CHAPTER 14

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

UNIT 1 – SPECIAL FEATURES OF AUDIT OF BANKS

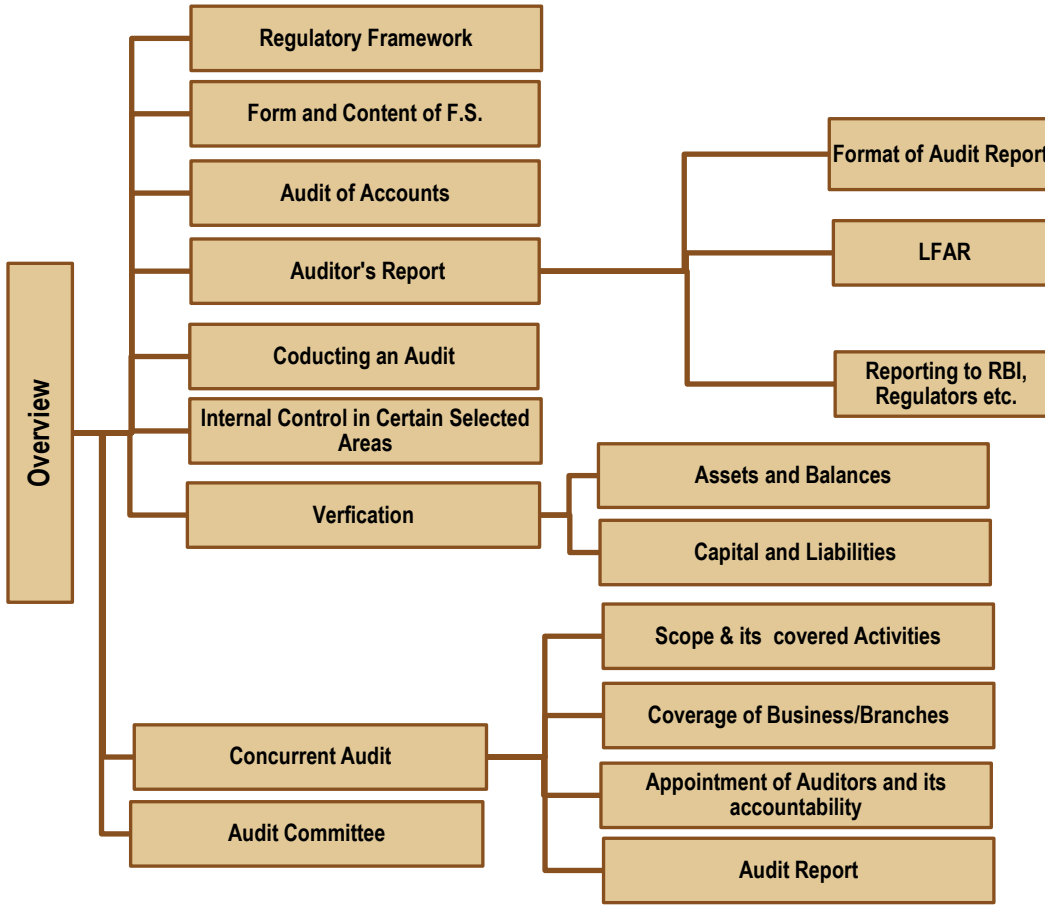
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Gain the knowledge of legal framework, form and content of financial statements of the banks.
- Know the feature of audit of accounts and auditor's report.
- Understand CRR, SLR and Capital Adequacy etc.
- Understand the prescribed procedure to be followed while doing verification of assets and liabilities of the bank.
- Acquire the knowledge of Concurrent Audit and types of activities to be covered in it.
- Know the role of audit committee in audit of banks.

© The Institute of Chartered Accountants of India

UNIT OVERVIEW



Viraj & Associates, an auditing firm of long standing and experience, has been appointed as one of Statutory Central Auditors of a nationalized bank. Trying to gain understanding of working of the bank including its internal control along with joint auditors, CA. Mansukh is also involved in reviewing treasury operations of the bank as part of gaining insight in bank's working.

Why are treasury operations of a bank significant from point of view of an auditor? Treasury operations are responsible for processing of all financial market transactions and play a crucial role in managing risks. Investments and forex & derivatives form two main components of treasury. In view of regulatory prudential norms on investments, audit of investments becomes very important as non-compliance with regulations could have a direct and material effect on

© The Institute of Chartered Accountants of India

financial statements of the bank. He is also trying to gain understanding of General IT controls and system application controls relating to these as investment function is automated in Bank.

He is also gaining knowledge of various types of deposit products of the bank (like CASA and term deposits) and process of determination of interest rates and other charges of these deposits as per rules laid down by bank. Going through bank policy on customer acceptance, procedures to verify compliance of KYC norms are in offing. Apart from it, planned verification of application of rate of interest to every deposit product on sample basis is also on the table. Verification of movement of interest expenses is also in audit plan arsenal.

He is also considering to go through complaints lodged by bank customers. What is necessity to plan procedures in this respect? Does auditor of a bank have anything to do with customer complaints? Certainly. It is due to the reason that such complaints may result into material liability or contingent liability.

CA. Piyush, Partner of P K S D & Associates (joint auditor) is in the process of familiarising himself with credit recovery policy of the Bank and guidelines of RBI regarding accounting and income recognition in this respect. He is also considering extent of automation of process relating to accounting of recovery of credit portfolio of the Bank. Besides, he wants to ensure consistency in income recognition process relating to order of recovery and its synchronization with internal policy of the Bank. He is also planning procedures to ensure upgradation of NPAs during the year in accordance with RBI norms.

Review of activities of Credit monitoring and restructuring department of Bank also falls in domain of his responsibilities. Why such a review is important for him as an auditor? It is due to the reason this department is responsible for implementing Bank's policies relating to credit monitoring and restructuring. Credit monitoring policy helps in managing credit risks in a systematic and effective manner. Further, this department may also be responsible for sanctioning of restructuring of stressed advances in accordance with RBI guidelines.

CA. Gopal, Partner of GSK & Co. (joint auditor) is verifying internal/office accounts of the bank including sundry/suspense accounts. Why does such verification assume importance? Such accounts can be used to commit frauds and malpractices like unauthorized opening and operation of such accounts for affording credits to certain borrower accounts to prevent them from slipping into NPAs. Opening of such accounts as well as their periodic reconciliation becomes too significant for Statutory Central Auditors to ignore.

© The Institute of Chartered Accountants of India

1. INTRODUCTION

The banking industry is the pivot of any economy and its financial system. Banks are one of the foremost agents of financial intermediation in an economy like India and, therefore, development of a strong and resilient banking system is of utmost importance. The banking institutions in the country are working in a competitive environment and their regulatory framework is aligned with the international best practices. Thus, financial deepening has taken place in India and continues to be in progress with a focus on orderly conditions in financial markets while sustaining the growth momentum.

Banks have certain characteristics distinguishing them from most other commercial enterprises.

Example

- Custody of large volumes of monetary items, including cash and negotiable instruments, whose physical security has to be ensured. This applies to storage and the transfer of monetary items, making banks vulnerable to misappropriation and fraud, necessitating establishment of formal operating procedures, well-defined limits for individual discretion and rigorous systems of internal control.
- Engagement in a large volume and variety of transactions in terms of number and value which necessarily require complex accounting and internal control systems and widespread use of Information Technology (IT).
- Operation through a wide network of geographically dispersed branches and departments necessitating a greater decentralization of authority and dispersal of accounting and control functions, with consequent difficulties in maintaining uniform operating practices and accounting systems, particularly when the branch network transcends national boundaries.
- Assumption of significant commitments without any transfer of funds. These items, called 'off-balance sheet' items, may at times not involve accounting entries and the failure to record such items may be difficult to detect.
- Engagement in transactions that are initiated at one location, recorded at a different location and managed at yet another location.

© The Institute of Chartered Accountants of India

- Direct Initiation and completion of transactions by the customer without any intervention by the bank's employees. **For example,** over the Internet or mobile or through automatic teller machines (ATMs).
- Integration and linkages of national and international settlement systems could pose a systemic risk to the countries in which they operate.
- Regulatory requirements by governmental authorities often influence accounting and auditing practices in the banking sector.

Special audit considerations arise in the audit of banks because of:

- the particular nature of risks associated with the transactions undertaken;
- the scale of banking operations and the resultant significant exposures which can arise within short period of time;
- the extensive dependence on IT to process transactions;
- the effect of the statutory and regulatory requirements;
- the continuing development of new products and services and banking practices which may not be matched by the concurrent development of accounting principles and auditing practices.

Evolution of technology and providing services through Net Banking and Mobiles has exposed banks to huge operational and financial risk.

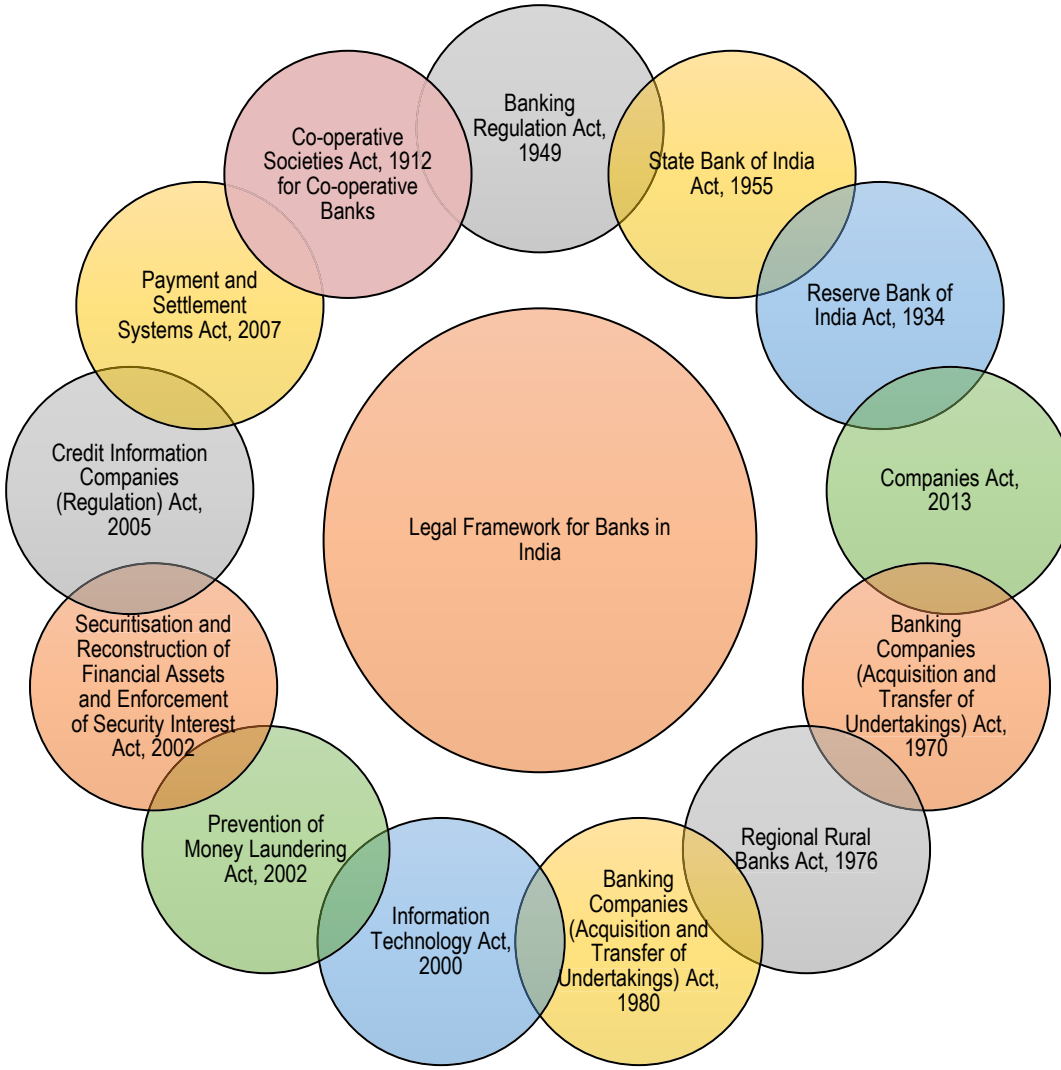
The auditor should consider the effect of the above factors in designing his audit approach. It is imperative for Branch Auditors and SCAs (Statutory Central Auditors) to have detailed knowledge of the products offered and risks associated with them, and appropriately address them in their audit plan to the extent they give rise to the risk of material misstatements in the financial statements.

In today's environment, the banks use different applications to carry out different transactions which may include data flow from one application to other application; the auditor while designing his plans should also understand interface controls between the various applications.

© The Institute of Chartered Accountants of India

2. LEGAL FRAMEWORK

There is an elaborate legal framework governing the functioning of banks in India. The principal enactments which govern the functioning of several types of banks are:



© The Institute of Chartered Accountants of India

Further, the Reserve Bank of India Act, 1934 gives wide powers to the RBI to give directions to banks which also have considerable effect on the functioning of banks

3. FORM AND CONTENT OF FINANCIAL STATEMENTS

Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit. Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.

Every banking company needs to comply with the disclosure requirements under the various Accounting Standards, as specified under section 133 of the Companies Act, 2013, read with Rule 7 of the Companies (Accounts) Rules 2014, in so far as they apply to banking companies or the Accounting Standards issued by the ICAI. It may be noted that implementation of Indian Accounting Standards (Ind AS) has been deferred by RBI for all scheduled commercial banks presently.

It is pertinent to state that preparation of balance sheet of a bank usually involves preparation of standalone financial statements and consolidated financial statements. Preparation of Standalone financial statements involve consolidation of branch accounts and incorporation of various verticals/departments of bank in case of a nationalized bank/public sector bank. The detailed procedures in this regard may vary from bank to bank. In case of private banks, the processes of accounting are centralized and there is no concept of mandatory branch audit in accordance with RBI guidelines.

Public sector banks and private banks are listed on recognized stock exchange and are required to comply with SEBI regulations including LODR.

3.1 Audit of Accounts & Appointment of Auditor

Sub-section (1) of section 30 of the Banking Regulation Act requires that the balance sheet and profit and loss account of a banking company should be audited by a person duly qualified under any law for the time being in force to be an auditor of companies.

© The Institute of Chartered Accountants of India

Most banks, especially those in nationalised banks or public sector, appoint four or more (depending upon their size and Board decision, as per RBI guidelines) firms of chartered accountants to act jointly as statutory central auditors (SCAs).

The appointment letter sent by banks in connection with the appointment of SCAs typically contains the following:

- Period of appointment.
- Particulars of other central auditors.
- Particulars of previous auditors.
- Procedural requirements to be complied with in accepting the assignment. **Example** 1. Letter of acceptance (the letter usually contains, *inter alia*, averment as to absence of disqualification for appointment, way in which the audit has to be conducted and confirmation of present name, constitution and address of the auditor), declaration of fidelity and secrecy, restriction on accepting other assignments from the bank, etc.
- A statement of division of work and review and reporting responsibilities amongst joint auditors in case of nationalised banks (Generally this is decided at a later stage)
- Scope of assignment which includes any special reports or certificates to be given by the SCAs in addition to the main report.
- In case of statutory branch auditors (SBAs), appointment letter is given on similar lines except in regard to particulars of other auditors and statement of division of work. However, it is to be noted that statutory branch audit is carried out by a single firm of chartered accountants.

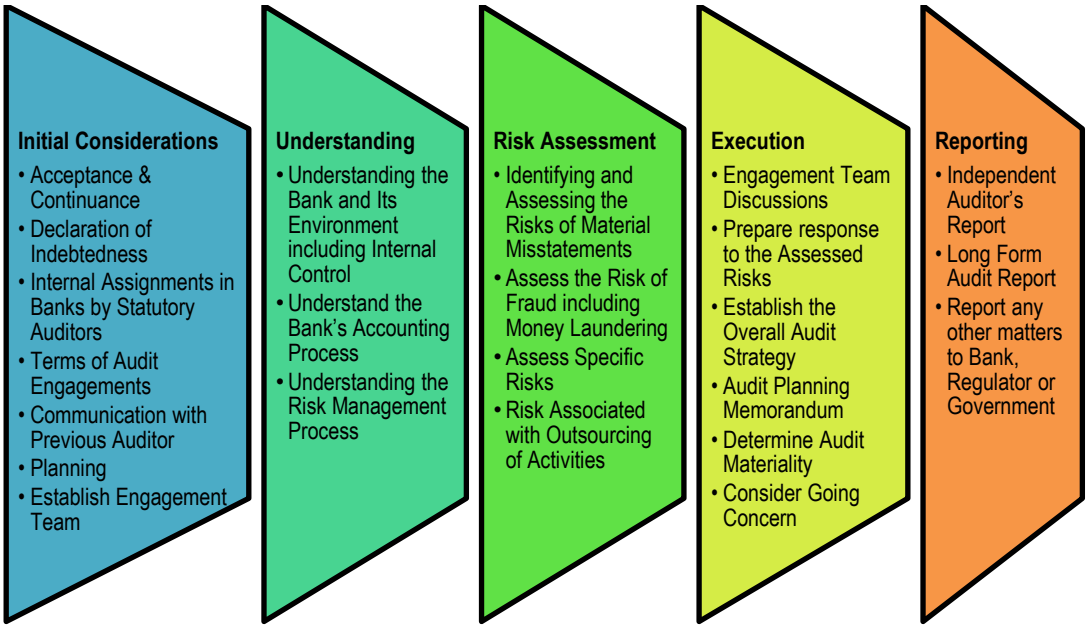
Authority appointing the Auditors - As per the provisions of the relevant enactments, the auditor of a banking company is to be appointed at the annual general meeting of the shareholders, whereas the auditor of a nationalised bank is to be appointed by the concerned bank acting through its Board of Directors.

In either case, approval of the Reserve Bank is required before the appointment is made.

© The Institute of Chartered Accountants of India

4. CONDUCTING AN AUDIT

The audit of banks or of their branches involves the following stages –



Stage I: Initial Considerations

Acceptance & Continuance: The assessment of engagement risk is a critical part of the audit process and should be done prior to the acceptance of an audit engagement since it affects the decision of accepting the engagement and in planning decisions if the audit is accepted.

Declaration of Indebtedness: The RBI has advised that the banks, before appointing their statutory central//branch auditors, should obtain a declaration of indebtedness i.e., a written confirmation that auditor/firm/partners/f/family members have not been declared as wilful defaulters by any bank/financial institution This is in addition to the declaration regarding absence of disqualifications stipulated in Section 141 of the Companies Act 2013 which includes borrowing above stipulated amount. Students may refer Chapter 12 of CA Intermediate Auditing and Assurance Study Material.

Internal Assignments in Banks by Statutory Auditors: The RBI decided that the audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the bank during the same year.

Terms of Audit Engagements: SA 210, "Terms of Audit Engagements" requires that for each period to be audited, the auditor should agree on the terms of the audit engagement with the bank before

© The Institute of Chartered Accountants of India

beginning significant portions of fieldwork. It is imperative that the terms of the engagement are documented, to prevent any confusion as to the terms that have been agreed in relation to the audit and the respective responsibilities of the management and the auditor, at the beginning of an audit relationship. This is usually done in the form of engagement letter which is written by the auditor and acknowledged by the bank.

Communication with Previous Auditor: As per Clause (8) of the Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant in practice cannot accept position as auditor previously held by another chartered accountant without first communicating with him/her in writing.

Planning: The audit plan needs to be properly documented with respect to timing, extent of checking, audit procedures to be followed at assertion level and should be flexible and updated or changed, as and when necessary.

Establish the Engagement Team: The assignment of qualified and experienced professionals is an important component of managing engagement risk. The size and composition of the engagement team would depend on the size, nature, and complexity of the bank's operations.

Stage II : Understanding

Understanding the Bank and Its Environment including Internal Control: An understanding of the bank and its environment, including its internal control, enables the auditor:

- to identify and assess risk;
- to develop an audit plan to determine the operating effectiveness of the controls, and to address the specific risks.

Understand the Bank's Accounting Process: The accounting process produces financial and operational information for management's use and it also contributes to the bank's internal control. Thus, understanding of the accounting process is necessary to identify and assess the risks of material misstatement whether due to fraud or not, and to design and perform further audit procedures.

Understanding the Risk Management Process: Management develops controls and uses performance indicators to aid in managing key business and financial risks. An effective risk management system in a bank generally requires the following:

© The Institute of Chartered Accountants of India

Oversight by those charged with governance	*Identification, measurement and monitoring of risks*	*Control activities*	*Monitoring activities*	*Reliable information systems*
• Those charged with governance (BOD/Chief Executive Officer) should approve written risk management policies. The policies should be consistent with the bank's business objectives and strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable.	• Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria	• A bank should have appropriate controls to manage its risks, including effective segregation of duties (particularly, between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliation of positions and results, setting of limits, reporting and approval of exceptions, physical security and contingency planning.	• Risk management models, methodologies and assumptions used to measure and manage risk should be regularly assessed and updated. This function may be conducted by the independent risk management unit.	• Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged with governance and management require risk management information that is easily understood and that enables them to assess the changing nature of the bank's risk profile.

Stage III : Risk Assessment

Identifying and Assessing the Risks of Material Misstatements: SA 315 requires the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures.

Assess the Risk of Fraud including Money Laundering: As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor's objective is to identify and assess the risks of material misstatement in the financial statements due to fraud, to obtain sufficient appropriate audit evidence on those identified misstatements and to respond appropriately. The attitude of professional scepticism should be maintained by the auditor to recognise the possibility of misstatements due to fraud.

The RBI has framed specific guidelines that deal with prevention of money laundering and "Know Your Customer (KYC)" norms. The RBI has from time to time issued guidelines ("Know Your Customer Guidelines – Anti Money Laundering Standards"), requiring banks to establish policies, procedures and controls to deter and to recognise and report money laundering activities.

© The Institute of Chartered Accountants of India

Assess Specific Risks: The auditors should identify and assess specific risks of material misstatement at the financial statement level which refers to risks that relate to the banking industry and the use of IT therein.

Risk Associated with Outsourcing of Activities: The modern-day banks make extensive use of outsourcing as a means of both reducing costs as well as making use of services of an expert not available internally. There are, however, certain risks associated with outsourcing of activities by banks and therefore, it is quintessential for the banks to effectively manage those risks.

Stage IV: Execution

Engagement Team Discussions: The engagement team should hold discussions to gain better understanding of bank and its environment, including internal control, and to assess the potential for material misstatements of the financial statements.

Response to the Assessed Risks: SA 330 "The Auditor's Responses to Assessed Risks" requires the auditor to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. The auditor should design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.

Establish the Overall Audit Strategy: SA 300 "Planning an Audit of financial Statements'' states that the objective of the auditor is to plan the audit so that it will be performed in an effective manner. For this purpose, the audit engagement partner should:

- establish the overall audit strategy, prior to the commencement of an audit; and
- involve key engagement team members and other appropriate specialists while establishing the overall audit strategy, which depends on the characteristics of the audit engagement.

Audit Planning Memorandum: The auditor should summarise the team's audit plan by preparing an audit planning memorandum in order to:

- Describe the expected scope and extent of the audit procedures to be performed by the auditor.
- Highlight all significant issues and risks identified during their planning and risk assessment activities, as well as the decisions concerning reliance on controls.
- Provide evidence that they have planned the audit engagement appropriately and have responded to engagement risk, pervasive risks, specific risks, and other matters affecting the audit engagement.

© The Institute of Chartered Accountants of India

Determine Audit Materiality: The auditor should consider the relationship between the audit materiality and audit risk when conducting an audit. The determination of audit materiality is a matter of professional judgment and depends upon the knowledge of the bank, assessment of engagement risk, and the reporting requirements for the financial statements. Judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement, or combination of both.

Consider Going Concern: In obtaining an understanding of the bank, the auditor should consider whether there are events and conditions which may cast significant doubt on the bank's ability to continue as a going concern.

Stage V: Reporting

Students should refer to the reporting requirements explained in heading 8. **Auditor's Report** of this Chapter.

[**Note:** For detailed understanding of stages involved for conducting an audit, as discussed above, students may refer Guidance Note on Audit of Banks.]

4.1 Special Considerations in IT Environment

The advent of working in CBS environment in banks coupled with changes in technology, use of different payment systems and integration of Aadhar for cardless transactions have changed the way banking used to be in earlier times. However, the technological developments have brought new challenges for auditors as audit is required to be conducted through the system. Considering the importance of IT systems in preparation and presentation of financial statements, it is imperative that bank should share detailed information with auditors like: -

- Overall IT policy, structure and environment of Bank's IT system
- Data processing and data interface under various systems
- Data integrity and data security
- Business Continuity plans and disaster control plans
- Accounting manual and critical accounting entries, their processes and involvement of IT systems
- Controls over key aspects, use of various account heads, expense booking, overdue identification etc.
- Controls on recording of various e-banking and internet banking products and channels
- MIS reports being generated and their periodicity

© The Institute of Chartered Accountants of India

- Major exception reports and process of generation including embedded logic
- Process of generating various information related to various disclosures in financial statements and involvement of IT systems

Overall review of IT environment and computerized accounting system has to be taken at head office level. The branch auditors generally do not have access to IT policy and processes implemented by the bank. Hence, based upon guidance and information received from Statutory central auditors, branch auditors need to ensure that data review and analysis through CBS is carried out and tests of controls and substantive checking of sample transactions is carried out at branch level and results are shared with statutory central auditors.

It is responsibility of statutory central auditors to obtain understanding of IT environment and various controls put in place by management and evaluate whether controls are operating effectively. The methodology adopted by the bank in implementing and monitoring controls should be discussed with head of IT department and based on this understanding, audit procedures can be designed. 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.
- Ensure that the system prevents unauthorised amendments to the programmes.
- 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 a daily basis by the concerned officials. It is important for auditor to understand the nature of exception and its impact on financials.
- Verify that the account master and balance cannot be modified/amended/altered except by the authorised personnel.

© The Institute of Chartered Accountants of India

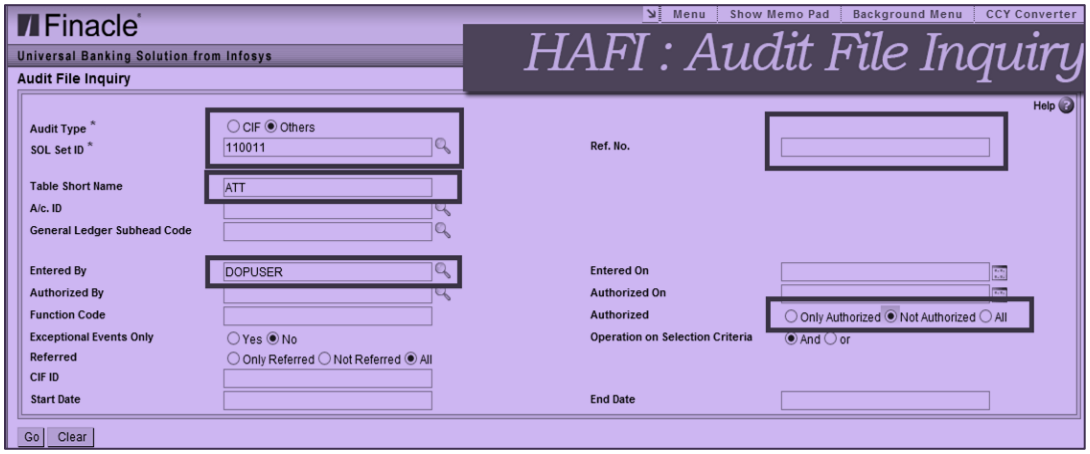
- Verify that all the general ledger accounts codes authorised by Head Office are in existence in the system.
- Verify that balance in general ledger tallies with the balance in subsidiary book. .

4.2 Internal Audit and Inspection

Central audit and inspection department in Banks is a combination of centralized function with some level of decentralization which is usually headed by a Chief Audit Executive. It is responsible for undertaking risk-Based Internal Audit (RBIA) as per the framework as stipulated by RBI. It is also responsible for identification of branches for revenue audit, 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. The primary function is to ensure that the audit function is handled smoothly, effectively & efficiently.

Risk-based Internal audit is conducted based upon the risk assessment of business and control risks of branches. The risk assessment process includes: -

- Identification of inherent business risks in various activities undertaken by branches (Business risk)
- Assessment of effectiveness of control systems for monitoring inherent risks of business activities of branch (Control risk)
- Making an assessment of level and direction of various risk areas and assess level and direction of overall business risk and control risk
- Drawing up of risk matrix taking into account factors viz. Risk of branch



© The Institute of Chartered Accountants of India

5. INTERNAL CONTROL IN CERTAIN SELECTED AREAS

System of Internal Control in Banks: Banks are required to implement and maintain a system of internal controls for mitigating risks, maintain good governance and to meet the regulatory requirements. Given below are examples of internal controls that are typically implemented in a bank:

Area of Focus	Examples of Internal Controls in a Bank
General	• The staff and officers of a bank should be shifted from one position to another frequently and without prior notice. • The work of one person should always be checked by another person (usually by an officer) in the normal course of business. • The arithmetical accuracy of the books should be proved independently every day. • All bank forms (e.g. Cheque books, demand draft/pay order books, travelers' cheques, foreign currency cards etc.) should be kept in the possession of an officer, and another responsible officer should verify the issuance and stock of such stationery. • The mail should be opened by a responsible officer. Signatures on all the letters and advices received from other branches of the bank or its correspondence should be checked by an officer with the signature book. • The signature book and the telegraphic code book should be kept with responsible officers and access should be allowed only to authorised officers. • The bank should take out insurance policies against loss due to all the risks such as fire, natural calamities, theft and employees' infidelity. • The financial powers of officers of different grades should be clearly defined. • There should be surprise inspection of head office and branches at periodic interval by the internal audit department. The irregularities pointed out in the inspection reports should be promptly rectified.
Cash	• Cash should be kept in the joint custody of two responsible officers. • In addition to normal checking by the chief cashier, cash should be test-checked daily and counted in full occasionally by a responsible

© The Institute of Chartered Accountants of India

	officer other than those handling the cash. Actual cash in hand should agree with the balance shown by the Day Book every day. • The cashier should have no access to the customer's ledger accounts and the Day Book. This is an important safeguard as the Bank managements are often tempted to use cashiers because of their shorter working hours as ledger clerks in the absence of regular staff etc. This can result in substantial losses to the bank. • The counterfoil of cash receipt vouchers (e.g. counterfeits of pay-in-slips lodged by the depositors) should be signed by an officer in Cash Department, in addition to the receiving cashier. • Payments should be made only after the vouchers (e.g. cheques, demand drafts etc.) have been passed for payment by the authorised officer and have been entered in the customer's account. • Receipt and payment scrolls or their totals should be compared with the cash column of the Day-Book by independent persons. • High value cash receipts and payments should be verified by a higher officer/ branch manager and the excess cash balance should be remitted to currency chest according to branch's retention limit on daily basis.
Clearings	• Under the Cheque Truncation System (CTS) 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. • As per RBI guidelines, the branch is required to either call the customer or email him for any cheque received for the amount of ₹ 5 lakh and above in respect of inward clearings. The Auditor may verify the compliance on test check basis. • The Auditor is to check whether signature of the drawer of the cheque is being verified by the staff or not as else there will be liability of the paying bank under all circumstances. • The unpaid cheques received in outward clearing should be either sent to the customers at their recorded address or the customers be informed to collect the same from bank branch.
Bills for Collection	• All the documents accompanying the bills should be received and entered in the Register by a responsible officer. At the time of dispatch, the officer should also see that all the documents are sent along with the bills.

© The Institute of Chartered Accountants of India

	• The accounts of customers or principals should be credited only after the bills have been collected or an advice to that effect received from the bank branch or agent to which they were sent for collection. • It should be ensured that bills sent by one branch for collection to another branch of the bank, are not taken in the bills for collection twice in the amalgamated balance sheet of the bank. For this purpose, the receiving branch should reverse the entries regarding such bills at the end of the year for closing purposes.
Bills Purchased	• At the time of purchase of the bills, an officer should verify that all the documents of title are properly assigned to the bank. • Sufficient margin should be kept while purchasing or discounting a bill to cover any decline in the value of the security etc. • If the bank is unable to collect a bill on the due date, immediate steps should be taken to recover the amount from the drawer against the security provided. • All irregular outstanding account/s should be reported to the Head Office. • In the case of bills purchased outstanding at the close of the year the discount received thereon should be properly apportioned between the two years.
Loans and Advances	• The bank should make advances only after satisfying itself as to the creditworthiness of the borrowers and after obtaining sanction from the proper authorities of the bank. • All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made. • Sufficient margin should be kept against securities taken to cover any decline in the value thereof and to comply with Reserve Bank directives. Such margins should be determined by the proper authorities of the bank as a general policy or after detailed scrutiny for specific accounts. • All the securities should be received and returned by responsible officer. They should be kept in the Joint custody of two such officers. • All securities requiring registration should be registered in the name of the bank or otherwise accompanied by the documents sufficient to give title of the bank. • All accounts should be kept within both the drawing power and the sanctioned limit as per prescribed norms. Additional temporary limit

© The Institute of Chartered Accountants of India

	may be sanctioned, for a maximum of 20% of existing limit and 90 days maximum tenure. • All the accounts which exceed the sanctioned limit or drawing power or are against unapproved securities or are otherwise irregular should be brought to the notice of the Management/Head Office regularly. • The operation (in each advance account) should be reviewed at least once every year.)
Demand Drafts	• The signatures on a demand draft should be checked by an officer with the Signature Book. • All the D.Ds. sold/ issued by a branch should be immediately confirmed by an advice to the paying branch. • If the paying branch does not receive proper confirmation of any D.D. from the issuing branch or does not receive credit in its account with that branch, it should take immediate steps to ascertain the reasons.
Inter Branch Accounts	• The accounts should be adjusted only on the basis of advices (and not on the strength of entries found in the statement of account) received from other branches, • Prompt action should be taken preferably by central authority, if any entries (particularly debit entries) are not responded to by any branch within a reasonable time.
Credit Card Operations	• There should be effective screening of applications with reasonably good credit assessments. • There should be strict control over storage and issue of cards. • There should be a system whereby a merchant confirms the status of unutilised limit of a credit-card holder from the bank before accepting the settlement, in case the amount to be settled exceeds a specified percentage of the total limit of the card holder. • There should be a system of prompt reporting by the merchants of all settlements accepted by them through credit cards. • Reimbursement to merchants should be made only after verification of the validity of merchant's acceptance of cards. • All the reimbursement (gross of commission) should be immediately charged to the customer's account. • There should be a system to ensure that statements are sent regularly and promptly to the customer.

© The Institute of Chartered Accountants of India

	• There should be a system to monitor and follow-up customers' payments. • Payments overdue beyond a reasonable period should be identified and attended to carefully. For defaulting customers, credit should be stopped by informing the merchants through periodic bulletins, as early as possible, to avoid increased losses. • There should be a system of periodic review of credit card holders' accounts. On this basis, the limits of customers may be revised, if necessary. The review should also include determination of doubtful amounts and the provisioning in respect thereof.

Example 2

While doing the audit of a branch of XYZ bank for the year ended 31st March 23, it was seen that the stock statements with the same figures are submitted by borrowers month after month with a change in the month at the top. These are just filed for formal compliance. Such things happen because a responsible official does not check the stock statements and get them entered in in the system, which is a lapse in internal control. Due to such a lapse, neither the borrower nor bank staff take it sincerely, thus posing a risk of loss to bank.

6. COMPLIANCE WITH CRR AND SLR REQUIREMENTS

(i) Cash Reserve Ratio (**CRR**) is a specified minimum fraction of the total deposits of customers, which commercial banks have to hold as reserves either in cash or as deposits with the central bank. One of the important determinants of cash balances to be maintained by banking companies and other scheduled banks is the requirement for maintenance of a certain minimum cash reserve.

While the requirement for maintenance of cash reserve by banking companies is contained in the Banking Regulation Act, 1949, corresponding requirement for scheduled banks is contained in the Reserve Bank of India Act, 1934.

The RBI, from time to time, reviews the evolving liquidity situation and accordingly decides the rate of CRR required to be maintained by scheduled commercial banks. Therefore, the auditor needs to refer to the master circular issued from time to time in this regard to ensure the compliance of CRR requirements.

(ii) Statutory Liquidity Ratio (SLR) Requirements – SLR is the requirement that every scheduled commercial bank in India is required to maintain in the form of certain liquid assets such as gold, cash and government approved securities before providing credit to the customers. The

© The Institute of Chartered Accountants of India

Reserve Bank of India requires statutory central auditors of banks to verify the compliance with SLR requirements of 12 odd dates in different months of a fiscal year not being Fridays. The objective of maintaining SLR is to have an amount in the form of liquid assets which can be used to handle a sudden increase in demand for the amount from the depositors. The resultant report is to be sent to the top management of the bank and to the Reserve Bank.

Correctness of the compilation of DTL (Demand and Time Liabilities) position; and

Maintenance of liquid assets as prescribed u/s 24 of Banking Regulation Act.

Audit Approach and Procedure:

Area of Focus	Suggested Audit Procedures

Compliance with CRR and SLR requirements	• Obtain an understanding of the relevant circulars/ instructions of the RBI, particularly regarding composition of items of DTL.
	• Request the branch auditors to send their weekly trial balance as on Friday and these are consolidated at the 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/her. The branch auditors should also be specifically requested to examine the cash balance at the branch on the selected dates.
	• Examine, on a test basis, the consolidations regarding DTL position prepared by the bank with reference to the related returns received from branches. The auditor should examine whether the valuation of securities done by the bank is in accordance with the guidelines prescribed by the RBI.
	• While examining the computation of DTL, specifically examine that items have been excluded from liabilities as per RBI guidelines. Some of these items are:-
	• Paid up capital, reserve, any credit balance in profit & loss account of bank, amount of loan taken from RBI and amount of refinance taken from EXIM bank, NHB, SIDBI and NABARD
	  ○ Part amounts of recoveries from the borrowers in respect of debts considered bad and doubtful of recovery.
	  ○ Amounts received in Indian currency against import bills and held in sundry deposits pending receipts of final rates.

© The Institute of Chartered Accountants of India

	○ 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. ○ Margins held and kept in sundry deposits for funded facilities. • Similarly, specifically examine that the items have been included in liabilities as per RBI guidelines. Some of these items are:- ○ Net credit balance in branch adjustment accounts. ○ 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'. ○ 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. • Examine whether the consolidations prepared by the bank include the relevant information in respect of all the branches. • It may be noted that, even though interest accrues daily, it is recorded in the books only at periodic intervals. Thus, examine whether such interest accrued but not accounted for in books is included in the computation of DTL. • The auditor at the central level should apply the audit procedures listed above to the overall consolidation prepared for the bank as a whole. Where such procedure is followed, the central auditor should adequately describe the same in the report. • While reporting on compliance with SLR requirements, the auditor should specify the number of unaudited branches and state that he/she has relied on the returns received from the unaudited branches in forming an opinion. Recently, there has been introduction of Automated Data Flow (ADF) for CRR & SLR reporting and the auditors should develop necessary audit procedures around this.

© The Institute of Chartered Accountants of India

7. VERIFICATION OF ASSETS

Before beginning verification of assets and balances, the auditor should obtain an accurate schedule of accounts in the prescribed format. The following are the steps involved in verification of assets and balances. -

I. **CASH, BANK BALANCES AND MONEY AT CALL AND SHORT NOTICE -** The Third Schedule to the Banking Regulation Act, 1949, requires disclosures to be made in the balance sheet regarding cash, balances with Reserve Bank of India, balances with other banks and money at call and short notice. Audit approach and audit procedures in respect of these items is discussed as under: -

Cash	Balances with Reserve Bank of India	Balances with Other Banks	Money at Call and Short Notice

Audit approach: The auditor's basic objective in verification of these items is their existence and completeness as on date of balance sheet and audit procedures have to be tailored to meet these. Remember that cash would be appearing in balance sheet of almost all branches. However, in most of the branches of a bank, there will be no bank account requiring reporting except in branches with treasury operations. Similarly, activity pertaining to money at call and short notice is handled by treasury department of the bank at head office level.

Banks have a robust system of internal controls pertaining to cash like joint custody of two responsible officers, checking of cash at periodic intervals etc due to higher risk of misappropriation. Similarly, the balance with other banks (in case of applicable branches) are reconciled periodically. The auditor has to be satisfied about effective operation and implementation of internal controls in this area.

Audit Procedures:

Area of Focus	Suggested Audit Procedures
Cash	• Carry out the physical verification of cash (including foreign currency, if any, ***cash at ATM and cash at cash deposit machines***) as close to the balance sheet date as possible. • The cash balance as physically verified should be agreed with the balance shown ***in the cash register/balance in CBS***.

© The Institute of Chartered Accountants of India

Balance with Reserve Bank of India	• Verify the ledger balances in each account with reference to the bank confirmation certificates and reconciliation statements as at the year-end. • Review the reconciliation statements, paying special attention to the following items appearing in the reconciliation statements: ○ Cash transactions remaining unresponded; ○ Revenue items requiring adjustments/write-offs; and ○ Other credit and debit entries originated in the statement provided by RBI remaining unresponded for more than 15 days.
Balance with Other Banks (Other than Reserve Bank of India)	Apart from the procedures described above in examining the balances with Reserve Bank of India, while reviewing the reconciliation statements, the auditor should pay particular attention to the following. • Examine that no debit for charges or credit for interest is outstanding and all the items which ought to have been taken to revenue for the year have been so taken. • Examine that no cheque sent or received in clearing is outstanding. • Examine that all bills or outstation cheques sent for collection and outstanding as on the closing date have been credited subsequently. • Examine large transactions in inter-bank accounts to ensure that no transactions have been put through for window-dressing particularly towards the close of year. The balances with banks outside India should also be verified in the manner described above. These balances should be converted into the Indian currency at the exchange rates prevailing on the balance sheet date
Money at Call and Short Notice	• Examine whether there is a proper system of authorisation, general or specific, for lending of the money at call or short notice. Compliance with the instructions or guidelines laid down in this behalf by the head office or controlling office of the branch, including the limits on lending's in inter-bank call money market should also be examined. • Call loans should be verified with the certificates of the

© The Institute of Chartered Accountants of India

	borrowers and the call loan receipts held by the bank. • Examine whether the aggregate balances comprising this item as shown in the relevant register tally with the control accounts as per the general ledger. • Examine subsequent repayments received from borrowing banks to verify the amounts shown under this head as at the year-end. It may be noted that call loans made by a bank cannot be netted-off against call loans received. • Verify that the interest has been properly accrued and accounted for on year-end outstanding balances of call/ short notice money.

II. INVESTMENTS

Audit approach:

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 effect on the financial statements. The latter aspect assumes special significance in the case of banks where investment transactions should be carried out within the numerous parameters laid down by the relevant legislation and directions of the RBI. The auditor should keep this in view while designing audit procedures relating to investments. Every bank has their own investment policy, which is drawn strictly in conjunction with RBI Master circular on investments. The entire compliance needs to be evaluated in terms of requirements of investment policy read with master circular RBI

Audit Procedures:

Area of Focus	Suggested Audit Procedures
Internal Control Evaluation and Review of Investment Policy	• 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. • It should clearly outline the broad investment objectives separately for the investments on its own account and investments on behalf of customers.
Separation of Investment Functions	• Check the segregation of duties within the bank staff in terms of executing trades, settlement and monitoring of such trades,

© The Institute of Chartered Accountants of India

	and accounting of the same (generally termed as front office, middle office and back-office functions' segregation).
Examination of Reconciliation	• Examine the reconciliation of the investment account, physically verify the securities on hand, obtain confirmations from counter-party banks for Bank Receipts (BRs) issued by such banks and on hand, obtain confirmation of Subsidiary General Ledger (SGL) balances with the Public Debt Office (PDO), and examine the control and reconciliation of BRs issued by the bank.
Examination of Documents	• Ascertain whether the investments made by the bank are within its authority. • Ensure 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. • The acquisition/disposal of investments should be verified with reference to the broker's contract note, bill of costs, receipts and other similar evidence.
Physical Verification	• Verify the investment scrips physically at the close of business on the date of the balance sheet. • Verify investments held with public debt office of RBI, custodians and depository with the statement of holdings as on date of balance sheet. Independent balance confirmation requests can be made in accordance with SA-505. In case independent confirmations are not received back, alternative audit procedures like getting bank personnel to download investment statement from E-Kuber for government securities (E-Kuber is CBS platform of RBI) in auditor's presence can be designed. • 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 extended period, the auditor should obtain written explanation from the management for the reasons thereof. The auditor should examine the reconciliation of BRs issued by the bank. BRs should not be issued in respect of transactions in government securities for which SGL facility is available. • If certain securities are held in the names of nominees, the auditor should examine whether there are proper transfer

© The Institute of Chartered Accountants of India

	deeds signed by the holders and an undertaking from them that they hold the securities on behalf of the bank.
Examination of classification and shifting	• Examine that entire investment portfolio of bank is classified under three categories i.e.HTM, HFT and AFS and shifting of securities is as per regulatory norms and laid down policy. • Examine whether the shifting of the investments from 'available for sale' to 'held to maturity' is duly approved by the Board of Directors of the bank.
Examination of Valuation	• Examine whether the method of accounting followed by the bank in respect of investments, including their year-end valuation, is appropriate. • Examine whether the investments have been properly classified into the three categories at the time of acquisition based on such intention as evidenced by the decision of the competent authority such as Board of directors, Asset Liability Committee (ALCO) or Investment Committee. • Examine compliance by the bank with the guidelines of the RBI relating to valuation of investments. • Verify that investments are classified as non-performing investments (NPI) as per applicable RBI guidelines. (Non-performing investments are those where interest/principal is in arrears and remains unpaid for more than 90 days). In such cases, banks have not to reckon income on securities and are required to make provisions for depreciation in value of investment. • Examine whether income from investments is properly accounted for. This aspect assumes special importance in cases where the bank has opted for receipt of income through the electronic/on line medium. • Verify whether adequate disclosure of any change in method of valuation of investment is made. • Examine whether the profit or loss on sale of investments has been computed and accounted for properly. • Verify that there is a proper system for recording and maintenance of TDS certificates received by the bank.
Dealings in Securities on Behalf of Others	• Examine whether prior approvals for carrying out such dealings have been obtained.

© The Institute of Chartered Accountants of India

	• Examine whether bank's income from such activities has been recorded and is fairly stated in the bank's financial statements. • Consider whether the bank has any material undisclosed liability from a breach of its fiduciary duties, including the safekeeping of assets.
Special-purpose Certificates Relating to Investments	• Examine whether the bank is maintaining separate accounts for the investments made by it on their 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.

Audit, Review and Reporting: Banks should undertake half-yearly reviews (as of 30th September and 31st March) of their investment portfolio. These half yearly reviews should not only cover the operational aspects of the investment portfolio but also clearly indicate amendments made to the investment policy and certify the adherence to laid down internal investment policy and procedures and RBI guidelines.

The internal auditors are required to separately conduct the concurrent audit of treasury transactions and the results of their report should be placed before the CMD once every month. Banks need not forward copies of the internal audit report to RBI. However, major irregularities observed in these reports and position of compliance thereto may be incorporated in the half yearly review of the investment portfolio.

III. ADVANCES

The Third Schedule to the Act requires classification of advances made by a bank from three different angles, *viz.*, nature of advance (like cash credit, overdrafts or term loans or bills purchased and discounted), nature and extent of security(like secured by tangible assets or covered by bank/govt guarantees), and and place of making advance (i.e. Whether in India or outside India). Further, advances in India are also to be classified also on sectoral basis (like priority sector or public sector).

Audit Approach: Advances generally constitute the major part of the assets of the bank. There are substantial number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors. The auditor is primarily concerned with obtaining evidence about the following while carrying out audit of advances:-

© The Institute of Chartered Accountants of India

- Amounts included in the balance sheet in respect of advances are outstanding at the date of balance sheet
- Advances represent amounts due to the bank
- Amounts due to the bank are appropriately supported by loan documents
- There are no unrecorded advances
- The stated basis of valuation of advances is appropriate and properly applied and recoverability of advances is recognized in their valuation.
- Advances are disclosed, classified and described in accordance with recognized accounting policies and practices and relevant statutory and regulatory requirements
- Appropriate provisions towards advances are made as per RBI norms, accounting standards and generally accepted accounting practices

It would be worth recalling that there exists elaborate and detailed control system & procedure in banks pertaining to appraisal, sanctioning, documentation, disbursal, review, monitoring and supervision of advances. Audit approach of advances should encompass designing appropriate audit procedures to obtain audit evidence in all these areas.

Audit Procedures - In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

Area of Focus	Suggested Audit Procedures
Evaluation of Internal Controls over Advances	• Examine area of credit appraisal and verify whether laid down procedures regarding credit appraisals including loan applications, preparation of proposals, obtaining satisfaction about credit worthiness of borrowers are being followed; • Examine advances are sanctioned according to delegated authority; • Examine all necessary loan documents have been executed after sanction but before disbursals are made to borrowers; • Examine compliance with stipulated terms of sanction and end use of funds more particularly in case of term loans; • Examine existence, enforceability and valuation of securities. In respect of securities requiring registration, examine this area also; • Examine the validity of the recorded amounts;

© The Institute of Chartered Accountants of India

	• Review operations of the accounts and look for adverse features like unauthorised over drawings beyond limits; • Examine whether system laid down in bank for review/renewals of advances is being followed; • Review whether drawing power is being calculated properly on basis of stock/book debt statements received from borrowers as stipulated in respective sanction letters; • Ensure compliance with Loan Policy of Bank as well as prudential norms of RBI including appropriate asset classification and provisioning.
Substantive Audit Procedures	• Verify correctness of master data of loan accounts updated in CBS. Check parameters like instalments, EMI, rate of interest, tenure of loans etc. • Verify that each customer of bank is tagged under single customer id in respect of all its accounts including those in which credit facilities are granted. • Examine all large advances while other advances may be examined on a sample basis. • Examine accounts identified to be problem accounts but which have not yet slipped into NPA category. This can be done by obtaining list of SMA1 and SMA2 borrowers from the bank and same can be considered for selection of problematic accounts. • Examine those accounts which have been adversely commented upon by concurrent auditors/bank's internal inspection/RBI inspection team. • Examine list of restructured accounts to ensure that restructure is as per RBI guidelines. Remember restructured account portfolio requires additional provisioning. • Examine quick/early mortality accounts. Any advance slippage to NPA within 12 months of its sanction is called as quick/early mortality case. • Verify completeness and accuracy of interest being charged. • Carry out appropriate analytical procedures.
Recoverability of Advances	• Review periodic statements submitted by the borrowers indicating the extent of compliance with terms and conditions. • Review latest financial statements of borrowers.

© The Institute of Chartered Accountants of India

	• Review reports on inspection of security. • Review auditor's reports in case of borrowers having credit facilities from the banking system beyond a cut-off limit fixed by board of directors of bank

Example 3

FT Cooperative Bank lent housing loan of ₹ 1 crore to Rahul, for an under construction flat. The project was still incomplete and the builder absconded. It turned out that the builder had taken a loan from another bank for the entire property on the basis of an equitable mortgage. Since equitable mortgage is not registered, FT bank was unable to trace the loan taken by the builder and therefore the borrower Rahul and FT bank both suffered.

It would be a better idea to first approve the builder after thoroughly examining his credentials, past performances etc., and then only consider giving loans to buyers of his flats to minimize such risks. In fact many banks nowadays do this. Somehow FT Coop bank did not take the precaution and landed in trouble. Further, CIBIL records of the builder also could have been checked. Loan sanctioning should not become a mere "tick the box" process.

Verification of asset classification, income recognition and Provision for Non-performing assets: An important aspect of audit of advances relates to their asset classification and provisioning (for provisioning norms refer Chapter 12 of Intermediate Auditing & Assurance Study Module). This implies that advances are classified in accordance with prudential norms on asset classification, income is recognized on actual record of recovery and a proper provision should be made in respect of advances where the recovery is doubtful.

Audit approach

The Reserve Bank has prescribed objective norms for determining the quantum of provisions required in respect of advances. The auditors must take / download the latest Master Circular of RBI to familiarise himself fully with the norms prescribed by RBI in this regard. The circulars issued by RBI after the date of issue of Master Circular and till the date of audit should also be taken / downloaded and reviewed by the auditors for its adherence. However, these norms should be construed as laying down the minimum provisioning requirements and wherever a higher provision is warranted in the context of the threats to recovery, such higher provision should be made.

In this regard, the provisions of section 15 of the Banking Regulation Act, 1949 may be noted. This section, which applies to banking companies, nationalised banks, State Bank of India and regional

© The Institute of Chartered Accountants of India

rural banks, requires the bank concerned to make adequate provision for bad debts to the satisfaction of its auditor before paying any dividends on its shares.

It may be noted that verification of applicable prudential norms on asset classification, income recognition and provisioning is an important responsibility of statutory branch auditor as well as statutory central auditor.

Area of Focus	Suggested Audit Procedures
Classification and Provision	• Verify whether bank has a system of ongoing identification and classification of advances through CBS without manual intervention and its accuracy in crystallising date of NPA. • Examine whether the classification made by the branch is appropriate. Particularly, examine the classification of advances where there are threats to recovery. • Examine whether the secured and the unsecured portions of advances have been segregated correctly and provisions have been calculated properly. • Review and compare the date of NPA of loan accounts mentioned in current year statements with that of previous year. Reasons for any change should be ascertained.
Accounts regularized near Balance sheet date	As per the Reserve Bank guidelines, if an account has been regularised before the balance sheet date by payment of overdue amount through genuine sources, the account need not be treated as NPA. Where, subsequent to repayment by the borrower (which makes the account regular), the branch has provided further funds to the borrower (including by way of subscription to its debentures or in other accounts of the borrower), the auditor should carefully assess whether the repayment was out of genuine sources or not. Where the account indicates inherent weakness based on the data available, the account should be deemed as NPA. In other genuine cases, the banks must furnish satisfactory evidence to the Statutory Auditors about the manner of regularisation of the account to eliminate doubts on their performing status. It is to be ensured that the classification is made as per the position as on date and hence classification of all standard accounts be reviewed as on balance sheet date. The date of NPA is significant to determine the classification and hence specific care be taken in this regard. NPA should be recognized only based on concept of Past Due/

© The Institute of Chartered Accountants of India

	Overdue concept, and not based on the Balance Sheet date.
Drawing Power Calculation	• Ensure that the drawing power is calculated as per the extant guidelines (i.e. the Credit Policy of the Bank) formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors reflected from respective sanction letters • Special consideration should be given to proper reporting of sundry creditors and stocks covered under LCs/guarantees for the purposes of calculating drawing power. It is to be ensured that declared stocks shall not cover borrower's liability outstanding in form of sundry creditors for goods or covered by LCs/guarantees availed for procurement of material. Similarly, in case bank has provided credit facility against primary security of book debts, net value of debtors (i.e. eligible trade debtors as per terms of sanction less bills discounted with banks) is to be arrived at. It is to be ensured that drawing power is calculated net of stipulated margin. Further, in case of consortium accounts, drawing power calculation and allocation made by lead bank is binding on member banks. • The drawing power needs to be calculated carefully in case of working capital advances to companies engaged in construction business. The valuation of work in progress should be ensured in consistent and proper manner. It also needs to be ensured that mobilization advance being received by the contractors is reduced while calculating drawing power. • The stock audit including audit of book debts should be carried out by the bank for all accounts having funded exposure of more than stipulated limit. 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.
Accounts with temporary deficiencies	• Banks 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 drawing power based on latest available stock statement, balance outstanding exceeding the limit temporarily and non-renewal of limits on the due date. However, stock statements relied upon by the banks

© The Institute of Chartered Accountants of India

	for determining drawing power should not be older than 3 months. The outstanding in the account based on drawing power calculated from stock statements older than 3 months are considered as irregular. Ensure adherence to these guidelines.
Limits not reviewed	• Accounts where regular/ad hoc limits are not reviewed within 180 days from the due date/date of ad hoc sanction, should be considered as NPA. Auditors should also ensure that the ad hoc/short reviews are not done on repetitive basis. In such cases, auditor can consider the classification of account based on other parameters and functioning of the account.
Asset classification to be borrower wise and not facility wise	• Ensure that asset classification is borrower wise and not facility wise. Therefore, it is to be ensured that all the facilities granted by a bank to borrower will have to be treated as NPA and not particular facility which has become irregular. Further, if debits arising out of devolvement of LC or invoked guarantees are kept in separate account, the outstanding balance should be treated as part of borrower's principal account for purpose of application of prudential norms on asset classification, income recognition and provisioning.
Government Guaranteed Advances	• If government guaranteed advance becomes NPA, then for the purpose of income recognition, interest on such advance should not to be taken to income unless interest is realized. However, for purpose of asset classification, credit facility backed by Central Government Guarantee, though overdue, can be treated as NPA only when the Central Government repudiates its guarantee, when invoked. This exception is not applicable for State Government Guaranteed advances, where advance is to be considered NPA if it remains overdue for more than 90 days. • In case the bank has not invoked the Central Government Guarantee though the amount is overdue for long, the reasoning for the same should be taken and duly reported in LFAR.
Agricultural Advances	• Ensure that NPA norms have been applied in accordance with the crop season determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops – short term/ long term - raised by an agriculturist, the NPA

© The Institute of Chartered Accountants of India

	norms would also be made applicable to agricultural term loans availed of by them. Also ensure that these norms are made applicable to all direct agricultural advances listed in Master Circular on lending to priority sector. • In respect of agricultural loans, other than those specified in the circular, ensure that identification of NPAs has been done on the same basis as non-agricultural advances.
Provisioning Towards Standard Assets	The auditor should check the latest RBI Circulars in this regard. It is be understood that provision for standard assets is also required to be made at variable rates in respect of different sectors for the funded outstanding in accordance with RBI norms as a matter of prudence. The provisions need to be checked in detail with the statement of advances. The bifurcation of standard advances under relevant category for proper calculation of provision should be checked and certified at branches level. The definition of respective items specified should be adhered as defined by RBI.
Restructured Advances	Restructuring is an act in which a lender, for economic or legal reasons relating to borrower's financial difficulty, grants concessions to the borrower. It may involve modification of terms of advances including alteration of amount of instalments/alteration of repayment period/rate of interest/sanction of additional credit facilities etc. to help in curing of default. RBI has given revised guidelines for treatment of restructured accounts by its circular. The auditor should verify compliance with the requirements of the circular issued in this regard. Banks may restructure the accounts classified under standard, substandard or doubtful categories. Banks cannot restructure accounts with retrospective effect. Once the bank receives an application/proposal in respect of an account for restructuring, it implies that the account is intrinsically weak. Accordingly, 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. On restructuring, the account will be downgraded from Standard to substandard. NPAs will remain in the same category.
Upgradation of Account	Examine all the accounts upgraded from NPA to standard category during the year, to ensure that the upgrading of each account is strictly

© The Institute of Chartered Accountants of India

	in terms of RBI guidelines. There can be a possibility of incorrect upgradation of account on the basis of partial recoveries made in the account and overdue portion might not have wiped out completely. There can also be a possibility of recoveries being made in the account after cut-off date and account being upgraded as on date of balance sheet.
Sale/ Purchase of NPAs	**In case of Sale/Purchase of NPA by 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 including non performing financial assets that may be purchased/sold, norms or such purchase/sale, valuation procedure and accounting policy. • only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years. • the assets have been sold/ purchased "without recourse' only i.e the entire credit risk associated with the non-performing asset should be transferred to the purchasing bank. • 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. • the NPA has been sold at cash basis only. Under no circumstances, NPA can be sold to another bank at a contingent price .The entire sale consideration has to be received on upfront basis. • the bank has not purchased an NPA which it had originally sold. **In case of sale of an NPA, the auditor should also ensure that:** • on the sale of the NPA, the same has been removed from the books of the account of selling bank on transfer; • 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. • 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

© The Institute of Chartered Accountants of India

	shortfall/ loss on account of sale of other non-performing financial assets. **Similarly, in case of purchase of NPAs, the auditor should verify that:** • the NPA purchased has been subjected to the provisioning requirements appropriate to the classification status in the books of the purchasing bank. • 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. • for the purpose of capital adequacy, banks have assigned 100% risk weights to the NPAs purchased from other banks.

TEST YOUR UNDERSTANDING 1

CA. Harshit is conducting statutory audit of branch of a public sector bank. On examining 20 large advances of the branch, he finds that in 5 examined cases, loan applications have been filled up scantily with important details left out. In these cases, it is also noticed that cash credit limits to the borrowers were enhanced during the year but there are no records pertaining to assessment of enhanced working capital requirements in respective borrower files. The branch is unable to show such assessments/workings in system either.

However, all the five accounts are operating satisfactorily. These accounts have been classified as standard assets by branch. Would above information prompt auditor to suggest change in asset classification of above accounts? What does depicted situation reflect?

IV. FIXED ASSETS

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. Premises wholly or partly owned by the banking company for the purpose of business including residential premises used by employees of bank are shown under the head "Premises". Other fixed assets include furniture & fixture, motor vehicles, computers, office equipment etc. 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).

© The Institute of Chartered Accountants of India

Section 9 of the Banking Regulation Act, 1949, 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.

Audit Approach : In most of the banks, fixed assets are generally purchased by the head office or regional/zonal offices. Statutory branch auditor has to ascertain the procedure followed and plan accordingly. In most of the banks, maintenance of records is centralized at head office level. In some of the banks, information relating to purchase, sale of fixed assets is accounted for with help of Fixed asset management software. The audit procedures have to be designed accordingly.

Audit Procedures

In carrying out the audit of fixed assets, the auditor is concerned primarily with obtaining evidence about their ownership, existence and valuation. For this purpose, the auditor should review the following:

Area of Focus	Suggested Audit Procedures
Internal Controls	Examine the system of internal controls broadly covering 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. • Ascertain whether the accounts in respect of fixed assets are maintained at the branch or centrally. • Ascertain the location of documents of title or other documents evidencing ownership of various items of fixed assets. • Examine whether acquisitions, disposals, etc. effected at the branch during the year have been properly communicated to the head office.
Premises	• 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 and documents such as, contractors' bills, work order records and record of payments.

© The Institute of Chartered Accountants of India

	• Examine whether the balances as per the fixed assets register reconcile with those as per the ledger and the final statements. • 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 useful life. • In case the title deeds are held at the head office or some other location, the branch auditor should obtain a written representation to this effect from the branch management and should bring this fact to the notice of the central statutory auditor through a suitable mention in the report. This fact should also be brought in the Long Form Audit Report (LFAR). • Where premises are under construction, it should be seen that they are shown under a separate heading, e.g., 'premises under construction'. • Advances/ payments to contractors for such assets should be shown under a separate item under the head "fixed assets". • Where the premises (or any other fixed assets) are re-valued, the auditor should examine the appropriateness of the basis of revaluation. The auditor should also examine whether the treatment of resultant revaluation surplus or deficit is in accordance with relevant Accounting Standard. The auditor should also check the impairment, if any, by applying the principles laid down in relevant Accounting Standard. • Examine that no immovable properties other than those required for the own use of the bank have been included in fixed assets (own use would cover use by employees of the bank, e.g., residential premises provided to employees). The branch auditor should also obtain a written representation to the above effect from the branch management.
Other Fixed Assets	• The procedures discussed above regarding premises also apply, to the extent relevant, to verification of other fixed assets. In respect of moveable fixed assets, the auditor should pay particular attention to the system of recording the movements as well as other controls over such fixed assets, e.g., their physical verification at periodic intervals by the branch management and/or by inspection/internal/concurrent audit team. The auditor should also examine whether discrepancies have been properly dealt with in the books of account and adequate provision in respect of any damaged assets has been made with appropriate approvals.

© The Institute of Chartered Accountants of India

	• In case of transfer of fixed assets, like furniture, office equipment, etc. from one branch to another; the auditor should examine whether accumulated depreciation in respect of such assets is also transferred. • In case of intangible assets, verify whether the relevant guidelines given by RBI by way of Circulars and the requirements of AS 26 have been followed. • Examine whether fixed assets have been properly classified. Fixed assets of similar nature only should be grouped together. **Example 4**. Items like safe deposit vaults should not be clubbed together with the office equipment's or the theft alarm system of the bank. • 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. • The auditor at head office level should examine if the consolidated fixed assets schedule matches in all respect and all the transfers in/out, are tallied. A broad check on the depreciation amount vis-a-vis the gross block of assets be reviewed with special emphasis on the computer hardware/software.
Sale of Fixed Assets	• Verify the copy of sale deed and receipt of the sale value, in respect of fixed assets sold during the year. Ensure that the profit/ loss on sale of assets has been properly accounted for.
Leased Assets	• Verify accounting and provisioning norms to be followed by banks undertaking leasing activity in accordance with RBI circulars and guidelines. The auditor, in respect of leased assets, should also have regard to the requirements of AS 19, "Leases".
Impairment of Assets	• Verify whether the guidelines given by RBI's circular on compliance with Accounting Standards,and the requirements of AS 28 have been followed.

V. OTHER ASSETS: The auditor may carry out the audit of various items appearing under the head 'other assets' in the following manner:

© The Institute of Chartered Accountants of India

Audit Procedures

Area of Focus	Suggested Audit Procedures
Inter-Office Adjustments	Examine whether Inter-branch accounts are normally reconciled at the central level. The auditor should report on the year-end status of inter-branch accounts indicating the dates up to which all or any segments of the 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 should ensure that any discrepancies found in inter-branch accounts have been properly dealt with in the books. The auditor can obtain the relevant information primarily from branch audit reports.
Interest Accrued	• 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. • Ensure that only such interest as can be realised in the ordinary course of business should be shown under this head. This is based on the principle, recognised in AS 9, that revenue cannot be recognised if there is a significant uncertainty about its collectability.
Tax Paid in Advance/Tax Deducted at Source	• Ensure that 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. • TDS Certificates / credits in the form 26AS, and claim of the same in Income Tax returns filed should be checked to ensure the justification of the claim towards such certificates. • At Head Office level, the availability of all the TDS Certificates / credits in the form 26 AS, and claim of the same in Income Tax returns filed should be checked to ensure the justification of the claim towards such certificates.
Stationery and Stamps	• Ensure that the item "Stationery and Stamps" includes only exceptional items of expenditure on stationery like bulk purchase of security paper which is to be written off over a period of time. Such items should be valued at cost. Normal expenditure on stationery is charged to profit & loss account. Therefore, this item may not appear at branch level as considerable part of stationery is supplied to branches by head office. • Evaluate the existence, effectiveness and continuity of internal controls over these items in the normal course of audit. It may be noted that the branch auditor is required to specifically comment on the adequacy of

© The Institute of Chartered Accountants of India

	the relevant internal controls in the LFAR. • 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. • 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	• Ensure that the heading includes those immovable properties/tangible assets which the bank has acquired in satisfaction of debts due or its other claims and these are being held with intention of being disposed off. • 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. • Check that the ownership of the property is legally vested with the bank. 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". • Ensure compliance with Section 9 of Banking Regulation Act, on holding period of such assets. • Ensure that as at date of acquisition, the assets should be recorded at lower of net book value of advance or net realisable value of asset acquired.

VI. OTHERS

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:

© The Institute of Chartered Accountants of India

Audit Approach and Procedures

Area of Focus	Suggested Audit Procedures
Non-Interest-Bearing Staff Advances	• Examine non-interest-bearing staff advances with reference to the relevant documentation and the policy in this regard which is framed by the bank. The availability, enforceability and valuation of security, if any, should also be examined. • Ensure that the same relates to employees on the rolls of the bank on the date of the preparation of financial statements.
Loans and Advances to Officials and Relatives	• The auditor should verify that loans have been ordinarily sanctioned by the next higher sanctioning authority as compared to the recipient of loan. • Loans to senior officers or of higher amount should have been reported to the Board.
Security Deposits	• Examine 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) with reference to documents containing relevant terms and conditions, and receipts obtained from the parties concerned. • Ensure that the deposit amount has not become due as per the terms and conditions. If it is so, then the recoverability of the same needs to be considered in detail and appropriate provision be made against the amount which is doubtful to recover.
Suspense Account	• Obtain from the management details of old outstanding entries in suspense account along with reasons for delay in adjusting the entries. Where the outstanding balances comprised in suspense account require a provision/write-off, the auditor should examine whether the necessary provision has been made/write-off.
Prepaid Expenses	• Examine whether the basis of allocation of expenditure to different periods is reasonable. • 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.
Miscellaneous Debit Balances on	• Review the ageing statements pertaining to these items. • Examine the recoverability of old outstanding items.

© The Institute of Chartered Accountants of India

Government Account	• Examine whether claims for reimbursement have been lodged by the branch in accordance with the relevant terms and conditions. The net balances of the amount recoverable at the Head Office level should also be taken along with the age-wise analysis of the same. In case of old outstanding balances without any confirmation or proper justification of the same, should be provided for in the accounts. • For major variance as compared to the previous year figures, verify whether reasons for the same have been recorded and reviewed.

8. VERIFICATION OF CAPITAL & LIABILITIES

I. CAPITAL

The auditor may carry out the audit of various items under 'Share Capital' in the following manner:

Audit Approach and Procedures

The auditor should verify the opening balance of capital with reference to the audited balance sheet of the previous year. In case there has been an increase in capital during the year, the auditor should examine the relevant documents supporting the increase. For example, in case of an increase in the authorised capital of a banking company, the auditor should examine the special resolution of shareholders and the Memorandum of Association. An increase in subscribed and paid-up capital of a banking company, on the other hand, should be verified with reference to prospectus/other offer document, reports received from Registrars to the issue, bank statement, returns filed with the Registrar of Companies etc.

Capital Adequacy: The term 'capital adequacy' is used to describe the adequacy of capital resources of a bank in relation to the risks associated with its operations.

Adequacy of capital of banks has been the subject matter of consideration by banking authorities around the world for several decades. An international agreement on a common risk-based capital framework and definition of bank capital was framed by the Committee on Banking Regulations and Supervisory Practices of the G-1O Nations (popularly known as the Basel Committee) and was formally adopted in 1988. Basel accords and frameworks were borne out of these deliberations.

The framework attempted to relate a bank's capital needs to its risk profile. Besides serving to strengthen the soundness and stability of the banking system, it also sought to give banks an incentive to hold lower-risk assets, incorporate off-balance sheet exposures explicitly into capital assessments, and achieve greater uniformity in application of capital standards to banks across different countries.

© The Institute of Chartered Accountants of India

8.1. Stress Testing

RBI has required that all commercial banks (excluding RRBs and LABs) shall put in place a Board approved 'Stress Testing framework' to suit their individual requirements which would integrate into their risk management systems. Stress tests are designed to understand whether a bank has enough capital to survive plausible adverse economic conditions and to maintain enough buffer to stay afloat under extreme scenarios.

8.2 BASEL III framework

Basel III norms relate to the Capital Adequacy requirement compliance which the Bank has to achieve as contained in the BASEL III accord. 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.

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.

The Basel III accord, aims at:

(a) improving the banking sector's ability to absorb shocks arising from financial and economic stress, irrespective of reasons thereof;

(b) improving risk management and governance practices; and

(c) strengthening banks' transparency and disclosure standards.

Capital Adequacy Measures in India: In India, the statutes governing various types of banks lay down the minimum capital requirements for them. Besides, there are also requirements for maintenance of statutory reserves. Considering the variations in minimum capital requirements applicable to distinct types of banks and taking into account the approach adopted by Basel Committee, the Reserve Bank prescribed, in year 1992, a uniform methodology for determining the capital adequacy of scheduled commercial banks (other than regional rural banks). The Master Circular on "Prudential Guidelines on Capital Adequacy and Market Discipline- New Capital Adequacy Framework (NCAF)", provides the guidelines to be followed by banks for capital adequacy. Some of the important aspects of the circular are covered below.

The basic approach of capital adequacy framework is that a bank should have sufficient capital to provide a stable resource to absorb any losses arising from the risks in its business. Capital is divided into tiers according to the characteristics/qualities of each qualifying instrument. For

© The Institute of Chartered Accountants of India

supervisory purposes capital is split into two categories: Tier I and Tier II, representing different instruments' quality as capital.

- *Tier I capital* consists mainly of share capital and disclosed reserves and it is a bank's highest quality capital because it is fully available to cover losses.
- ***Tier II capital*** consists of certain reserves and certain types of subordinated debt. The loss absorption capacity of Tier II capital is lower than that of Tier I capital.

Components of Capital: The Master Circular on Capital Adequacy discusses the Capital Funds in two categories – capital funds for Indian banks and capital funds of foreign banks operating in India.

In case of foreign banks operating in India, RBI's Master Circular on Capital Adequacy also lays down certain additional provisions in respect of capital to be followed by such banks.

Capital Risk Adequacy Ratio (CRAR): The CRAR is computed as follows:

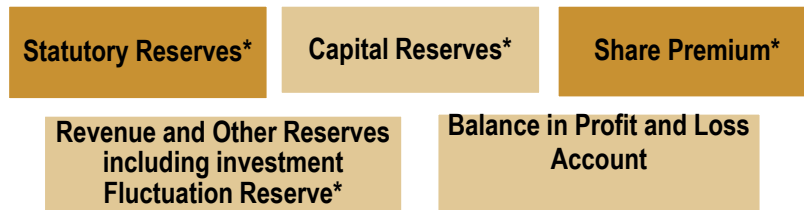
$$\frac{\text{Eligible Total Capital Funds}}{\text{Risk weighted assets and off-balance sheet items}} \times 100$$

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 for CRAR.

Example 6: For secured housing loans upto ₹ 75 lakh, the risk weight, subject to some conditions is 50%.for those above ₹ 75 lakhs, it is 75%, for loans to commercial real estate , it is 100%.Thus for a housing loan of ₹ 60 lakh given by the bank, the risk weighted asset will be taken at 60 x 50% = ₹ 30 lakhs for the purpose of the denominator in the above formula.

II. RESERVES AND SURPLUS

The following are required to be disclosed in the balance sheet under the head 'Reserves and Surplus'.



© The Institute of Chartered Accountants of India

*In respect of these items above, opening balance, additions during the year and deductions during the year are to be shown separately in respect of each item

Audit Approach and Procedures

The auditor should verify the opening balances of various reserves with reference to the audited balance sheet of the previous year. Additions to or deductions from reserves should also be verified in the usual manner, e.g., with reference to board resolution. In the case of statutory reserves and share premium, compliance with legal requirements should also be examined. Thus, the auditor should specifically examine whether the requirements of the governing legislation regarding transfer of the prescribed percentage of profits to reserve fund have been complied with. In case the bank has been granted exemption from such transfer, the auditor should examine the relevant documents granting such exemption. Similarly, it should be examined whether the appropriations from share premium account conform to the relevant legal requirements. Compliance with foreign laws in respect of overseas branches, need to be verified by the auditor.

III. DEPOSITS

Audit Approach

Deposits represent the important source of funds for banks. In carrying out audit of deposits and liabilities, the auditor is primarily concerned with obtaining reasonable assurance that all known liabilities are recorded and stated at appropriate amounts.

The following areas should be considered when auditing Deposits:

Remember that deposits accepted by banks are primarily of two types i.e those repayable on demand and those repayable after a fixed term. Current and saving accounts are the most common form of demand deposits. Term deposits (fixed deposits etc. known under different nomenclature in different banks) are repayable after a specified period of time ranging from 7 days at present to say one year or five years. Recurring deposits are also an important variant of term deposits in which a specified sum is deposited in the account at regular intervals for a pre-determined period. At maturity, proceeds are repaid to depositors along with interest.

© The Institute of Chartered Accountants of India

Deposits designated in foreign currencies e.g. Foreign currency non-resident deposits(FCNR) are accounts which are opened by Non-resident Indians in form of fixed deposit only.

Besides, there are some accounts like NRE [Non-Resident (External)Rupee account scheme] and NRO [Non-Resident Ordinary Rupee account scheme]. NRE accounts may be opened by Non-Resident Indians and persons of Indian origin. NRO accounts may be opened by all non-residents. These accounts may be maintained in form of savings, current, recurring or fixed deposit and are denominated in Indian Rupees.

Deposits would be appearing in balance sheet of most of the branches. Hence, these are of concern to auditors at branch and central/head office level.

Audit Procedures:

The auditor may verify various types of deposits in the following manner:

Area of Focus	Suggested Audit Procedures
Current and saving accounts	• ***Verify on a sample basis current account and saving accounts opened during the year for adherence to KYC norms. Verify that saving accounts are opened in name of individuals, HUF, some approved institutions like trusts, educational institutes etc. Remember that saving accounts are not opened for business or professional concern. The business transactions are carried in current accounts which can be opened for all kind of customers like companies, individuals, partnership firms etc.*** • Verify the balances in individual accounts on a sample basis. • Check the calculations of interest on a test check basis. Remember that no interest is paid generally on current accounts by banks. • Examine whether the procedure for obtaining balance confirmation periodically has been followed consistently. Examine, on a sampling basis, the confirmations received. • Ensure that debit balances in current accounts are not netted out on the liabilities side but are appropriately included under the head 'advances'. • Inoperative accounts (both current and saving) are a high-risk area of frauds in banks. As per RBI guidelines, 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. Verify on a sample basis some of inoperative accounts revived/closed during the year. Ensure that inoperative accounts are revived only with proper authority. In this regard, cases where there is significant reduction in balances of such accounts as

© The Institute of Chartered Accountants of India

	compared to previous year, examine authorisation for withdrawals.
Term deposits	• Examine whether the deposit receipts and cash certificates are issued serially and all of them are accounted for in the registers. • Verify in case of bulk deposits (₹ 2 crore and above for scheduled commercial banks presently), correct rate of interest has been offered. • In case of closure of term deposit, test check whether required foreclosure penalty has been deducted from applicable rate of interest payable. • Verify on sample basis some of recurring deposit accounts opened during the year. • Verify correctness of rate of interest on term deposits on sample basis.
Deposits designated in foreign currencies	• Verify some of FCNR accounts opened during the year on sample basis and ensure these conform to RBI directions. • Verify on sample basis permissible credits and debits in FCNR accounts as per RBI directions. • In case of FCNR accounts, examine whether these have been converted into Indian Rupees at rate notified in this behalf by head office. • Examine whether any resultant increase or decrease has been taken to the profit and loss account. • Verify that interest on deposits has been paid on the basis of 360 days in a year.
Others	• In case of NRE and NRO accounts, verify on a sample basis credits and debits as per RBI guidelines. Also check repatriablity. NRE accounts are repatriable whereas NRO accounts are not repatriable except for all current income subject to certain conditions.
General	• Verify that deposits of a bank are not inflated for purpose of balance sheet presentation. For example, some customers might be given overdrafts near date of balance sheet and the resultant overdrawn amounts may be placed as deposits with banks and further advances may be given on strength and security of these deposits. It would lead to inflated deposits as well as advances. The transactions may be reversed after close of the year. In such cases which indicate the possibility of window-dressing, the auditor should consider making a suitable qualification in main audit report besides other applicable reporting.

© The Institute of Chartered Accountants of India

	• 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'. • Ensure that framework relating to 'Know Your Customer' and Anti-Money Laundering measures is formulated and put in place by the bank.

IV. BORROWINGS

Audit approach

Borrowings of a bank are required to be shown in balance sheet as follows.

The total amount of secured borrowings included under the above heads is to be shown by way of a note to the relevant schedule. Secured borrowings for this purpose include borrowings/refinance in India as well as outside India. It may be noted that the inter-office transactions are not borrowings and therefore, should not be presented as such.

Audit Procedures:

Area of Focus	Suggested Audit Procedures
Borrowings	• Obtain and verify confirmation certificates and other supporting documents such as, agreements, correspondence, etc. • External confirmations received directly by the auditor from appropriate confirming parties 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 SA 505 "External Confirmations" which contains guidance on designing and performing external confirmation procedures to obtain relevant and reliable audit evidence. • 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. • 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.

© The Institute of Chartered Accountants of India

	• Examine the relevant correspondence or other documents to ensure that the branch has been authorised by the Head Office to borrow/retain other borrowings and that the terms on which borrowings have been made are in accordance with the authorisation. • Examine whether the amount shown in the branch accounts is properly classified based on security or otherwise.

V. OTHER LIABILITIES AND PROVISIONS

The Third Schedule to the Banking Regulation Act, 1949, requires disclosure of the following items under the head 'Other Liabilities and Provisions'.

Bills payable	Inter-office adjustments (net)	Interest accrued	Others (including provisions)

Audit Procedures:

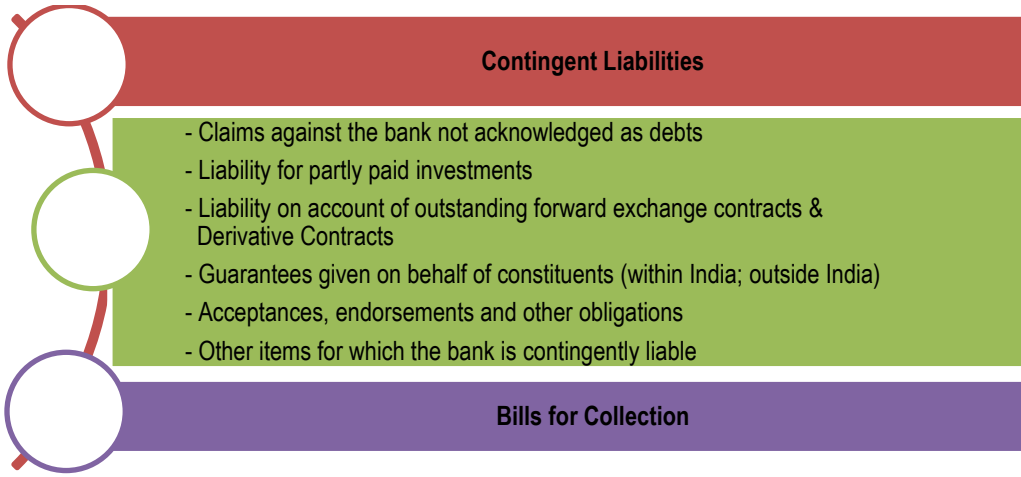
The auditor may verify the various items under the head 'other liabilities and provisions' in the following manner.

Area of Focus	Suggested Audit Procedures
Bills Payable	Evaluate the existence, effectiveness and continuity of internal controls over bills payable. Such controls should usually include the following- • Drafts, mail transfers, traveller's cheques, etc. should be made out in standard printed forms. • Unused forms relating to drafts, traveller's cheques, etc. should be kept under the custody of a responsible officer. • The bank should have a reliable private code known only to the responsible officers of its branches, coding and decoding of the telegrams should be done only by such officers. • The signatures on a demand draft should be checked by an officer with the specimen signature book. • All the telegraphic transfers and demand drafts issued by a branch should be immediately confirmed by advices to the branches concerned. On payment of these instruments, the paying branch should send a debit advice to the originating branch. Examine an appropriate sample of outstanding items comprised in bills payable accounts with the relevant registers. Reasons for old outstanding

© The Institute of Chartered Accountants of India

	debits in respect of drafts or other similar instruments paid without advice should be ascertained. Correspondence with other branches after the year-end (e.g., responding advices received from other branches, advices received from other branches in respect of drafts issued by the branch and paid by the other branches without advice) should be examined specially in so far as large value items outstanding on the balance sheet date are concerned.
Inter-office Adjustments	The balance in inter-office adjustments account, if in credit, is to be shown under this head.
Interest Accrued	Examine interest accrued with reference to terms of the various types of deposits and borrowings. It should be specifically examined that such interest has not been clubbed with the figures of deposits and borrowings shown under the head 'Deposits and Borrowings'.
Others (Including Provisions)	It may be noted that the figure of advances and investments in the balance sheet of a bank excludes provisions in respect thereof made to the satisfaction of auditors. The auditor should examine other provisions and other items of liabilities in the same manner as in the case of other entities.

VI. CONTINGENT LIABILITIES



Audit Approach

In respect of contingent liabilities, the auditor is primarily concerned with seeking reasonable assurance that all contingent liabilities are identified and properly valued. The auditor should obtain representation from management that:-

© The Institute of Chartered Accountants of India

(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.

Audit procedures

To this end, the auditor should, generally follow the audit procedures given below:

Area of Focus	Suggested Audit Procedures
Contingent Liabilities	• Ensure that there exists a system whereby the non-fund based facilities or additional/ad hoc credit facilities to parties are extended only to their regular constituents, etc. • 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. • Verify in case of LCs for import of goods, the payment to the

© The Institute of Chartered Accountants of India

	overseas suppliers is made based on shipping documents and after ensuring that the said documents are in strict conformity with the terms of LCs. • 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. • Test the completeness of the recorded obligations. • 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. • Review whether comfort letters issued by the bank has been considered for disclosure of contingent liabilities. • Examine whether the bank has given any guarantees in respect of any trade credit (buyer's credit or seller's credit) and the period of guarantees is co-terminus with the period of credit reckoned from the date of shipment. • Verify whether bank has extended any non-fund facility or additional/ad hoc credit facilities to other than its regular customers. In such cases, auditor should ensure concurrence of existing bankers of such borrowers and enquire regarding financial position of those customers.
Claims Against the Bank Not Acknowledged as Debts	• Examine the relevant evidence, e.g., correspondence with lawyers/ others, claimants, workers/officers, and workmen's/officers' unions. • Review the minutes of meetings of board of directors/committees of board of directors, contracts, agreements and arrangements, list of pending legal cases, and correspondence relating to taxes, and duties, etc. to identify claims against the bank. • Ascertain from the management the status of claims outstanding as at the end of the year. • A review of subsequent events would also provide evidence about completeness and valuation of claims.
Liability on Account of Outstanding Forward Exchange Contracts &	• 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

© The Institute of Chartered Accountants of India

derivative contracts	merchants to test the existence of such outstanding contracts. • The auditor may verify outstanding derivative contracts like options, interest rate swaps etc with reports generated in this regard.
Guarantees Given on Behalf of Constituents	• 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. • Ascertain whether there are adequate controls over unused guarantee 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. • Examine the guarantee register to seek evidence whether the prescribed procedure of marking off the expired guarantees is being followed or not. • Check the relevant guarantee registers with the list of outstanding guarantees to obtain assurance that all outstanding guarantees are included in the amount disclosed in this behalf. • Examine that expired guarantees are not included in this head. Verify guarantees with the copies of the letters of guarantee issued by the bank and with the counter-guarantees received from the customers. The auditor should also verify the securities held as margin. If a claim has arisen, the auditor should consider whether a provision is required in terms of the requirements of AS 29, "Provisions, Contingent Liabilities and Contingent Assets".
Acceptances, Endorsements and Other Obligations	• Evaluate the adequacy of internal controls over issuance of letters of credit and over custody of unused LC forms in the same manner as in the case of guarantees. • Verify the balance of letters of credit from the register maintained by the bank. The register indicates the amount of the letters of credits and payments made under them. The auditor may examine the guarantees of the customers and copies of the letters of credit issued. The security obtained for issuing letters of credit should also be verified. • Examine whether the bank has incurred a potential financial obligation in respect of letters of comfort and if such obligation

© The Institute of Chartered Accountants of India

	has been cast, ensure the amount to be disclosed under contingent liability.
Other Items for which the Bank is Contingently Liable	• Determine and verify any other items under this head as required. **For example**, outstanding underwriting contracts, bills rediscounting, disputed tax demands,
Bills for Collection	• Ensure that the bills drawn on other branches of the bank are not included in bills for collection. • Verify outward bills for collection with reference to the corresponding register maintained. • Examine collections made subsequent to the date of the balance sheet to obtain further evidence about the existence and completeness of bills for collection as on the date of Balance Sheet. • Examine the procedure for crediting the party on whose behalf a bill has been collected. Confirm that this procedure is in consonance with the nature of obligations of the bank in respect of bills for collection. • Examine that adequate internal controls exist 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.

Example 4:

A large scam happened at ABC bank wherein the employees, in collusion with an unscrupulous businessman, misused the SWIFT network to transmit messages to other banks on fund requirement. While all this was done using SWIFT passwords, the transactions were never recorded in the bank's core system, thereby keeping the bank management in the dark for years. No securities were being obtained. It caused loss of thousands of crores to the bank. Thus, it is important to give proper importance to the recording and disclosure of contingent liabilities even though they do not form part of the main balance sheet or at the most appear on both assets as well as liabilities side with equal amounts as contra items.

© The Institute of Chartered Accountants of India

9. AUDITOR'S REPORT

In the case of a nationalised bank, the auditor is required to make a report to the Central Government in which the auditor should state the following:

- Whether, in the auditor's opinion, the balance sheet is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the bank.
- In case the auditor had called for any explanation or information, whether it has been given and whether it is satisfactory.
- Whether or not the transactions of the bank, which have come to the auditor's notice, have been within the powers of that bank.
- Whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of audit.
- Whether the profit and loss account shows a true balance of profit or loss for the period covered by such account.
- Any other matter which the auditor considers should be brought to the notice of the Central Government.

9.1 Format of Audit Report

The auditors, central as well as branch, should also ensure that the audit report issued by them complies with the requirements of SA 700, "Forming an Opinion and Reporting on Financial Statements", SA 705, "Modifications to the Opinion in the Independent Auditor's Report", SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", SA 710, "Comparative Information-Corresponding Figures and Comparative Financial Statements" and SA 720, The Auditor's Responsibility Relating to Other Information in Documents Containing Audited Financial Statements.

© The Institute of Chartered Accountants of India

The auditor should ensure that not only the information relating to number of unaudited branches is given but quantification of advances, deposits, interest income and interest expense for such unaudited branches has also been disclosed in the audit report. Such disclosure in the audit report is not only in accordance with the best international trends but also provides useful information to users of financial statements.

It may be noted that, in addition to the aforesaid, the auditor of a banking company is also required to state in the report the matters covered by Section 143 of the Companies Act, 2013. However, it is pertinent to mention that the reporting requirements relating to the Companies (Auditor's Report) Order, 2020 is not applicable to a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949.

As per reporting requirements cast through Rule 11 of the Companies (Audit and Auditors) Rules, 2014 the auditor's report shall also include their views and comments on the following matters, namely:

(1) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;

(2) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;

(3) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

(4) (i) Whether the management has represented that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities ("Intermediaries"), with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries;

(ii) Whether the management has represented, that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including foreign entities

© The Institute of Chartered Accountants of India

("Funding Parties"), with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and

(iii) Based on such audit procedures that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to their notice that has caused them to believe that the representations under sub-clause (i) and (ii) contain any material mis-statement.

(5) Whether the dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013.

(6) Whether the company, has used such accounting software for maintaining its books of account which has a feature of recording audit trail (edit log) facility and the same has been operated throughout the year for all transactions recorded in the software and the audit trail feature has not been tampered with and the audit trail has been preserved by the company as per the statutory requirements for record retention.]

9.2 Long Form Audit Report

Besides the audit report as per the statutory requirements discussed above, 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). The long form audit report is to be given by statutory branch auditors as well as statutory central auditors. The LFAR for branch auditors is in form of questionnaire where observations/comments have to be provided on range of matters including cash, balance with banks, investments, advances, deposits etc. These are submitted by the statutory branch auditors to statutory central auditors.

The consolidation is done at head office level and LFAR for bank is submitted by statutory central auditors to management. The LFAR, on the bank, after due examination, should be placed before the ACB of the bank indicating the action taken/proposed to be taken for rectification of the irregularities, if any, mentioned therein; and a copy of the LFAR and the relative agenda note, together with the Board's views or directions, is submitted to RBI within 60 days of submission of LFAR by statutory auditors.

© The Institute of Chartered Accountants of India

9.3 Other Reporting Requirements

The RBI issued a Circular relating to implementation of recommendations of Committee on Legal Aspects of Bank Frauds applicable to all scheduled commercial banks (excluding Regional Rural Banks). The said circular provides details regarding liability of accounting and auditing profession including the professional conduct, non-disclosure of client information and need to report fraud.

Auditor should also consider the compliance with provisions of Standards on Auditing.

8. SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", explains that the duty of confidentiality is over-ridden by statute, law or by courts. Whereas an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error according to SA 240.

Further, as per sub-section 12 of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

It must be noted that auditor is not expected to consider each and every transaction but to evaluate the system as a whole. Therefore, if the auditor while performing normal duties comes across any instance, he/she should report the matter to the RBI in addition to Chairman/Managing Director/Chief Executive of the concerned bank.

9.4 Reports and certificates

Besides, as part of statutory audit process, statutory central auditor provides reports and certificates mainly consisting of following:-

- Report on adequacy and operating effectiveness of Internal financial Controls over Financial Reporting in case of banks
- Long form audit report.
- Report on compliance with SLR requirements.
- Report on whether the treasury operations of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.

© The Institute of Chartered Accountants of India

- Certificate on reconciliation of securities by the bank (both on its own investment account as well as PMS Banks' account).
- Certificate on compliance by the bank in key areas of prudential and other guidelines relating to such transactions issued by the RBI. (investment transactions)
- Report on 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 whether any serious irregularity was noticed in the working of the bank which requires immediate attention (in accordance with sec 143(12) of the Companies Act, 2013.)
- Certificate in respect of custody of unused Bank Receipt forms and their utilisation.
- Authentication of capital adequacy ratio, including disclosure requirements and other ratios reported in the notes to accounts.
- Report on status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to frauds and malpractices and of the recommendations of Jilani Committee on internal control and inspection/credit system.
- Report on instances of adverse credit-deposit ratio in the rural areas.
- Asset liability management.
- Certificate on Corporate Governance in case of banks listed on Stock Exchange. In some banks this certification may not be got done by the central auditors.
- Certification on claim of various interest subsidies and interest subvention.

10. CONCURRENT AUDIT

Concurrent audit, as the name suggests, is an audit or verification of transactions or activities of an organisation concurrently as the transaction/activity takes place. It is not a pre-audit. The concept in this audit is to verify the authenticity of the transaction/activity within the shortest possible time after the same takes place. It is akin to internal audit which is a concept recognised under the Companies Act. In view of the complexities of economic activities it is now well recognised that there must be a

© The Institute of Chartered Accountants of India

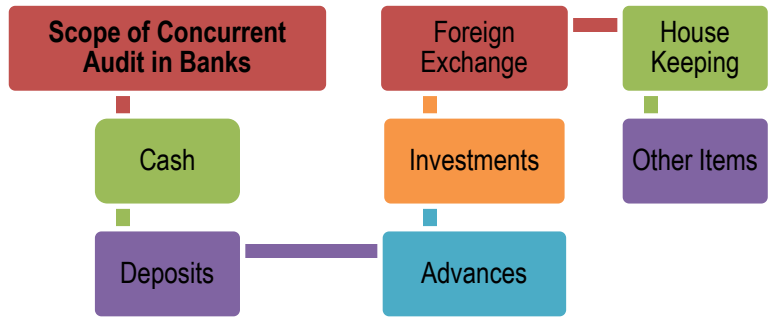
system of someone, other than the person involved in the operations, verifying the authenticity of the transaction/activity on a regular basis, so that any deviation from the laid down procedures can be noticed in the shortest possible time and remedial action can be taken.

The concept of concurrent audit in the public as well as the private sector banks has gained acceptance in recent years. In some banks, this task has been entrusted to the internal inspection staff who are not engaged in operational activities. In other banks, this work is allotted to outside professional firms of chartered accountants. The Reserve Bank of India (RBI) has issued certain guidelines for the conduct of this audit.

10.1 Scope of Concurrent Audit

The detailed scope of the concurrent audit should be clearly and uniformly determined for the Bank as a whole by the Bank's Central Inspection and Audit Department in consultation with the Bank's Audit Committee of the Board of Directors (ACB). In determining the scope, importance should be given to checking high-risk transactions having large financial implications as opposed to transactions involving lesser amounts. The detailed scope of the concurrent audit may be determined and approved by the ACB.

Further, the guidelines issued by the RBI cover all the key areas of activities of the branch which is under concurrent audit. Most banks have prepared an Audit Manual for this purpose. Broadly stated, the following areas are covered by these guidelines:



10.2 Concurrent Audit System in Commercial Banks

It hardly needs to be stressed that the concurrent audit system is to be regarded as part of a bank's early-warning system to ensure timely detection of irregularities and lapses which helps in preventing fraudulent transactions at branches. It is, therefore, necessary for the bank's management to bestow serious attention to the implementation of various aspects of the system such as selection of branches/coverage of business operations, appointment of auditors, appropriate reporting

© The Institute of Chartered Accountants of India

procedures, follow-up/rectification processes and utilisation of the feedback from the system for appropriate and quick management decisions.

The bank should once in a year review the effectiveness of the system and take necessary measures to correct the lacunae in the implementation of the programme.

10.3 Coverage of Business/Branches

The scope of work to be entrusted to concurrent auditors, coverage of business/branches, etc. is left to the discretion of the head of internal audit of banks with the due prior approval of the Audit Committee of the Board of Directors (ACB).

Banks may, however, ensure that risk sensitive areas identified by them as per their specific business models are covered under concurrent audit. The detailed scope of the concurrent audit may be determined and approved by the ACB.

The broad areas of coverage under concurrent audit shall be based on the identified risk of the unit and must include random transaction testing of sufficiently large sample of such transactions wherever required.

10.4 Types of Activities to be Covered

The areas that are typically covered as part of a concurrent audit and the suggested audit procedures are as follows:

Area of Focus	Suggested Audit Procedures
Cash	• Daily cash transactions with particular reference to any abnormal/ high value receipts and payments. • Proper accounting of inward and outward cash remittances. • Proper accounting of currency chest transactions, its prompt reporting to the RBI. • Expenses incurred by cash payment involving sizeable amount.
Investments	• Ensure that in respect of purchase or sale of securities the branch has acted within its delegated power having regard to its Head Office instructions. • Ensure that the securities held in the books of the branch are physically held by it. • Ensure that the branch is complying with the RBI/head Office

© The Institute of Chartered Accountants of India

	guidelines regarding BRs, SGL forms, delivery of scrips, documentation and accounting. • Ensure that the sale or purchase transactions are done at rates beneficial to the bank.
Deposits	• Check the transactions about deposits received and repaid. • Percentage check of interest paid on deposits may be made including calculation of interest on large deposits. • Check new accounts opened particularly current accounts. Operations in new current/SB accounts may be verified in the initial periods to see whether there are any unusual operations.
Advances	• Ensure that loans and advances have been sanctioned properly in accordance with delegated authority. • Ensure that securities and documents have been received and properly charged/ registered. • Ensure that post disbursement supervision and follow-up is proper, such as receipt of stock statements, instalments, recovery/ renewal of sanction limits, etc. • Verify whether there is any misutilisation of the loans and whether there are instances indicative of diversion of funds. • Check whether the letters of credit issued by the branch are within the delegated power and ensure that they are for genuine trade transactions. • Check the bank guarantees issued, whether they have been properly worded and recorded in the register of the bank. Whether they have been promptly renewed on the due dates. • Ensure proper follow-up of overdue bills of exchange. • Verify whether the classification of advances has been done as per RBI guidelines. • Verify whether the claims to DICGC and ECGC is submitted in time. • Verify that instances of exceeding delegated powers have been promptly reported to controlling/Head Office by the branch and have been confirmed or ratified at the required level.
Foreign Exchange	• Check foreign bills negotiated under letters of credit. • Check FCNR and other non-resident accounts whether the debits

© The Institute of Chartered Accountants of India

	and credits are permissible under rules. • Check whether inward/outward remittance have been properly accounted for. • Examine extension and cancellation of forward contracts for purchase and sale of foreign currency. Ensure that they are duly authorised and necessary charges have been recovered. • Ensure that balances in Nostro accounts in different foreign currencies are within the limit as prescribed by the bank. • Ensure that the overbought/oversold position maintained in different currencies is reasonable, considering the foreign exchange operations. • Ensure adherence to the guidelines issued by RBI/HO of the bank about dealing room operations. • Ensure verification/reconciliation of Nostro and Vostro account transactions/balances.
House Keeping	• Ensure that the maintenance and balancing of accounts, ledgers and registers including clean cash is proper. • Early reconciliation of entries outstanding in the inter-branch and inter-bank accounts, Suspense Account, Sundry Deposits Account, DDRR Account, Drafts Account, etc. • Ensure timely adjustment of large value entries. • Carry out a percentage check of calculations of interest, discount, commission and exchange. • Check whether debits in income account have been permitted by the competent authorities. • Check the transactions of staff accounts. • Examine the day book to verify as to how the differences in clearing have been adjusted. • Detection & prevention of revenue leakages through close examination of income and expenditure accounts. • Verify cheques returned/bills returned register and look into reasons for return of those instruments. • Checking of inward and outward remittances (DDs, MTs & TTs).
Other items	• In case the branch has been entrusted with government business, ensure that the transactions are done in accordance with the

© The Institute of Chartered Accountants of India

	instructions issued by Government, RBI & HQ. • Ensure that the branch gives proper compliance to the internal inspection/audit reports. • Ensure that customers' complaints are dealt with promptly. • Verify the statements, returns, statutory returns etc. submitted to RBI/ HQ.

10.5 Appointment of Concurrent Auditors and Accountability

• *The option to consider whether concurrent audit should be done by bank's own staff or external auditors is left to the discretion of individual banks.*
• ***In case the bank has engaged its own officials, they should be experienced, well trained and sufficiently senior. The staff engaged on concurrent audit must be independent of the branch where concurrent audit is to be conducted.***
• ***ACB of the bank shall decide the maximum tenure of external concurrent auditors with the bank. Generally, tenure of external concurrent auditors with a bank shall not be more than five years on continuous basis. However, no concurrent auditor shall be allowed to continue with a branch/business unit for a period of more than three years.***
• ***If external firms are appointed and any serious acts of omissions or commissions are noticed in their working their appointments may be cancelled and the fact may be reported to RBI & ICAI.***

10.6 Remuneration of Concurrent Auditor

Terms of appointment of the external firms of Chartered Accountants for the concurrent audit and their remuneration may be fixed by ACB of banks keeping in view various factors such as coverage of areas, skill sets required, number of staff required and time to be devoted to audit.

10.7 Reporting Systems

• There should be proper reporting of the findings of the concurrent auditors. For this purpose, each bank should prepare a structured format. The major deficiencies/ aberrations noticed during audit should be highlighted in a special note and given immediately to the bank's branch/controlling offices. A quarterly review containing key features brought out during the concurrent audits should be placed before the ACB.
• There should be zone-wise reporting of the findings of the concurrent audit to ACB and an annual appraisal/report of the audit system should be placed before the ACB.
• Before submission of the report the auditor should discuss the important issues on which

© The Institute of Chartered Accountants of India

	he/she wishes to report with the branch manager and concerned officers. This will enable the auditor to take into consideration the opposite view point and clarify any doubts.
•	Minor irregularities pointed out by the concurrent auditors are to be rectified in a timely manner. Serious irregularities should be reported to the controlling offices/ Head Offices for immediate action.
•	Whenever fraudulent transactions are detected, they should immediately be reported to Inspection & Audit Department (Head Office) as also the Chief Vigilance Officer as well as Branch Managers concerned (unless the branch manager is involved).
•	Follow-up action on the concurrent audit reports should be given high priority by the controlling office/Inspection and Audit Department and rectification of the features done without any loss of time.

11. AUDIT COMMITTEE

Banks are required to constitute an Audit Committee of their Board in pursuance of RBI guidelines. One of the functions of this committee is to provide direction and also oversee the operations of the total audit function in the bank. The committee also has to review the internal inspection/audit function in the bank, with special emphasis on the system, its quality and effectiveness in terms of follow up. The committee has to review the system of appointment and remuneration of concurrent auditors.

The Audit Committee is, therefore, connected with the functioning of the system of concurrent audit. The method of appointment of auditors, their remuneration and the quality of their work is to be reviewed by the Audit Committee. It is in this context that periodical meetings by the members of the audit committee with the concurrent auditors and statutory auditors help the audit committee to oversee the operations of the total audit function in the bank.

TEST YOUR UNDERSTANDING 2

You are conducting concurrent audit of branch of a public sector bank. It is a large branch having advances of about ₹ 500 crores including export advances of ₹ 300 crores. Some borrowers also get LCs issued from branch for importing raw diamonds from diamond hubs of Belgium. You want to be sure that there is no revenue leakage in branch. For the time being, you are focusing upon advances. Discuss any five areas pertaining to advances of the branch which you would verify to ensure no revenue leakage.

© The Institute of Chartered Accountants of India

TEST YOUR UNDERSTANDING 3

CA. Seema is appointed as stock auditor of Bhawani Rice Mills Pvt. Ltd. availing credit facilities from R.K. Puram Branch, Near Tamil Educational Society, New Delhi.

The borrower is enjoying cash credit limit of ₹ 12 crore from branch against security of paid stocks and debtors up to 90 days against margin of 25%. She proceeds to visit premises of Bhawani Rice Mills Pvt. Ltd. located on outskirts of Delhi. She verifies books of accounts and stock records of the company and also test checks quantity of paddy and rice of 20000 quintals and 8000 bags lying in premises of the company. Drawing power of ₹ 12.05 crore is computed in stock audit report and report stands submitted to bank.

After about a week, regular internal inspector appointed by Inspection department of bank also happened to visit premises of the borrower and found that rice contained in about 5000 bags included in stocks having approx. value of ₹ 1.50 crore was fungus ridden. The company was holding this stock for last 15 months.

How do you view the above situation? Discuss.

Integrated Case Scenario

CA. Madhusudan is conducting concurrent audit of a branch of a nationalized bank. It is a large branch having deposits of ₹ 350 crore and advances of ₹ 600 crore respectively. The deposits of branch consist of term deposits apart from CASA deposits. It is an old branch in operation since late 70s. Therefore, there are many dormant deposit savings, current and term deposit accounts at the branch.

Of late, the top management of the bank has been pushing for aggressive targets in opening of CASA deposits. He wants to ensure that CASA deposit accounts opened by the branch during his term comply with KYC norms.

During the course of concurrent audit of a particular month, he finds that temporary over limits are granted to few borrowers availing cash credit facilities up to 10% of their respective sanctioned limits. Granting of such over limits falls within the powers of Chief Manager of the said branch. It is also noticed by him that temporary overdrafts are allowed to few customers in their current accounts. However, granting of these temporary overdrafts also falls in Chief Manager's delegated powers. Temporary over limits and overdrafts as discussed above have been adjusted and paid before the end of the month.

It is further noticed by him during the same month that branch has sanctioned 5 fresh advances falling within Chief Manager's powers and conforming to bank norms aggregating to ₹ 10 crore. All

© The Institute of Chartered Accountants of India

these sanctioned advances pertain to same industry i.e., jute mills manufacturing jute sacks. He feels that branch's approach is not proper and sanction of 5 advances to the same industry lacks diversity and lending decision of branch is not proper.

He further notices that during the month, one borrower of branch falling under definition of "small enterprise" in MSME sector has shifted its credit facilities from the branch to a bank in private sector. The branch has levied foreclosure charges on outstanding credit facilities pertaining to borrower by disregarding *"Code of Bank's Commitment to Micro and Small Enterprises".* The borrower is still having current account with branch. Reversal of such charges would lead to revenue loss for branch. He is in a fix as far as reporting is concerned.

Keeping in view above, answer the following questions: -

1. As regards dormant deposit accounts in the branch, which of the following is not part of duty of concurrent auditor?

   (a). Verifying that dormant accounts are revived with appropriate authority

   (b). Examining authorisation for withdrawals

   (c). Following up with account holders to ensure status of accounts remains active

   (d). Verifying that dormant accounts at the branches ageing more than 10 years have been transferred to Deposit Education and Awareness Fund (DEAF)

2. The concurrent auditor wants to ensure that fresh CASA accounts opened in the branch are KYC compliant. Which of the following best sums up scope of KYC guidelines prescribed by RBI?

   (a). The basic purpose of such guidelines is to weed out duplicate customers at the same branch.

   (b). Such guidelines contain detailed requirements for banks to enable them to draw a 360-degree credit profile of the customers by monitoring of transactions. Its primary purpose is assisting banks in making prudent credit decisions.

   (c). Such guidelines have a basic objective of ensuring credit of Direct benefit transfers (DBT) in accounts of deserving account holders.

   (d). Such guidelines contain detailed requirements in respect of customer acceptance policy, customer identification procedures, monitoring of transactions and risk management.

© The Institute of Chartered Accountants of India

3. Which of the following statements is most appropriate as regards reporting of matters relating to temporary over limits in cash credit accounts and temporary overdrafts in current accounts?

   (a). The said instances cannot be reported as these fall in powers of Chief Manager.

   (b). The said instances can be reported in monthly concurrent audit report. No discussion is necessary with Chief Manager in this respect to ensure sanctity of report.

   (c). The said instances can be reported in monthly concurrent audit report. However, a discussion is necessary with Chief Manager in this respect.

   (d). The said instances cannot be reported as these fall in powers of Chief Manager and have been adjusted and paid before the end of the month.

4. Which of the following statements is most appropriate regarding sanction of fresh advances to borrowers in the same industry in a month from concurrent auditor's perspective?

   (a). Such a lending lacks diversity and needs to be reported without fail.

   (b). Such a lending increases credit risk for branch and needs immediate attention of higher authorities of bank.

   (c). Lending has been made within Chief Manager's powers. It does not fall in concurrent auditor's domain to question wisdom of lending decision conforming to bank norms.

   (d). Although lending has been made within Chief Manager's powers, branch should have reported to higher authorities flagging sanction of fresh advances to same industry. Only this aspect should be reported in concurrent auditor's report.

5. As regards matter of levying of foreclosure charges described in case scenario, what is appropriate course of action for concurrent auditor?

   (a). The matter should be reported even though it would lead to revenue loss for branch.

   (b). The matter should not be reported as it is part of duties of concurrent auditor to safeguard branch's revenue interests.

   (c). The matter should be reported only for its disregard of Code without highlighting revenue impact.

   (d). The matter concerns branch management's decision. It does not fall in purview of concurrent audit.

© The Institute of Chartered Accountants of India

Key Takeaways

- Special audit considerations arise in audit of banks due to particular nature of risks associated with transactions undertaken, scale of banking operations, extensive dependence on IT to process transactions, effect of statutory and regulatory requirements and continuous roll out of new products and services.
- Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit. Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.
- It is pertinent to state that preparation of balance sheet of a bank usually involves preparation of standalone financial statements and consolidated financial statements. Preparation of Standalone financial statements involve consolidation of branch accounts and incorporation of various verticals/departments of bank in case of a nationalized bank/public sector bank. The detailed procedures in this regard may vary from bank to bank. In case of private banks, the processes of accounting are centralized and there is no concept of mandatory branch audit in accordance with RBI guidelines.
- Most banks, especially those in nationalised banks or public sector, appoint four or more (depending upon their size and Board decision, as per RBI guidelines) firms of chartered accountants to act jointly as statutory central auditors (SCAs)
- As per the provisions of the relevant enactments, the auditor of a banking company is to be appointed at the annual general meeting of the shareholders, whereas the auditor of a nationalised bank is to be appointed by the concerned bank acting through its Board of Directors. In either case, approval of the Reserve Bank is required before the appointment is made.
- The technological developments have brought new challenges for auditors as audit is required to be conducted through the system.
- It is responsibility of statutory central auditors to obtain understanding of IT environment and various controls put in place by management and evaluate whether controls are operating effectively.
- Banks are required to implement and maintain a system of internal controls for mitigating risks, maintain good governance and to meet the regulatory requirements. Areas of focus in respect of internal control include cash, clearings, bills for collection, bills purchased, loans

© The Institute of Chartered Accountants of India

and advances, inter-branch accounts and credit card operations. Audit procedures have to be designed for verification of items of assets and liabilities taking into account special considerations relevant to banks.

- Advances generally constitute the major part of the assets of the bank. The audit of advances requires the major attention from the auditors. There exists elaborate and detailed control system & procedure in banks pertaining to appraisal, sanctioning, documentation, disbursal, review, monitoring and supervision of advances. Audit approach of advances should encompass designing appropriate audit procedures to obtain audit evidence in all these areas.
- Concurrent audit is an audit or verification of transactions or activities of an organisation concurrently as the transaction/activity takes place. The concept in this audit is to verify the authenticity of the transaction/activity within the shortest possible time after the same takes place.
- Concurrent audit system is to be regarded as part of a bank's early-warning system to ensure timely detection of irregularities and lapses which helps in preventing fraudulent transactions at branches. The important areas to be covered in concurrent audit include cash, investments, deposits, advances, foreign exchange and house- keeping etc.
- Banks are required to constitute an Audit Committee of their Board in pursuance of RBI guidelines. One of the functions of this committee is to provide direction and also oversee the operations of the total audit function in the bank. The committee also has to review the internal inspection/audit function in the bank, with special emphasis on the system, its quality and effectiveness in terms of follow up. The committee has to review the system of appointment and remuneration of concurrent auditors.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *Your firm has been appointed as Central Statutory Auditors of a Nationalised Bank. The Bank follows financial year as accounting year. Your Audit Manager informed that the bank has recognised on accrual basis income from dividends on securities and Units of Mutual Funds held by it as at the end of financial year. The dividends on securities and Units of Mutual Funds were declared after the end of financial year. Comment.*

© The Institute of Chartered Accountants of India

2. *As statutory central auditors of a Nationalized bank, what special points are to be borne in mind in the audit of compliance with "Statutory Liquidity Ratio" (SLR) requirements?*

3. *Explain the scope of concurrent audit of a bank with reference to Reserve Bank of India guidelines.*

4. *In course of audit of Good Samaritan Bank as at 31st March, 23 you observed the following:*

   (a) *In a particular account there was no recovery in the past 18 months. The bank has not applied the NPA norms as well as income recognition norms to this particular account. When queried the bank management replied that this account was guaranteed by the central government and hence these norms were not applicable. The bank has not invoked the guarantee. Please respond. Would your answer be different if the advance is guaranteed by a State Government?*

   (b) *The bank's advance portfolio comprised of significant loans against Life Insurance Policies. Write suitable audit program to verify these advances.*

5. *Your firm has been appointed as Central Statutory Auditors of a Nationalised Bank. The bank is a consortium member of Cash Credit Facilities of ₹ 50 crores to X Ltd. Bank's own share is ₹ 10 crores only. During the last two quarters against a debit of ₹ 1.75 crores towards interest the credits in X Ltd's account are to the tune of ₹ 1.25 crores only. Based on the certificate of lead bank, the bank has classified the account of X Ltd as performing. The Bank follows financial year as accounting year. Advise your views on the issue which were brought to your notice by your Audit Manager.*

6. *You have been appointed as an auditor of LCO Bank, a nationalized bank. LCO Bank also deals in providing credit card facilities to its account holder. The bank is aware of the fact that there should be strict control over storage and issue of credit cards. How will you evaluate the Internal Control System in the area of Credit Card operations of a Bank?*

7. *You have been appointed as Concurrent Auditor of a nationalized bank branch. The main business at the branch is dealing in foreign exchange. Suggest the main areas of coverage with regard to foreign exchange transactions of the said branch under concurrent audit.*

8. *While auditing FAIR Bank, you observed that a lump sum amount has been disclosed as contingent liability collectively. You are, therefore, requested by the management to guide them about the disclosure requirement of Contingent Liabilities for Banks. Kindly guide.*

9. *ABC Chartered Accountants have been appointed as concurrent auditors for the branches of Effective Bank Ltd. for the year 2022-23. You are part of the audit team for Agra branch of*

© The Institute of Chartered Accountants of India

the bank and have been instructed by your senior to verify the advances of the audit period. You are required to guide your assistant about the areas to be taken care while doing verification during the concurrent audit.

10. *In the course of audit of Skip Bank Ltd., you found that the Bank had sold certain of its non-performing assets. Draft the points of audit check that are very relevant to this area of checking.*

11. *Banks, because of certain characteristics, are distinguished from other commercial enterprises and hence it needs special audit consideration. As an auditor of a bank, specify the various peculiarities which may necessitate special audit consideration to be taken care by you?*

12. *ABC Bank had sanctioned credit limits of ₹ 100 lakh to M/s Volkart Ltd on 1st September 2021. The renewal of limits was due on 1st September 2022. While doing the statutory branch audit for the year ended 31st March 2023, you find that the renewal has not been done even though 180 days are over. The bank says that the renewal process has been initiated on time and most of the document are received. The account is operated regularly and is in order; balance is maintained within drawing power. It also shows a letter from Volkart stating that due to a sudden death of their auditor, a new auditor had to be appointed. Procedure for appointment took some time and the new auditor was doing the audit all over again. The limit was not renewed till 31/3/2023. However, the audited financials are received on 10th April 2023 and the renewal letter was issued immediately. Your assistant is insisting that the account must be classified as NPA since the limit was not renewed as on 31/3/2023. What is your opinion?*

13. *You are auditing a small bank branch with staff strength of the manager, cashier and three other staff S1 ,S2 and S3. Among allocation of work for other areas, S1 who is a peon also opens all the mail and forwards it to the concerned person. He does not have a signature book so as to check the signatures on important communications. S2 has possession of all bank forms (e.g. Cheque books, demand draft/pay order books, travelers' cheques, foreign currency cards etc.). He maintains a record meticulously which you have test checked also. However, no one among staff regularly checks that. You are informed that being a small branch with shortage of manpower, it is not possible to always check the work and records. Give your comments.*

© The Institute of Chartered Accountants of India

Answers to Test your understanding

1. An account becomes NPA when it ceases to generate income for bank. In the given situation, all the examined five accounts are operating satisfactorily. There is no reason for suggesting changes in their classification.

The matter of scantily filling up loan applications and lack for record for assessment of enhanced working capital requirements shows that internal control over advances in branch is not proper. The above said situation shows deficiencies in "credit appraisal" at branch level. Such deficiencies need to be highlighted by auditor in LFAR.

2. The areas of advances which need to be verified are as under: -

i. Interest rates fed in the system need to be verified with respect to corresponding sanction letters. It would help ensure that correct rate of interest is fed into the system and interest is applied properly at stipulated intervals on advances.

ii. Processing fees in respect of freshly sanctioned advances and renewed limits need to be levied in accordance with bank guidelines and these need to be verified. Any revision in processing fees from time to time has to be given effect to in accordance with circulars/manual of bank.

iii. Sanction of cash credit limits is generally accompanied with stipulation to submit stock statements. Non-submission of stock statements can involve levying of penal interest. Verification of this aspect is required.

iv. Verification of overdue interest on export bills purchased and packing credit facilities for overdue period.

v. Verification of charges/commission in respect of letters of credit issued in accordance with Bank's circulars/manual.

3. The above situation reflects that professional work of stock audit was not performed diligently by stock auditor. It is one of the important responsibilities of stock auditor to verify condition of stocks. The auditor's role is not limited to verify physical quantities only.

In given case, she should have got opened rice bags on test check basis. In the process, she could have come to know about fungus ridden condition of rice. Value of such rice should have been excluded while arriving at value of stocks for purpose of computation of drawing power. It shows that she has failed to perform her work diligently and drawing power calculated in the report submitted to bank is not proper.

© The Institute of Chartered Accountants of India

Answers to Integrated Case Scenario

1. (c)

2. (d)

3. (c)

4. (c)

5. (a)

Answers to Theoretical Questions

1. Banks may book income from dividend on shares of corporate bodies on accrual basis, provided dividend on the shares has been declared by the corporate body in its annual general meeting and the owner's right to receive payment is established. This is also in accordance with AS 9. In this case the dividends have been declared after the financial year end. Therefore, the recognition of income by the bank on accrual basis is not in order.

In respect of income from government securities and bonds and debentures of corporate bodies, where interest rates on these instruments are pre-determined, income could be booked on accrual basis, provided interest is serviced regularly and as such is not in arrears. It was further, however, clarified that banks may book income on accrual basis on securities of corporate bodies/public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the central government or a State government.

2. Refer Para no 6.

3. Refer Para no. 10.1

4. **(a)** **Government Guaranteed Advance:** If a government guaranteed advance becomes NPA, then for the purpose of income recognition, interest on such advance should not to be taken to income unless interest is realized. However, for purpose of asset classification, credit facility backed by Central Government Guarantee, though overdue, can be treated as NPA only when the Central Government repudiates its guarantee, when invoked.

Since the bank has not invoked the guarantee, the question of repudiation does not arise. Hence the bank is correct to the extent of not applying the NPA norms for provisioning purpose. But this exemption is not available in respect of income recognition norms. Hence the income to the extent not recovered should be reversed.

© The Institute of Chartered Accountants of India

The situation would be different if the advance is guaranteed by State Government because this exception is not applicable for State Government Guaranteed advances, where advance is to be considered NPA if it remains overdue for more than 90 days.

In case the bank has not invoked the Central Government Guarantee though the amount is overdue for long, the reasoning for the same should be taken and duly reported in LFAR.

(b) The Audit Programme to Verify Advances against Life Insurance Policies is as under-

(i) 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.

(ii) The auditor should also examine whether premium has been paid on the policies and whether they are in force.

(iii) Certificate regarding surrender value obtained from the insurer should be examined.

(iv) The auditor should particularly see that if such surrender value is subject to payment of certain premium, the amount of such premium has been deducted from the surrender value.

5. The bank is a consortium member of cash credit facilities of ₹ 50 crores to X Ltd. Bank's own share is ₹ 10 crores only. During the last two quarters against a debit of ₹ 1.75 crores towards interest, the credits in X Ltd.'s account are to the tune of ₹ 1.25 crores only. Sometimes, several banks form a group (the 'consortium') under the leadership of a 'lead bank' to make advance to a large customer on same conditions and security with proportionate rights. In such cases, each bank may classify the advance given by it according to its own experience of recovery and other factors. Since in the last two quarters, the amount remains outstanding and, thus, interest amount should be reversed. This is despite the certificate of lead bank to classify that the account as performing. Accordingly, the amount should be shown as non-performing asset.

6. Refer Para 5.

7. Refer Para 10.4.

8. Refer Para 8 - Part (VI)

9. Refer Para 7 sub heading III

10. Refer Para 7 sub heading III

© The Institute of Chartered Accountants of India

11. Refer Para 1

12. As per Guidelines of Reserve Bank of India the account should be classified as NPA if renewal is not done in 180 days. However, in the present case, operations in the account are excellent. The bank has shown a letter from that company that due to certain reasons the audited financial statements are delayed. Further, the limit has been renewed before signing the audit report.

Thus, even if the sanction was issued after the balance sheet date, it relates to the position as on the balance sheet date. Therefore, it is an adjusting event under AS 4, Contingencies and Events Occurring After the Balance Sheet Date. It is also a matter of substance over form.

The auditor would consider classifying the account as a standard asset.

13. Banks are required to implement and maintain a system of internal controls for mitigating risks, maintain good governance and to meet the regulatory requirements. Given below are examples of internal controls that are violated in the given situation:

In the instant case, S1 who is a peon opens all the mail and forwards it to the concerned person. Further, he does not have a signature book so as to check the signatures on important communications is not in accordance with implementation and maintenance of general internal control. As the mail should be opened by a responsible officer. Signatures on all the letters and advices received from other branches of the bank or its correspondence should be checked by an officer with the signature book.

All bank forms (e.g. Cheque books, demand draft/pay order books, travelers' cheques, foreign currency cards etc.) should be kept in the possession of an officer, and another responsible officer should verify the issuance and stock of such stationery. In the given case, S2 has possession of all bank forms (e.g. cheque books, demand draft/pay order books, travelers' cheques, foreign currency cards etc.). He maintains a record meticulously which were also verified on test check basis.

Further, contention of bank that being a small branch with shortage of manpower they are not able to check the work and records on regular basis, is not tenable as such lapses in internal control pose risk of fraud.

The auditor should report the same in his report accordingly.

© The Institute of Chartered Accountants of India

UNIT 2 – SPECIAL FEATURES OF AUDIT OF NON-BANKING FINANCIAL COMPANIES (NBFCs)

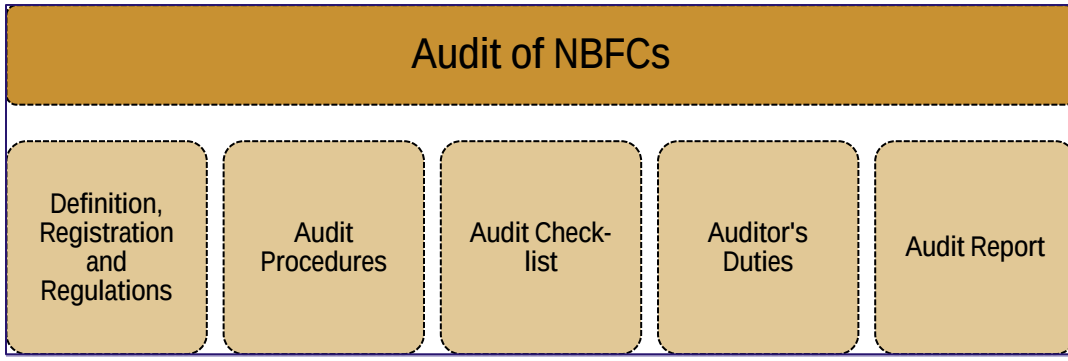
LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the definition, regulations and types of Non-Banking Finance Companies (NBFCs).
- Difference between Banks and NBFCs.
- Gain the knowledge of the prudential norms- Capital Requirements, Income Recognition, and Provisioning requirements.
- Learn the audit procedures and Audit Checklist for NBFCs.
- Apply & analyse the above-mentioned concepts in moderately complex scenarios.

© The Institute of Chartered Accountants of India

UNIT OVERVIEW



CA Sachet is appointed as the statutory auditor of an NBFC. How important are NBFCs in financial system of a large and diverse country as India? Part of country's financial services sector, NBFCs cater to variety of customers in rural and urban areas thus promoting inclusive growth. Such entities have become an important source of credit for those segments of society which cannot meet strict requirements of banks for lending purposes. They are popular in areas of housing finance, financing for commercial vehicles, microfinance industry, MSME sector and in other areas. And how does an NBFC differ from a bank? Although NBFCs lend like banks, they cannot accept demand deposits and are not part of payment and settlement system like banks.

As part of understanding NBFCs, Sachet found such entities to be strictly regulated. They have to obtain certificate of registration to commence business of non-banking financial institution. There are RBI directions and norms on acceptance of public deposits, capital adequacy, risk exposure and other measures to monitor financial solvency and reporting.

NBFCs are also subject to regulatory norms for asset classification, provisioning and income recognition as per directions of RBI. NBFCs having applicability of Ind AS are also required to consider principles of relevant Ind AS in the preparation of financial statements. In fact, financial statements of an NFBC having applicability of Ind-AS are required to be prepared in accordance with Division III of Schedule III of Companies Act, 2013. Audit approach to an NBFC has to take into account all such issues.

He was also checking for regulatory updates in NBFC sector as part of understanding it. He became aware of applicability of *"scale based"* regulations defining NBFCs on basis of their size, activity and perceived riskiness into four layers i.e., base layer, middle layer, upper layer and top layer.

© The Institute of Chartered Accountants of India

Whereas upper layer comprises of NBFCs specifically identified by RBI for enhanced regulatory requirement, top layer would ideally remain empty unless RBI is of the opinion that there is substantial increase in potential systemic risk from specific NBFCs in upper layer. Not in the upper layer published by RBI, he was trying to confirm classification of this very auditee company in accordance with such regulations.

Sensing that there was increased responsibility of an auditor of NBFC in view of various RBI directions, he tweaked his audit approach accordingly. Not only auditor of NBFC is required to report to shareholders, he is also responsible for making an additional report to the Board of Directors of the company on certain specified matters in accordance with RBI directions.

1. INTRODUCTION

Non-Banking Finance Company sector has evolved considerably in terms of its size, operations, technological sophistication, and entry into new areas of financial services and products. NBFCs are now deeply interconnected with the entities in the financial sector, on both sides of their balance sheets. Being financial entities, they are exposed to risks arising out of counterparty failures, funding and asset concentration, interest rate movement and risks pertaining to liquidity and solvency, as any other financial sector player. At the same time there are segments within the sector that do not pose any significant risks to the system.

Fig. : NBFCs*

Fig.: Audit of NBFCs*

* *Source: Techno Legal Journalists*
* *Source: Inventicon*

© The Institute of Chartered Accountants of India

Definition of NBFC: 45 I(f) of Reserve Bank of India (Amendment) Act, 1997 defines a non-banking financial company as:

(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;

(iii) Such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify;"

*Fig. : What is NBFC**

Further, in order to identify a particular company as Non-Banking Financial Company (NBFC), it will consider both assets and income pattern as evidenced from the last audited balance sheet of the company to decide its principal business. The company will be treated as NBFC when a company's financial assets constitute more than 50 per cent of the total assets (netted off by

---

** Source: Slideshare*

© The Institute of Chartered Accountants of India

intangible assets) and income from financial assets constitute more than 50 per cent of the gross income. A company which fulfils both these criteria shall qualify as an NBFC and would require to be registered as NBFC by RBI.

Registration and Regulation of NBFC:

Under Section 45–IA of the Reserve Bank of India Act, 1934, no non-banking financial company is allowed to commence or carry on the business of a non-banking financial institution without

- obtaining a certificate of registration issued by the Reserve Bank of India and
- having the net owned fund of twenty-five lakh rupees or such other amount, not exceeding hundred crore rupees, as the Bank may, by notification in the Official Gazette, specify.
- Provided that the Bank may notify different amount of net owned fund for different categories of non-banking financial companies.

RBI has notified different amounts of net owned fund for different categories of NBFCs including rupees 2 crore for certain categories of NBFCs

(For certain categories companies currently applying for registration as a NBFC, the minimum net owned fund requirement is INR 10 Crore (previously it was INR 2 Crore) (Minimum NOF amount may be higher depending on specific type of NBFC).

RBI has prescribed a timeline to meet NOF amount of INR 10 Crore in a phased manner for certain categories of existing NBFCs by 31st March 2027. However, for NBFC-P2P, NBFC-AA, and NBFCs with no public funds and no customer interface, the NOF shall continue to be INR 2 Crore.

A company incorporated under the Companies Act and desirous of commencing business of non-banking financial institution as defined under Section 45–IA of the RBI Act, 1934 can apply to the Reserve Bank of India in prescribed form along with necessary documents for registration. The RBI issues Certificate of Registration after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied.

The Reserve Bank of India has issued directions to non-banking financial companies on acceptance of public deposits, prudential norms like capital adequacy, income recognition, asset classification, provision for bad and doubtful debts, risk exposure norms and other measures to monitor the financial solvency and reporting by NBFCs.

Directions were also issued to auditors to report non-compliance with the RBI Act and the Regulations to the RBI, Board of Directors and shareholders. RBI has also issued Fair Practices Code to be adopted by all NBFCs while doing lending business. The guidelines inter alia, covered general principles on adequate disclosures on the terms and conditions of a loan and also adopting a non-coercive recovery method.

© The Institute of Chartered Accountants of India

Types of NBFCs- Compliance and Regulatory Perspective:

In terms of the Section 45-I(f) read with Section 45-I (c) of the RBI Act, 1934, as amended in 1997, non-banking financial company (NBFC) is a company registered under the Companies Act,1956/2013, engaged in the business of loans and advances, acquisition of shares/stocks/bonds/ debentures/ securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.

A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company).

NBFCs mandated to register under RBI

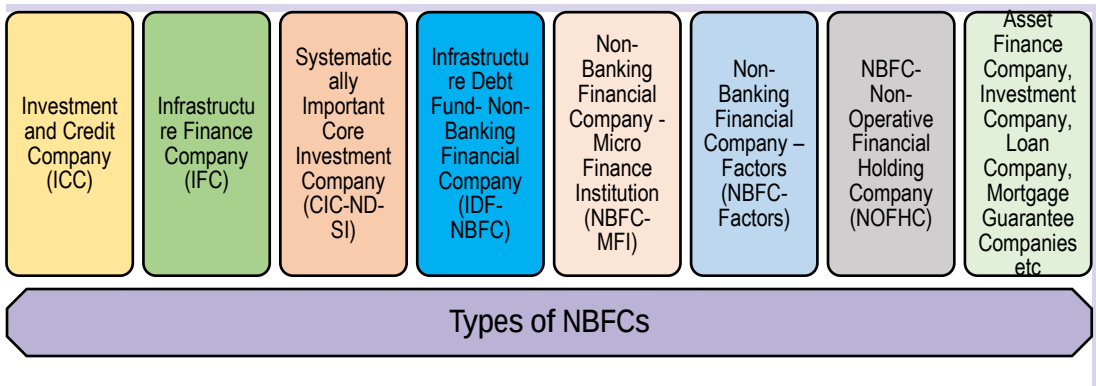
NBFCs registered with RBI are categorized as follows:

(a) in terms deposit acceptance or otherwise into Deposit and Non-Deposit accepting NBFCs;

(b) non deposit taking NBFCs by their size into systemically important and non-systemically important (NBFC-NDSI and NBFC-ND); and

(c) by the kind of activities, they conduct.

Within the categorization mentioned in (c) above, (i.e. by the kind of activity they conduct) the different types of NBFCs are as follows:



All NBFCs are either deposit taking or non-deposit taking. If they are non-deposit taking, ND is suffixed to their name (NBFC-ND).

© The Institute of Chartered Accountants of India

A. Companies exempted from registration under RBI

Companies that do financial business but are regulated by other regulators are given specific exemption by the Reserve Bank from its regulatory requirements for avoiding duality of regulation. Following NBFCs have been exempted from the requirement of registration under Section 45-IA of the RBI Act, 1934 subject to certain conditions.

➢ Housing Finance Institutions (regulated by National Housing Bank);
➢ Merchant Banking Companies (regulated by Securities and Exchange Board of India);
➢ Stock Exchanges (regulated by Securities and Exchange Board of India);
➢ Companies engaged in the business of stock-broking/sub-broking (regulated by Securities and Exchange Board of India);
➢ Venture Capital Fund Companies (regulated by Securities and Exchange Board of India);
➢ Nidhi Companies (regulated by Ministry of Corporate Affairs, Government of India);
➢ Insurance companies (regulated by Insurance Regulatory and Development Authority); and
➢ Chit Companies (as defined in clause (b) of section 2 of the Chit Funds Act, 1982 (Act 40 of 1982)).
➢ Specified Micro Finance Companies
➢ Securitisation and Reconstruction Companies
➢ Mutual Benefit Companies
➢ Core Investment Companies i.e. a non-banking financial company being a Core Investment Company referred to in the Core Investment Companies (Reserve Bank) Directions, 2016, which is not a Systemically Important Core Investment Company, as defined in sub-paragraph (xxv) of paragraph 3 of the Core Investment Companies (Reserve Bank) Directions, 2016.
➢ Alternative Investment Fund (AIF) Companies

Core Investment Companies with asset size of less than ₹ 100 crore, and those with asset size of ₹ 100 crore and above but not accessing public funds are exempted from registration with the RBI.

© The Institute of Chartered Accountants of India

Pursuant to the announcement of *Scale Based Regulation (SBR): A Revised Regulatory Framework for NBFCs* on 22 October 2021 to be effective from 01 October 2022, RBI has revised different facets of existing NBFC Classification and regulation like Capital Requirements, Governance Standards, Prudential Regulations, etc. based on four layers that are defined based on their size, activity, and perceived riskiness.

These four layers are NBFC – Base Layer (NBFC-BL), then NBFC- Middle Layer (NBFC-ML), NBFC Upper Layer (NBFC-UL) and lastly NBFC – Top Layer (NBFC-TL).

The Top layer is ideally expected to be empty and will be filled by RBI based on required need.

Details of NBFCs populating the various layers is mentioned below:

Base Layer

The Base Layer shall comprise of (a) non-deposit taking NBFCs below the asset size of ₹1000 crore and (b) NBFCs undertaking the following activities- (i) NBFC-Peer to Peer Lending Platform (NBFC-P2P), (ii) NBFC-Account Aggregator (NBFC-AA), (iii) Non-Operative Financial Holding Company (NOFHC) and (iv) NBFCs not availing public funds and not having any customer interface.

Middle Layer

The Middle Layer shall consist of (a) all deposit taking NBFCs (NBFC-Ds), irrespective of asset size, (b) non-deposit taking NBFCs with asset size of ₹1000 crore and above and (c) NBFCs undertaking the following activities (i) Standalone Primary Dealers (SPDs), (ii) Infrastructure Debt Fund - Non-Banking Financial Companies (IDF-NBFCs), (iii) Core Investment Companies (CICs), (iv) Housing Finance Companies (HFCs) and (v) Infrastructure Finance Companies (NBFC-IFCs).

Upper Layer

The Upper Layer shall comprise of those NBFCs which are specifically identified by the Reserve Bank as warranting enhanced regulatory requirement based on a set of parameters and scoring methodology as provided (for detailed circular scan the QR code given in Key Takeaways). The top ten eligible NBFCs in terms of their asset size shall always reside in the upper layer, irrespective of any other factor.

Top Layer

The Top Layer will ideally remain empty. This layer can get populated if the Reserve Bank is of the opinion that there is a substantial increase in the potential systemic risk from specific NBFCs in the Upper Layer. Such NBFCs shall move to the Top Layer from the Upper Layer.

© The Institute of Chartered Accountants of India

Categorisation of NBFCs carrying out specific activity

As the regulatory structure envisages scale based as well as activity-based regulation, the following prescriptions shall apply in respect of the NBFCs

(a) NBFC-P2P, NBFC-AA, NOFHC and NBFCs without public funds and customer interface will always remain in the Base Layer of the regulatory structure.

(b) NBFC-D, CIC, IFC and HFC will be included in Middle Layer or the Upper Layer (and not in the Base layer), as the case may be. SPD and IDF-NBFC will always remain in the Middle Layer.

(c) The remaining NBFCs, viz., Investment and Credit Companies (NBFC-ICC), Micro Finance Institution (NBFC-MFI), NBFC-Factors and Mortgage Guarantee Companies (NBFC-MGC) could lie in any of the layers of the regulatory structure depending on the parameters of the scale based regulatory framework.

(d) Government owned NBFCs shall be placed in the Base Layer or Middle Layer, as the case may be. They will not be placed in the Upper Layer till further notice.

References to NBFC-ND, NBFC-ND-SI & NBFC-D - From October 01, 2022:

All references to NBFC-ND shall mean NBFC-BL and all references to NBFC-D and NBFC-NDSI shall mean NBFC-ML or NBFC-UL, as the case may be. However, existing NBFC-ND-SIs having asset size between INR 500 Crore and below INR 1000 Crore (except those necessarily featuring in Middle Layer) will be known as NBFC- BL (for detailed circular scan the QR code given in Key Takeaways).

2. DIFFERENCE BETWEEN BANKS AND NBFCS

NBFCs lend and make investments and hence, their activities are akin to that of banks, however, there are a few differences between the two as given below:

i. NBFC cannot accept demand deposits, *however some NBFCs can accept Term Deposits;*

ii. NBFCs do not form part of the payment and settlement system and cannot issue cheques drawn on itself;

iii. deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation (DICGC) is not available to depositors of NBFCs, unlike in case of banks.

iv. No Minimum Exposure to Priority Sector required by NBFCs.

© The Institute of Chartered Accountants of India

3. PRUDENTIAL NORMS

3.1 Capital Requirements

Every applicable NBFC *as defined in the Master Direction- Non-Banking Financial Company – Systemically Important Non-Deposit Taking Company & Deposit Taking Company (Reserve Bank) Directions, 2016* shall maintain a minimum capital ratio consisting of Tier I and Tier II capital which shall not be less than 15 % of its aggregate risk weighted assets on-balance sheet and of risk adjusted value of off-balance sheet items.

The Tier I capital in respect of applicable NBFCs (other than NBFC-MFI and IDF-NBFC), at any point of time, shall not be less than 10% by March 31, 2017.

Applicable NBFCs primarily engaged in lending against gold jewellery (such loans comprising 50 percent or more of their financial assets) shall maintain a minimum Tier I capital of 12 %.

However, in the case of Non-Systemically Important Non-Deposit Taking Company (Reserve Bank) Directions, 2016, Net Owned Fund requirements have to be complied.

The RBI vide it's Guidelines dated 22nd October,2021 has revised the regulatory framework for NBFC basis the Scale. There are many changes made depending on the categorization of the NBFCs and those are broadly in the areas of NPA classification, Capital requirements, Prudential Guidelines specifically for NBFC- ML and NBFC-UL relating to Concentration of credit/ Investment, Sensitive Sector Exposure, Loans to Related parties and KMP, for NBFC-UL address Large Exposure framework, Internal exposure limit, Stricture and more broader Governance Guidelines, etc.

Note for Students : [Students may refer detailed Guidelines given in the Appendix.

Explanations: In these Directions, degrees of credit risk expressed as percentage weightages have been assigned to balance sheet assets. *For example, percentage weights assigned to Fixed Assets is 100, Cash & Bank Balances is 0, etc.* Hence, the value of each asset / item requires to be multiplied by the relevant risk weights to arrive at risk adjusted value of assets. The aggregate shall be taken into account for reckoning the minimum capital ratio. The risk weighted asset shall be calculated as the weighted aggregate of funded items as detailed hereunder:

S. No.	Weighted risk assets - On-Balance Sheet items	Percentage weight
(i)	Cash and bank balances including fixed deposits and certificates of deposits with banks	0

© The Institute of Chartered Accountants of India

(ii)	Investments:	
	(a) Approved securities [Except at (c) below]	0
	(b) Bonds of public sector banks	20
	(c) Fixed deposits/certificates of deposits/bonds of public financial institutions	100
	(d) Shares of all companies and debentures / bonds/ commercial papers of all companies and units of all mutual funds	100
	(e) All assets covering PPP and post commercial operations date (COD) infrastructure projects in existence over a year of commercial operation	50
(iii)	Current assets:	
	(a) Stock on hire (net book value)	100
	(b) Intercorporate loans/deposits	100
	(c) Loans and advances fully secured against deposits held	0
	(d) Loans to staff	0
	(e) Other secured loans and advances considered good [Except at (vi) below]	100
	(f) Bills purchased/discounted	100
	(g) Others (To be specified)	100
(iv)	Fixed Assets (net of depreciation):	
	(a) Assets leased out (net book value)	100
	(b) Premises	100
	(c) Furniture & Fixture	100
(v)	Other assets:	
	(a) Income tax deducted at source (net of provision)	0
	(b) Advance tax paid (net of provision)	0
	(c) Interest due on Government securities	0
	(d) Others (to be specified)	100

© The Institute of Chartered Accountants of India

(vi)	Domestic Sovereign:		
	(a)	Fund based claims on the Central Government	0
	(b)	Direct loan / credit / overdraft exposure and investment in State Government securities	0
	(c)	Central Government guaranteed claims	0
	(d)	State Government guaranteed claims, which have not remained in default / which are in default for a period not more than 90 days 20	20
	(e)	State Government guaranteed claims, which have remained in default for a period of more than 90 days	100

3.2 Income Recognition

The income recognition shall be based on recognised accounting principles. Income including interest/ discount/ hire charges/ lease rentals or any other charges on NPA shall be recognised only when it is actually realised. Any such income recognised before the asset became non-performing and remaining unrealised shall be reversed.

Asset classification: The asset classification norms as given below shall apply to every applicable NBFC (except NBFC-MFIs):

(1) Every NBFC shall, after taking into account the degree of well-defined credit weaknesses and extent of dependence on collateral security for realisation, classify its lease/hire purchase assets, loans and advances and any other forms of credit into the following classes, namely:

(i) Standard assets;

(ii) Sub-standard assets;

(iii) Doubtful assets; and

(iv) Loss assets.

(2) The class of assets referred to above shall not be upgraded merely as a result of rescheduling, unless it satisfies the conditions required for the upgradation.

(3) (i) Standard asset shall mean the asset in respect of which, no default in repayment of principal or payment of interest is perceived and which does not disclose any problem or carry more than normal risk attached to the business;

© The Institute of Chartered Accountants of India

(ii) "Sub-Standard Asset" shall mean:

(a) an asset which has been classified as non-performing asset for a period not exceeding 18 months (in case of NBFCs covered in Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016);

The period 'not exceeding 18 months' stipulated in this sub-clause shall be 'not exceeding 12 months' for the financial year ended March 31, 2018 and thereafter for NBFCs covered in Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

(b) an asset where the terms of the agreement regarding interest and / or principal have been renegotiated or rescheduled or restructured after commencement of operations, until the expiry of one year of satisfactory performance under the renegotiated or rescheduled or restructured terms;

Provided that the classification of infrastructure loan as a sub-standard asset shall be in accordance with the provisions of paragraph 25 of these Directions.

(iii) Doubtful Asset shall mean:

(a) a term loan, or

(b) a lease asset, or

(c) a hire purchase asset, or

(d) any other asset,

which remains a sub-standard asset for a period 'exceeding 18 months' (in case of NBFCs covered in Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016).

The period 'exceeding 18 months' stipulated in this sub-clause shall be 'exceeding 12 months' for the financial year ended March 31, 2018 and thereafter for NBFCs covered in Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

© The Institute of Chartered Accountants of India

(iv) Loss Asset shall mean:

(a) an asset which has been identified as loss asset by the applicable NBFC or its internal or external auditor or by the Bank during the inspection of the applicable NBFC, to the extent it is not written off by the applicable NBFC; and

(b) an asset which is adversely affected by a potential threat of non-recoverability due to either erosion in the value of security or non-availability of security or due to any fraudulent act or omission on the part of the borrower

(v) Non-Performing Asset (referred as "NPA") shall mean:

(a) an asset, in respect of which, interest has remained overdue for a period of six months or more;

(b) a term loan inclusive of unpaid interest, when the instalment is overdue for a period of six months or more or on which interest amount remained overdue for a period of six months or more;

(c) a demand or call loan, which remained overdue for a period of six months or more from the date of demand or call or on which interest amount remained overdue for a period of six months or more;

(d) a bill which remains overdue for a period of six months or more;

(e) the interest in respect of a debt or the income on receivables under the head 'other current assets' in the nature of short term loans/advances, which facility remained overdue for a period of six months or more;

(f) any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue for a period of six months or more;

NBFCs covered in Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, period of 'six months or more' stipulated in sub-clauses (a) to (f) shall be 'three months or more', for the financial year ended March 31, 2018 and thereafter].

This implies for NBFCs covered in Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, the criteria is 6 months only.

© The Institute of Chartered Accountants of India

(g) the lease rental and hire purchase instalment, which has become overdue for a period of twelve months or more;

[NBFCs covered in Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, the period of 'twelve months or more' stipulated in this sub-clause shall be 'three months or more' for the financial year ended March 31, 2018 and thereafter].

It implies that as per Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, the criteria is 12 months only.

(h) in respect of loans, advances and other credit facilities (including bills purchased and discounted), the balance outstanding under the credit facilities (including accrued interest) made available to the same borrower/beneficiary when any of the above credit facilities becomes non-performing asset.

[Provided that in the case of lease and hire purchase transactions, an applicable NBFC shall classify each such account on the basis of its record of recovery].

3.3 Provisioning Requirements

The provisioning requirements as given below shall apply to every applicable NBFC (except NBFC-MFIs): Every applicable NBFC shall, after taking into account the time lag between an account becoming non-performing, its recognition as such, the realisation of the security and the erosion over time in the value of security charged, make provision against sub-standard assets, doubtful assets and loss assets as provided hereunder:

The provisioning requirement in respect of loans, advances and other credit facilities including bills purchased and discounted shall be as under:

(i) Loss Assets: The entire asset shall be written off. If the assets are permitted to remain in the books for any reason,100% of the outstanding shall be provided for;

(ii) Doubtful Assets:

(a) 100% provision to the extent to which the advance is not covered by the realisable value of the security to which the applicable NBFC has a valid recourse shall be made. The realisable value is to be estimated on a realistic basis;

© The Institute of Chartered Accountants of India

(b) In addition to item (a) above, depending upon the period for which the asset has remained doubtful, provision to the extent of 20% to 50% of the secured portion (i.e. Estimated realisable value of the outstanding) shall be made on the following basis:

Period for which the asset has been considered as doubtful	Percent of provision
Up to one year	20
One to three years	30
More than three years	50

(iii) Sub-standard assets: A general provision of 10 percent of total outstanding shall be made.

(iv) Standard asset provisioning: Every NBFC (covered under Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016) shall make provisions for standard assets at 0.40 per cent by the end of March 2018 and thereafter, of the outstanding, which shall not be reckoned for arriving at net NPAs.

Note: As per Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, every applicable NBFC shall make provision for standard assets at 0.25 percent of the outstanding amount.

The provision towards standard assets need not be netted from gross advances but shall be shown separately as 'Contingent Provisions against Standard Assets' in the balance sheet.

The above regulatory requirements are to be amended in a phased manner under the Scale-Based Regulation prescribed by RBI for NBFCs.

[Students may refer Master Direction NBFC - Non-Systemically Important Non-deposit Taking Company (Updated as on February 17, 2020) and Master Direction NBFC - Systemically Important Non-deposit Taking Company and Deposit Taking Company (Updated as on February 17, 2020) for detailed guidelines on prudential norms relating to Non-Banking Financial Companies covered in these Directions.]

© The Institute of Chartered Accountants of India

4. AUDIT PROCEDURES

The following are the necessary steps involved -

(1) Ascertaining the Business of the Company - The first step in carrying out the audit of a NBFC is to scan through the Memorandum and Articles of Association of the company, so as to acquaint oneself with the type of business that the company is engaged into. Normally, the Memorandum of Association of any company would be very wide in scope thereby permitting it to undertake a host of business activities, but companies generally lend to specialise in and focus on a few select activities. An auditor should, therefore, make a careful study of the business policy of the company so as to ascertain its principal business activities. For this purpose, an auditor may also scan through the minutes of the Board/Committee Meetings and hold discussions with the top level management to ascertain the corporate business plan/strategy which would give him a clear picture as to the principal objects of the company. An auditor should then independently corroborate his findings with the actual business done by the company, as reflected by the company's financial results.

The task of ascertaining the principal business activity of any NBFC is of paramount importance since the very classification of a company as a NBFC and its further classification would all depend upon its principal business activity. Based on the classification of a company, it will be required to comply with the provisions relating to limits on acceptance of public deposits as contained in the NBFC Public Deposit Directions.

(2) Evaluation of Internal Control System - The responsibility of maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of its business vests with the management. A sound internal control system would enable an organisation to plug loopholes in its workings, particularly in the detection of frauds and would also aid in timely decision making. An auditor should gain an understanding of the accounting system and related internal controls adopted by the NBFC to determine the nature, timing and extent of his audit procedures. An auditor should also ascertain whether the internal controls put in place by the NBFC are adequate and are being effectively followed.

In particular, an auditor should review the effectiveness of the system of recovery prevalent at the NBFC. He should ascertain whether the NBFC has an effective system of periodical review of advances in place which would facilitate effective monitoring and follow up. The absence of a periodical review system could result in non-detection of sticky advances at

© The Institute of Chartered Accountants of India

their very inception which may ultimately result in the NBFC having an alarmingly high level of NPAs.

(3) Registration with the RBI - Section 45-IA inserted in the RBI Act, 1934, w.e.f. 9th January, 1997, has made it incumbent on the part of all NBFCs to comply with registration requirements and have minimum net owned funds (NOF) of ₹ 10 crore (Although the requirement of minimum NOF at present stands at ₹ 200 lakh, . However, for strengthening the financial sector and technology adoption, and in view of the increasing complexities of services offered by NBFCs, it shall be mandatory for all NBFCs to raise minimum NOF to ₹ 10 crore) for commencing/ carrying on its business. An auditor should obtain a copy of the certificate of registration granted by the RBI or in case the certificate of registration has not been granted, a copy of the application form filed with the RBI for registration. It may particularly be noted that NBFCs incorporated after 9th January, 1997 are not entitled to commence business without first obtaining a registration certificate from the RBI. An auditor should, therefore, verify whether the dual conditions relating to registration with the RBI and maintenance of minimum net owned funds have been duly complied with by the concerned NBFC.

Every NBFC holding public deposits is required to invest a specified percentage (as the RBI may specify from time to time). The RBI has also prescribed a format for reporting to ensure compliance with the requirement of maintenance of liquid assets on a quarterly basis. This quarterly return (duly signed by an officer of the NBFC) is required to be submitted within prescribed time limit from the end of the relevant quarter and with reference to investments held in approved securities during the relevant quarter. The auditor should ascertain whether investment in prescribed liquid assets have been made and whether quarterly returns as mentioned above have been regularly filed with the RBI by the concerned NBFC.

(4) NBFC Acceptance of Public Deposit Directions (Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016) - The auditors must ascertain whether the company properly classified as per the requirements of various regulations. In case, the NBFC has not been classified by the RBI, the classification of a company will have to be determined after a careful consideration of various factors such as particulars of earlier registration granted, if any, particulars furnished in the application form for registration, company's Memorandum of Association and its financial results. Thereafter,

© The Institute of Chartered Accountants of India

it must be ascertained whether the company has complied with the following aspects in relation to the activity of mobilisation of public deposits:

(i) The ceiling on quantum of public deposits has been linked to its credit rating as given by an approved credit rating agency. Obtain a copy of the credit rating assigned to NBFC and check whether the public deposits accepted/held by it are in accordance with the level of credit rating assigned to it.

In the event of a upgrading/downgrading of credit rating, the auditor should bear in mind that the NBFC will have to increase/reduce its public deposits in accordance with the revised credit rating assigned to it within a specified time frame and should ensure that the NBFC has informed about the same to the RBI in writing.

In the event of downgrading of credit rating below the minimum specified investment grade, a non-banking financial company, being an investment and credit company or a factor, shall regularise the excess deposit as provided hereunder:

(a) with immediate effect, stop accepting fresh public deposits and renewing existing deposits;

(b) all existing deposits shall run off to maturity; and

(c) report the position within 15 working days, to the concerned Regional Office of the RBI where the NBFC is registered.

Provided no matured public deposit shall be renewed without the express and voluntary consent of the depositor.

(ii) Test check the interest calculations in respect of public deposits mobilised by a NBFC to ascertain that the NBFC has not paid interest in excess as per specification.

Likewise, test check the brokerage/ commission/ incentive calculations with the bills and vouchers for reimbursement of out of pocket expenses submitted by the parties to ascertain that the NBFC has not paid brokerage/ commission/ incentive/ reimbursement of expenses in excess as per specification.

(iii) Ascertain whether the NBFC has accepted or renewed any public deposit only after a written application form the depositor in the form to be supplied by the company, and shall contain all particulars specified in the Non-Banking Financial Companies and Miscellaneous Non-Banking Companies (Advertisement) Rules, 1977. Further ensure

© The Institute of Chartered Accountants of India

whether it contain the specific category of depositor, i.e., whether depositor is a shareholder or a director or a promoter or a member of public.

(iv) Verify the deposit register maintained by a NBFC and test check the particulars that have been entered therein in respect of each depositor with supporting receipts issued to the depositors. Also check whether the NBFC is regularly paying its deposits on due dates and in the case of a delay/default, the reasons for the delay/default and the actual date of payment.

(v) Check whether the investments made in approved liquid assets by a NBFC holding public deposits have been lodged in safe custody with a designated scheduled commercial bank as required by the NBFC Acceptance of Public Deposits Directions and also whether. certificate was obtained from the RBI to that effect.

(vii) Check whether the NBFC has filed its prescribed returns in a timely manner.

(viii) In the case of NBFCs not accepting/holding public deposits, check whether a board resolution has been passed by the NBFC to the effect that it has neither accepted any public deposits nor would it accept any public deposits during the year.

(ix) In the case of Group Holding Investment Companies, check whether the NBFC has passed a board resolution to the effect that the company has invested or would invest/hold its investments in share and securities of group companies specifying the names of the companies. In addition to the above, group holding investment companies are required to give a further undertaking that it would not trade in such shares/securities and that it has neither accepted nor would it accept any public deposits during the year.

(5) NBFC Prudential Norms -

(i) Check compliance with prudential norms encompassing income recognition, income from investments, accounting standards, accounting for investments, asset classification, provisioning for bad and doubtful debts, capital adequacy norms, prohibition on granting of loans by a NBFC against its own shares, prohibition on loans and investments for failure to repay public deposits and norms for concentration of credit/investments.

(ii) An auditor should ensure that the Board of Directors of every NBFC granting/intending to grant demand/call loans shall frame and implement a policy for the company.

© The Institute of Chartered Accountants of India

(iii) An auditor should assess on the basis of examinations conducted by him whether the NBFC has complied with the prudential norms. In particular, he should verify that advances and other credit facilities have been properly classified as standard/substandard/doubtful/loss and that proper provision has been made in accordance with the Directions.

(iv) In respect of Non-Performing Assets, an auditor should check whether the unrealised income in respect of such assets has not been taken to the Profit & Loss Account on an accrual basis. Income from NPAs should be accounted for on realisation basis only.

(v) Check whether all accounts which have been classified as NPAs in the previous year also continue to be shown as such in the current year also. If the same is not treated as an NPA in the current year, the auditor should specifically examine such accounts to ascertain whether the account has become regular and the same can be treated as performing as per the Directions.

TEST YOUR UNDERSTANDING 1

"Fin crazy" is a P2P online platform owned by Future Technologies Pvt Limited which is registered with RBI as NBFC. Peer to Peer Platform (P2P) means an intermediary providing the services of loan facilitation via online medium or otherwise to the participants.

Participants have to enter into an arrangement with NBFC-P2P to lend on its platform or avail loan facilitation services provided by it. It provides only as a medium connecting lenders and borrowers. It also carries out the credit assessment and risk profiling of the participants on the platform. It also provides services relating to loan documentation and loan recovery. The company falls outside purview of upper layer.

Where does such NBFC fit into in accordance with scale-based regulations? Suggest few audit procedures for above NBFC-P2P.

5. CLASSIFICATION OF FRAUDS BY NBFC

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.

© The Institute of Chartered Accountants of India

(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) Negligence and cash shortages.

(e) Cheating and forgery.

(f) Irregularities in foreign exchange transactions.

(g) Any other type of fraud not coming under the specific heads as above.

Cases of 'negligence and cash shortages' and 'irregularities in foreign exchange transactions' referred to in items (d) and (f) above are to be reported as fraud if the intention to cheat/ defraud is suspected/ proved. However, the following cases where fraudulent intention is not suspected/ proved, at the time of detection, will be treated as fraud and reported accordingly:

(a) cases of cash shortages more than ₹ 10,000/- and

(b) cases of cash shortages more than ₹ 5000/- if detected by management/ auditor/ inspecting officer and not reported on the occurrence by the persons handling cash.

NBFCs, covered in Master Direction - Monitoring of Frauds in NBFCs (Reserve Bank) Directions, 2016, having overseas branches/offices should report all frauds perpetrated at such branches/offices also to the Reserve Bank as per the prescribed format and procedures.

6. AUDIT CHECK-LIST

Some important points that may be covered in the audit of NBFCs, in addition to the audit points that may be covered for companies in general, are given below:

(eg. NBFC - Investment and Credit Company (NBFC-ICC)

i. Physically verify all the shares and securities held by a NBFC. Where any security is lodged with an institution or a bank, a certificate from the bank/institution to that effect must be verified.

ii. Verify whether the NBFC has not advanced any loans against the security of its own shares.

iii. Verify that dividend income wherever declared by a company, has been duly received by an NBFC and interest wherever due [except in case of NPAs] has been duly accounted for. NBFC Prudential Norms require dividend income on shares of companies and units of

© The Institute of Chartered Accountants of India

mutual funds to be recognised on cash basis. However, the NBFC has an option to account for dividend income on accrual basis, if the same has been declared by the body corporate in its Annual General Meeting and its right to receive the payment has been established. Income from bonds/debentures of corporate bodies is to be accounted on accrual basis only if the interest rate on these instruments is predetermined and interest is serviced regularly and not in arrears.

iv. Test check bills/contract notes received from brokers with reference to the prices vis-à-vis the stock market quotations on the respective dates.

v. Verify the Board Minutes for purchase and sale of investments. Ascertain from the Board resolution or obtain a management certificate to the effect that the investments so acquired are current investments or Long-Term Investments.

vi. Check whether the investments have been valued in accordance with the NBFC Prudential Norms and adequate provision for fall in the market value of securities, wherever applicable, have been made there against, as required by the Directions.

vii. Obtain a list of subsidiary/group companies from the management and verify the investments made in subsidiary/group companies during the year. Ascertain the basis for arriving at the price paid for the acquisition of such shares and whether the Valuation is as per Prudential norms.

viii. Check whether investments in unquoted debentures/bonds have not been treated as investments but as term loans or other credit facilities for the purposes of income recognition and asset classification.

ix. An auditor will have to ascertain whether the requirements of AS 13 “Accounting for Investments” or other accounting standard, as applicable, (to the extent they are not inconsistent with the Directions) have been duly complied with by the NBFC.

x. In respect of shares/securities held through a depository, obtain a confirmation from the depository regarding the shares/securities held by it on behalf of the NBFC.

xi. Verify that securities of the same type or class are received back by the lender/paid by the borrower at the end of the specified period together with all corporate benefits thereof (i.e. dividends, rights, bonus, interest or any other rights or benefit accruing thereon).

xii. Verify charges received or paid in respect of securities lend/borrowed.

© The Institute of Chartered Accountants of India

xiii. Obtain a confirmation from the approved intermediary regarding securities deposited with/borrowed from it as at the year end.

xiv. An auditor should examine whether each loan or advance has been properly sanctioned. He should verify the conditions attached to the sanction of each loan or advance i.e. limit on borrowings, nature of security, interest, terms of repayment, etc.

xv. An auditor should verify the security obtained and the agreements entered into, if any, with the concerned parties in respect of the advances given. He must ascertain the nature and value of security and the net worth of the borrower/guarantor to determine the extent to which an advance could be considered realisable.

xvi. Obtain balance confirmations from the concerned parties.

xvii. As regards bill discounting, verify that proper records/documents have been maintained for every bill discounted/rediscounted by the NBFC. Test check some transactions with reference to the documents maintained and ascertain whether the discounting charges, wherever, due, have been duly accounted for by the NBFC.

xviii. Check whether the NBFC has not lent/invested in excess of the specified limits to any single borrower or group of borrowers as per NBFC Prudential Norms.

xix. An auditor should verify whether the NBFC has an adequate system of proper appraisal and follow up of loans and advances. In addition, he may analyse the trend of its recovery performance to ascertain that the NBFC does not have an unduly high level of NPAs.

xx. Check the classification of loans and advances (including bills purchased and discounted) made by a NBFC into Standard Assets, Sub-Standard Assets, Doubtful Assets and Loss Assets and the adequacy of provision for bad and doubtful debts as required by NBFC Prudential Norms.

(Note: The above checklist is not exhaustive. It is only illustrative. There could be various other audit procedures which may be performed for audit of an NBFC. Based on the nature and size of the NBFC, the auditor will have to perform specific audit techniques in that regard)

© The Institute of Chartered Accountants of India

7. AUDITOR'S DUTY

The following are the important duties of an auditor -

7.1 Compliance with NBFC Auditor's Report - RBI Directions

The RBI Directions have considerably increased the responsibility of auditors of NBFCs. A very onerous task of reporting to the Board of Directors on certain specified matters and to the RBI on an exception basis has been imposed upon him. This reporting requirement is in addition to the normal reporting requirements to the shareholders under section 143 of the Companies Act, 2013. Auditors will, thus, have to be very careful whilst carrying out audits of NBFCs to ensure that all matters which they are required to take into consideration for the purposes of reporting to the RBI have been taken due care of.

Section 45MA of the Reserve Bank of India Act, 1934 was introduced with effect from 13.12.1974. Under this provision the auditor of a non-banking financial company or a non-banking miscellaneous company which has accepted public deposits, has to inquire whether or not the company has furnished to the Reserve Bank of India statements, information of particulars relating to the deposits as are required to the furnished under Chapter IIIB of the Reserve Bank of India Act, 1934. The provision further states that if on inquiry the auditor is not satisfied about the compliance by the company, it is his duty to make to the Reserve Bank of India giving the aggregate amount of deposits held by the company. The auditor is also required to incorporate the report or intended to be made to the Reserve Bank of India in his report to the company under Section 143 of the Companies Act, 2013.

Report to Board of Directors under RBI Directions as per Master Direction No. DNBS. PPD.03/66.15.001/2016-17 dated September 29, 2016

(1) The Reserve Bank of India (RBI) has issued Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2016 (the Directions) to auditor of every non-banking financial companies.

(2) The Directions shall apply to every auditor of a non-banking financial company as defined in section 45 I(f) of the Reserve Bank of India Act, 1934.

Auditors to submit additional Report to the Board of Directors: In addition to the Report made by the auditor under Section 143 of the Companies Act, 2013 or section 227 of the Companies Act, 1956 (Act 1 of 1956) on the accounts of a non-banking financial company examined for every financial year ending on any day on or after the commencement of

© The Institute of Chartered Accountants of India

these Directions, the auditor shall also make a separate report to the Board of Directors of the Company on the matters specified in paragraphs 3 and 4 below.

(3) Material to be included in the Auditor's report to the Board of Directors: The auditor's report on the accounts of a non-banking financial company shall include a statement on the following matters, namely –

(A) In the case of all non-banking financial companies:

I. Conducting Non-Banking Financial Activity without a valid Certificate of Registration (CoR) granted by the RBI is an offence under chapter V of the RBI Act, 1934. Therefore, if the company is engaged in the business of non-banking financial institution as defined in section 45-I (a) of the RBI Act and meeting the Principal Business Criteria (Financial asset/income pattern) as laid down vide the RBI's press release dated April 08, 1999, and directions issued by DNBR, auditor shall examine whether the company has obtained a Certificate of Registration (CoR) from the RBI.

II. In case of a company holding CoR issued by the RBI, whether that company is entitled to continue to hold such CoR in terms of its Principal Business Criteria (Financial asset/income pattern) as on March 31 of the applicable year.

III. Whether the non-banking financial company is meeting the required net owned fund requirement as laid down in Master Direction - Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

Note: Every non-banking financial company shall submit a Certificate from its Statutory Auditor that it is engaged in the business of non-banking financial institution requiring it to hold a Certificate of Registration under Section 45-IA of the RBI Act and is eligible to hold it. A certificate from the Statutory Auditor in this regard with reference to the position of the company as at end of the financial year ended March 31 may be submitted to the Regional Office of the Department of Non-Banking Supervision under whose jurisdiction the non-banking financial company is registered, within one month from the date of finalization of the balance sheet and in any case not later than December 30th of that year.

The format of Statutory Auditor's Certificate (SAC) to be submitted by NBFCs has been issued vide DNBS. PPD.02/66.15.001/2016-17 Master Direction- Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016.

© The Institute of Chartered Accountants of India

(B) In the case of a non-banking financial companies accepting/holding public deposits

Apart from the matters enumerated in (A) above, the auditor shall include a statement on the following matters, namely-

(i) Whether the public deposits accepted by the company together with other borrowings indicated below viz.

(a) from public by issue of unsecured non-convertible debentures/bonds;

(b) from its shareholders (if it is a public limited company); and

(c) from entities which are not excluded from the definition of 'public deposit' in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016, are within the limits admissible to the company as per the provisions of the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016;

(ii) Whether the public deposits held by the company in excess of the quantum of such deposits permissible to it under the provisions of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016 are regularised in the manner provided in the said Directions;

(iii) Whether the non-banking financial company is accepting "public deposit" without minimum investment grade credit rating from an approved credit rating agency as per the provisions of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016;

(iv) Whether the capital adequacy ratio as disclosed in the return submitted to the Bank in terms of the Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016 has been correctly determined and whether such ratio is in compliance with the minimum CRAR prescribed therein;

(v) In respect of non-banking financial companies referred to in clause (iii) above,

(a) whether the credit rating, for each of the fixed deposits schemes that has been assigned by one of the Credit Rating Agencies listed in Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016 is in force; and

© The Institute of Chartered Accountants of India

(b) whether the aggregate amount of deposits outstanding as at any point during the year has exceeded the limit specified by the such Credit Rating Agency;

(vi) Whether the company has violated any restriction on acceptance of public deposit as provided in Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016;

(vii) Whether the company has defaulted in paying to its depositors the interest and/or principal amount of the deposits after such interest and/or principal became due;

(viii) Whether the company has complied with the prudential norms on income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, and concentration of credit/investments as specified in the Directions issued by the Bank in terms of the Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016;

(ix) Whether the company has complied with the liquid assets requirement as prescribed by the Bank in exercise of powers under section 45-IB of the RBI Act and whether the details of the designated bank in which the approved securities are held is communicated to the office concerned of the RBI in terms of NBS 3; Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016;

(x) Whether the company has furnished to the RBI within the stipulated period the return on deposits as specified in the NBS 1 to – Non- Banking Financial Company Returns (Reserve Bank) Directions, 2016;

(xi) Whether the company has furnished to the RBI within the stipulated period the quarterly return on prudential norms as specified in the Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016;

(xii) Whether, in the case of opening of new branches or offices to collect deposits or in the case of closure of existing branches/offices or in the case of appointment of agent, the company has complied with the requirements contained in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016.

© The Institute of Chartered Accountants of India

(C) In the case of a non-banking financial company not accepting public deposits

Apart from the aspects enumerated in (A) above, the auditor shall include a statement on the following matters, namely: -

(i) Whether the Board of Directors has passed a resolution for non- acceptance of any public deposits;

(ii) Whether the company has accepted any public deposits during the relevant period/year;

(iii) Whether the company has complied with the prudential norms relating to income recognition, accounting standards, asset classification and provisioning for bad and doubtful debts as applicable to it in terms of Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016;

(iv) In respect of Systemically Important Non-deposit taking NBFCs as defined in Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016:

(a) Whether the capital adequacy ratio as disclosed in the return submitted to the RBI in form NBS - 7, has been correctly arrived at and whether such ratio is in compliance with the minimum CRAR prescribed by the RBI;

(b) Whether the company has furnished to the RBI the annual statement of capital funds, risk assets/exposures and risk asset ratio (NBS-7) within the stipulated period.

(v) whether the non-banking financial company has been correctly classified as NBFC Micro Finance Institutions (MFI) as defined in the Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

(D) In the case of a company engaged in the business of non-banking financial institution not required to hold CoR subject to certain conditions

Apart from the matters enumerated in (A)(I) above where a company has obtained a specific advice from the RBI that it is not required to hold CoR from the RBI, the auditor shall include a statement that the company is complying with the conditions stipulated as advised by the RBI.

© The Institute of Chartered Accountants of India

(4) Reasons to be stated for unfavourable or qualified statements: Where, in the auditor's report, the statement regarding any of the items referred to in paragraph 3 above is unfavourable or qualified, the auditor's report shall also state the reasons for such unfavourable or qualified statement, as the case may be. Where the auditor is unable to express any opinion on any of the items referred to in paragraph 3 above, his report shall indicate such fact together with reasons therefor.

(5) Obligation of auditor to submit an exception report to the RBI

(I) Where, in the case of a non-banking financial company, the statement regarding any of the items referred to in paragraph 3 above, is unfavorable or qualified, or in the opinion of the auditor the company has not complied with:

(a) the provisions of Chapter III B of RBI Act (Act 2 of 1934); or

(b) Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016; or

(c) Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

It shall be the obligation of the auditor to make a report containing the details of such unfavourable or qualified statements and/or about the non-compliance, as the case may be, in respect of the company to the concerned Regional Office of the Department of Non-Banking Supervision of the RBI under whose jurisdiction the registered office of the company is located as per first Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016.

(II) The duty of the Auditor under sub-paragraph (I) shall be to report only the contraventions of the provisions of RBI Act, 1934, and Directions, Guidelines, instructions referred to in sub-paragraph (1) and such report shall not contain any statement with respect to compliance of any of those provisions.

7.2 Compliance with CARO 2020

As per CARO 2020, the auditor is required to report that –

I. Whether during the year the company has made investments in, provided any guarantee or security or granted any loans or advances in the nature of loans, secured or unsecured, to companies, firms, Limited Liability Partnerships or any other parties, If so,

© The Institute of Chartered Accountants of India

(a) whether the investments made, guarantees provided, security given and the terms and conditions of the grant of all loans and advances in the nature of loans and guarantees provided are not prejudicial to the company's interest;

(b) in respect of loans and advances in the nature of loans, whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;

(c) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;

(d) whether the company has granted any loans or advances in the nature of loans either repayable on demand or without specifying any terms or period of repayment, if so, specify the aggregate amount, percentage thereof to the total loans granted, aggregate amount of loans granted to Promoters, related parties as defined in clause (76) of section 2 of the Companies Act, 2013; [Paragraph 3(iii)]

(II) (a) Whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.

(b) Whether the company has conducted any Non-Banking Financial or Housing Finance activities without a valid Certificate of Registration (CoR) from the Reserve Bank of India as per the Reserve Bank of India Act, 1934;

(c) Whether the company is a Core Investment Company (CIC) as defined in the regulations made by the Reserve Bank of India, if so, whether it continues to fulfil the criteria of a CIC, and in case the company is an exempted or unregistered CIC, whether it continues to fulfil such criteria;

(d) Whether the Group has more than one CIC as part of the Group, if yes, indicate the number of CICs which are part of the Group; [Paragraph 3(xvi)]

(Note: Students are required to refer Guidance Note on CARO, 2020 for more details).

TEST YOUR UNDERSTANDING 2

Sugam Housing Finance Limited is in the business of housing finance activities having asset size of ₹ 800 crores. Its principal business is of providing finances for housing mainly to individuals. It is not identified by RBI in upper layer. Under scale-based regulations introduced by RBI, what should be appropriate classification for such a company?

Is there any specific reporting requirement under CARO, 2020 for statutory auditor of a company engaged in housing finance activities?

© The Institute of Chartered Accountants of India

8. INDIAN ACCOUNTING STANDARDS (IND AS)

8.1 Applicability of Indian Accounting Standards (Ind AS) on NBFCs

As per Rule 4 (1)(iv) of the Companies (Indian Accounting Standards) Rules, 2015 and as amended by Companies (Indian Accounting Standards) (Amendment) Rules, 2016, NBFCs are required to comply with Indian Accounting Standards (Ind AS) as under-

(i) Accounting periods beginning 1 April 2018: Listed and unlisted NBFCs having a net worth of ₹ 500 crore or more and holding, subsidiary, joint venture or associate companies of such NBFCs;

(ii) Accounting periods beginning 1 April 2019: All other listed NBFCs, unlisted NBFCs having a net worth of ₹ 250 crore or more but less than ₹ 500 crore and holding, subsidiary, joint venture or associate companies of such NBFCs.

The net worth shall be calculated in accordance with the standalone financial statements of the NBFCs as on 31st March 2016 or the first audited financial statements for accounting period which ends after that date.

8.2 Format for preparation of financial statements by NBFCs under Ind- AS

The Ministry of Corporate Affairs (MCA) vide notification dated October 11, 2018 introduced Division III under Schedule III of the Companies Act, 2013, wherein a format for preparation of financial statements by NBFCs complying with Ind AS has been prescribed.

Every NBFC required to comply with Ind AS shall prepare its financial statements as per below format:

Illustrative format of Balance Sheet under Division III of Schedule III-

Particulars	Note No.	Figures as at the end of current reporting period (₹)	Figures as at the end of previous reporting period (₹)
ASSETS			
(1) Financial Assets (a) Cash and cash equivalents			

© The Institute of Chartered Accountants of India

Particulars	Note No.	Figures as at the end of current reporting period (₹)	Figures as at the end of previous reporting period (₹)
(b) Bank balance other than (a) above (c) Derivative financial instruments (d) Receivables (1) Trade Receivables (2) Other Receivables (e) Loans (f) Investments (g) Other Financial assets			
(2) Non-Financial Assets (a) Inventories (b) Current tax assets (net) (c) Deferred tax assets (net) (d) Investment property (e) Biological assets other than bearer plants (f) Property, Plant and Equipment (g) Capital work-in-progress (h) Intangible assets under development (i) Goodwill (j) Other intangible assets (k) Other non-financial assets (to be specified)			
Total Assets			
LIABILITES AND EQUITY			
LIABILITIES			
(1) Financial Liabilities (a) Derivative financial instruments (b) Payables (I) Trade Payables			

© The Institute of Chartered Accountants of India

Particulars	Note No.	Figures as at the end of current reporting period (₹)	Figures as at the end of previous reporting period (₹)
(i) total outstanding dues of micro enterprises and small enterprises (ii) total outstanding dues of creditors other than micro enterprises and small enterprises (II) Other Payables (i) total outstanding dues of micro enterprises and small enterprises (ii) total outstanding dues of creditors other than micro enterprises and small enterprises (c) Debt Securities (d) Borrowings (other than debt securities) (e) Deposits (f) Subordinated liabilities (g) Other financial liabilities (to be specified)			
(2) Non-financial Liabilities (a) Current tax liabilities (net) (b) Provisions (c) Deferred Tax Liabilities (net) (d) Other non-financial liabilities (to be specified)			
(3) Non-financial Capital (a) Equity share capital (b) Other equity			
Total Liabilities and Equity			

© The Institute of Chartered Accountants of India

Illustrative format of Statement of Profit and Loss prescribed under Division III of Schedule III

Particulars	Notes No.	Figures for the current reporting period (₹)	Figures for the previous reporting period (₹)
Revenue from operations (a) Interest Income (b) Dividend income (c) Rental income (d) Fee and commission income (e) Net gain on fair vale changes (f) Net gain on derecognition of financial instruments under amortised category (g) Sale of products (including Excise duty) (h) Sale of services (i) Others (to be specified)			
Total revenue from operations (I)			
Other income (to be specified) (II)			
Total Income (III= I + II)			
Expenses (a) Finance costs (b) Fees and commission expense (c) Net loss on fair vale changes (d) Net loss on derecognition of financial instruments under amortised category (e) Impairment on financial instruments (f) Cost of material consumed (g) Purchases of stock-in-trade (h) Changes in Inventories of finished goods, stock-in-trade and work-in-progress (i) Employee Benefits Expenses			

© The Institute of Chartered Accountants of India

Particulars	Notes No.	Figures for the current reporting period (₹)	Figures for the previous reporting period (₹)
(j) Depreciation, amortization and impairment (k) Other expenses (to be specified			
Total Expenses (IV)			
Profit / (loss) before exceptional items and tax (V= III - IV)			
Exceptional items (VI)			
Profit / (loss) before tax (VII= V - VI)			
Tax Expense (VIII): (1) Current tax (2) Deferred tax			
Profit / (loss) for the period from continuing operations (IX= VII - VIII)			
Profit / (loss) for the period from discontinued operations (X)			
Tax Expense of discontinued operations (XI)			
Profit / (loss) for the period from discontinued operations after tax (XII= X - XI)			
Profit / (loss) for the period (XIII= IX + XII)			
Other Comprehensive Income (XIV)			
(A) (i) Items that will not be reclassified to profit or loss (specify items and amounts) (ii) income tax relating to items that will not be reclassified to profit or loss SUB-TOTAL (A)			
(B) (i) Items that will be reclassified to profit or loss (specify items and amounts)			

© The Institute of Chartered Accountants of India

Particulars	Notes No.	Figures for the current reporting period (₹)	Figures for the previous reporting period (₹)
(ii) income tax relating to items that will be reclassified to profit or loss SUB-TOTAL (B)			
Other Comprehensive Income (A+B)			
Total Comprehensive Income for the period (XV = XIII + XIV) (Comprising Profit (Loss) and other Comprehensive Income for the period)			
Earnings per equity share (for continuing operations) (XVI) Basic (₹) Diluted (₹)			
Earnings per equity share (for discontinued operations) (XVII) Basic (₹) Diluted (₹)			
Earnings per equity share (for continuing and discontinued operations) (XVIII) Basic (₹) Diluted (₹)			

Note : Student may also refer illustrative format of Statement of Changes in Equity prescribed under Division III of Schedule III for more understanding.

8.3 Difference between Division II (Ind- AS- Other than NBFCs) and Division III (Ind- AS- NBFCs) of Schedule III

The presentation requirements under Division III for NBFCs are similar to Division II (Non NBFC) to a large extent except for the following:

(a) NBFCs have been allowed to present the items of the balance sheet in order of their liquidity which is not allowed to companies required to follow Division II.

© The Institute of Chartered Accountants of India

(b) An NBFC is required to separately disclose by way of a note any item of 'other income' or 'other expenditure' which exceeds 1 per cent of the total income. Division II, on the other hand, requires disclosure for any item of income or expenditure which exceeds 1 per cent of *the revenue from operations or ₹10 lakhs, whichever is higher.*

(c) NBFCs are required to separately disclose under 'receivables', the debts due from any Limited Liability Partnership (LLP) in which its director is a partner or member.

(d) NBFCs are also required to disclose items comprising 'revenue from operations' and 'other comprehensive income' on the face of the Statement of profit and loss instead of showing those only as part of the notes.

(e) Separate disclosure of trade receivable which have significant increase in credit risk & credit impaired

(f) The conditions or restrictions for distribution attached to statutory reserves have to be separately disclose in the notes as stipulated by the relevant statute.

TEST YOUR UNDERSTANDING 3

You are auditor of a deposit taking NBFC (NBFC-D). The NBFC is identified by RBI in its upper layer and its financial statements are required to prepared in accordance with requirements of Ind AS. The following is extract of statement of profit and loss for year ending 31St March, 2023 in accordance with Division III of Schedule III of Companies Act, 2013. Previous year figures are ignored.

Particulars	Note No.	Figures for year ended 31st March, 2023 (in ₹ Crores)
Revenue from Operations		
(i) Interest income	15	9500
(ii) Dividend income		-
(iii) Rental Income		150
(iv) Fees and commission income	16	100
(v) Net gain on fair value changes	17	150
(vi) Net gain on derecognition of financial instruments under amortised category		
(I) Total revenue from operations		9900
(II) Other Income	18	100
(III) Total Income		10000

© The Institute of Chartered Accountants of India

On going through details of head "other expenditure" in expenses side of statement of profit and loss, it is noticed that there is an expenditure relating to manpower outsourcing cost amounting to ` 99.50 crores included under "other expenditure".

Does it meet the requirements of Division III of Schedule III of Companies Act, 2013?

Integrated Case Scenario

CA. Parampara is statutory auditor of *"Lohit Finance Limited",* a micro finance institution, working pre-dominantly in states popularly described as "seven sisters of North East", West Bengal, Odisha and Andhra Pradesh. It is a non-deposit taking NBFC catering to credit requirements of rural and semi-urban households and provides small ticket loans. She has performed audit procedures for year 2022-23 and following further information is given as under:-

(A) The Board of Directors of the company has passed a resolution in its meeting held on 1.5.22 for non-acceptance of public deposits during year ended 31st March, 2023.

(B) The company has obtained certificate of registration dated 15th March, 2012 from RBI in pursuance of section 45-IA of RBI Act, 1934 and it is entitled to hold such certificate of registration in terms of its financial assets/income pattern for year ended 31st March, 2023.

(C) The company has identified instances of cash embezzlement by the employees during the year. Such instances relate to employees fleeing after collection of instalments from customers at some centres. The total amount involved is ₹15 lacs and ₹ 5 lacs have been recovered subsequently. The matter has also been reported in note 35 of financial statements.

(D) It falls in middle layer of scale-based regulations and regulations for a systemically important non-deposit taking NBFC are applicable to it. Its capital adequacy ratio is stated in note 36 of financial statements.

(E) Audit procedures performed by her included testing design and operating effectiveness of controls relating to allowances for loan losses using Expected credit loss model (ECL) in accordance with Ind AS 109. Tests of details performed by her included verifying assumptions affecting ECL calculations.

Keeping in view above information, answer the following questions: -

1 The Board of Directors has passed a resolution for non- acceptance of public deposits during year 2022-23. Which of the following statements is most appropriate in this regard as regards reporting obligations of auditor are concerned?

(a) Passing of board resolution for non-acceptance of public deposits, being an internal

© The Institute of Chartered Accountants of India

governance matter, is not required to be reported by auditor.

(b) Matter of passing of board resolution for non-acceptance of public deposits is a specific reporting requirement for auditor under CARO, 2020.

(c) Matter of passing of board resolution for non-acceptance of public deposits is a specific reporting requirement in auditor's additional report to the Board of Directors of the company.

(d) Matter of passing of board resolution for non-acceptance of public deposits is a specific reporting requirement in auditor's additional report to the Board of Directors of the company as well as under CARO, 2020.

2. Which of the following statements is most appropriate in respect of reporting requirements relating to certificate of registration of the company obtained from RBI as described in para [B] of the case?

(a) It is the duty of auditor to report whether company has obtained certificate of registration as required under section 45-IA of RBI Act, 1934 in auditor's additional report to the Board of Directors of the company.

(b) It is the duty of auditor to report whether company has obtained certificate of registration as required under section 45-IA of RBI Act, 1934 in auditor's additional report to the Board of Directors of the company as well as under CARO,2020.

(c) It is the duty of auditor to report whether company has obtained certificate of registration as required under section 45-IA of RBI Act, 1934 under CARO,2020.

(d) It is the duty of auditor to report whether company has obtained certificate of registration as required under section 45-IA of RBI Act, 1934 in auditor's additional report to the Board of Directors of the company as well as under CARO,2020. Further, it is also required to be reported in auditor's additional report to Board of Directors whether company is entitled to hold such certificate in terms of its financial assets/income pattern.

3. Regarding instances of cash embezzlement identified by the company during the year, which of the following statements best fits into reporting requirements of an auditor?

(a) Such instances are required to be reported under CARO, 2020 under relevant clause.

(b) Cash embezzled amount is less than ₹1 crore. No reporting under CARO, 2020 is required of such instances.

(c) Such instances are required to be reported under CARO, 2020 as well as in auditor's additional report to Board of Directors of company.

© The Institute of Chartered Accountants of India

(d) Such instances are to be specifically reported in auditor's report under Section 143(3) of Companies Act,2013.

4. As regards description of capital adequacy ratio as described in para [D] of case, which of the following statements meets regulatory reporting requirements?

(a) Auditor has to ascertain and verify whether such ratio has been disclosed in financial statements in notes to accounts.

(b) Auditor has to ascertain and verify whether such ratio as disclosed in NBS-7 has been correctly arrived at.

(c) Auditor has to ascertain and verify whether such ratio as disclosed in NBS-7 has been correctly arrived at and whether such ratio is in compliance with minimum CRAR prescribed by RBI.

(d) Auditor has to ascertain and verify whether such ratio has been disclosed in financial statements in notes to accounts and has been correctly arrived at and is in compliance with minimum CRAR prescribed by RBI.

5. The auditor has performed audit procedures relating to allowances for loan losses using ECL in accordance with Ind AS 109. As these allowances involve significant judgment and estimates, she wants to state how it was addressed by her. How she can do that?

(a) By stating it in Auditor's additional report to Board of Directors.

(b) By stating it in matters as required under Section 143(3) of Companies Act.

(c) By incorporating Emphasis of Matter Paragraph in Independent auditor's report.

(d) By identifying it as Key audit matter in Independent auditor's report.

Key Takeaways

- A company incorporated under the Companies Act and desirous of commencing business of non-banking financial institution as defined under Section 45–IA of the RBI Act, 1934 can apply to the Reserve Bank of India in prescribed form along with necessary documents for registration. The RBI issues Certificate of Registration after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied.
- A non-banking company is defined under RBI Act as:-

  (i) A financial institution which is a company;

© The Institute of Chartered Accountants of India

(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;

(iii) Such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify.

Further, in order to identify a particular company as Non-Banking Financial Company (NBFC), it will consider both assets and income pattern as evidenced from the last audited balance sheet of the company to decide its principal business. The company will be treated as NBFC when a company's financial assets constitute more than 50 per cent of the total assets (netted off by intangible assets) and income from financial assets constitute more than 50 per cent of the gross income. A company which fulfils both these criteria shall qualify as an NBFC and would require to be registered as NBFC by RBI.

- RBI has issued directions to non-banking financial companies on acceptance of public deposits, prudential norms like capital adequacy, income recognition, asset classification, provision for bad and doubtful debts, risk exposure norms and other measures to monitor the financial solvency and reporting by NBFCs.
- RBI has introduced scale based regulations for NBFCs based on four layers that are defined based on their size, activity, and perceived riskiness. The four layers are- Base layer, middle layer, upper layer and top layer.
- NBFCs lend like banks. However, such entities cannot accept demand deposits although some can accept term deposits. These also do not form part of payment and settlement system. DICGC cover is not available to depositors of NBFCs. No minimum exposure to priority sector is required by NBFCs.
- Every applicable NBFC shall, after taking into account the time lag between an account becoming non-performing, its recognition as such, the realisation of the security and the erosion over time in the value of security charged, make provision against sub-standard assets, doubtful assets and loss assets in accordance with prescribed norms.
- Audit procedures for NBFCs have to be tailored in accordance of nature of business of NBFC and regulatory directions.

© The Institute of Chartered Accountants of India

- Besides issuing a report in accordance with requirements of section 143(3) of Companies Act and covering matters specified under CARO, 2020, statutory auditor of NBFC is also required to submit an additional report to Board of Directors of the company.
- The Reserve Bank of India (RBI) has issued Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2016 (the Directions) to auditor of every non-banking financial companies in this regard. Under these directions, auditor of an NBFC has to submit an additional report to the Board of Directors of the company covering matters specified in these directions.

Circular on Scale Based Regulation (SBR): A Revised Regulatory Framework for NBFCS: SCAN ME !

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *Define NBFC. Also give a brief description about types of NBFCs covering any five NBFCs.*
2. *Shubham & Associates are going to start the audit of NBFCs. They have not performed much work for the NBFCs in the past years. You are required to explain the requirements related to registration and regulation of NBFCs which an auditor needs to keep in his mind while planning the audit of NBFC which would help this firm.*
3. *Satyam Pvt Ltd is a company engaged in trading activities, it also has made investments in shares of other Companies and advanced loans to group companies amounting to more than*

© The Institute of Chartered Accountants of India

50% of its total assets. However, trading income constitutes majority of its total income. Whether the Company is an NBFC?

4. *Shivam & Co LLP are the auditors of NBFC (Investment and Credit Company). Some of the team members of the audit team who audited this NBFC have left the firm and the new team members are in discussion with the previous team members who are still continuing with the firm regarding the verification procedures to be performed. In this context, please explain what verification procedures should be performed in relation to audit of NBFC - Investment and Credit Company (NBFC-ICC).*

5 *You are appointed as the auditor of a NBFC registered with the RBI and which is accepting and holding public deposits. You are considering your reporting requirement in addition to your report made under Section 143 of the Companies Act, 2013 on the accounts of this NBFC as per the prescribed Directions.*

Please explain what points are required to be known in respect of separate report to be given by you to the Board of Directors of this NBFC.

6. *Kamna & Co LLP, a firm of Chartered Accountants, was appointed as auditor of an NBFC. The audit work has been completed. The audit team which was involved in the fieldwork came across various observations during the course of audit of this NBFC and have also limited understanding about the exceptions which are required to be reported in the audit report. They would like to understand in detail regarding the obligations on the part of an auditor in respect of exceptions in his report so that they can conclude their work. Please explain.*

7. *The Statutory Auditor of the NBFC company is required to give a report to the Board of Directors. What shall be the content of the Auditor's Report to the Board.*

8. *Krishna Pvt Ltd is primarily into the business of selling computer parts. However, the company is fulfilling the Principal Business Criteria as at the balance sheet date i.e. Financial Assets are more than 50 % of total assets and Financial Income is more than 50% of Gross Income. What shall be the obligation of the Statutory Auditor in such a scenario?*

9. *Mr. G. has been appointed as an auditor of LMP Ltd., a NBFC company registered with RBI. Mr. G is concerned about whether the format of financial statements prepared by LMP Ltd. is as per notification issued by the Ministry of Corporate Affairs (MCA) dated October 11, 2018. The notification prescribed the· format in Division III under Schedule III of the Companies Act, 2013 applicable to NBFCs complying with Ind-AS. Mr. G wants to know the differences in the presentation requirements between Division II and Division III of Schedule III of the Companies Act, 2013. Help Mr. G.*

© The Institute of Chartered Accountants of India

10. *Abhimanyu Finance Ltd. is a Non-Banking Finance Company and was in the business of accepting public deposits and giving loans since 2015. The company was having net owned funds of ₹1,50,00,000/-(one crore fifty lakhs) and was not having registration certificate from RBI and applied for it on 30th March 2023. The company appointed Mr. Kabra as its statutory auditors for the year 2022-23. Advise the auditor with reference to auditor procedures to be taken and reporting requirements on the same in view of CARO 2020?*

Answers to Test your Understanding.

1. NBFC-P2P falls in base layer in accordance with scale-based regulations of RBI. Few audit procedures for NBFC-P2P are as under: -

   - Gaining an understanding of business conducted by NBFC-P2P. It should be verified that company undertakes only permissible activities applicable to such type of NBFCs like providing online marketplace to participants for lending and borrowing. It should not be engaged in business of lending funds on its own.
   - Verifying certificate of registration obtained from RBI for carrying business of P2P platform.
   - Verifying Board approved policy setting out eligibility criteria for participants i.e lenders and borrowers.
   - Verifying board approved policy for pricing of services provided by P2P platform
   - Verification of adherence to lending and borrowing guidelines prescribed by RBI
   - Verifying appropriate arrangements have been entered into among participants and NBFC-P2P.
   - Compliance with reporting requirements of RBI
   - Verifying board approved policy for grievance redressal and complaints

2. The said company is not identified in upper layer by RBI. Under scale based regulations introduced by RBI, NBFCs undertaking housing finance activities constitute "middle layer". The asset size is not relevant in such a case. All housing finance companies not identified in upper layer would constitute middle layer due to nature of such activities undertaken by them.

   There is specific reporting requirement under CARO, 2020 under clause 3 (xvi)(b) which requires auditor to report whether the company has conducted any non-Banking financial or

© The Institute of Chartered Accountants of India

housing finance activities without a valid Certificate of Registration (CoR) from the Reserve Bank of India as per the Reserve Bank of India Act, 1934.

3. An NBFC is preparing financial statements in accordance with requirements of Division III of Schedule III of Companies Act, 2013 has to separately disclose by way of note any item of "other expenditure" exceeding 1% of total income.

   The said expenditure of ₹99.50 crore does not exceed 1% of total income. Hence, it meets requirements of Division III of Schedule III of Companies Act, 2013.

Answers to Integrated Case Scenario

1. (c)
2. (d)
3. (a)
4. (c)
5. (d)

Answers to Theoretical Questions

1. Refer Para 1 – Definition and Types of NBFCs.
2. An auditor should know following points regarding registration and regulation of NBFCs: Under Section 45–IA of the RBI Act, 1934, no NBFC shall commence or carry on the business of a non-banking financial institution without

   - obtaining a certificate of registration issued by the RBI; and
   - having a net owned fund (NOF) of ₹ 25 lakhs (₹ Two crore since April 1999) not exceeding two hundred lakhs rupees, as the RBI may, by notification in the Official Gazette, specify.

   (The RBI (Amendment) Act (1997) provided an entry point norm of ₹ 25 lakh as the minimum NOF which was revised upwards to ₹ 2 crore for new NBFCs seeking grant of certificate of registration (CoR) on or after 21 April 1999).

   A company incorporated under the Companies Act and desirous of commencing business of non-banking financial institution as defined under Section 45–IA of the RBI Act, 1934 can apply to the RBI in prescribed form along with necessary documents for registration. The RBI

© The Institute of Chartered Accountants of India

issues CoR after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied.

However, to obviate dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI viz. Venture Capital Fund/Merchant Banking companies/Stock Broking Companies registered with SEBI, Insurance Company holding a valid CoR issued by IRDA, Nidhi Companies as notified under Section 406 of the Companies Act, 2013, Chit Companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982 or Housing Finance Companies regulated by National Housing Bank.

The RBI has issued directions to NBFCs on acceptance of public deposits, prudential norms like capital adequacy, income recognition, asset classification, provision for bad and doubtful debts, risk exposure norms and other measures to monitor the financial solvency and reporting by NBFCs.

Directions were also issued to auditors to report non-compliance with the RBI Act and regulations to the Reserve Bank, Board of Directors and shareholders.

3. In order to identify a particular company as Non-Banking Financial Company (NBFC), it will consider both assets and income pattern as evidenced from the last audited balance sheet of the company to decide its principal business. The company will be treated as NBFC when a company's financial assets constitute more than 50 per cent of the total assets (netted off by intangible assets) and income from financial assets constitute more than 50 per cent of the gross income. A company which fulfils both these criteria shall qualify as an NBFC and would require to be registered as NBFC by Reserve Bank of India.

   In the given case, though Satyam Pvt Ltd is fulfilling the criteria on the asset side, but however is not fulfilling the criteria on the income side, the company cannot be classified as a deemed NBFC.

4. Refer Para 6

5. Refer Para 7.1(3), (4)

6. Refer Para 7.1(5)

7. Ref Para 7.1

   The statutory auditor of Karma Pvt Ltd, being a Non-Deposit Taking Non-Systemically Important NBFC is required to submit separate report to the Board of Directors on the matters as specified as below:

© The Institute of Chartered Accountants of India

I. Conducting Non-Banking Financial Activity without a valid Certificate of Registration (CoR) granted by the RBI is an offence under chapter V of the RBI Act, 1934. Therefore, if the company is engaged in the business of non-banking financial institution as defined in section 45-I (a) of the RBI Act and meeting the Principal Business Criteria (Financial asset/income pattern) as laid down vide the RBI's press release dated April 08, 1999, and directions issued by DNBR, auditor shall examine whether the company has obtained a Certificate of Registration (CoR) from the RBI.

II. In case of a company holding CoR issued by the RBI, whether that company is entitled to continue to hold such CoR in terms of its Principal Business Criteria (Financial asset/income pattern) as on March 31 of the applicable year.

III. Whether the non-banking financial company is meeting the required net owned fund requirement as laid down in Master Direction - Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

Apart from the aspects enumerated above, the auditor shall include a statement on the following matters, namely: -

(i) Whether the Board of Directors has passed a resolution for non- acceptance of any public deposits;

(ii) Whether the company has accepted any public deposits during the relevant period/year;

(iii) Whether the company has complied with the prudential norms relating to income recognition, accounting standards, asset classification and provisioning for bad and doubtful debts as applicable to it in terms of Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016;

Where, in the auditor's report, the statement regarding any of the items referred to matters specified above is unfavourable or qualified, the auditor's report shall also state the reasons for such unfavourable or qualified statement, as the case may be. Where the auditor is unable to express any opinion on any of the items referred above, his report shall indicate such fact together with reasons thereof.

© The Institute of Chartered Accountants of India

8. Ref Para 7.1

In the given case, Krishna Pvt Ltd is fulfilling the Principal Business Criteria i.e. Financial Assets are more than 50 % of total assets and Financial Income is more than 50 % of Gross Income. The company which fulfils both these criteria shall qualify as an NBFC and hence is required to obtain Certificate of Registration (CoR) with Reserve Bank of India. In such a scenario, the statutory auditor has an obligation to submit exception report to the RBI on the following matters :

(I) Where, in the case of a non-banking financial company, the statement regarding any of the items referred to in paragraph 3 of the Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2016, is unfavourable or qualified, or in the opinion of the auditor the company has not complied with:

(a) the provisions of Chapter III B of RBI Act (Act 2 of 1934); or

(b) Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016; or

(c) Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

It shall be the obligation of the auditor to make a report containing the details of such unfavourable or qualified statements and/or about the non-compliance, as the case may be, in respect of the company to the concerned Regional Office of the Department of Non-Banking Supervision of the RBI under whose jurisdiction the registered office of the company is located as per first Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016.

(II) The duty of the Auditor under sub-paragraph (I) shall be to report only the contraventions of the provisions of RBI Act, 1934, and Directions, Guidelines, instructions referred to in sub-paragraph (1) and such report shall not contain any statement with respect to compliance of any of those provisions.

9. Refer Para 8.3

10. As per Clause (xvi) of Paragraph 3 of CARO 2020, the auditor is required to report that "whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained."

© The Institute of Chartered Accountants of India

The auditor is required to examine whether the company is engaged in the business which attract the requirements of the registration. The registration is required where the financing activity is a principal business of the company. The RBI restrict companies from carrying on the business of a non-banking financial institution without obtaining the certificate of registration.

Audit Procedures and Reporting:

(i) The auditor should examine the transactions of the company with relation to the activities covered under the RBI Act and directions related to the Non-Banking Financial Companies.

(ii) The financial statements should be examined to ascertain whether company's financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income.

(iii) Whether the company has net owned funds as required for the registration as NBFC.

(iv) Whether the company has obtained the registration as NBFC, if not, the reasons should be sought from the management and documented.

(v) The auditor should report incorporating the following:-

(1) Whether the registration is required under section 45-IA of the RBI Act, 1934.

(2) If so, whether it has obtained the registration.

(3) If the registration not obtained, reasons thereof.

In the instant case Abhimanyu Finance Ltd. is a Non Banking Finance Company and was in the business of accepting public deposits and giving loans since 2015. The company was having net owned funds of ₹ 1,50,00,000/-(one crore fifty lakhs) which is less in comparison to the prescribed limit i.e. 2 crore rupees and was also not having registration certificate from RBI (though applied for it on 30th March 2021). The auditor is required to report on the same as per Clause (xvi) of Paragraph 3 of CARO 2020.

© The Institute of Chartered Accountants of India