracts generated from the bank's computerised accounting system or manual register maintained by the branch. The auditor may physically verify the underlying documents including confirmations from merchants to test the existence of such outstanding contracts.

15.46 *Derivatives Contract:* The Auditor may verify outstanding derivatives contracts (options, cross currency swaps, interest rate swaps, etc.) with report generated from treasury application. The audit procedure mentioned may be used for verification of derivative contracts:

- The Auditor may also verify the outstanding margin *vis a vis* the outstanding forward foreign exchange contracts/derivative contracts with reference to margin, if any, stipulated in terms of sanction.

- The Auditor may also perform analytical procedure by analysing the commission/fee earned from these transaction *vis a vis* aggregate transactions during the period.

Guarantees Given on Behalf of Constituents

15.47 The Auditor should ascertain whether there are adequate internal controls over issuance of guarantees, e.g., whether guarantees are issued under proper sanctions, whether adherence to limits sanctioned for guarantees is ensured, whether margins are taken from customers before issuance of guarantees as per the prescribed procedures, etc.

15.48 The Auditor should ascertain whether there are adequate controls over custody of unused guarantee forms, if the bank has process of issue of guarantees in pre-printed forms, e.g., whether these are kept under the custody of a responsible official, whether a proper record is kept of forms issued, whether stock of forms is periodically verified and reconciled with the book records, etc.

15.49 The Auditor should examine the guarantee register/statements generated from the computerised system to seek evidence whether the prescribed procedure of marking off the expired guarantees is being followed or not.

15.50 The Auditor should check the relevant guarantee registers/statements generated from the computerised system with the list of outstanding guarantees to obtain assurance that all outstanding guarantees are included in the amount disclosed in this behalf. The Auditor should also examine that expired guarantees where claim period is also over are not included in this head. He should verify guarantees with the copies of the letters of guarantee issued by the bank and with the counter-guarantees received from the customers. He should also verify the securities held as margin. The auditor should examine as to whether adjustments/provision as required have been made in respect of contingent obligations that have ceased.

15.51 The auditor should obtain a written confirmation from the management that all obligations in respect of guarantees have been duly recorded and that there are no guarantees issued up to the balance sheet date which are yet to be recorded and that there are no obligations that have intrinsically ceased, which are included as contingent liabilities as on the balance sheet date.

15.52 In case of counter guarantees issued in favour of foreign banks for guaranteeing the obligation of bank's constituents in India, generally these guarantees are termed as "stand by letter of credit" or "letter of credit". These guarantees, standby letters of credit, letters of credit are transmitted through

SWIFT messages, which has standard formats of different types of transactions. The auditor may verify the SWIFT message to test such transactions.

15.53 The Auditor should verify whether proper guidelines have been laid down for classification of Guarantees as Performance or Financial and whether such guidelines have been scrupulously followed, considering that commission and margin and the risk weights are different for Performance and Financial Guarantees.

Acceptances, Endorsements and Other Obligations

15.54 The Auditor should evaluate the adequacy of internal controls over issuance of letters of credit and over custody of unused LC forms, if the bank has process of issue of LCs in pre-printed forms, in the same manner as in the case of guarantees.

15.55 The Auditor should verify the balance of letters of credit from the register maintained by the bank. The register indicates the amount of the letters of credits and the extinguishment of obligations based on utilisation by the customer.

Other Acceptances and Endorsements

15.56 The Auditor should study the arrangements made by the bank with its customers. He should verify the amounts of the bills with the register maintained/statements generated from computerised system by the bank for such bills. The Auditor should also examine whether such bills are marked off in the register on payment at the time of maturity.

15.57 In respect of letters of comfort, the Auditor should examine whether the bank has incurred a potential financial obligation under such a letter. If a comfort letter does not cast any such obligation on the bank, no disclosure under contingent liability is required on this account. The audit procedure applicable for auditing bank guarantees as mentioned above, *mutatis mutandis*, applies to the audit of the acceptances, endorsements and other obligations.

Common Procedures

15.58 The Auditor should obtain a written confirmation from the management that all obligations assumed by way of acceptances, endorsements and letters of credit have been duly recorded and there are no such obligations assumed up to the balance sheet date, which are yet to be recorded.

15.59 The Auditor should ascertain whether a contingent obligation assumed by a bank either by way of acceptance, endorsement etc., has resulted in an actual obligation owing to any act or default on the part of its constituent. In such a case, the auditor should assess whether a provision is required to be made in the accounts for the bank's obligation, which should be determined after taking into account the probable recovery from the customer.

15.60 Various tests need to be carried out to ensure that IT applications have resulted in consisted and reliable system for inputting, processing and generation of output of data as required under Jilani Committee Recommendations at the branch level.

15.61 Verification is to be done for existence of the internal control as to whether bank guarantees/LCs are issued in security forms serially numbered, under two officers' signatures of the bank -above certain cut off point in triplicate, binding on beneficiary to seek confirmation of Controlling Office (incorporation of suitable condition in the document) etc., and unused security stationery are to be kept under joint custody as required under Ghosh Committee recommendations (Relating to frauds and malpractices in banks to be implemented at the Branch level).

15.62 Verification is to be done whether all bank guarantees renewed/extended after the original due dates - including extension of due date of Letter of credits are duly reflected in CBS ,as this is one fraud prone area; possibility of heavy leakage of income exists in the absence of proper validation in the system.

Other Items for Which the Bank is Contingently Liable

15.63 The Auditor should examine whether commitments under all outstanding underwriting contracts have been disclosed as contingent liabilities. Similarly, the Auditor should also examine whether commitment made to participate in the venture capital fund or private equity fund or AIF or similar funds, which has not been called up or unpaid till the Balance Sheet date have been disclosed as contingent liabilities. For this purpose, the auditor should examine the terms and conditions of the relevant contracts.

15.64 Rediscounting is generally done with the RBI or other financial institutions or, in the case of foreign bills, with foreign banks. If the drawer dishonours the bill, the rediscounting bank has a right to proceed against the bank as an endorser of the bill. The Auditor may check this item from the register of bills rediscounted maintained by the branch. He should satisfy himself that all the bills are properly marked off on payment at the time of maturity.

15.65 The Auditor should check whether any liability is involved in cases lodged against the bank.

15.66 The Auditor may verify other items under this head in the same manner as in case of other entities.

Bills for Collection

15.67 The Auditor should examine whether the bills drawn on other branches of the bank are not included in bills for collection.

15.68 Inward bills are generally available with the bank on the closing day and the auditor may inspect them at that time. The bank dispatches outward bills for collection soon after they are received. They are, therefore, not likely to be in hand at the date of the balance sheet. The Auditor may verify them with reference to the register maintained for outward bills for collection.

15.69 The Auditor should also examine collections made subsequent to the date of the balance sheet to obtain further evidence about the existence and completeness of bills for collection.

15.70 Regarding bills for collection, the Auditor should also examine the procedure for crediting the party on whose behalf the bill has been collected. The procedure is usually such that the customer's account is credited only after the bill has actually been collected from the drawee either by the bank itself or through its agents, etc. This procedure is in consonance with the nature of obligations of the bank in respect of bills for collection.

15.71 The commission of the branch becomes due only when the bill has been collected. The Auditor should, accordingly, examine that there exists adequate internal control system that debits the customer's account with the amount of bank's commission as soon as a bill collected is credited to the customer's account. The auditor should also examine that no income has been accrued in the accounts in respect of bills outstanding on the balance sheet date.

Co-acceptance of Bills

15.72 The Auditor should examine whether the bank has instituted an adequate internal control system to comply with the safeguards as set out by the RBI's Master Circular No. RBI/2015-16/76 DBR. No. Dir. BC.11/13.03.00/2015-16 dated July 1, 2015 on "Guarantees and Co-acceptances" to ascertain whether such system, *inter alia*, captures all such items, appropriately records the same and also determines all the material items forming contingent liabilities, whether any item needs a provision in the books.

Disclosures

Balance Sheet Disclosure

15.73 The Third Schedule to the Banking Regulation Act, 1949, requires the disclosure of the following as a footnote to the balance sheet.

(a) Contingent Liabilities

- I. Claims against the bank not acknowledged as debts
- II. Liability for partly paid investments
- III. Liability on account of outstanding forward exchange contracts & Derivatives Contracts
- IV. Guarantees given on behalf of constituents
 - (a) In India
 - (b) Outside India
- V. Acceptances, endorsements and other obligations
- VI. Other items for which the bank is contingently liable *

(b) Bills for Collection

*This will include the amounts transferred to DEAF and remaining unclaimed.

15.74 The Auditor should report in the LFAR the list of major items of the contingent liabilities (other than constituent's liabilities such as guarantees, letter of credit, acceptances, endorsements, etc.) not acknowledged by the branch.

Profit and Loss Account

16.01 Sub-section (1) of section 29 of the Banking Regulation Act, 1949, requires the preparation of Profit and Loss Account in Form B of the Third Schedule to the Act or as near thereto as the circumstances admit. This sub-section is applicable to Banking Companies, Nationalised Banks, State Bank of India and its Subsidiaries, and Regional Rural Banks.

Disclosures

16.02 The Profit and Loss Account as set out in Form B has four broad heads:

- Income
- Expenditure
- Profit/ Loss
- Appropriations

The information to be provided under each of the above heads is also specified in the Schedule. It would be pertinent to note that knowledge of the Bank's accounting policies is of utmost importance before verifying the items within the profit and loss account. The Auditor must make enquiries with the management to ascertain whether there have been any changes in the accounting policies and also review the closing circulars issued by the controlling authorities of the Bank.

Applicability of AS 5 and Materiality

16.03 Accounting Standards are intended to apply only to items that are material. Since materiality is not objectively defined, RBI, vide its Circular No. DBOD. No.BP. BC. 89 /21.04.018/2002-03 dated March 29, 2003 on "Guidelines on compliance with Accounting Standards (AS) by banks", has advised that all banks should ensure compliance with the provisions of accounting standards in respect of any item of prior period income or expenditure, which exceeds one per cent of total income/ total expenditure of the bank if the income or expenditure is reckoned on gross basis or one per cent of the net profit before taxes or net losses as the case may be if the income is reckoned on net of costs.

16.04 This guidance of the RBI needs to be applied to the Branch Audits by suitable modification and assessing the impact of "Tolerable Errors & Unadjusted Misstatements" keeping in view their nature and the materiality indicated by the

Central Statutory Auditors or closing circulars issued by the controlling authorities of the bank.

16.05 Since the format of the profit and loss accounts of banks prescribed in Form B under Third Schedule to the Banking Regulation Act, 1949 does not specifically provide for disclosure of the impact of prior period items on the current year's profit and loss, such disclosures, wherever warranted, may be made in the 'notes on accounts' to the balance sheet of banks. The relevant extract of LFAR on income is as under:

Has the test checking of interest/discount/ commission/ fees etc. revealed excess/short credit of a material amount? If so, give details thereof.

Background & Audit Approach

Interest Earned

16.06 The following items are included under this head:

- (a) *Interest/Discount on Advances/Bills*: This includes interest and discount on all types of loans and advances like cash credit, overdrafts, demand loans, term loans, export loans, domestic and foreign bills purchased and discounted (including those rediscounted), overdue and penal interest and interest subsidy, if any, relating to such advances/bills. The amount to be included under this head is net of the share of participating banks under inter-bank participation schemes on risk-sharing basis. In modern day banking, the entries for interest income on advances are automatically generated through a batch process in the CBS system.
- (b) *Interest Income on Investments*: This will be generally dealt by treasury at the Head Office level so branch will not have any income under such head.
- (c) *Interest on Balances with RBI and Other Inter-bank Funds*: This will be generally dealt by treasury at the Head Office level so branch will not have any income under such head.
- (d) *Others*: This includes any other interest/discount income not included in the above heads. Interest on advances given by the bank to staff member in its capacity as employer rather than as banker should be included under this head.

Income from Investments

16.07 Interest and dividend on investments are usually accounted for at the Treasury Branch of the bank or at the Head Office. Thus, a branch will not have any income under such head.

Other Income

16.08 The following items are included under this head:

- (i) *Commission, Exchange and Brokerage*: This item comprises of the following:
 - (a) Commission on bills for collection.
 - (b) Commission/exchange on remittances and transfers, e.g. demand drafts, NEFT, RTGS, etc.
 - (c) Commission on letters of credit and guarantees, letter of comforts.
 - (d) Loan processing, arranger and syndication fees.
 - (e) Mobile banking fees.
 - (f) Credit/Debit card fee income including annual fee income, merchant acquiring income, interchange fees, etc.
 - (g) Rent from letting out of lockers.¹²
 - (h) Commission on Government business.
 - (i) Commission on other permitted agency business including consultancy and other services.
 - (j) Brokerage on securities.
 - (k) Fee on insurance referral.
 - (l) Commission on referral of mutual fund clients.
 - (m) Service/transaction banking charges including charges levied for transaction at other branches.
 - (n) Income from rendering other services like custodian, demat, investment advisory, cash management and other fee based services.
- (ii) *Profit on sale of Land, Buildings and Other Assets*: This item includes profit (net of any loss) on sale of land, buildings, furniture, motor vehicles, gold, silver, etc.
- (iii) *Profit on exchange transactions*: This includes revaluation gains/losses on forward exchange contracts and other derivative contracts, premium income/expenses on options, etc.

¹² As per the Notes and Instructions for compilation of the profit and loss account, issued by the Reserve Bank, this item should come under this head. There is, however, a contrary view in some quarters that locker rent should be included in miscellaneous income. The latter view seems more plausible.

- (iv) Income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India.
- (v) Miscellaneous income

Profit/Loss on Revaluation of Property, Plant & Equipment (PPE)

16.09 According to the "Notes and Instructions" for compilation of profit and loss account, issued by the RBI, the net profit/loss on revaluation of the aforesaid assets may also be shown under this item. In this regard, the requirements of AS 10 (Revised), *Property, Plant & Equipment*, relating to revaluation of fixed assets assume significance. According to the AS 10 (Revised), when a PPE is revalued in financial statements, the entire class of assets should be revalued, or the selection of assets for revaluation should be made on a systematic basis. It is also provided that an increase in net book value arising on revaluation of fixed assets should be credited directly to owners' interests under the head of revaluation reserve. However, if such increase is related to and not greater than a decrease arising on revaluation which was previously recorded as a charge to the profit and loss account, it may be credited to the profit and loss account. On the other hand, any decrease in net book value arising on revaluation of fixed assets should be charged directly to the profit and loss account except that to the extent that such a decrease is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it may be charged directly to revaluation reserve account.

16.10 From the above, it can be seen that as per AS 10 (Revised), surplus on revaluation of a fixed asset cannot be credited to the profit and loss account except to the extent that such surplus represents a reversal of a related previous revaluation decrease that was charged to the profit and loss account.

Profit on Exchange Transactions

16.11 This item includes profit (net of loss) on dealings in foreign exchange and will be applicable at treasury or selected foreign designated branches.

Income Earned by Way of Dividends, etc. from Subsidiaries and Joint Ventures abroad/in India

16.12 As investments are usually dealt with at the head office level, this item may not appear in the profit and loss account of a branch.

Miscellaneous Income

16.13 This head generally includes the following items of income:

- (a) Recovery in Written off Accounts.
- (b) Rental income from bank's properties.

- (c) Security charges.
- (d) Insurance charges recoverable from customers.
- (e) Other income from carrying out other services like selling of gold coins etc.

16.14 The "Notes and Instructions for compilation of profit and loss account", issued by the Reserve Bank, require that in case any item under this head exceeds one per cent of the total income, particulars thereof may be given in the notes.

Income

16.15 In carrying out an audit of income, the Auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transactions, which took place during the relevant period and pertain to the bank, that there is no unrecorded income, and that income is recorded in proper amounts and is allocated to the proper period. In view of the mandatory requirement of recognition of income, the recognition of revenue will have to be subjected to examination *vis-à-vis* the guidelines. *Vide* circular DBOD.No.BP. BC. 89 /21.04.018/2002-03 dated 29th March 2003 on "Guidelines on compliance with Accounting Standards (AS) by banks, RBI has advised that in respect of any income which exceeds one percent of the total income of the bank if the income is reckoned on a gross basis or one percent of the net profit before taxes if the income is reckoned net of costs, should be considered on accrual as per AS-9. If any item of income is not considered to be material as per the above norms, it may be recognised when received and the Auditors need not qualify the statements in that situation. As per AS-9 Revenue Recognition, revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognised when no significant uncertainty as to measurability or collectability exists. If revenue recognition is postponed, as per AS 9, an enterprise should also disclose the circumstances in which the revenue recognition has been postponed pending the resolution of significant uncertainties.

16.16 Since the entire accounting in banks is done on the CBS, the Auditor should plan the audit procedures based on controls testing. If he is not satisfied with the controls in place for accounting and recording of items of income and expenses correctly, he should resort to more of substantive checking of documents and records.

16.17 In case the Auditor decides to adopt the control reliance strategy, the Auditor should perform test of controls which mitigate the risk of what could go wrong.

16.18 As per Auditing Standards Revenue is always considered as Presumed Risk of Material Mis-statements. The Auditor therefore should plan the audit and test the controls considering mainly following assertions/attributes:

1. Occurrence – Whether recorded revenue is valid and accounting of revenue is not as per the terms of contract
2. Completeness – All revenue transactions are accounted for the period covered under audit
3. Accuracy – The Auditor needs to satisfy this assertion on the basis of system controls and risk assessment and substantive audits of samples derived.
4. Cut-off – Revenue is correctly accounted in case of period based contract.
5. Classification – Gross Revenue and Net revenue bifurcation is correctly adhered.
6. Disclosures – Verify the various disclosures requirements as per BR act, accounting standards and RBI directives.

Interest Income

16.19 As a measure of control and also to ensure that the legal remedies against defaulting borrowers are not adversely affected, banks commonly follow the procedure of recording interest on non-performing advances in a separate account styled as 'Interest Suspense/ Interest Not Collected Account (INCA)/ Unrealised interest of previous year (UIPY) ' or other similar account. Amounts lying in Interest Suspense Account do not represent income of the bank and have also to be deducted from the relevant advances. The auditor should report the following in LFAR:

Has the branch compiled with the Income Recognition norms prescribed by RBI (The Auditor may refer to the instructions of the controlling authorities of the bank regarding charging of interest on non-performing assets).

16.20 The Auditor should check whether, in terms of the income recognition guidelines issued by the RBI, the bank has either reversed or made provision in respect of interest accrued and credited to income account, in respect of an advance (including bills purchased and discounted) that becomes NPA during the year. Income in case of NPA account should be recognised only on realisation on cash basis as per circular no. RBI/2015-16/101DBR.No.BP.BC.2/21.04.048/ 2015-16 dated July 01, 2015 "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining

to Advances". These norms are also applicable to Government Guaranteed Advances.

16.21 The said norms also require that the banks should not recognise income from those projects under implementation which have been classified as sub-standard and it should be recognised only on cash basis. The auditor should also, accordingly, see whether any interest on such projects which has been recognised as income in the past is either reversed or a provision for an equivalent amount is made in the accounts.

16.22 The Auditor may assess the overall reasonableness of the figure of interest earned by working out the ratio of interest earned on different types of assets to the average quantum of the respective assets during the year. The Auditor should obtain an in-depth understanding as to how the bank's management monitor their business, analyse its credit portfolio and the interest income thereon.

16.23 For example, the auditor may obtain from the bank an analysis of sector-wise and segment-wise deployment of credit, including the lending rates of advances in various sectors and figures of advances outstanding at the end of each month/quarter. From such information, the Auditor may work out a weighted average lending rate. This analysis can be done for corporate and retail loan portfolio separately. In case of retail loans, the portfolio can be further bifurcated into home loans, auto loans, personal loans, jewel loans, etc. Further, the Auditor should understand the process of computation of the average balance and re-compute the average balance on sample basis.

16.24 The Auditor should set the expectation for the movement in yield based on the discussion and inquiries made with the management; rate movement observed in the industry, etc., and should obtain explanations for major variances in the yield on month basis or quarterly basis.

16.25 To ascertain completeness of interest income in the analysis, the Auditor should obtain general ledger break-up for the interest income earned during the respective months/quarter and examine whether the aggregation of the same agrees with the interest income considered for the yield analysis. The Auditor should analyze monthly/quarterly yields and document the reasons for the variances as per the expectation set. The Auditor may compare the average yield on advances with the corresponding figures for the previous years and analyse any material differences. The Auditor may also compare

the reported market yield in percentage terms with market rates, RBI rates, advertised rates and rates across various products of the bank. Interest Income includes interest accrued but not due on investments.

16.26 The Auditor should, on a test check basis, verify the rates of interest as per terms of sanction in the CBS as well as the calculation of interest through product rate sheets generated by CBS to satisfy himself about the following:

- (a) Interest has been charged on all the performing accounts up to the date of the balance sheet.
- (b) Interest rates charged are in accordance with the bank's internal regulations, directives of the RBI and agreements with the respective borrowers. The scrutiny of interest rates charged is particularly important in the case of advances made on floating interest rate basis.

The rate of interest is normally linked with MCLR/ base rate of bank. But in case of consortium advances, the rate is normally linked with the MCLR/ Base rate of lead bank or highest rate of member's bank. The rate of interest is reset from time to time. Normally the bank disables the field of fixed rate and links with its own MCLR/ base rate. Whenever there is change in the MCLR base rate of the bank, the rate of interest is changed in such accounts also.

The Auditor should check the sanction letter and find whether the rate of interest is reset as per sanction letter during the year. Special care should be given when there is change in MCLR of the bank.

- (c) Discount on bills outstanding on the date of the balance sheet has been properly apportioned between the current year and the following year.
- (d) Any interest subsidy received (or receivable) from RBI in respect of advances made at concessional rates of interest is correctly computed.
- (e) The moratorium period entered also effects the date of application of interest in the account and should therefore also be verified on samples Basis.

16.27 The Auditor should also understand the process of accrual of interest income on credit card portfolio. Credit card account will be treated as an NPA if the minimum amount due as stated in statement is not fully paid within 90 days from the date of next statement.

16.28 The Auditor should understand the assumption taken for accrual of interest income such as revolving portfolio, standard assets etc. and independently assess the reasonableness of these assumptions.

16.29 Identification of NPA on CIF level should also to be applied in cases of Credit Card NPA. The auditor should verify the same for the purpose of revenue recognition as well.

16.30 The Auditor should also satisfy himself that interest on non-performing assets has not been recognised unless realised.

16.31 As per AS 9, "Revenue Recognition", dividends should be recognised when the right to receive payment is established, i.e. dividend has been declared by the corporate body at its Annual General Meeting and the owner's right to receive payment is established.

16.32 The Auditor should test certain samples of the dividend income booked during the period by obtaining the counterfoils of dividend warrants and the amount credited in the bank account.

16.33 In the case of bill discounting, interest income is received in advance and hence the auditor should examine whether the interest income for the period has been accounted for properly and the balance is treated as other liabilities. In CBS, the interest on bill discounted is system driven and the auditor should verify the in-built logic of the system. For the sample cases, the auditor should verify the interest income on bill discounted by obtaining the underlying documents like purchase order, letter of credit, etc. Also for the overdue bills, the auditor should confirm whether the interest for the overdue period has been accrued by the system or is calculated manually by the Branch.

16.34 The Auditor should also understand the process of increase or decrease in Marginal Cost of funds based Lending Rate (MCLR) and process of updating in the system. The Auditor should ascertain compliance with RBI guideline in respect of increase in tenor of retail loan due to increase in MCLR and also verify on sample basis as to whether the increase/decrease in base rate is effected in the system on the effective date.

16.35 Interest income includes interest accrued but not due on assets. However, as banks normally debit the borrower's account with interest due on the month end, at balance sheet date there would not usually be any amount of interest accrued but not due on advances on balance sheet date. Auditor should verify the same.

16.36 The Auditor should examine the completeness of accrual of the interest by obtaining a detailed break-up of the loan portfolio (scheme wise or segment wise) and the interest accrual on the same. The aggregation of loan portfolio should agreed with to the general ledger.

16.37 The auditor should examine whether interest has accrued on the entire investment and money market lending portfolio by obtaining the detailed break-up of the investment and money market lending portfolio along with the interest accrued thereon and agree the same with the general ledger. The Auditor should re-compute the interest accrual on sample basis considering parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc., from the term sheet, deal ticket, agreements, etc.

16.38 In determining the extent of sample checking, the Auditor should take into account, *inter alia*, the results of the analytical procedures and the reports, if any, on income and expenditure/ revenue audit as well as other internal and RBI inspection reports and their compliance by the bank. The Auditor's assessment of the effectiveness of concurrent audit would also affect the extent of his detailed checking of interest earned. In determining the extent of sample checking, the auditor may place greater emphasis on examining interest on large advances.

Commission Income

16.39 The Auditor may check the items of commission, exchange and brokerage on a test check basis. Such examination can be done for commission earned on bills sent for collection, commission on letters of credit, guarantees and letter of comfort. The auditor should examine whether the commission on non-funded business (e.g., letters of credit, guarantees and bills for collection) has been properly apportioned between the current year and the following year.

16.40 The Auditor should obtain details of loans sanctioned and disbursed during the period as well as verify the policy of the bank for booking the processing fee income on such loans. For corporate loans, the processing fee income for the material loans sanctioned and disbursed should be re-computed and verified on test check basis by obtaining the loan agreements, sanction letter, etc. Further, for loans sanctioned but not disbursed wherein the processing fee or non-utilisation fee income has been booked on accrual basis, the Auditor should verify the subsequent receipt of the same and enquire for subsequent reversals. For retail loans, the Auditor should perform analytical procedures for computing the processing fee percentage for different ticket size loans.

16.41 The Auditor should obtain an understanding of the various types of fee income earned on credit cards and debit cards. Further, the Auditor should obtain the rate matrix for various fees charged to the customer. On a sample basis, the Auditor should verify whether the fees charged and accounted is as per the rate matrix. Interchange fees is earned from service providers namely Visa, Master card, Amex proportionate to the transactions entered by the customer. On a sample basis, the Auditor should verify whether the interchange fees have been received and accounted as per the agreement. Merchant acquiring income is earned on the transactions entered by the customers of other banks on the bank's terminal. The Auditor should perform analytical procedures for such income and obtain the explanation for the variances, if any.

16.42 The Auditor should understand how management monitors non-funded business and use their analysis for analytical procedures. The Auditor should understand the relation of fee income with the business. For example, checking of month on month /quarter loan processing fees with sanction value to arrive at average processing fees on monthly/quarterly basis. The Auditor should analyse monthly/quarterly fee percentage and document the reasons for the variances as per the expectation set. Similarly the Auditor can perform analysis of other fee income by doing monthly/quarterly guarantee fees with average monthly/quarterly guarantee amount, interchange credit card fees *vis a vis* interchange transactions etc.

16.43 The Auditor may also compare the average fee income with the corresponding figures for the previous years and analyse any material differences.

16.44 The Auditor should also check whether any fees or commission earned by the banks as a result of renegotiations or rescheduling of outstanding debts has, in terms of the income recognition guidelines issued by the RBI, have been recognised on an accrual basis over the period of time covered by the renegotiated or rescheduled extension of credit.

16.45 According to the guidelines for income recognition, asset classification, etc., issued by the RBI, if interest income from assets in respect of a borrower becomes subject to non-accrual, fees, commission and similar income with respect to same borrower that have been accrued should cease to accrue for the current period and should be reversed or provided for with respect to past periods, if uncollected. The Auditor should examine whether the bank has accordingly made suitable adjustments for de-recognition/ reversal of uncollected commission, etc.

16.46 Fee on insurance referral is fast emerging as a major source of income for banks. In terms of the RBI Master Circular No. DBR.No.FSD.BC 19/24.01.001/2015-16 dated July 1, 2015 on "Para Banking Activities", banks are permitted to undertake insurance business as agents of insurance companies on fee basis or referral arrangement without any risk participation subject to the conditions prescribed under the Master Circular. The Auditor should carefully examine the agreement entered into by the bank and the concerned insurance company to see the basis for calculation of the said fee, time when the referral fees becomes due to the bank. Normally, as an industry practice, such agency arrangements also contain clauses known as "claw back" of agency fee, whereby if the client referred to the insurance company by the bank fails to pay the insurance premium for a stipulated amount of time, the agency fees paid or due to the bank becomes recoverable from the bank or is frozen. Such clauses have a direct impact on the recognition of income from the agency fees in terms of Accounting Standard 9, "Revenue Recognition" and may, therefore, require creation of a corresponding provision in the accounts.

Income on account of Commitment Charges

16.47 Many times, it is noticed that the Loan Sanction letter contains a clause to the effect that if the borrower is not availing the full sanctioned limited in case of cash credit accounts, bank is supposed to levy commitment charges on the unavailed portion of the loan which is usually recognised as income of the period in which the same is realised by the bank. However, the Auditor has to ensure that the same is accounted for on accrual basis so that the income on this account is not understated.

Expenses

16.48 Expenditure is to be shown under three broad heads: interest expended; operating expenses; and provisions and contingencies.

In the LFAR of the branch, the following question is to be answered by the branch auditor:

Has the test check of interest on deposits revealed any excess/short debit of material amount? If so, give details thereof.

Interest Expended

16.49 The following items are included under this head:

- (a) *Interest on Deposits*: This includes interest paid/ payable on all types of deposits including deposits from banks and other institutions. Usually,

the rates of term deposits of banks are amended from time to time by the ALCO or the Board.

- (b) *Interest on Reserve Bank of India/ Inter-Bank Borrowings:* This includes interest/ discount on all borrowings and refinance from the RBI and other banks.
- (c) *Others:* This includes discount/ interest on all borrowings/ refinance from financial institutions. All other payments like interest on participation certificates, penal interest paid, etc. may also be included here.

16.50 The RBI has issued Master Direction no. RBI/DBR/2015-16/19 DBR.Dir.No.84/13.03.00/2015-16 "Reserve Bank of India (Interest Rate on Deposits) Directions, 2016 on March 03, 2016 (updated as on February 22, 2019) which contains the 'Interest Rate Framework'. The RBI has deregulated the savings bank deposit interest rate. In other words, the banks are free to determine their savings bank deposit interest rate. The Auditor should verify that prior approval of the Board/Asset Liability Management Committee (if powers are delegated by the Board) has been obtained by the bank while fixing interest rates on such deposits.

16.51 The Auditor should review the circulars or guidelines issued by the controlling authorities of the Bank to identify the changes in the Interest Rates during the year.

16.52 The RBI has also deregulated the interest rates on Non Resident (External) Rupee Deposits and Ordinary Non-Resident (NRO) Accounts as follows:

- Banks are free to determine their interest rates on both savings deposits and term deposits of maturity of one year and above under Non-Resident (External) Rupee (NRE) Deposit accounts and savings deposits under Ordinary Non-Resident (NRO) Accounts. However, interest rates offered by banks on NRE and NRO deposits cannot be higher than those offered by them on comparable domestic rupee deposits.
- Prior approval of the Board/Asset Liability Management Committee (if powers are delegated by the Board) needs to be obtained by a bank while fixing interest rates on such deposits. At any point of time, individual banks need to offer uniform rates at all their branches.
- The revised deposit rates apply only to fresh deposits and on renewal of maturing deposits.

- Banks also need to closely monitor their external liability arising on account of such deregulation and ensure asset-liability compatibility from systemic risk point of view.

16.53 The RBI has consolidated instructions pertaining to FCNR(B) deposits by Banks. Specific consideration should be given to the ceiling on interest rates, 360 days to a year basis for interest payment, rounding off of interest etc. Recurring Deposits should not be accepted under the FCNR (B) Scheme. The interest on FCNR (B) deposits should be calculated and paid at intervals of 180 days each and thereafter for the remaining actual number of days. However, the depositor will have the option to receive the interest on maturity with compounding effect.

Interest on Deposits

16.54 The Auditor may assess the overall reasonableness of the amount of interest expense in accordance with Master Direction no. DBR.Dir. No.84/13.03.00/2015-16 dated March 03, 2016 (Updated as on February 22, 2019) on "Reserve Bank of India (Interest Rate on Deposits) Directions, 2016" by analysing ratios of interest paid on different types of deposits and borrowings to the average quantum of the respective liabilities during the year. For example, the Auditor may obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The Auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material. The Auditor may also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences. The Auditor should obtain general ledger break-up for the interest expense incurred on deposits (savings and term deposits) and borrowing each month/quarter. The Auditor should analyse month on month (or quarter) cost analysis and document the reasons for the variances as per the benchmark stated. He should examine whether the interest expense considered in the cost analysis agrees with the general ledger. The Auditor should understand the process of computation of the average balance and re-compute the same on sample basis.

16.55 The Auditor should, on a test check basis, verify the calculation of interest. He should satisfy himself that:

- (a) Interest has been provided on all deposits and borrowings up to the date of the balance sheet; and verify whether there is any excess or short credit of material amount.

- (b) Interest rates are in accordance with the bank's internal regulations, the RBI directives, and agreements with the respective depositors.
- (c) In case of Fixed Deposits it should be examined whether the Interest Rate (as applicable) in the accounting system are in accordance with the Interest Rate mentioned in the Fixed Deposit Receipt/Certificate.
- (d) Interest on Savings Accounts should be checked on a test check basis in accordance with the rules framed by the bank in this behalf.
- (e) Discount on bills outstanding on the date of the balance sheet has been properly apportioned between the current year and the following year.
- (f) Payment of brokerage is properly authorized.
- (g) Interest on inter-branch balances has been provided at the rates prescribed by the head office.
- (h) Interest on overdue/ matured term deposits should be estimated and provided for.

16.56 The Auditor should ascertain whether there are any changes in interest rate on saving deposits and term deposits during the period. The auditor should obtain the interest rate card for various types of term deposits and analyse the interest cost for the period. The Auditor should examine the completeness that there has been interest accrued on the entire borrowing portfolio by obtaining the detailed breakup of the money market borrowing portfolio and the interest accrued and the same should agree with the GL code wise break up. The Auditor should re-compute the interest accrual on sample basis i.e., by referring to the parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc. from the term sheet, deal ticket, agreements, etc.

Other question to be answered by the Auditor in LFAR is:

Does the bank have a system of estimating and providing interest accrued on overdue/matured/ unpaid/ unclaimed term deposits including in respect of deceased depositors?

16.57 In most of the banks, now a days, term deposits are auto renewed. If the bank is not following the practice of auto renewal or customer has not given consent for auto renewal, then the Bank should provide for interest on overdue Term Deposit. The auditor should check whether Branch has the practice of generating overdue Deposits report and making provision for interest as per the

Bank's policy. If the same is carried out centrally then the Auditor can check whether all overdue deposits are considered by Central team by taking report from them.

Another question in the context of LFAR is "Are there any divergent trends in major items of income and expenditure, in comparison with corresponding previous year, which are not satisfactorily explained by the branch? If so, the same may be reported."

16.58 As explained earlier the Auditor should carry out variance analysis of all expenses head and seek clarification from the Branch for major variances, if any. Also based on variances, the Auditor shall modify samples in respect of specific expenses.

16.59 The other expenses head and audit procedure is as under:

- (i) *Payments to and Provisions for Employees:* This item includes salaries and wages of staff, allowances, bonus, other staff benefits like provident fund, pension, gratuity, leave fare concession, staff welfare, medical allowance to staff, etc. It may be noted that provision for terminal benefits like pension and gratuity is usually made only at the head office level. Salaries and allowances payable to the bank's staff and officers are usually governed by agreement with the employee unions or awards of a Courts/Tribunals. The payroll process is generally centralized in all banks. Auditors should ascertain the control available at the branch level and test check sample working.
- (ii) *Rent, Taxes and Lighting:* This item includes rent paid by the bank on buildings, municipal and other taxes, electricity charges and other similar charges and levies. The Auditor should specifically review cases where rental increases are in dispute and unpaid. Necessary provisions / disclosures should be appropriately made. It may be noted that income-tax and interest on tax are not to be included under this head. Similarly, house rent allowance and other similar payments to staff would not appear under this head.
- (iii) *Printing and Stationery:* This item includes books and forms and stationery used by the bank and other printing charges except those incurred by way of publicity expenditure. While some stationery may have been purchased by the branch, other stationery (security paper like draft forms, cheque books) would have been received by the branch from the head office. The

Auditor should specifically note the bank policy in this regard whether the same is expensed out on purchase or on usage. In any case any unusable or outdated stationery should be expensed out. If any stationery is shown as an asset, necessary physical verification should be done.

- (iv) *Advertisement and Publicity*: This item includes expenditure incurred by the bank for advertisement and publicity, including printing charges of publicity material. The Auditor should specifically review such agreements to find out commitments made for such expenses in future periods.
- (v) *Depreciation on Bank's Property*: This item includes depreciation on bank's own property, motor cars and other vehicles, furniture, electrical fittings, vaults, lifts, leasehold properties, non-banking assets, etc. Depending on the procedure followed in the bank, provision for depreciation may be either centralised at the head office level through fixed asset management software or decentralized and manual at branches and other offices. The Auditor should specifically review the residual value and useful life at the year end and provide for additional depreciation in case there is any downward revision in the useful life or change in residual value. The Auditor should ensure that fixed assets are accounted from the date the asset is put to use. Necessary accounting of the asset to be done and depreciation calculated from this date. Generally, banks account for fixed assets on date of final payment irrespective of the asset being put to use much earlier.

The Auditor should note the process for verifying assets booked by branch but allotted to employees and located at Bank residential premises allotted to these employees. The Auditors should verify the calculation of depreciation by exporting the relevant report from software.

The auditor should also ensure that the movement of asset on account of transfer of employees are reconciled and confirmed by the Transferee Branch to ensure appropriated depreciation charge on those assets.

- (vi) *Directors' Fees, Allowances and Expenses*: Expenditure incurred in this regard is recorded under this head. This item is dealt with at the head office level and would not therefore be relevant at the branch level.
- (vii) *Auditors' Fees and Expenses*: Remuneration payable to Statutory Auditors and Branch Auditors and expenses in connection with audit like reimbursements are recorded under this head. This item is usually dealt

with at the head office level and would not therefore be relevant at the branch level.

- (viii) *Law Charges*: All legal expenses and reimbursement of expenses incurred in connection with legal services are to be included here. The Auditor should specifically review the Legal agreements to note future commitments for payables. Expenses paid to advocates recovered from Borrowers by direct debit to that account should be specifically noted for consistency in accounting. The Auditor should also co-relate law charges with the contingent liability appearing in financial statement or with the specific annexure/report to be certified by the Branch Auditors'. Some banks also have a separate vertical for handling legal issues and the auditor may rely on confirmations / reconciliation of number of pending cases to ensure adequacy of the data considered for accounting of law charges.
- (ix) *Postage, Telegrams, Telephones, etc.*: This item includes all postal charges like stamps, telegrams, telephones, tele-printers, etc. Issuance of telegrams has been discontinued since 15th July 2013 and this head is now just for academic purposes.
- (x) *Repairs and Maintenance*: This item includes repairs to bank's property, their maintenance charges, etc. Amortization of such expenses should be specifically noted.
- (xi) *Insurance*: This item is usually dealt with at the head office level and may not therefore be relevant at the branch level. This includes premium paid to DICGC, Insurance of Cash on Hand, in ATM & in transit and also Insurance of Fixed Assets, Employee Fidelity Insurance, Fraud Covers, Coverage for Cyber Risks. The Auditor should specifically ensure that all risks are insured adequately. Decision not to insure specific risks / assets should be approved at appropriate management level and the Auditor should obtain the relevant documents for record.
- (xii) *Direct Marketing Expenses*: These are the expenses incurred mainly for sourcing of retails loans/credit cards and collection of retail overdue loans. RBI circular RBI/2006/167/DBOD.NO. BP.40/21.04.158/2006-07 dated 3rd November 2006 on Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by banks, clearly states that activities of internal audit, compliance function and decision making functions like

compliance with KYC norms for opening deposit accounts, according sanction for loans (including retail loans) and management of cannot be outsourced.

- (xiii) *Other Expenditure*: This item includes all expenses other than those included in any of the other heads, like, license fees, donations¹³, subscriptions to papers, periodicals, entertainment expenses, travel expenses, etc. The Notes and Instructions for compilation of profit and loss account, issued by the Reserve Bank, require that in case any particular item under this head exceeds one per cent of the total income, particulars thereof may be given in the notes. The Auditor should check such large value items reported under this head and identify the nature of items and if appropriate account head is available it should be classified in that head.

16.60 Some banks follow the policy of providing for the promotional points earned by the customers on the use of Debit/Credit cards on actuarial basis. These provisions could be shown under this head.

16.61 Expenses should be accounted on accrual basis and not on cash basis. The auditor may review payment vouchers of April month to ascertain the correctness of provision made for expenses.

Operating Expenses

16.62 Generally the audit procedures followed by Auditors in any entity are to be followed.

¹³ The Reserve Bank of India, from time to time, prescribes the limits up to which banks can make donations. As per the Reserve Bank of India's circular no. DBOD. No. Dir. BC. 50/ 13.01.01/ 2005-06 dated December 21, 2005 on "Donations by banks", the policy relating to donations given by banks to various entities may be formulated by the Board of Directors of the banks. While formulating any such policy, the circular requires the directors to take into account inter alia, the following principles:

- (i) profit making banks, during a financial year, may make donations up to one percent of the published profits for the previous years. This limit of one percent would include contributions made by the bank to any fund created for specific purposes such as encouraging research and development in fields related to banking. However, donations/ subscriptions to the Prime Minister's National Relief Fund and to professional bodies related to banking industry, such as the Indian Banks Association, Indian Institute of Banking etc., is excluded from such limit of one percent.
- (ii) loss making banks can make donations up to Rs. 5 lakhs in a financial year including donations to the Prime Minister's National Relief Fund and other professional organisations listed in (i) above.

The circular has clarified that the unutilised portion of one percent cannot be carried forward to the next year. The Circular also outlines the procedure for making contribution to the Prime Minister's National Relief Fund.

Payments to and Provisions for Employees

16.63 The Auditor should ascertain the procedure followed by the bank in this regard while verifying this item. The Auditor should obtain the human resource policy and identify the benefits available to employees. The Auditor should understand the compensation structure and process of payment of salary, benefits like employee stock options, car assistance, leave encashment, asset assistance, etc. to the various grades of employees. He should obtain the standard compensation structure for each grade of employee. In case, where payment is made on production of evidence or incurrence by employee, auditor should ascertain whether provision for the same has been made in the books.

16.64 The Auditor should perform an overall analytical review for the payments and provisions for employees by month on month grade-wise analysis of the employees cost and number of employee in that grade to identify per employee cost month on month and enquire about the variances, if any. The auditor should examine whether all the benefits for all the employees have been appropriately accounted for and should also check the calculation of salaries and allowances, etc. on a test check basis with reference to appointment/ awards/ offer letters. He may also assess the reasonableness of expenditure on salaries, allowances, etc. by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.

16.65 The Auditor should also obtain an understanding of the provision for payment of bonus and other incentive and ascertain adequacy of the amount recorded by the bank. Further, the Auditor should verify whether the bank has made adequate provisions for employee benefits and has complied with the recognition, measurement and disclosure requirements of AS 15, "Employee Benefits".

Rent, Taxes and Lighting

16.66 The Auditor may test check the following:

- Rent paid - verify whether adjustments have been made for the full year on account of rent at the rates as applicable and as per agreement in force.
- Rent does not include House Rent Allowance to employees.
- Check whether municipal rates/ taxes are duly paid/ adjusted for the year under audit.
- Enquire whether any disputed liability exists on this account up to the year-end.

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- Further, the Auditor should obtain the listing of the premises which have been obtained on lease. If the lease agreements have escalation clause, lease equalization should be done in accordance with AS-19, "Leases" unless the terms and conditions of the lease indicate otherwise.
- In addition, the Auditor should perform month on month rent analysis and verify major variance in the average rent per month per branch. The Auditor should also verify the provision made for the expired lease rent agreements.

Printing and Stationery

16.67 The Auditor should verify this item with reference to documents evidencing purchase/debit note received.

Advertisement and Publicity

16.68 Expenditure incurred by the bank for advertisement and publicity, including printing charges of publicity material is verified with the documents.

Repair and Maintenance Expenses

16.69 The Auditor should verify the Annual Maintenance Contract (AMC) at the Branch and should verify the provisioning and prepaid accounting of these contracts.

Depreciation on Bank's Property

16.70 The Auditor should ascertain the procedure followed by the bank while verifying this item. This item includes depreciation on bank's own property, motor cars and other vehicles, furniture, electrical fittings, vaults, lifts, leasehold properties, non-banking assets, etc. Depending on the procedure followed in the bank, provision for depreciation may either be centralised at the head office level or decentralised.

16.71 The Auditor should check head office instructions as regards adjustments of depreciation on the fixed assets of the Branch. The auditor should also check whether depreciation on fixed assets has been adjusted at the rates and in the manner required by head office.

16.72 The auditor may also report unadjusted depreciation on assets acquired but not capitalised. The Auditor should re-compute the depreciation for the period, perform depreciation rationalisation and agree the amount with the general ledger. The Auditor may also verify and obtain explanation for the unadjusted depreciation on assets acquired but not capitalised.

Provisions and Contingencies

16.73 This item represents the aggregate of the provisions made in respect of the following:

- (a) Non-performing assets.
- (b) Taxation.
- (c) Diminution in the value of investments.
- (d) Provisions for contingencies.

16.74 Provisioning norms for NPA are given in Master Circular no. RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 dated 1st July 2015 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances". Interest reversal in case of advances which have become NPA to be specifically checked. The most important item included in this head is the provision in respect of non-performing assets. The other provisions are usually made at the head office level.

Deferred Tax Liability on Special Reserve created under Section 36(1)(viii) of the Income Tax Act, 1961

16.75 RBI vide Circular No. DBOD.No.BP.BC.77/21.04.018/2013-14 on "Deferred Tax Liability on Special Reserve created under Section 36(1)(viii) of the Income Tax Act, 1961" dated December 20, 2013 has advised banks, that as a matter of prudence, DTL should be created on Special Reserve.

16.76 For this purpose, banks may take the following course of action:

- a) If the expenditure due to the creation of DTL on Special Reserve as at March 31, 2013 has not been fully charged to the Profit and Loss account, banks may adjust the same directly from Reserves. The amount so adjusted may be appropriately disclosed in the 'notes to accounts' of the financial statements for the financial year 2013-14.
- b) DTL for amounts transferred to Special Reserve from the year ending March 31, 2014 onwards should be charged to the Profit and Loss Account of that year.

16.77 In view of the requirement to create DTL on Special Reserve, banks may reckon the entire Special Reserve for the purpose of computing Tier-I Capital. Reference in this regard is also drawn to the Announcement "Manner of Reporting by the Auditors In Respect of RBI's Circular on Deferred Tax Liability on Special Reserve created under Section 36(1) (viii) of the Income Tax Act, 1961" dated April 30, 2014 issued by the Auditing and Assurance Standard Board of the Institute of Chartered Accountants of India.

Appropriations

16.78 Under this head, the net profit/ loss for the year as well as profit/ loss brought forward have to be shown. The appropriations of the aggregate thereof are to be shown under the following heads:

- (a) Transfer to Statutory Reserves.
- (b) Transfer to Capital Reserves.
- (c) Transfer to Investment Fluctuation Reserve.
- (d) Transfer to Debenture Redemption Reserve.
- (e) Transfer to Other Reserves.
- (f) Transfer to Government/ Proposed Dividend.
- (g) Transfer to Tax on Dividend.

16.79 The appropriation of profits are decided at the head office level. This item would not therefore appear in the profit and loss account at the branch level. The Statutory Central Auditor should therefore verify compliance with the statutory requirement regarding transfers to reserve accounts and the other appropriation as applicable will have to be taken into consideration while verifying these. According to RBI circular RBI/2006-07/132 DBOD.BP.BC No. 31 / 21.04.018/ 2006-07 dated 20th September 2006 on "Section 17 (2) of Banking Regulation Act, 1949 – Appropriation from Reserve Fund" all expenses including provisions and write-offs recognized in a period, whether mandatory or prudential, should be reflected in the profit and loss account for the period as an 'above the line' item (i.e. before arriving at the net profit).

Expenditure

Provisions and Contingencies

16.80 The Auditor should ascertain compliance with the various regulatory requirements for provisioning as contained in the various circulars.

16.81 The Auditor should obtain an understanding as to how the Bank computes the provision on standard assets and non-performing assets. It will primarily include the basis of the classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets. For verification of provision on standard assets, the Auditor should verify the loan classification on a sample basis. The Auditor should obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balance with the general ledger. The Auditor should examine whether by performing re-computation the provisions in respect of standard loans, NPA and NPI comply with the regulatory requirements.

16.82 The Auditor should obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation. The Auditor should re-compute the provision for tax by applying the applicable tax rate after considering the allowances and disallowances as per Income Tax Act, 1961 and as per Income Computation and Disclosure Standards (ICDS). The other provisions for expenditure should be examined *vis a vis* the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

Audit Reports and Certificates

BASEL Capital Adequacy Norms

17.01 Basel III Norms relate to the Capital Adequacy requirement compliance which the Bank has to achieve as contained in the BASEL III accord. The conclusive working or the calculation of capital adequacy is undertaken at the Head Office of the Bank. The information related to capital is available at the Head Office which is verified by the Statutory Central Auditors of the Bank along with verification of working and calculation of capital adequacy for bank as a whole. However, the calculation of risk weighted asset (RWA) values is undertaken at the branch level w.r.t. the assets at the respective branches and the same is required to be verified and certified by the SBAs. The calculation of RWAs as certified by SBAs (as well as departmental auditors) is consolidated at the head office.

Thus, a SBA needs to understand the fundamental concept of methodology of calculation capital adequacy as per Basel III norms to ensure that the preliminary level calculations of RWAs at branch level are duly verified.

Introduction

17.02 Basel capital adequacy norms are meant for the protection of depositors and shareholders by prescriptive rules for measuring capital adequacy, thereby evolving methods of determining regulatory capital and ensuring efficient use of capital.

17.03 Basel III Accord strengthens the regulation, supervision and risk management of the banking sector. It is global regulatory standard on capital adequacy of banks, stress testing as well as market liquidity risk.

17.04 The Basel III Accord, aims at the following:

- a. improving the banking sector's ability to absorb shocks arising from financial and economic stress, irrespective of reasons thereof.
- b. improving risk management and governance practices.
- c. strengthening banks' transparency and disclosure standards.

17.05 Basel II was fully implemented in all commercial banks (except RRBs and LABs) in India by March 31, 2009. In this regard, the RBI had issued a Master Circular no. DBR.No.BP.BC.4/21.06.001/2015-16 dated July 1, 2015 on

"Prudential Guidelines on Capital Adequacy and Market Discipline - New Capital Adequacy Framework (NCAF)".

17.06 The major changes made in Basel III over Basel II are as under:

- (a) **Quality of Capital:** One of the key elements of Basel III is the introduction of much stricter definition of capital, which means the higher loss-absorption capacity, which in turn would lead to banks becoming stronger with enhanced capacity to withstand periods of stress.
- (b) **Capital Conservation Buffer:** Beginning 31st March, 2016, Banks are required to hold capital conservation buffer of 0.625 per cent, which would be gradually increased to 2.5 per cent by 31st March, 2019. As per RBI circular ref no. RBI/2020-21/93 DOR.CAP.BC.No.34/21.06.201/2020-21 dated February 05, 2021, in view of the continuing stress on account of COVID-19, RBI has decided to defer the implementation of the last tranche of 0.625 per cent of the Capital Conservation Buffer (CCB) to October 01, 2021. Accordingly, the minimum capital conservation ratios in para 15.2.2 of Part D 'Capital Conservation Buffer Framework' of Master Circular, DBR.No.BP.BC.1/ 21.06.201/ 2015-16 dated July 1, 2015 on 'Basel III Capital Regulations', shall continue to apply till the CCB attains the level of 2.5 per cent on October 01, 2021. This is to ensure that banks maintain a cushion of capital that can be used to absorb losses during periods of financial and economic stress, without affecting the core capital adequacy of 9 per cent.
- (c) **Counter cyclical Buffer:** The counter cyclical buffer is designed to achieve broader macro-prudential goal of protecting banking sector from periods of excess aggregate credit growth (wherein excessive credit growth results in system-wide (national level) build-up of risk). The counter cyclical buffer is implemented on need-based basis.
- (d) **Minimum Common Equity and Tier 1 Capital Requirement:** The minimum requirement for common equity, the highest form of loss-absorbing capital, has been increased to 5.50 per cent of RWA. The Minimum Tier 1 capital has been increased to 7 per cent, which means that Additional Tier I (AT 1) capital can be a maximum of 1.50 per cent of RWA and excess of Tier I capital can be used for Tier II capital. Though, the minimum total capital (Tier I plus Tier II) requirement remains at 9 per cent, which means that the Tier 2 capital can be admitted maximum of 2 per cent of RWA. With the requirement of gradually maintaining 2.5 per cent of RWA as Capital Conservation Buffer in the form of CET 1, the minimum overall capital requirement increases to 11.50 per cent of RWA by 31st March, 2020 (as per RBI circular dated January 10, 2019). [Refer to Press Release

for Domestic Systemically Important Banks (D-SIBs)].

- (e) **Leverage Ratio:** Analysis of the 2008 financial crisis indicates that value of assets went down much more than what was perceived based on their risk rating, which led to stipulation of Leverage Ratio. Therefore, under Basel III, a simple, transparent, non-risk based leverage ratio has been introduced. A Leverage Ratio is the relative amount of capital to total assets (not risk-weighted). It has been decided that the minimum Leverage Ratio shall be 4 per cent for Domestic Systemically Important Banks (DSIBs) and 3.5 per cent for other banks. These guidelines shall be effective from the quarter commencing October 1, 2019.
- (f) **Liquidity Ratios:** Under Basel III, a framework for liquidity risk management has been set up. Liquidity Coverage Ratio (LCR) has become operational since 1st January, 2015.

17.07 Basel III capital regulation has been implemented from April 1, 2013 in India in phases and it was planned to be fully implemented as on March 31, 2020 but because of the COVID-19 pandemic, it has now been postponed to October 01, 2021.

Guidelines on BASEL III Capital Regulations

17.08 The RBI had issued circular no. DBOD.No.BP.BC.98 /21.06.201/2011-12 dated May 2, 2012 on the subject "Guidelines on Implementation of Basel III Capital Regulations in India". Through this circular, the RBI has prescribed the final guidelines on Basel III capital regulations. RBI issued a Master Circular no. RBI/2015-16/58 DBR.No.BP.BC.1/21.06.201/ 2015-16 dated July 1, 2015 on Basel III Capital Regulations. Following are main features of these guidelines:

- These guidelines became effective from April 1, 2013 in a phased manner. The Basel III capital ratios were planned to be fully implemented by March 31, 2019, but have since been postponed.

As per RBI circular ref no. RBI/2020-21/93 DOR.CAP.BC.No.34/ 21.06.201/ 2020-21 dated February 05, 2021, in view of the continuing stress on account of COVID-19, RBI has decided to defer the implementation of the last tranche of 0.625 per cent of the Capital Conservation Buffer (CCB) to October 01, 2021. Accordingly, the minimum capital conservation ratios in para 15.2.2 of Part D 'Capital Conservation Buffer Framework' of Master Circular, DBR.No.BP.BC.1/21.06.201/2015-16 dated July 1, 2015 on 'Basel III Capital Regulations', shall continue to apply till the CCB attains the level of 2.5 per cent on October 01, 2021. Further, the pre-specified trigger for loss absorption through conversion / write-down of Additional Tier 1 instruments (PNCPS and PDI) shall remain at 5.5 per cent of RWAs and

will rise to 6.125 per cent of RWAs from October 01, 2021.

- The RBI issued circular DoR.BP.BC.No.76/21.06.201/2019-20 dated June 21, 2020 w.r.t. 'Assignment of Risk Weights on Credit Facilities (Guaranteed Emergency Credit Line) under the Emergency Credit Line Guarantee Scheme' specifying that credit facilities extended under the scheme guaranteed by NCGTC which are backed by an unconditional and irrevocable guarantee provided by Government of India, Member Lending Institutions shall assign zero percent risk weight on the credit facilities extended under this scheme to the extent of guarantee coverage.
- The capital requirements for the implementation of Basel III guidelines may be lower during the initial periods and higher during the later years. While undertaking the capital planning exercise, banks should keep this in view.
- Banks are required to maintain LCR of 100 per cent with effect from January 1, 2019.
- In order to accommodate the burden on banks' cash flows on account of the Covid19 pandemic, RBI vide its Circular No. RBI/2019-20/217 DOR.BP.BC.No.65/21.04.098/2019-20 dated 17th April, 2020 has permitted the Banks to maintain LCR as under:
 - (i) From the date of circular to September 30, 2020 - 80 per cent
 - (ii) Oct 1, 2020 to March 31, 2021 - 90 per cent
 - (iii) April 1, 2021 onwards - 100 per cent
- Banks are required to prepare LCR restoration plans if there is a breach of the aforesaid prescribed LCR requirement.
- Banks are also required to disclose capital ratios under Basel III from the quarter ending June 30, 2013.

Components of Capital

17.09 Total regulatory capital will consist of the sum of the following categories:

- (i) Tier 1 Capital (going-concern capital)
 - (a) Common Equity Tier 1
 - (b) Additional Tier 1

(ii) Tier 2 Capital (gone-concern capital)

Limits and Minima

	Regulatory Capital	As per cent to RWAs
(i)	Minimum Common Equity Tier 1 Ratio	5.5
(ii)	Capital Conservation Buffer (comprised of Common Equity)	2.5
(iii)	Minimum Common Equity Tier 1 Ratio plus Capital Conservation Buffer [(i)+(ii)]	8.0
(iv)	Additional Tier 1 Capital	1.5
(v)	Minimum Tier 1 Capital Ratio [(i) +(iv)]	7.0
(vi)	Tier 2 Capital	2.0
(vii)	Minimum Total Capital Ratio (MTC) [(v)+(vi)]	9.0
(viii)	Minimum Total Capital Ratio plus Capital Conservation Buffer [(vii)+(ii)]	11.5

Capital – What Constitutes Tier 1 and Tier 2 – a Representative Sample

17.10 Master Circular no. DBR.No.BP.BC.1/21.06.201/ 2015-16 dated July 1, 2015 on Basel III Capital Regulations discusses the capital funds in two categories – capital funds for Indian banks and capital funds of foreign banks operating in India. The following table shows the components of the capital funds for Indian *vis a vis* foreign banks operating in India:

	Indian Banks	Foreign Banks operating in India
Tier I Capital Common Equity Tier I (CET 1)	Paid up equity capital (ordinary shares) ¹⁴	Interest free funds from Head Office ¹⁵
	Share premium on issue of common shares	
	Statutory reserves	Statutory reserves kept in Indian books

¹⁴ Refer Annexure 1 to Master Circular on Basel III Capital Regulations for criteria.

¹⁵ Refer Annexure 2 to Master Circular on Basel III Capital Regulations for criteria.

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	Capital reserves representing surplus arising out of sale proceeds of assets	Capital reserves representing surplus arising out of sale of assets in India held in a separate account and which is not eligible for repatriation so long as the bank functions in India
	Other disclosed free reserves, if any	Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India
	Revaluation reserves with discount of 55 per cent (with effect from 1 st March 2015), subject to meeting conditions prescribed in RBI circular dated 1 st March 2016	Revaluation reserves with discount of 55 per cent (till 29 th February 2016), subject to meeting conditions prescribed in RBI circular dated 1 st March 2016
	Foreign currency translation reserve arising due to translation of financial statements of their foreign operations in terms of Accounting Standard (AS) 11 at a discount of 25 per cent, subject to meeting conditions prescribed in RBI circular dated 1 st March 2016	Foreign currency translation reserve arising due to translation of financial statements of their foreign operations in terms of Accounting Standard (AS) 11 at a discount of 25 per cent, subject to meeting conditions prescribed in RBI circular dated 1 st March 2016
	Balance in Profit and Loss Account at the end of the previous financial year	
	Profits of current financial year on a quarterly basis provided the incremental provisions made for NPA at the end of any of the four quarters of the previous financial year	

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	have not deviated more than 25 per cent from the average of the four quarters with certain adjustments given in the Master Circular	
		Interest free funds remitted from abroad for the purpose of acquisition of property and held in a separate account in Indian books provided they are non-repatriable and have the ability to absorb losses regardless of their source
	Less: Regulatory adjustments / deductions applied in the calculation of Common Equity Tier 1 capital	Less: Regulatory adjustments / deductions applied in the calculation of Common Equity Tier 1 capital
Additional Tier I (AT 1)	Perpetual non-cumulative preference shares ¹⁶	Head office borrowings in foreign currency by foreign banks operating in India as per criteria ¹⁷
	Share premium on instruments included in AT 1 capital	
	Debt Capital instruments including Perpetual Debt instruments ¹⁸	
	Any other instrument notified by RBI from time to time	Any other instrument notified by RBI from time to time
	Less: Regulatory adjustments / deductions applied in the calculation of Additional Tier 1 capital	Less: Regulatory adjustments / deductions applied in the calculation of Additional Tier 1 capital

¹⁶ Refer Annexure 3 to Master Circular on Basel III Capital Regulations for criteria.

¹⁷ Refer Annexure 4 to Master Circular on Basel III Capital Regulations for criteria.

¹⁸ Refer Annexure 4 to Master Circular on Basel III Capital Regulations for criteria.

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Tier II Capital	Revaluation reserves with discount of 55 per cent (till 29 th February 2016)	Revaluation reserves with discount of 55 per cent (till 29 th February 2016)
	General provisions against future but presently unidentified losses and loss reserves	General provisions against future but presently unidentified losses and loss reserves
	Debt Capital instruments ¹⁹	Head Office (HO) borrowings in foreign currency received as part of Tier 2 debt capital
	Perpetual Cumulative Preference Shares (PCPS) / Redeemable Non-Cumulative Preference Shares (RNCPS) / Redeemable cumulative preference shares (RCPS) ²⁰	Perpetual Cumulative Preference Shares (PCPS) / Redeemable Non-Cumulative Preference Shares (RNCPS) / Redeemable cumulative preference shares (RCPS) ²¹
	Premium on instruments included in Tier 2	
	Less: Regulatory adjustments / deductions applied in the calculation of Tier 2 capital	Less: Regulatory adjustments / deductions applied in the calculation of Tier 2 capital

17.11 In the case of foreign banks operating in India, RBI's Master Circular on Capital Adequacy also lays down certain additional provisions in respect of capital to be followed by such banks.

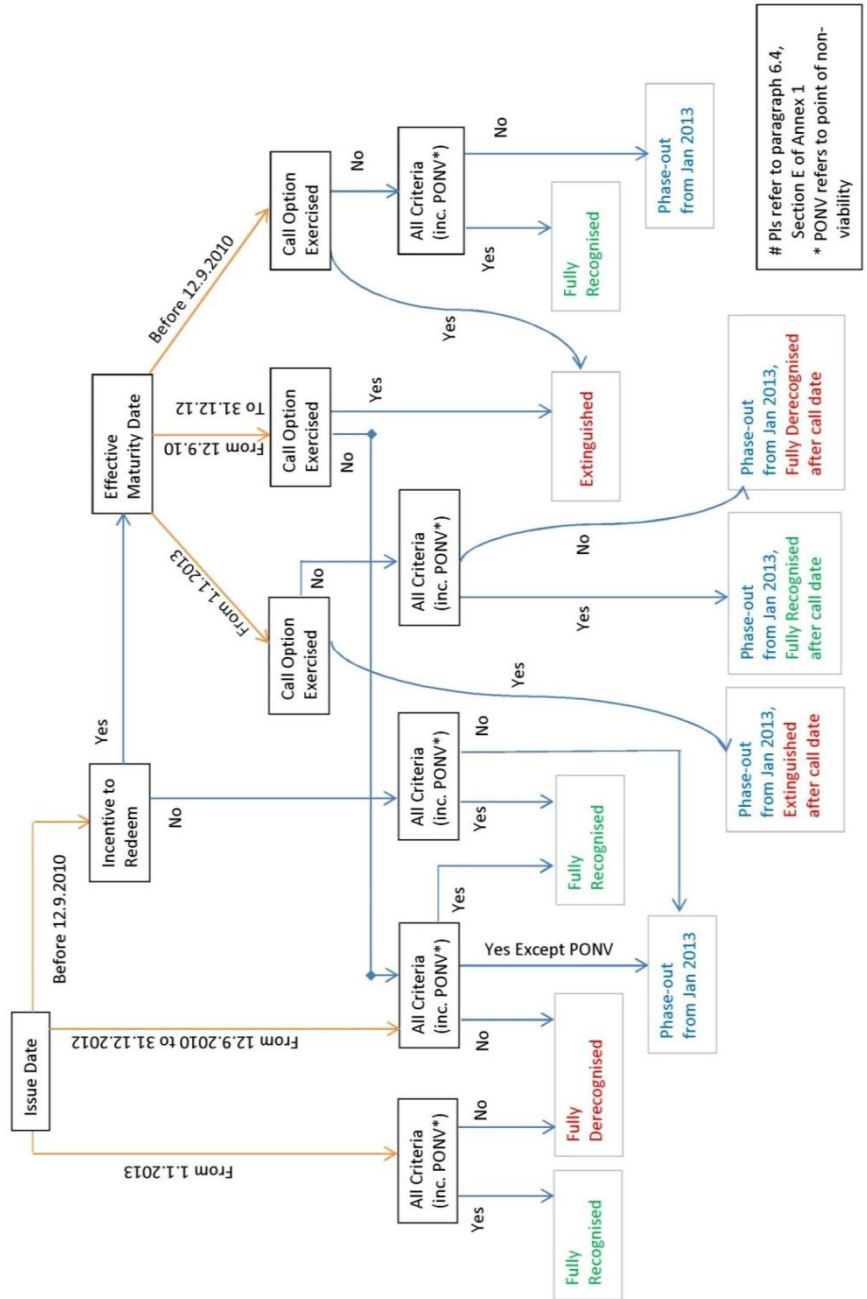
17.12 Capital instruments which no longer qualify as AT 1 capital or Tier 2 capital (e.g. IPDI and Tier 2 debt instruments with step-ups) will be phased out beginning January 1, 2013. Fixing the base at the nominal amount of such instruments outstanding on January 1, 2013, their recognition will be capped at 90 per cent from January 1, 2013, with the cap reducing by 10 per cent in each subsequent year. This cap will be applied to Additional Tier 1 and Tier 2 capital instruments separately and refers to the total amount of instruments outstanding which no longer meet the relevant entry criteria. The following chart graphically depicts the provisions relating to such instruments:

¹⁹ Refer Annexure 5 to Master Circular on Basel III Capital Regulations for criteria.

²⁰ Refer Annexure 6 to Master Circular on Basel III Capital Regulations for criteria.

²¹ Refer Annexure 6 to Master Circular on Basel III Capital Regulations for criteria.

TRANSITIONAL ARRANGEMENTS FOR NON-EQUITY REGULATORY
CAPITAL INSTRUMENTS



Deductions from CET I, AT I and Tier II

17.13 The deductions from CET I, AT I and Tier II are tabulated below:

Item	Extent of Deduction (in %)		
	CET I	AT 1	Tier II
Intangible assets including goodwill	100	---	
Losses in the current period	100	---	
Losses brought forward from previous periods	100	---	
Deferred tax asset associated with accumulated losses	100	----	
Cash Flow hedge reserve	100	---	
Shortfall of provisions to expected losses	100	---	
Gains on sale related to securitisation transactions	100	---	
Cumulative gains and losses due to changes in own credit risk on fair valued liabilities	100	---	
Defined benefit pension fund liabilities and un-amortised employees' benefits	100	-	
Investments in own shares (if not already netted off paid-up capital on reported balance sheet) including indirect investments	100	---	
DTAs which relate to timing differences (other than those related to accumulated losses)	Excess of 10% of CET-1	----	
DTAs on timing difference along with limited recognition of significant investments in the common shares of unconsolidated financial (i.e. banking, financial and insurance) entities taken together	Excess of 15% of CET-1		
Equity investments in insurance subsidiaries	100		
Investments in equity instruments of other subsidiaries and capital of other Banks,	100		

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Item	Extent of Deduction (in %)		
	CET I	AT 1	Tier II
insurance companies etc. which is more than 10% of Bank's CET1			
Equity investments in non-financial subsidiaries	100		
Intra group transactions beyond permissible limits	100		
Reciprocal cross investments in capital of other banks in the same component of capital	Full	Full	Full
Securitization exposure	50	50	
Investment in financial subsidiaries and associates which is above 30 per cent in the paid-up equity of entity and not consolidated for the capital adequacy purposes	50	50	
Shortfall in the regulatory capital requirements in the de-consolidated entity	50	50	
Such amount of investment in the following which is in excess of 10 per cent of investing bank's capital funds: <ul style="list-style-type: none"> • Equity shares; • Perpetual Non- Cumulative Preference Shares; • Innovative Perpetual Debt Instruments; • Upper Tier II Bonds; • Upper Tier II Preference Shares; • Subordinated debt instruments; and • Any other instrument approved as in the nature of capital. 	50	50	
Investments made by a banking	50	50	

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Item	Extent of Deduction (in %)		
	CET I	AT 1	Tier II
subsidiary/associate in the equity or non-equity regulatory-capital instruments issued by its parent bank			
If net overseas placements with Head Office/other overseas branches/other group entities exceed 10 per cent of the bank's minimum CRAR requirement, the amount in excess of this limit would be deducted from Tier I capital	100	---	

Capital to Risk-weighted Assets Ratio (CRAR)

17.14 The RBI requires banks to maintain a minimum CRAR of 9 per cent on an ongoing basis. The Master Circular on Capital Adequacy contains detailed guidelines on calculation of risk weighted assets and off-balance sheet items and CRAR.

17.15 The CRAR is computed as follows:

$$\frac{\text{Eligible Total Capital funds} \times 100}{\text{Credit Risk RWA} + \text{Market Risk RWA} + \text{Operational Risk RWA}}$$

17.16 The minimum CRAR is required to be maintained at consolidated level also as per Basel III Guidelines. The requirements mentioned above relates to standalone Bank only. For the requirement for the consolidated capital, the readers may refer Master Circular no. DBR.No.BP.BC.1/21.06.201/ 2015-16 dated July 1, 2015 on Basel III Capital Regulations number RBI/2015-16/58 DBR.No.BP.BC.1/21.06.201/2015-16 dated 1st July 2015.

Board Oversight

17.17 The board of directors and senior management of each subsidiary/overseas branch should be responsible for conducting their own assessment of the subsidiary's/overseas branch's operational risks and controls and ensuring that the subsidiary/overseas branch is adequately capitalised in respect of those risks.

Disclosure (Pillar 3)

17.18 Pillar 3 aims primarily at disclosure of a bank's risk profile and capital adequacy. It is recognised that the Pillar 3 disclosure framework does not conflict with requirements under accounting standards, which are broader in scope. The banks in India have to follow Pillar 3 disclosure over and above the RBI master circular on "Disclosure in Financial Statements - Notes to Accounts". Information would be regarded as material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information. Pillar 3 disclosures will be required to be made by the individual banks on a standalone basis when they are not the top consolidated entity in the bank.

Role of Statutory Branch Auditors (SBAs)

17.19 In case of credit risk management, the underlying computation for Basel III is based on credit ratings, which may be driven centrally and passed on to branches such that branches follow head office instructions in its entirety. This way the bank SBAs check only the computation process and test check the source rather than getting into the credit rating process. The SBAs can assess any issues relating to completeness and correctness of the data, which is used to compute the underlying risks emanating from credit market and operational risk. It is a pyramid approach whereby data from branches get consolidated at head office. The SCAs may choose to test check certain source data and also verify the basis considered at the head office. The SBAs are advised to read the latest RBI circulars dated October 12, 2020 and October 16, 2020.

17.20 It will not be practical to expect the branch to comprehensively understand the Basel III requirements in its entirety. Thus, the SBAs should assess the sufficiency of the instructions provided to the branch by the head office and its adherence at the branch level. Any error at bank branch level can have a cascading effect at the head office level, especially when a large number of branches are involved.

17.21 At the Branch Level, the Auditors will have to verify whether proper bucketing of assets has been done correctly or not. The risk weights are allocated to each bucket and therefore it has to be ensured by the SBAs that the respective advances have been reflected in the correct bucket so the risk weights are correctly calculated for the advances held at the branch. While verifying the bucketing of corporate and institutional advances the Auditors should call for the latest credit ratings of the borrowers which should not be more than one year old. The Auditors should further confirm whether separate ratings are obtained for short term as well as long term advances. Although the reports shall be generated from the system, it is important to verify whether the

figures match with the general ledger balances (or limits whichever is higher) where ever required and the aggregate advances match with the return. Auditors are also required to verify the bucketing for non-fund based advances like Bank Guarantees and Letter of Credit which are also allotted risk weights.

17.22 Proper classification of all advances in SME sector, Commercial and Institutional Sector (with appropriate External Credit Rating), Restructured Advances, Non-Performing Assets, Unrated Institutional advances, etc. should be ensured.

17.23 Appropriate classification of Guarantees into Performance and Financial along with the cash margins held there against should also be verified. An Illustrative Audit Checklist for Capital Adequacy is given as **Annexure A** to this Chapter.

Special Purpose Reports and Certificates

Introduction

17.24 The SBAs have to issue various Special Purpose Reports and certificates at branch level. SBAs should ensure the correctness of financial / non-financial information given in these certificates.

17.25 The appointment letter normally contains the exhaustive list of all such reports and certificates which are required to be certified by the SBA's. These are to be verified and certified by the SBAs to ensure their correctness and accuracy. Since the SBAs have a direct access to the supporting branch documents and the relevant information, various readers / users of these certificates, such as Bank Management, CSA's, State Government/Central Government as well as RBI rely upon the Reports and Certificates issued by the SBAs and actually use them to release the various grants and subvention amounts to Banks.

17.26 The purpose of these Reports/Certificates may be for:

- a) Disclosure requirements. SLR/CRR, Provisions of NPA's, Movement of NPA Provisions, Gross/Net NPA, Asset Liability Management related returns, Exposure to Sensitive Sectors, Unhedged foreign currency exposures, etc.
- b) Related to Provisions to be made (other than advances) like Fraud, Suspense Account, etc.
- c) Certificates related to Compliance of Internal Control Systems and Prevention of Frauds (Ghosh /Jilani Reports/Certificates).
- d) Certification relating to various Subsidies, Interest subvention, loan waivers,

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etc. to be issued to RBI who is acting as an agency on behalf of Central and State Governments for administration of various Public welfare schemes. Normally the advances to Priority sectors like Agriculture, SME Sector, Educational Loans, Public Housing loans, etc. are covered under this head.

- e) Certification from SBAs relating to correctness of provisions and compliance of IRAC norms in respect of advances.
- f) Memorandum of Changes – MOCs for the changes recommended by the SBAs to be considered by the Bank and SCAs in respect of increase/decrease in assets/liabilities balances and/or increase/decrease in profit/loss at the branch.
- g) Certificates in respect of Physical custody of Branch in respect of Investment scrips e.g. Local Municipal Bonds, Gold Coins, etc. held by the Branch on behalf of Head Office.
- h) Some additional certifications needed could be as under:
 - (i) Compliance with SLR requirements on 12 odd dates spread over the entire year (not being Fridays) & the accuracy in the computation of net DTL.
 - (ii) Verification of fortnightly CRR/SLR returns on a sample basis on at least 12 occasions during the year, including the last fortnightly returns, pertaining to every reporting quarter.
 - (iii) Adherence to income recognition, asset classification and provisions (IRAC Norms).
 - (iv) Implementation of gold card scheme for exporters as per extant instructions.
 - (v) Process and Policy adherence to MCLR.
 - (vi) Accuracy of computation of assessable deposits and premium (DICGC) classified under Priority Sector.
 - (vii) Correctness of the interest subvention claims under Interest Subvention Scheme for short term crop loans and Kisan credit card.
 - (viii) In cases of Frauds the, Process of Reporting to Central Fraud Registry, Classification and monitoring of red flagged accounts.
 - (ix) Reporting of serious irregularities, if any.
 - (x) Compliance with exposure norms under Large Exposure Framework.
 - (xi) Compliance with instructions - Un-authorized operation of Internal/Office Accounts.

(xii) Automation of Income Recognition, Asset Classification and Provisioning processes in banks.

(xiii) Implementation of COVID-19 –Regulatory Package.

Regulatory Requirements

17.27 The Reserve Bank of India *vide* Master Direction No: DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 Dated July 01, 2016 (updated July 03, 2017) on "Frauds- Classification and Reporting and *vide* its Circular no. RBI 2011-12/266/ DBS.FrMC.BC.No.4/23.04.001/2011-12 dated November 21, 2011 Frauds – Classification and Reporting by commercial banks and select FIs", issued guidelines for classification of frauds and reporting of frauds to RBI, Central Office as well as the concerned regional office of the Department of Banking Supervision / Financial Conglomerate Monitoring Division (FCMD) at Central Office under whose jurisdiction the bank's Head Office/branch is situated. The reporting requirements for various categories of frauds based on financial exposure are specified in the aforesaid Master Directions.

While issuing a special purpose report or certificate, the Auditors should bear in mind the recommendations made in the Guidance Note on Reports or Certificates for Special Purposes (Revised 2016) issued by the Institute of Chartered Accountants of India (ICAI).

Audit Approach

17.28 At the time of accepting the audit assignment, issuing engagement letter, preparing audit program, maintaining adequate working papers, the SBAs should appropriately comply with the requirements of Guidance Note on Reports or Certificates for Special Purposes (Revised 2016) issued by the ICAI. They may also refer covering report for certificates as prescribed in **Annexure B** "Illustrative Format of Covering Report for various Certificates issued by SBAs" of this Chapter.

17.29 The SBAs may verify the contents of certificates to be issued at branch level. All the Returns submitted by branch to various higher authorities of the respective bank and also to various authorities of the regulators as per the Master Directions dated July 03, 2017 shall be verified. In case of frauds, Branch Auditors should ensure the correctness of financial implication caused due to such frauds and confirm that adequate provision for the same has been made.

17.30 Considering various types of Certificates and Reports to be issued by the SBAs, it is very important for the Auditors to verify their correctness and accuracy from the available branch records and documents, as the Bank, SCAs,

RBI and other Governmental agencies use this data for consolidation, disclosure and also releasing various subsidies and waivers. Mostly the data certified by SBAs is consolidated and further certified and endorsed by the SCAs at the head office.

17.31 Where ever possible SBAs should reconcile or tally the closing balance of the return with the General Ledger Heads in the Trial Balance of the Branch as at the year end. This will be especially important for semi-automatic or manual returns. For system generated returns without manual intervention, it should still be ensured that they tally with the year-end figures, though detailed verification may not be warranted.

17.32 UDIN needs to be generated for Reports and Certificates issued by SBAs, as per the FAQs on UDIN issued by ICAI "Since UDIN has to be generated per Assignment per Signatory on a given date, one UDIN will suffice for the Bank Audit Report including LFAR and Certificates. However, separate UDIN will be required for Tax Audit Report being separate assignment." Further while generating UDIN, the details of multiple reports and certificates can be entered by "Add more" button.

Certificates and Reports

17.33 In addition to their audit reports, the SBAs and SCAs may also be required by their terms of engagement or statutory or regulatory requirements to issue other reports or certificates. For example, presently, the branch auditors are required to issue reports/certificates on the following matters besides their main audit report:

- Long Form Audit Report for Branch.
- Certificate as to whether the income recognition, asset classification and provisioning have been made as per the guidelines issued by the RBI from time to time.
- Report on the status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to frauds and malpractices and of the recommendations of the Jilani Committee on internal control and inspection/credit system.
- Certificate of cash and bank balances.
- Certificate relating to MOC entries of the previous year being accounted for.

As the MOC's are prepared and passed after the accounting year is over during the course of the statutory audit itself, the actual accounting entries in the records of the branch are passed during the next year. Therefore

SBA's need to verify whether the previous year's MOCs have been effected at the Branch and accordingly they have to issue the necessary certificate. Thus, for the current year audit of 2020-21, SBAs would verify the MOCs accounting effects recommended by previous year's SBAs i.e. for the year 2019-20.

- Certificate relating to credit/ deposit ratio.
- Certification for advances to infrastructure project and income generated thereon.
- Statement of accounts Re-structured/ Re-scheduled/ Re-negotiated related to CDR and non-CDR accounts.
- Certificate of advances exceeding Rs.10 Crores.
- Certificate for IRAC Status of Credit Exposure in respect of Non-Performing Investments.
- Certificates for IRAC Status of Credit Exposure in respect of borrowers having exposure with foreign offices.
- Certificate for agricultural interest subvention claim @2% for residual period of repayment of the loans disbursed during Financial Year.
- Certificate for agricultural interest subvention claim @2% for disbursements made during Financial Year.
- Certificate for additional interest subvention (Incentive @3%) for prompt repayment for short term production loans disbursed during Financial Year. Certain other certificates as may be prescribed by the concerned bank in their respective closing instructions or appointment letters.
- Certificate of interest subvention for certain housing loans.
- Certificate of interest subvention for certain education loans.
- Certificate on unhedged foreign currency exposure in case of borrowal having exposure of 1 crore or more.
- Certificate on exposure to sensitive sectors, i.e. exposure to capital market, infrastructure and real estate sector.
- Certificate in respect of ECGC claims filed at the branch and its status.
- Memorandum of changes –

In case of disagreement of the SBA with the Branch management on any matter related to compliance of IRAC norms or in case of any mistake observed by the SBA, it necessitates a change either in Asset/Liability and/or Income/Expenditure at the Branch which would affect the financial statements of the branch for the year under audit, then SBA can issue MOC for such disagreement or the mistake observed. The SBA should

confirm that the amount is material enough warranting MOC and is above the threshold limit prescribed in the bank circular. It should be further ensured that MOC is prepared with correct account heads and codes and also the correct amount, since these MOCs would be consolidated at the HO level and these should not contain any discrepancy. A short reason or remark leading to MOC also should be mentioned in the MOC to make it self explanatory. Further MOCs effected at the branch should be countersigned by the Branch Manager. Even if there is no entry to be suggested in MOC, still it is advisable to issue a NIL MOC for the sake of providing clarity to the SCA.

- Certain other additional certificates as may be prescribed by the concerned bank in their respective closing instructions or appointment letters.

Implementation of Ghosh & Jilani Committee Recommendations

Introduction

17.34 The RBI had set up a High Level Committee on Frauds and Malpractices in Banks under the Chairmanship of Shri A. Ghosh, the then Deputy Governor, RBI to enquire into various aspects of frauds and malpractices in banks with a view to make recommendations to reduce such incidence. The Committee submitted its Report in June, 1992. The recommendations contained in the report are related to frauds and malpractices in banks.

17.35 The RBI had set up a "Working Group to Review the Internal Control and Inspection and Audit System in Banks" under the Chairmanship of Mr. Rashid Jilani. The Working Group was constituted in February, 1995 to review the efficiency and adequacy of internal control and inspection and audit system in banks with a view to strengthening the supervision system, both on-site and off-site, and ensuring reliability of data.

Regulatory Requirements

Ghosh Committee Recommendations

17.36 The RBI in its efforts towards ensuring a strong, efficient and resilient banking system in the country, vide its Circular No. DBS.Co.PPP.BC.No.39/ND-01.005/99-2000 dated November 1, 1996, issued instructions relating to frauds and malpractice in banks. The Circular was issued for the implementation of the 44th report of the Committee on Government Assurances

– Ghosh and Jilani Committees' Recommendations.

17.37 The recommendations are divided into four groups as under:

- (i) *Group-A*: Recommendations, which have to be implemented by the banks immediately.
- (ii) *Group-B*: Recommendations requiring RBI's approval.
- (iii) *Group-C*: Recommendations requiring approval of Government of India.
- (iv) *Group-D*: Recommendations requiring further examination in consultation with IBA.

17.38 The RBI has summarised each of these recommendations for the purpose of reporting of their implementation by the banks, in a 'yes' or 'no' format. The RBI has also categorised these recommendations into:

- (i) applicable to branches;
- (ii) applicable to Controlling Offices like, Regional and Zonal Offices (some banks may have some other name for controlling offices);
- (iii) applicable to Head Office; and
- (iv) applicable to Treasury Operations.

17.39 The report of the Ghosh Committee deals, mainly with the issues related to day-to-day administrative functions that take place in a bank. The main objective behind the recommendations contained in the Ghosh Committee Report is to ensure that there exists a proper system in banks to ensure the safety of assets, compliance with the laid down policies and procedures, accuracy and completeness of the accounting and other records, proper segregation of duties and responsibilities of the staff and also timely prevention and detection of frauds and malpractices.

Jilani Committee Recommendations

17.40 The 44th Report of the Committee on Government Assurances expressed concern that despite reporting of the compliance with recommendations of the Jilani Committee, by the controlling office/branches, the same might not have been implemented. Accordingly, RBI laid down the following procedure to ensure the implementation of the recommendations:

- A format containing 25 questions was issued to indicate the answer as either "Implemented" or "Not Implemented".
- Information received from all branches and ROs/ZOs to be consolidated at Head Office level and submission of consolidated statement to RBI.
- Implementation of recommendations to be verified during concurrent

audit/inspection of branches/controlling offices and comment on the same to be included in their report.

17.41 The report of the Jilani Committee contains twenty five recommendations which can broadly be divided into three categories, (i) dealing with the EDP environment in the banks, (ii) dealing with the inspection/internal audit system in the bank and (iii) dealing with other miscellaneous aspects of functioning of a bank. The RBI has summarised each of these recommendations for the purpose of reporting of their implementation by the banks, in a 'Implemented' or 'not implemented' format. Some of the recommendations of Jilani Committee are to be implemented by the banks at the branch office level, whereas some others are applicable to the regional/zonal/head office level. However, some recommendations find applicability at all levels.

Responsibility of the Management

17.42 The RBI, vide its subsequent Circular dated June 28, 2002, issued to the banks has required the concurrent auditors and inspectors of the bank branches/controlling offices to verify and comment in their reports as to the status of implementation of the recommendations of the Ghosh and the Jilani Committees in the banks.

17.43 In terms of the letters issued to the banks regarding appointment of the Statutory Central Auditors by the RBI, the Auditors are also required to verify and comment upon the compliance by the bank in regard to the status of the implementation of the recommendations of the Ghosh and the Jilani Committees.

17.44 From the above it is clear that the implementation of the recommendations of the Ghosh and the Jilani Committees is the responsibility of the management of the banks. The responsibility of the statutory auditors is to verify and report on the status of implementation of these recommendations, thus far and no further. The results of the verification carried out by the statutory auditor and his/her comments thereon are to be given in a separate report.

17.45 RBI through its Master Circular No. DBR. No. Dir. BC.11/13.03.00 /2015-16 dated July 01, 2015 on "Guarantees and Co-acceptances" has required that Banks should implement the following recommendations made by the Ghosh Committee:

- (i) In order to prevent unaccounted issue of guarantees, as well as fake guarantees, as suggested by IBA, bank guarantees should be issued in serially numbered security forms.

- (ii) While forwarding guarantees, banks should caution the beneficiaries that they should, in their own interest, verify the genuineness of the guarantee with the issuing bank.

17.46 The RBI through Master Circular no. RBI/2015-16/95 DBR.No.Dir.BC.10/13.03.00/2015-16 dated July 1, 2015 on "Loans and Advances – Statutory and Other Restrictions". requires that banks should ensure compliance with the recommendations of the Ghosh Committee and other internal requirements relating to issue of guarantees to obviate the possibility of frauds in the areas of issuance of Bank Guarantees in favour of Financial Institutions, credit facilities extending to bank against the guarantees issued by other banks/FIs and advancement of Gold (Metal) Loans.

17.47 In this regard, it may be noted that the RBI has also issued Master Directions No. RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 dated July 1, 2016 (updated July 03, 2017) on Frauds – Classification and Reporting by commercial banks and select FIs. These directions deal with Classification of Frauds, Reporting of Frauds to RBI, Quarterly Returns, Reports to the Board, Fraud Monitoring Returns, etc. and the Auditor should verify the compliance of the same.

17.48 The RBI has issued a Master Circular no. RBI/2015-16/100 DBR.No.CID.BC.22/20.16.003/2015-16 dated July 01, 2015 on "Wilful Defaulters", which also specifies the role of Auditors including recommendations about action to be taken against negligent / deficient Auditors wherein falsification of accounts on the part of borrower is observed. Further, it specifies that to monitor end-use of funds, if the lenders desire a specific certification from the borrowers' Auditors regarding diversion / siphoning of funds by the borrower, the lender should award a separate mandate to the Auditors for the purpose. In addition to this, banks are advised that with a view to ensuring proper end-use of funds and preventing diversion/siphoning of funds by the borrowers, lenders could consider engaging their own auditors for such specific certification purpose without relying on certification given by borrower's Auditors. However, this cannot substitute bank's basic minimum own diligence.

17.49 In order to ensure that directors are correctly identified and in no case, persons whose names appear to be similar to the names of directors appearing in the list of willful defaulters, are wrongfully denied credit facilities on such grounds, banks/FIs have been advised to include the Director Identification Number (DIN) as one of the fields in the data submitted by them to RBI/CIC.

17.50 In terms of Para 2.9 of Master Circular on Wilful Defaulters as stated above, Banks / FIs have already been advised to submit the list of suit-filed

accounts and non-suit filed accounts of wilful defaulters of Rs. 25 lakh and above on a monthly or more frequent basis to all the four Credit Information Companies. This would enable such information to be available to the banks / FIs on a near real time basis.

17.51 Further, in terms of RBI Circular no. RBI / 2016-17 / 284 Ref. DBS.CO.PPD.BC.No.9/11.01.005/2016-17 dated April 20, 2017 on Compliance with Ghosh Committee Recommendations", compliance to the Ghosh Committee recommendation also need not be reported to Audit Committee of the Board of Directors (ACB). However, banks are advised to ensure that:

- i) the compliance to these recommendations is complete and sustained; and
- ii) these recommendations are appropriately factored in the internal inspection/audit processes of banks and duly documented in their manual/ instructions, etc.

Audit Approach and Procedures

17.52 The RBI has prescribed separate formats to be filled in by the banks for reporting on compliance with/ implementation of the recommendations of the Ghosh and Jilani Committees. The responsibility of the statutory auditors is to certify the status of compliance with/ implementation of the recommendations of the Ghosh and Jilani Committees. Accordingly, the following procedures may be adopted by the statutory auditors of branches as well as the Statutory Central Auditors for certifying the compliance/ implementation status of the Ghosh and Jilani Committees recommendations.

- In case of the branch, the SBA shall enquire from the management of the branch whether it has prepared the prescribed report on the implementation status of the recommendations of the Ghosh and Jilani Committees. If yes, then whether the same has been forwarded to the Head Office for necessary action. If no, then the Auditor should obtain necessary representation from the management as to why the report has not been prepared and/ or submitted and should appropriately qualify his report.
- In case of the Head Office, the SCA shall obtain a confirmation from the management whether it has received the report on the implementation status of the recommendations of the Ghosh and Jilani Committees from all the branches, regional/ zonal offices, etc. and also whether it has prepared the status report as applicable to the Head Office level. The SCA shall obtain a list of the branches, regional/ zonal offices which have not submitted the prescribed report. Such a list would help the SCA to have a broad idea as to the extent of implementation of the recommendations by the bank as a whole.

- The SCA should obtain and review a copy of the implementation status report(s) so prepared and submitted. Such a review would help the Auditors identify areas which are susceptible to fraud/ malpractices. The results of such a review may also require the Auditor to re-consider the nature, timing and extent of the procedures adopted by him for carrying out the audit as well as his audit findings.
- In case of Branch audit, where the concerned branch has been subjected to a concurrent audit, then the report of the concurrent auditor on the status of implementation of the recommendations of the Ghosh and Jilani Committees should also be obtained. In case, the branch is not subject to a concurrent audit, the SBA should enquire whether it had been subjected to any inspection either by the in-house inspection department or by the inspectors of the RBI. The Auditor should review the comments, if any, of the concurrent auditor or such inspectors on the said implementation status report.
- The SCA may also request the management to provide a list of branches which had been subjected to a concurrent audit/ inspection by the in-house inspection department or the inspectors from the RBI. SCA may, if considered necessary, select some such branches and review the comments of the concurrent auditors/ inspectors on the status of implementation of the recommendations. This would help to identify any common cause of concern among the bank branches.
- Where the status report, as prepared by the management indicates that any of the recommendations have not been implemented, the SCA/SBA should request the concerned management to give a written representation as to why the particular recommendation(s) has/have not been implemented.
- The SBA/SCA may also consider it necessary to carry out test checks to ensure whether the recommendations which have been said to have been implemented in the status report have indeed been implemented by the management.

17.53 In case, SBA/SCA examination reveals that any of the recommendations indicated as having been implemented, have in fact not been implemented by the management, or where there is a failure to comply with any of the recommendations of the two Committees, would not only indicate a weakness in the internal control system in the bank but also raise doubts as to the integrity of the management. The Auditor may, also need to re-consider the nature, timing and extent of other audit procedures as also the truth and accuracy of any other management re-presentations obtained by the auditor.

Certificate / Report

17.54 Based on the work done, the auditor should assess whether any information obtained during the verification indicates that any of the recommendations of the Ghosh and Jilani Committees have not been implemented, either in full or in part. The auditor may consider expressing either disclaimer or appropriate comments in respect of certain clauses such as Item Nos. 1.1 and 1.11 of Part II of Group A of Ghosh Committee.

17.55 The above-mentioned Certificate should describe the scope of the verification undertaken to enable the readers to understand the nature of work performed and make it clear that a full-fledged investigation had not been undertaken. The certificate of the Auditor should also draw attention to the following facts:

- That the responsibility for the implementation of the recommendations of the Ghosh and the Jilani Committees is solely that of the management of the bank.
- That the Auditor has also considered the reports of all or certain, as the case may be, concurrent auditors/inspectors of the bank branches on the status of implementation of the recommendations of the Ghosh and Jilani Committees at the branch office and controlling offices.
- That the verification was limited primarily to enquiries and obtaining confirmations from the management and other appropriate persons.
- That the auditor has carried out test checks to assess the status of implementation of the recommendations of the Ghosh and Jilani Committees.

17.56 **Annexure C** to this Chapter provides an illustrative format of the auditor's certificate w.r.t. compliance with/ implementation of the recommendations of the Ghosh and Jilani Committees.

Tax audit

Introduction

17.57 Normally Tax Audit at the branch has a limited scope. Many times the scope of work is defined by the Head office in its letter of appointment. As most of the information is available at the Head office, the scope is limited to the verification process limited to the Branch data and supporting documents available there. Some of the Banks allot the work to SCAs or to External Audit firms other than SCAs/SBAs.

17.58 In the following paragraphs, we shall cover only the important matters relevant at the branch level. Although, it is expected that the Branch makes full and correct disclosures in Form 3CD, the branch auditors are expected to

exercise their professional skepticism to confirm whether the disclosures made by the branch are correct and exhaustive and accordingly give their report in Form 3 CA for the branch under audit.

17.59 Fixed Assets and Depreciation – Clause No. 18 of Form 3CD

Branch Auditors should verify the Fixed Assets register maintained at the branch and more specifically the new assets purchased during the year and its tax invoices. The amount capitalized in the books of the branch, GST input credit (if any) and proper asset classification in the Block of assets also needs to be verified. From the last year's audited return, the opening balances of current year's return should be verified block wise. The calculation of depreciation should be verified in the light of the latest circular or as per closing instructions circular issued by the Head Office.

17.60 General Scrutiny of Expenses/Charges – Clause No. 21 (a) of Form 3CD

General scrutiny of charges or the Profit and Loss expense heads should be done to identify any nature of expenses which would be of personal nature (not related to the business of the Bank and other than contractual nature), capital or revenue nature. It should also be ensured that if the Branch has paid any penalty or fine which requires disclosure under the relevant clause of the Form 3CD, whether it has been done or not.

17.61 Non deduction/Non Payment of TDS and General compliance related to TDS Provisions – Clause 21(b) of Form 3 CD

General scrutiny of expenses should also be made keeping in mind the relevant TDS provisions covered under various sections and sub sections of 194 and 195 of the Income tax Act, 1961. Payments made to Non-residents (including interest payments made to NRE Account holders) interest, contractors, professionals, property owners, etc. should be verified keeping in mind the TDS provisions. It should be confirmed whether appropriate tax has been deducted and paid on various payments made to certain persons. Tax on fixed deposit interest shall be deducted at source by the system automatically, which also needs to be checked on a test check basis.

Likewise, compliance with the provisions of Tax collected at Source (TCS) is also to be ensured by the SBA. Any case of non-compliance with both TDS and TCS provisions should be reported under the appropriate sub-clause of Form 3CD.

17.62 Disallowance under Section 40A(3) read with Rule 6 DD – Clause No. 21(d) of Form 3CD

General scrutiny of expenses or charges may also reveal any disallowance

under Section 40A(3) (read with Rule 6 DD) of the Income Tax Act, 1961 if payment of more than Rs. 10,000/- is made otherwise than by way of account payee cheque or account payee draft. Auditors are expected to make an appropriate disclosure about the non-availability of evidence under this clause, apart from any specific case of non-compliance.

17.63 *Payment of Interest to any MSME Supplier – Clause no. 22 of Form 3CD*

Auditors should obtain an appropriate representation from the Branch management whether it has paid any interest to any of its vendors or suppliers registered under MSME for delayed payment. Under Section 23 of the Micro, Small and Medium Enterprises Development Act, 2006. As such interest is required to be disclosed under this clause and to be claimed disallowed in the computation of income for the Bank.

17.64 *GST Compliance with respect to ITC – Clause 27 (a)*

Normally the Bank has got a global GST number and files one consolidated return at the head office level. For the purpose of claiming the Input tax credit, it obtains the monthly return about the Input tax credit along with other details from all its branches and submits a consolidated claim in the return filed at the head office. Then in such cases Branch Auditor can give a suitable disclosure.

17.65 *Prior Period Income/Expenses – Clause 27 (b)*

Branch auditor while doing a general scrutiny of Charges should also identify any prior period expenditure debited to Branch Profit and Loss account.

17.66 *Repayment of loan or deposit exceeding the limit specified in Section 269T – Clause 31 (c) and (d)*

Considering the high volume of transactions at the branch, the Auditor should obtain suitable management representation from the Branch Management and make appropriate disclosure in the relevant clause of the tax audit report.

17.67 *TDS Compliance – Clause No. 34 (a) to (c).*

This is the most important reporting clause in the Branch tax audit report. This clause required the auditors to verify and report Section wise details about the Total expenditure incurred at the branch covered under various sections:

- 194 A- Interest
- 194 I – Rent
- 194 J – Fees for Professional and Technical Services
- 194 C – Payment made to contractors

17.68 The branch expenditure heads are required to be further classified into the above sections, especially the payments made to contractors are spread in various expenditure heads at the branch are required to be considered wherever applicable. Similar is the case of fees for Professional and Technical services. While reporting the amounts in column no. 3 these have to be matched with the PL heads year-end figures wherever necessary.

17.69 Further, from the total amount from each head above the amount on which TDS is not applicable due to various reasons are to be excluded to determine the amount on which the TDS is required to be deducted. From the balance amount in column 4 where the TDS is required to be deducted again needs to be classified under following categories:

- a) Amounts on which TDS at regular rates is to be made on the above.
- b) Amounts on which TDS to be made at concessional rate (based on the certificates obtained from Income Tax authority) and TDS on above.
- c) Amounts on which tax is not deducted (to be matched with disclosure at Clause No.21 (b) of Form 3CD.
- d) Tax Deducted but not paid.

17.70 The accuracy in reporting under this clause is important because, this is the most voluminous consolidation statement for reporting on the consolidated tax audit report for the Bank as a whole and if there are any discrepancies in this particular clause, then regional/zonal/HO consolidation is hampered and delayed.

17.71 Clause No. 34 (b) and (c) are applicable if the Branch has obtained a TAN and it is doing its compliance at the Branch level. In such a case the Branch auditor is also required to verify the position, accuracy and timeliness of filing of Quarterly ETDS returns filed by the branch and confirm the appropriate disclosure about the dates of filing, Interest payment and delayed filing fees paid by the branch. It is better to obtain CONSO files from TRACES and do the independent consolidation of four quarters and verify the data furnished by the branch to avoid the delay in verification of voluminous data.

17.72 As most of the points in Form 3CD are required to be verified only at the head office level, the branch auditors should make appropriate disclosure about the limitation of its scope Form 3CA submitted along with Form 3CD.

Annexure A

Illustrative Audit Checklist for Capital Adequacy

The checklist is only illustrative in nature. Members are expected to exercise their professional judgment while using the check list depending upon facts and circumstances of each case.

Audit Procedures	
CET 1, AT 1 and Tier II	
1. Tally the balances in the various elements of capital from the trial balance/ groupings/ draft financial statements.	
2. Check whether various instruments comply with the guidelines as laid down in Master Circular by referring to the Terms of Offer and whether the same are approved by the Board or other appropriate committee.	
3. Check whether appropriate discounting has been applied in the case of instruments issued.	
4. In case of foreign banks, examine whether the undertaking has been obtained that the bank would not remit abroad the funds received and shown as Capital Reserve or Remittable Surplus.	
5. Examine whether various limits up to which individual elements are to be included in CET1, AT1 and Tier II capital as laid down in the Master Circular are adhered to.	
6. Verify various deductions with the balances in the audited accounts and check the same for limits and eligibility (e.g. securitisation exposure) as laid down in the Master Circular.	
7. Verify the correctness of progressive discount based on the remaining maturity of instruments eligible for AT1 and Tier II.	
Capital Charge on Credit Risk	
The capital charge for credit risk is the sum total of the capital charge to be maintained in respect of the	

<p>following:</p> <ul style="list-style-type: none"> • On balance sheet items. • Off balance sheet items. • Failed transactions. • NPAs. • Securitisation transactions. <p>duly adjusted for haircuts based on the nature of the collateral.</p>	
<i>Risk Weights – On Balance Sheet Items</i>	
The risk weights for all on balance sheet items need to be determined based on the credit ratings assigned by the rating agencies chosen by the RBI.	
<p>1. Reconcile the balances of various advances and other operating receivables where there is a credit risk and which are considered for calculation with the following schedules in the financial statements to ensure completeness:</p> <ul style="list-style-type: none"> • Schedule 6 – Cash and balances with Reserve Bank of India. • Schedule 7- Balances with Banks and Money at Call and Short Notice. • Schedule 9- Advances. • Schedule 11(vi) – Other Assets – Others. 	
2. Review and document the process of compilation and mapping of the various items on balance sheet based on the categories and their risk weights together with the appropriate ratings and / or other conditions, as applicable.	
3. For a sample of transactions verify the ratings with the letters issued by the rating agencies and accordingly check the correctness of the risk weights assigned.	
4. In cases where the risk weights are dependent on the fulfilment of certain conditions (other than ratings) verify the compliance therewith based on	

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the appropriate documentary evidence (e.g. claims on banks, regulatory retail portfolio, claims against residential property etc.).	
5. Verify the validity of guarantees issued by Central or State Government. Verify whether the bank has properly classified claims on State Government and claims guaranteed by State Government due to difference risk weight.	
6. Verify the correctness of claims on CGTSI and ECGC.	
7. Verify the classification of loans – restructured loans/ NPAs/ NBFC/ CRE/ CRE-RH etc.	
8. Verify LTV ratio on a test check basis in respect of housing loans.	
<i>Risk Weights – Off Balance Sheet Items</i>	
<p>The risk weight for all off balance sheet credit exposures is generally calculated as a two step process as under, separately for market and non-market related exposures:</p> <ul style="list-style-type: none"> • The notional amount is converted into a credit equivalent amount by multiplying the amount by the specified credit conversion factor (for non market transactions) or by applying the current exposure method (for market related transactions). • The resulting credit equivalent amount is multiplied by the risk weight applicable to the counterparty or the purpose for which finance is extended or the type of asset, whichever is higher. <p>Where the exposure is secured by eligible collateral or guarantee, the credit risk mitigation guidelines may be applied.</p>	
1. Reconcile the balances of the various off balance sheet exposures which are considered for calculation with the financial statements, especially the schedule of contingent liabilities.	

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2. Review and document the process of compilation and mapping of the various off balance sheet item based on the nature of the instruments.	
3. For a sample of non-market transactions, check the calculations of the credit equivalent amount with specified credit conversion factor based on the nature of the instrument. Check the necessary documentation to confirm the nature of the instrument.	
4. For a sample of market related transactions, check the necessary documentation to confirm the nature of the contract and accordingly check the calculations for the current credit exposure and the potential future exposure.	
5. Verify the classification of Financial and Performance Guarantee by perusing the sample guarantee issued by the branches.	
6. Verify whether bills accepted under Letter of Credit is assigned 100 per cent risk weight as CCF.	
7. Verify whether the bank has proper control for accounting Buyer's credit/ Letter of Comfort.	
8. Verify the correctness of undrawn exposures.	
Capital Charge – Failed Transactions	
1. Review and document the procedures for tracking and monitoring the credit risk exposure arising from unsettled transactions, both on Delivery Versus Payment (DVP) and non DVP basis.	
2. For a sample of DVP transactions, examine whether the settlement has taken place on a timely basis. In case of delays, check the calculation of the capital charge by multiplying the positive current exposure by the prescribed factor depending upon the number of days delayed.	
3. For a sample of non-DVP transactions, examine whether the settlement has taken place as per the contracted maturity. In case of delays, ascertain whether any payment made is considered as a	

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loan and the appropriate risk weight is considered. In case of settlement beyond five days ascertain whether the full amount is deducted from the capital.	
<i>Risk weights – NPAs</i>	
1. Review and document the procedures for identifying the unsecured portion of NPAs separately for qualifying residential mortgages and others.	
2. For a sample of residential mortgages which are NPAs, examine whether they meet with the qualifying criteria with regard to the LTV ratio and other factors and accordingly check the assignment of the risk weight for the unsecured portion depending upon the level of provisioning.	
3. For a sample of NPAs other than residential mortgages check the assignment of the risk weight based on the level of provisioning.	
4. In respect of 3 above for identifying the secured portion examine whether only eligible collateral are considered and the same are properly documented and the bank has a clear and marketable title to realise the same.	
5. Verify whether bucketing in difference risk weight in respect of NPAs based on NPA provision is carried out by the system and verify the correctness of classification on a test check basis	
<i>Capital Charge – Securitisation transactions</i>	
Banks are required to hold regulatory capital after adjusting the prescribed deductions eligible against all securitisation exposures including those arising from provision of credit mitigants, investment in asset backed securities, retention of subordinated tranche and extension of liquidity facility or credit enhancement.	
Examine whether the securitisation transactions fulfil the requirements as prescribed in Master Circular on	

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<p>"Prudential Guidelines on Capital Adequacy and Market Discipline - New Capital Adequacy Framework" (extract of the 'Revision to the Guidelines on Securitisation Transactions', issued vide circular DBOD.No.BP.BC.103/ 21.04.177/ 2011-12 dated May 07, 2012on 'Revision to the Guidelines on Securitisation Transactions') to be eligible for deduction from capital.</p>	
<p>1. Based on the above, for a sample of transactions / deals examine whether the prescribed deduction from both CET 1, AT I and Tier II capital has been correctly done based on the rating and the level of provisions. Review the necessary documentation in support of the same.</p>	
<p>2. Based on the above ascertain whether the appropriate risk weights have been assigned.</p>	
<p>Collateral Risk Management and Credit Risk Mitigation</p>	
<p>The objective of collateral risk management is to ensure that only the eligible collateral are considered for netting off which are adjusted for volatility depending upon the nature of the capital and further subjected to various types of haircuts for different categories of mismatches like currency and tenor mismatches.</p>	
<p>1. Review and document the process for collateral risk management as appropriate and relevant including but not limited to:</p> <ul style="list-style-type: none"> • Ageing reports. • Confirmation procedures. • Control of documents. • Compliance with covenants. • Audit of collateral by independent agencies. 	
<p>2. Examine whether the bank has complete legal rights to enforce the security including specific lien and is subject to haircuts for residual tenor mismatch and currency mismatch. Check the necessary documentation in respect thereof.</p>	

Capital Charge for Market Risk	
<p>Capital charge for market risk involves computation of the capital charge on interest rate related instruments and equities in the trading book and foreign exchange risk, including gold and other precious metals. Accordingly, the following would be covered:</p> <ul style="list-style-type: none"> • Securities under the HFT and AFS category. • Open gold and FX position limits. • Trading position in derivatives. • Derivatives entered into for hedging trading book exposures. 	
Interest Rate – General Market Risk	
<p>The capital requirement for general market risk is the sum of the following four components:</p> <ol style="list-style-type: none"> (i) Net short (only derivatives) or long position in the trading book. (ii) Small proportion of matched position for each time band (vertical disallowance). (iii) A larger proportion of the matched positions across different time bands (horizontal disallowance). (iv) Net change for positions in options where applicable. 	
1. Reconcile the balances considered for calculation of the general interest rate risks trading book positions with the figures reported in the financial statements.	
2. Review and document the process for computation of the price sensitivity (modified duration) for each instrument and test check the calculations for a sample of instruments.	
3. Review the process of capturing the above data into different time bands based on the maturity and accordingly apply the prescribed change in yield and check the calculations for the resulting capital charge and the consequential vertical and horizontal disallowances.	

<i>Interest Rate – Specific Risk</i>	
<p>The specific interest rate capital charge for different types of debt securities / issuers is prescribed separately for the following categories:</p> <ul style="list-style-type: none"> • Central, State and Foreign government bonds under HFT and AFS category. • Banks bonds under HFT and AFS category. • Corporate bonds and securitised debt under HFT and AFS category. 	
1. Reconcile the balances of government securities under AFS and HFT considered for computation of specific interest rate capital charge with the financial statements.	
2. Review and document the process of compilation of data in respect of various types of government securities under AFS and HFT based on the type of investment and the residual maturity.	
3. For a sample of transactions in respect of the above, verify the allocation percentage of the specific risk capital based on the type of investment and residual maturity based on the verification of the relevant documentation.	
4. Reconcile the balances of bonds issued by banks under AFS and HFT considered for computation of specific interest rate capital charge with the financial statements.	
<p>5. Review and document the process of compilation of data in respect of various types of bonds issued by banks held as investments under AFS and HFT based on the following parameters:</p> <ul style="list-style-type: none"> • Level of capital adequacy. • Nature of the bank (scheduled or non-scheduled). • Residual maturity. 	
6. For a sample of transactions in respect of the above, verify the allocation percentage of the	

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specific risk capital based on the various parameters based on the verification of the relevant documentation.	
7. Reconcile the balances of corporate bonds and securitised debt under AFS and HFT considered for computation of specific interest rate capital charge with the financial statements.	
8. Review and document the process of compilation of data in respect of corporate bonds and securitised debt instruments held as investments under AFS and HFT based on the following parameters: <ul style="list-style-type: none"> • Rating assigned. • Nature of the investment. • Residual maturity. 	
9. For a sample of transactions in respect of the above, verify the allocation percentage of the specific risk capital based on the various parameters based on the verification of the relevant documentation.	
<i>Equity – General and Specific Market Risk</i>	
A uniform percentage of 9 per cent is currently attracted for the gross equity position for both specific and general risks.	
<i>Foreign Exchange and Gold</i>	
These currently attract a risk weight of 100 per cent which is in addition to the capital charge for credit risk for on and off balance sheet items.	
1. Check the computation of the net open position in each currency as a summation of the following: <ul style="list-style-type: none"> • Net spot position. • Net forward position. • Guarantees and similar instruments. • Net future expenses / incomes not yet accrued but fully hedged. 	
2. Based on the calculations of the market risk for each of the above check the computation of the	

aggregate capital charge of market risks. <i>Interest rate risk</i> a) General market risk <ul style="list-style-type: none">• Net position• Horizontal disallowance• Vertical disallowance b) Specific market risk <i>Specific and general market equity risk Foreign Exchange and gold.</i>							
Capital Charge for Exposure to Entities with Unhedged Foreign Exchange Exposures (UFCE)²²							
1. Ascertain the amount of the UFCE: UFCE may exclude items which are effective hedge against each other viz. financial hedge and natural hedge (On sample basis, the UFCE considered by the Bank can be verified with the certificates issued by the statutory auditor of the borrower entities, which is usually taken by the Bank from them on a quarterly/ half yearly basis). 2. Estimate the extent of likely loss. 3. Estimate the riskiness of the unhedged position and provide appropriately:							
<table><tr><td>Likely Loss/EBID (%)</td><td>Incremental Provisioning Requirement on the total credit exposures over and above extant standard asset provisioning</td><td>Incremental Capital Requirement</td></tr><tr><td>Up to 15 per cent</td><td>0</td><td>0</td></tr></table>	Likely Loss/EBID (%)	Incremental Provisioning Requirement on the total credit exposures over and above extant standard asset provisioning	Incremental Capital Requirement	Up to 15 per cent	0	0	
Likely Loss/EBID (%)	Incremental Provisioning Requirement on the total credit exposures over and above extant standard asset provisioning	Incremental Capital Requirement					
Up to 15 per cent	0	0					

²² RBI/2013-14/448 DBOD.No.BP.BC. 85 /21.06.200/2013-14 dated January 15, 2014.

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More than 15 per cent and up to 30 per cent	20bps	0	
More than 30 per cent and up to 50 per cent	40bps	0	
More than 50 per cent and up to 75 per cent	60bps	0	
More than 75 per cent	80 bps		
Banks should calculate the incremental provisioning and capital requirements at least on a quarterly basis . However, during the periods of high USD-INR volatility, the calculations may be done on a monthly basis.			
Capital Charge for Operational Risk			
Currently banks are required to maintain capital charge for operational risk at 15 per cent of the average gross income for the last three financial years			
<ol style="list-style-type: none"> 1. Obtain the computation of the gross total income and verify the same from the respective years audited financial statements. 2. Examine whether the various deductions from the net profit are appropriately considered. 			

- For computing the gross income for determining the capital to be held against operational risk, there is a clarification that the same should be considered based on the average of the last three financial years. However, there is no clarity as to whether this includes the current financial year though the better practice would be to consider the average of the preceding three years.

Annexure B

Illustrative Format of Covering Report for various Certificates issued by SBAs

Independent Auditor's Certificate for various certificates issued during the Statutory Audit of [Name of the Branch] [Branch Code] of [Name of the Bank] for the Financial year 2020 – 2021.

1. This Certificate is issued in accordance with the terms of our agreement dated [date of Engagement Letter].
2. The accompanying Statement contains various certificates issued by us during the Statutory Audit of [Name of the Branch] [Branch Code] of [Name of the Bank] for the Financial year 2020 – 2021, listed in Annexure [Name], which we have initialled for identification purposes only.

Managements' Responsibility for the Statement

3. The preparation of the accompanying Statement is the responsibility of the Management of the Bank. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and presentation of the Statement, and applying an appropriate basis of preparation; and making estimates that are reasonable in the circumstances.
4. The Management is also responsible for ensuring that the (Name of the Branch) (Branch Code of Bank) (Name of the Bank) complies with the requirements of the Equity Listing Agreement and for providing all relevant information to the Securities and Exchange Board of India.

Auditor's Responsibility

5. Pursuant to the requirements of the various RBI guidelines, our responsibility is to express reasonable assurance in the form of an opinion based on our audit and examination of books and records on test check basis, as to whether the [Name of the Branch] [Branch Code] of [Name of the Bank] has undertaken only those activities that have been specifically permitted by the RBI and has complied with the specified terms and conditions.
6. We audited the financial statements of [Name of the Branch] [Branch Code] of [Name of the Bank] for the Financial year 2020 – 2021, on which we issued an unmodified audit opinion vide our reports dated [date of Audit Report]. Our audit of these financial statements was conducted in accordance with the Standards on Auditing and other applicable authoritative pronouncements issued by the Institute of Chartered Accountants of India. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

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7. We conducted our examination of the Statements/Certificates given in Annexure [Name], in accordance with the Guidance Note on Reports or Certificates for Special Purposes issued by the Institute of Chartered Accountants of India. The Guidance Note requires that we comply with the ethical requirements of the Code of Ethics issued by the Institute of Chartered Accountants of India.

8. We have complied with the relevant applicable requirements of the Standard on Quality Control (SQC) 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

Opinion

9. Based on our examination as above, and the information and explanations given to us, we report that the Statement in Annexure [Name] is in agreement with the books of account and other records of [Name of the Branch] [Branch Code] of [Name of the Bank] for the Financial year 2020 – 2021 as produced to us for our examination, and the information thereof is prepared, in all material respects, in accordance with the applicable criteria.

Restriction on Use

10. This certificate has been prepared at the request of the [Name of the Branch] [Branch Code] of [Name of the Bank] solely with reference to our appointment letter, for the purpose of onward compilation of various certificates and disclosure requirements for [Name of the Bank] as a whole. It should not be used by any other person or for any other purpose. Accordingly, we do not accept or assume any liability or any duty of care or for any other purpose or to any other party to whom it is shown or into whose hands it may come without our prior consent in writing.

For
Chartered Accountants
Firm's Registration Number:

Partner / Proprietor
Membership Number:
UDIN

Place:
Date:

Annexure C

**Illustrative Format of Certificate w.r.t. Compliance/
Implementation Status of the Recommendations of the
Ghosh and Jilani Committees**

We have examined the attached Format of compliance/ implementation by _____ (name of bank/ bank branch/Department/Zonal Office) with the recommendations of the Ghosh Committee relating to Frauds and Malpractices in Banks and Format of Progress in Implementation of Jilani Committee recommendations, as prepared by the management. The responsibility for compliance with/ implementation of the recommendations of the Ghosh and the Jilani Committees is that of the management of the _____ (name of the bank/ bank branch/Department/Zonal Office). Our responsibility is to examine the report on the status of compliance therewith as contained in the attached Formats, as prepared by the management, thus far and no further.

We have not carried out an investigation into the status of compliance by/ implementation of the management with the recommendations of the Ghosh and Jilani Committees. Our examination is limited to inquiries and obtaining confirmations from the management and other appropriate persons and test checks of the attached status of recommendations.

Based on our above examination, subject to the matter highlighted below, we certify that to the best of our knowledge and belief and according to the information and explanation given to us and as shown by the records examined by us, the attached Formats of compliance with the recommendations of the Ghosh and Jilani Committees, as prepared by the management is correct.

1.
2.

Date:

Place:

For and on behalf of
Chartered Accountants
(Firm Registration No.)

.....
(Name and Designation)
(Membership Number)
UDIN

Gold / Bullion / Security Items

18.01 The Reserve Bank of India has discontinued the Gold/ Bullion sale at bank branches. RBI designates certain Banks every year for the purpose of importing Gold and selling it onward to customers. Besides some Banks sell retail Gold coins of a specific purity in specific denominations to their customers.

18.02 In such cases, the Auditor should ensure that:

- 1) Gold coins are stored properly in fire proof safe custody.
- 2) Insurance cover is obtained.
- 3) Stock records are properly maintained showing receipts, sales and closing stock.
- 4) Activity of verification and balancing of stocks is carried out on daily basis.
- 5) Sales / transfers within branches are made at prices determined by a systematic central driven process.
- 6) Proper entries are made in the books.
- 7) Tax payments if any including billing of invoices is carried out properly.

18.03 The Auditor should duly verify the process and report discrepancies, if any. Escalations could be made depending on the gravity of the issue. Appropriate reporting could be made in the LFAR as follows:

- a) Does the system ensure that gold/bullion are in the effective joint custody of two or more officials, as per the instructions of the controlling authorities of the bank?

The Auditor needs to take the details of the name and designation of the people who have joint custody of the same. The same needs to be verified as per the system laid down and the exceptions if any should be reported.

- b) Does the branch maintain adequate records for receipt, issues and balances of gold/bullion and updated these regularly? Does the periodic verification reveal any excess/shortage of stocks as compared to book records and the discrepancies observed have been promptly reported to the controlling authorities of the bank?

The records maintained in this regard should be verified by the Auditors. The details of discrepancies noticed and the reporting to the controlling authorities should be taken and delays if any should be reported.

- c) Does the system of the Bank ensure adequate internal control over issue and custody of security items (Term Deposit Receipts, Drafts, Pay Orders, cheque Books, Traveller's Cheques, Gift Cheques, etc.)? Whether the system is being followed by the branch? Have you come across cases of missing/lost items? For the purpose of review of compliance for this Audit area the Auditor may consider the following points.
- The Head Office instructions should be reviewed for existence of internal control.
 - Carry out the physical verification of security items including stamps.
 - Review whether lost security items have been promptly reported to the Controlling Authority.
 - Review the accounting treatment of Stationery items in financials. Different banks follow different policies w.r.t. valuation and accounting of Stationery and stamps.
 - Comment on the usage of security items during the year and the stock of such items *vis a vis* usage.
 - Report lacunas observed in the system at the branch as this is a fraud prone area.

Books and Records

19.01 With respect to review and reporting of Books and Records, Branch auditors are required to report on the following points in the Long Form Audit Report.

- a) 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:
- At present, all the banks have implemented the core banking system. The Auditor should report the system implemented at bank.
 - The Auditor should also compile and review the details of other soft wares deployed by the bank.
 - The reporting requirement in LFAR expects Auditor to report the soft wares which are not integrated with CBS. There can be numerous soft wares implemented by the banks. However, the Auditor should review the soft wares which have an impact on the financial transactions, reporting or any core activity which have not been integrated and report accordingly.
 - For instance, whether the SWIFT System, Structured Financial Messaging System (SMFS), System for Lockers etc. have been integrated with CBS and if so, what is the degree / percentage of integration of such system with CBS is required to be reviewed and commented upon.
 - The requirement of reporting of soft wares / systems not integrated with CBS require in-depth review of all systems in place. Moreover, the auditor should also review the activities carried out manually at branch viz. compilation of details for various reporting, etc.
- b) (i) 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 and are pending compliance? If yes give details.
- The branch auditor should seek a confirmation from Branch Management for IS Audit carried out at branch. If any IS Audit is carried out at branch, the Branch Auditor should seek the copy of the report.

- The issues reported by IS Auditor should be reviewed from two important aspects viz. i) Impact of Issue identified on Branch Books and ii) Compliance status of the issue. All the pending items with status thereof should be reported.
- Necessary explanations (wherever required) should be obtained on issues reported by IS Auditor.

(ii) Whether branch is generating, and verifying exception reports at the periodicity as prescribed by the bank.

- Each bank has a system of generation of various exception reports at the prescribed intervals. The Branch Auditor should obtain the list of exception reports prescribed by bank along with its periodicity for review.
- The auditor on sample basis should verify whether the branch has followed the instructions issued by Bank w.r.t. generation and verification of exception reports.
- The exception reports contain various types of transactions. Review of such transaction on sample basis will help the Auditor in ascertaining the nature of the transactions and risk involved.

iii) Whether the system of bank warrants expeditious compliance of daily exception reports and whether there are any major observations pending such compliance at the year end.

- The branch auditor should review whether exception reports which are required to be generated, reviewed and commented upon on daily basis have been complied with.
- Are there any issues which have not been complied / marked as pending compliance? If so, the status of the same should be obtained. All the critical items should be reported with status thereof.

iv) Whether the bank has laid down procedures for manual intervention to system generated data and proper authentication of the related transactions arising there from along with proper audit trail of manual intervention has been obtained.

- The branch auditor should obtain instructions issued by the bank for process to be followed when system generated data is manually altered.

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- In case such instructions have not been issued, the same should be commented upon.
- Moreover, the auditor should also review the cases wherein the system data, report, reporting, etc. have been manually altered. However, identification of such case is a complex process. The branch auditor should identify the reporting requirement and should review the system on sample basis to ascertain the authenticity of data.
- There have been instances of manual updation of Interest Rate / refund of excess interest by debiting revenue / expenditure account. Such transaction should also be reviewed from manual intervention perspective.

v) Furnish your comments on data integrity (including data entry, checking correctness / integrity of data, no back ended strategies etc.) which is used for MIS at HO / CO level.

- Data integrity aspect is generally handled at Data Administration level i.e. at Head Office / Corporate Office. Branches do not have any role to play in this aspect. However, the data entry being done at branch level which is used for MIS at HO / CO level needs to be reviewed at branch level. The Auditor should carry out test check to verify that the data being entered at branch level is done properly and there is proper maker checker principle for verification of the same.

Inter Branch/Office Accounts

A. Introduction and Bank Process

20.01 Office accounts are mostly used for internal business transactions of banks or transactions to facilitate movement of funds in a flow of transaction. Banks have large number of transactions involving substantial sums with the other banks, branches and controlling office or other business establishments and hence such transactions are carried out through office accounts. Therefore, it becomes very important to monitor the same. It is the responsibility of the bank to reconcile their transactions on a daily basis and keep a track on un-reconciled transactions.

20.02 Following are the major transactions which occur between branches and Head office through inter-office accounts:

- a. Issue of remittance instruments like drafts/TTs/MTs on other branches.
- b. Payment of remittance instruments like drafts/TTs/MTs drawn by other branches.
- c. Payment to / receipts from other branches of the proceeds of instruments received/sent for collection /realization/clearing.
- d. Cash sent to/received from other branches.
- e. Payment of instruments like gift cheques/ banker's cheques/ interest warrants/ dividend warrants/repurchase warrants/refund warrants / traveller's cheques, etc.
- f. Profit/loss transferred by the branch to head office.
- g. Government receipts and payments handled by the banks.
- h. Operations by the authorised branches on the bank's NOSTRO accounts through the Treasury/ International Banking Division.
- i. Foreign exchange transactions entered into by the branch for which it has to deal with the nodal forex department of the bank for exchange of rupees with foreign currency.
- j. Deposits into and withdrawal of money, by branches into currency chest maintained by another branch.

- k. Transactions through NEFT, RTGS, NACH, UPI, etc.
- l. ATM transactions of the customer either at ATMs linked with other banks or branches or with merchant establishments.
- m. Internet based transactions.
- n. Credit card related transactions of the customers.
- o. Control Accounts of Indian Branches maintained with Overseas Branches of the bank.
- p. Capital Funds with the Overseas Branches.
- q. Head Office balances with the overseas branches including subordinated debt lent to the overseas branches.
- r. GST transactions of Bank branches within a zone and Zonal or Head office.
- s. TDS of the branches is deposited by the central office.
- t. Parking of subsidies received from Government under various schemes.
- u. Head Office, 'Bad debts written off' account.

20.03 In respect of CBS, office accounts are bifurcated between accounts which mandatorily require the bank to enter a reference number while passing entry (pointing) and accounts which do not have such mandate (non-pointing). In respect of pointing accounts, reconciliation is easier as the entries can be knocked off based on reference number and each outstanding entry constituting outstanding balance at reporting date can be identified. In case of non-pointing, reconciliation require manual intervention and tracking due to non-availability of unique reference number.

20.04 The branch writes off the loan balance due to OTS or otherwise and credit the balance of loan account and debit to Head Office bad debts written off account. The same is transferred to head office after due approval of the competent authority.

20.05 The Auditors should verify the balance in this head and should seek explanation why the balance is not transferred to head office.

20.06 GST is normally centralised in banks but the entry of input is generated by the branch. The auditor should verify the expense voucher to ensure that no blocked credit is claimed by the branches and all eligible credit is claimed. The entry of reverse charge may also be examined.

20.07 In CBS most of the above mentioned transactions are automatically

executed by the system. Hence only where there is manual intervention these are to be monitored.

20.08 Following are the most common types of errors observed in the office accounts:

- Recording of particulars in incorrect fields.
- Posting of transactions in incorrect office accounts.
- Errors in writing the amounts.
- Recording the same transaction twice.
- Squaring off the transaction by same amount without checking the transactions.
- Merging of branches two branches into one and data is migrated to another branch but in absence of reference of original entry, the transaction is not matched by the system.

Forced matched transactions

20.09 The RBI has issued a letter to all Banks regarding certain objectionable practises observed by RBI in respect of office accounts. RBI has also instructed the Banks to conduct a comprehensive audit of office accounts and place the same before Audit Committee.

- Disguising cash transaction of customer to avoid AML reporting and bypassing CTR/STR reporting of the same.
- Disbursal of loan or repayment of loan through office account General Ledger resulting in misuse of funds and window dressing.
- No mandatory requirement of keying in reference number in case of pointing accounts.
- Opening of saving and current account and funds movement thereon misused and routed through office accounts.
- Crediting a dummy entry by debiting the office account to the credit of borrowers account and then debiting so as to maintain the "standard" status of borrower or to prevent from becoming NPA.
- Netting off liability related GLs with debit balances with credit balances in other GLs resulting in disclosing net outstanding in Financials of the Bank.
- Many income accounts do not have debit freeze or reference id for reversing charges.

B. Audit Approach

20.10 Office accounts have been a very sensitive area and can prove to be problematic or prone to errors and frauds. The Auditor should review the system of operation for such sensitive accounts. Several times it has been observed that there are old entries in such accounts due to migration issues. The auditor should check thoroughly the details of such entries with their ageing and also the improvement in settlement of the entries on a periodic basis by the bank including its reporting to the appropriate higher authorities at regular intervals.

- Every bank has its own procedures and methodology for office accounts transactions and hence it is very important for the Auditor to understand the procedure followed by the bank for recording the same.
- Every office account is opened for specific purpose and hence the Auditor on sample basis should review the transactions in office accounts to verify whether the transactions in accounts are matching with the purpose of account.
- Normally as part of MIS reporting, branches report only Ageing analysis of the outstanding balances of office accounts; however the Auditor should verify whether there are any entries near to reporting date where second effect is to either office accounts or borrower account especially overdue account. In former scenario, the Branch is avoiding long pending entry in office account by transferring to other office account and in later, the branch is trying to avoid classifying an account as NPA.
- The RBI has directed banks to carry out comprehensive audit to ensure that internal accounts are not allowed to be used unauthorized and proper checks are exercised before opening any such account, including adherence to the delegated power.
- Banks have to make 100 per cent provision against the net debit balance arising out of the un-reconciled entries outstanding for more than six months in the inter-branch account, from the year ending March 31st, 2004 vide RBI circular no. DBOD No. BP.BC. 73 /21.04.018/2002-03 dated 26th February, 2003 on "Inter-branch Accounts- Provisioning for net debit balance".
- In terms of the RBI Circular, from 1st April 1999, banks should maintain category wise/Head wise accounts of various types of transactions under inter branch accounts, if any and the netting off the transactions should be done on category wise, hence the net debit in one category is not to be set-off against net credit in another category.

- Banks have been advised by RBI to segregate the credit entries outstanding for more than five years in inter-branch accounts and transfer them to a separate blocked account which should be shown in the balance sheet under the head 'Other liabilities and provisions–Others' (Schedule 5). While arriving at the net amount of inter-branch transactions for inclusion in the balance sheet, the aggregate amount of Blocked Account should be excluded and only the amount representing the remaining credit entries should be netted against debit entries. Banks have been advised that any adjustment from the Blocked Account should be permitted only with the authorisation of two officials, one of whom should be from outside the branch concerned, preferably from the controlling/head office if the amount exceeds Rs.1 lakh.
- There are some transactions like dividend warrant, interest warrant, refund order etc. which required special attention because in the recent past number of transactions have been reported by the banks in these groups. In these transactions the funds are deposited at one branch and payments take place at other branches. Hence to prevent the frauds outstanding balances of these accounts should be checked with professional skepticism.
- The Auditor should review all material transactions accounted in office accounts just before the year end and where required, request the bank management to rectify the same by accounting in the correct account head.
- The Auditor should cautiously review all material transactions outstanding in office accounts even if it is outstanding for more than 6 months for which 100 per cent provision is made.
- The Auditor should check all adjustments in the office accounts and ensure that the adjustments are done properly and supported by adequate documentary evidence as to its validity. The Auditor should also verify that the reversal entries are made under proper authority and after due explanation and evidence.
- The Auditor should report on the year end status of office accounts indicating the dates up to which all or any segments of accounts have been reconciled. The Auditor should also indicate the number and amount of outstanding entries in the inter branch accounts, giving the relevant information separately for debit and credit entries. The Auditor can obtain the relevant information primarily from branch audit reports.
- Nostro Accounts at branch - Branches should also prepare reconciliation statement (REC) relating to those accounts for each of the Foreign Offices

or Foreign Correspondents, as the case may be for examination by SBAs.

- In respect to subsidy cases, the Auditor may verify that the credit to loan account is not treated as recovery of interest and principal and NPA accounts are not correctly identified. The banks may be advised in case of back end subsidy accounts, instead of opening Subsidy term loan, teaser rate of interest may be fixed in the term loan account of the borrower and subsidy may be credited after the expiry of Lock in period.
- Also, the Auditor may review jottings/listing of Current / Savings Bank account to check whether any account is opened with Generic Name/ Branch Address/ Bank Address/ Bank PAN, etc. If such account is identified then the Auditor should verify the purpose of opening the account and thoroughly review the transactions in the account. Also report about existence of such account and transactions in the same in LFAR.

20.11 In CBS environment, in case of inter branch transactions the inter branch account is automatically debited or credited by the system. An example of the same is as under:

If person A having savings bank account in X branch withdraws cash from Y branch. In such scenario, the following entries are passed:

In the Books of Branch Y	In the Books of Branch X
Inter Sol/ Branch A/c (Branch Y).... Dr	'A' savings bank A/c Dr
To Cash	To Inter Sol/ Branch (Branch X) A/c

At day end the balance in Inter Sol / Branch A/c for Bank as a whole should be Nil. The Statutory Central Auditor should verify the same.

C. Reporting

20.12 The Auditor needs to verify the following:

- Whether the bank has an effective system of office accounts w.r.t. each type of entries?
- Whether the bank has requisite audit trail w.r.t. reconciled entries?
- Age-wise analysis of unreconciled entries for each type of entry covered under office accounts, as on balance sheet date along with subsequent clearance, thereof if any.
- Whether the bank has a defined procedure for auto and forced matching of entries should be commented upon?

- Whether there are any unusual entries observed in the reconciliation process?
- Whether the bank has made adequate provision w.r.t. unreconciled entries as per the RBI guidelines and to the satisfaction of the Auditor?
- Suggest for improvement in existing system related to inter-branch reconciliation.

For LFAR purposes the Auditor needs to comment on Inter-Branch Accounts

20.13 *Does the branch expeditiously comply with/ respond to the communications from the designated cell/ Head Office as regards unmatched transactions? As at the year-end are there any unresponded/ uncomplained queries or communications beyond 7 days? If so, give details?*

- Now a day's CBS is implemented and hence the question of reconciliation of Inter – Branch Accounts does not arise at the Branch.

21

Fraud

Introduction

Definitions of Fraud

21.01 The term 'fraud' has been defined in several statutes:

- **Indian Contract Act, 1872:** As per section 17, "Fraud" means and includes any of the following acts committed by a party to a contract, or with his connivance, or by his agents, with intent to deceive another party thereto or his agent, or to induce him to enter into the contract:-
 - (1) the suggestion, as a fact, of that which is not true, by one who does not believe it to be true;
 - (2) the active concealment of a fact by one having knowledge or belief of the fact;
 - (3) a promise made without any intention of performing it;
 - (4) any other act fitted to deceive;
 - (5) any such act or omission as the law specially declares to be fraudulent.

Explanation.—Mere silence as to facts likely to affect the willingness of a person to enter into a contract is not fraud, unless the circumstances of the case are such that, regard being had to them, it is the duty of the person keeping silence to speak, or unless his silence is, in itself, equivalent to speech.

- **Companies Act, 2013:** As per Section 447, "Fraud" in relation to the affairs of a company or any body corporate, includes any act, omission, concealment of any fact, or, abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its Creditors or any other person, whether or not there is any wrongful gain, or any wrongful loss.
- **The Reserve Bank of India** has defined the term "fraud" in its guidelines on frauds as under.

"A deliberate act of omission or commission by any person, carried out in

the course of a banking transaction or in the books of accounts maintained manually or under computer system in banks, resulting into wrongful gain to any person for a temporary period or otherwise, with or without any monetary loss to the bank”.

- **Standard on Auditing 240 issued by ICAI** defines Fraud thus: – “An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.”

Classification of Frauds

21.02 In order to have uniformity in reporting, frauds have been classified as under, based mainly on the provisions of the Indian Penal Code:

- a. Misappropriation and criminal breach of trust.
- b. Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
- c. Unauthorised credit facilities extended for reward or for illegal gratification.
- d. Cash shortages.
- e. Cheating and forgery.
- f. Fraudulent transactions involving foreign exchange.
- g. Any other type of fraud not coming under the specific heads as above.

As regards cases under (d) and (f) above cash shortages resulting from negligence and fraudulent forex transactions involving irregularities / violation of regulations have also to be reported as fraud if the intention to cheat/defraud is suspected or proved. Notwithstanding the above, the following cases shall be treated as fraud and reported accordingly:

- a. on the day of occurrence by the persons handling cash cases of cash shortage more than Rs. 10,000/-, (including at ATMs); and
- b. cases of cash shortage more than Rs. 5,000/- if detected by management / auditor/ inspecting officer and not reported.

Types of Fraud in Banking System

21.03 There are numerous ways in which banking frauds are committed. The frauds committed in banking system can be classified under different types, based on the historical data available. Some examples of banking frauds are as under:

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- **Account opening fraud:** This involves an account being opened with either fake or original KYC documents with an intent to depositing and cashing of fraudulent cheques/ instruments.
- **Cheque kiting:** It is the method where by a depositor utilizes the time required for cheques (which is issued from an account having insufficient funds) to clear, to obtain an unauthorized loan with or without any interest charge.
- **Cheque fraud:** It is the most common method where frauds are committed through stolen cheques and forged signatures.
- **Counterfeit securities:** In this type of fraud, forged, duplicated or tampered documents, securities, bonds and certificates are presented as security for availing loan.
- **Digital fraud:** Under this type of fraud, the fraudster resorts to hacking, tampering to gain unauthorised access to siphon off or misappropriate funds.
- **Loan fraud:** This type of fraud is committed by lending funds to a non-borrowing customer or allowing a borrowing customer to exceed his credit limit, without adequate sanction / authority.
- **Money laundering fraud:** This type of fraud is committed by concealing the existence, source or use of illegally obtained money, by converting the cash into untraceable transactions in banks.
- **Letters of Credit:** This type of fraud is most common in international trade but has been observed in domestic trade also. In respect of international trade, these instruments used in cross borders transactions with underlying trade documents which are forged, altered, adjusted and take longer to identify ultimate destiny of merchandise. In respect of domestic trade these instruments are used to convert non funded facility into cash in purported trade transactions. Cash generated through such transactions is diverted or misappropriated out of system.
- **Advanced Fees Fraud:** This is popularly also known as "419 scam". Advanced fees fraud may involve agent with an offer of a lucrative business proposition / promise to make substantial funds available against advance fee or series of advance fees.

Early Warning Signals

21.04 Early Warning Signals (EWS) are those, which when noticed in any loan account, should alert the bank officials about some wrong doings in the loan

accounts which may turn out to be fraudulent. An illustrative list of some EWS as per Master Directions on Frauds – Classification and Reporting by commercial banks and select FIs (RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016-17) (updated as on July 3, 2017) are as follows:

1. a) Default in undisputed payment to the statutory bodies as declared in the Annual report.
 b) Bouncing of high value cheques.
2. Frequent change in the scope of the project to be undertaken by the borrower.
3. Foreign bills remaining outstanding with the bank for a long time and tendency for bills to remain overdue.
4. Delay observed in payment of outstanding dues.
5. Frequent invocation of BGs and devolvement of LCs.
6. Under insured or over insured inventory.
7. Invoices devoid of TAN and other details.
8. Dispute on title of collateral securities.
9. Funds coming from other banks to liquidate the outstanding loan amount unless in normal course.
10. In merchanting trade, import leg not revealed to the bank.
11. Request received from the borrower to postpone the inspection of the godown for flimsy reasons.
12. Funding of the interest by sanctioning additional facilities.
13. Exclusive collateral charged to a number of lenders without NOC of existing charge holders.
14. Concealment of certain vital documents like master agreement, insurance coverage.
15. Floating front / associate companies by investing borrowed money.
16. Critical issues highlighted in the stock audit report.
17. Liabilities appearing in ROC search report, not reported by the borrower in its annual report.
18. Frequent request for general purpose loans.
19. Frequent *ad hoc* sanctions.

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20. Not routing of sales proceeds through consortium/ member bank/ lenders to the company.
21. LCs issued for local trade/ related party transactions without underlying trade transaction.
22. High value RTGS payment to unrelated parties.
23. Heavy cash withdrawal in loan accounts.
24. Non production of original bills for verification upon request.
25. Significant movements in inventory, disproportionately differing vis-a-vis change in the turnover.
26. Significant movements in receivables, disproportionately differing vis-à-vis change in the turnover and/or increase in ageing of the receivables.
27. Disproportionate change in other current assets.
28. Significant increase in working capital borrowing as percentage of turnover.
29. Increase in Fixed Assets, without corresponding increase in long term sources (when project is implemented).
30. Increase in borrowings, despite huge cash and cash equivalents in the borrower's balance sheet.
31. Frequent change in accounting period and/or accounting policies.
32. Costing of the project which is in wide variance with standard cost of installation of the project.
33. Claims not acknowledged as debt high.
34. Substantial increase in unbilled revenue year after year.
35. Large number of transactions with inter-connected companies and large outstanding from such companies.
36. Substantial related party transactions.
37. Material discrepancies in the annual report.
38. Significant inconsistencies within the annual report (between various sections).
39. Poor disclosure of materially adverse information and no qualification by the statutory auditors.
40. Raid by Income tax /sales tax/ central excise duty officials.

41. Significant reduction in the stake of promoter /director or increase in the encumbered shares of promoter/director.
42. Resignation of the key personnel and frequent changes in the management.

Banks may choose to adopt or adapt the relevant signals from this list and also include other alerts/signals based on their experience, client profile and business models.

Expectations of Regulator

21.05 Central Fraud Monitoring Cell (CFMC) of RBI has analysed statistics of reported frauds in the banking system during the period FYs 2014 to 2018. Based on the said analysis some of the points worth noting are as under:

- There has been increasing trend in terms of number of frauds reported on both counts volume and value.
- About 90 per cent of the frauds in terms of value involved have happened in credit portfolio.
- Out of the frauds reported in FY 2018, frauds involving amount above Rs. 50 crores accounted for 80 per cent of total frauds reported.

21.06 The identified factors facilitating fraud are as under:

- Opening current account with banks outside consortium without the No Objection Certificate from lenders.
- Deficient and fraudulent services/certificates by Third Party Entities (TPEs).
- Diversion of funds by the borrowers through various means including through associated / shell / front-end companies.
- Lapses in credit underwriting standards.
- Failure to identify the Early Warning Signals (EWS) of incipient frauds.

21.07 It is expected that while conducting bank branch audit the Auditor should plan and perform the audit to obtain reasonable assurance with respect to existence and effectiveness of fraud identification and reporting framework laid down as per Master Directions on Frauds – Classification and Reporting by commercial banks and select FIs RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/ 2016-17 (Updated as on July 03, 2017) and Master Circular on Wilful Defaulters RBI/2015-16/100 DBR.No.CID.BC.22/ 20.16.003/2015-16 issued on July 1, 2015.

Role and Responsibility of the Auditor

21.08 Branch Auditor's primary objective is to opine on true and fair view of branch financial statements. The audit process needs to confirm compliance with standards on auditing issued by the Institute of Chartered Accountants of India (ICAI). Specific to the area concerning fraud, as laid down in SA 240, the Auditor has responsibility to plan and perform the audit to obtain reasonable assurance as to whether the financial statements taken as a whole are free of material misstatement, whether caused by error or fraud. SA 240 requires auditor to perform procedures with an objective to:

- identify and assess the risks of material misstatement in the financial statements due to fraud;
- obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
- respond appropriately to identified or suspected fraud.

21.09 While reporting on fraud in LFAR, the Statutory Branch Auditor has to provide appropriate responses to identified or suspected fraud.

21.10 Further, RBI circular. DBS.FGV(F) No.BC.15/23.08.001/2002-2003 has mandated that all Statutory, Internal and concurrent auditors appointed by the bank have "to specifically report, simultaneously, to the Chief Executive Officer of the bank and Central Office of the Department of Banking Supervision, RBI, Mumbai, any matter susceptible to be fraud or fraudulent activity or any foul play in any transactions." Further instances of fraud or fraudulent activity where the amount involved is Rs. 100 lakhs or above should be reported to the Reserve Bank of India, Department of Banking Supervision, Central Office, Mumbai and all other instances should be reported to Regional office of the Reserve Bank of India, Department of Banking Supervision under whose jurisdiction the Head Office of the bank falls.

Audit Approach and Procedures

21.11 Suggested audit approach and procedures to be performed are as follows:

- Based on review of advances consider whether the branch is having an effective credit monitoring for its advances portfolio.
- Obtain internal circulars of the bank pertaining to fraud identification and reporting.

- Examine whether the branch has an adequate system in place to identify Early Warning Signals (EWS) of incipient sickness / fraudulent activities in respect of loans within shortest possible time.
- Obtain and review reports of internal auditor, concurrent auditor, internal inspector, revenue audit, system audit and vigilance functions and assess existence of any of the early warning signals (EWS).
- If any of the aforesaid reports are pointing out existence of early warning signals in any of the accounts, conduct further enquiries with the branch to assess the branch has taken appropriate action and current status thereof.
- Enquire about any fraud reported to Controlling Authority/vigilance department, Head Office during the financial year and current status thereof.
- Whether frauds are examined from staff angle and, wherever necessary, the cases are reported to the Vigilance Cell for further action.
- Whether preventive/punitive steps have been taken by the bank during the year to reduce/minimise the incidence of frauds.
- Whether frauds have taken place because of laxity in following the systems and procedures and, if so, whether effective action has been taken to ensure that the systems and procedures are scrupulously followed by the staff concerned.
- Whether frauds are reported to local Police or CBI, as the case may be, for investigation, as per the guidelines issued in this regard to public sector banks by Government of India.
- Review the analysis of frauds according to different categories detailed in Paragraph 2.2.1 of Master Directions on frauds and also the different business areas.
- Review and analyse modus operandi of major frauds reported during the year along with their present position.
- Whether adequate provision for fraud has been done.
- Based on the audit procedures carried out, provide your suggestions.

Reporting

21.12 Though the objective of the statutory auditor is not to find out fraud / fraudulent activity or its possibility, it would be advisable for the statutory auditor to assess the existence and effectiveness of fraud risk mitigating and avoidance framework and controls implemented by the auditee bank.

Main report

21.13 Branch auditor needs to consider the impact of his observations made in respect of fraud on overall presentation of financial statements of the bank while opining on these financial statements.

LFAR

21.14 The branch auditor needs to report the particulars of frauds discovered during the year under audit. The Auditor is also required to provide his suggestions based on his audit to minimise the possibilities of their occurrence.

The Auditors has to furnish particulars of: :

- (i) Frauds detected/classified but confirmation of reporting to RBI not available on record at branch.
- (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.
- (iii) In respect of fraud, based on your overall :
observation, please provide your comments on the potential risk areas which might lead to perpetuation of fraud (e.g. falsification of accounts/false representation by the borrower; misappropriation of funds especially through related party/ shell company transactions; forgery and fabrication of financial documents like invoices, debtor lists, stock statements, trade credit documents, shipping bills, work orders and encumbrance certificates and avail credit; Use of current accounts outside consortium where Trust and Retention Account (TRA) is maintained, to divert funds; List of Debtors/ Creditors were being fabricated and receivables were not followed up/ write off of debt of related parties; Fake export/shipping bill, etc.; Over statement of invoice amount, stock statements, shipping bills, turnover; fly by night operations - including the cases where vendors, related/

associate parties, manufacturing units etc.
aren't available on the registered addresses;
Round Tripping of funds, etc.)

- (iv) 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.

Relevant circulars

1. RBI Master Circular No. RBI/2015-16/100 DBR.No.CID.BC.22/20.16.003/2015-16 dated July 01, 2015 on "Wilful Defaulters".
2. RBI Master Direction no. RBI/DBS 2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 dated July 01, 2016 (Updated as on July 03, 2017) on Fraud – Classification and Reporting by commercial banks and selected FIs.

22.01 The Long Form Audit Report (LFAR) mentions a separate clause titled "Miscellaneous" wherein the Auditors are required to provide their specific comments on the relevant questions. The LFAR is a detailed questionnaire on several of the key aspects which the Branch auditor has to reply for the perusal of the Bank Management. Miscellaneous includes a residuary clause wherein the branch auditor can specify his observations on any of the areas of the Branch, which he feels necessary to be highlighted for the specific attention of the Management and SCA. The relevant questions are detailed below:

- (a) In framing your audit report/ LFAR, have you considered the major adverse comments arising out of the latest reports such as:
 - i) Previous year's Branch Audit Report/ LFAR;
 - ii) Internal audit/ Snap Audit/ concurrent audit report(s);
 - iii) Credit Audit Report;
 - iv) Stock audit Report;
 - v) RBI Inspection Report, if such inspection took place;
 - vi) Income and Expenditure (Revenue) Audit;
 - vii) IS/IT/Computer/Systems Audit; and
 - viii) Any special inspection/investigation report.

As part of Audit Planning, the Branch Auditor should review various audit reports of audits carried out by internal audit department or other departments of the Bank and any other external authorities. The adverse comments in these reports should be considered while conducting branch audit. Also, the Auditor should verify the status of the open observations in these reports and report the same in LFAR in respective paras as open observations from other audit reports. The Auditor shall comment how he/she has considered observations / adverse comment while conducting audit in this para.

- (b) Are there any other matters, which you, as branch auditor, would like to bring to the notice of the management or the Statutory Central Auditors?

The Auditor can put his observations under this clause which have not been reported elsewhere in the report. The Auditor should use this clause to highlight any matter which he feels is of importance for the attention of the SCA and the Management. Some of the observations can be – the software licences being used at the Branch are not genuine, pen drive can be used on the desktop PCs at the Branch, placement of the branch server, router etc., General housekeeping of the branch, overall monitoring of the accounts etc.

Audit of Foreign Exchange Business

23.01 Long Form Audit Report (LFAR) for Bank branches requires the Auditors to review and comment on following aspects w.r.t. Branches Dealing in Foreign Exchange Business.

1. Are there any material adverse features pointed out in the reports of concurrent auditors, internal auditors and/ or the Reserve Bank of India's inspection report which continue to persist in relation to NRE/ NRO/ FCNR-B/ EEFC/ RFC and other similar deposits accounts. If so, furnish the particulars of such adverse features.
2. Whether the branch has followed the instructions and guidelines of the controlling authorities of the bank with regard to the following in relation to the foreign exchange and, if not, state the irregularities.
 - (a) deposits
 - (b) advances
 - (c) export bills
 - (d) bills for collection
 - (e) dealing room operations (where a branch has one)
 - (f) any other area

3. NOSTRO Accounts

Obtain from the branch management, a list of all NOSTRO Accounts maintained/ operated by the branch.

- (a) Whether the bank has a system of periodic confirmation/ reconciliation of the balances in NOSTRO accounts maintained with each overseas bank/ correspondent? Has such confirmation been received and account reconciled at year end in each case. If not, give details.
- (b) Whether the system of the bank ensures that all entries originated by overseas banks/correspondents, have been duly responded promptly in the respective NOSTRO accounts maintained by the bank?
- (c) Are there any dormant/closed NOSTRO accounts in respect of which balances continue to exist in the books of the branch, at year end?

- (d) Have the NOSTRO balances been converted at year end at the rates of exchange as prescribed by controlling authorities?
 - (e) In case, any matter deserves special attention of the management, the same may be reported
4. Does the Branch follow the prescribed procedures in relation to maintenance of Vostro Accounts?

23.02 This Chapter is divided into following parts.

Part – 1: Adherence to instructions and guidelines of controlling authorities in relations to foreign exchange business carried out.

Part – 2: Nostro & Vostro Accounts related.

23.03 Further, the Auditor should refer to the master directions issued by RBI in this respect which are stated as under:

- 1. Master Directions – Deposits and Accounts (RBI/FED/2015-16/9 FED Master Direction No. 14/2015-16)
- 2. Master Direction – Remittance of Assets (RBI/FED/2015-16/8 FED Master Direction No. 13/2015-16)
- 3. Master Direction – Miscellaneous (RBI/FED/2017-18/14 FED Master Direction No. 19/2015-16)
- 4. Master Direction – Opening and Maintenance of Rupee/Foreign Currency Vostro Accounts of Non-resident Exchange Houses (RBI/FED/2015-16/16 FED Master Direction No.2/2015-16)

Part 1: Adherence to instructions and guidelines of controlling authorities in relation to Foreign Exchange business

23.04 The LFAR deals with review of adherence to instructions and guidelines issued by RBI by branch w.r.t. Foreign Exchange Business in the field of:

- a. Deposits
- b. Advances
- c. Export Bills
- d. Bills for Collection
- e. Dealing Room operations
- f. Any other area

23.05 The Auditor should ensure compliances with internal policies of the Bank and with various Master Directions as stated below:

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For the purpose of review of the said aspects the Auditor should refer to various master directions issued by RBI in this respect. Few of the relevant master directions are listed below:

1. External Commercial Borrowings, Trade Credits and Structured Obligations (RBI/FED/2018-19/67 FED Master Direction No.5/2018-19) read with Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019 (Notification No.FEMA/395/2019-RB)
2. Establishment of Branch Office (BO)/ Liaison Office (LO)/ Project Office (PO) or any other place of business in India by foreign entities (RBI/FED/2015-16/6 FED Master Direction No.10/2015-16)
3. Direct Investment by Residents in Joint Venture (JV) / Wholly Owned Subsidiary (WOS) Abroad (RBI/FED/2015-16/10 FED Master Direction No. 15/2015-16)
4. Borrowing and Lending transactions in Indian Rupee between Persons Resident in India and Non-Resident Indians/ Persons of Indian Origin (RBI/FED/2015-16/2 FED Master Direction No. 6/2015-16)
5. Liberalised Remittance Scheme (LRS) (RBI/FED/2017-18/3 FED Master Direction No. 7/2015-16)
6. Other Remittance Facilities (RBI/FED/2015-16/4 FED Master Direction No. 8/2015-16)
7. Remittance of Assets (RBI/FED/2015-16/8 FED Master Direction No. 13/2015-16)
8. Deposits and Accounts (RBI/FED/2015-16/9 FED Master Direction No. 14/2015-16)
9. Import of Goods and Services (RBI/FED/2016-17/12 FED Master Direction No. 17/2016-17)
10. Reporting under Foreign Exchange Management Act, 1999 (RBI/FED/2015-16/13 FED Master Direction No.18/2015-16)
11. Miscellaneous (RBI/FED/2017-18/14 FED Master Direction No. 19/2015-16)
12. Opening and Maintenance of Rupee/Foreign Currency Vostro Accounts of Non-resident Exchange Houses (RBI/FED/2015-16/16 FED Master Direction No.2/2015-16)
13. Export of Goods and Services (RBI/FED/2015-16/11 FED Master Direction No. 16/2015-16)
14. Money Transfer service Scheme (MTSS) (RBI/FED/2016-17/52 FED

Master Direction No.1/2016-17)

15. Insurance (RBI/FED/2015-16/5 FED Master Direction No.9/2015-16)
16. Compounding of Contraventions under FEMA,1999 (RBI/FED/2015-16/1 FED Master Direction No.4/2015-16)

Part 1 (a) – Deposits

23.06 Detailed guidance for Deposit accounts is provided in Chapter 13, "Borrowings and deposits" of Section B of this Guidance Note.

Part 1 (b) – Advances

23.07 Advances funded in foreign currency are handled in specialized branches. The auditor should note the following:

Export Financing

A. Pre-Shipment/Packing Credit to Exporters

23.08 Important Points:

- Export packing credit can be in Indian Rupees and in Foreign Currency.
- To be issued basis letter of credit or a confirmed and irremovable order for the export of goods/services, unless specifically waived.
- Period of packing credit will depend upon the circumstances of the individual case subject to maximum period for of 360 days.
- EPC / PCFC is disbursed against specific orders, in one lumpsum tranche or against the requirement as per export orders.
- To arrive at the eligible amount of drawl under EPC / PCFC facility, the amount of contract is first aligned to FOB basis, prescribed margin is deducted and thereafter the same is converted to rupees. The said eligible amount can be drawn in INR under Rupee Credit Facility and in Foreign currency in case of PCFC facility.
- Each original contract or LC is endorsed for PC granted.
- In packing credit running account facility PC is adjusted on FIFO basis and not contract to contract.
- Monthly stock statement for PC facility should be furnished wherein DP is available from paid goods only and book debts or unpaid goods are not permitted.
- Stock, RM, WIP & FG should remain fully insured with policy endorsed in bank's favour.

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- Rupee export packing credit can be shared between an Export Order Holder (EOH) and sub-supplier of raw materials, components etc., of the exported goods subject to:
 - Running account facility is not allowed.
 - Bankers to an EOH will open an inland LC specifying the goods to be supplied by the sub-supplier.
 - The above scheme is an additional window beside the existing system of sharing of packing credit. Further it has to be verified that the total quantum of advance or period cannot be extended.
- Liquidation of EPC / PCFC will be by way of exports proceeds only. Liquidation by any other means than by way of exports will attract – commercial rate of interest as per Bank's Policy. However, as per Master Directions on Export of Goods and Services issued by RBI it is prescribed that AD Category – I banks may permit exporters to repay packing credit advances whether availed in Rupee or in foreign currency from balances in their EEFC account and / or Rupee resources to the extent exports have actually taken place.

Accounting aspects

- Banks open separate loan account in CBS for EPC / PCFC. It helps in monitoring the utilization and liquidation.
- Bank at the request of the borrower must convert the amount of Pre-Shipment credit into Post-Shipment credit by discounting / purchasing the export bills. When PC is granted no export bill should be sent on collection basis. If in case any problem is there in purchase of a bill say discrepant documents, bill should be purchased and proceeds credited to PC account and PC account should be earmarked till it is accepted or paid by the foreign bank.

Compliance aspects

- *End use of funds*

Banks should keep a close watch on the end-use of the funds and ensure that credit at concessional rates of interest is used for genuine requirements of exports only. The cheques/withdrawal from the PC account should be made to the suppliers of the raw materials purchased/ processed or for manufacturing expenses of the goods to be exported. Banks should also monitor the progress made by the exporters in timely fulfilment of export orders.

Order Book Maintenance

- Banks maintain order book / register to track export orders vis-a-vis Export Credit extended.
- PC should be supported by valid export orders on hand. If any export order or LC is expired the same should be extended or replaced.

Submission of Export Documents

- If pre-shipment advances are not liquidated from proceeds of bills on purchase, discount, etc. on submission of export documents within 360 days from the date of advance, or from balance in EEFC account and / or Rupee resources to the extent exports have actually taken place, the advances will not be treated as export credit *ab initio*.
- If exports do not materialise at all, banks should charge on relative packing credit domestic lending rate plus penal rate of interest, if any, to be decided by the banks on the basis of a transparent policy approved by their Board.

Auditing aspects

- Generate the list of EPC / PCFC accounts opened and maintained by the branch.
- Verify whether all details are correctly filled in Masters.
- Whether the liquidation of EPC / PCFC is as per RBI guidelines? If not, whether interest rate as per Bank's Policy is charged or not.
- Documents evidencing end use of funds should be verified.
- Whether genuineness of Export LC is confirmed before sanctioning EPC / PCFC?
- If remitting bank advises, bill is required to be presented to the alternate drawee, then necessary approval and borrower consent should be obtained.
- Similarly the advance should be covered under bank's WTPCG cover if stipulated. Premium should be recovered from the client if stipulated.

B. Post-Shipment Credit to Exporters

Export Bills Discounted / Purchased

23.09 Banks extend the following credits to exporters:

- Banks extend credits to Exporters by way of
 - Export bills purchased / discounted / negotiated

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- Advances against Bills on collection basis.
- Financing against duty drawback receivable from the Government.
- Facility of discounting / purchase of bill is available in both Indian Rupee and in Foreign Currency.

Revenue aspects

- Interest on Bill Discounting / Purchase is revenue for the bank. The Auditor should review the accounting policy of the bank in this regards.
- Bank also charges fees for export bill lodgement and claims courier and other charges for submission of Export Documents.

Accounting aspects

- In case of Discounting / Purchase in Foreign Currency:
 - The rupee equivalent of the discounted value of the export bills will be payable to the exporter and the same should be utilised to liquidate the outstanding export packing credit.
 - As the discounting of bills/extension of foreign exchange loans (DP bills) will be in actual foreign exchange, banks may apply appropriate spot rate for the transaction.
 - The rupee equivalents of discounted amounts/foreign exchange loan may be held in the bank's books distinct from the existing post-shipment credit accounts.
 - In case of overdue bills, banks may charge overdue interest as per the interest rate policy of bank from the due date to the date of crystallization.

Compliance aspects

- In case of overdue bills, IRAC Norms for overdue bills will be applicable and the advance will be subject to Asset Classification.
- Export Bills will be subject to maximum period of 365 days.

Auditing aspects

- Generate a report on Export Bills purchased/negotiated during the audit period.
- Verify whether details are correctly filled in Masters especially amount and discounting rate.

- Generate a report on outstanding / realized export bills during the audit period.
- In case of overdue bills check whether the interest has been charged as per Bank's Policy.
- Verify whether the period of sanction is within the period prescribed by RBI i.e. 360 days.
- Verify credit report on buyer should be held from international agency.
- ECGC buyer wise cover should be obtained by the exporter client if stipulated.
- Similarly the advance should be covered under bank's WTPSG cover if stipulated.

Import Financing

Trade Credits

23.10 Trade Credit (TC) is defined by RBI in Master Direction No. RBI/FED/2018-19/67 FED Master Direction No.5/2018-19 dated March 26, 2019 (Updated as on August 08, 2019) - External Commercial Borrowings, Trade Credits and Structured Obligations as follows.

'Trade Credits (TC) refer to the credits extended by the overseas supplier, bank, financial institution and other permitted recognised lenders for maturity, as prescribed in this framework, for imports of capital/non-capital goods permissible under the Foreign Trade Policy of the Government of India. Depending on the source of finance, such TCs include suppliers' credit and buyers' credit from recognised lenders.'

23.11 *Framework prescribed for TCs:* TC for imports into India can be raised in any freely convertible foreign currency (FCY denominated TC) or Indian Rupee (INR denominated TC), as per the framework given in the table below:

Sr. No.	Parameters	FCY denominated TC	INR denominated TC
i	Forms of TC	Buyers' Credit and Suppliers' Credit.	
ii	Eligible borrower	Person resident in India acting as an importer.	
iii	Amount under	Up to USD 150 million or equivalent per import transaction for oil/gas refining & marketing, airline and shipping	

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Sr. No.	Parameters	FCY denominated TC	INR denominated TC
	automatic route	companies. For others, up to USD 50 million or equivalent per import transaction.	
iv	Recognised lenders	<p>1. <i>For suppliers' credit:</i> Supplier of goods located outside India.</p> <p>2. <i>For buyers' credit:</i> Banks, financial institutions, foreign equity holder(s) located outside India and financial institutions in IFSCs located in India.</p> <p><i>Note:</i> Participation of Indian banks and non-banking financial companies (operating from IFSCs) as lenders will be subject to the prudential guidelines issued by the concerned regulatory departments of the Reserve Bank. Further, foreign branches/subsidiaries of Indian banks are permitted as recognised lenders only for FCY TC.</p>	
v	Period of TC	The period of TC, reckoned from the date of shipment, shall be up to three years for import of capital goods. For non-capital goods, this period shall be up to one year or the operating cycle whichever is less. For shipyards / shipbuilders, the period of TC for import of non-capital goods can be up to three years.	
vi	All-in-cost ceiling per annum	Benchmark rate plus 250 bps spread.	
vii	Exchange rate	Change of currency of FCY TC into INR TC can be at the exchange rate prevailing on the date of the agreement between the parties concerned for such change or at an exchange rate, which is less than the rate prevailing on the date of agreement, if consented to by the TC lender.	For conversion to Rupee, exchange rate shall be the rate prevailing on the date of settlement.
viii	Hedging provision	The entities raising TC are required to follow the	The overseas investors are eligible to hedge their

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Sr. No.	Parameters	FCY denominated TC	INR denominated TC
		guidelines for hedging, if any, issued by the concerned sectoral or prudential regulator in respect of foreign currency exposure. Such entities shall have a board approved risk management policy.	exposure in Rupee through permitted derivative products with AD Category I banks in India. The investors can also access the domestic market through branches / subsidiaries of Indian banks abroad or branches of foreign banks with Indian presence on a back to back basis.
ix	Change of currency of borrowing	Change of currency of TC from one freely convertible foreign currency to any other freely convertible foreign currency as well as to INR is freely permitted.	Change of currency from INR to any freely convertible foreign currency is not permitted.

23.12 The typical flow of transaction of TC (with underlying import through LC transaction) is as follows:

- 1) The borrower imports goods from foreign supplier against Foreign Letter of Credit (FLC) drawn in favour of foreign supplier. *[The Buyer's Credit can also be arranged for transactions of Import on Collection basis and Direct Import cases.]*
- 2) The borrower either through its Indian bank or on its own approaches foreign bank (or overseas / foreign branches / offices of Indian banks), financial institutions foreign equity holder for Buyer's Credit and Supplier for availing Suppliers' Credit for payment to be made to the foreign supplier;
- 3) Issuance of Letter of Comfort by Indian bank to the foreign bank is not permitted. However, Banks are permitted to issue Bank Guarantee in favour of overseas TC lender (subject to compliance with provisions contained in Master Circular No.DBR.No.Dir.BC.11/13.03.00/2015-16 dated July 1, 2015 on "Guarantees and Co-acceptances", as amended from time to time). Banks are also permitted to create charge on assets for TC so arranged.
- 4) The TC Lender remits funds to the NOSTRO Account of Indian bank which is handling import transaction (under buyer's credit) or agree to extend date

of payment under Supplier's credit for buyer and securing payment through bill discounting with all expenses on buyer.

- 5) The Indian bank remits the funds to foreign supplier through its NOSTRO Accounts in case of Buyer's Credit.
- 6) The Indian bank subsequently retires and reverses the Letter of Credit in its book and passes another entry for creation of a non-fund based (contingent) liability of Bank Guarantee (if issued).
- 7) On the due date of TC, the Indian bank remits the funds (inclusive of interest) to the overseas bank and recovers the similar amount from its customer.

The entries of the inward and outward remittances (specified in steps 3 and 4) are to be recorded in the books of accounts (NOSTRO Mirror Account) of the Indian bank.

- 8) For the purpose of raising TC, the importer may also offer security of movable assets (including financial assets) / immovable assets (excluding land in SEZs) / corporate or personal guarantee for raising TC. ADs may, therefore, be allowed to permit creation of charge on security offered / accept corporate or personal guarantee, duly ensuring that
 - (i) There exists a security clause in the loan agreement requiring the importer to create charge, in favour of overseas lender / security trustee on immovable assets / movable assets / financial securities / issuance of corporate and / or personal guarantee;
 - (ii) No Objection Certificate, wherever necessary, from the existing lenders in India has been obtained;
 - (iii) Such arrangement is co-terminus with underlying TC;
 - (iv) In case of invocation, the total payments towards guarantee should not exceed the dues towards TC; and
 - (v) Creation/ enforcement / invocation of charge shall be as per the provisions contained in Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India) Regulations, 2000 and Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 or any other relative Regulations framed under the Foreign Exchange Management Act, 1999 and should also comply with FDI/FII/SEZ policy/ rules/ guidelines.

23.13 Following documents are required to be verified by the statutory auditors during review of Buyers' Credit and Suppliers' Credit Transaction and its accounting treatment in the Indian Bank's books.

- 1) (Loan) Agreement, if any, entered between the Indian importer (borrower), overseas TC lender, the Indian bank (facilitator).
- 2) SWIFT messages originated by overseas bank specifying the terms of TC.
- 3) The calculation of contingent liability towards Bank Guarantee is inclusive of interest accrued on the TC as on financial statement date.
- 4) Documentation / agreement between overseas TC lender and Indian Bank, (if any) and, any further confirmatory documents exchanged between overseas bank and Indian bank.
- 5) Review of documents specifying right of recovery against borrower, in case if the borrower defaults in repayment of TC.
- 6) Balance confirmations obtained from the overseas TC lender.
- 7) Charge created in the records of RoC, if required, related to the security offered for TC vis-à-vis disclosure of TC in the financials of borrowers as secured / unsecured loan.
- 8) Acknowledgement of debt, if any, obtained from the borrower.
- 9) The period of finance for non-capital goods is lower of operating cycle or one year (three years for shipyards / shipbuilders).
- 10) Form 15CA / Form 15CB(income tax) compliances made by the borrower.

Revenue aspects of TC transaction

23.14 Bank issuing BG for TC Transaction earns commission / charges.

Unusual increase in revenue by way of commission and charges should be inquired into.

Accounting aspects of TC transaction

23.15 The following are the accounting aspects of TC transactions:

- Issuance of BG for TC is considered as Non-Funded facility by banks.
- The important aspect is to ensure that the fields in CBS match with details reported in SWIFT message sent for BG. The BG is generally communicated through MT760 which includes certain separately identifiable details.
- The Auditor should also review the text of the guarantee to confirm correctness of accounting treatment in books of accounts.
- The Auditor should also review any messages sent through MT799 (Free

Text Format) type SWIFT messages. In this type of message the vital details are included as a text and not as separately identifiable fields. In view of this even when an automated information reporting system (from CBS to SWIFT) has been implemented, there is still a possibility of flowing certain vital information through SWIFT message text which may not have been recorded in CBS.

- The Auditor needs to verify the internal control process implemented by the bank to ensure that all swift messages are properly accounted for and verify that direct access to swift system is not granted, and the concerned officials enter swift through the CBS system alone.

Compliance aspects of TC transactions

23.16 TC transactions involve the following compliances:

- TC transaction should be within the prescribed tenure.
- Interest rate and other costs for TC transaction must be within the prescribed All-in-Cost ceiling.
- There are certain restrictions on availing TC for select commodities. Tenure prescribed in Master Circular issued by RBI for the said TC transaction must be adhered to. For instance, certain restrictions have been imposed on TC for import of Gold, Diamonds, precious metals etc. The Auditor may refer to Master Directions on Import of Goods and Services (Updated as on October 28, 2020) RBI/FED/2016-17/12 FED Master Direction No. 17/2016-17 issued on January 1, 2016 for the same.

Auditing aspects of TC transactions

23.17 Following are the auditing aspects in TC transactions:

- Underlying transaction for TC is Import Transactions. Hence, it is important for the Auditors to verify the Evidence of Import. Exchange Control Copy of Bill of Entry / Entry in IDPMS is the document / confirmation which can be said to be Evidence of Import. In case of TC availed by SEZ units the Auditor may review the compliance of provisions provided under Master Directions for Trade Credit.
- The Auditor should check the Offer Letter issued by overseas lender and conformity of TC transaction with FEMA guidelines.
- Are there any cases of devolvement by borrower in remitting TC amount in past? In such cases bank which has issued LoU / LoC / BG has to remit the funds on due date to Foreign Lender. Check whether there are any cases of such nature during Audit Period? The reason for devolvement should be verified and put on records.

- Whether the Fees / Charges for BG issuance / charges creation is collected upfront?

Part 1 (c) – Export Bills

23.18 There are different types of Export Bills in Foreign Exchange transactions viz. Export Bills on Collection, Export Bills Discounted / Purchased, Advance against Export Bills etc.

Important aspects of Export Bills discount/ purchase have been mentioned above. For detailed guidelines the Auditor should refer Master Direction – Export of Goods and Services (Updated as on March 23, 2016) RBI/FED/2015-16/11 FED Master Direction No. 16/2015-16 issued on January 1, 2016 and guidelines provided in RBI/2019-20/206A.P.(DIR Series) Circular No.27 dated April 01, 2020.

Part 1 (d) – Bills for collection

23.19 Under Import bills for collection the Foreign Seller sends goods through shipping channel and documents to its banker with an instruction to send the same to the Importer's Banker. The document so sent contains instructions on handling of the said documents. The Importer's Bank will follow the instruction mentioned in the bill schedule and deliver the documents to the buyer.

In this type of transaction Importer's Banker is dealing only as a mediator i.e. in case the Importer does not pay the bill amount the Importer's bank will notify the Exporter's Bank and will act as per Exporter's Bank instruction.

Revenue aspects of Import Bills on Collection

23.20 Import bills on collection involve the following revenue aspects:

- Bank charges fees / commission for handling bills on collection.
- Generally, it is observed that in case of Forex Transactions handled through CBS, the charges are collected by CBS. However, the Auditor should carry out walkthrough process of collection of charges. Sanction for waiver/concession in charges must be verified.

Accounting aspects of Import Bills on Collection

23.21 The accounting aspects on collection of import bills are the following:

- The bills are lodged in CBS / recorded in Import Bills on Collection register
- In case of CBS, the payment of Bill made through Bill module in CBS. CBS will update the outstanding Bill Liability on realization event.
- Only contra transaction for Contingent Liability is created for Import Bills on Collection.

Compliance aspects of Import Bills on Collection

23.22 The compliance aspects on collection of import bills are the following:

- Import Bills under collection must form part of Contingent Liability.
- Lodgement, Realization and Closure of Bill should be carried out through Bill module under CBS.

Auditing aspects of Import Bills on Collection

23.23 The auditing aspects on collection of import bills are the following:

- Generate bill balancing report for import bills on collection transaction. It is preferable to have the said report generated for 31st March.
- Carry out physical verification of all outstanding bills appearing under Bill Balancing Reports. Special attention should be given to bills under "Lodgement" status for availability of Transport Documents (In normal course, transport documents along with other documents are handed over only after payment in case of Sight Bill or only after acceptance of bill of exchange in case of usance bill).
- Verify whether total of outstanding import bills on collection as per bill balancing report agrees with bills for collection under contingent liability?
- Whether the activity of collection of charges is system driven or manual? Select appropriate sample based on the review of process.
- It is generally observed that the activity of collection of charges for discrepancy memo is manual. If so, verify whether the charges have been properly collected or not.
- Overdue bills report should be obtained and follow up done with the bank may be verified.
- Compliance of GST on the Charges so collected and accounting thereof.

Part 1 (e) – Dealing Room operations

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

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

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

Front Office (Dealing Room)

- Money and fixed income dealings
- Forex and derivatives
- Treasury sales
- Equities
- Primary dealers
- Debt sales
- Credit default swaps

Middle Office (Risk)

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

Back Office

- Settlement and follow up
- Reconciliations
- Accounting
- Valuation

23.26 Increasing regulation and compliance requirements and the need for risk management have made 'treasury front and back office efficiency' as one of the most critical factors in ensuring the well-being of any bank today. This is especially important as the operations of treasury become more onerous while financial products become increasingly complex, despite streamlining of processing systems. Staff of Front Office, Middle Office and Back Office should be segregated and all the work should not be handled by one officer.

Front office Operations

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

23.28 The dealers are primarily responsible to check for counterparty

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

23.29 Quoting of rates to clients should be based on ongoing market and specific policy should be framed for loading of margins based on size of the transactions.

Middle office Operations

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

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

Back office Operations

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

23.32 An important development in the back office has been the advent of straight-through processing (STP), also called 'hands-off' processing. This has been made possible through enhancement of computer system to real time online input in the trading platform, which in turn has meant that the back office can authorise/confirm deals pending for authorisation in the trading platform. In practice this is done automatically by matching incoming data from counterparties and thereby focusing on investigating exceptions. With the introduction of online trading systems, the deal is 'confirmed' as it is done, allowing the back office to concentrate principally on handling exceptions, settlement and monitoring and risk control.

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

Functions of Back Office

Input and completion

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

Counterparty confirmation

23.35 The second core function for the back office is to verify the deal from the counterparty as soon as possible after the transaction has been done. For

bank-to-bank trading, the verification can take the form of a confirmation of a deal done through Reuters conversation or trading systems, or a broker's confirmation if the deal has been done through a broker. Telephone confirmations are also sought for immediate authorisation. Further, the banks have entered into bilateral agreement with counterparty banks who are members of CCIL; whereby exchange of confirmations for Forex Interbank deals (matched on CCIL) have been discontinued.

23.36 Deals done with customers (non-banks) will normally be confirmed by e-mail, with instructions swapped on the telephone, depending on the arrangements. Increasingly, however, corporate customers are using automatic confirmation-matching services. It is essential that the deal is confirmed independently of the trader before any kind of value is given or payment is made.

Settlement

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

Brokerage is paid on settlement basis in case of Forex Transactions.

Reconciliation

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

Others

23.39 Card rates should be decided in the beginning of the day and should be prominently displayed uniformly in all exchange dealing branches.

Net Overnight Open Position Limit (NOOPL)

23.40 NOOPL may be fixed by the boards of the respective banks and communicated to the Reserve Bank immediately. However, such limits should

not exceed 25 per cent of the total capital (Tier I and Tier II capital) of the bank.

23.41 The Net Open position may be calculated as per the method given below:

Calculation of the Net Open Position in a Single Currency

23.42 The open position must first be measured separately for each foreign currency. The open position in a currency is the sum of (a) the net spot position, (b) the net forward position and (c) the net options position.

a) Net Spot Position

The net spot position is the difference between foreign currency assets and the liabilities in the balance sheet. This should include all accrued income/expenses.

b) Net Forward Position

This represents the net of all amounts to be received less all amounts to be paid in the future as a result of foreign exchange transactions, which have been concluded. These transactions, which are recorded as off-balance sheet items in the bank's books, would include:

- i. spot transactions which are not yet settled.
- ii. forward transactions.
- iii. Guarantees and similar commitments denominated in foreign currencies which are certain to be called.
- iv. Net future income/expenses not yet accrued but already fully hedged (at the discretion of the reporting bank).
- v. Net of amounts to be received/paid in respect of currency futures, and the principal on currency futures/swaps.

c) Net Options Position

The net options position is the "delta-equivalent" spot currency position as reflected in the authorized dealer's options risk management system, and includes any delta hedges in place which have not already been included under 1(a) or 1(b) (i) and (ii) above.

23.43 Calculation of the overall net open position involves measurement of risks inherent in a bank's mix of long and short position in different currencies. It has been decided to adopt the "shorthand method" which is accepted internationally for arriving at the overall net open position. Banks may, therefore, calculate the overall net open position as follows:

- i. Calculate the net open position in each currency.

- ii. Calculate the net open position in gold.
- iii. Convert the net position in various currencies and gold into Rupees in terms of existing RBI / FEDAI Guidelines. All derivative transactions including forward exchange contracts should be reported on the basis of Present Value (PV) adjustment.
- iv. Arrive at the sum of all the net short positions.
- v. Arrive at the sum of all the net long positions.

Overall net foreign exchange position is the higher of (iv) or (v). The overall net foreign exchange position arrived at as above must be kept within the limit approved by the bank's Board.

23.44 Authorised Dealer banks should report all derivative transactions including forward exchange contracts on the basis of PV adjustment for the purpose of calculation of the net open position. Authorised Dealer banks may select their own yield curve for the purpose of PV adjustments. Banks however should have an internal policy approved by its ALCO regarding the yield curve/(s) to be used and apply it on a consistent basis.

Audit Approach and Procedures

23.45 Examination of compliance with statutory and regulatory requirements is also an important objective in audit of dealing rooms. The Auditors should keep this in view while designing their audit procedures relating to dealing rooms.

Process Review, Walk through and Control Testing

23.46 Banks normally have documented standard operating procedures (SOPs), hence auditor can peruse SOPs for understanding and documenting significant processes. During the process understanding, Auditors may identify various control points in the process like reconciliation, maker checker, segregation of duties, etc. The Auditors may carry out walk through of few transactions for validating process understanding and existence of identified controls. Identified controls needs to be further segregated to manual controls and IT controls for testing of those controls for sample transactions. This sample needs to be selected randomly from total population of transactions as per the methodology.

23.47 In today's scenario, most of the dealing room functions of banks are performed in an automated environment (for example, trade booking, settlement and accounting). In such a situation, it becomes imperative for the Auditors to test the general information technology controls and system

application controls around the functioning of the systems involved and also the interfaces between various systems.

23.48 Some of the typical audit procedures would include:

- perusing reports on concurrent audit of treasury transactions, system audit report, if any and follow-up action taken by the management thereon.
- perusing the half yearly review of portfolio by the Board of Directors of the bank and also reviewing annual inspection report of the RBI carried out under Section 35 of the Banking Regulation Act, 1949.
- Verification of voice recording mechanism and to ensure user ids of dealers left / transferred/ on leave is deactivated / suspended on timely basis.

Part 1 (f) –Other Area

23.49 Apart from the transactions referred to above in detailed, bank Branches carry out various other transactions as well. The Auditor should review the nature of transactions carried out by branch, the role of bank branch in transaction in terms of FEMA guidelines and should review applicable Master Directions / Circulars, Notifications.

23.50 The Auditors should also review linkages between CBS system and SWIFT system.

23.51 The RBI has suggested banks to centralize / ensure effective control over access and sending messages through SWIFT system by bank branches. In case the SWIFT message system is centralized the Auditor should review system / process of generation of SWIFT Messages. Auditors may, on test check basis get the SWIFT messages generated from the said system and compare the same with CBS information. Any deviation observed should be reported under LFAR.

- (i) Clean collection instruments.
- (ii) Images of clean instruments should be sent to the correspondent banks for collection.
- (iii) As per arrangements the proceeds are immediately credited to the Nostro account. However the same is released to the beneficiary after a reserve period say 21 days during which they can debit our account for a returned instrument.

- (iv) In case of purchase of an instrument proper approval of the branch head or proper authority should be obtained, recover interest for 15 days and credit proceeds to the depositor's account.

23.52 Encashment of TC & CNs: Travellers cheques are encashed after taking signature on the same before an Officer who witnesses the signing of each and every TC. His passport particulars are noted, original PP is verified regarding his identity and the cash is paid at the prevailing prescribed rates. The list of Lost & Stolen TCs are verified before making payment. TCs are sent for collection to the respective correspondent.

23.53 Auditors may also refer to the RBI/2012-13/383 A.P.(DIR series) circular No.76 dated January 17, 2013 wherein various compliance are stated which the bank as an authorised dealer is required to fulfil, any contravention of which may invite penal consequences.

Part – 2: Nostro & VOSTRO Accounts related

23.54 As per the need of LFAR for NOSTRO & VOSTRO Accounts:

Obtain from the branch management, a list of all NOSTRO Accounts maintained/ operated by the Branch

23.55 A nostro account refers to an account that a bank holds in a foreign currency in another bank. As explained earlier in case of receipts in foreign currency by the Bank from other countries, the counter party/ foreign bank will remit funds in nostro account of the Bank. Then based on transaction types and obtention of necessary documents, the bank will transfer amount in nostro account to customer Rupee account post conversion or EEFC accounts.

23.56 The starting phase of this audit should be to obtain a list of all the NOSTRO accounts maintained / operated by the branch. Also, the Branch will have mirror account of each nostro account in its Trial Balance. The list shall contain all the relevant details in this regard including the account number, country, currency, etc. Ideally list of nostro accounts provided by the Branch and details of mirror accounts should match.

- a) Whether the bank has a system of periodic confirmation/ reconciliation of the balances in Nostro accounts maintained with each overseas Bank/ correspondent? Has such confirmation been received and account reconciled at year end in each case. If not, give details.

One of the important elements of the audit of NOSTRO accounts is to check on the transactions entered through these accounts. It is important that these accounts are duly confirmed and reconciled between the two

branches. The Auditor should check the confirmations received by the bank branch from their overseas bank and also the reconciliation of the same. The Auditor should not only verify the same relating to year end but also verify if the branch had process of periodic reconciliation and confirmation of the same. With respect to year end, the Auditor may also consider to obtain independent confirmation from the overseas branch in case of material balances / transactions. The reconciliation also needs to be tallied with the subsequent transactions after year end.

- b) Whether the system of the Bank ensures that all entries originated by overseas banks/correspondents, have been duly responded promptly in the respective NOSTRO accounts maintained by the Bank?

The overseas bank / correspondent intimates to the respective branch for each transaction entered by them relating to them. It is imperative on the part of the branch to respond to the same at the earliest. Timely response results in proper entries and reconciliation of the same on timely basis.

The Auditor should study the process and system of the bank in this regard and also whether the branch is acting as per the system defined. Delays in the same if any should be properly highlighted and the impact of the same at year end needs to be looked upon and wherever required, appropriate entries should be passed or given in MOC.

- c) Are there any dormant/closed Nostro accounts in respect of which balances continue to exist in the books of the Branch, at year end?

The auditor needs to examine the transactions entered in the respective Nostro accounts. There could be some of the accounts where there are no transactions but still the balances are lying outstanding. The reasons for the same needs to be taken and verified and reported accordingly.

- d) Have the Nostro balances been converted at year end at the rates of exchange as prescribed by controlling authorities?

The Nostro accounts are in foreign currency. For the purposes of the accounting as per norms, these would need to be converted into Indian Rupees at each period end. Accordingly, it is imperative that the rate of conversion used for the same is proper. Generally, the rate of conversion is put in the system of the bank and the same rate is used for conversion of all the such balances at the whole bank. The Auditor needs to check that the rates feeded in the system are the ones which are as prescribed by the controlling authorities. It also needs to be verified that the rates prescribed by the controlling authorities are appropriate.

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As per RBI circular RBI/2018-19/34/ DBR.Ret.BC. No.01/ 12.01.001 /2018-19 dated August 02, 2018 on "Maintenance of CRR/SLR on Foreign Currency Assets/Liabilities– Reference rate for INR/USD and exchange rate of other major currencies" for conversion of foreign Currency Assets/ Liabilities reference rate from FBIL should be taken. If reference rate is not available from FBIL, Banks may continue to use New York closing pertaining to the day end of the reporting Friday for conversion of such currency into USD.

- e) In case, any matter deserves special attention of the management, the same may be reported

The Auditor needs to use his professional skepticism to check if there are any unusual transactions or any unusual trend or significant transactions reflected in the NOSTRO accounts. If any such transactions are noted, the same needs to be further verified with respect to documents and purpose and in case if the auditor is not satisfied, the same should be referred in LFAR.

The reconciliation of Nostro accounts (with Nostro Mirror Accounts) needs to be scrutinized carefully to analyze and ascertain if any inwards remittances are received on behalf of the customers / constituents of the bank and have remained unaccounted and / or any other debit (inward) entries have remained unaccounted and are pertaining to any liabilities for the bank. These need to be properly reported.

Borrowings from abroad by banks in India needs to be considered as 'liabilities to other' and thus, needs to be considered at gross level unlike 'liabilities towards banking system in India', which are permitted to be netted off against 'assets towards banking system in India'. Thus, the adverse balances in Nostro Mirror Account needs to be considered as 'Liabilities to other'

- (f) Does the Branch follow the prescribed procedures in relation to maintenance of Vostro Accounts?

The procedure and process reported for NOSTRO needs to be carried out for VOSTRO accounts as well.

Clearing House Operations by Service Branches

Introduction/ Bank's Process

24.01 The Service Branch/ Clearing House primarily acts as an intermediary between branches and banks to ensure processing of negotiable instruments. Considering functions of this branch, the primary objective of the Auditor is to ensure that there are no long old outstanding open entries as well as unreconciled entries.

24.02 The Service Branch ensures that the duly balanced outward clearing batches are received from the various branches within the prescribed time schedule. The outward clearing presentation for the bank as a whole, duly balanced and with the necessary control documents, should be forwarded to the Cheque Processing Centre as per the time schedule stipulated by it.

24.03 Under the Cheque Truncation System implemented by RBI, an electronic image of the cheque is transmitted to the paying branch through the clearing house, along with relevant information like data on the MICR band, date of presentation, presenting bank, etc. This effectively eliminates the associated cost of movement of the physical cheques, reduces the time required for their collection. Under this approach the entire cheque volume in the country which was earlier cleared through 66 MICR Cheque Processing locations is consolidated into the three grids in New Delhi, Chennai and Mumbai. The illustrative jurisdiction of the three grids are indicated below:

- **New Delhi Grid:** National Capital Region of New Delhi, Haryana, Punjab, Uttar Pradesh, Uttarakhand, Bihar, Jharkhand, Rajasthan and the Union Territory of Chandigarh.
- **Mumbai Grid:** Maharashtra, Goa, Gujarat, Madhya Pradesh and Chattisgarh.
- **Chennai Grid:** Andhra Pradesh, Telangana, Karnataka, Kerala, Tamilnadu, Odisha, West Bengal, Assam and the Union Territory of Puducherry.

24.04 Under grid-based Cheque Truncation System clearing, all cheques drawn on bank branches falling within in the grid jurisdiction are treated and cleared as local cheques.

24.05 In CTS, the presenting bank (or its branch) captures the data (on the MICR band) and the images of a cheque using their Capture System (comprising of a scanner, core banking or other application) which is internal to them, and have to meet the specifications and standards prescribed for data and images.

24.06 To ensure security, safety and non-repudiation of data / images, end-to-end Public Key Infrastructure (PKI) has been implemented in CTS. As part of the requirement, the collecting bank (presenting bank) sends the data and captured images duly signed digitally and encrypted to the central processing location (Clearing House) for onward transmission to the paying bank (destination or drawee bank). For the purpose of participation, the presenting and paying banks are provided with an interface / gateway called the Clearing House Interface (CHI) that enables them to connect and transmit data and images in a secure and safe manner to the Clearing House (CH).

24.07 Only CTS 2010 compliant instruments can be presented for clearing through CTS. The separate non-CTS clearing sessions in CTS grid centres has been discontinued with effect from December 31, 2018. As on September 2020, all ECCS centres have been migrated to CTS. Positive Pay system for Cheque Truncation shall be implemented from January 1, 2021.

24.08 Cheques are scanned and retained at the presenting bank and do not move physically move to the paying bank. To meet the legal requirements, the presenting banks have to preserve the physical instruments in their custody securely for a period of 10 years.

Income Recognition and verification by auditors

24.09 The Auditor should get the SOP for income accrual at these branches. Basis of income booking should be understood, normally an amount accrues based on number of instruments processed and charges / fees for processing is booked in service / clearing branch and it is debited to the branch for which instruments are processed / decoded. Income recognized needs to be checked by the Auditor with respective instruments processed.

24.10 The Auditor should also examine the correspondence with RBI Clearing house and ensure that branches directly dealing with RBI clearing house are following applicable rules and regulations. The Auditor should check that RBI account, if any, is reconciled as at year-end. The Auditor should also check that Penalty / charges / late fees if any charged by RBI are accounted for by the branch. RBI levies penalty for omissions and errors. Such penalties should be accounted for only after obtaining approval from competent authority who is vested with discretionary powers for such expenditure.

24.11 The Service branch is required to install devices/machines to detect the frauds. The Auditor should verify whether such machines are being used extensively and whether they are in working condition etc.

24.12 Inward Clearing

- The Auditor is to check whether signature of the drawer of the cheque is being verified by the staff religiously or not as else there will be liability of the paying bank under all circumstances.
- If the encoded amount is more than the cheque amount and the cheque is passed through oversight, it will create contingent liability for the bank. The Auditor is required to verify if any claims for refund of the amount excess debited are received from the customer, such claims to be verified and if necessary provision for that to be made.
- As per RBI guidelines, the branch is required to either call the customer or email him for any cheque received for the amount of Rs. 5 lakh and above. The Auditor may verify the compliance on test check basis.

Outward Clearing

24.13 For outward clearing the following need to be done:

- Branch is required to verify if the cheque paper quality invariably.
- Branch is also required to verify if the signature of the drawer of the cheque is chemically altered.
- If the encoded amount is more than the cheque amount and the cheque is sent for collection and passed through oversight by the paying bank, it will create contingent liability for the bank. The Auditor is to verify if any claims for refund of the amount excess credited are received from the other banks, such claims to be verified and if necessary provision for that to be made.

Fraud Monitoring

24.14 After centralising the clearing transactions work, both inward and outward, at the service branch, perpetration of fraud in this area has increased. The Service branch should initiate steps on ongoing basis to prevent frauds. All the staff at service branch to be involved in awareness programmes and training programmes to minimise frauds. They should be made aware about the frauds taken place in recent past in other banks to ensure against its repetition in the bank.

24.15 The Auditor should check that the cheque collection charges including Speed Clearing Charges are not levied by banks if the collecting bank and the paying bank are located within the jurisdiction of the same CTS grid even though they are located in different cities.

24.16 LFAR Reporting

1. Does the branch have a system of periodic review of the outstanding entries in clearing adjustments accounts? In your view has the system generally been complied with?
 - To obtain note or to review existing SOP followed by the Branch / Bank.
 - To check the process to review outstanding entries. Whether nature of entries examined and reason assessed. Check action taken to reconcile the unreconciled entries.
 - Any MIS/ exceptional report generated from System.
 - System for reporting of long outstanding entries to Head Office.
 - to ensure daily printout of inward and outward clearing scroll are generated by the service branch and corrections if any are done by the authorised official in the system itself.
 - to verify that no high value transactions are routed through personal accounts.
 - to examine the report on failure to lodge clearing cheques.
 - whether any amount lying in suspense for clearing difference for an unusual long period- normally any entry should not remain outstanding for more than 3 working days of lodgement.
 - To examine whether any instrument stolen or fraudulently obtained by a fraudster if red flagged in the system on the basis of communication from the concerned bank.
 - The Auditor should check all relevant documents maintained by the branch and comments on level of compliance by the Branch. In case branch has not followed the defined process/ system like non-reporting of long outstanding entries etc., the Auditor should report same.
2. Whether review of the clearing adjustments accounts (inwards/ outwards) reveals any old/ large/ unusual outstanding entries, which remain unexplained? Give year-wise break-up of outstanding in number and value:
 - To obtain clearing adjustment account and review old entries
 - To obtain ageing of old entries along with nature of such entries.
 - On sample basis, check old entries from the system, to ensure correctness of ageing given by the Branch.

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- On sample basis, check origination of old outstanding entries.
- Check action taken to reconcile the unreconciled entries.

Year-wise break up should be given of outstanding clearing in number and value in the following format:

Inward Clearing	Number Value
Normal Clearing	
High Value	
Inter-Branch Clearings	
National Clearings	
Returned/ Dishonored Clearings	

Outward Clearing	Number Value
Normal Clearing	
High Value	
Inter-Branch Clearings	
National Clearings	
Returned/ Dishonored Clearings	

3. Has the Branch strictly followed the guidelines of the controlling authority of the bank with respect to operations related to clearing transactions? Comment on the systems and procedures followed by the Branch in this regard.
- Considering the unique nature of operations of the clearing branch, the Controlling authority (Head Office) normally issues guidelines with respect to operations of clearing transactions. The Auditor should obtain those guidelines from the Branch / controlling office and ensure that the Branch is complying with it.
 - The auditor should carry out walk-through of some sample transactions & check reporting done by the Branch to Head office to understand the process followed by the Branch.

Recovery of Non-Performing Assets by Asset Recovery Branches

Introduction and Bank's Process

25.01 Banks have designated branches/ department for recovery of Non-Performing Assets(NPA). The accounts which are already marked as NPA are transferred from other branches to this branch for centralized monitoring. The responsibility of this branch is to ensure the best resolution/ recovery from these NPA accounts either by recovery or restructuring or realization from liquidation of security. The details of primary and collateral security available with Bank with respect to these NPA accounts are also maintained at this branch.

Audit approach, procedures including regulatory considerations

25.02 Refer chapter 11 "Reporting for Advances" of Section B of this Guidance Note for guidance on audit of NPA, Provisioning, Restructuring.

25.03 Other critical aspects to be considered by the Auditor in case of Asset Recovery Branches are as follows:

- Asset Recovery Branches deal with only NPA accounts. Most of them are old and with large outstanding amounts. The Auditor should obtain a list of all NPA accounts at the start of the financial year, movement during the year and closing NPA Accounts. To ensure that opening and closing balances are matching with respective trial balance.
- The accounts get classified as NPA either due to record of recovery or non-financial indicators like Inherent weakness in account, Non-Achievement of DCCO, Failure to comply with key restructuring conditions, Erosion in value of security etc. It is important to understand the reason of NPA for each account.
- The Auditor for this purpose also needs to consider the policy of transferring NPA accounts to these branches, especially with reference to system aspect. Also it needs to see policy of transferring back to respective branches when the account got upgraded.
- To analyse the reason for movement during the year. Key reasons for movement will be as follows:

- Accounts transferred from other branches to Asset recovery branches during the year or vice-versa.
- Accounts upgraded during the year – special attention is required for audit of these accounts.
- Recovery effected during the year.
- Movement in provision due to change in classification of NPA or change in value of security.
- To check that interest income on NPA is recognized only on actual receipt, Interest accrued earlier and not received should be reversed.
- To verify adherence to policy related to expenses incurred by the Banks after accounts become NPA.
- Recovery - The following aspects need to be checked:
 - In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner. The appropriate policy to be followed is to recognise income as per AS 9, "Revenue Recognition" when certainty is attached to realisation and accordingly amount reversed/derecognised or not recognised in the past should be accounted. Interest partly/fully realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.
 - In case of long-term loans, the valuation report of the security pledged (the date of valuation and the values) to be seen. A valuation report normally contains three values (Fair value, market value and distress value). The policy adopted by the bank for consideration of value needs to be seen. Banks generally consider Fair value to reduce the burden of provision in absence of specific direction from RBI. The matters need to be judged based on the facts of the cases and short fall, if any, is to be provided as per RBI norms.
 - Valuation reports should not be older than three years.
 - In case of cash credit the values of the security as entered in the CBS should be cross checked with the terms in the sanction letter.
 - Consider any orders issued by any of the authorities like DRT, SARFAESI etc.

- Verify the CGTMSE amount as recorded in the books for facilities availed under MSME schemes since provision and classification are made after deducting the claimed amount. In most of the cases the amounts are recorded as per the claims lodged by the bank with the Authorities. In case of some banks, the branches forward the application to the respective regional offices who in turn upload the details in the Government portal. Any subsequent change in the portal are not incorporated in the individual borrower level, for e.g. any rejection or modification of the claim lodged with the Authorities.
- In order to reflect the actual receivable amounts, proper classification and provision, this exercise should be done periodically for the bank as a whole which will include both NPA and standard accounts.
- To ensure compliance with the requirements of RBI circular on Prudential Framework for Resolution of Stressed Assets dated June 07, 2019 and the requirements of the Insolvency and Bankruptcy Code, 2016, in case where the Borrower has been referred to IBC.

Guidelines on Sale/Purchase of NPAs

25.04 The Master Circular on Advances requires the Board of Directors of banks to lay down policy in respect of the sale/ purchase of NPAs, including:

- (a) non-performing financial assets that may be purchased/ sold;
- (b) norms and procedure for purchase/ sale of such financial assets;
- (c) valuation procedure to be followed to ensure that the economic value of financial assets is reasonably estimated based on the estimated cash flows arising out of repayments and recovery prospects;
- (d) delegation of powers of various functionaries for taking decision on the purchase/ sale of the financial assets etc.; and
- (e) accounting policy.

25.05 The RBI also casts a responsibility on the Board to satisfy itself that the bank has adequate skills to purchase non-performing financial assets and deal with them in an efficient manner which will result in value addition to the bank.

25.06 Banks while selling NPAs should, work out the net present value of the estimated cash flows associated with the realisable value of the available securities net of the cost of realisation. The sale price should generally not be lower than the net present value so arrived.

25.07 The estimated cash flows are normally expected to be realised within a period of three years and at least 10 per cent of the estimated cash flows should

be realised in the first year and at least 5 per cent in each half year thereafter, subject to full recovery within three years.

25.08 A bank may purchase/sell non-performing financial assets from/to other banks only on 'without recourse' basis, i.e., the entire credit risk associated with the non-performing financial assets should be transferred to the purchasing bank. The selling bank shall ensure that the effect of the sale of the financial assets should be such that the asset is taken off the books of the bank and after the sale there should not be any known liability devolving on the selling bank.

25.09 Banks should ensure that subsequent to sale of the non-performing financial assets to other banks, they do not have any involvement with reference to assets sold and do not assume operational, legal or any other type of risks relating to the financial assets sold. Consequently, the specific financial asset should not enjoy the support of credit enhancements / liquidity facilities in any form or manner.

25.10 Under no circumstances can a sale to other banks be made at a contingent price whereby in the event of shortfall in the realisation by the purchasing banks, the selling banks would have to bear a part of the shortfall. Further, NPAs can be sold to other banks only on cash basis. The entire sale consideration should be received upfront and the asset can be taken out of the books of the selling bank only on receipt of the entire sale consideration.

25.11 A non-performing financial asset should be held by the purchasing bank in its books at least for a period of 12 months before it is sold to other banks. Banks should not sell such assets back to the bank, which had sold the NPA.

25.12 Banks are also permitted to sell/buy homogeneous pool within retail non-performing financial assets, on a portfolio basis provided each of the non-performing financial assets of the pool has remained as non-performing financial asset for at least 2 years in the books of the selling bank. The pool of assets would be treated as a single asset in the books of the purchasing bank.

25.13 The selling bank should pursue the staff accountability aspects as per the existing instructions in respect of the non-performing assets sold to other banks.

25.14 Prudential norms for banks for the purchase/sale transactions issued by RBI, from time to time, should be adhered to.

25.15 As per the Master Circular no. RBI/2015-16/101 DBR.No.BP.BC.2/21.04. 048/2015-16 dated July 01, 2015 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances", if the sale is in respect of Standard Asset and the sale consideration is higher than

the book value, the excess provisions may be credited to Profit and Loss Account. Excess provisions which arise on sale of NPAs can be admitted as Tier II capital subject to the overall ceiling of 1.25 per cent of total Risk Weighted Assets. Accordingly, these excess provisions that arise on sale of NPAs would be eligible for Tier II status.

Asset Classification Norms for sale/purchase of NPA

25.16 The asset classification norms for sale/purchase of NPAs are as follows:

- (i) Non-performing financial assets purchased, may be classified as 'standard' in the books of the purchasing bank for a period of 90 days from the date of purchase. Thereafter, the asset classification status of the financial asset purchased, shall be determined by the record of recovery in the books of the purchasing bank with reference to cash flows estimated while purchasing the asset which should be in compliance with requirements as discussed in previous paragraphs.
- (ii) The asset classification status of an existing exposure (other than purchased financial asset) to the same obligor in the books of the purchasing bank will continue to be governed by the record of recovery of that exposure and hence may be different.
- (iii) Where the purchase/sale does not satisfy any of the prudential requirements prescribed in these guidelines the asset classification status of the financial asset in the books of the purchasing bank at the time of purchase shall be the same as in the books of the selling bank. Thereafter, the asset classification status will continue to be determined with reference to the date of NPA in the selling bank.
- (iv) Any restructure/reschedule/rephrase of the repayment schedule or the estimated cash flow of the non-performing financial asset by the purchasing bank shall render the account as a non-performing asset.

Provisioning Norms

Books of Selling Bank

25.17 The provisioning norms for books of the selling bank are as under:

- (i) When a bank sells its non-performing financial assets to other banks, the same will be removed from its books on transfer.
- (ii) If the sale is at a price below the net book value (NBV) (i.e., book value less provisions held), the shortfall should be debited to the profit and loss account of that year.

- (iii) If the sale is for a value higher than the NBV, the excess provision shall not be reversed but will be utilised to meet the shortfall/ loss on account of sale of other non-performing financial assets.

Books of Purchasing Bank

25.18 The provisioning norms for books of purchasing bank are as under:

The asset shall attract provisioning requirement appropriate to its asset classification status in the books of the purchasing bank.

Accounting of Recoveries

25.19 Any recovery in respect of a non-performing asset purchased from other banks should first be adjusted against its acquisition cost. Recoveries in excess of the acquisition cost can be recognised as profit.

Capital Adequacy

25.20 For the purpose of capital adequacy, banks should assign 100 per cent risk weights to the non-performing financial assets purchased from other banks. In case the non-performing asset purchased is an investment, then it would attract capital charge for market risks also.

Exposure Norms

25.21 The purchasing bank will reckon exposure on the obligor of the specific financial asset. Hence these banks should ensure compliance with the prudential credit exposure ceilings (both single and group) after reckoning the exposures to the obligors arising on account of the purchase.

Disclosure Requirements

25.22 Banks which purchase non-performing financial assets from other banks shall be required to make the following disclosures in the Notes on Accounts to their Balance sheets:

- A. Details of non-performing financial assets purchased: (Amounts in Rupees crore)
 - 1. (a) No. of accounts purchased during the year.
(b) Aggregate outstanding.
 - 2. (a) Of these, number of accounts restructured during the year.
(b) Aggregate outstanding.
- B. Details of non-performing financial assets sold: (Amounts in Rupees crore)
 - 1. No. of accounts sold.

2. Aggregate outstanding.
 3. Aggregate consideration received.
 4. Additional consideration realized in respect of accounts transferred in earlier years.
 5. Aggregate gain / loss over net book value.
- C. Details of Book Value of investments in Security receipts: (Amounts in Rupees crore)
1. Book Value of investments in Security receipts - Backed by NPA's sold by bank as underlying.
 2. Book Value of investments in Security receipts – Backed by NPA's sold by other banks / financial institutions/ non – banking financial companies as underlying.
 3. Totals of the above.

25.23 The purchasing bank shall furnish all relevant reports to RBI, Credit Information Company which has obtained Certificate of Registration from RBI and of which the bank is a member etc. in respect of the non-performing financial assets purchased by it.

Sale/ Purchase of NPAs

25.24 In case of a sale/ purchase of NPAs by the bank, the Auditor should examine the policy laid down by the Board of Directors in this regard relating to procedures, valuation and delegation of powers.

25.25 The Auditor should also examine to find that:

- (i) only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years;
- (ii) the assets have been sold/ purchased "without recourse" only;
- (iii) subsequent to the sale of the NPA, the bank does not assume any legal, operational or any other type of risk relating to the sold NPAs;
- (iv) the NPA has been sold at cash basis only;
- (v) the bank has not purchased an NPA which it had originally sold.

25.26 In case of sale of an NPA, the auditor should also examine that:

- (i) on the sale of the NPA, the same has been removed from the books of the account.
- (ii) the short fall in the net book value (NBV) has been charged to the profit and loss account.

- (iii) where the sale is for a value higher than the NBV, no profit is recognised and the excess provision has not been reversed but retained to meet the shortfall/ loss on account of sale of other non-performing financial assets.

25.27 Similarly, in case of purchase of NPAs, the Auditor should verify that:

- (i) the NPA purchased has been subjected to the provisioning requirements appropriate to the classification status in the books of the selling bank.
- (ii) any recovery in respect of an NPA purchased from other banks is first adjusted against its acquisition cost and only the recovered amount in excess of the acquisition cost has been recognised as profit.
- (iii) for the purpose of capital adequacy, bank has assigned 100 per cent risk weights to the NPAs purchased from other banks.

25.28 LFAR Reporting

1. In respect of borrowers with outstanding of Rs. 10.00 Crores and above and other sample accounts selected by Auditor, the information should be obtained from the Branch Management. Comments of the Branch Auditor on advances with significant adverse features and which might need the attention of the management / Statutory Central Auditors should be appended to the Long Form Audit Report.
 - To obtain list and information of borrowers having outstanding of Rs.10.00 Crores and above.
 - To review movement during the year in those accounts.
 - The branch auditors should review each account and give comments on adverse features, if any in accounts.
 - The comments of branch auditors will be either account specific or observations on system which may have impact on bank as whole. Auditor should highlight nature of each comment for proper action to be taken by the management / Statutory Central Auditors.
 - The reporting in LFAR is not substitute for qualification or modification in audit report. Hence if the observation of Auditors warrants qualification in audit report, the auditor should make reporting of same in main report.
 - If the observation of the Auditor is having impact on financial numbers like short provisioning, error in valuation of securities etc., the Auditor should get the same rectified by suggesting appropriate MOC for the same.

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2. List the accounts with outstandings in excess of Rs. 10.00 Crores, which have been upgraded from Non-Performing to Standard during the year and the reasons thereof.

Sr. No.	Name of the Unit / Account	Outstanding [Rs. In Crore]	IRAC Status as on 31st March [Last Year]	IRAC Status as on 31st March [Current Year]	Reasons
1					
2					
3					
4					
5					

- To obtain a list of all upgrade accounts during the year. In some cases, once the accounts are upgraded same are being transferred to other branches hence may not appear in closing balances of this branch.
 - To analyse the reason of upgrade and link the same with reason for classifying an account as NPA.
 - To check entries for recovery in core banking system to ensure there is full recovery of all dues before upgrade of account.
3. Whether the Branch has a system of updating periodically, the information relating to the valuation of security charged to the Bank?
- To obtain details of security charged to the bank against all NPA accounts.
 - To understand and review process of updating value of security in the system.
 - The branch auditor should enquire as to the existence of the system, if any, pertaining to the valuation of security charged to the bank. If the system is in existence, the Auditor should examine whether the system periodically updates the information pertaining to the value of such security and takes necessary steps for increase/diminution in the value of such security.
 - If branch has not timely updated value of security in the books then

Auditor shall update it by issuing of MOC.

- The Branch Auditor shall check that the minimum realisable value of securities from two or more different valuation report of securities for advance above Rs 10.00___ Crore to be updated in the books and that valuation report shall not be older than three years.
- The Branch Auditor should check and ensure that the value of other securities like stock, Book Debt, Etc. Are realisable in nature and it is not older than the specified time limit.

4. Age-wise analysis of the recovery suits filed and pending may be furnished, for the last 3 years along with latest status thereof.

Year	No. of Accounts	Amount [Rs. In Crore]
------	-----------------	-----------------------

Up to March 2018

2018-19

2019-20

2020-21

- To obtain the list of all recovery suits filed and pending as at reporting date.
 - To give details of age-wise details of recovery suits.
5. Is the Branch prompt in ensuring execution of decrees obtained for recovery from the defaulting borrowers? Also list the time barred decrees, if any, and reasons thereof. Give age-wise analysis of decrees obtained and not executed.
- In case decrees have been obtained for recovery from the defaulting borrowers, the Auditor should check whether the branch is prompt in execution of decrees like, drawings from the account and payment from these accounts have been stopped. If not, the same should be reported. The list should be given in the case of time barred decrees with the reasons therefor.
6. List the recoveries and their appropriation against the interest and the principal and the accounts settled / written off / closed during the year as per the bank's policy. Give particulars of recoveries which are pending for appropriation as on year-end with reasons thereof.
- A list will have to be annexed which will specify the non-performing advances recovered and the amounts adjusted towards interest and principal. A list of the accounts settled, written off or closed, if any, will

also have to be attached. The Auditor should satisfy himself whether the recoveries appropriated against interest are in accordance with the RBI guidelines and normal accounting principles.

7. List the new borrower accounts transferred to the Branch during the year. Have all the relevant documents and records relating to these borrower accounts been transferred to the Branch? Has the Branch obtained confirmation that all the accounts of the borrower [including non-fund-based exposures and deposits pending adjustment / margin deposits] been transferred to the Branch?
 - A list of new borrower accounts transferred to the branch from the other branches during the year should be annexed. The Auditor should verify whether the documents and records relating to the transferred accounts have been obtained like, letter from the transferor branch, detail of the accounts, etc. The branch should also obtain a confirmation that all the accounts of the borrower (including non-fund based exposures and deposits pending adjustment/ margin deposits) have been transferred to the branch. In case any adverse features have been observed in such transfer, the same should be reported.

Bank Branch Audit and GST Compliance

Background

26.01 GST, a paradigm shift from origin based to destination-based tax in indirect tax regime was implemented in India from 1st July 2017.

Article 366(12A) of the Constitution of India provides that, **Goods and Services Tax** means any tax on supply of goods, or services or both except taxes on the supply of the alcoholic liquor for human consumption.

India adopted Dual GST model in view of the federal structure of the country. Here, Centre and States simultaneously levy GST on taxable supply of goods or services or both which, takes place within a State or Union Territory. The Centre also has the power to tax intra-State sales and States are also empowered to tax services.

Extent of GST

26.02 GST in India comprises of the following:

- (A) **Central Goods and Services Tax Act, 2017** ("the CGST Act") which extends to the whole of India.

In terms of Section 2(56) of CGST Act:

"India" means the territory of India as referred to in Article 1 of the Constitution, its territorial waters, seabed and sub-soil underlying such waters, continental shelf, exclusive economic zone or any other maritime zone as referred to in the Territorial Waters, Continental Shelf, Exclusive Economic Zone and other Maritime Zones Act, 1976, and the air space above its territory and territorial waters.

Central Goods and Service Tax (CGST) is levied on all intra-State supplies of taxable goods and/or services and collected by the Central Government.

- (B) **State Goods and Services Tax Act, 2017** ("the SGST Act") is levied and collected by the State Government/ Union Territory with State Legislatures. The SGST Act of the respective State/Union Territory with State Legislature [Delhi and Pondicherry]** extends to the whole of that respective State/Union Territory.

***State: includes a Union territory with Legislature [Section 2(103) of CGST Act].*

- (C) **Union Territory Goods and Services Tax Act, 2017 ("the UTGST Act")** extends to the Union territories of the Andaman and Nicobar Islands, Lakshadweep, Dadra and Nagar Haveli, Daman and Diu, Chandigarh and other territory, i.e. the Union Territories without State Legislature [Section 1 of the UTGST Act]. UGST is levied and collected by Central Government through appointed administrator.
- (D) **Integrated Goods and Services Tax Act, 2017 ("the IGST Act")** extends to the whole of India. IGST is levied on all inter-State supplies of goods or services or both (except alcoholic liquor for human consumption) at a rate recommended by the GST Council (not exceeding 40 per cent). It is collected by Central Government.

Apart from the above Acts there is one more Act under GST namely "The Goods and Services (Compensation to States) Act 2017". This Act was introduced to provide for compensation to the States for the loss of VAT revenue, if any arising on account of implementation of GST. This tax is levied on a few supplies at present. It is provided that such levy will be collected for five years but this period can be extended on recommendation of the GST Council.

NOTE: It is pertinent to mention here that, GST extends to whole of India including the State of Jammu and Kashmir. Though, GST was implemented in the State of Jammu and Kashmir from 8th July, 2017 *vide* the Central Goods and Services Tax (Extension to Jammu and Kashmir) Ordinance, 2017 and the Integrated Goods and Services Tax (Extension to Jammu and Kashmir) Ordinance, 2017 extending the domain of Central GST Act and the Integrated GST Act to the State of Jammu and Kashmir.

26.03 Now with the advent of Jammu and Kashmir Reorganisation Act, 2019, from 31st October, 2019, State of Jammu and Kashmir has been re-constituted into two union territories:

- Jammu and Kashmir (Union territory of Jammu and Kashmir with Legislature); and
- Ladakh (Union territory of Ladakh without Legislature) *vide* Jammu and Kashmir Reorganisation Act 2019.

26.04 In this regard, Ministry of Home Affairs (Department of Jammu and Kashmir Affairs) issued Jammu and Kashmir Reorganisation (Removal of Difficulties) Order, 2019 which *inter alia* stipulates that-

- The Jammu and Kashmir Goods and Services Tax Act, 2017 shall be

applicable to the Union Territory of J&K; and

- The Union Territory Goods and Services Tax Act, 2017 shall be applicable to the Union Territory of Ladakh.

26.05 In this regard, CBIC vide Notification no. 62/2019 dated 26-11-2019 as amended by Notification no. 03/2020-Central Tax dated 01st January 2020 has notified transition plan with respect to J&K reorganization w.e.f. 31.10.2019 to be followed till 31.12.2019. Persons whose principal place of business was in J&K till 30-10-2019 and continues to be so in either of the Union Territories (UTs) from 31-10-2019:

- The October 2019 tax period will be from 1st to 30th October 2019 and for November 2019 tax period it will from 31st October till 30th November 2019.
- The tax to be declared and paid through GSTR-3B shall be irrespective of the tax amounts shown in the invoices raised between 31 -10- 2019 to 31-12-2019. This implies that any adjustments can be allowed in GSTR-3B.
- Such taxpayers are allowed to transfer the input tax credit available under GSTIN registered under the erstwhile State of J&K to the new GSTIN now logged in either of two UTs, subject to following conditions:
 - The taxpayers must inform of the transfer to the jurisdictional officers of both the erstwhile State of J&K as well as newly formed UTs as may be applicable.
 - proportion of transfer must be based on the ratio of the turnover earned in each of the UTs.
 - the transfer must be indicated by filing in the GSTR-3B of any tax period transition date, debiting ITC in the transferor's electronic credit ledger [Table 4 (B) (2)] and crediting the transferee's electronic credit ledger [Table 4 (B) (5)].
- The State taxes will be converted to Union territory taxes from 01st day of January 2020. All such taxpayers are relieved from compulsory registration if they make interstate supplies till 31-12-2019 i.e. transitional period.

26.06 However, there is ambiguity with regard to fresh registration for the taxpayers who were registered in the state of Jammu & Kashmir before the reorganization Act and having additional place of registration in the State of Ladakh UT (Formed after reorganization). In respect of such taxpayers, no clarity has been provided by the Government as the till date neither such taxpayers have been automatically provided the fresh GSTN or nor any mechanism has been provided for obtaining the fresh registration to the taxpayer who have

premises in the UT of Ladakh. For the existing taxpayers registered under J & K State earlier with State code(01), having Principal Place of Business in jurisdiction of Union territory of Ladakh then such taxpayer has been allotted the New GSTN no with (with UT code "38"). In respect of such taxpayers, instructions have been issued that they are requested to use new GSTINs while generating the invoices and receiving of supplies etc. w.e.f. 1st Jan 2020.

Levy

26.07 In terms of charging section 9(1) of the CGST Act/ Section 5(1) of the IGST Act, the Central goods and services tax (CGST)/ Integrated goods and services tax (IGST) shall be levied on all intra-State/ inter State supplies of goods or services or both, except on the supply of alcoholic liquor for human consumption, on the value determined under section 15 and at such rates, not exceeding 20 per cent, as may be notified by the Government on the recommendations of the Council and collected in such manner as may be prescribed and shall be paid by the taxable person.

Supply

As inferred from the above, the taxable event under GST is a "**Supply**".

26.08 The term Supply as per Section 7(1) of the CGST Act includes:

- (a) all forms of supply of goods or services or both such as sale, transfer, barter, exchange, licence, rental, lease or disposal made or agreed to be made for a consideration by a person in the course or furtherance of business;
- (b) import of services for a consideration whether or not in the course or furtherance of business; and
- (c) the activities specified in Schedule I, made or agreed to be made without a consideration.

26.09 Further, Section 7(1A) of the CGST Act stipulates that, certain activities or transactions which constitute supply as per Section 7(1) are to be treated as supply of goods or supply of services as referred to in Schedule II.

26.10 Section 7 (2) of the CGST Act, states that notwithstanding anything contained in section 7(1):

- (a) activities or transactions specified in Schedule III; or
- (b) such activities or transactions undertaken by the Central Government, a State Government or any local authority in which they are engaged as public authorities, as may be notified by the Government on the recommendations of the Council;

shall be treated neither as a supply of goods nor a supply of services.

26.11 Section 7(3) provides that the Government may, on the recommendations of the Council, specify, by notification, the transactions that are to be treated as:

- (a) a supply of goods and not as a supply of services; or
- (b) a supply of services and not as a supply of goods.

26.12 Hence, the following parameters, can be adopted to characterize a transaction as supply:

1. There should be a supply. Supply of either goods or service or both other than supply of goods or services excluded under GST.
2. Supply should be made for a consideration.
3. Supply should be made in the course or furtherance of business.
4. Supply should be made by a taxable person.
5. Supply should be a taxable supply.

26.13 While aforesaid parameters describe the concept of supply, there are a few exceptions to the requirement of supply being made for a consideration and in the course or furtherance of business. However, there are the following exceptions:

- (i) As laid down in section 7(1) (c) activities specified in Schedule I, made or agreed to be made without a consideration are deemed to be a supply even without consideration.
- (ii) Further as per section 7(1) (b) import of services for a consideration, whether or not in the course or furtherance of business is treated as supply.

26.14 Supply may be **composite supply** or **mixed supply**. Composite supply means a supply made by a taxable person to a recipient consisting of two or more taxable supplies of goods or services or both, or any combination thereof, which are naturally bundled and supplied in conjunction with each other in the ordinary course of business, one of which is a principal supply. "Mixed supply" means two or more individual supplies of goods or services, or any combination thereof, made in conjunction with each other by a taxable person for a single price where such supply does not constitute a composite supply. The tax liability on a composite or a mixed supply shall be determined in the following manner, namely:

- a) a composite supply comprising two or more supplies, one of which is a principal supply, shall be treated as a supply of such principal supply; and

- b) a mixed supply comprising two or more supplies shall be treated as a supply of that particular supply which attracts the highest rate of tax.

Other Important Definitions

26.15 At this juncture, after understanding the term supply, it is of paramount importance to know what goods or services under GST are:

Section 2(52) of the CGST Act defines goods as under:

***“goods** means every kind of movable property other than money and securities but includes actionable claim, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before supply or under a contract of supply”.*

Section 2(102) of the CGST Act defines Services as under:

***“services** means anything other than goods, money and securities but includes activities relating to the use of money or its conversion by cash or by any other mode, from one form, currency or denomination, to another form, currency or denomination for which a separate consideration is charged”.*

26.16 Now since money and securities both are excluded from definition of goods and services, it is imperative to understand these terms under GST:

As per Section 2(75) of the CGST Act:

***“money** means the Indian legal tender or any foreign currency, cheque, promissory note, bill of exchange, letter of credit, draft, pay order, traveller cheque, money order, postal or electronic remittance or any other instrument recognised by the Reserve Bank of India when used as a consideration to settle an obligation or exchange with Indian legal tender of another denomination but shall not include any currency that is held for its numismatic value”.*

Section 2(101) of the CGST Act defines ‘securities’ thus:

***“securities** shall have the same meaning as assigned to it in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956”.*

Section 2 of the Securities Contracts (Regulation) Act, 1956 defines “securities” to include—

- (i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;
- (ia) derivative;

- (ib) units or any other instrument issued by any collective investment scheme to the investors in such schemes;
- (ic) security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;
- (id) units or any other such instrument issued to the investors under any mutual fund scheme;

Explanation.—For the removal of doubts, it is hereby declared that "securities" shall not include any unit linked insurance policy or scrips or any such instrument or unit, by whatever name called, which provides a combined benefit risk on the life of the persons and investment by such persons and issued by an insurer referred to in clause (9) of section 2 of the Insurance Act, 1938 (4 of 1938)

- (ie) any certificate or instrument (by whatever name called), issued to an investor by any issuer being a special purpose distinct entity which possesses any debt or receivable, including mortgage debt, assigned to such entity, and acknowledging beneficial interest of such investor in such debt or receivable, including mortgage debt, as the case may be;
- (ii) Government securities;
- (iia) such other instruments as may be declared by the Central Government to be securities; and
- (iii) rights or interest in securities.

26.17 Further, from definition of securities, GST applicability on certain transactions can be analyzed:

Sr. No.	Nature	Applicability of GST
1	Shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;	Specifically covered in definition of Security, hence no GST.
2	units or any other instrument issued by any collective investment scheme to the investors in such schemes;	Specifically covered in definition of Security, hence no GST.

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3	Security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;	Specifically covered in definition of Security, hence no GST.
4	Units or any other such instrument issued to the investors under any mutual fund scheme;	Specifically covered in the definition of security and hence no GST.
5	Government securities;	Specifically covered in definition of Security, hence no GST.
6	Forward Contract in Currencies - Actual delivery of underlying currency;	It is not covered in the definition of securities and hence would be treated as normal supply of goods and liable to GST (Commission portion).
7	Forward Contract in Currencies - Where the settlement takes place by way of net settlement of differential of the forward rate over the prevailing market rate on the settlement date;	These are derivative transactions and covered in the definition of securities, hence no GST
8	Future Contract	It is a financial derivative and falls within the definition of securities and hence not liable to GST. Commission and documentation charges will be liable for GST.

26.18 Therefore, no GST will be levied on activities and transactions covered in the definition of "money and securities".

Applicability to Banking Sector

26.19 As evident from the above, GST is applicable on Banking services as far as it qualifies the taxable event i.e. Supply of Services. However, following supplies made without consideration as specified in Schedule I of the CGST Act, 2017 are subject to GST:

- Permanent transfer or disposal of business assets where input tax credit has been availed on such assets.
- Inter Unit Supply: Supply of goods/ services or both between related

persons or between distinct persons as specified in section 25, when made in the course or furtherance of business.

- As per Section 22(1) of CGST Act, every supplier shall be liable to be registered under this Act **in the State or Union territory**, other than special category States, **from where** he makes a taxable supply of goods or services or both, if his aggregate turnover in a financial year exceeds twenty lakh rupees Registration under GST has to be taken.
- *Further as per section 25(2) A person seeking registration under this Act shall be granted a single registration in a State or Union territory.*

Provided that a person having multiple places of business in a State or Union territory may be granted a separate registration for each such place of business, subject to such conditions as may be prescribed.

Hence have to take separate registrations for branches in each state or voluntarily Banks can take separate registrations for each branch/office. Such separate registrations shall be distinct persons under the Act.

Therefore, any supply of goods or services or both between branches/offices/head Office of the Banks having separate registrations, without consideration, shall be considered as supply under GST for payment of tax.

- Any activity amounting to supply provided by the employer to the employee without consideration will be taxable under GST, except where the value such supply does not exceed Rs. 50,000 in a financial year.

Although no consideration is involved here, payment of tax needs to done on the value determined in terms of section 15 of the CGST Act read with Rule 28 of the CGST Rules.

Such transactions are generally not captured in the books of accounts, and therefore the Auditor should apply substantive audit procedure to check compliances.

Exemptions relating to Banking Sector

26.20 GST is applicable on all services provided by the banks except the followings:

- Services by the Reserve Bank of India;

It needs to be noted that services provided by Bank to RBI are exigible to GST Services provided by the banks to Reserve Bank of India/ United Nations, etc. are taxable as these are not specifically exempt or

excluded from GST.

- Services by way of—
 - (i) extending deposits, loans or advances in so far as the consideration is represented by way of interest or discount (other than interest involved in credit card services);
 - (ii) *inter se* sale or purchase of foreign currency amongst banks or authorised dealers of foreign exchange or amongst banks and such dealers.

Where-

(zk) "interest" means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) but does not include any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized;

- Services provided by a banking company to Basic Saving Bank Deposit (BSBD) account holders under Pradhan Mantri Jan Dhan Yojana (PMJDY). *[inserted w.e.f. 01-01-2019 vide Notification No. 28/2018-Central Tax (Rate), dated 31-12-2018 in CGST and vide Notification No. 29/2018-Integrated Tax (Rate), dated 31-12-2018 in IGST.]*
- Services by an acquiring bank, to any person in relation to settlement of an amounts up to Rs. 2,000 in a single transaction transacted through credit card, debit card, charge card or other payment card service.

Explanation. — For the purposes of this entry, "*acquiring bank*" means any banking company, financial institution including non-banking financial company or any other person, who makes the payment to any person who accepts such card.

- Services supplied by Central Government, State Government, Union territory to their undertakings or Public Sector Undertakings (PSUs) by way of guaranteeing the loans taken by such undertakings or PSUs from the banking companies and financial institutions. *[Initially this exemption was inserted w.e.f. 27-07-2018 vide Notification No. 14/2018-Central Tax (Rate), dated 26-07-2018 in CGST and vide Notification No. 15/2018-Integrated Tax (Rate), dated 26-07-2018 in IGST. Later, the words "banking companies and" were inserted w.e.f. 01-01-2019 vide Notification No. 28/2018-Central Tax (Rate), dated 31-12-2018 in CGST and vide Notification No. 29/2018-Integrated Tax (Rate), dt.31-12-2018.]*

- Services by way of collection of contribution under the Atal Pension Yojana.
- Services by way of collection of contribution under any pension scheme of the State Governments.
- Services by the following persons in respective capacities:
 - (a) business facilitator or a business correspondent to a banking company with respect to accounts in its rural area branch;
 - (b) any person as an intermediary to a business facilitator or a business correspondent with respect to services mentioned in entry (a); or
 - (c) business facilitator or a business correspondent to an insurance company in a rural area.
- Services by an intermediary of financial services located in a multi services SEZ with International Financial Services Centre (IFSC) status to a customer located outside India for international financial services in currencies other than Indian rupees (INR).

Where-

The intermediary of financial services in IFSC is a person,-

- (i) who is permitted or recognised as such by the Government of India or any Regulator appointed for regulation of IFSC; or
- (ii) who is treated as a person resident outside India under the Foreign Exchange Management (International Financial Services Centre) Regulations, 2015; or
- (iii) who is registered under the Insurance Regulatory and Development Authority of India (International Financial Service Centre) Guidelines, 2015 as IFSC Insurance Office; or
- (iv) who is permitted as such by Securities and Exchange Board of India (SEBI) under the Securities and Exchange Board of India (International Financial Services Centres) Guidelines, 2015.

[inserted w.e.f. 25-01-2018 vide Notification No. 2/2018-Central Tax (Rate), dated 25-01-2018 in CGST and vide Notification No. 2/2018-Integrated Tax (Rate), dated 25-01-2018 in IGST]

- Services provided to the Central Government, State Government, Union territory under any insurance scheme for which total premium is paid by the Central Government, State Government and Union territory.

Intra/ inter-state supply of the above services has been specifically exempted vide Notification No. 12/2017- Central Tax (Rate) dated 28th June, 2017["Notification No. 12/2017"] and Notification No. 09/2017-Integrated Tax (Rate) dated 28-6-2017 ["Notification No. 9/2017-ITR"] as amended from time to time.

26.21 Additional exemptions under the IGST are:

- services received by RBI from outside India in relation to management of foreign reserves. [*Notification No. 9/2017-ITR*]
- services imported by a unit or a developer in the Special Economic Zone for authorised operations. [*Notification No. 18/2017-Integrated Tax (Rate) dated 5-7-2017*]

26.22 Services provided by Asian Development Bank (ADB) and International Finance Corporation (IFC) are exempt from GST as clarified by CBIC vide Circular No. 83/02/2019-GST, dated 1-1-2019 read with C.B.I. & C. Circular No. 211/1/2019-S.T., dated 15-1-2019.

26.23 The ADB Act, 1966 provides that notwithstanding anything to the contrary contained in any other law, the Bank, its assets, properties, income and its operations and transactions shall be exempt from all the taxation and from all customs duties. The Bank shall also be exempt from any obligation for payment, withholding or collection of any tax or duty [Section 5 (1) of the ADB Act, 1966 read with Article 56 (1) of the schedule thereto refers]. *Vide letter No. 1/28/2002-ADB dated 22-01-2004* to ADB, it is conveyed that services provided by ADB are exempted from service tax.

26.24 Similarly, IFC Act, 1958 also provides that notwithstanding anything to the contrary contained in any other law, the Corporation, its assets, properties, income and its operations and transactions authorised by the Agreement, shall be immune from all taxation and from all customs duties. The Corporation shall also be immune from liability for the collection or payment of any tax or duty [Section 3 (1) of IFC Act, 1958 read with Article VI, Section 9 (a) of the Schedule thereto refers].

26.25 CESTAT Mumbai *vide* final order dated 17-10-2016 in the case of *M/s Coastal Gujarat Power Ltd.* has held that when the enactments that honour international agreements specifically immunize the operations of the service provider from taxability, a law contrary to that in the form of Section 66A of Finance Act, 1994 will not prevail. With the provider being not only immune from taxation but also absolved of any obligation to collect and deposit any tax, there is no scope for subjecting the recipient to tax. There is no need for

a separate exemption and existing laws enacted by the sovereign legislature of the Union suffice for the purpose of giving effect to agreements.

26.26 Accordingly, it is clarified that the services provided by IFC and ADB are exempt from GST in terms of provisions of IFC Act, 1958 and ADB Act. The exemption will be available only to the services provided by ADB and IFC and not to any entity appointed by or working on behalf of ADB or IFC.

Taxability of the Income Earned by Banks

26.27 Albeit interest income forms the major part of the income of bank but due to globalisation banking sector has involved themselves into numerous activities resulting into variety of incomes. Let us analyze the applicability of GST on various income so earned by banks:

- 1) **Interest income** - The income earned by way of grant of loans, deposits etc., is a taxable supply. However, by virtue of entry 27(a) of Notification No. 12/2017 and entry 28(a) of Notification No. 12/2017-ITR, no GST is payable on income earned by way of interest **except interest income earned through credit card**. The relevant extract of the said entry is as under:

SI No.	Chapter, Section, Heading, Group or Service Code (Tariff)	Description of services	Rate (%)	Condition
27	Heading 9971	(a) Services by way of— (a) extending deposits, loans or advances in so far as the consideration is represented by way of interest or discount <u>(other than interest involved in credit card services)</u> ;	NIL	NIL

Para 2 clause (zk) of Notification No. 12/2017 clarifies that interest does not include any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilised.

Therefore, audit from the perspective of GST may be restricted to the

fundamental question as to whether the income is rightly characterized as 'interest' to enjoy the exemption under GST and especially the income earned from credit card services as it is taxable under GST.

- 2) **Commission income** – Such income is classified as a supply of service transaction and accordingly would be classified in terms of chapter heading as specified in the relevant notifications issued under GST.

Commission earned (on accrual) is liable to GST. For e.g.: A Ltd. wants to invest in fixed securities / bonds which can be only routed through ICICI bank as they have exclusive rights for subscribing the same. ICICI bank gets 2 per cent commission on the amounts so subscribed. For the period 2020-21, the bank earns Rs. 250 crores of commission from such subscription which is recorded as 'Other Income'. The Auditor has to check

- Whether GST is appropriately disbursed on the said amount.
- Whether payments are made by complying with the due date for payment of GST.
If the tax is not discharge, then appropriate disclosure would be required.
- Verify that the returns filed reveal the correct amount of liability. Discrepancy in the returns filed (after any revision) and liability as determined may be disclosed.
- Interest being mandatory may be suitably included in the disclosure.
- Suitable disclosure as to whether any contingency exists in respect of applicable penalty may also be provided.

Further, review of agreements where commission is earned must be carried out thoroughly and if any milestone incentives, performance bonus, time bonus etc., is provided then appropriate tax treatment should be suggested.

- 3) **Brokerage income**-This income is classified as a supply of service transaction and accordingly would be classified in terms of chapter heading as specified in the relevant notifications issued under GST.
- 4) **Agency charges** -Generally, such income is earned on account of being appointed as an agency either by RBI, State Governments, Central Governments or by some corporates. Under such arrangements, banks act as a facilitator/collection centre and in lieu of provision of such services such banks collect certain fees as "Agency charges". Such charges are liable for payment of GST. Very often, the underlying arrangement will be of agency, but it may be described in a

contemporary terminology like 'enablement charge' or 'facilitation fee' or simple 'management fee' which may appear misleading.

The Auditor needs to analyse the relevant agreements entered and has to study the flow of consideration and its nature and thereafter decide the taxability and the amount on which GST is applicable. The same has to be communicated to the management if no GST is being paid till date.

- 5) **Portfolio management service:** Generally, the said services are being provided by different entities within the banking sector. Due to stiff competition and one-stop window for priority customer's (i.e. customers who are depositing amount beyond a certain limits) only one person provides all such services and thereafter relevant commission is split between entities or costs are shared. In fact, inter-branch sharing of portfolio management services in lieu of the skill set available in selected branches between different states is taxable and a fair value has to be assigned to such transactions and applicable GST is payable on such transactions. Further, appropriate classification has to be made for such supply of services under relevant chapter heading as per the notifications issued under GST.
- 6) **Account maintenance charges:** It is a common practice that in most of the banks certain charges are recovered towards maintenance. The said charges are nominal but the same is liable for payment of GST. Accordingly, the concerned concurrent /internal /statutory auditor would have to check on this aspect of taxability and ensure compliance.
- Further, even locker charges are being recovered from the customers on an annual basis which is liable for payment of GST. There can be different modes of arrangement for availing such income, but such income is taxable under GST.
- 7) **Credit/Debit card charges-** Income earned by way of issuing and maintaining such transactions were liable for payment of GST. Therefore, the Auditor should carefully examine such transactions and appropriate disclosures be made in case of non-compliance with relevant tax provisions. Following question in FAQs released is relevant in this regard-

*Q. Whether GST will be levied on **interchange fees on card settlement fees paid/shared by banks?***

Ans. Fees charged for card settlement is a consideration which is part of a separate transaction between the banks which are parties to this

transaction and shall be liable to GST. This is a B2B supply and credit of this transaction is available.

- 8) Digital payment facilities-** Banks charges some convenience fees from persons who accept payment through debit card, credit card or through some other card service. The charges earned by the bank are chargeable under GST. No GST will be payable in respect of services provided by bank, to any person in relation to settlement of an amount up to Rs. 2000 in a single transaction transacted through credit card, debit card or charge card or other payment card service.
- 9) Sale and purchase of foreign currency:** Banking companies receiving consideration for providing services by way of securities and foreign exchange broking and purchase or sale of foreign currency, including money changing is chargeable to GST on special value calculated as per option availed in terms of Rule 32 of CGST Rules, 2017.

Hence at the time of conversion (purchase/sale) of foreign currency to Indian currency or vice a versa, GST is applicable in two stages; once on the charges separately levied by banks for such conversion and secondly on value of sale/purchase as per Rule 32 of CGST Rules, 2017.

However, pursuant to entry no. 27(b) of Notification No. 12/2017 and entry no.28(b) of Notification no 9/2017-ITR, inter-bank transactions of sale or purchase of foreign currency or transactions with authorized dealers of money changing are exempted under GST regime.

10) Other income-

- Income earned by banks by way of penalties, retention charges etc are liable for payment of GST.
- Realisation of payment (NPA) by way of disposal of NPA to an asset reconstruction company [ARC] or to any other buyer is a debatable issue. There is a variant view to the aforesaid transaction and the taxability will depend upon the structuring of the transaction. One view is that this transaction may be considered as actionable claim and GST will also not apply as definition of supply [Clause 6 Schedule III read with Section 7] under CGST Act exclude actionable claim. Another view is that, this transaction may be an

outright sale. And when there is outright sale, the GST applicability will depend on the nature of underlying asset sold and is to be paid by borrower. e.g. IVY Bank sells one of its NPA as a going concern to Company ABC then the instant transaction is taxable under GST but the same is classified as a supply of service and accordingly the rate of tax payable is NIL in terms of Entry 2 classified under Chapter 99 as specified under Notification No. 12/2017.

26.28 The aforesaid discussion on the nature of services by bank and their taxability is summarised as under:

SI No.	Nature of Service	Remarks about Taxability
1.	Assignment or Sale of Debts	Not Chargeable (Sale, transfer or assignment of debts falls within the purview of the actionable claims, which are neither good nor service as per Schedule III of the CGST Act.)
2.	Bank Guarantee Commission Charges	Taxable
3.	Bill Discounting	Exempt to the extent of interest component. However, commission, fees, brokerage or documentation charges will be taxable.
4.	Charges on Cheque Bouncing	Taxable
5.	Interest and charges on delay/ non-payment of credit card bills	Taxable
6.	Charges for issuance of Demand Draft	Taxable
7.	Loan or other Documentation Charges	Taxable
8.	Forward Contract in Currencies	Where the settlement takes place by way of actual delivery of underlying currency, then such forward contracts would be treated as normal supply of goods and liable to GST (Commission portion).

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		Where the settlement takes place by way of net settlement of differential of the forward rate over the prevailing market rate on the settlement date, the same would be falling within the purview of 'securities' as securities are neither 'goods' nor 'services' as defined in the CGST Act, 2017, therefore future contracts are not chargeable to GST.
9.	Future Contracts	Not Chargeable (Since it is financial derivative and falls within the definition of securities (which is neither goods nor service in GST) and hence they are not liable to GST. Commission and documentation charges will be liable for GST.
10.	Income from Commercial Paper or Certificate of Deposit	Exempt, due to nature of interest.
11.	Inspection Charges	Taxable
12.	Interest/ Discount on Loans / Deposits or Advances	Exempt
13.	Issuance of Bank Statement Charges	Taxable, except for Basic Saving Bank Deposit (BSBD) account holders under Pradhan Mantri Jan Dhan Yojana (PMJDY).
14.	Issuance of Letter of Credit	Exempt, as it is included in the definition of 'Money' u/s 2(75) of CGST Act and hence outside the definition of goods and services.
15.	Ledger Folio Charges	Taxable
16.	Loan takeover transactions	Taxable (GST will be charged on the processing fees charged for the takeover of the loan).
17.	Processing Fees on Loans	Taxable
18.	Promissory Notes	Not Chargeable [As it is covered in the definition of "money" (which is neither good nor service in GST) and hence

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		exempt. However, if any extra amount is charged in the name of commission, fees, brokerage etc. then it will be chargeable].
19.	Sale of Derivatives	Not Chargeable (Since derivatives falls within the definition of securities (which is neither good nor service in GST) and hence they are not liable to GST. However, if any extra amount charged in the name of commission, fees, brokerage etc. then it will be chargeable.
20.	Security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act	Exempt, as covered under definition of "securities", which is excluded from definition of "Goods" and "Services".
21.	Services provided to Reserve Bank of India	Interest charged on deposit kept with RBI is exempt. Other charges are taxable, as not exempt specifically.
22.	Standing Instruction Charges	Taxable, except for Basic Saving Bank Deposit (BSBD) account holders under Pradhan Mantri Jan Dhan Yojana (PMJDY).
23.	Stop Payment Charges	Taxable, except for Basic Saving Bank Deposit (BSBD) account holders under Pradhan Mantri Jan Dhan Yojana (PMJDY).
24.	Services supplied by a recovery agent to a bank.	Taxable under RCM
25.	Services supplied by individual Direct Selling Agents (DSAs) other than a body corporate, partnership or limited liability partnership firm to bank.	Taxable under RCM
26.	Services provided by BF/BC to a banking company in compliance with RBI's	Exempt in Entry no. 39 [Heading no. 9971] of Notification 12/2017

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	CircularNo.DBOD.No.BL.BC.5 8/22.01.001/2005-2006dated 25.01.2006 and subsequent instructions on the issue.	
27.	Services provided by a banking company to Basic Saving Bank Deposit (BSBD) account holders under Pradhan Mantri Jan Dhan Yojana (PMJDY).	Exempt by NN 28/2018 dated 31 st December 2018.
28.	business facilitator or a business correspondent to a banking company with respect to accounts in its rural area branch;	Exempt by Notification 12/2017
29.	any person as an intermediary to a business facilitator or a business correspondent with respect to services mentioned in Entry 28	Exempt by Notification 12/2017
30.	Penal interest in case of delay payment of EMI	Exempt with reference to Circular No. 102/21/2019- GST dated 28 th June 2019
31.	Foreclosure charges for foreclosure of loan to compensate for the loss in interest income	Under Service tax regime taxability of such income was under litigation and recently CESTAT (LB) Madras in its decision in case of M/s Repco Home Finance Ltd. Reported at 2020-TIOL- 1039-CESTAT-MAD-LB has held that Service tax cannot be levied on the foreclosure charges levied by the banks and non-banking financial companies on premature termination of loans under "banking and other financial services" as defined under section 65 (12) of the Finance Act, 1994 One may take the base of the above stated decision and argue that under GST as well the said income is not

		taxable. However, the view of the department may differ and it may cause litigation in the future.
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Hence all income sources of the banks, have to be thoroughly scrutinized and thereafter the Auditor has to comment on its taxability, classification and compliance with tax payment along with interest, applicable penalty and transparency in disclosure in the returns filed.

Rate of Tax under GST

26.29 Broadly the rates of tax in GST are – Nil; 0.25; 3; 5; 12; 18 and 28 per cent. Depending upon the classification of goods or types of services, different rates are applicable on different goods or services. These rates are uniform across India. In case IGST is levied, the rate is applied in consolidation, say 18% IGST; and in case CGST and SGST are levied, the rate is applied in two equal parts say 9 per cent CGST and 9 per cent SGST.

The charging section of CGST Act and IGST Act provides an upper cap of rate as 20 per cent and 40 per cent respectively. However, currently the actual maximum tax prescribed on any commodity or services is 28 per cent plus cess, if applicable.

There is an increase in the tax rate from 15 per cent in service tax (erstwhile indirect tax) to 18 per cent under GST on the transaction charges levied on the financial services provided by the banks in relation to credit card, fund transfer, ATM transactions, processing fees on loans etc.

Classification of Goods and Services

26.30 When we say that different rates have been prescribed for different types of goods and services or when we say that tax is payable under reverse charge for specific types of goods and services, we recognise these different types of goods and services by their classification under the GST Law. How the law has classified these goods and services is explained below.

- 1. Classification of goods-** Classification of goods in the GST Law is based on HSN Codes. HSN system is a '*Harmonised System of Nomenclature*' to give a unique code to each commodity by which it is recognized for the purpose of international trade. Each code is accompanied with the corresponding description of goods which are covered under that code.

In the GST Law, the HSN codes of the Customs Tariff Act have been recognised. In the Customs Tariff Act, 1985, there are 98 Chapters containing these codes. Each Chapter pertains to a broader class of commodities and contains sub-codes for sub-classes of such commodity.

- 2. Classification of services** - In GST, a list of different classes of services has been given *vide Annexure to Notification No. 11/2017-Central Tax (Rate)*. This Annexure contains 4 to 6 digit numeral codes for every description of services. One has to identify the service code which matches with the description of service.

TIME OF SUPPLY under GST

26.31 Supply has been understood to hold the key to the incidence of GST, but it is the 'time of supply' that determines the occasion when this incidence will come to rest.

In order to calculate and discharge tax liability it is important to know the date when the tax liability arises i.e. the date on which the charging event has occurred. In GST law, it is known as *Time of Supply*. GST law has provided separate provisions to determine the time of supply of goods and time of supply of services. Sections 12, 13 & 14 of the CGST Act, 2017, deal with time of supply and by virtue of section 20 of the IGST Act, 2017, these provisions are also applicable to inter-State supplies chargeable to integrated tax.

26.32 Therefore, it is essential to comprehend the *time of supply of services* provided by the banks. Pursuant to section 13 of the CGST Act, time of supply of services shall be the earliest of the following dates, namely: —

- a) the date of issue of invoice by the supplier, if the invoice is issued within the period prescribed under ~~sub-section (2) of~~²³ section 31 or the date of receipt of payment, whichever is earlier; or
- b) the date of provision of service, if the invoice is not issued within the period prescribed under ~~sub-section (2) of~~²⁴ section 31 or the date of receipt of payment, whichever is earlier; or
- c) the date on which the recipient shows the receipt of services in his books of account, in a case where the provisions of clause (a) or clause (b) do not apply.

²³ Omitted vide The Central Goods and Services Tax Amendment Act, 2018 w.e.f. 01.02.2019.

²⁴ Omitted vide The Central Goods and Services Tax Amendment Act, 2018 w.e.f. 01.02.2019.

Explanation: -

- Date of receipt of payment: The date on which the payment is entered in the books of account of the supplier or the date on which the payment is credited to his bank account, whichever is earlier.
- Date of issue of invoice: If the supplier of services is an insurer or banking company or financial institution including NBFC, invoice is to be issued within 45 days from the date of supply of service.

26.33 It is pertinent to mention that, where the supplier of taxable service receives an amount up to Rs. 1,000/- in excess of the amount indicated in the tax invoice, the time of supply to the extent of such excess amount shall, at the option of the said supplier, be the date of issue of invoice relating to such excess amount.

Time of supply in case of reverse charge

26.34 In case of supplies in respect of which tax is paid or liable to be paid on reverse charge basis, the time of supply shall be, earlier of the following dates, namely: -

- (a) the date of payment as entered in the books of account of the recipient or the date on which the payment is debited in his bank account, whichever is earlier; or
- (b) the date immediately following sixty days from the date of issue of invoice or any other document, by whatever name called, in lieu thereof by the supplier;

Further, where it is not possible to determine the time of supply under clause (a) or clause (b), the time of supply shall be the date of entry in the books of account of the recipient of supply.

26.35 Moreover, in case of supply by associated enterprises, where the supplier of service is located outside India, the time of supply shall be the date of entry in the books of account of the recipient of supply or the date of payment, whichever is earlier.

26.36 Time of supply of goods or services (Residual provisions): In case it is not possible to determine the time of supply under aforesaid provisions, the time of supply is:

- Due date of filing of return, in case where periodical return has to be filed.
- Date of payment of tax in all other cases.

Invoice

26.37 As inferred from the above, GST is chargeable at the time of supply. Invoice is an important indicator of the time of supply. Tax invoice is the primary document evidencing the supply by the supplier and vital for availing input tax credit by the recipient. Under the GST regime, an "invoice" or "tax invoice" means the tax invoice referred to in section 31 of the CGST Act. This section mandates issuance of invoice or a bill of supply for every supply of goods or services or both.

26.38 The type of invoice to be issued depends upon the category of registered person making the supply. For eg. if a registered person is making supplies, then a tax invoice needs to be issued by such registered person. However, if a registered person is dealing only in exempted supplies or is availing composition scheme, then such registered person needs to issue a bill of supply in lieu of tax invoice. Further, where a registered person is supplying taxable as well as exempted goods or services or both to an unregistered person, a single-invoice-cum-bill of supply may be issued for all such supplies.

26.39 In terms of Rule 46 of the CGST Rules, 2017, subject to Rule 54 (*Tax invoice in special cases*), a tax invoice referred to in section 31, shall be issued by the registered person containing the following:

- (a) name, address and GSTIN of the supplier;
- (b) a consecutive serial number, not exceeding sixteen characters, in one or multiple series, containing alphabets or numerals or special characters hyphen or dash and slash symbolised as "-" and "/" respectively, and any combination thereof, unique for a financial year;
- (c) date of its issue;
- (d) name, address and GSTIN or UIN, if registered, of the recipient;
- (e) name and address of the recipient and the address of delivery, along with the name of State and its code, if such recipient is un-registered and where the value of taxable supply is Rs. 50,000/- or more;
- (f) name and address of the recipient and the address of delivery, along with the name of the State and its code, if such recipient is un-registered and where the value of the taxable supply is less than ` 50,000/- and the recipient requests that such details be recorded in the tax invoice;
- (g) Harmonised System of Nomenclature code for goods or services;

[As regards the requirement to quote the HSN of the supplies, the annual turnover of the registered person for the previous year shall be referred. In case of suppliers having annual turnover in the previous year:

- i. Up to Rs.1.5 Crore – No HSN required
- ii. Exceeding Rs. 1.5 Crore up to Rs. 5 Crore – HSN up to 2 digits required
- iii. Exceeding Rs.5 Crore – HSN up to 4 digits required.

8 Digit HSN Code needs to be quoted in case of Export Turnover irrespective of the quantum of turnover.

The term 'annual turnover' has not been defined. Therefore, it may be understood, to be the turnover in the State as defined in Section 2(112) of the Act, computed for the preceding financial year.

It is also relevant to note that there has been no notification issued in respect of services, separately. However, considering that the term 'HSN' has been used commonly in respect of both goods and services, the aforesaid order can be applied even in respect of services, while quoting the code from the scheme of Classification of Services, as provided in *Notification No. 11/2017-Central Tax (Rate) dated.28-06-2017.*]

- (h) description of goods or services;
- (i) quantity in case of goods and unit or Unique Quantity Code thereof;
- (j) total value of supply of goods or services or both;
- (k) taxable value of supply of goods or services or both considering discount or abatement, if any;
- (l) rate of tax (central tax, State tax, integrated tax, Union territory tax or cess);
- (m) amount of tax charged in respect of taxable goods or services (central tax, State tax, integrated tax, Union territory tax or cess);
- (n) place of supply along with the name of State, in case of a supply in the course of inter-State trade or commerce;
- (o) address of delivery where the same is different from the place of supply;
- (p) whether the tax is payable on reverse charge basis; and
- (q) signature or digital signature of the supplier or his authorized

representative.

However, such signatures or digital signature shall not be required in the case of issuance of an electronic invoice in accordance with the provisions of the Information Technology Act, 2000 (21 of 2000).

26.40 Further, the Government may, by notification, on the recommendations of the Council, and subject to such conditions and restrictions as mentioned therein, specify that the tax invoice shall have Quick Response (QR) code. In this regard, w.e.f.01/10/2020, Government has notified vide N/N- 72/2019 of CGST Act dated 13th December 2019 that, an invoice issued by a registered person, whose aggregate turnover in a financial year exceeds Rs. 500 crore, to an unregistered person (hereinafter referred to as B2C invoice), shall have Quick Response (QR) code. Where such registered person makes a Dynamic QR code available to the recipient through a digital display, such B2C invoice issued by such registered person containing cross-reference of the payment using a Dynamic QR code, shall be deemed to be having QR code.

26.41 Further, Notification No 68/2019-Central Tax dated 13th December 2019, *inter alia* inserted Rule 48(4) of CGST Rules, 2017, which stipulates that the invoice shall be prepared by including particulars contained in Form GST INV-01 after obtaining an Invoice Reference Number by uploading information contained therein on the Common Goods and Services Tax Electronic Portal in such manner and subject to such conditions and restrictions as may be specified in the notification. In this regard, w.e.f.1st April 2020, vide Notification No. 70/2019 dated 13th December 2019, the Government have notified registered person, whose aggregate turnover in a financial year exceeds Rs. 100 crores, as a class of registered person who shall prepare invoice in terms of Rule 48(4) in respect of supply of goods or services or both to a registered person.

The Government has also notified the Common Goods and Services Tax Electronic Portal for the purpose of preparation of the invoice as per Rule 48(4).

26.42 It is pertinent to mention that in case of export of goods or services, the invoice shall carry an endorsement as follows:

1. Where the supply is effected on payment of IGST: *"Supply meant for export/supply to SEZ unit or SEZ developer for authorised operations on payment of integrated tax"* or
2. Where the supply is effected without payment of IGST: *"Supply meant*

for export/supply to SEZ unit or SEZ developer for authorised operations under bond or letter of undertaking without payment of integrated tax". And details in lieu of those specified in Rule 46 (e) cited supra, contain the following:

- (i) name and address of the recipient;*
- (ii) address of delivery; and*
- (iii) name of the country of destination.*

Time Limitation for Issuance of Invoice

26.43 Section 31(2) read Rule 47 provide that a registered person supplying taxable services shall, before or after the provision of service but within 30 days *(or 45 days in case of suppliers of services being an insurer / banking company / financial institution, including a NBFC)* from the date of supply of the service, issue a tax invoice, showing the description, value, tax charged thereon and such other particulars as has been prescribed in the Invoice Rules.

26.44 Further, an insurer or a banking company or a financial institution, including a NBFC, or a telecom operator, or any other class of supplier of services as may be notified by the Government on the recommendations of the Council, making taxable supplies of services between distinct persons as specified in section 25, may issue the invoice before or at the time such supplier records the same in his books of account or before the expiry of the quarter during which the supply was made.

26.45 Moreover, the Government may, on the recommendations of the Council, by notification and subject to such conditions as may be mentioned therein, specify the categories of services in respect of which:

- (a) Any other document issued in relation to the supply shall be deemed to be a tax invoice; or
- (b) Tax invoice may not be issued.

26.46 Therefore, an insurer / banking company / financial institution, including a NBFC may issue an invoice or any other document in lieu thereof.

26.47 Rule 54 of the CGST Rules which contain provisions relating tax invoices in cases of special services, *inter alia* stipulates that, an insurer or a banking company or a financial institution, including a non-banking financial company, may issue a consolidated tax invoice or any other document in lieu thereof, by whatever name called for the supply of services made during a month at the end of the month, whether issued or made available, physically or electronically whether or not serially numbered, and whether or not

containing the address of the recipient of taxable service but containing other information as mentioned under rule 46.

26.48 The signature or digital signature of the supplier or his authorised representative shall not be required in the case of issuance of a consolidated tax invoice or any other document in lieu thereof as per the Information Technology Act, 2000.

26.49 Further, Section 31 (1)(b) read with the proviso to rule 46 provides that a registered person [other than the supplier engaged in making supply of services by way of admission to exhibition of cinematograph films in multiplex screens,] may not issue a tax invoice if the value of the goods or services or both supplied is less than Rs. 200/- subject to the following conditions, namely:

- (1) the recipient is not a registered person; and
- (2) the recipient does not require such invoice.

However, the supplier shall issue a consolidated tax invoice for such supplies at the close of each day in respect of all such supplies.

Therefore, Banking companies have the option to issue a consolidated tax invoice or any other document in lieu of tax invoice for the supply of services made during a month, at the end of the month, either in physical form or electronically.

Note

- A registered person on receipt of advance payment with respect to any supply shall issue receipt voucher.
- Further, where at the time of receipt of advance:
 - the rate of tax is not determinable the tax shall be paid at the rate of 18 per cent.
 - the nature of supply is not determinable, the same shall be treated as inter-State supply.
- Where, on receipt of advance payment with respect to any supply of goods or services or both the registered person issues a receipt voucher, but subsequently no supply is made and no tax invoice is issued in pursuance thereof, the said registered person may issue to the person who had made the payment, a refund voucher against such payment.
- A registered person who is liable to pay tax under section 9(3) or 9(4) shall issue an invoice in respect of goods or services or both received by him from the supplier who is not registered on the date of receipt of

goods or services or both. Here, a registered person may issue a consolidated invoice at the end of a month for supplies covered under section 9(4), the aggregate value of such supplies exceeds Rs. 5,000/- in a day from any or all the suppliers.

- A registered person who is liable to pay tax u/s 9(3) or (4) shall issue a payment voucher at the time of making payment to the supplier.
- GST Law specifies the particulars to be contained in documents evidencing supply:

CGST Rule	Document substantiating supply
Rule 46	Invoice
Rule 49	Bill of supply
Rule 50	Receipt voucher
Rule 51	Refund voucher
Rule 52	Payment voucher
Rule 53	Revised tax invoice and credit or debit notes

- In cases where tax invoice has been issued for supply of any goods or services or both and subsequently it is found that the value or tax charged in that invoice is more than what is actually payable/ chargeable or where the recipient has returned the goods, the supplier can issue a credit note to the recipient.

In cases where tax invoice has been issued for supply of any goods or services or both, and subsequently it is found that the value or tax charged in that invoice is less than what is actually payable/chargeable, the supplier can issue a debit note to the recipient.

The adjustment of GST already paid is allowed only by way of issuance of credit/debit note in terms of Section 34 of the CGST Act, 2017. The proviso to section 34(2) of the CGST Act, 2017 provides that no reduction in liability would be allowed if the incidence of tax has been passed on to another person. If bad debts are on account of deficiency in supply of services, or tax charged being greater than actual tax liability, or goods returned, GST paid on the same is refundable subject to fulfilment of the prescribed conditions. Therefore, GST already paid on bad debts, as used in the trade parlance, cannot be adjusted.

- The tax invoice must be prepared in triplicate for goods, and in duplicate

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for services. Each copy of the tax invoice in case of service, is required to be marked as follows:

Goods	Services
1. ORIGINAL FOR RECIPIENT	1. ORIGINAL FOR RECIPIENT
2. DUPLICATE FOR TRNSPORTER	2. DUPLICATE FOR SUPPLIER
3. TRIPLICATE FOR SUPPLIER	–

Value of Taxable Supply Under GST

26.50 Once it is determined that an activity or transaction is supply under GST, ascertaining the value of the same becomes significant.

26.51 Under Section 15(1) The value of a supply of goods or services or both shall be the transaction value, which is the price actually paid or payable for the said supply of goods or services or both where the supplier and the recipient of the supply are not related, and the price is the sole consideration for the supply.

26.52 Explanation to Section 15 of the CGST Act deems the following persons to be “related persons”:

- Officers / Directors of one another’s business.
- Partners in business.
- Employer – employee.
- A person directly / indirectly owns / controls / holds 25 per cent more of the outstanding voting stock or shares of both the persons.
- One directly / indirectly controls the other.
- Both are directly / indirectly controlled by a third person.
- Together, they directly / indirectly control a third person.
- Members of the same family.
- Sole agent / distributor / concessionaire of the other.

S-15(2) INCLUDES:	Transaction Value	EXCLUDES
(i) Amounts charged by the supplier to recipient in respect of any taxes, duties, cesses, fees and charges levied under any statute,	Transaction Value discount	(i) Before / at the time of supply Single condition: Such discount is duly recorded in the invoice

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<p>other than taxes paid under GST regime;</p> <p>(ii) Amount incurred by recipient which is liable to be paid by the supplier and not included in price actually paid or payable;</p> <p>(iii) Charges by Supplier to Recipient being:</p> <p>Incidental expenses (e.g.: packing, commission)</p> <p>(iv) Charges for anything done by the supplier at the time or before the supply, in respect thereof</p> <p>Interest/ late fee/ penalty for delayed payment of consideration</p> <p>(v) Subsidies directly linked to price – for supplier receiving the subsidy (excluding Central and State Govt. subsidies; i.e., Government subsidies will not be included in transaction value)</p>	<p>▪ After the supply: Cumulative conditions:</p> <p>Agreement establishing discount entered into before / at the time of supply</p> <p>Discount specifically linked to relevant invoices</p> <p>ITC reversed by the recipient to the extent attributable to the discount</p>
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26.53 To determine value of certain specific transactions, specific rules have been incorporated in CGST Rules, 2017 (Rule 27-35). Rules pertaining to banking Sector are:

Banking sector provides services of purchase and sale of foreign currency to its customers, the value of which can be ascertained in terms of Rule 32(2) of the CGST Rules as:		
OPTION –I [Section 32(2)(a)]	OPTION -II [Section -32(2)(b)]	
<p>When exchanged from or/ to INR:</p> <p>(i) Difference of Buying rate / Selling rate and RBI reference rate X Total units of currency</p> <p>(If RBI reference rate is not</p>	Where Amount of currency exchanged	

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available, value shall be 1 per cent of gross amount of INR received or provided) (ii) If neither of the two currencies exchanged in INR, (iii) the value shall be equal to 1 per cent of the lesser of the two amounts (iv) the person changing the money would have received by converting any of the two currencies into INR (v) on that day at the reference rate provided by RBI.	Up to Rs. 1 lakh	1 per cent of the gross amount of currency exchanged or Rs. 250/-, <i>whichever is higher</i>
	Rs. 1 lakh and up to Rs. 10 lakhs	Rs. 1,000/- plus 0.5 per cent of the gross amount of currency exchanged above Rs. 100,000/-
	exceeding Rs. 10 lakhs	Rs. 5,500/- plus 0.10 per cent of the gross amount of currency exchanged above Rs. 10 lakhs or Rs. 60,000/-, <i>whichever is lower</i>

Note - A person supplying the services may exercise the option to ascertain the value in terms of clause(b) for a financial year and such option shall not be withdrawn during the remaining part of that financial year.

26.54 Further, it is pertinent to mention here that Rule 34 of the CGST Rules provides the rate of exchange of currency, other than Indian rupees, for determination of Value as under:

Transactions undertaken in foreign currency must be translated into Indian Rupees. The rate of exchange for the determination of the value of taxable goods shall be the applicable rate of exchange as notified by the Board under section 14 of the Customs Act, 1962 and for the determination of the value of taxable services it shall be the applicable rate of exchange determined as per the generally accepted accounting principles for the date of supply in respect of such supply in terms of section 12 or, as the case may be, section 13 of the Act.

Valuation of services between the distinct and related persons (excluding agents)

26.55 Generally, banks would have lots of common/ shared services being supported from Head Office such as call center, security software etc. Further, many times one branch would internally provide service to other

branches for example: resolving issue of a customer having PAN India accounts, providing local information etc. to other branches etc. The value will be determined in terms of Rule 28 of the CGST Rules, 2017 as under:

(a) The open market value of such supply	
(b) If open market value is not available	Value of supply of goods or services of like kind and quality
(c) If value of supply is not determinable under clause (a) or (b)	Value as determined by application of Rule 30 or Rule 31, in that order
<i>Provided that where goods are intended for further supply as such by the recipient, the value shall, at the option of the supplier, be an amount equivalent to 90% of the price charged for the supply of goods of like kind and quality by the recipient to his customer not being a related person</i>	
<i>Where the recipient is eligible for full input tax credit, the value declared in the invoice shall be deemed to be the open market value of goods or services</i>	

Value of supply based on cost i.e. cost of supply plus 10 per cent mark-up (Rule 30 of the CGST Rules 2017).

Value of supply determined by using reasonable means should be consistent with the principles and general provisions of GST law (Rule 31 of the CGST Rules 2017).

Value of supply in case of Re-posessed Assets from defaulting borrowers

26.56 Rule 32(5) provides that where a taxable supply is provided by a person dealing in buying and selling of second hand goods i.e., used goods as such or after such minor processing which does not change the nature of the goods and where no input tax credit has been availed on the purchase of such goods, the value of supply shall be the difference between the selling price and the purchase price and where the value of such supply is negative, it shall be ignored.

Provided that the purchase value of goods repossessed from a defaulting borrower, who is not registered, for the purpose of recovery of a loan or debt shall be deemed to be the purchase price of such goods by the defaulting borrower reduced by 5 per cent points for every quarter or part thereof, between the date of purchase and the date of disposal by the person making such repossession.

Rate of exchange of currency, other than Indian rupees, for determination of value

26.57 The rate of exchange for determination of value of taxable goods or services or both shall be the applicable RBI reference rate for that currency on the date of supply as determined in terms of section 12 or section 13 of the CGST Act.

Value of supply inclusive of integrated tax, central tax, State tax, Union territory tax

26.58 Where the value of supply is inclusive of GST, the tax amount shall be determined in the following manner, Tax amount= (Value inclusive of taxes X GST tax rate in %)/(100+ sum of GST tax rates in %)

For example - If the value inclusive of tax is Rs. 100/- and applicable GST tax rate is 18 per cent then Tax amount = $(100 \times 18) / (100 + 18) = 1800 / 118 = \text{Rs. } 15.25$

Nature of Supply and Place of Supply

26.59 The term 'Place of Supply' is of vital importance role in the GST. To know the nature of supply whether the supply is inter-State supply or intra-State supply, one should know the place of supply to determine the nature of supply.

Inter-State Supplies



26.60 Section 7 of the IGST Act, provides as to when the supplies of goods and/or services shall be treated as supply in the course of inter-State trade/commerce.

Sections 7(1) and 7(2) of IGST Act, primarily cover two kinds of supplies – Supply of *goods* within India and supply of *goods* imported into India respectively and Sections 7(3) and 7(4) of IGST Act, cover two kinds of supplies – supply of *services* within India and import of *services* into India respectively. Certain supplies of goods or services are treated as supplies in the course of inter-State trade or commerce as defined in Section 7(5) of the IGST Act.

26.61 Inter-State Supplies: Section 8(1) of IGST Act, deals with supply of *goods* and Section 8(2) of IGST Act with Supply of *Services* treated as supplies in the course of intra-State trade or commerce.

Section 8(2) of IGST Act reads thus:

“Subject to the provisions of section 12, supply of services where the location of the supplier and the place of supply of services are in the same State or same Union territory shall be treated as intra-State supply:

Provided that the intra-State supply of services shall not include supply of services to or by a Special Economic Zone developer or a Special Economic Zone unit.

Explanation 1 --For the purposes of this Act, where a person has, --

- (i) an establishment in India and any other establishment outside India;*
- (ii) an establishment in a State or Union territory and any other establishment outside that State or Union territory; or*
- (iii) an establishment in a State or Union territory and any other establishment ~~being a business vertical~~²⁵ registered within that State or Union territory;*

then such establishments shall be treated as establishments of distinct persons.

Explanation 2 --A person carrying on a business through a branch or an agency or a representational office in any territory shall be treated as having an establishment in that territory.”

²⁵ Omitted vide The Integrated Goods And Services Tax (Amendment) Act, 2018 w.e.f 01.02.2019

With regard to supply of service, if the twin factors of *'location of supplier of services'* and *'place of supply of services'* are in the same State or UT, then such supply will be treated as intra-State supply. Location of the supplier of services has been defined in the Act to mean 'place of business from where supply is made and duly registered for the purpose'. It also includes other places and reference may be had to the discussion in respect of inter-State supply of services for the implications of this definition.

For e.g. Consider audit services being provided by a Chartered Accountant located in Delhi to a company in Delhi. For the purpose of the audit, the Chartered Accountant visits the company's factory located in Noida. Here, although the Chartered Accountant is physically moving to Noida, he is not supplying the audit services from Noida. The transaction will be an intra-State supply from Delhi to Delhi.

Therefore, it is relevant to understand the terms *'location of supplier of services'* and *'place of supply of services'* to determine the nature of supply.

26.62 Section 2 (15) of IGST Act states that, location of supplier of services means –

- (a) where a supply is made from a place of business for which the registration has been obtained, the location of such place of business;
- (b) where a supply is made from a place other than the place of business for which registration has been obtained (a fixed establishment elsewhere), the location of such fixed establishment;
- (c) where a supply is made from more than one establishment, whether the place of business or fixed establishment, the location of the establishment most directly concerned with the provision of the supply; and
- (d) in the absence of such places, the location of the usual place of residence of the supplier.

26.63 Where, Section 2(85) provides inclusive definition of place of business and Section 2(50) provides exclusive definition of fixed establishment thus:

- place of business includes:
 - (a) a place from where the business is ordinarily carried on, and includes a warehouse, a godown or any other place where a taxable person stores his goods, supplies or receives goods or services or both; or
 - (b) a place where a taxable person maintains his books of account; or

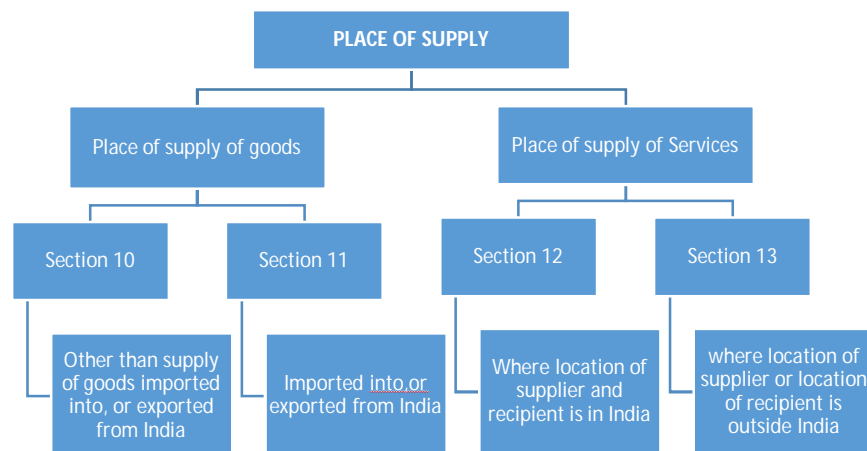
- (c) a place where a taxable person is engaged in business through an agent, by whatever name called.
- fixed establishment means;
 - a place (other than the registered place of business)
 - which is characterised by –
 - a sufficient degree of permanence; and
 - suitable structure in terms of human and technical resources to supply services, or to receive and use services for its own needs.

It can be inferred from the above that, in case of services provided by bank to a customer from multiple locations, the location of supplier will be the home branch/ account branch. The other branches providing services to such customer actually provide services to the home branch/ account branch.

Place of Supply

26.64 Provisions relating to place of supply are contained in sections 10 to 14 of IGST Act. For understanding the concept of place of supply in case of services, it is imperative to know the phrase "*Location of the recipient*" as provided in the following 4 sub-clauses of Section 2(14) of IGST Act:

- (a) Services received at a place of business where registration is obtained – Location of such place of business.
- (b) Services received at a fixed establishment (i.e., a place of business not registered, but having a sufficient degree of permanence involving human and technical resources) – Location of such fixed establishment.
- (c) Services received at more than one establishment – Location of the establishment most directly concerned with the receipt of the supply.
- (d) Services received at a place other than above – Location of the usual place of residence of the recipient (address where the person is legally registered/ constituted in case of recipients other than individuals).



Default Rule for services other than the 12 specified services		
S.No.	Description of Supply	Place of Supply
1.	B2B	Location of such Registered Person
2.	B2C	(i) Location of the recipient where the address on record exists, and (ii) Location of the supplier of services in other cases
Default Rule for cross-border supply of services other than 9 specified services		
Description of Supply: ANY	Place of Supply: Location of the recipient of service; If not available in the ordinary course of business, the location of the supplier of service	

Place of supply for Banking Sector

26.65 In the case of banks and financial institutions the place of supply will have to be determined as under:

- In case, where the location of the banks or location of the recipient of service is in India, section 12(12) of the IGST Act, 2017, provides for the place of supply of services -

The place of supply of banking and other financial services, including stock broking services to any person shall be the location of the

recipient of services on the records of the supplier of services.

Provided that, if the location of recipient of services is not on the records of the supplier, the place of supply shall be the location of the supplier of services.

Hence, the place of supply of banking and other financial services, to any person shall be the location of the recipient of services on the records of the supplier of services. The address available on the records of the Bank or Financial Institution, which is ordinarily used for communication with the customer, may be considered as the Place of Supply. In case where the address location of recipient of services is not on the records of the supplier, the place of supply shall be the location of the supplier of services.

- In cases, where the location of the banks or location of the recipient of service is outside India, section 13(8) of the IGST Act, 2017, provides as under:

The place of supply of the following services shall be the location of the supplier of services, namely: --

- (a) *services supplied by a banking company, or a financial institution, or a non-banking financial company, to account holders;*
- (b) *intermediary services;*
- (c) *services consisting of hiring of means of transport, including yachts but excluding aircrafts and vessels, up to a period of one month*

Explanation - For the purposes of this sub-section, the expression, --

- (a) *"account" means an account bearing interest to the depositor, and includes a non-resident external account and a non-resident ordinary account;*
- (b) *"banking company" shall have the same meaning as assigned to it 2 of 1934. under clause (a) of section 45A of the Reserve Bank of India Act, 1934;*
- (c) *"financial institution" shall have the same meaning as assigned to it 2 of 1934. in clause (c) of section 45-I of the Reserve Bank of India Act, 1934;*
- (d) *"non-banking financial company" means, --*
 - (i) *a financial institution which is a company;*
 - (ii) *a non-banking institution which is a company, and which has as*

its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner; or

- (iii) *such other non-banking institution or class of such institutions, as the Reserve Bank of India may, with the previous approval of the Central Government and by notification in the Official Gazette, specify.*

In terms of section 13(8) of the IGST Act, 2017 service provided by the bank to its account holder shall be deemed to be service provided at the place where such bank is located. "Account" here means an account bearing interest to the depositor, and includes a non-resident external account and a non-resident ordinary account.

26.66 Further, in terms of section 13 of the IGST Act, 2017, where Location of Supplier or Location of Recipient is outside India, place of supply will be the location of the recipient of the services. Where the location of the recipient of services is not available in the ordinary course of business, the place of supply shall be the location of the supplier of services. Therefore, the service provided by the bank to person other than an account holder located outside India, shall be the location of the supplier of services. Accordingly place of supply of service provided by the bank to its customer located outside India shall be the location of bank and Central tax and State tax or Union territory tax, as the case may be, will be payable.

26.67 Further Section 2(13) of IGST Act defines the term 'intermediary'

"intermediary" means a broker, an agent or any other person, by whatever name called, who arranges or facilitates the supply of goods or services or both, or securities, between two or more persons, but does not include a person who supplies such goods or services or both or securities on his own account;

As inferred from section 13(8)(b) of IGST Act, the place of supply in the case intermediary services provided by a banking company, or a financial institution, or a non-banking financial company, to account holders shall be the location of the supplier.

Registration

26.68 One of the criteria to exemplify a transaction to be a supply under GST is that the supply should be made by a taxable person. Section 2 (107) of the CGST provides that taxable person means a person who is registered or liable to be registered under section 22 or section 24. Therefore,

understanding provisions pertaining to registration under GST is indispensable.

26.69 During the pre-GST regime, the services provided by the banks were liable to service tax, which was a central tax only. Therefore, in spite of banks having their branches spread in multiple states, they had an option to have a centralised registration, payment and compliance. Accordingly, most of the banks opted for centralised registration and its compliance activities were managed at this centralised registration centre.

26.70 Unlike the concept of centralized registration available under erstwhile service tax, under GST every supplier effecting taxable supplies, subject to a threshold limit is liable for registration and hence the concept of Centralized registration does not exist here.

26.71 In terms of section 22 of the CGST Act, every supplier shall be liable to be registered under this Act in the State or Union territory, other than special category States [as specified in sub-clause (g) of clause (4) of Article 279A of the Constitution], from where he makes a taxable supply of goods or services or both, if his aggregate turnover in a financial year exceeds Rs. 20 lakh and in case of special category state wherein the registration limit is Rs. 10 lakhs. It is important to note that registration is required 'in' the State 'from which' taxable supplies are made. Registration is not required 'in' the State 'to' which taxable supplies are made, even though this is a destination-based tax.

26.72 Explanation to Section 22 defines 'Special Category States' as the States specified in sub-clause (g) of clause (4) of Article 279A of the Constitution except Jammu & Kashmir.²⁶ Following are the list of States provided in Article 279A(4)(g) of the Constitution:

"Arunachal Pradesh, Assam, Jammu & Kashmir, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, Tripura, Himachal Pradesh, Uttarakhand".

Further, *w.e.f. 1-02-2019 vide CGST, (Amendment) Act, 2018 read with Notification No.2/2019 dated 29.01.2019*, the States of Arunachal Pradesh, Assam, Meghalaya, Sikkim, Himachal Pradesh, and Uttarakhand have been excluded from the definition of Special category States for the purpose of Section 22 of GST Act, 2017.

Therefore, now for all States excepting the States of Manipur, Mizoram, Nagaland and Tripura, threshold limit for registration is Rs.20 lakhs.

Moreover, *w.e.f. 1-02-2019 vide the CGST, (Amendment) Act, 2018*, the Second Proviso to Section 22(1) has been inserted to provide that

²⁶ Inserted vide CGST (Extension to Jammu and Kashmir) Act, 2017 w.e.f.8-07-2017.

Government may, at the request of a special category State and on the recommendations of the Council, enhance the aggregate turnover referred to in the first proviso from ₹ 10 lakhs to such amount, not exceeding ₹ 20 lakhs and subject to such conditions and limitations, as may be so notified.

26.73 It needs to be noted that the proviso to section 22(1) appearing in the CGST Act also appears in the SGST Act(s). As a result, for a taxable person in a non-Special Category State, who has a branch in Special Category State, the threshold becomes Rs. 10 lacs and not Rs. 20 lacs.

26.74 Besides the above, with effect from 1st April 2019, the Central Government vide Notification No. 10/2019-Central Tax dated 7th March 2019 has granted exemption to persons engaged exclusively in the supply of goods and whose aggregate turnover in the financial year does not exceed Rs 40 lakh from obtaining registration except persons making intrastate supplies in the States of Arunachal Pradesh, Manipur, Meghalaya, Mizoram, Nagaland, Puducherry, Sikkim, Telangana, Tripura and Uttarakhand.

26.75 From above it is important to understand the term aggregate turnover which means the aggregate value of all taxable supplies, exempt supplies, export of goods or services or both and inter-State supplies of persons having the same PAN, to be computed on all India basis and excludes CGST/SGST, IGST, UTGST and cess.

26.76 Aggregate turnover does not include the value of inward supplies on which tax is payable on reverse charge basis.

26.77 For calculating the threshold limit, as per Explanation to section 22 of the CGST Act, the turnover shall include all supplies made by the taxable person, whether on his own account or made on behalf of all his principals. Further, supply of goods by a registered job worker, after completion of job work, shall be treated as the supply of goods by the "principal" referred to in section 143 (i.e. Job work procedure) of this Act. The value of such goods shall not be included in the aggregate turnover of the registered job worker.

26.78 Now, it is important to mention that section 23 provides relaxation from the requirement of obtaining registration to the following two categories of persons -

- Agriculturist.
- Persons engaged exclusively in the supply of exempted goods or services or both.

The Government on the recommendation of the council, by notification may specify the category of persons who may be exempted from obtaining registration under this Act.

26.79 The term exclusive indicates engaging in only those supplies which are exempt. Therefore, if a supplier is supplying both exempt and non-exempt goods and/or services, then this provision is not applicable, and he is required to obtain registration under section 22 and aggregate turnover will include both taxable as well as well exempted supplies.

26.80 A person whose 'entire' supply consists of 'exempt supplies', is excluded from obtaining registration in terms of section 23 of the CGST Act.

Compulsory Registration Under GST

26.81 Notwithstanding anything contained under section 22 (1) , Section 24 of the CGST Act provides the categories of persons who shall be required to be registered under this Act irrespective of the threshold. The following categories of persons are required to obtain registration compulsorily under this Act:

- (i) Persons making any inter-State taxable supply

Exception: vide Notification 10/ 2017–Integrated Tax, dated 13.10.2017, persons making inter State supply of services and having turnover not exceeding Rs. 20 lakhs have been exempt u/s. 23 from obtaining registration. Accordingly, only persons who make inter-State supply of goods have to compulsorily obtain registration and not eligible to claim the benefit of notification no. 10/2017-Integrated Tax dated 13.10.2017.

However, the aggregate value of supply of services should not exceed Rs. 10 lakhs in respect of Special Category States except the States of Jammu and Kashmir, Arunachal Pradesh, Assam, Himachal Pradesh, Meghalaya, Sikkim and Uttarakhand.

- (ii) casual taxable persons making taxable supply.
- (iii) persons who are required to pay tax under reverse charge.
- (iv) person who are required to pay tax under section 9(5).
- (v) non-resident taxable persons making taxable supply.
- (vi) persons who are required to deduct tax under section 51.
- (vii) persons who make taxable supply goods or services or both on behalf of other taxable persons whether as an agent or otherwise.
- (viii) input service distributor.
- (ix) persons who supply goods or services or both, other than supplies specified under section 9(5), through such electronic commerce operator who is required to collect tax at source under section 52.

- (x) every electronic commerce operator who is required to collect tax at source under section 52.
- (xi) every person supplying online information and database access or retrieval services from a place outside India to a person in India, other than a registered person.
- (xii) such other person or class of persons as may be notified by the Government on the recommendations of the Council.

Note: Out of the twelve categories of person who need to take registration compulsorily, two categories of person are most relevant to the banking sector i.e person who is required to pay tax under reverse charge [listed at (iii) above] and Input service distributors [listed at (vii) above].

Effective date of Registration

26.82 Where the application for registration has been submitted within thirty days from the date on which the person becomes liable to registration, the effective date of registration shall be date on which he become liable for registration.

26.83 Where an application for registration has been submitted by the applicant after thirty days from the date of his becoming liable to registration, the effective date of registration shall be the date of grant of registration.

26.84 In case of registration pursuant to any survey, enquiry, inspection, search or any other proceedings, the effective date shall be the date of order of registration.

26.85 Section 25 read with Rules 8 to 26 of the CGST Rules, 2017 related to registration provides a detailed road map on the procedural aspects of the registration. The time limit for application is 30 days (for persons other than casual taxable person or a non-resident taxable person) and casual taxable person or a non-resident taxable person shall have to obtain the registration at least 5 days prior to the commencement.

GST applicability on receipt of services under RCM

26.86 Generally, the obligation to discharge GST lies on the supplier. But there exist certain cases in which reverse charge is applicable and hence the duty to discharge tax is cast on the recipient of supply. Even various expenses incurred by the banks are exigible to tax under on Reverse Charge Mechanism ("**RCM**"). No partial reverse charge will be applicable under GST. 100 per cent tax will be paid by the recipient if reverse charge mechanism applies.

26.87 All taxpayers required to pay tax under reverse charge have to

mandatorily obtain registration and the threshold exemption is not applicable on them. Payment of taxes under Reverse Charge cannot be made with utilisation of Input Tax Credit and has to be made in cash.

26.88 Section 9(3) of CGST/ Section 5(3) of the IGST Act specify the categories of supply of goods or services or both as notified by Government on recommendations of the Council on which RCM is applicable. In this regard, the Govt. vide Notification No. 13/2017- Central Tax (Rate) dated 28.06.2017 ("Notification 13/2017") / Notification No. 10/2017- Integrated Tax (Rate) dated 28.06.2017 ("Notification 10/2017-ITR") as amended from time to time specify the category of services on which RCM is applicable

26.89 The list of such services mentioned in Notification 13/2017 are as under:

Sl. No.	Category of Supply of Services	Supplier of service	Recipient of Service
(1)	(2)	(3)	(4)
1	Supply of services by a goods transport agency (GTA), [who has not paid central tax at the rate of 6%,] ²⁷ in respect of transportation of goods by road to- (a) any factory registered under or governed by the Factories Act, 1948(63 of 1948);or (b) any society registered under the Societies Registration Act, 1860 (21 of 1860) or under any other law for the time being in force in any part of India; or (c) any co-operative society established by or under any law; or	Goods Transport Agency (GTA)	(a) Any factory registered under or governed by the Factories Act, 1948 (63 of 1948); or (b) any society registered under the Societies Registration Act, 1860 (21 of 1860) or under any other law for the time being in force in any part of India; or (c) any co-operative society established by or under any law; or (d) any person registered under the

²⁷ Inserted vide Notification No. 22/2017 – Central Tax (Rate) dt. 22.08.2017

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	<p>(d) any person registered under the CGST Act or the IGST Act or the SGST Act or the UTGST Act; or</p> <p>(e) any body corporate established, by or under any law; or</p> <p>(f) any partnership firm whether registered or not under any law including association of persons; or</p> <p>(g) any casual taxable person.</p> <p>[Provided that nothing contained in this entry shall apply to services provided by a goods transport agency, by way of transport of goods in a goods carriage by road, to, -</p> <p>(a) a Department or establishment of the Central Government or State Government or Union territory; or</p> <p>(b) local authority; or</p> <p>(c) Governmental agencies, which has taken registration under the CGST Act, 2017 (12 of 2017) only for the purpose of deducting tax under section 51 and not for making a taxable supply of goods or services.]²⁸</p>		<p>CGST Act or the IGST Act or the SGST Act or the UTGST Act; or</p> <p>(e) any body corporate established, by or under any law; or</p> <p>(f) any partnership firm whether registered or not under any law including association of persons; or</p> <p>(g) any casual taxable person; located in the taxable territory.</p>
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²⁸ Inserted vide Notification No. 29/2018 – Central Tax (Rate) dt. 31.12.2018.

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2	<p>[Services provided by an individual advocate including a senior advocate or firm of advocates by way of legal services, directly or indirectly.</p> <p><i>Explanation.- "legal service" means any service provided in relation to advice, consultancy or assistance in any branch of law, in any manner and includes representational services before any court, tribunal or authority.]²⁹</i></p>	An individual advocate including a senior advocate firm	Any business entity located in the taxable territory.
3	Services supplied by an arbitral tribunal to a business entity.	An arbitral tribunal.	Any business entity located in the taxable territory.
4	Services provided by way of sponsorship to any body corporate or partnership firm.	Any person	Any body corporate or partnership firm located in the taxable territory.
5	<p>Services supplied by the Central Government, State Government, Union territory or local authority to a business entity excluding, -</p> <p>(1) renting of immovable property, and</p> <p>(2) services specified below-</p> <p>(i) services by the Department of Posts by</p>	Central Government, State Government, Union territory or local authority	Any business entity located in the taxable territory.

²⁹ Substituted vide corrigendum to Notification No. 13/2017-Central Tax (Rate), dt. 25.09.2017. Prior to substitution it read: "Services supplied by an individual advocate including a senior advocate by way of representational services before any court, tribunal or authority, directly or indirectly, to any business entity located in the taxable territory, including where contract for provision of such service has been entered through another advocate or a firm of advocates, or by a firm of advocates, by way of legal services, to a business entity."

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	<p>way of speed post, express parcel post, life insurance, and agency services provided to a person other than Central Government, State Government or Union territory or local authority;</p> <p>(ii) services in relation to an aircraft or a vessel, inside or outside the precincts of a port or an airport;</p> <p>(iii) transport of goods or passengers.</p>		
5A	Services supplied by the Central Government, State Government, Union territory or local authority by way of renting of immovable property to a person registered under the Central Goods and Services Tax Act, 2017 (12 of 2017).	Central Government, State Government, Union territory or local authority	Any person registered under the Central Goods and Services Tax Act, 2017. ³⁰
5B	Services supplied by any person by way of transfer of development rights or Floor Space Index (FSI) (including additional FSI) for construction of a project by a promoter.	Any person	Promoter ³¹
5C	Long term lease of land (30 years or more) by any	Any person	Promoter ³²

³⁰ Inserted vide Notification No. 3/2018 – Central Tax (Rate) dt. 25.01.2018

³¹ Inserted vide Notification No. 5/2019 – Central Tax (Rate) dt. 29.03.2019.

³² Inserted vide Notification No. 5/2019 – Central Tax (Rate) dt. 29.03.2019.

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	person against consideration in the form of upfront amount (called as premium, salami, cost, price, development charges or by any other name) and/or periodic rent for construction of a project by a promoter.		
6	Services supplied by a director of a company or a body corporate to the said company or the body corporate.	A director of a company or a body corporate	The company or a body corporate located in the taxable territory.
7	Services supplied by an insurance agent to any person carrying on insurance business.	An insurance agent	Any person carrying on insurance business, located in the taxable territory.
8	Services supplied by a recovery agent to a banking company or a financial institution or a non-banking financial company.	A recovery agent	A banking company or a financial institution or a non-banking financial company, located in the taxable territory.
³³ (9)	Supply of services by a music composer, photographer, artist or the like by way of transfer or permitting the use or enjoyment of a copyright covered under clause (a) of sub-section (1) of section 13 of the Copyright Act, 1957 relating to original dramatic, musical or artistic works to a music company, producer or the like.	Music composer, photographer, artist, or the like	Music company, producer or the like, located in the taxable territory.

³³ Substituted vide Notification No. 22/2019-Central Tax (Rate) dated 30.09.2019 effective from 1.10.2019.

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9	Supply of services by an author, music composer, photographer, artist or the like by way of transfer or permitting the use or enjoyment of a copyright covered under clause (a) of sub-section (1) of section 13 of the Copyright Act, 1957 relating to original literary, dramatic, musical or artistic works to a publisher, music company, producer or the like.	Author or music composer, photographer, artist, or the like	Publisher, music company, producer or the like, located in the taxable territory.)
³⁴ [9A]	Supply of services by an author by way of transfer or permitting the use or enjoyment of a copyright covered under clause (a) of sub-section (1) of section 13 of the Copyright Act, 1957 relating to original literary works to a publisher.	Author	Publisher located in the taxable territory: Provided that nothing contained in this entry shall apply where,- (i) the author has taken registration under the Central Goods and Services Tax Act, 2017 (12 of 2017), and filed a declaration, in the form at Annexure I, within the time limit prescribed therein, with the jurisdictional CGST or SGST Commissioner, as the case may be, that he exercises the option to pay central tax on the

³⁴ Inserted vide Notification No. 22/2019- Central Tax (Rate) dated 30.09.2019 effective from 1.10.2019.

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			<p>service specified in column (2), under forward charge in accordance with Section 9 (1) of the Central Goods and Service Tax Act, 2017 under forward charge, and to comply with all the provisions of Central Goods and Service Tax Act, 2017 (12 of 2017) as they apply to a person liable for paying the tax in relation to the supply of any goods or services or both and that he shall not withdraw the said option within a period of 1 year from the date of exercising such option;</p> <p>(ii) the author makes a declaration, as prescribed in Annexure II on the invoice issued by him in Form GST Inv-I to the publisher.]</p>
10	Supply of services by the members of Overseeing	Members of Overseeing	Reserve Bank of India.] ³⁵

³⁵ Inserted vide Notification No. 33/2017 – Central Tax (Rate) dt 13.10.2017

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	Committee to Reserve Bank of India	Committee constituted by the Reserve Bank of India	
11	Services supplied by individual Direct Selling Agents (DSAs) other than a body corporate, partnership or limited liability partnership firm to bank or non-banking financial company (NBFCs).	Individual Direct Selling Agents (DSAs) other than a body corporate, partnership or limited liability partnership firm.	A banking company or a non- banking financial company, located in the taxable territory. ³⁶
12	Services provided by business facilitator (BF) to a banking company	Business facilitator (BF)	A banking company, located in the taxable territory. ³⁷
13	Services provided by an agent of business correspondent (BC) to business correspondent (BC).	An agent of business correspondent (BC)	A business correspondent, located in the taxable territory. ³⁸
14	Security services (services provided by way of supply of security personnel) provided to a registered person: Provided that nothing contained in this entry shall apply to, - (i)(a) a Department or Establishment of the Central Government or State Government or Union	Any person other than a body corporate	A registered person, located in the taxable territory. ³⁹

³⁶ Inserted vide Notification No. 15/2018 – Central Tax (Rate) dt 26.07.2018.

³⁷ Inserted vide notification No. 29/2018 – Central Tax (Rate) dt 31.12.2018.

³⁸ Inserted vide notification No. 29/2018 – Central Tax (Rate) dt 31.12.2018.

³⁹ Inserted vide notification No. 29/2018 – Central Tax (Rate) dt 31.12.2018.

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	territory; or (b) local authority; or (c) Governmental agencies; which has taken registration under the Central Goods and Services Tax Act, 2017 (12 of 2017) only for the purpose of deducting tax under section 51 of the said Act and not for making a taxable supply of goods or services; or (ii) a registered person paying tax under section 10 of the said Act.		
⁴⁰ 15	Services provided by way of renting of any motor vehicle designed to carry passengers where the cost of fuel is included in the consideration charged from the service recipient, provided to a body corporate	Any person, other than a body corporate who supplies the service to a body corporate and does not issue an invoice charging central tax at the rate of 6 per cent to the service recipient	Any body corporate located in the taxable territory.

⁴⁰ Substituted vide Notification No. 29/2019- Central Tax (Rate) dt. 31.12.2019. Prior to this substitution it was read as below which was inserted vide Notification No. 22/2019- Central Tax (Rate) dated 30.09.2019 effective from 1.10.2019.

15.	Services provided by way of renting of a motor vehicle provided to a body corporate	Any person other than a body corporate, paying central tax at the rate of 2.5% on renting of motor vehicles with input tax credit only of input service in the same line of business	Any body corporate located in the taxable territory
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⁴¹ 16	Services of lending of securities under Securities Lending Scheme, 1997 ("Scheme") of Securities and Exchange Board of India ("SEBI"), as amended.	Lender i.e. a person who deposits the securities registered in his name or in the name of any other person duly authorised on his behalf with an approved intermediary for the purpose of lending under the Scheme of SEBI	Borrower i.e. a person who borrows the securities under the Scheme through an approved intermediary of SEBI.
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In addition to the above list given under Central Tax- Rate, following additional category of supply of services is listed under **Notification 10/2017-ITR** on which GST shall be paid by the recipient on reverse charge basis:

Sl. No.	Category of Supply of Services	Supplier of service	Recipient of Service
(1)	(2)	(3)	(4)
1	Any service supplied by any person who is located in a non-taxable territory to any person other than non-taxable online recipient	Any person located in a non-taxable territory	Any person located in the taxable territory other than non-taxable online recipient.
2	Services supplied by a person located in non-taxable territory by way of transportation of goods by a vessel from a place outside India up to the customs station of clearance in India	A person located in non-taxable territory	Importer, as defined in clause (26) of section 2 of the Customs Act, 1962(52 of 1962), located in the taxable territory.

⁴¹ Inserted vide Notification No. 22/2019- Central Tax (Rate) dt. 30.09.2019 effective from 1.10.2019.

RCM as per section 9(4) of the CGST Act or section 5(4) of the IGST Act

26.90 Pursuant to section 9(4) of the CGST Act or section 5(4) of the IGST Act, supply of taxable goods or services or both by an unregistered supplier to a registered person was exigible to CGST/IGST under RCM.

26.91 Thereafter, *vide* Notification No.8/2017-Central Tax (Rate) dated 28.06.2017, intra-State supply of taxable goods or services or both by an unregistered supplier to a registered person were exempt from CGST provided the aggregate value of such supplies of goods and/or services received by a registered person from any or all the unregistered suppliers did not exceed Rs. 5,000 in a day. However, no such parallel notification was issued under IGST for inter State supplies.

26.92 Subsequently, the aforesaid limit was withdrawn *vide* Notification no. 38/2017- Central Tax (Rate) dated 13.10.2017 and hence, intra-State supply of taxable goods or services or both by an unregistered supplier to a registered person was exempted till 31.03.2018.

26.93 Moreover, *vide* Notification No. 32/2017 – Integrated Tax (Rate) dated 13.10.2017, the Central Government exempted inter-State supply of goods or services or both received by a registered person from any unregistered supplier, from IGST leviable under section 5(4) of IGST Act till 31.03.2018.

26.94 Later, this provision of reverse charge was deferred till 30.09.2019. Then, in view of bringing into effect the amendments (regarding RCM on supplies by unregistered persons) in the GST Acts, reverse charge exemption Notification No. 8/2017-Central Tax (Rate) dated 28.06.2017 and Notification No. 32/2017 – Integrated Tax (Rate) dated 13.10.2017 have been rescinded with effect from 1.02.2019 *vide* Notification No 01/2019-Central/ Integrated Tax (Rate), dated 29-01-2019.

26.95 Further, with effect from 1st February 2019, the Central/Integrated Goods and Services Tax (Amendment) Act, 2018 has substituted section 9(4) of the CGST Act/ 5(4) of the IGST Act, as under:

“(4) The Government may, on the recommendations of the Council, by notification, specify a class of registered persons who shall, in respect of supply of specified categories of goods or services or both received from an unregistered supplier, pay the tax on reverse charge basis as the recipient of such supply of goods or services or both, and all the provisions of this Act shall apply to such recipient as if he is the person liable for paying the tax in relation to such supply of goods or services or both.”

Hence, reverse charge on inward supply of goods and / or services effected

by a registered person from an unregistered supplier is applicable only in respect of (a) notified 'class of registered persons' and (b) notified 'categories of goods or services'.

26.96 Some of the services which are relevant with respect to the banking sector are explained in details in the following paragraphs:

- **Services provided by recovery agent** -Generally, loans are the areas wherein the banks earn major portion of their income. It is the most organized form of extending credit to customers and interest is earned as an income in respect of such credits extended. Majority of banks spend great time and effort in recovering credits so granted.

Further, many banks sell their loans to third parties or hire third party agents to initiate recovery on their behalf.

Loans sold to factoring agents are not liable for payment of GST. The Auditor should examine to ensure that these transactions would be 'exempt supply' depending on whether these are with or without recourse.

Another type of transaction is where third parties are hired to initiate recovery on behalf of the banks which is purely a service transaction and liable to payment of GST. Further, RCM is applicable on such transactions and therefore the banks which hire such third-party agents are liable for payment of GST on the fees so paid to these recovery agents/third party agents. Banks also provide infrastructure, phone facilities and such other benefits to these third-party agents in order to perform their services. Even such value is required to be taken into consideration while determining the value of supply for the purpose of payment of GST.

An auditor, should check the agreements between the bank and the recovery agent. Under GST regime, the bank should raise a self-invoice and thereafter appropriate GST @18 per cent should be paid on the same. The income so earned should be disclosed in the relevant chapter heading as classified under the GST regime.

- **Services provided by insurance agent**- If the banks are also engaged in business of insurance, then the services provided by such insurance agent who sell insurance products of the banks is liable for payment of GST. Further, the amount on which tax is payable is commission so paid to the insurance agent. Such commission also includes reimbursement by any mode.

The insurance division of the banks so receiving the services from those insurance agents are liable for payment of GST under RCM.

An Auditor, should check the agreements between the bank and the insurance agent. Under GST regime, the bank should raise a self-invoice and thereafter appropriate GST @ 18 per cent should be paid on the same. The income so earned should be disclosed in the relevant chapter heading as classified under the GST regime.

- **Services provided by goods transport agency service** - W.e.f. July 1, 2017 *vide Entry No.1 of Notification 13*, if any services in respect of transportation of goods by road are provided by goods transport agency (GTA) to the following recipients located in the taxable territory, then the recipient of service is liable to pay tax under reverse charge:

- (a) Any factory registered under or governed by the Factories Act, 1948 (63 of 1948); or
- (b) any society registered under the Societies Registration Act, 1860 (21 of 1860) or under any other law for the time being in force in any part of India; or
- (c) any co-operative society established by or under any law; or
- (d) any person registered under the CGST Act or the IGST Act or the SGST Act or the UTGST Act; or
- (e) any body corporate established, by or under any law; or
- (f) any partnership firm whether registered or not under any law including association of persons; or
- (g) any casual taxable person.

However, w.e.f. from 22nd August 22, 2017 *vide Notification No. 22/2017* dated 22.08.2017 which amended Notification 13/2017, the GTA was given an option to pay to GST @ 5 per cent (2.5 CGST+2.5 SGST/ 5 per cent IGST) if no input tax credit is availed subject to RCM. Further, if GTA has been availed ITC/ GST is to be paid by the GTA @12 per cent.

Further, w.e.f. 1st January, 2019 *vide Notification No. 29/2018-Central Tax (Rate)*, dated 31-12-2018, nothing contained in this entry shall apply to services provided by a GTA, by way of transport of goods in a goods carriage by road, to, -

- (a) a Department or establishment of the Central Government or State Government or Union territory; or
- (b) local authority; or

(c) Governmental agencies;

which has taken registration under the CGST, 2017 (only for the purpose of deducting tax under section 51 and not for making a taxable supply of goods or services.

Therefore, the Auditor has to check that correct ITC is taken, and appropriate person has discharged the tax. Carriage of Goods by Road Act, 2007 mandates that no motor vehicle undertakes transport of goods by road except with a proper registration of such motor vehicle. Every consignment must be accompanied by a forward note or receiving note. Merely because goods are not of substantial value or not involving supply or involving inter-branch movement, it is not appropriate to avoid issuing such a 'note'. When such 'note' is issued, the transporter will be a GTA. Under the GST notification, GTA is one who issues a consignment note '*by whatever name called*'.

- **Services provided by advocates:** W.e.f. 1st July , 2017 In terms of entry no. 2 of Notification 13/2017, RCM was applicable on services supplied by an individual advocate including a senior advocate by way of representational services before any court, tribunal or authority, directly or indirectly, to any business entity located in the taxable territory, including where contract for provision of such service has been entered through another advocate or a firm of advocates, or by a firm of advocates, by way of legal services, to a business entity.

Thereafter a Corrigendum to Notification No. 13/2017 was issued [M.F. (D.R.) Corrigendum F. No. 336/20/2017-TRU, dated 25-9-2017], and RCM was made applicable on services provided by an individual advocate including a senior advocate or firm of advocates by way of legal services, directly or indirectly.

"Legal service" means any service provided in relation to advice, consultancy or assistance in any branch of law, in any manner and includes representational services before any court, tribunal or authority.

Very often, legal services are availed by banks 'on account of' their customers. Here, Auditors should ensure that banks do not withhold themselves from payment of RCM on legal fee paid on the premise that these services are availed 'on account of' their customers, especially when the legal fee is debited to customer's account. It is more appropriate that banks discharge RCM as fee from advocate will be issued to bank. Very often, it is observed that where expenses are

incurred but debited to customer's account, RCM liability thereon, is somehow omitted. Customer's being unaware of the various components of costs that are embedded in the amounts debited to the account, RCM liability cannot possibly be discharged by them. Hence, banks may be advised to suitably ensure RCM is complied with.

- **Service provided by way of import of services:** Many banks do spend a lot of funds on procuring services from abroad. Where the supply of goods or services or both are taxable in nature, GST is payable by the recipient bank. Some important areas are summarized as under:

1. **Bond floating expenditure:** Generally, bond floating expenditure is an expenditure which though appropriately recorded in the books of accounts, skips the attention and the applicable taxes are not discharged often in respect of the same. Therefore, the concerned Auditor should thoroughly inspect the books of accounts and identify all payments in foreign currency for compliance with these provisions.

For e.g.: IVY Bank wants to issue bonds in NYSE and for the said purpose has appointed WYE bank a leading bank of America for floating the said bonds and acting as a lead merchant banker. The fee for the same is generally a fixed per centage of the ticket size which is recorded appropriately in the books of accounts. The instant transaction is taxable in terms of Section 13 (2) of the IGST Act, 2017.

Under the GST regime, the same requires a thorough analysis of the transaction, these are generally taxable as per Section 13 of the IGST Act, 2017. However, the answer may vary depending upon the structuring of the transaction.

2. **Underwriting charges:** If underwriting charges are paid in foreign currency to an underwriter who is located outside India, then GST is payable on such transactions. Appropriate ledgers, contracts etc., should be scrutinised in great detail and thereafter relevant disclosures should be made regarding taxability on the same.
3. **I.T infrastructure cost:** It is a common cost which the banks bear on all-India basis and execute one common contract for the same if the vendor is based outside India or the technicians are outside India and payment is being disbursed in foreign currency. Though, such cost requires careful apportionment in terms of appropriate provisions including rules and depending upon the nature of the

transaction appropriate GST (generally @ 18 per cent) is payable. Further, credit for GST so paid is available.

NOTE-It is pertinent to mention here that, certain services exigible to service tax under RCM have been discontinued under GST like rent-a-cab, Manpower Supply, Security services, works contract service etc.

Input Tax Credit

26.97 Under the GST regime, a banking company or a financial institution including a non-banking financial company engaged in supplying services by way of accepting deposits, extending loans or advances shall have the following two options to avail Input tax credit in terms of Section 17(4) of the CGST Act 2017. And the option once exercised shall not be withdrawn during the remaining part of the financial year.

Option I

Reverse the credit pertaining to exempted services as per the method stated in Section 17(2) of the CGST Act, 2017 read with the relevant State Act and Rules thereof.

Option II

Avail 50 per cent of the eligible input tax credit on inputs, capital goods and input services in that month and the rest shall lapse. Accordingly the following procedure be adopted in accordance with Rule 38 of the CGST Rules, 2017:

1. Such banking company or financial institution shall not avail credit of:
 - the tax paid on inputs and input services that are used for non-business purposes; and
 - the credit attributable to the supplies specified in Section 17(5), in **FORM GSTR-2**.
2. Further, the condition of 50 per cent restriction would not be applicable in case of the tax paid on supplies made by one registered person to another registered person having the same PAN. Hence, a banking company or financial institution shall avail the credit of tax paid on inputs and input services in case of supplies made to its own branches i.e. inter branch i.e., by one registered person to another registered person having different GSTIN.

Avail full credit on inter-branch supply of services between distinct persons of the banking or NBFC company. In other words, if HO has restricted the credit to 50 per cent and those goods or services are

involved in inter-branch taxable supplies, the receiving branch is NOT required to further apply the 50 per cent restriction. This relief is provided in second proviso to section 17(4).

3. 50 per cent of the remaining amount of input tax shall be admissible and shall be furnished in **FORM GSTR-2**.
4. The amount referred to in point 2. and 3 above shall subject to the provisions of Sections 41, 42 and 43, be credited to the electronic credit ledger of the said banking company or financial institution.

NOTE- The non-applicability of 50 per cent reversal is only to the extent of inter-branch services between registered branches having the same PAN in India. Thus, tax paid on services received from a related person / distinct person located outside India would be liable to 50 per cent reversal.

Apportionment of credit

26.98 Section 17 (2) of the CGST Act stipulates that, where the goods or services or both are used by the registered person partly for effecting taxable supplies including zero-rated supplies under this Act or under the IGST Act and partly for effecting exempt supplies under the said Acts, the amount of credit shall be restricted to so much of the input tax as is attributable to the said taxable supplies including zero-rated supplies.

26.99 Credit attributable to exempt supplies is not available to a registered person. Exempt for this purpose means all supplies other than taxable and zero-rated supplies and specifically include the following:

- Supplies liable to tax under reverse charge mechanism
- Transactions in securities
- Sale of land
- Subject to Para 5(b) of Schedule II, sale of building.

26.100 Moreover, *vide CGST Amendment Act, 2018 w.e.f 1-02-2019*, the "value of exempt supply" shall not include the value of activities or transactions specified in Schedule III, except those specified in paragraph 5 of the said Schedule i.e., Sale of Land (S-III) / building (S-II).

26.101 Rule 42 of the CGST Rules, 2017: Manner of determination of ITC in respect of inputs or input services and reversal thereof *via* illustration:

Sl. No	Particulars	Reference	CGST	SGST/UTGST	IGST

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1	Total input tax on inputs and input services for the tax period May 2018	T	1,00,000	1,00,000	50,000
	Out of the total input tax (T):				
2	Input tax used exclusively for non-business purposes (Note 1)	T1	10,000	10,000	5,000
3	Input tax used exclusively for effecting exempt supplies (Note 1)	T2	10,000	10,000	5,000
4	Input tax ineligible under Section 17(5) (Note 1)	T3	5,000	5,000	2,500
	Total		25,000	25,000	12,500
	ITC credited to Electronic Credit Ledger (Note 1)	$C1 = T - (T1 + T2 + T3)$	75,000	75,000	37,500
	Input tax credit used exclusively for taxable supplies (including zero-rated supplies) [Note 4]	T4	50,000	50,000	25,000
	Common credit	$C2 = C1 - T4$	25,000	25,000	12,500
	Aggregate value of exempt supplies for the tax period May 2018 (Note 2 & 3)	E	25,00,000	25,00,000	25,00,000
	Total Turnover of the registered person for the tax period May	F	1,00,00,000	1,00,00,000	1,00,00,000

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	2018 (Note 2)				
	Credit attributable to exempt supplies (Note 5)	$D1 = (E/F) * C2$	6,250	6,250	3,125
	Credit attributable to non-business purposes	$D2 = C2 * 5\%$	1,250	1,250	625
	Net eligible common credit [Note 6]	$C3 = C2 - (D1 + D2)$	17,500	17,500	8,750
	Total credit eligible (Exclusive Common) +	G = T4 + C3	67,500	67,500	33,750

Note 1: T1, T2, T3 and T4 shall be DETERMINED AS ABOVE and declared in Form GSTR-2 and at summary level in FORM GSTR-3B

Note 2: If the registered person does not have any turnover for May 2018, then the value of E and F shall be considered for the last tax period for which such details are available

Note 3: Aggregate value of exempt supplies and the total turnover shall exclude the amount of any duty or tax levied under entry 84 and entry 92A of List I of the Seventh Schedule to the Constitution and entry 51 and 54 of List II of the said Schedule.

Remarks: Please note in case of supply of services covered by clause (b) of paragraph 5 of Schedule II of the Act (in case of apartment construction project-promoter), the calculation of Note 4 and 5 will done differently. For detail Refer Rule 42 of the CGST Rules

Note 6: Amount of 'C3', 'D1' and 'D2' shall be computed separately for ITC of CGST, SGST, UTGST and IGST declared in FORM GSTR-3B or through FORM GST DRC-03.

And the amount equal to aggregate of 'D1' and 'D2' shall be reversed by registered person in FORM GSTR-3B or through FORM GST DRC-03.

Note 7: The registered person is expected to make such computation for each tax period and reverse the same in the periodic returns being filed by such registered person. However, on completion of the financial year, input tax credit shall be determined accurately based on actuals, in the same

manner as provided in Rule 42. A reconciliation is required to be done on an annual basis (between the amounts reversed for each tax period during the year and the amount determined at the end of the financial year) and any excess credit availed needs to be reversed with interest while short credit, if any, needs to be re-availed within 6 months from end of the financial year.

26.102 It is to be noted that the registered person would be required to remit excess ITC claimed (as determined in Note 7 above) with interest calculated at for the period starting from the first day of April of the succeeding financial year till the date of payment. However, no interest can be claimed if, at the end of the financial year, it is found that short credit was availed.

26.103 Therefore, an Auditor can check whether the concerned branch is reversing ITC in compliance to the above Rule. If ITC is not reversed in compliance to the above Rules, it shall be treated as ITC wrongly taken and the same will be recovered along with the interest under Section 50 of the CGST Act, 2017.

26.104 Note the following pre-requisites for availing credit by registered person pursuant to section 16(2) of the CGST Act:

- (a) He (Registered Person) is in possession of tax invoice or any other specified tax paying document.
- (b) He has received the goods or services. "Bill to ship to" scenarios also included.
- (c) Tax is actually paid by the supplier.
- (d) He has furnished the return.
- (e) If the inputs are received in lots, he will be eligible to avail the credit only when the last lot of the inputs is received.
- (f) He should pay the supplier the value of the goods or services along with the tax within 180 days from the date of issue of invoice, failing which the amount of credit availed by the recipient would be added to his output tax liability, with interest [rule 37(1) & (2) of CGST Rules, 2017]. However, once the amount is paid, the recipient will be entitled to avail the credit again. In case part payment has been made, proportionate credit would be allowed.

26.105 Beside the above, the value of supplies in respect of the following shall be deemed to have been paid and ITC shall not be reversed in such cases:

- Value of supplies made without consideration as per Schedule-I.
- Value of supplies on account of any amount added in accordance with section 15(2) (b), i.e. any amount that the supplier is liable to pay in relation

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to such supply but which has been incurred by the recipient of the supply and not included in the price actually paid or payable for the goods or services or both (Notification No. 26/2018-Central Tax, dated 13.06.2018).

- Value representing discount for which financial credit notes have been issued by the supplier.
- Note- Provisions of section 18(6) of the CGST Act, 2017 for reversal of input tax credit availed on capital goods would be applicable to banks only to the extent of the input tax credit availed by it.

Documents required for availing credit (Sec 36 of the CGST Act)

(a) Invoice issued by a supplier of goods or services or both as per Section 31	(b) Invoice issued as per Section 31(2)(f) by recipient along with proof of payment of tax	(c) A debit note issued by supplier under Section 34
(d) Bill of entry or similar document prescribed under Customs Act, 1962	(e) Revised invoice	(f) Document issued by Input Service Distributor

Restriction/ No ITC allowed to be availed

- Beyond September of the following FY to which invoice pertains or date of filing of annual return, whichever is earlier. However, due date of taking ITC for FY 17-18 was extended till 31st March, 2019.
- In terms of Section 36(4), ITC to be availed by a registered person in respect of invoices or debit notes, the details of which have not been uploaded by the suppliers under section 37(1), shall not exceed 10 per cent⁴² of the eligible credit available in respect of invoices or debit notes the details of which have been uploaded by the suppliers under section 37(1) of the CGST Act.

No ITC can be availed in terms of Section 17(5) of CGST Act, 2017

No ITC shall be available in respect of the following namely:

⁴² Substituted vide Notification No. 75/2019 - Central Tax dated 26-12-2019 w.e.f.1-01-2020. Prior to such substitution it was 20 % vide Notification No. 495/2019 - Central Tax dated dt. 09.10.2019 via which Section 36(4) was inserted.

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(a) motor vehicles for transportation of persons having approved seating capacity of not more than 13 persons (including the driver), except when they are used for making the following taxable supplies, namely: —

(A) further supply of such motor vehicles; or	(B) transportation of passengers; or	(C) imparting training on driving such motor vehicles;
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(aa) vessels and aircraft except when they are used—

(i) for making the following taxable supplies, namely	(ii) for transportation of goods
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A. further supply of such vessels or aircraft; or	B. transportation of passengers; or	C. imparting training on navigating such vessels; or	D. imparting training on flying such aircraft;
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(ab) services of general insurance, servicing, repair and maintenance in so far as they relate to motor vehicles, vessels or aircraft referred to in clause (a) or clause (aa):

However, ITC is available respect of such services	
(i) where the motor vehicles, vessels or aircraft referred to in clause (a) or clause (aa) are used for the purposes specified therein;	(ii) where received by a taxable person engaged – (I) in the manufacture of such motor vehicles, vessels or aircraft; or (II) in the supply of general insurance services in respect of such motor vehicles, vessels or aircraft insured by him;

(b) the following supply of goods or services or both—

(i) food and beverages, outdoor catering, beauty treatment, health services, cosmetic and plastic surgery, leasing, renting or hiring of motor vehicles, vessels or aircraft referred to in clause (a) or clause (aa) except when used for the purposes specified therein, life insurance	(ii) membership of a club, health and fitness centre; and	(iii) travel benefits extended to employees on vacation such as leave or home travel concession
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<i>and health insurance ###</i>		
<i>### Provided that the ITC shall be available where an inward supply of such goods or services or both is used by a registered person for making an outward taxable supply of the same category of goods or services or both or as an element of a taxable composite or mixed supply;</i>		

Note- The provisions have been amended so as to allow ITC in respect of goods or services or both specified above if it is made obligatory for an employer to provide such services under any law for the time being in force.

In all the above cases [section 17(5)(b)], the credit will be available if the goods or services are required to be provided by the employer through any obligation imposed under any law.

(c) *works contract services when supplied for construction of immovable property, (other than plant and machinery), except where it is an input service for further supply of works contract service;*

(d) *goods or services or both received by a taxable person for construction of an immovable property (other than plant and machinery) on his own account, including when such goods or services or both are used in the course or furtherance of business;*

Explanation. - For the purpose of clause (c) and (d), the expression "construction" includes re-construction, renovation, additions or alterations or repairs, to the extent of capitalization, to the said immovable property.

(e) *goods or services or both on which tax has been paid under section 10;*

(f) *goods or services or both received by a non-resident taxable person except on goods imported by him;*

(g) *goods or services or both used for personal consumption;*

(h) *goods lost, stolen, destroyed, written off or disposed of by way of gift or free samples; and*

(i) *any tax paid in accordance with the provisions of sections 74, 129 and 130. i.e., any tax paid due to short payment on account of fraud, suppression, mis-declaration, seizure, detention.*

Credit utilization

26.106 In terms of section 49 of the CGST Act, the amount of ITC available in the electronic credit ledger of the registered person on account of:

- IGST shall first be utilised towards payment of IGST and the amount remaining, if any, may be utilised towards the payment of CGST and

SGST/UTGST, in that order.

- CGST shall first be utilised towards payment of CGST and the amount remaining, if any, may be utilised towards the payment of IGST.
- SGST/UTGST shall first be utilised towards payment of SGST/UTGST and amount remaining, if any, may be utilised towards payment of IGST. However, w.e.f. 1-02-2019 *vide* the CGST (Amendment) Act, 2018, ITC on account of SGST/UTGST shall be utilised towards payment of IGST only where the balance of ITC on account of CGST is not available for payment of IGST.
- CGST shall not be utilised towards payment of SGST/ UTGST and vice versa respectively [section 49(5)(e) and (f)].

26.107 Subsequently, w.e.f. 1-02-2019, Sections 49A and 49B have been inserted *vide* the CGST Amendment Act 2018. Section 49A stipulates that notwithstanding anything contained in section 49, ITC on account of CGST, SGST/UTGST shall be utilised towards payment of IGST, CGST, SGST or UTGST as the case may be, only after the ITC available on account of IGST has first been utilised fully towards such payment.

26.108 Further, Section 49B of the CGST Act, 2017 provides that notwithstanding anything contained in ITC Chapter V of the CGST Act and subject to section 49(5)(e) and (f) of the CGST, the Government may, on the recommendations of the Council, prescribe the order and manner of utilisation of the ITC on account of IGST, CGST, SGST or UTGST, as the case may be, towards payment of any such tax.

26.109 In this regard, w.e.f. 29-03-2019 *vide Notification No. 16/2019 – Central Tax dated 29.03.2019*, Rule 88A of the CGST Rules has been inserted which provides the order of utilization of ITC as under:

*“Input tax credit on account of integrated tax shall first be utilised towards payment of integrated tax, and the amount remaining, if any, may be utilised towards the payment of central tax **and** State tax or Union territory tax, as the case may be, in any order:*

Provided that the input tax credit on account of central tax, State tax or Union territory tax shall be utilised towards payment of integrated tax, central tax, State tax or Union territory tax, as the case may be, only after the input tax credit available on account of integrated tax has first been utilised fully.”

Return Under GST – Banking Sector

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26.110 To avoid Interest and penalties, timely filling GST Return is of paramount importance. Every registered banking and/or financial institution including non-banking financial company is liable to file GSTR-3B, GSTR-1, GSTR-6, GSTR 9 and GSTR-9C.

FORM	PARTICULARS	DUE DATE	APPLICABLE TO
GSTR-3B	Monthly summary return	20 th of the next month	All registered persons (other than Input Service Distributor (ISD), person liable to deduct TDS and personally liable to collect tax at source).
GSTR-1	Outward Supplies > 1.5 Crore Outward Supplies < 1.5 Crore	11 th of the next month Last date of month subsequent to the quarter	Normal / Regular Taxpayer
GSTR-6	Monthly return by input service distributors	13 th of the next month	Input Service Distributor
GSTR-9	Annual return	31 st December of the next Financial Year For FY 18-19 last date was 31 st Dec, 2020 and for FY 19-20 last date has been extended up to 28 th February 2021.	Normal tax payer Voluntary Filing of GSTR – 9 in case of Turnover not exceeds 2 Cr in Previous FY)
GSTR-9C	Annual return along with the copy of audited annual accounts and a reconciliation statement	31 st December of the next Financial Year For FY 18-19 last date was 31 st Dec, 2020 and for FY 19-20 last date has been extended up to 28 th February 2021.	Normal tax payer having aggregate turnover of more than Rs. 2 crores (Now Limit is - Exceeding 5 Cr)

Obligation to furnish information return

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26.111 Any person, being a banking company within the meaning of section 45A(a) of the Reserve Bank of India Act, 1934, who is responsible for maintaining record of registration or statement of accounts or any periodic return or document containing details of payment of tax and other details of transaction of goods or services or both or transactions related to a bank account or consumption of electricity or transaction of purchase, sale or exchange of goods or property or right or interest in a property under any law for the time being in force, shall furnish an information return of the same in respect of such periods, within such time, in such form and manner and to such authority or agency as may be prescribed.[Section150(1)(e) of the CGST Act]

26.112 Furthermore, if the Commissioner, or an officer authorised by him in this behalf, considers that the information furnished in the information return is defective, he may intimate the defect to the person who has furnished such information return and give him an opportunity of rectifying the defect within 30 days from the date of such communication of information or within such further period. If the defect in the return is not rectified within the time prescribed, the information return should be treated as not submitted and penalty of Rs.100/- per day for each day during which the failure continues, would be payable subject to a maximum of Rs. 5,000 in terms of section 123 of the CGST Act.

26.113 Moreover, if no information return is filed, within the stipulated period, authority may serve a notice requiring him to furnish of such return within a period not exceeding 90 days from the date of service of the notice and such person shall furnish the information return.

Note:

Department in terms of Circular no.129/48/2019-GST dated 24th December 2019 follow Standard operating procedure in case return is not filed on time as:

Timeline	Action by Department
3 Days prior to Due Date i.e. on 17 th of any month	A system generated message would be sent to all the registered persons to remind them about filing of the return for the tax period by the due date.
After due date i.e. any day after 20 th of any month	A system generated mail / message would be sent to all the defaulters immediately after the due date to the effect that the said registered person has not furnished his return for the said tax period; the said mail/message is to be sent to the authorized signatory as well as the proprietor/ partner/director/ karta, etc.
Five days after due date i.e. 25 th of any	A notice in FORM GSTR-3A (under section 46 of the CGST Act read with rule 68 of the CGST Rules) shall

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month	be issued electronically to such registered person who fails to furnish return under section 39, requiring him to furnish such return within fifteen days.
15 days from 25 th of any month	<ol style="list-style-type: none"> 1. In case the said return is still not filed by the defaulter within 15 days of the said notice, the proper officer may proceed to assess the tax liability of the said person (under section 62) of the CGST Act, to the best of his judgement taking into account all the relevant material which is available or which he has gathered and would issue order (under rule 100) of the CGST Rules in FORM GST ASMT-13. 2. The proper officer would then be required to upload the summary thereof in FORM GST DRC- 07. 3. For the purpose of assessment of tax liability under section 62 of the CGST Act, the proper officer may take into account the details of outward supplies available in the statement furnished (under section 37 (FORM GSTR-1)), details of supplies auto-populated in FORM GSTR-2A, information available from e-way bills, or any other information available from any other source, including from inspection (under section 71). 4. In deserving cases [Not specified] , based on the facts of the case, the Commissioner may resort to provisional attachment to protect revenue (under section 83 of the CGST Act) before issuance of FORM GST ASMT-13.
30 days after service of assessment order	<p>In case the defaulter furnishes a valid return within 30 days of the service of assessment order in FORM GST ASMT13, the said assessment order shall be deemed to have been withdrawn (in terms of section 62(2) of the CGST Act).</p> <p>However, if the said return remains unfurnished within the statutory period of 30 days from issuance of order in FORM ASMT-13, then proper officer may initiate recovery proceedings (under section 78) and</p>

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	recovery of Tax (under section 79) of the CGST Act
Any time after above 30 days	The proper officer would initiate action for cancellation of registration (under section 29(2) of the CGST Act) in cases where the return has not been furnished for the period specified in section 29

Input Service Distributor

26.114 Input Service Distributor (ISD) is an office of the supplier of goods or services or both where a document (like invoice) of services attributable to other locations are received (since they might be registered separately). Since the services relate to other locations the corresponding credit should be transferred to such locations (having separate registrations) as services are supplied from there. Please note ISD cannot be an office that does any supply of its own but must be one that merely collects invoice for services and issues prescribed document for its distribution.

26.115 ISD cannot normally be used in a situation where there is a liability to pay GST. It can only receive input tax credits on invoices related to input services and distribute such credits in the manner discussed below. An ISD cannot discharge tax liability under reverse charge. This would require obtaining another registration as a regular registered person and discharge RCM liability.

26.116 Section 20 read with Rule 39 of the CGST Act deals with the manner and procedure of distribution of credit by ISD. ISD shall distribute the credit of CGST as CGST or IGST and IGST as IGST or CGST, by way of issue of a document containing, the amount of ITC credit being distributed in such manner as may be prescribed and subject to certain conditions. ISD may distribute the credit available for distribution in the same month in which it is availed. As per Rule 39(1)(e) and (f) of the said rules, ISD shall distribute:

- ITC on account of CGST and SGST or UTGST
 - in respect of recipient located in the same state shall be distributed as CGST and SGST or UTGST respectively.
 - in respect of a recipient located in a State or Union territory other than that of the ISD, be distributed as IGST.
- the amount to be so distributed shall be equal to the aggregate of the amount of ITC of CGST and SGST or UTGST that qualifies for distribution to such recipient in accordance with Rule 39(1)(d).
- ITC on account of IGST shall be distributed as IGST.

26.117 The conditions to be adhered as prescribed in section 20 are:

- the credit can be distributed to recipients against a document containing such details as may be prescribed.

Where ISD is an office of a banking company or a financial institution, including a nonbanking financial company, a tax invoice shall include any document in lieu thereof, by whatever name called, whether or not serially numbered but containing the prescribed information.

Each type of tax must be distributed through a separate ISD invoice. However, there is no requirement to issue ISD invoices at an invoice-level (received from the supplier of the service). However, there is no requirement to issue ISD invoices at an invoice-level (received from the supplier of the service).

- the amount of ITC distributed shall not exceed the amount of credit available for distribution.
- the credit of tax paid on input services attributable to recipient of credit shall be distributed only to that recipient.
- the credit of tax paid on input services attributable to more than one recipient of credit shall be distributed amongst such recipient(s) to whom the input service is attributable and such distribution shall be pro rata on the basis of the turnover in a State or turnover in a Union Territory of such recipient, during the relevant period, to the aggregate of the turnover of all such recipients to whom such input service is attributable and which are operational in the current year, during the said relevant period.
- the credit of tax paid on input services attributable to all recipients of credit shall be distributed amongst such recipients and such distribution shall be pro rata on the basis of the turnover in a State or turnover in a Union Territory of such recipient, during the relevant period, to the aggregate of the turnover of all recipients and which are operational in the current year, during the said relevant period.

Payment dates

26.118 GST should be disbursed by following the due dates mentioned below: — 20th of the next month. FORM GST PMT-6 Challan for deposit of GST — valid for 15 days from the date of generation of challan.

26.119 Further, interest under Section 50, to be paid in case of failure to pay tax or part thereof to the Government within period prescribed is 18 per cent from the due date of payment to the actual date of payment of tax And 24 per cent in case Excess claim of Input Tax Credit or excess reduction in output tax liability.

Accounts and Records

26.120 Section 35-36 of the CGST Act and Rule 56 to 58 of CGST Rules deals with provisions pertaining to accounts and records. Rule 56 of the CGST Rules provide for the documents with maintenance of accounts by registered persons. Rule 56(7) stipulates that every registered person shall keep the books of account at the principal place of business and books of account relating to additional place of business mentioned in his certificate of registration and such books of account shall include any electronic form of data stored on any electronic device.

26.121 Section 36 *inter alia* prescribes that, every assessee shall retain the books of accounts and other records until the expiry of 72 months (6 years) from the due date for filing of Annual Return for the year pertaining to such accounts and records. If the Annual Returns for the FY 2017-18 are filed on say 31.12.2018, even then, the books of account and other records are to be maintained till 31.12.2024. Even if the annual return is filed earlier, the start date for considering 72 months runs from the end of due date to file the annual return.

26.122 In case an appeal or revision or any other proceeding is pending before any Appellate Authority or Provisional Authority or Appellate Tribunal or Court, or in case the assessee is under investigation for an offence under Chapter XIX, the assessee shall retain the books of account and other records pertaining to the subject matter of such appeal or revision or proceeding or investigation for a period of one year after final disposal of such appeal or revision or proceeding, or for the period specified records u/s 35(1), whichever is later.

26.123 Based on the above discussions, an exemplary Questionnaire for GST Audit of Banks is prepared as under:

Name of the Branch:

GSTIN:

Particulars/information for the year

PART A: Basic Details of Assessee	
1.	Name of the Supplier/ Recipient of Supply
2.	Full address of (Note- In GST, there is no Concept of Centralised Registration. State wise registration prevails and each unit in the respective states should be added in the registration certificate

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	<i>classifying as a principal place of business in the State and others as additional place of business).</i>
	Address of the Branch under audit and address of the branches in the State:
3.	List of GST registration numbers in the State with date of registration and nature of registration as Supplier/ Recipient of Supply.
4.	Validity Period of Registration (in case of casual person and NRI)
5.	PAN of the assessee
6.	List the principal activities (Note- In order to understand the taxability of various supplies provided by the concerned branch/head office, it is important to identify the various supplies provided by such branch or head office. For this purpose, the auditors may analyse the various income heads (Operating and Non-Operating). Hence in GST various Lists of principal supplies need to be provided by the unit registered (assessee) i.e., branch)
7.	Is there any change in the activities stated above during the year as compared to immediately preceding year? Whether the same is included in registration (Note- Check whether any new service is provided by the concerned branch or head office. If yes, being an auditor, we can check whether the same is updated in the GST Registration Certificate or not? However, GST portal allows addition of Top 5 supplies only. It becomes important because taxability of any activity depends upon its nature and any exemption or relief will be available accordingly).
8.	Whether taxpayer has maintained accounts and records in terms of Section 35 -36 of the CGST Act, 2017 read with Rule 56 to 58 of the CGST Rules, 2017.
PART B: EXEMPTION AVAILABLE UNDER CGST/SGST/IGST	
9.	Broad description of nature of income
10.	Erstwhile service tax law was not applicable in case of J&K but GST is applicable, so check no transaction is left. (b) Are services provided outside India? If Yes, please specify nature of Service and amount involved
11.	Broad description of exempted services provided, if any, along with

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	Notification No. and amount Involved
12.	Whether GST is leviable on Transaction in Money under GST?
13.	Whether securities/ derivatives are exigible for GST?
14.	Whether any service charges or administrative charges or entry charges are recovered in addition to interest on a loan, advance or a deposit such as locker rent, folio charges, loan processing fee, late payment fee, lease management fee, rent, management fee etc. are exigible to GST?
15.	Whether the Bank is trading in Commercial paper /Certificates of deposits? If yes, whether any separate charges are collected, and GST being paid on the same and provide details thereon.
16.	Whether GST is levied on late fee charges collected from credit card holders? If yes, then whether GST is being paid on the same and give details thereof.
PART C: COMPLIANCES UNDER GST ACTs AND RULES, 2017	
11 (a)	Is Section 9(3) of the CGST Act read <i>with Notification No.13/2017</i> as amended followed by the bank?
11 (b)	If the answer to (a) is No, specify the head of expenditure and corresponding details
11 (c)	<ul style="list-style-type: none"> • Whether GST has been paid on RCM on services procured from supplier in terms of Section 9(3) of the CGST Act? • Whether GST has been paid on advances paid by the banks u/s 9(3) of the CGST Act? • Whether all inward supplies (whether creditable or not) flow into the books of the bank through the GSTR-1 of any registered supplier? If not, have such supplies been reported in GSTR-2/ 3B under section 9(3) of CGST Act / 5(4) of IGST Act, even if no tax is payable from 13th October, 2017? • Whether in respect of each inward supply where no tax has been paid, is there a clear disclosure made to the Auditors as to the reasons for the tax position taken in each case? The Auditor may examine, if the tax position taken requires to be reported in the

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	<p>audit report or other communication?</p> <ul style="list-style-type: none"> Whether the credit taken in respect of services covered under RCM is taken only after making payment of GST under RCM?
17.	<p>(a) Whether payment and other ledger entries are made in terms of the CGST Act and payment rules given in CGST Rules, 2017? [Refer Annexure B (for discharge of liability)]</p> <p>(b) If tax is paid belatedly, specify interest paid on delayed payment under Section 50 of the CGST Act, 2017?</p> <p>(c) Whether RCM tax liability is not discharged by utilizing the accumulated ITC?</p>
18.	<p>The banking sector provides services of purchase and sale of foreign currency to its customers, the value of which can be ascertained in terms of Rule 32(2) of the CGST Rules, hence liable to GST. However, (i) inter se sale or purchase of foreign currency amongst banks or authorised dealers of foreign exchange or amongst banks and such dealers is exempt vide Notification No.12/2017.[Note- Auditor has to check, the value of supply of services in relation to the purchase or sale of foreign currency, including money changing is determined in terms of Rule 32(2)] and also check the parties involved in the supply.</p>
PART D: COMPLIANCE OF ITC PROVISIONS GIVEN UNDER CGST ACT AND CGST RULES, 2017	
19.	<p>(a) Whether ITC taken/ utilized is matching with books of accounts and GST returns (Annexure A)</p> <p>(b) If the answer of (a) above is negative, Report differences thereof.</p>
20.	<p>Whether ITC credit taken, utilized and reversed on input services / inputs and Capital goods (Annexure C) is as per the CGST Act read with CGST Rules?</p>
21.	<ul style="list-style-type: none"> Whether the head office has not availed depreciation under section 32 of the Income Tax Act, 1961 on the amount of GST on the capital goods on which input tax credit has been availed? Whether the bank has taken the Input Tax Credit in respect of input and capital goods / services on the basis of proper duty paying documents, containing all particulars as prescribed by CGST Rules read with section 31 of the CGST Act, 2017?

22.	<p>Where the taxpayer is registered as an ISD the Auditor should check the following points:</p> <ul style="list-style-type: none"> (a) <i>Ensure that every person being an ISD shall make a separate application for registration as such Input Service Distributor?</i> (b) <i>Whether an ISD invoice is issued to each recipient of credit on every distribution in terms of CGST Act read with CGST Rules?</i> (c) <i>Ensure, Credit distributed does not exceed the credit available for distribution?</i> (d) <i>Whether ISD is distributed to those taxable persons whose PAN no is same as that of ISD (Under GST)?</i> (e) <i>Whether credit attributable to a specific unit is distributed to that unit only?</i> (f) <i>Whether, Section 20 of the CGST Act is adhered in reference to the manner of distribution of credit by ISD?</i> (g) <i>Whether, procedure for distribution of ITC by ISD is adhered?</i> (h) <i>Whether tax paid on input services used by a particular location (registered as supplier), is to be distributed only to that location?</i> (i) <i>Whether, credit of tax paid on input service used by more than one location who are operational is to be distributed to all of them based on the pro rata basis of turnover of each location in a State to aggregate turnover of all such locations who have used such services?</i> (j) <i>Ensure that, each type of tax must be distributed through a separate ISD invoice?</i> (k) <i>Whether the credit of IGST is distributed as IGST, irrespective of the location of the ISD?</i> (l) <i>Whether the aggregate of CGST and SGST and UTGST), as IGST, where the ISD is located in a State other than that of the recipient of credit?</i> (m) <i>Whether the CGST and SGST (or UTGST) is distributed as the CGST and SGST (or UTGST), respectively, where the ISD is located in the same State as that of the recipient?</i> (n) <i>Whether turnover for the distribution has been determined in</i>
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	<p><i>accordance with the CGST Rules?</i></p> <p>(o) <i>Ensure every ISD shall, for every calendar month or part thereof, furnish a return in FORM GSTR-6 within 13 days after the end of such month?</i></p>
23.	List of major Input services /inputs on which the company takes ITC: whether it comply with CGST Act read with CGST Rules.
24.	<p>Whether credit has been reversed for every month for an amount equal to 50 per cent of the Input Tax Credit availed on inputs, input services and capital goods or input tax credit has been reversed in respect of exempted supplies on actual basis?</p> <p>Note- such reversal is not required in case of cross charge made to other branches (refer Rule 42)</p>
25.	<p>Whether ITC distributed is in compliance with Section 20 of the CGST Act 2017,</p> <p>If the answer to the above is in negative, provide the discrepancy in the distribution and reasons thereof.</p>
26.	Amount of ITC received from ISD, if any together with address of the unit from which it is received.
27.	Whether any input tax credit has been claimed on invoice/ debit notes after the due date of furnishing of the return under section 39 for the month of September of the subsequent financial year or furnishing of the relevant annual return?
PART E: COMPLAINTS OF GST ACTS AND CGST RULES, 2017	
28.	<p>(i) Value of service provided to persons other than account holders where tax not charged on the ground that the place of supply is outside the taxable territory.</p> <p>(ii) Value of services exported.</p> <ul style="list-style-type: none"> • With payment of IGST and claimed refund. • Without payment of IGST under the cover LUT or Bond and claimed refund.
29.	Whether conditions for export of supply of service satisfied to avail benefit of export supply without payment of tax, as such benefit is subject to furnishing of LUT/Bond?

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30.	Is the payment for services exported received by the service provider in convertible foreign currency within the time limit prescribed by RBI? If not, give details.
PART F- OTHERS	
31.	<ul style="list-style-type: none">• Whether GST have been properly charged by the head office, regional offices, zonal offices in case of inter unit / branch transactions?• Whether the registered person have filed the applicable returns on timely basis as notified by the Government?• Whether IGST has been paid on 'import of services'?• Whether ITC has been reversed with Interest, if recipient fails to pay the amount to the supplier within 180 days(Rule 37)?• Whether Tax wrongfully collected and paid to Central or State Government (interstate supply considered as intra state supply or vice versa)?• If Yes, state the details of transaction (quantum)• GST audit report for earlier year should be examined for comments by GST auditor. Also the concurrent audit reports need to be reviewed for any comment on GST.

NOTE: Also refer Frequently Asked Questions (FAQ) issued by CBIC on Banking, Insurance and Stock Brokers Sector updated as on 27.12.2018 which is relevant for GST Audits as given at below cited link:

http://cbic.gov.in/resources/htdocs-cbec/gst/27122018-UPDATED_FAQs%20ON%20BANKING,%20INSURANCE%20AND%20STOCK%20BROKERS.pdf;jsessionid=26FC0CC2AE1BD05BAEB2B153C4EEE8E8

NAME OF THE ASSESSEE

ANNEXURE A

RECONCILIATION OF TURNOVER FOR THE YEAR.....

GSTR 1: RECON WITH BOOKS		
	Total Credits in statement of profit and loss	XXX
Less:	Not Goods / Not Services - e.g. dividend income	(XXX)
Less:	Sch III Items which is not a Supply e.g.: Land & Building etc	(XXX)
Less:	April - June Supplies (only for FY 2017-18)	(XXX)
Less:	Receipts not in the course of business	(XXX)
Add:	Sch I Supplies like Branch Transfer not in books, but supply as per GST Law	XXX
Add:	Receipts capitalised but taxable to GST	XXX
Less:	Profit on Sale of capital goods	(XXX)
Add:	Taxable Value of Supply of capital goods	XXX
Add:	Advance received during the current period	XXX
Less:	Advance of earlier period adjusted during the current period	(XXX)
Less:	Closing unbilled revenue recognised - but time of supply did not arise	(XXX)
Add:	Opening unbilled revenue (Billed during the period/Time of supply falls in the month)	XXX
	Total Value in GSTR 1	XXX
Less:	Exempted Supply	(XXX)
Less:	Non-Taxable Supplies: Supplies Like HSD, Motor Spirit Etc including Liquor	(XXX)
Less:	NIL Rated Supply	(XXX)
	Taxable Value in GSTR 1	XXX

NAME OF THE ASSESSEE

ANNEXURE B

Details of Discharge of Liabilities

A		CGST				SGST				IGST				Cess			
	Month	Liability	Credit utilised	Cash utilised	Ratio	Liability	Credit utilised	Cash utilised	Ratio	Liability	Credit utilised	Cash utilised	Ratio	Liability	Credit utilised	Cash utilised	Ratio
	Apr																
	May																
	Jun																
	Jul																
	Aug																
	Sep																
	Oct																
	Nov																
	Dec																
	Jan																
	Feb																
	Mar																
	Tot al																

B		CGST				SGST				IGST				Cess			
	Month	Liability for	Liability	Delay	Date of	Interest	Liability	Delay	Date of off -	Interest	Liability	Delay	Date of off -	Interest	Liability	Delay	Date
	Apr																

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	May																
	Jun																
	Jul																
	Aug																
	Sep																
	Oct																
	Nov																
	Dec																
	Jan																
	Feb																
	Mar																
	Total																

ANNEXURE C

Details of Input Tax Credit

A		Goods / services on which ITC is eligible (A)				Goods / services on which ITC is ineligible (B)				Total inward supplies	Out of (B), Value of capital goods on which credit is not availed on account of Sec. 16(3) of the CGST Act, 2017 (Depreciation claimed on Capital Goods on GST component under the IT Act, 1961)
	Month	Value of Inputs	Value of Input services	Value of Capital goods	Total ineligible	Value of Inputs	Value of Input services	Value of Capital goods	Total eligible	To match with Annex 4	
	Apr										
	May										
	Jun										
	Jul										
	Aug										
	Sep										
	Oct										
	Nov										
	Dec										
	Jan										

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	Feb										
	Mar										
	Total										

B. Out of total of (A), eligible credits on supplies received from related persons and distinct persons

GSTIN of supplier	Nature of relationship	Value of supply		Tax		
		Goods	Services	CGST	SGST	IGST

ITC reversal

A	Details of amount of tax credit paid as output tax liability u/s 16 r/w Rule 37, which was reclaimed during the year													
			<i>Amount of credit reclaimed upon payment of consideration</i>											
	Month in which the credit was paid as output liability	Amount of ITC paid as output tax liability u/s 16(2) read with Rule 37	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar
	PY -3													
	PY -2													
	PY -1													
	Apr		-											
	May		-	-										

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	Jun		-	-	-									
	Jul		-	-	-	-								
	Aug		-	-	-	-	-							
	Sep		-	-	-	-	-	-						
	Oct		-	-	-	-	-	-	-					
	Nov		-	-	-	-	-	-	-	-				
	Dec		-	-	-	-	-	-	-	-	-			
	Jan		-	-	-	-	-	-	-	-	-	-		
	Feb		-	-	-	-	-	-	-	-	-	-	-	
	Mar		-	-	-	-	-	-	-	-	-	-	-	-
	Total													

B Details of amount of tax credit paid as output tax liability u/s 16 r/w Rule 37, which was reclaimed during the year														
			<i>Month in which the amount of credit should have been paid as output liability u/s 16(2) r/w rule 37</i>											
	Month in which the credit was paid as output liability	Amount of ITC paid as output tax liability u/s 16(2) r/w Rule 37	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar
	Apr													
	May													
	Jun													
	Jul													
	Aug													

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	Sep													
	Oct													
	Nov													
	Dec													
	Jan													
	Feb													
	Mar													
	Total													