Guidance Note on Audit of Banks

Attention

Members' attention is invited to relevant circulars issued by the Reserve Bank of India up to February 28, 2013, included in a CD accompanying this Guidance Note for ease of use and reference. Members are advised to keep track of legislative / regulatory developments, for example, circulars of the Reserve Bank of India, issued subsequent to the aforementioned date and having a bearing on the statutory audit of banks / bank branches for the year ended March 31, 2013.

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

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E-mail	:	aasb@icai.org

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Foreword

The Banking Sector is the most dominant segment of the financial sector in the Indian economy. It is fairly mature in terms of product range and reach. The banking sector, like all economic activities, is also exposed to the risk in the conduct of their business. However, Indian banks continue to build on their strengths with good quality audits serving as the backbone of the strong banking system in place today.

In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets relative to other banks in comparable economies. The statutory auditors have had a critical role to play in this.

I am happy that the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India has come out with the Revised 2013 Edition of the Guidance Note on Audit of Banks. The Revised edition incorporates the impact of the various circulars of the Reserve Bank of India as well as certain important pronouncements of the Institute which would be relevant to bank audits for the financial year ending March 31, 2013.

At this juncture, I wish to place my appreciation to CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board for his zeal and commitment in bringing out such literature and make it available to the members at large thereby enabling them in maintaining quality in the audit services rendered.

I am confident that the members would find the revised edition of the Guidance Note immensely helpful.

New Delhi
March 15, 2013

CA. Subodh Kumar Agrawal
President, ICAI

Preface

Audit of banks has been much in the limelight in the professional and regulatory circles for a variety of reasons. As the financial year 2012-13 draws to an end, the members who have been allotted bank statutory central audits and bank branch audits would be busy preparing for these audits. The Profession must utilize this opportunity to demonstrate how an audit of financial statements is not just a regulatory requirement to be complied with but it indeed has an immense value to not only the auditee banks but also to the banking regulator, i.e., the Reserve Bank of India.

At this juncture, it gives me immense pleasure to place in your hands the 2013 edition of the Guidance Note on Audit of Banks, which would help the auditors in efficient and effective conduct of the audit. This edition of the Guidance Note has been updated since the last edition which came out in 2011. During these two years a number of important directives have been issued by the banking regulator i.e., the Reserve Bank of India which the statutory auditors are required to be aware of, particularly, those brought about by the RBI through its various Master Circulars and a number of other relevant circulars. I also take this opportunity to reiterate that the auditor's report for the financial year 2012 – 13 onwards would have to be issued in the revised format as prescribed under the Revised SA 700 issued by the Institute of Chartered Accountants of India.

I take this opportunity to place on record my sincere gratitude and appreciation for the members of the Mumbai study group, *viz.*, CA Shriniwas Y. Joshi, coordinator of the study group, CA Vipul Choksi, CA Ashutosh Pednekar, CA Akeel Master, CA Sanjay Khemani, CA Vikas Kumar, CA Zubin Billimoria, CA Manish Sampat, CA Niranjan Joshi, CA Sandeep Welling, CA Shivratan Agarwal, CA Ulhas Chitale, CA Gautam Shah, CA Neville M. Daruwalla and CA Ashwin Suvarna for squeezing time out of their pressing professional and personal commitments to work on the 2013 edition of the Guidance Note on Audit of Banks and finalise it in a short time.

I also wish to place on record my gratitude to CA. Subodh K Agrawal, President, ICAI and CA. K Raghu, Vice President, ICAI for their unstinted support to the activities of the Board.

I am also grateful to my colleagues at the Auditing and Assurance Standards Board, CA. Naveen ND Gupta, Vice Chairman, AASB, CA. Rajkumar S Adukia, CA. Jay Ajit Chhaira, CA. Shriniwas Y Joshi, CA. Sanjeev Maheshwari, CA. Dhinal A Shah, CA. Shiwaji B Zaware, CA. M. Devaraja Reddy, CA. S. Santhanakrishnan, CA. J. Venkateswarlu, CA. Manoj Fadnis, CA. Sanjiv K Chaudhary and CA. Vijay K Gupta for their support to the various projects of the Board. I also wish to thank the Secretariat of the Auditing and Assurance Standards Board for their efforts in giving the Guidance Note its final shape.

I am sure that like its predecessors, the readers would find this updated edition of the Guidance Note also extremely useful.

March 15, 2013
Kolkata

CA. Abhijit Bandyopadhyay,
Chairman,
Auditing & Assurance Standards Board

Foreword to Seventh Edition

The Banking system remains, as always, the most dominant segment of the financial sector in the Indian economy. Today, the banking sector in India is fairly mature in terms of supply, product range and reach. The banking sector, like all economic activity is also exposed to risk in the exercise of their business. Indian banks continue to build on their strengths with good quality audits serving as the backbone of the strong banking system in place today.

In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets relative to other banks in comparable economies in its region. The responsibility for this lies on the shoulders of the auditors.

I am pleased to note that the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India has, in order to help the members maintain the good quality of bank audits, come out with the 2011 Edition of the Guidance Note on Audit of Banks. The Revised edition incorporates the impact of the various circulars of the Reserve Bank of India as well as certain important pronouncements of the Institute which would be relevant to bank audits for the financial year ending March 31, 2011.

At this juncture, I wish to place my appreciation to CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board for his zeal and commitment to reach out to the members in the profession in maintaining quality in the audit services rendered by them. More so, as the Guidance Note on Audit of Banks is a publication which is eagerly awaited by one and all.

I am extremely confident that the members would find the revised edition of the Guidance note immensely helpful in efficiently conducting audit of banks.

New Delhi

March 11, 2011

CA. G RAMASWAMY
President, ICAI

Preface to Seventh Edition

The banking industry is a systemically important industry for the Indian economy in general and financial sector in particular as it comprises nearly 90% of the total financial services sector of the country. The banking industry in India has undergone significant transformation since the initiation of the financial sector reforms that were part of the structural reforms of early 1990s. The banking sector has steadily evolved from a state-directed banking system into a fairly open competitive banking system.

Banking in India has become service oriented, maturing from the days of 'walking in business' to the present situation of 24 hour banking solutions to attract customers. With such widespread and rapid growth of the banking industry and their entry into a wide variety of services like insurance, mutual funds, etc., the onus of the healthy sustenance and growth of the banking industry lies on the back of reliable financial statements which can only be assured by good quality audits. The bank audit is thus an important step for all banks who seek a better optimization of its overall management.

To help the members provide value add audit of the financial statements of a bank, the Institute has brought out the 2011 edition of the *Guidance Note on Audit of Banks*, thoroughly revised in the light of the relevant circulars issued by the Reserve Bank of India between 2009 till date. Since adequate and appropriate understanding of an auditee is a prerequisite for any effective audit, the Guidance Note contains comprehensive information on the working of a modern bank, its control systems, books of account, legal and regulatory requirements, including introduction of new banking concepts, in addition to comprehensive information and audit guidance on important items on the financial statements of banks.

The 2011 Guidance Note covers critical aspects such as Knowledge of the Banking Industry, Risk Assessment and Internal Control, Items of Bank's Financial Statements and Auditing Aspects, Long Form Audit Reports, Special Aspects. The text of the relevant circulars of the Reserve Bank of India is given in the CD with the Guidance Note.

At this juncture, I would wish to place my gratitude to CA. G Ramaswamy, President and CA. Jaydeep N Shah, Vice President, ICAI for their support and valuable guidance to the initiatives of the Auditing and Assurance Standards Board. My sincere thanks is also due to CA. M M Khanna, CA. Sanjay Vasudeva and CA. Ajay K Jain from New Delhi and CA. Vipul Chokshi from Mumbai for their valuable inputs in making the 2011 edition of the Guidance Note more useful and comprehensive.

I also wish to place on record my sincere thanks to my colleagues at the Board, *viz.,* CA. Rajkumar S Adukia, Vice-Chairman, AASB, CA. Amarjit Chopra, CA. Naveen N.D. Gupta, CA. Sanjeev K. Maheshwari, CA. M. Devaraja Reddy, CA. Rajendra Kumar P., CA. J. Venkateswarlu, CA. Sumantra Guha, CA. Anuj Goyal, CA. Pankaj Tyagee, CA. Jayant P. Gokhale, CA. S. Santhanakrishnan, CA. Mahesh P. Sarda, CA. Vijay Kumar Garg, CA. V. Murali, CA. Nilesh S. Vikamsey, Ms. Usha Sankar, Shri Prithvi Haldea, CA. David Jones, CA. Sanjay Vasudeva, CA. Raviprasad, CA. P.R. Vittel, CA. C.N. Srinivasan and CA. Ramana Kumar B for their views for further improvements to the Guidance Note. My sincere gratitude is also due to all my other Central Council colleagues without whose support this edition of the Guidance Note would not seen the light of the day.

I am extremely confident that the Guidance Note would prove to be highly useful and relevant for authoritative reference for the auditors and also for all those who are connected with the banking industry in one way or other.

Kolkata
March 11, 2011

CA. Abhijit Bandyopadhyay
Chairman
Auditing and Assurance Standards Board

Foreword to Sixth Edition

India's banking industry must strengthen itself significantly in order to support the modern and vibrant economy which India aspires to be. The last decade has seen many positive developments in the Indian banking sector. Policy makers have made some notable changes in policy and regulation to help strengthen the sector. These changes include strengthening prudential norms, enhancing the payments system and integrating regulations between commercial and co-operative banks.

For safe and sound banking system, one of the most important ingredient is reliable, clear financial information supported by quality audits. At the same time, audit also complements supervisory efforts of the regulators in risk management and efficient functioning of banking system.

In order to equip our members with requisite updated knowledge on functional areas of the banking operation, I am pleased to note that the Auditing and Assurance Standards Board of the Institute has brought out the revised edition of the Guidance Note on Audit of Banks. The revised edition has been updated by incorporating insightful guidance into the impact of various new/ revised circulars issued by the Reserve Bank of India.

I am sure that the members will find the revised Guidance Note, like its earlier editions, useful in providing a comprehensive overview of the functioning of a bank and guidance on critical aspects of a bank audit. I am confident that this publication would surely help the members in discharging their responsibility in an effective manner.

New Delhi
February 04, 2009

Ved Jain
President, ICAI

Preface to Sixth Edition

Liberalization and de-regulation process that started in 1991-92 made a sea change in the working and reach of the banking system. From a totally regulated environment, it has moved gradually into a market driven competitive system though the move towards global benchmarks has been, by and large, calibrated and regulator driven.

In this dynamic environment, the auditors of banks, in their own way, play a crucial role in upholding and enhancing the credibility of the banking system. In order to equip the members with updated knowledge on banking industry, the Auditing and Assurance Standards Board has been from several past years coming out with Guidance Note on Audit of Banks. The 2009 edition of the Guidance Note has thoroughly been revised by taking the impact of the relevant circulars issued by the RBI from time to time. The audit procedures have been thoroughly revised in view of the issuance of risk-based Standards on Auditing which have come into force with effect from 1st April, 2008. Further, three new chapters have been added in the 2009 edition, i.e., “Special features of bank treasury operations, foreign exchange and derivative transactions”, “Basel II” and “Disclosure requirements in financial statements”.

I wish to place on record my sincere gratitude to CA. Vipul K. Choksi, FCA, convenor of the Study Group constituted at Mumbai and all the other members of the Study Group, viz., CA Abhijit Sanzgiri, CA Ashutosh Pednekar, CA Akeel Master, CA Ketan Vikamsey, CA Sanjay Khemani, CA Vikas Kumar, CA Zubin Billimoria, CA. Kamlesh Vikamsey, CA. Uday Chitale, CA. Asit Pal, CA. Jatin Lodaya, CA. Shiv Ratan Agarwal CA. Manoj Daga and CA Dharini Shah who have squeezed time from their professional and personal commitments to complete this mammoth task of revising the Guidance Note. I would also take the opportunity of placing on record my gratitude to all the members of the Expert Group viz., CA. Amarjit Chopra, CA. K. P. Khandelwal CA. S. Santhanakrishnan, CA.

Manoj Fadnis and CA. Shanti Lal Daga for their invaluable comments and suggestions. I am also thankful to all my colleagues on the Auditing and Assurance Standards Board and Council for their continuous support and guidance.

I am sure that the members will find the guidance contained in this revised edition effective in conducting audit of banks and their branches.

New Delhi
February 04, 2009

Harinderjit Singh
Chairman
Auditing and Assurance Standards Board

Foreword to Fifth Edition

Sounding clichéd as I may do, yet I would begin with stating what has been said at a number of for a number of times that the economic growth and development of the society hinges to a large extent on the soundness of the accountancy profession. It is one profession which has had a reach and has enjoyed unwavering trust of one and all, not withstanding the political, cultural or economic barriers that might have separated them.

Whereas this unwavering trust has placed the accountancy profession in a unique position to command authority and respect, it has also been something which has given sleepless nights to not only the regulators but also the professional accountancy bodies across the world. These professional bodies have been working relentlessly towards equipping their members with the latest knowledge and skill sets to help them perform efficiently and uphold that trust.

The Institute too has been committed to that cause and has a clear approach to keeping its members technically sound. Issuing authoritative technical literature has been an integral part of this approach. The challenge however is to keep that literature current and relevant. I am happy to note that the Auditing and Assurance Standards Board of the Institute has brought out the revised version of the Guidance Note on Audit of Banks incorporating the latest regulatory and other professional requirements having an impact on audit of banks.

I am sure that the readers will find the revised Guidance as useful as its earlier version, not only as a one stop reference for audit procedures in case of banks but also as a concise compendium of significant banking activities.

New Delhi
February 4, 2008

Sunil H. Talati,
President, ICAI

Preface to Fifth Edition

Banking is a unique industry in itself. In a world divided by political, economic and social boundaries and barriers, it acts as a glue to keep it integrated in one way or the other. This fact has been underlined time and again; the tremors of the recent crises in the US banking industry have been felt in almost all parts of the world. Extensive geographical spread, wide array of products and services offered, high volumes of transactions many of which are quite complex, advanced level of automation, large customer base are some of the other elements of uniqueness of the banking industry.

This uniqueness of banking industry, however, poses a major challenge in the audit of banks. The answer to this challenge for the auditors lies, to a considerable extent, I personally believe, in two things, one, having a firm grip on the knowledge of the banking industry and second, in keeping update with the professional (in particular the latest auditing standard & pronouncements), regulatory and other industry related developments. The Guidance Note on Audit of Banks (2008 edition) has been designed keeping in view the aforesaid requirements. The Guidance Note has been divided into four parts, first, the knowledge of the banking industry and its operational aspects; second, related audit procedures; third, LFAR both at the branch as well as head office level; and fourth, special purpose reports and certificate and other special aspects, etc. Also the relevant circulars are contained in the accompanying CD. At this juncture, I also wish to underline the fact that it is necessary to read the Guidance Note in its entirety to properly appreciate the guidance given therein.

I would like to place on record my sincere gratitude to CA S Swaminathan, from Chennai who volunteered to undertake this mammoth task of revising and restructuring the 2006 edition of the Guidance Note. I am also thankful to all my colleagues in the Auditing and Assurance Standards Board and Council for their continuous support and guidance. I would also like to place on record my thanks to CA. Ashok Batra from Delhi and CA. Mitil Chokshi from Mumbai for providing his invaluable inputs on the Guidance Note. I also wish to appreciate the contribution of CA. Priya Subramaniam, Senior Assistant Director, Board of Studies in respect of taxation of banks. Finally, I

also wish to record my thanks to Shri Vijay Kapur, Director, Auditing and Assurance Standards Board and his team at the AASB Secretariat for giving final shape to the revised Guidance Note.

I am sure that the readers would find the guidance note useful.

New Delhi

February 4, 2008

Harinderjit Singh
Chairman
Auditing and Assurance Standards Board

Foreword to Fourth Edition

Since the issuance of the last edition of the Guidance Note on Audit of Banks in March 2005, a number of important developments have taken place in the banking sector, warranting attention of the auditors. Some of these developments are usual and happen every year such as the issuance of the revised income recognition and asset classification norms, investment exposure norms, etc. Some of these changes, however, highlight some major policy shifts by the Reserve Bank of India and would have a lasting impact on the future of the banking industry in India, such as move towards risk-based supervision of banks, para banking activities, new capital adequacy norms, etc.

In addition, the banking industry in India in the recent past has been a witness to the flurry of merger and acquisition activities. Further, the recent years have also seen a growing interest of the banking industry in the capital markets. It is, therefore, essential that members undertaking statutory audit of banks keep themselves abreast with the latest developments in the banking including the actions of the banking regulator, the Reserve Bank of India. I am happy to note that the Auditing and Assurance Standards Board has brought out the 2006 edition of the Guidance Note on Audit of Banks well in-time to keep the members abreast with the vital changes in the banking to help them appropriately understand the impact of these changes on their audit.

I sincerely hope that the members would find this edition of the Guidance Note also useful and informative.

New Delhi
March 14, 2006

T N Manoharan
President

Preface to Fourth Edition

The economic development of any country depends significantly on the support that it gets from the banking sector of the economy. In order to build up a resilient banking industry, it is essential that the industry is founded on sound banking principles and practices, complemented by effective regulation and supervision. The recent past has witnessed the banking industry becoming the focus of investment opportunities be it by way of IPOs or mergers and acquisitions or FDI. Another significant development over the past few years has been the growing activism of the banking industry in the capital markets.

The mammoth amounts of public monies being handled by the banks as well as the inherent vulnerable nature of the banking industry, however, make it imperative that the activities of the industry are closely monitored and regulated without strangulating the spirit of entrepreneurship. Audit forms an integral and important part of such monitoring and regulation. For past number of years the members of the Institute have been taking on this responsibility with that extra fervour and commitment. The Institute too has been actively supporting the members in their role as statutory auditors of banks by bringing out a number of technical publications dealing with the various aspects of bank audit, especially the Guidance Note on Audit of Banks. The Guidance Note deals with several important aspects of bank audit both at branch as well as head office level. Keeping abreast with the latest developments in the banking industry and understanding their impact on audit of banks is quintessential for the auditors if they want to make any value addition.

The 2006 edition of the Guidance Note contains guidance on important aspects such as risks associated with the banking industry, assessment of the risk based internal audit system in banks, audit of ATMs, audit under CDR, and more importantly the revised formats of the audit reports of nationalized banks as well as banking companies, to name a few. This edition of the Guidance Note is targeted at helping the members understand the various developments in the banking industry since the issuance of the 2005 edition of the Guidance Note and their impact on their audits. Some of the important aspects of the banking industry that have undergone a change as a result of regulatory intervention include the changes in the prudential norms on income recognition and asset classification, exposure norms for credit and investment portfolio, loans and advances, capital adequacy requirements, changes in the CRR, SLR, new guidelines on corporate debt restructuring as well as small and medium enterprises, introduction of risk based supervision in banks, guidelines on securitization of standard assets, KYC norms, etc. Some other important developments that have impacted the banking industry are the banking cash transaction tax, the fringe benefit tax, service tax etc. Further, for ease of reference of the readers, the important changes in the 2006 edition from the 2005 edition are also indicated by way of footnote references.

The 2006 edition of the Guidance Note is divided into two Sections, Section I contains the Text of the guidance whereas Section II contains the Appendices. Section I is divided into four parts – initial considerations, audit of branches, audit of head office and special purpose reports and certificates. Part II contains the text of the relevant circulars of the Reserve Bank of India as well as the formats of the audit reports. For the benefit of the readers, the appendices have also been given in a CD along with the Guidance Note.

At this juncture, I wish to place on record my immense gratitude to S/Shri Dinesh Mehta, FCA, Rajiv Sogani, FCA, Anil Goyal, FCA, Atul Atolia, FCA, Ashok Batra, FCA and Nitant Trilokekar, FCA who squeezed time out of their busy professional and personal lives to revise certain important aspects of the Guidance Note. My thanks are also due to Shri Nagesh D Pinge, Sr. General Manager, ICICI Bank for his contribution in respect of the guidance on risk based internal audit in banks. I also express my gratitude to Shri Amarjit Chopra, FCA, my colleague in the Council as well as my immediate predecessor as Chairman, Auditing and Assurance Standards Board under whose able guidance and vision the revision of the 2005 Guidance Note was initiated. I also wish to place my sincere thanks to my colleagues at the Auditing and Assurance Standards Board for their valuable inputs on the draft Guidance Note. My thanks are also due to my colleagues at the Council, in specific to Shri Harinderjit Singh, also Vice Chairman of AASB as well as Shri S C Vasudeva, for their incisive comments on improving upon the draft Guidance Note and giving it a final shape. I also wish to place on record the efforts put in by Shri Vijay Kapur, Secretary, Auditing and Assurance Standards Board and his team of officers, viz., Smt. Puja Wadhera, Senior Technical Officer, Shri Nitin Singhal and Shri Amit Sinha, Executive Officers in finalizing the Guidance Note.

I am confident that the bank audit being just round the corner, this edition of the Guidance Note too, as its predecessors, prove to be of immense use to the members as also other interested readers.

New Delhi	Sunil Goyal
March 16, 2006	*Chairman*
	Auditing and Assurance Standards Board

Foreword to Third Edition

An audit based on the sound knowledge of the audit client is quintessential if the Profession has to maintain its competitive edge as well as the confidence reposed in it by all. Audit of the banking sector is no exception to that. In fact, audit of a bank requires quite good knowledge of almost all the functional areas of the banking operations.

As all are aware, the Institute has taken a number of initiatives to keep the members abreast with the latest developments in the areas of professional relevance, be it in the form of technical literature or seminars, etc. The 2005 edition of the Guidance Note on Audit of Banks, developed by the Auditing and Assurance Standards Board is one such initiative. This edition is thorough update of the Guidance Note issued in 2001 and the subsequent 2003 Supplement.

I am happy to note that the 2005 edition also contains an insightful guidance into the impact of various new/revised circulars of the Reserve Bank of India with respect to prudential norms, exposure norms on investments, etc. In tune with times, the Guidance Note also contains specific guidance on service tax matters.

With bank audits just around the corner, I am sure that this edition of the Guidance Note on Audit of Banks too will prove to be immensely useful to our members in discharge of their attest functions in the most appropriate manner.

New Delhi (Kamlesh S. Vikamsey)
March 31, 2005 *President*

Preface to Third Edition

The banking industry is no doubt the backbone of any economy. It is, therefore, very essential to ensure that the banking industry remains healthy and robust. The accountancy profession, within its given means and scope of work contributes actively by ensuring proper financial reporting and disclosure aspects of the banking industry. Statutory audit of banks is one such area by which the accountancy profession makes such a contribution.

To be able to contribute to the health of the banking industry, it is essential that the statutory auditors are well equipped in terms of the knowledge of the banking industry. Guidance Note on Audit of Banks is an important tool in the kitty of the members of the Institute to gain an insight into the systems and processes in the significant functional areas of the banking industry, such as the acceptance of deposits, credit, investments, fixed assets, branch functions, etc. These all are obviously aimed at helping the members understand and effectively evaluate the internal controls and accounting systems in a bank.

A number of changes have taken place in the banking sector, having a bearing on the functioning of the banks as also, consequently, statutory audit of banks. The 2005 edition of the Guidance Note, therefore, is an extensively revised and updated version of the 2001 Guidance Note and the 2003 Supplement, all with the basic aim of keeping our members abreast with the latest developments in the area of bank audits. Like the 2001 Guidance Note and the Supplement, the 2005 edition too delves into the impact of several new circulars in the field of prudential and income recognition norms, investment norms, exposure of investments, investment portfolio etc., on the functioning of as well as financial reporting by the banks. In addition, the Guidance Note also touches upon the aspect of application of various Accounting Standards, issued after the 2003 Supplement as well as the Report of the N D Gupta Committee on Compliance with Accounting Standards by Banks. Another critical area in the banking industry, which is being stressed upon by the Reserve Bank of India is prevention of money laundering. The regulator has issued a number of circulars relating to “Know Your Customer” guidelines. These circulars too have been dealt with by the revised Guidance Note.

The revised Guidance Note also provides an insight into the technological advancements impacting the banking sector, such as the internet banking feature, etc. In addition to the above, as is the norm, the Appendices to the revised Guidance Note contain the text of various relevant circulars issued by the Reserve Bank of India as a source of ready reference for readers as also the illustrative format of the auditor's report. In nut shell, the Guidance Note aims to provide a comprehensive overview of the functioning of a bank and critical aspects of a bank audit.

At this juncture, I wish to place my gratitude to the Study Group constituted at Indore under the Convenorship of Shri Manoj Fadnis, FCA, which prepared the basic draft of the revised Guidance Note at such a short notice. In particular my special thanks are due to S/Shri Aseem Trivedi and Santosh Deshmukh of Indore for the hard work put in by them. S/Shri Ashok Batra and Nishith Seth of Delhi also deserve special mention for their valuable contribution. I am also grateful to all my colleagues at the Auditing and Assurance Standards Board for providing insights from their rich knowledge and experience for improving upon the draft Guidance Note. A word of thanks is also due to all my colleagues at the Council for providing their invaluable guidance and support in giving the final shape to the revised Guidance Note.

I am extremely grateful to Shri Vijay Kapur, Secretary, Auditing and Assurance Standards Board, for his efforts and valuable inputs which were so essential in bringing out this Guidance Note. Also my thanks are due to technical staff of Auditing and Assurance Standards Board for their valuable contribution.

I am sure that the members and other interested users will find this edition of the Guidance Note useful in discharge of their professional obligations.

New Delhi
March 30, 2005

Amarjit Chopra
Chairman
Auditing and Assurance Standards Board

Foreword to the Second Edition

The banking system in India, perhaps, is one of the largest in the world as far as its extensive branch network is concerned. The role of the banking sector in the overall growth and development of the Indian economy is also quite significant and laudable. Today, disclosure practices followed by Indian commercial banks are almost at par with those of international banks. The introduction of prudential norms, capital adequacy norms, requirement to attach the financial statements of the subsidiaries beginning from year 2000-01 are definite measures to bring more transparency in the banking industry. In this context, the Reserve Bank of India has been performing a stellar role by issuance of detailed guidelines in close consultation with the ICAI.

In view of stringent disclosure practices and far-reaching technological developments, the role of accounting profession with respect to the banking industry has assumed considerable significance. The original Guidance Note on Audit of Banks was issued in 1994. In view of far reaching changes, it was imperative to revise the Guidance Note, to bring it in line with these developments. I am pleased to note that the Auditing Practices Committee of the Institute has brought out the revised Guidance Note on Audit of Banks. A salient feature of the revised Guidance Note is that a considerable emphasis has been laid on explaining the distinguishing characteristics of the banking industry – how it operates, what transactions take place, the sequence of these transactions, the accounting system for recording the transactions and the legal and regulatory framework within which it operates. Another important feature of the revised Guidance Note worth mentioning is that it deals separately with the audit of banks at the head office and that at the branch level.

The draft of the Guidance Note was considered by the Council of the Institute at its meeting held on 6th, 7th and 8th March 2001. I wish to specially commend the efforts and contribution made by Mr. S. Gopalakrishnan, Chairman, Mr. K.S. Vikamsey, Vice-Chairman and all the members of the Auditing Practices Committee who undertook the mammoth task of bringing out the revised Guidance Note in such short span of time. I also wish to thank the members of the Central Council of the Institute for their valuable suggestions in enriching the contents of the revised Guidance Note.

I appreciate the efforts of Mr Vijay Kapur, Secretary, Auditing Practices Committee of the Institute and his team of Officers, without whose untiring efforts, this Guidance Note would not have been published in time.

I am sure that the revised Guidance Note would prove immensely useful not only to the members who have an experience in audit of banks but also those members who are uninitiated to the area of bank audit.

New Delhi (N.D. Gupta)
March 20, 2001 *President*

Preface to the Second Edition

While the auditing principles remain the same regardless of the nature of the entity under audit, the manner of their application has to be determined in the context of the specific features of the industry to which the entity belongs and also the specifics of the entity itself. This revised Guidance Note seeks to provide guidance on application of generally accepted auditing principles in the specific context of Banks.

A number of developments have taken place in the Banking industry. Some of the prominent changes include, from time to time, in prudential guidelines relating to income recognition, asset classification, provisioning and investment valuation, capital adequacy and extensive computerization of Banking operations. These developments have necessitated a thorough revision of the Guidance Note to maintain its relevance in the changed scenario.

This Guidance Note makes a clear distinction between audit at Branch level and Head office level and elaborates on general considerations in audit of Banks at Head Office/Branch level and special consideration in the case of audit of Branches.

The Guidance Note consists of 29 chapters (besides a number of appendices), divided into four parts:

- Part I deals with general considerations in audit of banks and applies to audit at both head office level and branch level.
- Part II deals with special considerations in the case of audit of branches.
- Part III deals with audit at head office and zonal/regional office level.
- Part IV deal with special-purpose reports and certificates to be issued by auditors of head office or branches of banks.

While every attempt has been made to cover the latest circular issued by Reserve Bank of India on the subject, it is advisable for` the members in the ever changing scenario to keep a constant watch on the latest developments in the Banking sector and familiarize themselves on the update.

I am confident that the members will find this Guidance Note user friendly and a good companion on the subject.

I take this opportunity to express my sincere thanks to Shri M.M. Khanna, Past Council Member and past/present members of the Auditing Practices Committee for their valuable contribution in the preparation of the Guidance Note.

I would like to record my sincere appreciation to the faculty who assisted the Committee in preparation of this Guidance Note. I also wish to thank Shri Vijay Kapur, Secretary, Auditing Practices Committee and his team whose untiring efforts made it possible for the Committee to bring out this Guidance Note in good time.

Hyderabad
March 20, 2001

(S. Gopalakrishnan)
Chairman
Auditing Practices Committee

Foreword to the First Edition

I am glad to note that the Auditing Practices Committee of the Council of the Institute is bringing out this Guidance Note on Audit of Banks.

Banking is a dynamic activity which has constantly been undergoing a change. In recent years, there has been a remarkable change in the nature, volume and spread of transactions of banks. Apart from this, the non-traditional functions of banks, e.g., foreign exchange activities, merchant banking, portfolio management, investment, etc., have acquired considerable importance during this period. Another significant development from the auditors' view point is the issuance, by the Reserve Bank of India, of detailed guidelines regarding income recognition, asset classification, provisioning and other related matters. Yet another development which affects the work of bank auditors is the revision of formats of financial statements of banks as also of the formats of long form audit reports. These developments made it imperative for the Institute to revise its existing publications dealing with audit of banks. I am glad that the Auditing Practices Committee took up the work of revision on a priority basis and completed this task in a short period. The draft prepared by the Committee was considered by the Council at its meeting held in September, 1994 and approved for publication.

The members would recall that during the first half of 1994, a series of seminars on the subject of 'Bank of Audit' was organised at all major places throughout the country. For this purpose, the Institute had brought out a uniform background material. The present Guidance Note draws heavily on the background material, supplemented by the large number of suggestions made during the course of the seminars. The Guidance Note, thus, reflects the collective thinking of the profession on the subject.

It is noteworthy that the earlier edition of this publication on 'Audit on Banks' was in the form of a 'Study'. However, considering the importance of the banking sector in the economy, it has been decided to bring out the present edition in the form of a Guidance Note. As the members are aware, Guidance Notes are recommendatory in nature. Accordingly, while carrying out the statutory audit of a bank or a branch of a bank, a member should ordinarily follow the recommendations made in this Guidance Note except where he is satisfied that in the circumstances of the case, it may not be necessary to do so.

In the fast changing economic scenario of the country, the banking sector is likely to witness many more changes in the years to come. I am sure, the Auditing Practices Committee will strive to keep this publication up-to-date by revising it periodically. However, the process of revision, by its very nature, takes time. Therefore, I would strongly urge upon the members to keep a constant watch on the developments in the banking sector specially insofar as they affect their work and adapt their audit procedures and techniques in response to the changes in the environment.

I have great pleasure in acknowledging the efforts and the contribution made by the Chairman of the Auditing Practices Committee, Mr. Dipankar Chatterji. I profoundly thank members of the Auditing Practices Committee and of the Council for their valuable suggestions. On behalf of the Council, I would like to record the sincere appreciation to the faculty of the Technical Directorate especially to Dr. Kamal Gupta, Technical Director and Mr. Ashok Arora, Deputy Director, for their utmost dedication and technical input in bringing out this publication.

I am sure, the members would find the guidance contained in this publication useful in conducting the audit of banks and their branches.

New Delhi
November 22, 1994

B.P. Rao
President

Preface to the First Edition

The Auditing Practices Committee has pleasure in placing before the members this Guidance Note on Audit of Banks. The Guidance Note is a thoroughly revised, updated and enlarged edition of the two existing publications titled 'Study on Audit of Banks' and 'Guidance Note on Long Form Audit Reports in case of Public Sector Banks'.

The need for bringing out this revised edition arose because of a number of significant developments in the banking sector which have affected the work of the auditors in recent years. One of the most significant developments is the issuance of guidelines for income recognition, asset classification, provisioning and other related matters by the Reserve Bank of India. The guidelines lay down objective parameters for determining the quantum of provision required in respect of advances. Similarly, with the issuance of guidelines for valuation of investments, a considerable degree of uniformity has been brought about in the manner in which investments are accounted for and valued by banks.

The formats of financial statements of banks have been recently modified, thereby bringing about a greater degree of transparency therein. The Reserve Bank of India has similarly revised the formats of long form audit reports and also extended the requirement for obtaining such reports to private banks and foreign banks.

The changes in the nature and volume of activities of banks also affect the work of the auditors. In particular, the treasury functions of banks such as investments, foreign exchange, etc., have assumed considerable significance in the last few years. The portfolio management services rendered by banks have also been a subject matter of considerable interest during the last couple of years.

This revised edition seeks to respond to the above, as well as several other, developments that have taken place since the publication of the last editions of the aforesaid two publications. I would like to particularly draw the attention of the members to the chapter on Audit Objectives and Approach to audit of banks in the present-day context. I would also like to make a special mention of chapters dealing with investments and advances with have been thoroughly revised in the context of the relevant guidelines issued by the Reserve Bank of India.

Apart from a thorough revision of the existing chapters, several new chapters have also been added to provide guidance on areas which have gained considerably in significance during the last few years. These chapters deal with the problem of arrears in inter-branch accounts, examination of foreign exchange transactions, application of analytical procedures by the auditors, and consolidation of accounts of branches. A separate chapter deals with the role of the statutory auditors of banks in relation to portfolio management services. Similarly, a chapter has been added to provide guidance on the requirement of the Reserve Bank of India that the statutory auditors of a bank give a separate report on compliance with the SLR requirements.

The ten appendices to the Guidance Note contain useful reference material for the auditors. These include the formats of financial statements of banks, revised formats of audit reports in case of nationalised banks and banking companies, formats of long form audit reports and the various guidelines issued by the Reserve Bank of India regarding securities transactions of banks, valuation of investments, income recognition, asset classification, provisioning and other related matters.

An important aspect to which I would like to invite the attention of the members in the new nomenclature of this publication. As would be observed, this publication is in the form of a Guidance Note while the earlier publication on Audit of Banks was in the form of a 'Study'. The decision to bring out this edition in the form of a Guidance Note has been taken by the Council in the context of the increasing importance of the banking sector in the economy.

I must acknowledge the very hard work put in by the members of the Auditing Practices Committee, members of the Study Group formed in Calcutta for preparing the background material for Seminars on Bank Audit and also Mr. T. Neogi, F.C.A., Mr S.V. Zaregaonkar, F.C.A., and Mr K.Kannan, F.C.A. who gave their unstinted time and guidance. The Technical Directorate made an extraordinary effort to bring out this publication. Special mention must be made of Mr. Ashok Arora, Deputy Director. Only shortage of space prevents me from special mention of many others who have given their invaluable help.

The changes in the banking sector are taking place at a rapid pace. In this edition of the Guidance Note, an attempt has been made to capture the relevant developments till September 15, 1994. It is, however, appreciated that as the future unfolds itself, many of the aspects dealt with in the Guidance Note may need revision. It will be the endeavour of the Auditing Practices Committee to update this publication on a regular basis. In this task, I invite suggestions from members as to how the utility of this publication can be enhanced.

I hope the members will find the guidance provided in this publication useful while conducting statutory audit of banks and their branches.

Calcutta
November 21, 1994

Dipankar Chatterji
Chairman
Auditing Practices Committee

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Introduction

A well-organised and efficient banking system is a pre-requisite for economic growth. Banks play an important role in the functioning of organised money markets. They act as a conduit for mobilising funds and channelising them for productive purposes. The Indian banking system, like the banking system in other countries, has played a significant role in the economic growth of the country. In order to meet the banking needs of various sections of the society, a large network of bank branches has been established. The volume of operations and the geographical spread of banks in India are steadily on the rise.

Accounts and Audit of Banks

All types of banks – nationalised banks, other public sector commercial banks, private sector commercial banks, regional rural banks, co-operative banks as well as term-lending institutions – are required by their respective governing statutes to prepare annual accounts. The form and content of annual accounts of commercial banks and regional rural banks are identical. The form and content of annual accounts of co-operative banks are somewhat different from those applicable to commercial/regional rural banks. The form and content of annual accounts of different term-lending institutions also vary.

The annual accounts of all types of banks are required to be audited. The requirements relating to audit – qualifications and disqualifications of auditors, manner of their appointment, content of audit report, etc. – are prescribed in the respective statutes governing different types of banks and are not totally identical.

Scope of the Guidance Note

This Guidance Note is intended to assist the auditors in carrying out audit of annual accounts of banks. Standard on Auditing (SA) 200 (Revised), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing" establishes the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with SAs. Further, it sets out the overall objectives of the independent auditor, and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority and structure of the SAs, and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the SAs. Also, it states that the purpose of an audit is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form that opinion.

The scope of an audit of financial statements is determined, among other matters, by the applicable statutory and regulatory requirements and pronouncements of the Institute. Thus, an auditor's work is influenced to a considerable extent by the requirements relating to accounts and audit of the statute under which he is appointed as well as by the relevant requirements of the regulatory authorities (mainly, the Reserve Bank of India). As these requirements vary for different types of banks, it is not possible to lay down a single set of guidelines that could be applied in all cases.

In view of the above limitation, this Guidance Note deals with the subject of audit of banks primarily in the context of statutory provisions and regulatory requirements applicable to commercial banks in both the public and the private sectors. However, it is recognised that like transactions entered into by different banks would generally warrant application of similar audit procedures except in so far as those procedures address any specific requirements of audit examination or reporting under a statutory or regulatory provision.

The terms of engagement of auditors appointed to carry out audit of annual accounts of banks presently require them to also furnish some special purpose reports or certificates besides their audit report on the annual accounts.

The Guidance Note is divided into five parts as follows:

- *Part I – Knowledge of the Banking Industry* deals with the basic knowledge relating to the banking industry, statutory and regulatory aspects, accounting and auditing aspects relevant for the banking industry.

- *Part II – Risk Assessment and Internal Control* deals with audit procedures to be followed by an auditor under the two risk based Standards, i.e., Standard on Auditing (SA) 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" and SA 330, "The Auditor's Responses to Assessed Risks" which have come into force w.e.f. 01.04.08.

- *Part III- Items of Bank's Financial Statements and Auditing Aspects* provides guidance on the auditing issues relating to bank's balance sheet and profit and loss items.

- *Part IV – Long Form Audit Report (LFAR)* deals with regulatory requirements with respect to LFAR, both at branch as well as head office level and the auditor's procedures therefor.

- *Part V – Special Aspects* deals with special-purpose reports and certificates to be issued by auditors of head office or branches of banks.

Besides annual accounts, listed banks are required to present quarterly / half yearly financial results. RBI in consultation with SEBI has made quarterly review mandatory for all listed banks, whereas for un-listed banks the said review is on a half yearly basis. Such audit or review may be carried out either by the auditors appointed to carry out the audit of annual accounts or by any other chartered accountant or firm of chartered accountants, depending on the regulatory requirements in this regard.

This Guidance Note does not address special considerations applicable in audit or review of interim financial statements/information. Guidance Note issued on specific issues be referred to, as in this note such issues are not repeated.

It may be pointed out that, apart from the statutory audit, certain other types of audit are also usually carried out in banks, such as internal audit, concurrent audit, inspection, income and expenditure audit (also called revenue audit), etc. These audits may be conducted either by the bank's own staff or by firms of chartered accountants appointed for the purpose. The

Reserve Bank of India also conducts inspection of important branches and reviews activities of head offices of banks (called 'annual financial review'). This Guidance Note, however, does not deal with such types of audit/inspection. The Guidance Note also does not deal with tax audit of banks under section 44AB of the Income-tax Act, 1961.[1]

Circulars issued by Reserve Bank of India are hosted in its website www.rbi.org.in. This site may be visited for availing the advantage of updating on various issues on Banking.

[1] For guidance in this regard, reference may be made to Guidance Note on Tax Audit under Section 44AB of the Income-tax Act, 1961, issued by the Institute of Chartered Accountants of India.

PART – I

I-1
Banking in India

An Overview of Banking Institutions in India

1.01 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 impact of reforms initiated in the decade of nineties is showing up as greater efficiency, productivity and diversity in the Indian banking system. The banking institutions in the country are performing in a competitive environment and their regulatory framework is now 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.

1.02 The Reserve Bank of India (hereinafter referred to as RBI) acts as the monetary authority and the central bank of the country.

1.03 Presently, there are following four types of banking institutions in India:

(a) Commercial banks;

(b) Regional rural banks;

(c) Co-operative banks; and

(d) Development banks (more commonly known as 'term-lending institutions').

1.04 The following paragraphs describe the salient features of different types of banking institutions enumerated above.

Commercial Banks

1.05 Commercial banks are by far the most widespread banking institutions in India. Typically, commercial banks provide the following major products and services.

(a) *Acceptance of Deposits*: Acceptance of deposits from the public is one of the most important functions of a commercial bank. Commercial banks accept deposits in various forms: term deposits, savings bank deposits, current account deposits, etc.

(b) *Granting of Advances*: This again is an important function of commercial banks. Advances granted by commercial banks take various forms such as cash credit, overdrafts, purchase or discounting of bills, term loans, etc. Apart from granting traditional facilities, banks are also providing facilities like issuance of commercial papers, ECB on behalf of bank/borrower, securitisation of credit sales, cash overdraft, etc.

(c) *Remittances*: Remittances involve transfer of funds from one place to another. Two of the most common modes of remittance of funds are drafts and telegraphic/mail transfers (TT/MT). Drafts are issued by one branch of the bank and are payable by another branch of the bank (or, in case there being no branch of the bank at the place of destination, branch of another bank with which the issuing bank has entered into necessary arrangement). The drafts are handed over to the applicant. In the case of telegraphic/mail transfer, no instrument is handed over to the applicant; the transmission of the instrument is the responsibility of the branch. Generally, the payee of both the TT and the MT is an account holder of the paying branch. Electronic funds transfer (EFT) is another mode of remittance which facilitates almost instantaneous transfer of funds between two centres electronically.

(d) *Collections*: The customers can lodge various instruments such as cheques, drafts, pay orders, travellers cheques, dividend and interest warrants, tax refund orders, etc., drawn in their favour and the trade bills drawn by them on their buyers with their bank for collection of the amount from the drawee (the bank or the drawee of the bill). They can also lodge their term deposit receipts and other similar instruments with the bank for collection of the proceeds from the bank with which the term deposit, etc., is maintained. Banks also collect instruments issued by post offices, like national savings certificates, postal orders, etc.

The instruments mentioned above may be payable locally or at outside centres. The instruments payable locally are collected through the clearing house mechanism, while the instruments payable outside are sent by the bank, with which instrument has been lodged, for collection to the branches of the issuing bank at those centres or, if there is no such branch, to other banks.

Clearing house settles the inter-bank transactions among the local participating member banks. Generally, post offices are also members of the house. There may be separate clearing houses for MICR (Magnetic Ink Character Recognition) and non-MICR instruments. The clearing house is managed by the RBI, State Bank of India or any other bank nominated by RBI. In case a bank has many branches within the area of a clearing house, it nominates one branch to act as the 'nodal' branch of that bank for all the branches within that area. This nodal branch collects instruments to be presented by other branches also. The accounts of all member banks are maintained by the clearing house. All member banks have to pay an agreed sum to the bank managing the clearing house for meeting the cost of infrastructure and services it provides to them.

In addition to the regular clearing houses as discussed above, Electronic Clearing Service (ECS) is also in vogue. ECS takes two forms: ECS credit or ECS debit.

- In the case of ECS credit, there is a single receiver of funds from a large number of customers, e.g., public utilities, mutual funds, etc. The beneficiary (i.e., the receiver of funds) obtains mandate from its customers to withdraw funds from their specified bank accounts on a particular date. These customers may have accounts with different banks in the same clearing house area. Before the specified date, the beneficiary compiles bank-branch-wise particulars of the accounts to be debited and furnishes the details in the electronic media like a floppy disk to its own bank which, in turn, arranges to provide them to the banks concerned, through the clearing house, for verification of particulars of accounts. Any discrepancies are rectified and, on the specified date, the accounts are debited by the respective banks and the beneficiary gets the credit.
- In the case of ECS debit, there is a single account to be debited against which a number of accounts with a number of banks in the same clearing house area are credited. This system is useful for distribution of dividend/interest, payment of salaries by large units, etc.

Roll-out of Speed Clearing is one of the many initiatives taken by RBI for improving efficiency in the time frame for and process of collection of outstation cheques – the time frame has reduced from 7-45 days to 2-3 days, Speed Clearing leverages on the Core Banking Solutions (CBS) implemented in banks across the country and facilitates realization of outstation cheques drawn on CBS-enabled branches at the local centre itself, thus obviating the need of such cheques to physically move to the outstation centre. Keeping in view the benefits to customers as also the infrastructural and processing preparedness of banks, RBI, vide its circular no. DPSS.CO.CHD. No. 1514 / 03.01.03 / 2010-2011 dated January 4, 2011 on "Enhancing the scope of Speed Clearing" decided to extend the scope of Speed Clearing to cover all transaction codes, other than those relating to government cheques. Banks, however, need to exercise usual care and caution while handling such instruments. These revised instructions are effective from February 1, 2011.

e) *Receipt of Foreign Contribution on behalf of the registered persons/ organization*:- Scheduled Banks also handle the foreign contribution receipt on behalf of the registered persons/ organization as per the Foreign

Contribution (Regulation) Act, 2010. Banks need to ensure that the concerned persons/organization are registered with the Central Government or has obtained the prior permission to receive such foreign contribution if required by law, and that no branch other than the specified branch accepts 'foreign contribution'.

As per Foreign Contribution (Regulation) Rules, 2011, every bank has to send a report to the Central Government within thirty days of any transaction, in respect of receipt of foreign contribution by any person who is required to obtain a certificate of registration or prior permission under the Act, but who was not granted such certificate or prior permission as on the date of receipt of such remittance. Such report has to contain the following details: (a) Name and address of the donor,(b) Name and address of the recipient,(c) Account number,(d) Name of the Bank and Branch,(e) Amount of foreign contribution (in foreign currency as well as Indian Rupees),(f) Date of receipt,(g) Manner of receipt of foreign contribution (cash/cheque/electronic transfer etc.)

Banks also have to send the abovementioned report to the Central Government within 30 days from the date of such last transaction in respect of receipt of any foreign contribution in excess of 1 crore or equivalent thereto in a single transaction or in transaction within 30 days by such persons. The RBI has issued detailed guidelines in its Master Circular No. DBOD.AML.BC.No. 12 /14.08.001/ 2012-13 dated July 2, 2012 on "Guidelines issued under Section 36(1)(a) of the Banking Regulation Act, 1949 - Implementation of the provisions of Foreign Contribution (Regulation) Act, 2010"[@]

(f) *Cash Management Product*: A derivative of the collection business, this facility is provided for expeditious transfer of funds collected by a customer at the specified centres in the country to his central account with the use of computers/satellites. It is particularly useful for large units which have their sales/collection network in a very wide geographical area. Only selected branches of a bank may handle the business due to the infrastructural requirements.

(g) *Issuance of Letters of Credit and Guarantees*: These are two important services rendered by banks to customers engaged in business, industrial and commercial activities. A letter of credit (LC) is an undertaking by a bank to the payee (the supplier of goods and/or services) to pay to him, on behalf of the applicant (the buyer) any amount up to the limit specified in the LC, provided the terms and conditions mentioned in the LC are complied with. The guarantees are required by the customers of banks for submission to the

[@] Revised in 2013 Edition.

buyers of their goods/services to guarantee the performance of contractual obligations undertaken by them or satisfactory performance of goods supplied by them, or for submission to certain departments like excise and customs, electricity boards, or to suppliers of goods, etc., *in lieu of* the stipulated security deposits.

(h) *Merchant Banking Business*: Many bank branches act as collection agents to issue business for merchant bankers. The customer and the bank have to agree to the modalities of the scheme, like names of branches authorised as collecting branches, the procedure for retaining the subscription and its remittance periodically, the documents required by the customer from the collecting branches, etc.

(i) *Credit Cards*: The processing of applications for issuance of credit cards is usually entrusted to a separate division at the central office of a bank. The dues against credit cards are collected by specified branches. Many of them also act as 'cash points' to provide cash to the cardholder on demand up to the specified limits. Most credit cards issued by banks are linked to one of the international credit card networks like VISA, Master or Amex.

(j) *Technology-based Services*: Many banks have started providing internet banking services and phone banking services. Some banks, acting as stock brokers, also provide facility to their customers to buy or sell securities on stock exchanges through the internet. The fast changing technology has synchronised the banking facility in such a way that the customer need not come physically to the bank for any transactions. The banks are now providing the facility of payment of utility bills, railway reservation, tax deposition through ATM/internet and also provide recharge facility to mobile phone users.

(k) *Dividend/Interest/Refund Warrants*: Many entities require facilities for distribution of funds to their shareholders and others. For this purpose, they issue warrants in favour of shareholders/others payable at designated branches of specified banks, with a prior arrangement with the banks concerned. The aggregate amount of the warrants or other instruments issued is deposited by the entity with a nodal branch. The designated branches pay the warrants when presented to them.

(l) *Safe-keeping Services*: Banks provide services for safe keeping of the scrips and valuables of customers in their vaults. A receipt is issued to the customer by the branch at the time of deposit of the items and an acknowledgement is obtained from him at the time of delivery. Each transaction – a receipt or delivery – is duly recorded in appropriate register(s) and periodically, the items physically available are cross-checked with the balances as per registers.

(m) *Lockers*: This facility is provided to customers for safe-keeping of their valuables, etc., in lockers. The branch has no knowledge of the contents of the locker. Only the account holder (the hirer) or his *bonafide* representative, duly authorised by the account holder, can operate on the locker. Each access to the locker is properly recorded in the appropriate registers.

(n) *Handling Government Business*: Banks act as agents for receipts and payments on behalf of various government departments. There are authorised branches to handle the specified type of work. Normally, a specified branch acts as a nodal branch for a particular segment of the government business within a given geographical area. The responsibility of the nodal branch includes obtaining details of transactions from the linked branches and to reconcile their accounts *inter se* and with the department concerned. Banks are remunerated for handling this business by way of service charges which are usually as agreed or a stated percentage of the collections or payments, as the case may be.

(o) *Depository Participant (DP) Services*: The depository system is meant to facilitate quick transfer of stock market securities in a dematerialised form from the seller to the buyer by using satellite connectivity. The depository scheme is operated presently by two depositories – Central Depository Services Limited (CDSL) and National Securities Depository Limited (NSDL). Depository participants, i.e., bank branches providing depository services are in effect agents of the depository concerned. Each participating branch has to get itself registered with a depository. The customer has to open an account with the branch which provides the DP services. This account is debited by the branch with the securities sold by the account holder and credited with the purchases.

(p) *Automated Teller Machines (ATMs)*: Operations on ATMs are through a card which contains information about the cardholder in a magnetic form. The cardholder has to also use the password (also known as Personal Identification Number, i.e., PIN) to carry out any transaction through ATM. Earlier, ATMs were used merely as cash dispensing machines but now-a-days, other services like issue of drafts, deposit of cash and instruments, balance enquiry, etc., are also being provided by many banks. ATMs may be on-site (i.e., housed in the branch premises) or off-site. The transactions routed by the customers through the ATMs may be entered into the books of account of the branch either on-line (i.e., simultaneously with the transactions) or off-line. However, on an off-line mode, the proper recording of transactions needs to be ensured.

(q) *Exchange of Notes*: Banks exchange mutilated notes from the public for good quality notes. These mutilated notes are periodically sent to the RBI which gives equivalent credit to the branch concerned.

(r) *Debit Cards*: Debit cards are issued by the bank where customer is having his account. The debit cards are generally issued from central office of the bank. The debit card facilitates the customer to pay at any authorised outlet as well as to withdraw money from ATM from his account. The debit cards are sometimes networked with inter-bank network.

(s) *Auto Sweep facility in saving account*: The banks are offering auto sweep facility in saving accounts of their customers where balance exceeding a certain limit automatically get transferred to term deposit account having higher rate of interest and in case of need, the funds in term deposit automatically gets transferred to saving account.

(t) *Third Party Advertisement on ATM Network*: The banks are providing advertisement facility to the vendors on ATM Network. The advertisement on ATM Network provides the opportunity of earning revenue to the bank.

(u) *Securitisation of future lease rentals*: The banks are advancing loans to lessor on securitisation of future lease rentals receivable based on the mortgage of leased assets at net present value (NPV). The banks are advancing the loans to lessor (owners) of the assets under a tri-partite agreement and collect the future rentals to appropriate the advance made.

(v) *Derivatives*: Financial derivatives are gaining importance in India. Banks are offering derivative options against exchange fluctuation losses.

(w) *Prepaid Payment Instruments in India*[1] –Pre-paid payment instruments are payment instruments that facilitate purchase of goods and services against the value stored on such instruments. The value stored on such instruments represents the value paid for by the holders by cash, by debit to a bank account, or by credit card. The pre-paid instruments can be issued as smart cards, magnetic stripe cards, internet accounts, internet wallets, mobile accounts, mobile wallets, paper vouchers and any such instrument which can be used to access the pre-paid amount (collectively called Payment Instruments hereafter). The pre-paid payment instruments that can be issued in the country are classified under three categories *viz*. (i) Closed system payment instruments (ii) Semi-closed system payment instruments and (iii) Open system payment instruments. Issuer may be the persons operating the payment systems issuing pre-paid payment instruments to individuals/organizations. The money collected is retained by these persons and they make payment to the merchants who are part of the acceptance arrangement directly, or through a settlement arrangement. Further it requires

[1] RBI *vide* its circular no. DPSS.CO.PD.No. 1873 /02.14.06/ 2008-09 dated April 27, 2009 on "Policy Guidelines for issuance and operation of Prepaid Payment Instruments in India" provides the broad guidelines on this subject.

that other non-bank persons issuing payment instruments are required to maintain their outstanding balance in an escrow account with any scheduled commercial bank subject to the following conditions:

- The amount so maintained shall be used only for making payments to the participating merchant establishments.
- No interest is payable by the bank on such balances.
- A quarterly certificate from the auditors shall be submitted certifying that the entity has been maintaining adequate balance in the account to cover the outstanding volume of payment instruments issued.
- The entity shall also submit an annual certificate, as above, coinciding with the accounting year of the entity to the Reserve Bank of India.
- Adequate records indicating the daily position of the value of instruments outstanding vis-à-vis balances maintained with the banks in the escrow accounts shall be made available for scrutiny to the Reserve Bank or the bank where the account is maintained on demand.

Further, RBI vide its circular no. DPSS.CO.OSD. No. 1445 /06.12.001/ 2010-2011 dated December 27, 2010 on "Issuance and operation of Prepaid Payment Instruments in India – Auditor Certificate on the balances in Escrow account" advised to furnish a quarterly certificate on the balances held in the Escrow account in accordance with the above Guidelines, from an auditor within a fortnight from the end of the quarter to which it pertains.

Para-banking Activities

1.06 Banks also undertake certain eligible financial services or para banking activities either departmentally or by setting up subsidiaries. However, banks can set up subsidiary for undertaking such activities only with prior approval of RBI. Some of those activities are listed below:

(i) *Equipment Leasing, Hire Purchase and Factoring Services*: Banks also undertake equipment leasing, hire purchase and factoring services as departmental activities.

(ii) *Mutual fund business*: Banks are not permitted to directly undertake mutual fund business but sponsor mutual funds, subject to the RBI guidelines in this regard. Banks normally refer clients to these mutual funds and earn a commission* in return.

* Keeping in view the need for transparency in the interest of the customers to whom the products are being marketed / referred, the banks are advised to disclose to the customers, details of all the commissions / other fees (in any form) received, if any, from the various mutual fund / insurance / other financial services companies for marketing / referring their products. This disclosure would be required even in cases where the bank is marketing/ distributing/ referring products of only one mutual fund/ insurance companies etc.

Banks may enter into agreements with mutual funds for marketing the mutual fund units subject to the terms and conditions specified in the RBI Master Circular on "Para Banking Activities".

(iii) *Money Market Mutual Funds (MMMFs)*: Banks can also sponsor MMMFs business subject to the prior approval of the RBI. The MMMFs are, however, subject to regulation by the Securities and Exchange Board of India (SEBI). Banks also, at time, provide cheque-writing facilities for MMMFs subject to the RBI guidelines in this regard.

(iv) *Insurance Agents*: Though banks are prohibited from undertaking insurance business, yet in terms of the RBI guidelines in this regard, banks can act as agents of insurance companies on fee* basis, without any risk participation.

(v) *Primary Dealership Business* – Banks can undertake primary dealership business subject to the approval of the RBI and after satisfying certain eligibility criteria prescribed by the RBI:

(A) Banks, which do not at present, have a partly or wholly owned subsidiary and fulfill the following criteria:

a. Minimum Net Owned Funds of Rs. 1,000 crore.

b. Minimum CRAR of 9 percent.

c. Net NPAs of less than 3% and a profit making record for the last three years.

(B) Indian banks which are undertaking PD business through a partly or wholly owned subsidiary and wish to undertake PD business departmentally by merging/taking over PD business from their partly/wholly owned subsidiary subject to fulfilling the criteria mentioned in A (a) to (c) above.

(C) Foreign banks operating in India who wish to undertake PD business departmentally by merging the PD business being undertaken by group companies subject to fulfilment of criteria at A (a) to (c).

(vi) *Pension Funds Management*: Banks have been permitted to undertake Pension Funds Management (PFM) through their subsidiaries set up for the purpose subject to their satisfying the eligibility criteria prescribed by Pension Fund Regulatory Development Authority (PFRDA) for Pension Fund Managers. PFM can not be undertaken departmentally. Banks intending to undertake pension funds management as per the guidelines set out in the RBI Master Circular on "Para Banking Activities".

(vii) *Underwriting of Corporate Shares and Debentures:* Banks can undertake underwriting of corporate shares and debentures within the ceiling prescribed for the bank's exposure to capital markets and subject to the

provisions contained in the Section 19(2) and 19(3) of the Banking Regulation Act, 1949. The guidelines contained in the SEBI (Underwriters) Rules and Regulations, 1993 and those issued from time to time are also to be complied with. Moreover, banks should not underwrite issue of Commercial Paper by any Company or Primary Dealer and not extend Revolving Underwriting Facility to short term Floating Rate Notes/Bonds or debentures issued by corporate entities. However, with effect from April 16, 2008, banks may exclude their own underwriting commitments, as also the underwriting commitments of their subsidiaries, through the book running process for the purpose of arriving at the capital market exposure both on a solo and consolidated basis.

(viii) *Sponsors to Infrastructure Debt Funds (IDFs) -* In order to accelerate and enhance the flow of long term funds to infrastructure projects for undertaking the Government's ambitious programme of infrastructure development, scheduled commercial banks have been allowed to act as sponsors to Infrastructure Debt Funds (IDFs). IDFs can be set up either as Mutual Funds (MFs) or as Non-Banking Finance Companies (NBFCs). While IDF-MFs will be regulated by SEBI (SEBI has amended the Mutual Funds Regulations to provide regulatory framework for IDF-MFs by inserting Chapter VI-B to the MF Regulations), IDF-NBFCs will be regulated by Reserve Bank of India (RBI). Banks can sponsor IDF-MFs and IDF-NBFCs with prior approval from RBI subject to the conditions given in the 2012 RBI Master Circular on Para Banking Activities.[@]

(ix) *Membership of currency futures exchanges -* Scheduled commercial banks (AD Category I) have been permitted to become trading / clearing members of the currency derivatives segment to be set up by the Stock Exchanges recognized by SEBI, subject to their fulfilling the following prudential requirements:-

a) Minimum networth of Rs. 500 crores,

b) Minimum CRAR of 10%

c) Net NPA not exceeding 3%

d) Net Profit for last 3 years

Banks which fulfill the conditions mentioned above should lay down detailed guidelines with Board's approval for conduct of this activity and management of risks. It should be ensured that the bank's position is kept distinct from the clients' position. In case of supervisory discomfort with the functioning of a bank, the Reserve Bank may impose restrictions on the bank regarding the conduct of this business as it deems fit.

[@] Revised in 2013 Edition.

The banks which do not meet the above minimum prudential requirements are permitted to participate in the currency futures market only as clients.[@]

1.07 The RBI has issued a Master Circular No. DBOD.NO.FSD.BC 24/24.01.001/2012-13 dated July 2, 2012 on "Para Banking Activities" containing instructions/guidelines issued by it to banks in respect of their para banking activities (The circular is given in the CD along with the Guidance Note).

1.08 Commercial banks operating in India can be divided into two categories based on their ownership – public sector banks and private sector banks. However, irrespective of the pattern of ownership, all commercial banks in India function under the overall supervision and control of the RBI.

1.09 Public sector banks comprise the State Bank of India, its seven subsidiaries (also called 'associate banks' of State Bank of India; these are State Bank of Bikaner and Jaipur, State Bank of Hyderabad, State Bank of Indore, State Bank of Mysore, State Bank of Patiala, State Bank of Saurashtra, and State Bank of Travancore) and nationalised banks.

1.10 While the majority stake in State Bank of India is of the Government of India, there are private individual/institutional shareholders also. The share capital of associate banks of State Bank has been subscribed to by the parent bank and private shareholders.

1.11 The ownership of private sector banks is in private hands. They are of three types:

(a) Indian scheduled commercial banks other than public sector banks. (The term 'scheduled commercial banks' refers to commercial banks which are included in the Second Schedule to the Reserve Bank of India Act, 1934.) It may be noted that not all scheduled banks are commercial banks; some co-operative banks are also scheduled banks. Commonly known as 'banking companies', these banks are 'companies' registered under the Companies Act, 1956 or an earlier Indian Companies Act.

(b) Non-scheduled banks.

(c) Indian branches of banks incorporated outside India, commonly referred to as 'foreign banks'.

1.12 Some of the banks have set up subsidiaries – wholly-owned or partly-owned – to operate in some specialised spheres of activity such as merchant banking, funds management, housing finance, dealing in government securities, etc. These subsidiaries do not carry on all the principal functions of a commercial bank.

[@] Revised in 2013 Edition.

Regional Rural Banks

1.13 These banks have been established "with a view to developing the rural economy by providing, for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas, credit and other facilities, particularly to the small and marginal farmers, agricultural labourers and artisans and small entrepreneurs" (Preamble to the Regional Rural Banks Act, 1976). While regional rural banks can carry on any business in which a bank is legally permitted to engage. Section 18 of the Regional Rural Banks Act, 1976, specifically lists the following businesses which such a bank may undertake:

(a) the granting of loans and advances, particularly to small and marginal farmers and agricultural labourers, whether individually or in groups, and to co-operative societies, including agricultural marketing societies, agricultural processing societies, co-operative farming societies, primary agricultural credit societies or farmers' service societies, for agricultural purposes or agricultural operations or for other purposes connected therewith;

(b) the granting of loans and advances, particularly to artisans, small entrepreneurs and persons of small means engaged in trade, commerce or industry or other productive activities, within the notified area in relation to the RRB.

1.14 In order to strengthen and consolidate RRBs, the government in 2005 initiated the process of amalgamation of RRBs in a phased manner. Consequently, the total number of RRBs has reduced from 196 to 82 as on March 31, 2010," Further, the Government of India has issued a notification dated May 17, 2007 specifying 'Regional Rural Bank' as 'bank' for the purpose of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002.

1.15 In recent years, in an attempt to strengthen the regional rural banks, several measures have been taken by the Central Government and the RBI. These banks are no longer required to confine their lending to the weaker sections and are permitted to lend to non-target groups also up to specified limits. They can also undertake various types of business such as issuance of guarantees, demand drafts, travellers' cheques, etc. Moreover, RRBs are no longer required to confine their operations only within local limits notified by the Central Government; they are now permitted, subject to fulfilling service area obligations, to lend monies outside their service area. In the wake of these developments, the distinction between commercial banks and RRBs has become somewhat blurred.

1.16 Each RRB has a public sector bank as its 'sponsor bank'. Capital in each such bank is contributed by the Central Government, the sponsor bank and the State Government Concerned in proportion of 50, 35 and 15 per cent, respectively.

1.17 Apart from subscribing to the share capital of a RRB sponsored by it, the sponsor bank is also required to train personnel of the RRB as also to provide managerial and financial assistance to such bank during the first five years of the latter's functioning (this period can, however, be extended by the Central Government).

1.18 Like commercial banks, regional rural banks also function under the overall supervision and control of the RBI. Some of the regulatory functions of the RBI in relation to RRBs have been delegated to the National Bank for Agriculture and Rural Development (NABARD).

Co-operative Banks

1.19 These are banks in the co-operative sector which cater primarily to the credit needs of the farming and allied sectors. Co-operative banks include central co-operative banks, state co-operative banks, primary co-operative banks and land development banks. Of these, primary co-operative banks operate in metropolitan cities, urban and semi-urban centres to cater principally to the credit needs of small industrial units, retail traders, etc. Due to their existence primarily in urban areas, primary co-operative banks are more commonly known as 'Urban Co-operative Banks' (UCB). The UCB sector, has witnessed significant improvement in recent years. Constitution of Task Forces for Urban Co-operative Banks (TAFCUBs) has instilled public confidence in the UCB sector which is evident from the increase in deposits for three successive years, i.e., from 2005-06 to 2007-08. Land development banks provide long-term finance for agriculture and have a two-tier structure – State Land Development Banks and the Primary Land Development Banks, the latter being at District or Block level. In a few states, however, the structure is unitary where the State Land Development Bank directly carries out activities through its own branches at district level.

1.20 Each co-operative bank operates within a specific geographic jurisdiction as determined by its bye-laws. Unlike commercial banks which raise funds primarily in the form of deposits from public, co-operative banks rely to a considerable extent on the RBI for providing funds at concessional rates. Co-operative banks can lend monies only to their members or to registered societies. RBI is the regulatory authority for co-operative banks also, though some of its regulatory functions in relation to co-operative banks are now vested in NABARD.

Development Banks

1.21 As these banks were started with the objective of providing only long-term finance for development purposes, they are referred to as 'development banks' or 'term-lending institutions'. These institutions provide facilities for the units set up in any part of the country. Of late, some of these institutions have sponsored commercial banks also. Besides these all-India level institutions, virtually every state has a State Financial Corporation and a State Industrial Development Corporation (though they may be known by different names) to cater to the needs of the units set up in that particular state. Normally, state-level institutions have a monetary ceiling on the quantum of finance they can grant to a single unit.

Foreign Banks

1.22 Foreign banks operate in India through a network of branches and do not have a separate legal entity existence in India. However, for all practical purposes, the RBI regulates the functioning of these banks in India, with regards to scale and nature of business they undertake in India. Foreign banks normally have a CEO or a Country Head as the highest decision making authority based out of the country. This position generally reports to the regional management board or the global board as the case may be. In comparison to a locally incorporated bank, the management structure of foreign banks is not very 'top' concentrated, i.e., it will be minus the various boards and committees.

1.23 Foreign banks operate with limited branch network in the country and operate in a structure wherein most of their operations are centralised. Bank branches operate as customer relationship windows and do not record substantial financial statements impacting transactions. Almost all foreign banks are technologically advanced and use a high level of IT integration into their operations. These systems, in most instances, are similar to those being used by their branches globally. Due to cost-benefit and other considerations, in some instances, foreign banks, get certain financial or other information processed at one of their global centres. This processing of data out of the country is generally with specific consent from the RBI. Due to their existence in global financial centres and their expertise, banks undertake complex treasury transactions (to the extent allowed by RBI regulations). In most cases these transactions are undertaken back to back with their foreign branches and would be hedged from a local risk perspective. Additionally, banks also undertake and participate in international advisory and syndication transactions, in partnership with their international branches, which in effect generates fee revenue for the bank.

Branch Network of Commercial Banks

1.24 Apart from term-lending institutions, commercial banks are arguably the most important constituent of the banking system in India. To carry out their functions effectively, these banks have established a large network of branches in India. Based on their location, these 'domestic' branches are commonly classified into rural branches, semi-urban branches, urban branches and metro branches. Apart from these domestic branches, some banks have also established offices abroad. The foreign offices of banks are generally of the following types:

- *Full-fledged branches* – Such branches transact all kinds of banking business.
- *Off-shore banking units* – Such branches transact foreign exchange business of any kind except domestic banking business with the residents/ corporations, etc., domiciled in the country concerned.
- *Subsidiaries* – The laws in some countries do not permit foreign banks to open their branches in those countries. Therefore, Indian banks have to set up wholly or partly-owned subsidiaries in such countries.
- *Representative offices* – Such branches do not transact any banking business. The objective behind setting up such offices is to maintain close liaison with the important bodies there to promote mutual business interests.

1.25 Generally, branches of banks conduct a variety of banking business under one roof. Recently, however, the trend of creating 'thrust-based' or 'focus-based' branches has caught up. This has led to setting up of branches by banks exclusively for a specified segment of their clients. Presently, such specialised branches are generally of the following types (nomenclature may, however, vary from bank to bank):

- Personal Banking branches, catering to the needs of individual customers only.
- Commercial or Industrial Finance branches, catering to the needs of industries in the small, medium and/or large sectors.
- Recovery branches, which deal only with the recovery aspects of non-performing advances which were originally granted at other branches of the bank.
- Housing Finance branches which deal only with housing loan proposals – from individuals, and in some cases, also from the developers of housing units.
- Agricultural Finance branches, catering to the needs of the agriculture sector only.
- Service branches, handling only the local clearing instruments received from outstation branches or from other local branches of

the bank for collection.

- Commodity specific branches, which handle the accounts, predominantly borrowal accounts, of the units belonging to a particular industry, e.g., leather, diamonds.
- Overseas or International Banking or Foreign Exchange branches catering to the banking needs of those enterprises which are engaged in imports into/exports from India.
- Corporate or Industrial Finance/SME/SSI branches, catering exclusively to the requirements of the large, medium and small scale industrial units respectively.
- NRI (Non-Resident Indian) branches, catering exclusively to the banking needs of NRIs.
- Securities branches, dealing only with the securities portfolio of the bank.

1.26 The trend towards specialisation may, in future, cause the opening of dedicated branches of various other segments of clients such as, government business, remittance business, trade sector business, locker business, rehabilitation, educational loans, etc.

Organisational Structure of Banks

1.27 While the exact organisational structure may differ from one bank to another, most large-sized public sector banks have a four-tier structure – head office, zonal offices, regional offices and branches (the nomenclature may, however, vary among banks) – each tier of the structure being responsible for performing the functions specified by the Head Office.

1.28 At the apex level is the head office of the bank whose main functions are:

- Laying down policies and procedures for smooth and efficient functioning of the bank and to review them periodically.
- Deciding on the extent of powers – financial and administrative – which may be vested in various functionaries of the bank.
- Planning and performance budgeting.
- Asset-liability management.
- Laying down lending policy of the bank, the risk management guidelines, and the rehabilitation and recovery guidelines including policies for compromise, settlement and write-off.
- Deciding about the interest rates on both the deposits and the loans as well as about charges for various services and review interest rates and charges periodically.

- Treasury and investment management (usually handled by the head office, though in some cases, select large branches may also be involved in this function).
- Monitoring and controlling the functioning of various offices of the bank. Periodic inspections and internal audit are important constituents of such monitoring and control mechanism.
- Reconciling the transactions among various offices of the bank.
- Introducing new products and services and reviewing the existing ones.
- Issuing instructions to branches and other offices from time to time on matters deserving their attention or requiring compliance by them.

1.29 At the second level are the zonal offices which are responsible for overall working of the branches in their areas of operation. Zonal offices act as a link between the branches and the head office, either directly or through regional offices.

1.30 Below the zonal offices are the regional offices which are the immediate controllers of the branches under their jurisdiction. They are responsible for business development, compliance with the laid down systems and procedures, satisfactory customer service, quick redressal of complaints and submissions of the required statements/reports/returns by branches under their jurisdiction. They are also responsible for smooth functioning of the branches under them.

1.31 Branches are lowest in the hierarchy of the banking organisation structure. In fact, the banking operations (i.e., accepting deposits and making loans) actually take place at the branch level. Their jobs are numerous, practically everything in relation to banking, except the pricing of products/services and the policy formulation.

1.32 Some branches have extension counters and sub-offices functioning under them. The extension counters/sub-offices are meant for specific locations like airports, large institutions, large project sites, etc., and cater exclusively to the banking needs (either all or limited) of the concerned locale.

Role of the Reserve Bank of India as the Central Bank

1.33 The RBI is the central bank of our country. As such, RBI is responsible for development and supervision of the constituents of the Indian financial system (which comprises banks and non-banking financial institutions) as well as for determining, in conjunction with the Central Government, the monetary and credit policies keeping in with the need of the hour. Among its important functions are issuance of currency; regulation of currency issue; acting as banker to the central and state governments; and acting as banker to commercial and other types of banks including term-lending institutions. Besides, RBI has also been entrusted with the responsibility of regulating the activities of commercial and other banks. No bank can commence the business of banking or open new branches without obtaining licence from RBI. The RBI also has the power to inspect any bank.

1.34 RBI is empowered under section 21 of the Banking Regulation Act, 1949, to control advances by banks in general or by any bank in particular. Among the measures that the RBI can adopt for this purpose are to prescribe purposes and extent of advances, margin requirements, maximum exposure to a single borrower, rate of interest and other terms and conditions, etc. Besides these measures (which are usually called 'selective credit control' measures), RBI also controls the total volume of bank credit by varying bank rate through open market operations or by varying cash reserve and similar requirements.

1.35 Bank rate refers to the rate of interest at which the RBI re-discounts the first class bills of exchange or other eligible instruments from banks. Variations in bank rate affect the interest rates charged by banks – generally, interest rates of banks move up or down *in tandem* with movements in bank rate.

1.36 Open market operations involve sale or purchase of government securities in the open market. When RBI buys government securities from banks in the open market, the funds in the hands of selling banks increase, enabling them to expand credit, and *vice versa*.

1.37 Banks are required to maintain at least a prescribed minimum percentage of their demand and time liabilities in India in the form of cash and/or current account balances with the RBI (called 'cash reserve ratio'). Additionally, they are required to maintain a further percentage in the form of cash and/or other liquid assets (called 'statutory liquidity ratio'). Varying the cash reserve ratio and/or statutory liquidity ratio enables the RBI to increase or decrease (as the case may be) the funds available to banks for lending and other similar purposes.

1.38 Apart from directions relating to operational matters, RBI also issues, from time to time, guidelines on accounting matters to be followed by banks. These guidelines have a profound effect on annual accounts of banks. The text of the notifications/circulars/guidelines, etc., issued by RBI are normally also available on its website **www.rbi.org.in**.

I-2
Legal Framework

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

- Banking Regulation Act, 1949.
- State Bank of India Act, 1955.
- Companies Act, 1956.
- State Bank of India (Subsidiary Banks) Act, 1959.
- Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970.
- Regional Rural Banks Act, 1976.
- Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.
- Information Technology Act, 2000.
- Prevention of Money Laundering Act, 2002.
- Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.
- Credit Information Companies Regulation Act, 2005.
- Payment and Settlement Systems Act, 2007.

2.02 Besides, the above enactments, the provisions of the Reserve Bank of India Act, 1934, also affect the functioning of banks. The Act gives wide powers to the RBI to give directions to banks which also have considerable effect on the functioning of banks.

Salient Provisions of Banking Regulation Act, 1949

2.03 Of the above, the Banking Regulation Act, 1949 (hereinafter referred to as "the Act"), is the most important as it affects the functioning of all institutions carrying on banking business whereas the other enactments relate only to certain specific type(s) of banks. Some of the important provisions of the Act are briefly described below, since familiarity with them is essential for the performance of the duties of an auditor. It may, however, be emphasised that the ensuing discussion is not an exhaustive discussion on all the relevant provisions of the Act. It may also be noted that some of the provisions discussed hereunder are not applicable to certain types of banks in view of there being specific provisions with regard to the relevant matters in the respective principal statutes governing their functioning.

Sec 4: Power to Suspend Operation of the Act

2.04 On a representation made by the RBI in this behalf, the Central Government may suspend the operation of the Act or of any provision thereof for a period up to 60 days either generally or in relation to any specified banking company. In case of a special emergency, the Governor of the RBI or, in his absence, any authorised Deputy Governor may also, similarly, suspend such operation for a period up to 30 days. In either case, the Central Government has a power to extend the period of suspension, from time to time, but the said extension should not exceed a period of 60 days at any one time. The total period of suspension cannot, however, exceed one year.

Sec 5(b): Banking

2.05 'Banking' is defined as "the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise".

Sec 5(c): Banking Companies

2.06 A *banking company* means "any company which transacts the business of banking in India". The term 'company' for this purpose covers companies registered in India as well as foreign companies. It has been clarified that any company which is engaged in the manufacturing of goods or carries on any trade, and which accepts deposits of money from the public merely for the purpose of financing its business as such manufacturer or trader, shall not be deemed to transact the business of banking [*Explanation* to section 5(c)].

Sec 6: Forms of Business

2.07 Section 6 of the Act permits a banking company to engage in certain forms of business in addition to the business of banking. Besides the forms of business specifically listed in clauses (a) of sub-section (1) of section 6, a banking company may do "all such other things as are incidental or conducive to the promotion or advancement of the business of the company" [clause (n) of sub-section (1) of section 6]. Under clause (o), a banking company may engage in any other form of business (besides those covered by other clauses), which the Central Government may, by notification in the Official Gazette, specify as a form of business in which it is lawful for a banking company to engage.

2.08 Under sub-section (2) of section 6, a banking company is prohibited from entering into any form of business other than those covered by sub-section (1) of the said section. Section 8 specifically prohibits a banking company from buying, selling or bartering of goods except in connection with the realisation of a security held by it. It also prohibits a banking company from engaging in any trade of buying/selling or bartering of goods for others except in connection with collecting or negotiating bills of exchange or in connection with undertaking the administration of estates as executor, trustee or otherwise. However, the above prohibitions are not applicable to any business specified by the Central Government in pursuance of clause (o) of sub-section (1) of section 6.

Sec 11, 12 and 13: Requirements as to Minimum Paid-up Capital and Reserves and Regulation of Capital

2.09 Section 11 of the Act lays down the requirements as to minimum paid-up capital and reserves. Different limits have been laid down for banking companies incorporated outside India and other banking companies. Under section 12, the capital of a banking company can consist of ordinary (i.e., equity) shares only, except where preference shares have been issued prior to July 1, 1944 or where the banking company has been incorporated before January 15, 1937[2]. Section 13 restricts the pay out; either directly, or indirectly, of commission, brokerage, discount or remuneration in any form in respect of any shares issued by a banking company to two and one-half percent of the paid-up value of the said shares.

Sec 14 and 14A: Prohibition on Creation of Charge on Unpaid Capital

2.10 A banking company is prohibited from creating any charge on their un-paid shares. A banking company is also prohibited from creating floating charge on the undertaking or any property of the company or any part thereof unless the creation of such floating charge is certified in writing by the RBI as not being detrimental to the interest of the depositors of such company.

Sec 15: Restriction on Payment of Dividend

2.11 No banking company shall pay any dividend on its shares until all its capitalised expenses (including preliminary expenses, organisation expenses, share-selling commission, brokerage, amount of losses incurred and any other item of expenditure not represented by tangible assets) have been completely written off. A banking company may, however, pay dividends on its shares without writing off:

[2] The attention of the members is also invited to RBI's circular no. DBOD.BP.BC.42/21.01.002/2007-08 of October 29, 2007 on "Guidelines for issuing preference shares as part of regulatory capital".

a. Depreciation, if any, in the value of Investments in approved securities where such depreciation has not been capitalised or otherwise accounted for as loss,

b. Depreciation, if any, in the value of its investments in shares, debentures or bonds where adequate provision for such depreciation has been made to the satisfaction of the auditors,

c. Bad debts, if any, where adequate provision for such bad debts has been made to the satisfaction of the auditors.

Sec 17: Reserve Fund

2.12 Every banking company incorporated in India is required to transfer out of the balance of profit of each year as disclosed in the Profit and Loss account to reserve fund, a sum equivalent to 20% of its profit before declaration of dividend. Central Government may on recommendation of the RBI having regard to adequacy of its paid up capital and reserves declare in writing that the provisions of Section 17(1) shall not apply to the banking company. Where a banking company appropriates any sum or sums from the reserve fund or the share premium account, it shall report the fact to the RBI.

Sec 18: Cash Reserve

2.13 Every banking company, other than a scheduled bank, is required to maintain in India a cash reserve with itself or by way of balance in a current account with the RBI, or by way of net balance in current accounts or in one or more of the aforesaid ways, a sum equivalent to at least three per cent of the total of its demand and time liabilities in India as on the last Friday of the second preceding fortnight.

2.14 Such companies are also required to submit to the RBI before the twentieth day of every month, a return showing the amount so held on alternate Fridays during a month with particulars of its demand and time liabilities in India on such Fridays or if any such Friday is a public holiday under the Negotiable Instruments Act, 1881 (26 of 1881), at the close of business on the preceding working day.

Sec 19: Restriction on Nature of Subsidiary Companies

2.15 A banking company is prohibited from forming a subsidiary company except for the following purposes:

a. For undertaking any of the businesses which, under clauses (a) to (o) of Section 6(1), is permissible for a banking company,

b. With the previous approval of RBI in writing for carrying on of the business of banking exclusively outside India,

c. For undertaking of such other business, which RBI may, with the prior approval of the Central Government, consider conducive to the spreading of banking in India or to be otherwise useful or necessary in public interest.

2.16 A banking company shall not hold shares in any other company other than the subsidiary, whether as pledgee, mortgagee or absolute owner of an amount exceeding 30% of the paid up share capital of that company or 30% of its own paid up share capital and free reserves, whichever is less. No shares shall be held as pledgee, mortgagee or absolute owner in any company, other than a subsidiary company, in the management of which any managing director or manager of the banking company is in any manner concerned or interested.

Sec 20 and 21: Restriction on Loans and Advances

2.17 Section 20 of the Banking Regulation Act, 1949, (hereinafter referred to as 'the Act') lays down restrictions on loans and advances by banks. Apart from banking companies, nationalised banks, State Bank of India, its subsidiaries, and regional rural banks are also covered by this section. Accordingly, none of these banks can grant loans and advances in the following circumstances:

(a) on the security of its own shares;

(b) to or on behalf of any of its directors;

(c) to any firm in which any of its directors is interested as a partner, manager, employee or guarantor;

(d) any company of which, or of a subsidiary of the holding company of which, any of the directors of the bank is a director, manager, employee or guarantor or in which he holds substantial interest. This restriction, however, does not apply to the following companies:

   (i) a subsidiary of the banking company;

   (ii) a company registered under section 25 of the Companies Act, 1956; and

   (iii) a government company.

(e) any individual in respect of whom any of its directors is a partner or guarantor.

2.18 Under section 20(5) of the Act, the RBI has been empowered to clarify whether any transaction is a loan or advance for the purpose of this section and the decision of RBI thereon shall be final. In doing so, the RBI would consider the nature of the transaction, the period within which and the manner and the circumstances in which, any amount due on account of the transaction is likely to be realised, the interest of the depositors and other relevant considerations. In exercise of this power, the RBI has, vide its circulars DBOD.No.BC.415/ 08.95.005/98 dated September 29, 1998 and DBOD.No.BC.26/08.95.005/99 dated April 1, 1999 excluded certain loans to directors from the purview of section 20.

2.19 Under section 20A of the Act, a banking company is prohibited from remitting, wholly or partly, the debts due to it by certain persons without obtaining the prior approval of the RBI. Any such remission made without the prior approval of the RBI is void and ineffective. The persons specified in this behalf are:

(a) any director of the banking company;

(b) any firm or company in which any director is interested as director, partner, managing agent or guarantor; and

(c) any individual if any director of the bank is his partner or guarantor.

The above prohibition also applies to nationalised banks, State Bank of India, its subsidiaries, and regional rural banks.

2.20 Under section 21 of the Act, the RBI has the power to determine the policy in relation to advances to be followed by banking companies generally, or by any banking company in particular. In particular, the RBI can give directions to banking companies regarding:

(a) the purposes for which advances may or may not be made;

(b) the margins to be maintained in respect of secured advances;

(c) the maximum amount of advances or other financial accommodation which may be made by a banking company to any one company, firm, association of persons or individual;

(d) the maximum amount up to which guarantees may be given by a banking company on behalf of any one company, firm, association of persons or individual; and

(e) the rate of interest and other terms and conditions on which advances or other financial accommodation may be made or guarantees may be given.

2.21 Every banking company (as also a nationalised bank, State Bank of

India, a subsidiary of State Bank of India, and a regional rural bank) is bound to comply with the policy determined, and directions given, by the RBI.

Sec 22: Licensing of Banking Companies

2.22 Section 22 of the Act prohibits a company from carrying on banking business in India unless it holds a license issued by the RBI. The licence may be a conditional licence. The licence may be cancelled if the company ceases to carry on banking business in India or fails to comply with the conditions imposed upon it under sub-section (1) of this section or fails to fulfil any other condition laid down in the section.

Sec 23: Restrictions on Opening and Transfer of Places of Business

2.23 Under section 23, prior permission of the RBI is required for opening of new, or transfer of existing, places of business in India. Similarly, prior permission from RBI is required by a banking company incorporated in India for opening a new, or transferring an existing, place of business outside India. The above restrictions, however, do not cover the change of location of an existing place of business within the same city, town or village. Further, opening of a temporary place of business for a period not exceeding one month is also exempted provided the conditions laid down in this behalf are satisfied. The term 'place of business' includes any sub-office, pay office, sub-pay office and any place of business at which deposits are received, cheques are encashed or monies are lent.

2.24 It may be noted that recently, the RBI has permitted banks to open new places of business or transfer existing ones without obtaining specific permission from it provided certain conditions specified by the RBI in this behalf are satisfied.

Sec 24: Maintenance of a Percentage of Assets (SLR)

2.25 Section 24 mandates that a scheduled bank, in addition to the average daily balance required to be maintained under Section 42 of the Reserve Bank of India Act, 1934 every other banking company, in addition to the cash reserve required to be maintained under section18, shall maintain in India, assets of the value which shall not be less than such percentage not exceeding forty percent of the total of its demand and time liabilities in India as on the last Friday of the second preceding fortnight, in such form and manner as the RBI may by notification in the Official Gazette, specify from time to time.

2.26 Section 25 requires that the assets in India of every banking company at the close of business on the last Friday of every quarter or if that day is a public holiday, at the close of the preceding working day, shall not be less than 75% of its demand and time liabilities in India.

Returns to be Submitted to the RBI

2.27 The Banking Regulation Act, 1949 requires banking companies, nationalised banks, State Bank of India, its subsidiaries, and regional rural banks to furnish the following returns to the RBI:

(a) Monthly return of assets maintained in India in accordance with section 24 and demand and time liabilities in India at the close of business on each alternate Friday during the month. [Section 24]

(b) Quarterly return of assets and liabilities in India at the close of business on the last Friday of every quarter. [Section 25]

(c) Annual return of unclaimed accounts which have not been operated for 10 years. [Section 26]

(d) Monthly return of assets and liabilities in India at the close of business on the last Friday of every month. [Section 27]

2.28 The above types of banks have also to furnish such other statements or information as may be required by the RBI under section 27 of the Act. In exercise of its powers under the aforesaid section, the RBI requires a large number of returns to be furnished to it. Some of the important returns required to be furnished to the RBI are as enumerated below, with their periodicity indicated in parentheses.

(a) Report on Non-performing Advances (annual)

(b) Statement showing the position of reconciliation of investment account (annual)

(c) Statement on compromises and settlements involving write off (half-yearly)

(d) Statement on bad debts written off (annual)

(e) Details of Doubtful or Loss Assets and also Suit Filed accounts with outstandings aggregating Rs. one crore and above (half-yearly)

(f) Details of remittance of profits/surplus retained in India (annual)

(g) Particulars of provisions held on problem credits of overseas branches (half-yearly)

(h) Inter-branch reconciliation (quarterly)

(i) Reconciliation of outstanding inter-branch accounts (annual)

(j) Reconciliation of clearing differences (annual)

(k) Position of balancing of books (quarterly)

(l) Returns relating to frauds, robbery, etc., including fraud involving Rs. one crore and above (quarterly)

(m) Return of Capital Adequacy (quarterly)

(n) Return on Asset Quality (quarterly)
(o) Asset-liability management (monthly)
(p) Return in respect of Statutory Liquidity Ratio (monthly)

Sec 29-33: Provisions Relating to Accounts and Audit

2.29 Section 29 of the Act lays down requirements as to profit and loss account and balance sheet. Section 30 deals with audit of profit and loss account and balance sheet prepared in accordance with section 29. Section 31 deals with publication of profit and loss account and balance sheet and their submission to RBI, whereas section 32 deals with submission of profit and loss account and balance sheet alongwith the auditor's report to the Registrar of Companies. Section 33 deals with display of audited balance sheet and profit and loss account by companies incorporated outside India and carrying on banking business in India. These provisions are discussed in detail in Chapter 3 of Part I of the Guidance Note. It may be noted that some of the above provisions are not applicable to nationalised banks, State Bank of India, subsidiaries of State Bank of India, regional rural banks, and co-operative banks (this aspect is discussed later in this Chapter).

Other Important Provisions of the Banking Regulation Act, 1949

2.30 Besides the above provisions, a number of other provisions of the Act are relevant to the work of the auditor. Some of the important provisions are as follows:

Section 9	Disposal of non-banking assets (Banks are prohibited to hold any immovable property other than assets for its own use and should dispose off the assets held in satisfaction of claim within 7 years or such extended period as RBI allows.)
Section 36A	Certain provisions of the Act do not apply to certain banking companies
Section 49A	Restriction on acceptance of deposits, withdrawable by cheque
Section 45Y	Power of Central Government to make rules for the preservation of records

2.31 Further, the provisions of the Banking Regulation Act, 1949, except as provided for in the said Act, will override anything to the contrary contained in the:

- memorandum or articles of the banking company or
- in any agreement executed by it or

- in any resolution passed by the banking company in a general meeting or its Board of Directors.

Reserve Bank of India Act, 1934

2.32 As per section 42, every bank included in the Second Schedule of the Reserve Bank of India Act shall maintain with the RBI an average daily balance of not less than 3% of its total demand and time liabilities. RBI has power to increase the said rate by issuing notification in the Gazette of India but the increased rate shall not exceed 20% of its total demand and time liabilities.

Inspection by the RBI

2.33 Wide powers have been given to the RBI under section 35 for inspection of any banking company and its books and accounts. The Central Government can also direct the RBI to cause such an inspection.

Power of the RBI to Give Directions

2.34 The RBI is empowered to issue such directions to banking companies generally or to any banking company in particular as it deems fit in public interest, or in the interest of banking policy, or to prevent the affairs of any banking company from being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company, or to secure the proper management of any banking company generally (section 35A). The RBI is also empowered to caution or prohibit banking companies generally or any particular banking company against entering into any particular transaction or class of transactions, and generally give advice to any banking company [Clause (a) of sub-section (1) of section 36].

Applicability of Various Enactments to Different Types of Banks

2.35 As mentioned in paragraph 2.01 above, a number of enactments govern the functioning of banks in India. While the Banking Regulation Act, 1949 is applicable to all types of banks (though some of its provisions may not be applicable to certain types of banks or may be applicable with certain modifications), the other enactments are relevant only to particular type(s) of banks. The enactments applicable to different types of banks are discussed below.

Nationalised Banks

2.36 Nationalised banks are governed by –

(a) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980; and

(b) specified provisions of the Banking Regulation Act, 1949.

2.37 Fourteen banks were nationalised under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 while another six were nationalised under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980. The provisions of these two enactments are identical and deal, *inter alia*, with such matters as the following:

- Authorised and paid-up capital
- Annual accounts
- Qualifications, appointment, powers and duties of auditor (including contents of audit report)
- Disposal of profits
- Special audit at the instance of the Central Government
- Time and place of annual general meeting and business to be transacted thereat
- Restrictions on payment of bonus to officers and other employees
- Powers of the Board of Directors to make regulations in consultation with the RBI and with the previous sanction of the Central Government

2.38 Apart from all the provisions of the aforesaid Act of 1970/1980, the following provisions of the Banking Regulation Act, 1949, also apply to nationalised banks by virtue of section 51 of the latter Act:

Section 10	Prohibition of employment of managing agents and restrictions on certain forms of employment
Section 13	Restriction on commission, brokerage, discount, etc., on sale of shares
Section 14	Prohibition of charge on unpaid capital
Section 14A	Prohibition of floating charge on assets
Section 15	Restrictions as to payment of dividend
Section 17	Reserve Fund
Section 19	Restriction on nature of subsidiary companies

Section 20	Restrictions on loans and advances
Section 20A	Restriction on power to remit debts
Section 21	Power of Reserve Bank to control advances by banking companies
Section 21A	Rate of interest charged by banking companies not to be subject to scrutiny by Courts
Section 23	Restrictions on opening of new, and transfer of existing, places of business
Section 24	Maintenance of a percentage of assets
Section 25	Assets in India
Section 26	Return of unclaimed deposits
Section 27	Monthly returns and power to call for other returns and information
Section 28	Power to publish information
Section 29 [excluding sub-section (3)]	Accounts and balance sheet
Section 30 [excluding sub-sections (1B), (1C) and (2)]	Audit
Section 31	Submission of returns
Section 34	Accounting provisions of the Act not retrospective
Section 35	Inspection
Section 35A	Power of the Reserve Bank to give directions
Section 36 [excluding clause (a) of sub-section (1)]	Further powers and functions of Reserve Bank
Section 45Y	Power of Central Government to make rules for the preservation of records
Section 45Z	Return of paid instruments to customers
Section 45ZA	Nomination for payment of depositors' money

Section 45ZB	Notice of claims of other persons regarding deposits not receivable
Section 45ZC	Nomination for return of articles kept in safe custody with banking company
Section 45ZD	Notice of claims of other persons regarding articles not receivable
Section 45ZE	Release of contents of safety lockers
Section 45ZF	Notice of claims of other persons regarding safety lockers not receivable
Section 46	Penalties
Section 46A	Chairman, director, etc., to be public servants for the purposes of Chapter IX of the Indian Penal Code
Section 47	Cognisance of offences
Section 47A	Power of Reserve Bank to impose penalty
Section 48	Application of fines
Section 50	Certain claims for compensation barred
Section 52	Power of Central Government to make rules
Section 53	Power to exempt in certain cases

State Bank of India and its Subsidiaries

2.39 State Bank of India and its subsidiaries are governed by –

(a) State Bank of India Act, 1955/State Bank of India (Subsidiary Banks) Act, 1959, as the case may be; and

(b) specified provisions of the Banking Regulation Act, 1949.

2.40 The provisions of the Banking Regulation Act, 1949, applicable to State Bank of India and its subsidiaries are specified in section 51 of the said Act and are the same as those applicable to nationalised banks (described in paragraph 2.38 above).

Companies Act, 1956

2.41 Section 2 of the Banking Regulation Act, 1949, provides that the provisions of the Act shall be in addition to, and not, save as expressly provided there under, in derogation of the Companies Act, 1956, and any other law for the time being in force. Thus, banking companies attract the provisions of both the Banking Regulation Act, 1949, as well as the Companies Act, 1956. In case the provisions of these enactments are at variance, the provisions of the Banking Regulation Act, 1949, shall prevail.

Regional Rural Banks

2.42 Regional rural banks are governed by –

(a) Regional Rural Banks Act, 1976; and

(b) specified provisions of the Banking Regulation Act, 1949.

2.43 The provisions of the Banking Regulation Act, 1949, applicable to regional rural banks are specified in section 51 of the said Act and are the same as those applicable to nationalised banks (described in paragraph 2.38 above).

Co-operative Banks

2.44 Co-operative banks are governed by –

(a) the Co-operative Societies Act, 1912, or the Co-operative Societies Act of the state concerned, as the case may be; and

(b) Part V of the Banking Regulation Act, 1949.

2.45 Part V of the Banking Regulation Act, 1949, modifies certain provisions of the Act in their application to co-operative banks and omits certain others. The sections which have been significantly modified in their application to co-operative banks are sections 2, 5-A, 6, 7, 8, 9, 11, 18, 19, 20, 21, 22, 23, 24, 27, 29, 31, 35, 35A, 36, 36A, 49A, 52, 54 and 55. Besides, the First Schedule to the Act is not applicable to co-operative banks while the Third and the Fourth Schedules to the Act have been replaced by a schedule applicable only to co-operative banks.

Scheduled Banks

2.46 These are the banks included in the Second Schedule to the Reserve Bank of India Act, 1934. The RBI includes a bank in the said Schedule if it fulfils certain conditions.

2.47 The RBI gives certain facilities to scheduled banks including the following:

(a) Purchase, sale and rediscounting of certain bills of exchange (including foreign bills of exchange) or promissory notes.

(b) Purchase and sale of foreign exchange.

(c) Making of loans and advances to scheduled banks.

(d) Maintenance of the accounts of scheduled banks in its banking department and issue department.

(e) Remittance of money between different branches of scheduled banks through the offices, branches or agencies of the RBI free of charge or at nominal charges.

Regulatory Directives

2.48 Section 35A of the Banking Regulations Act empowers the RBI to issue directions to banking companies generally or in particular, from time to time and such directions shall be binding on all the banking companies. Vested with such power, RBI has issued various circulars regarding banking supervision, banking operations, etc. The circulars issued by RBI deal with issues among other things, accounting, accounting standards, financial statement disclosures, etc. It is mandatory for every banking company to follow the directions and RBI closely monitors such compliances. The circulars issued by RBI covers every facet of banking business.

2.49 RBI issues Master Circulars every year by consolidating the earlier circulars on the subject and the latest circulars issued are updated. The master circulars and other circulars are hosted on RBI website (*www.rbi.org.in)*. The latest series of master circulars were issued by the RBI on 2nd July, 2012 in respect of various matters concerning banking business, valuation of investments, revenue recognition, para-banking activities, capital adequacy, frauds classification and reporting, risk management, classification of advances, etc. Some of these master circulars have been provided in the CD enclosed with this Guidance Note.

I-3

Accounting and Auditing Framework

3.01 This Chapter discusses the statutory provisions and regulatory requirements affecting the accounts and audit of banks. As provisions relating to accounts and audit of co-operative banks may differ from one State to another, they are not discussed in this Guidance Note.

Form and Content of Financial Statements

3.02 Sub-sections (1) and (2) of section 29 of the Banking Regulation Act, 1949, deals with the form and content of financial statements of a banking company and their authentication. These sub-sections are also applicable to nationalised banks, State Bank of India, subsidiaries of the State Bank of India, and Regional Rural Banks.

3.03 Sub-section (1) of section 29 requires every banking company 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. These financial statements have to be prepared as on the last working day of each financial year (i.e., 31st March) in respect of all business transacted during the year. A foreign banking company (i.e., a banking company incorporated outside India and having a place of business in India) has to similarly prepare a balance sheet and a profit and loss account every year in respect of all business transacted through its branches in India.

Salient Features of the Third Schedule

3.04 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.

3.05 The balance sheet as well as the profit and loss account are required to be presented in vertical form. Capital and liabilities are to be presented under the following five broad heads:

- Capital
- Reserves and Surplus
- Deposits

- Borrowings
- Other liabilities and provisions

3.06 Assets are required to be presented under the following six broad heads:

- Cash and Balances with Reserve Bank of India
- Balances with Banks and Money at call and short notice
- Investments
- Advances
- Fixed assets
- Other assets

3.07 Details of items of capital, liabilities and assets are required to be presented in the prescribed form in various schedules.

3.08 The aggregate amounts of contingent liabilities and bills for collection are to be presented on the face of the balance sheet. While details of contingent liabilities are to be presented by way of a schedule.

3.09 The following items are required to be presented on the face of the profit and loss account.

I. *Income*

Interest earned

Other income

II. *Expenditure*

Interest expended

Operating expenses

Provisions and contingencies

III. *Profit (Loss)*

Net profit (loss) for the year

Profit/loss brought forward

IV. *Appropriations*

Transfer to statutory reserves

Transfer to other reserves

Transfer to Government/Proposed Dividend

Balance carried over to balance sheet

3.10 Prescribed details of interest earned, other income, interest expended and operating expenses are required to be given by way of schedules to the profit and loss account.

Disclosures Prescribed by RBI

3.11 In addition to the disclosures to be made in the balance sheet and profit and loss account in pursuance of the requirements of the Third Schedule to the Act, the RBI has, vide its Master Circular no. DBOD.BP.BC No.14 /21.04.018/2012-13 of July 2, 2012 on "Disclosure in Financial Statements –Notes to Accounts", prescribes disclosures to be made in the Notes to Accounts in respect of certain significant aspects of the items of financial statements of banks[@] (The circular is given in the CD along with the Guidance Note).

Disclosures Required Under Accounting Standards

3.12 The disclosure requirements under the various Accounting Standards, issued by the Central Government under the Companies Accounting Standard Rules, 2006 as well as any other Accounting Standards issued by the ICAI are also to be complied with.

Requirements of the Banking Regulation Act, 1949, *vis-a-vis* Companies Act, 1956

3.13 The requirements of the Companies Act, 1956, relating to the balance sheet and profit and loss account of a company, in so far as they are not inconsistent with the Banking Regulation Act, 1949, also apply to the balance sheet or profit and loss account, as the case may be, of a banking company [sub-section (3) of section 29 of the Act]. It may be noted that this provision does not apply to nationalised banks, State Bank of India, its subsidiaries and regional rural banks.

Banks Listed on a Stock Exchange

3.14 Banks listed on a stock exchange have to also comply with the requirements of the Listing Agreement as amended from time to time. In respect of securities issued and traded on foreign bourses, if any, the issuer bank has to comply with the applicable regulations of that jurisdiction.

Financial Statements, Auditor's Report and Directors' Report of Subsidiary

3.15 Public sector banks are also required to annex the balance sheet, profit and loss account, report of the board of directors and auditor's report in

[@] Revised in 2013 edition.

respect of each of their subsidiaries, to their own financial statements. The banking companies are required to attach the financial statements, directors' report and auditor's report to their own annual reports by virtue of section 212 of the Companies Act, 1956.

Notes and Instructions Issued by RBI

3.16 The RBI has issued notes and instructions for compilation of balance sheet and profit and loss account. These notes and instructions provide an authoritative interpretation of the requirements of the Third Schedule to the Act and are thus useful in preparation of financial statements of banks.

Signatures

3.17 Sub-section (2) of section 29 of the Act requires that the financial statements of banking companies incorporated in India should be signed by the manager or principal officer of the banking company and by at least three directors (or all the directors in case the number is less than three). The financial statements of a foreign banking company are to be signed by the manager or agent of the principal office in India. It may be noted that the accounts of a branch are usually signed by the manager of the branch and/or the accountant.

3.18 The provisions of sub-section (2) of section 29 are also applicable to nationalised banks, State Bank of India, its subsidiaries, and regional rural banks.

Accounting Policies

(Other than those related to consolidated financial statements)

3.19 The term 'accounting policies' refers to the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

3.20 The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation and presentation of the financial statements. The accounting policies followed vary from enterprise to enterprise. An accounting policy may be significant because of the nature of the entity's operations even if amounts for current and prior periods are not material. The principle consideration should be whether disclosure of an accounting policy would assist users in understanding how transactions, other events and conditions are reflected in the balance sheet and profits/loss account.

3.21 Recognising the need for disclosure of accounting policies by banks, the RBI has required all scheduled banks to disclose their significant accounting policies. The accounting policies are required to be disclosed at one place along with the notes on accounts. A specimen form in which accounting policies may be disclosed has also been given by the RBI. The specimen indicates broadly the areas in respect of which the accounting policies followed by a bank should be disclosed. Banks can, however, make necessary modifications to suit their individual needs.

3.22 The specimen form given by the RBI recommends the disclosure of the fact that the financial statements are prepared on the historical cost basis and conform to the statutory provisions and practices prevailing in the country. Besides, disclosure of accounting policies relating to the following areas is recommended in the specimen form:

(a) Transactions involving foreign exchange, *viz*., monetary assets and liabilities, non-monetary assets, income and expenditure of Indian branches in foreign currency and of overseas branches, and profit/loss on pending forward contracts.

(b) Investments.

(c) Provisions in respect of doubtful advances.

(d) Fixed assets and depreciation.

(e) Staff benefits.

(f) Significant provisions deducted in computing net profit, e.g., provision for income-tax, provision for doubtful advances, etc.

(g) Grouping of contingency funds in presenting balance sheet.

3.23 The specimen form of accounting policies was issued by the RBI in 1991. Since then, the RBI has issued a number of guidelines relating to income recognition, asset classification, provisioning and investments. These guidelines have had a profound impact on the accounting policies of banks in the relevant areas. Disclosure of accounting policies formulated by banks to comply with these guidelines is essential to enable the users to properly understand the financial statements. Besides, in the case of banks having overseas branches, the methodology adopted for translating the financial statements of such branches may also constitute a significant accounting policy.

Conformity of Accounting Policies with Accounting Standards

3.24 The Institute of Chartered Accountants of India (ICAI) issues, from time to time, accounting standards for use in the preparation of general purpose financial statements issued to the public by such commercial, industrial or business enterprises as may be specified by the Institute from time to time and subject to the attest function of its members. The Central Government has notified the Accounting Standards issued by the Institute of Chartered Accountants of India under The Companies (Accounting Standards) Rules, 2006 (except, AS 30, AS 31 and AS 32). Reference may be made to the Announcement "Harmonisation of various differences between the Accounting Standards issued by the ICAI and the Accounting Standards notified by the Central Government" issued by the ICAI. The following is the list of Accounting Standards issued by the ICAI as on 01.01.2013:

AS 1	Disclosure of Accounting Policies
AS 2	Valuation of Inventories
AS 3	Cash Flow Statements
AS 4	Contingencies and Events Occurring After the Balance Sheet Date
AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 6	Depreciation Accounting
AS 7	Construction Contracts (Revised)
AS 9	Revenue Recognition
AS 10	Accounting for Fixed Assets
AS 11	The Effects of Changes in Foreign Exchange Rates (Revised-2003)
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments
AS 14	Accounting for Amalgamations
AS 15	Employee Benefits
AS 16	Borrowing Costs
AS 17	Segment Reporting

AS 18	Related Party Disclosures
AS 19	Leases
AS 20	Earnings Per Share
AS 21	Consolidated Financial Statements
AS 22	Accounting for Taxes on Income
AS 23	Accounting for Investments in Associates in Consolidated Financial Statements
AS 24	Discontinuing Operations
AS 25	Interim Financial Reporting
AS 26	Intangible Assets
AS 27	Financial Reporting of Interests in Joint Ventures
AS 28	Impairment of Assets
AS 29	Provisions, Contingent Liabilities and Contingent Assets
AS 30	Financial Instruments: Recognition and Measurement
AS 31	Financial Instruments: Presentation
AS 32	Financial Instruments: Disclosures

3.25 Of the twenty eight standards notified under the Companies (Accounting Standards) Rules, 2006, presently, the following standards are not applicable to banks to the extent specified.

(a) AS 13, “Accounting for Investments”, does not apply to investments of banks.

(b) AS 11, “The Effects of Changes in Foreign Exchange Rates”, does not apply to accounting of exchange difference arising on a forward exchange contract entered to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction. However, it shall apply to exchange differences in respect of all other forward exchange contracts.

3.26 RBI has issued Circular no. DBOD.No.BP.BC.76/ 21.04.018/2004-05 dated March 15, 2005 and Circular no. DBOD.BP.BC.76/21.04.018/2005-06 dated April 5, 2006, containing the guidelines on compliance with AS 11 (Revised 2003).

Audit of Accounts

3.27 Sub-section (1) of section 30 of the Banking Regulation Act, 1949 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. Similar provisions are contained in the enactments governing nationalised banks [Section 10 of the Banking Companies (Acquisition and Transfer of Undertakings) Act of 1970/1980], State Bank of India [section 41 of the State Bank of India Act, 1955], subsidiaries of State Bank of India [section 41 of the State Bank of India (Subsidiary Banks) Act, 1959], and regional rural banks [section 19 of the Regional Rural Banks Act, 1976]. It is important to note that section 41 of the State Bank of India Act, 1955, specifically provides that the affairs of the bank shall be audited by "two or more auditors". Further, the members, while carrying out audit of a bank (head office or branches) are required to comply with the Engagement and Quality Control Standards[3], issued by the Institute of Chartered Accountants of India. A list of the Engagement and Quality Control Standards applicable to audit of financial statements of a bank is given in Chapter 1 of Part II.

3.28 As mentioned in Chapter 1 of this Part, banks operate through a network of branches. The financial statements of branches (comprising branch's profit and loss account, balance sheet and various returns to head office) are incorporated in preparing the financial statements of the bank as a whole. The requirements of section 30 of the Act and the corresponding requirements of other enactments governing different types of banks, referred above, relate to audit of financial statements of the bank as a whole and not to audit of financial statements of branches. The discussion in paragraphs 3.29 to 3.58 below is also in the context of audit of financial statements of the bank as a whole. The provisions relating to audit of financial statements of branches are discussed later in paragraphs 3.59 to 3.66. Further, the members, while carrying out audit of a bank (head office or branches) are required to comply with the Engagement and Quality Control Standards issued by the Institute of Chartered Accountants of India (ICAI).

Qualifications of Auditor

3.29 According to section 226 of the Companies Act, 1956, a chartered accountant, a firm of chartered accountants or a restricted state auditor can be appointed as an auditor of a company. However, the following persons cannot be appointed as an auditor of a company:

(a) a body corporate;

(b) an officer or employee of the company;

[3] Hitherto known as Auditing and Assurance Standards.

(c) a person who is a partner, or who is in the employment of an officer or employee of the company;

(d) a person who is indebted to the company for an amount exceeding one thousand rupees, or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding one thousand rupees; or

(e) a person holding any security, i.e., an instrument which carries voting rights of the company.

3.30 The aforesaid section further provides that a person is not qualified for appointment as auditor of a company if he is disqualified for appointment as an auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company. Section 226 also provides that if an auditor becomes subject, after his appointment, to any of the disqualifications described in the preceding paragraph, he shall be deemed to have vacated his office.

3.31 As regards the disqualification on account of indebtedness, a partner of a firm of chartered accountants is disqualified when the firm is indebted to the company in excess of the prescribed limit and vice versa*.

3.32 It may be noted that in case of indebtedness in excess of the specified limit as mentioned above, the chartered accountant concerned (or the firm of chartered accountants) becomes disqualified to audit any branch of the bank; the disqualification is not confined to appointment as auditor of the particular branch to which the debt is owed.

3.33 In the context of banks, the expression indebtedness would cover, *inter alia*, the amounts outstanding in respect of credit cards issued by a bank. Thus, where the credit card outstanding exceed the prescribed limit of Rs.1,000, the chartered accountant in whose name the card is issued as well as the firm of which he is a partner would be disqualified for appointment as an auditor of the issuing bank.

3.34 The qualification for appointment as an auditor as prescribed in law are the minimum qualifications and a regulatory authority (or an individual bank) may lay down further conditions to determine the eligibility of a chartered accountant or a firm of chartered accountants for appointment as an auditor. The further conditions (which, of course, must be reasonable)

* Readers may also refer to the "Guidance Note on Independence of Auditors", issued by the ICAI.

may relate to such matters as experience of the chartered accountant /firm/partners of the firm, staff strength, etc. and may be laid down to ensure that the chartered accountants/firms of chartered accountants appointed as auditors possess the requisite skills and resources to carry out the audit effectively.

Appointment of Auditor

3.35 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 bank concerned acting through its Board of Directors. In either case, approval of the RBI is required before the appointment is made. The auditors of the State Bank of India are to be appointed by the Comptroller and Auditor General of India in consultation with the Central Government. The auditors of the subsidiaries of the State Bank of India are to be appointed by the State Bank of India. The auditors of regional rural banks are to be appointed by the bank concerned with the approval of the Central Government.

3.36 As mentioned earlier, the State Bank of India Act, 1955, specifically provides for appointment of two or more auditors. Besides, nationalised banks and subsidiaries of State Bank of India also generally appoint two or more firms as joint auditors.

Remuneration of Auditor

3.37 The remuneration of auditor of a banking company is to be fixed in accordance with the provisions of section 224 of the Companies Act, 1956 (i.e., by the company in general meeting or in such manner as the company in general meeting may determine). The remuneration of auditors of nationalised banks and State Bank of India is to be fixed by the RBI in consultation with the Central Government. The remuneration of auditors of subsidiaries of State Bank of India is to be fixed by the latter. In the case of regional rural banks, the auditors' remuneration is to be determined by the bank concerned with the approval of the Central Government.

Powers of Auditor

3.38 The auditor of a banking company or of a nationalised bank, State Bank of India, a subsidiary of State Bank of India, or a regional rural bank has the same powers as those of a company auditor in the matter of access to the books, accounts, documents and vouchers. He is also entitled to require from the officers of the bank such information and explanations as he may think necessary for the performance of his duties. In the case of a banking company, he is entitled to receive notice relating to any general meeting. He is also entitled to attend any general meeting and to be heard there at on any part of the business, which concerns him as an auditor.

3.39 It is important to note that under section 10 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980, the auditor of a nationalised bank may employ accountants or other persons at the expense of the bank to assist him in audit of accounts. Similar provisions exist in section 41 of the State Bank of India Act, 1955 and the State Bank of India (Subsidiary Banks) Act, 1959. These provisions are aimed at facilitating the work of auditors of these banks by empowering them to appoint the auditors of branches and are particularly important in the context of the fact that the above enactments do not contain any specific provisions for audit of branches of these banks. This is unlike banking companies where audit of branches is required under section 228 of the Companies Act, 1956. It may be noted that the Regional Rural Banks Act, 1976, does not contain any provisions relating to audit of branches. Accordingly, in the case of such banks, audit of branches is also carried out by the auditors appointed for the bank as a whole.

Auditor's Report

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

(a) whether, in his 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, and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory;

(b) whether or not the transactions of the bank, which have come to his notice, have been within the powers of that bank;

(c) whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit;

(d) whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and

(e) any other matter which he considers should be brought to the notice of the Central Government.

3.41 The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalised bank.

3.42 The auditor's report in the case of subsidiaries of State Bank of India is identical to the auditor's report in the case of a nationalised bank, except that all references to Central Government have to be construed instead as references to the State Bank of India. Similar is the position in the case of regional rural banks, except that the references are instead to the bank concerned.

Format of Audit Report

3.43 The auditors, central as well as branch, should also ensure that the audit report issued by them complies with the requirements of Revised SA 700, "Forming an Opinion and Reporting on Financial Statements", SA 705, "Modifications to the Opinion in the Independent Auditor's Report" and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report". The auditor should ensure that not only 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, for example, though the absolute number of unaudited branches might be quite large but in relation to overall operations of the bank such unaudited branches are quite miniscule and thus, not material. Therefore, the auditor should ensure that the complete information in respect of unaudited branches is collected and disclosed in the audit report.

3.44 Further, in accordance with the recent Announcement issued by the Institute of Chartered Accountants of India, the bank branch auditors need to mention the total number of debits/ credits and amounts in the Memorandum of Changes submitted by them, under the Other Matters Paragraph in the their audit report. This would help in ensuring that all issues raised by the bank branch auditors in the Memorandum of Changes, including those which have not per se been accepted by the bank branch managements, have been duly brought to the knowledge of the statutory central auditors. It may be noted that the information in respect of Memorandum of Changes under the "Other Matters Paragraph" would include both such MoCs which have been accepted as well as those not accepted by the bank branch management, though this distinction need not per se be brought out in the audit report.[@]

3.45 An illustrative format of the auditor's report in the case of Nationalised Banks is reproduced in Appendix 4 to this Guidance Note.

3.46 In addition to matters on which he is required to report to the

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[@] Revised in 2013 Edition.

shareholders under the Companies Act, 1956, the auditor of a banking company is also required to state in his report:

(a) whether or not the information and explanations required by him have been found to be satisfactory;

(b) whether or not the transactions of the company which have come to his notice have been within the powers of the company;

(c) whether or not the returns received from the branch offices of the company have been found adequate for the purpose of his audit;

(d) whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and

(e) any other matter which he considers should be brought to the notice of the shareholders of the company.

3.47 It may be noted that in the case of a banking company, by virtue of the provisions of clause (d) of sub-section (3) of section 227 of the Companies Act, 1956, the auditor has to specifically report whether, in his opinion, the profit and loss account and balance sheet of the banking company comply with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956.

3.48 The Companies (Amendment) Act, 2000 has inserted two new clauses (e) and (f) in section 227(3) of the Companies Act, 1956. Clause (e) requires that the auditor's report shall state "in thick type or in italics the observations or comments of the auditors which have any adverse effect on the functioning of the company". Clause (f) requires the auditor to report "whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274". Member's attention is invited to the Revised Guidance Note on section 227(3) (e) and (f) of the Companies Act, 1956.

3.49 It may also be noted that the Companies (Auditor's Report) Order, 2003 (Revised in 2005), is not applicable to banking companies.

3.50 An illustrative format of the audit report in the case of a banking company is given in Appendix 3 to the Guidance Note.

Long Form Audit Report

3.51 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 matters which the banks require their auditors to deal with in the long form audit report have been specified by the RBI.

Reporting to RBI

3.52 The RBI issued a Circular No. DBS.FGV.(F).No. BC/ 23.08.001/2001-02 dated May 3, 2002 relating to implementation of recommendations of the Committee on Legal Aspects of Bank Frauds (Mitra Committee) and the recommendations of the High Level Group set-up by the Central Vigilance Commission applicable to all scheduled commercial banks (excluding RRBs). Regarding liability of accounting and auditing profession, the said circular provided as under:

> "If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action".

3.53 As per the above requirement, the member shall be required to report the kind of matters stated in the circular to regulator, i.e., RBI. In this regard, attention of the members is also invited to Clause 1 of Part I of the Second Schedule to the Chartered Accountants Act, 1949, which states that:

> "A chartered accountant in practice shall be deemed guilty of professional misconduct, if he discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise than as required by any law for the time being in force."

3.54 Under the said provision, if a member of the Institute *suo motu* discloses any information regarding any actual or possible fraud or foul play to the RBI, the member would be liable for disciplinary action by the Institute. However, a member is not held guilty under the said clause if the client explicitly permits the auditor to disclose the information to a third party. If the above-mentioned requirement of the Circular is included in the letter of appointment (which constitutes the terms of audit engagement) then it would amount to the explicit permission by the concerned bank (client) to disclose information to the third party, i.e., the RBI.

3.55 Thus, auditors while reporting such a matter to C&MD of the bank should also report the matter simultaneously to the Department of Banking Supervision, RBI provided the terms of audit engagement require him to do so.

3.56 Auditor should also consider the provisions of SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements". Para 37 of the said Standard explains that the duty of confidentiality is over-ridden by statute, law or by courts (For example, the auditor is required to report certain matters of non-compliance to RBI as per the requirements of the Non-Banking Financial Companies Auditor's report (Reserve Bank) Directions, 1988, issued by the RBI).

3.57 RBI has issued a Master Circular no. DBS.FrMC.BC.No.1/23.04.001/2012-13 dated July 2, 2012 on "Frauds – Classification and Reporting" (The circular is given in the CD along with the Guidance Note) on the matters relating to classification and reporting of frauds and laying down a suitable reporting system. As per the said circular, the primary responsibility for preventing frauds is that of bank management. Banks are required to report frauds to the board of directors and also to the RBI.

3.58 In the aforesaid context, it may be emphasised that such a requirement does not extend the responsibilities of an auditor in any manner whatsoever as far as conducting the audit is concerned. The requirement has only extended the reporting responsibilities of the auditor. As far as conduct of audit is concerned, the auditor is expected to follow the Standards on Auditing issued by the ICAI and perform his functions within that framework. SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements " states that 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. Members' attention is invited to audit procedures as dealt in Chapter 2 of Part II of the Guidance Note.

3.59 There are several reporting requirements relating to frauds, if detected, in LFAR and Ghosh Committee recommendations. The auditor should also refer to reports of internal auditors, concurrent auditors, inspectors, etc., which may point out significant weaknesses in the internal control system. Such an evaluation would also provide the auditor about the likelihood of occurrence of transaction involving exercise of powers much beyond entrusted to an official. It must be noted that auditor is not expected to look into each and every transaction but to evaluate the system as a whole. Therefore, if the auditor while performing his normal duties comes across any instance, he should report the matter to the RBI in addition to Chairman/Managing Director/Chief Executive of the concerned bank.

Audit of Branches

3.60 Audit of branches of banking companies is required under section 228 of the Companies Act, 1956. It is thus obligatory for a banking company to get the financial statements of each of its branch offices audited except where exemption from audit is obtained in respect of certain branches under the Companies (Branch Audit Exemption) Rules, 1961 and as per the guidelines of the RBI issued from time to time.

3.61 The branch auditor has the same powers and duties in respect of audit of financial statements of the branch as those of the central auditors in relation to audit of head office. The branch auditor's report on the financial statements examined by him is forwarded to the central auditors with a copy to the management of the bank. The branch auditor of a public sector bank, private sector bank or foreign bank is also required to furnish a long form audit report to the bank management and to send a copy thereof to the central auditors. The central auditors, in preparing their report on the financial statements of the bank, deal with the branch audit reports in such manner as they consider necessary.

3.62 Some Indian banks also have overseas branches. The audit of financial statements of these branches is usually carried out by an accountant duly qualified to act as an auditor of the branch in accordance with the laws of the country concerned. The form of audit report is usually governed by the laws of the country in which the branch is situated.

Branch Audit *vis-à-vis* Audit at Head Office Level

3.63 There is a significant difference in the scope of audit at a branch of a bank (conducted by branch auditors) and at head office (conducted by central auditors) as well as other controlling offices such as zonal offices and regional offices (usually conducted by central auditors). This difference stems from the fact that the banking business – receiving deposits and making loans and advances – as well as most other banking services take place at the branch level; in the normal course, the head office and the regional/zonal offices do not conduct any banking business. They are generally responsible for administrative and policy decisions which are executed at the branch level. However, accounting for certain transactions, for example, those relating to treasury functions (viz., investments, funds management, bill re-discounting) is usually centralised, i.e., carried out at the head office. Specialised activities like merchant banking are carried on by separate divisions which operate at the head office and/or at the large designated branches.

3.64 The branch auditors furnish their audit reports on the branch financial statements to central auditors. Branch returns (comprising balance sheet, profit and loss account and other information relevant for preparation of financial statements of the bank such as particulars of advances) are also received at the head office from un-audited branches. Audited as well as un-audited branch returns are consolidated at the head office. (In some banks, returns pertaining to a region/zone are sent by the branches to the region/zone concerned and are consolidated there. The returns received from various regions/ zones are then consolidated at the head office.)

3.65 The central auditors, apart from examining consolidation of branch returns, look into specific matters which are normally not dealt with at the branch level. These generally include the following:

- Depreciation on assets like premises, etc., where the recording of the relevant fixed assets is centralised at the head office.
- Valuation of investments, and provisions for depreciation in value thereof.
- Provisions in respect of non-performing advances and doubtful elements of other current assets.
- Provisions for gratuity, pension and other retirement benefits.
- Provision for payment of bonus or ex-gratia in lieu of bonus.
- Provision for interest on overdue term deposits.
- Provision for interest on saving bank deposits beyond the date upto which interest has been provided at the branch level. [For expeditious finalisation of financial statements of branches, some banks follow the practice of requiring the branches to provide for interest on savings bank deposits based on balances therein as at a cut-off (say, 25th March). The interest for the remaining period is provided at the head office level on an estimated basis.]
- Provision in respect of losses arising from frauds discovered.
- Provision for taxation.
- Provision for audit fee.
- Provisions to meet any other specific liabilities or contingencies, the amount of which is material, for example, provision for revision in pay-scales of employees, provision for foreign exchange fluctuations, etc.
- Transfers to reserves.
- Dividends.
- Any other matter dealt with at the head office.

3.66 Another area which is of utmost importance for the central auditors in the present-day context is that related to inter-office reconciliation. Such reconciliation is mostly centralised at the head office. Each bank has laid down methods and procedures for reconciling the transactions among the various offices of the bank.

3.67 SA 600, 'Using the Work of Another Auditor', states that the principal auditor should consider the significant findings of the other auditor. The central auditors have to judge whether the observations appearing in the branch auditor's reports, though considered material at the branch level are material in the context of the financial statements of the bank as a whole.

Other Important Provisions Relating to Accounts and Audit

3.68 Section 31 of the Banking Regulation Act, 1949 requires publication of annual accounts (balance sheet and profit and loss account) and auditor's report thereon to be published in the prescribed manner. It is further required that three copies of the above-referred documents should be furnished as returns to the RBI within three months from the end of the period to which they relate. The RBI can extend the aforesaid period by a further period not exceeding three months. These requirements are applicable to banking companies, nationalised banks, State Bank of India, its subsidiaries, and regional rural banks. The regional rural banks are, however, required to furnish the aforesaid returns to NABARD also.

3.69 Section 32 of the Act requires a banking company (but not other types of banks) to furnish three copies of its annual accounts and auditor's report thereon to the Registrar of Companies at the same time when it furnishes these documents to the RBI. This is considered compliance with section 220 of the Companies Act, 1956 also.

3.70 Every banking company incorporated outside India is required by section 33 of the Act, to display, not later than the first Monday in August every year, in a conspicuous place in its principal office and every branch office in India a copy of its last audited annual accounts. It has to also similarly display its complete audited balance sheet and profit and loss account relating to its banking business as soon as they are available. The aforesaid documents have to be kept displayed until replaced by subsequent corresponding documents.

I-4
Accounting Systems

4.01 The preceding chapters discussed the legal and regulatory requirements relating to accounts applicable to various types of banks. Banks have evolved elaborate accounting systems to secure compliance with these requirements as also to ensure that their operations are conducted smoothly and efficiently. This Chapter discusses the salient features of accounting systems of banks.

4.02 An accounting system can be defined as the series of tasks in an entity by which transactions are processed as a means of maintaining financial records. Such a system recognises, calculates, classifies, posts, analyses, summarises and reports transactions.

4.03 The auditor of a bank needs to obtain a thorough understanding of the accounting system of the bank to assess the relevance and reliability of the accounting records and other source data underlying the financial statements. He should gain an understanding of the books of account and other related records maintained by the auditee. He should also understand the flow of various kinds of transactions. He can gain such understanding through enquiries of appropriate personnel, by making reference to documents such as accounting manual, procedures manual and flow charts, and by observing the actual conduct of operations.

4.04 The accounting system in an enterprise is designed keeping in view the nature and volume of operations and information needs of management and third parties with whom the enterprise has dealings. As such, the accounting systems differ amongst different enterprises. In the banking sector too, differences exist among various banks in this regard. The following discussion should, therefore, be construed, as generic in nature and the auditor should ascertain the exact design of the accounting system in each auditing situation.

Salient Features of Accounting Systems of Banks

4.05 Banks, like most other large-sized institutions, follows the mercantile system of accounting. Thus, the system of recording, classifying and summarising the transactions in a bank is in substance no different from that followed in other entities having similar volume of operations. However, in the case of banks, the need for the ledger accounts, especially those of customers, being accurate and up-to-date is much stronger than in most other types of enterprises. A bank cannot afford to ignore its ledgers particularly those containing the accounts of its customers and has to enter each and every transaction in its ledgers as soon as it takes place. In the case of banks, relatively lesser emphasis is placed on books of prime entry such as cash books or journals.

4.06 Banks follow the accounting procedure of 'voucher posting' under which the vouchers are straightaway posted to the individual accounts in the subsidiary ledgers. Simultaneously, the debit and credit vouchers relating to particular type of transactions (e.g., savings bank accounts, current accounts, demand loans, cash credit accounts, etc.) get posted to the respective control account in the General Ledger. The trial balance of the general ledger is prepared every day.

4.07 Transactions in a bank are of two types – cash and non-cash. In the case of the latter, also called 'transfer transactions', one or both of the accounts concerned may be of the customers or the internal accounts of the bank. For example, if 'A' deposits a cheque drawn in his favour by 'B', who is also a customer of the branch, the accounts of the two customers will be affected. On the other hand, if `A' deposits draft drawn on the branch, the 'Draft' account – an internal account of the bank - will be debited. Likewise, on payment of interest on deposit accounts, the `Interest Account' at the branch will be debited and many personal accounts credited.

4.08 Both debit and credit operations on all accounts – either by customers or by the bank itself – are made by means of vouchers. There are two kinds of vouchers – one, which evidence only debit or credit to an account, and the other, which contain both debit and credit to different accounts. For the sake of convenience, the latter kinds of vouchers may be called as 'composite vouchers'.

4.09 The debit vouchers are of many kinds, broadly the following:

(i) Cheques issued by the customers.

(ii) Cheques /pay orders issued by the bank.

(iii) Withdrawal forms received from the savings bank accountholders.

(iv) Drafts issued by other branches of the bank payable at the branch.

(v) Drafts issued by other banks on the branch, in terms of an approved arrangement between the two banks.

(vi) Dividend/interest warrants issued by the bank's customers and payable by the branch in terms of an approved arrangement.

(vii) Traveller's cheques issued by any branch of the bank which are presented to the branch for payment.

(viii) Drafts/pay orders issued by the branch itself which are cancelled at the request of the customer and amount is refunded to him.

(ix) Instruments like Traveller's cheques/gift cheques, etc., of other banks which are paid by the branch in terms of an approved arrangement.

(x) Letters of authority signed by the customers, containing 'Standing Instructions'.

(xi) Debit vouchers prepared by the branch on its printed stationery which are authorised by a designated official of the bank and may also carry authority from the customers in some cases, if the debit is to his account at the branch.

(xii) In respect of realisation of collection instruments sent to other branches of the bank, a debit advice (which may be known by different names in different banks) prepared by the other branch may itself be treated as a debit voucher.

(xiii) In case of remittance of funds by one branch to the other by means of Telegraphic Transfer or a Mail Transfer, the bank may treat the advice of transfer itself as debit voucher or may prepare a separate debit voucher.

(xiv) The credit vouchers are also of many kinds, broadly the following:

(xv) Pay-in-slips filled in by the customers (depositors as well as borrowers) for deposit of amounts in their accounts. Generally, the pay-in-slips are in a standard format adopted by the bank but there may be cases of a special kind of pay-in-slips in respect of some customers pursuant to a formal agreement between the bank and the customer.

(xvi) Applications for issue of Demand Drafts, Mail Transfers, Telegraphic Transfers, Banker's Cheques, Pay Orders, Gift Cheques, Traveller's cheques and other similar instruments. Some of these applications may be made on behalf of the branch itself for the payments it has to make.

(xvii) Challans for deposits into the accounts of Central/State

Government, e.g., on account of direct/indirect taxes or under schemes like public provident fund, etc.

(xviii) Credit vouchers prepared by the branch on its printed stationery which are authorised by an official of the bank. Normally, these vouchers are signed on behalf of the branch only but there may be some instances where the customer concerned also signs on the voucher as evidence that the transaction actually pertains to him. Examples are: deposit of locker charges (credited to an income account of the bank); deposit of money with the bank for purchase of non-judicial stamps required for execution of documents in favour of the bank, etc.

(xix) On payment of collection instruments received from other branches of the bank, a credit advice (which may be known by different names in different banks) or a copy of the collection schedule received from the other branch may itself be treated as a credit voucher.

4.10 It may be stated here that in case of debits or credits of similar nature to a large number of accounts in the same ledger or group of ledgers (e.g., debit on account of periodic interest, inspection charges, etc., or credit on account of periodic payment of interest to depositors), it is a common practice among banks to prepare a consolidated voucher on their stationery and enclose thereto a list containing details of accounts debited/credited and the amount of debit/credit.

4.11 As stated earlier, apart from debit vouchers and credit vouchers, there is also a category of 'composite vouchers'. These vouchers record the particulars of both debit and credit accounts. Most of the transactions covered by composite vouchers pertain to the internal accounts of the bank, i.e., non-customer accounts. Examples are: bills received for collection; letters of credit issued by the branch; guarantees issued by the branch, etc. Such vouchers may also be prepared to rectify an error while debiting/crediting an account. For example, in case the Current Account is debited in General Ledger instead of Cash Credit Account by mistake, the composite voucher will show debit to Cash Credit Account with a corresponding credit to Current Account.

4.12 All entries in the personal ledgers and the summary sheets are checked by persons other than those who have made the entries. Most clerical errors are thus detected immediately.

Principal Books of Account

4.13 The principal books of account, subsidiary books and statistical records generally maintained by banks are described in the following paragraphs. It may, however, be emphasised that the exact nature of such books may differ from one bank to another, depending upon the individual requirements of each bank.

General Ledger

4.14 The general ledger contains control accounts of all personal ledgers, the profit and loss account and different asset and liability accounts. There are certain additional accounts also (known as contra accounts) which are kept with a view to keeping control over transactions which have no direct effect on the assets and liabilities of the bank, and represent the agency business handled by the bank on which it earns service charges, e.g., letters of credit opened, bills received or sent for collection, guarantees given, etc.

Profit and Loss Ledger

4.15 For managerial purposes, the account heads in the profit and loss ledgers are more detailed than those shown in the published profit and loss accounts of banks. For example, there are separate accounts for basic salary, dearness allowance and various other allowances, which are grouped together in the published accounts. Similarly, various accounts comprising general charges, interest paid, interest received, etc., are maintained separately in the profit and loss ledgers.

Subsidiary Books

Personal Ledgers

4.16 Each control account in the general ledger is supported by a subsidiary ledger. Thus, in respect of control accounts relating to accounts of customers, subsidiary ledgers are maintained for:

(a) various types of deposit accounts (savings bank, current account, recurring deposits, etc.) which contains accounts of individual customers. Each account holder is allotted a separate folio in the ledger;

(b) various types of loan and related accounts (cash credit, term loans, demand loans, bills purchased and discounted, letters of credit opened, bank guarantees issued) wherein the liability of each customer is reflected.

4.17 Separate registers are maintained to record the particulars of term deposits (including derivatives like call deposits, certificates of deposits, etc.). Banks generally do not allot separate folios to each customer. The register is divided into various sections, each section for a particular period of deposit and/or the rate of interest payable on deposits. As mentioned earlier, postings to these registers are made directly from vouchers and all the vouchers entered in each ledger/register in a day are summarised into voucher summary sheets. The voucher summary sheets are prepared in the department which originates the transactions, by persons other than those who write the ledgers. They are subsequently checked with the vouchers by persons generally unconnected with the writing of ledgers/registers or the voucher summary sheets. However, most of the banks are now under Core Banking and, hence, all the deposits received are automatically recorded in the respective registers.

Bills Registers

4.18 Details of different types of bills are kept in separate registers which have suitable columns. For example, bills purchased, inward bills for collection, outward bills for collection etc., are entered serially on a daily basis in separate registers. In the case of bills purchased or discounted, party-wise details are also kept in normal ledger form. This is done to ensure that the sanctioned limits of parties are not exceeded.

4.19 Entries in these registers are made with reference to the original documents. A voucher for the total amount of the transactions of each day is prepared in respect of each register. This voucher is entered in the day book. When a bill is realised or returned, its original entry in the register is marked off. A daily summary of such realisations or returns is prepared in separate registers whose totals are taken to vouchers which are posted in the day book.

4.20 In respect of bills for collection, contra vouchers reflecting both sides, i.e., debit and credit, are prepared at the time of the original entry, and this entry is reversed on realisation.

4.21 Outstanding entries are summarised at stipulated intervals nd their totals agreed with the balances of the respective control accounts in the general ledger.

Other Registers/Records

4.22 There are different registers/records to record detailed particulars of various types of transactions. These registers/records do not form part of books of account but support the entries/balances in the various accounts. Some of the important registers/records relate to the following:

(a) Drafts issued (separate registers may be maintained for drafts issued by the branch on other branches of the same bank and those on the branches of its correspondents in India or abroad).

(b) Drafts paid (separate registers may be maintained on the same pattern as in the case of drafts issued).

(c) Issue and payment of –

(i) telegraphic transfers.

(ii) mail transfers.

(iii) bankers' cheques/pay orders/Traveller's cheques/gift cheques

(d) Letters of credit.

(e) Letters of guarantee.

4.23 Entries in these registers are made from original documents which are also summarised on vouchers every day. These vouchers are posted into the day book.

4.24 Outstanding entries are summarised at stipulated intervals and their totals agreed with the respective control accounts in the general ledger.

4.25 There are frequent transactions amongst the branches of the bank which are settled through the mechanism of inter-office accounts. The examples of such transactions include payment/realisation of bills/cheques, etc., sent for collection by one branch to the other, movement of cash between them, transfer of funds where one branch acts as an agent of the other, e.g., for government–related business. All such transfers of funds are channelised through a nodal account (this account has different names in different banks, e.g., Head Office Account, Inter-office Account, and so on). This is a crucial account both for banks as well as the auditors for two reasons – first, many frauds have been perpetrated on banks through this account and second, banks are now required to make provision for entries routed through this account which remain unreconciled beyond a time period specified by the RBI. For a detailed discussion on this aspect, reference may be made to Chapter 13 of Part III.

4.26 Banks maintain a Suspense Ledger to record various suspense accounts. Sometimes, transactions of a transitory nature, e.g., travel advances to employees, are recorded in a suspense account pending their adjustment in the related expense/income account. Some banks maintain separate ledgers for suspense accounts and sundry deposits accounts. The amounts lying in these accounts need regular monitoring to clear them.

4.27 Suitable registers with back-up registers to record classification under numerous sub-heads are maintained for:

(a) Establishment expenses.

(b) Interest and discount income.

(c) Incomes by way of commission.

(d) Interest expenditure.

(e) Provision for interest accrued but not due on deposits.

(f) Fixed assets.

(g) Stationery consumed/in hand.

(h) Interest payable to, and receivable from head office, in respect of advances and deposits respectively. A peculiar feature of accounting systems of banks is that the branches, notionally, have no funds of their own. All deposits accepted at the branch are deemed to have been passed on to the bank's head office and all loans made at the branch are deemed to have been made out of funds received from the head office. The head office pays interest to the branch for its deposits and charges interest from the branch for its advances. The rates of such interest charged and paid by head office are decided by the head office during the course of the year and are an important factor in calculating the profit or loss of a branch. The mechanism may be known by different names in different banks. All calculations in this regard are done at the branches only and suitable entries are passed, generally at the year-end. These entries, however, get offset in the process of consolidation of accounts and have no effect on the financial statements of the bank as a whole.

(i) Instruments received from customers for payment/collection by the branch. Clearing of locally payable instruments is an important function of banks. Some banks maintain separate registers to record details of various types of instruments lodged by customers whereas some other banks use a common book to record all kinds of instruments lodged by customers.

4.28 Separate registers are maintained to record and summarise the transactions relating to a particular head of account like Current Account, Savings Bank, Cash Credit, Term Loans. Such books may be called Log Books, Day Books, etc. The totals in this book are carried over to the Cash Book.

Departmental Journals

4.29 Each department of a bank maintains a journal to note the transfer entries passed by it. These journals are memoranda books only, as all the entries made there are also made in the day book through voucher summary sheets. The purpose of such a journal is to maintain a record of all the transfer entries originated by the department. For example, the loans and overdrafts department will pass transfer entries for interest charged on various accounts every month, and as all these entries will be posted in the journal of that department, the officer concerned can easily find out the accounts in respect of which the interest entry has been passed. Since all the vouchers passed during the day are entered into the day book only in a summary form, it may not be possible to get this information from the day book without looking into the individual vouchers.

4.30 As has been mentioned earlier, a 'composite voucher' (or two separate vouchers for debit and credit) is generally prepared for each transfer entry. The composite voucher is generally prepared by and entered into the journal of the department which is accordingly credited to the other department. For example, if any amount is to be transferred from current account of a customer to his savings bank account, the voucher will be prepared by the current accounts department and entered in the journal of that department.

4.31 Besides the books mentioned above, various departments of a bank have to maintain a number of books to facilitate their work. Some of the important departmental books are described below.

Cash Department

4.32 The following books are usually maintained by the cash department:

(a) Receiving cashiers' cash book

(b) Paying cashiers' cash book

(c) Head cashier's book

(d) Cash balance book

4.33 Cash Book may have one column, or two or three columns, depending upon the system adopted by the bank to record cash, transfer and clearing transactions separately or to treat all of them as cash transactions. Two points may be noted here:

(a) 'Transfer' relates to only those transactions where both debit and credit transactions are made in the accounts at the same branch and includes operations on non-customer accounts also. Clearing transactions essentially relate to customer accounts and the branch handles either payment or receipt of the underlying amount.

(b) Banks generally maintain a register (commonly called Transfer Scroll) wherein brief particulars of the debit and credit sides of a transaction are entered. At the end of the day, the register shows the total value of transfer transactions handled which has to agree with the 'Transfer' column of the Cash Book, if there is such a system. In the case of a single-column Cash Book, the total of the day's transactions must agree with the total of cash and transfer transactions, as per the cash and transfer scrolls of the branch.

4.34 Banks have introduced different systems to facilitate quick payments to customers. The most prevalent system is the teller system. Under this system, the tellers keep both cash as well as ledger cards and the specimen signature cards of each customer in respect of current and savings bank accounts. The teller is authorised to make payment up to a particular amount. On receipt of the cheque, he checks it, passes it for payment, enters in the ledger card and makes the payment to the customer.

Outward Clearing Department

4.35 The following books are usually maintained by the outward clearing department:

(a) Clearing cheques received book for entering cheques received from customers for clearing;

(b) Bank-wise list of the above cheques, one copy of which is sent to the clearing house along with the cheques.

Inward Clearing Department

4.36 The inward clearing department maintains a memorandum book to record the number of cheques given to each department. Most of the banks have centralised debiting of inward clearing cheques at the respective service branches. In such cases, the inward cheques will be retained at the service branch itself.

Loans and Overdrafts Department

4.37 The Loans and Overdrafts Department usually maintains the following books:

(a) Registers to record details of documents executed by the borrowers and guarantors in respect of credit facilities

(b) Securities registers for recording details of securities in respect of credit facilities

(c) Pending documents and document deficiency register

(d) Godown registers maintained by the godown-keepers of the bank

(e) Price register giving the wholesale prices of commodities pledged with the bank

(f) Overdraft sanction register

(g) Drawing power book

(h) Delivery order books

(i) Storage books

(j) Stock statements registers for loan accounts

(k) Suit filed register

(l) Inspection register for loan accounts

Deposits Department

4.38 The Deposits Department usually maintains the following books:

(a) Account opening and closing register

(b) Fixed Deposits, Rate Register giving analysis of fixed deposits rates

(c) Due date diary

(d) Specimen signature cards, containing specimen signatures of deposit account holders.

Establishment Department

4.39 The Establishment Department usually maintains the following books:

(a) Salary and allied registers, such as, attendance register, leave register, overtime register, etc.

(b) Register of fixed assets, e.g., furniture and fixtures, vehicles, etc.

(c) Registers to record receipt, issue and balance of stationery including security papers, e.g., draft forms, cheque books, etc.

(d) Old records registers.

General

4.40 Besides the above, banks also maintain the following books:

(a) Specimen signature book (of the bank's officers).

(b) Private telegraphic code and cyphers.

(c) Back up registers for various types of returns/statements.

(d) Safe Deposit Lockers / Safe Custody registers.

(e) Registers to record particulars of lost instruments (drafts, cheques, etc.) based on details received from the head office.

(f) Transit books through which instruments are sent to the cash department for payment by the official authorising such payment.

(g) Registers to record particulars of outstanding inter-office entries received from the reconciliation department of the bank which are to be responded to by the branch.

(h) Cheque books issued register.

(i) Token register.

(j) Stop payment register.

Flow of Transactions

4.41 The books of account and other books and records maintained by banks have been described above. It is necessary for the auditor to understand how various kinds of transactions executed by a bank get reflected in various books. The following paragraphs accordingly provide a brief overview of the flow of transactions commonly carried out by banks. The emphasis is on transactions carried out at the branch level since it is at this level that banking business and most other types of transactions usually take place.

Customers' Accounts

4.42 Transactions with customers (both depositors as well as borrowers) generally account for a substantial proportion of the total transactions at the branch level. These transactions involve either a credit or a debit to the respective customer accounts.

Credits to Customers' Accounts

4.43 The customers may deposit cash, instruments payable at the branch itself (e.g., cheques issued by other customers of the branch/drafts issued by another branch of the bank or another bank as per approved arrangement, which is payable at the branch), or instruments drawn on other branches of the bank/other banks located within the area of the clearing house of which the branch is a member. Generally, clearing houses are managed by the RBI or branches of State Bank of India having currency chest. In some cases, the clearing house may be managed by other banks also. Besides, there may be separate clearing houses managed by the same or by different banks for MICR (Magnetic Ink Character Recognition) and non-MICR instruments. Deposits in a customer's account can be made by any other person also (besides the customer himself).

4.44 All deposits are made by filling-in the relevant pay-in-slips. All pay-in-slips have two portions – one becomes the voucher for the bank and the other (the counterfoil) is returned to the depositor as acknowledgement of deposit.

4.45 For deposit of cash, the amount is deposited with the cashier authorised to receive cash who puts a scroll number and his initials on the voucher as also on the counterfoil. The counterfoil, duly signed and stamped, is handed over to the depositor and the voucher is eventually sent to the official responsible for maintaining the customer's account. The official enters the voucher in the account and puts his initials on it in token of having posted it in the customer's account. After posting, the voucher is sent to the cash book section or other section, as per the bank's procedure, which supervises the work relating to Day Books, at the end of the day.

4.46 For deposits of 'transfer' instruments, there is a designated counter which receives the pay-in-slips[4], tallies the particulars filled in the slip with the enclosed instruments, returns the duly signed, stamped and dated counterfoil to the depositor and records the particulars of the customer's account and the instrument in a register maintained for the purpose. This register is generally supervised by an official who sends both the pay-in-slip and the instrument to the desk where the instrument is to be handled, against

[4] The concept of having cheque drop boxes has also come into vogue wherein banks have almost done away with the system of having a separate counter for receiving cheques. Instead banks now maintain a locked cheque drop box in their premises alongwith a receiving acknowledgment stamp of the bank. The customers now fill up the cheque deposit slip and themselves put the bank's cheque receiving acknowledgement stamp on the bank's copy of the deposit slip as well as their own counterfoil and drop the cheque in the box. However, both the options are available to the customer as RBI Circular No. RPCD.CO.RF.BC.NO./40/07.40.06/2006-07 dated December 26, 2006 on "Cheque Drop Box Facility and the facility for acknowledgement of cheques" requires the banks to invariably display on the Cheque Drop-Box itself that "Customers can also tender the cheques at the counter and obtain acknowledgement on the pay-slips". Further, RBI vide its circular no.DPSS.CO.CHD.No. 485 / 03.06.01 / 2010-11 dated September 1, 2010 on "Dishonour / Return of Cheques - Need to Mention the 'Date of Return' in the Cheque Return Memo" mandates the banks to indicate the 'date of return' in the Cheque Return Memo.

the acknowledgement of the receiving official. (It may be clarified that a number of instruments can be tendered with one pay-in-slip provided they are all 'transfer' transactions, i.e., payable at the branch). The debit instrument is posted in the account concerned by the official handling the desk who then marks it with a 'Transfer' stamp with date and sends both the debit and the credit vouchers to the passing officer (details given later in the chapter). The officer puts his initials or signatures (as per the procedure in the bank) on both the vouchers. Thereafter, the credit voucher is sent to the Transfer Scroll in-charge who records brief particulars of both the debit and the credit vouchers in the scroll and sends the credit voucher to the desk where the customer's account is handled. Only the credit voucher `passed' by the competent official is posted in the account. In case the debit instrument cannot be paid for some reasons (insufficient funds/post-dated/different signatures/stale/ payment stopped by the drawer, etc.), the counter clerk records the particulars in a register, usually called 'Cheques Returned' register and seeks instructions from the branch manager or officer designated by the bank to deal with such matters. The competent official records his decision (to either pay or return the instrument) on the register. Normally, in case of payment of such instruments, the official records 'Pay' on the instruments also. If unpaid, the instrument is returned to the customer.

4.47 It is possible that there is more than one instrument along with a single pay-in-slip and these instruments are handled at different desks. In such cases, though the procedure outlined above is followed for passing the debit vouchers, the credit voucher may be authenticated, generally, by the official who passes the last debit voucher. Besides, it is also possible that out of many debit instruments, only a few are paid and the others returned. This would mean that the customers' account cannot be credited with the amount shown in the pay-in-slip. In such cases, banks generally credit the account with the amount mentioned in the slip and separately raise a debit for the amount of instruments returned. This is because the banks, on their own, cannot change the amount in the slip after having given the counterfoil to the depositor.

4.48 The customer can also deposit the 'clearing' instruments with the bank. When a customer deposits a clearing instrument with his bank, the designated desk in-charge checks the voucher and the instruments, gives stamped, signed and dated counterfoil to the depositor, enters the particulars in a register maintained for recording the pay-in-slips received from the customers, and sends the credit voucher along with the instrument to the clearing section in the branch. Once the clearing section receives confirmation of payment of an instrument lodged by it in the clearing house (local clearing usually takes 1-4 days and an instrument is generally deemed to be cleared if it is not received back within a certain time stipulated for the purpose, by the clearing house rules), its in-charge passes the credit vouchers which are sent to the section where the customer's account is handled, for posting in the customer's account. As regards the instruments received back unpaid, there are two ways of dealing with them. One is to credit the customer's account with the amount of pay-in-slip and then to debit the account with the amount of instruments returned. The other method is not to post the credit voucher at all and treat it as cancelled; this is, however, done only in cases where all the instruments lodged along with a particular pay-in-slip are returned unpaid. Credits also may come from RTGS (Real Time Gross Settlement), NEFT (National Electronic Fund Transfer) or ECS (Electronic Clearing System) which do not involve physical movement of cheques/payment instruments.

4.49 The customers also deposit various kinds of bills (including cheques), as under, payable in India or abroad:

- Bills for collection (against which the bank does not grant any advance to the customer).
- Bills for negotiation (against which the bank provides advance to the customers) – purchase of demand bills and discounting of usance bills.

4.50 Bills for collection are generally tendered along with a pay-in-slip whereas those for negotiation are tendered along with a letter from the customer. Where the instruments are for collection, these are handled by the Bills Collection Section. This section or any other designated desk in the branch accepts the pay-in-slip and the enclosed bills and gives acknowledgement (counterfoil) to the depositor. The details of the bills are entered in a Bill Collection Register. Each bill is allotted a distinctive number which is recorded on all vouchers/documents pertaining to the transaction. A forwarding schedule (or collection schedule) is prepared giving details of the instruments like drawee, date of instrument, any special instructions given by the drawer, etc. The bill is enclosed to this schedule and sent to the branch which has to collect the proceeds from the drawee. On receipt of the advice of the payment of the bill, the originating branch credits the customer's account with the amount of the bill paid (less any charges deducted by the collecting branch) and simultaneously recovers its own commission for handling the transaction by debit to the customer's account. The procedure stated above is common to both the demand and usance bills, though nomenclature of the registers and the forwarding schedules used for the purpose may be different.

4.51 As regards the bills tendered for negotiation, the transaction may relate to either the customers who have been granted regular limits for the facility or those who need this facility only occasionally. In the latter case, the bank would have prescribed an authority to approve the negotiation. Generally, bills are submitted by customers along with a forwarding letter while the cheques are submitted with a pay-in-slip, along with a request to negotiate the same. The cases of regular limits are handled by the Loan Section and the official dealing with the accounts or other designated authority approves the bills for negotiation after ensuring that the limit can accommodate the bills or that, in case of any overdrawing, these have been permitted by a competent authority. The bills negotiated are entered in the Purchase/Discount registers and the customer's bill account. Like the collection schedule, the Purchase/ Discount schedules are prepared and sent along with the bills to the branch concerned for realisation. The amount of the bills negotiated is immediately credited to the customer's account, after deducting the prescribed bank charges. In due course, on receipt of payment of the bills, along with overdue interest (if the bills are paid by the drawees after the due dates) or on return of the bills, if unpaid, the entry in the customer's account is reversed. In case of return, the amount of the bill, together with overdue interest at the rates prescribed by the bank, is recovered from the customer. The negotiation of the bills can also be done under the letters of credit (LCs) issued by a bank in favour of the customer. The accounting procedure in case of negotiation under LC is the same as explained above, however, the recording of such bills may be done in a separate set of registers. The negotiating branch also maintains a record of the due dates of bills negotiated and follows up with the realising branches if the proceeds are not received in time.

4.52 The accounting procedure for export bills – whether for collection or for negotiation – is essentially the same as that for domestic bills as discussed above; the books and registers may, however, have different names and columns, as these transactions involve conversion of a foreign currency into Indian rupees.

4.53 Some credits are made in customers' accounts by the bank itself, the most common example being the periodic interest on a deposit account and refund of any excess recoveries made earlier. In such cases, the bank may prepare either the pay-in-slip or the plain credit voucher. These vouchers also follow the same route as for those tendered by the customers except that such vouchers are not entered in the register meant for recording the instruments lodged by customers.

4.54 The cardinal principle followed by banks is that the credit is given to the customer only after the corresponding debit has been approved by an authorised official at the branch.

Debits to Customers' Accounts

4.55 In respect of a running account (mainly current/savings bank/cash credit), the most common source of debit is the cheque (or withdrawal form in the case of a savings bank account) or a letter of authority signed by the customer or RTGS/NEFT. In case the customer or the holder of the instrument wants to withdraw cash against this instrument, he presents it to the designated counter which maintains the ledger containing the drawer's account and, in acknowledgement, is given a token bearing a distinctive number. The counter staff records the token number on the instrument and obtains the presenter's signatures on the reverse of the instrument. He then verifies the balance in the account (credit balance in deposit accounts and limit sanctioned in advances accounts). If it is sufficient to meet the amount mentioned in the instrument, he posts it in the account, puts his initials on the instrument in token of having posted it and marks it with a 'pay cash' stamp. The instrument is then sent to the official in charge of that particular counter for authorising the payment. He authorises the payment of the instrument by signing it which serves as an instruction to the cash department to pay the amount to the presenter of the instrument. Each passing official maintains a payment scroll in which he records the account no., token no. and amount of the instrument passed by him. The serial number at which a particular instrument is noted in the official's scroll is recorded on the instrument also. Thereafter, duly passed instrument is sent for payment to the cash department in a `passed voucher book' or `transit voucher book'. The paying cashier acknowledges the receipt of the instrument by initialling the relative entry in the book which is returned to the passing official. The cashier obtains the token from the presenter as also his signatures on the reverse of the instrument which is an acknowledgement of receipt of amount by the presenter and makes payment to him. The particulars of payment including the denomination of notes/coins given in payment are recorded in the cashier's scroll. The serial number in the scroll at which the payment is entered is also recorded on the instrument and the `cash paid' stamp affixed on it under signatures or initials of the cashier.

4.56 The customer may want to purchase an instrument/receipt like Demand Draft, Mail Transfer, Telegraphic Transfer, Pay Order, Banker's cheque, Term Deposit, Call Deposit, Travellers' cheque, Gift cheque, or any other similar product of the bank, or make any payment to the government.

For the purpose, he tenders the debit instrument (cheque/authority letter, etc.) at the counter where his account is maintained, along with the appropriate credit voucher duly filled in (application form, pay-in-slip, challan, etc.). The counter staff verifies that the vouchers are in order and that sufficient balance is available in the account. He then posts the instrument in the account and the same procedure, as in case of cash payments, is followed upto the stage of authorisation by the official concerned except that instead of a 'Pay Cash' stamp, a 'Transfer' stamp is put by the counter staff on both the instrument and the credit voucher there against. After passing the debit and the credit vouchers, the official sends all the vouchers to the transfer scroll desk where the particulars of all the debit and credit vouchers are recorded and the credit vouchers sent to the respective desks which handle those products.

4.57 Customer's accounts are debited on account of instruments received in clearing also. All the instruments received through the clearing house, which are payable at the branch, are received by the clearing section and handed over to the desks concerned against acknowledgement. Subsequent procedure is the same as for transfer instruments except that there is no credit voucher with the instrument. The passing official has only to pass the debit instruments which bear the clearing stamp of the bank presenting them. The consolidated credit voucher is passed by the clearing section in-charge.

4.58 In case the counter staff notices that the balance in the account is inadequate to pay the instrument or the instrument is defective, he has to seek the instructions of the designated authority through the Cheques Returned Register.

4.59 Paragraphs 4.55 to 4.57 above deal with cases where the customer's account is debited on account of the instruments signed by him. In addition, there are cases in which the bank raises the debits to the customer's account on its own (though, of course, under intimation to the customer). The examples of such debits are:

- Carrying out the standing instructions received from the customer (including charges for executing these instructions).
- Payment of bills under letters of credit opened by the branch on behalf of the customer.
- Payment for guarantees issued at the request of the customer, which are duly invoked by the beneficiary.
- Periodic interest on loan accounts.

- Rectification of any erroneous entry in the account.
- Recovery of bank charges for which the bank holds an express or implied authority like loan application processing charges, ledger fees, inspection charges, locker rent, ATM annual charges, bill handling charges, issue of duplicate drafts etc., noting of 'stop payment instructions' given by the customer, return of cheques issued by the customer due to insufficiency of funds in the account, and so on.

4.60 A separate mention deserves to be made of the bills received by the branch for collection from its customer (being the drawee of the bill). On receipt of such a bill, the branch sends intimation to the drawee giving the details of the bill. The drawee presents a debit instrument for the amount to be paid (bill amount plus bank charges plus overdue interest, if applicable) to the Bills Section at the branch, along with the intimation received by him from the branch. He does not submit any credit voucher to the branch in such cases. The credit vouchers are internal to the branch and are prepared by the branch itself. The debit instrument given by the customer is processed like any other 'transfer' instrument, as discussed above.

4.61 Two points should be kept in view with regard to debits to the customers' account:

- Only the customers or their duly constituted attorneys can authorise a debit to the account (unlike a credit which can be made by any person).
- Debit instrument has to be passed first and the credit voucher only thereafter.

Issue of Drafts

4.62 Each bank has its own standard application form which has to be filled in by the applicant. Many banks have opened service branches at important centres. Wherever such branches exist, the outstation branches are instructed to draw the drafts only on them. In some cases, the drafts may be made payable on other banks also if there is such an arrangement between the issuing bank and the paying bank. Such type of transactions are quite common in international banking area.

4.63 If the customer wants to tender cash for purchase of the draft, he tenders the draft application and the required amount of cash (amount of draft and the bank commission) to the cashier concerned. The cashier, after making necessary entries in his books, releases the voucher which is sent to the drafts issue desk. The counter staff prepares the draft as per the customer's instructions, enters it in the Drafts Issued register, gets it signed by an authorised official, and hands it over to the applicant against his acknowledgement.

4.64 If the customer wants a draft against a transfer transaction (generally, a cheque drawn on his account), the voucher is prepared after the customer's account has been debited.

4.65 The branch may, at times, need to issue drafts (or banker's cheque or pay order) on its own account, e.g., for remittance of proceeds of a bill received for collection directly from the drawer of the bill. In such cases, the draft application is signed on behalf of the bank, giving particulars of the Bill No. paid; the remaining procedure is the same as described above.

4.66 In respect of drafts issued, an advice is generally sent to the drawee branch. Besides, some banks have a system whereby issue of drafts above a prescribed amount is also confirmed to the drawee branch by a coded telegram/by telephone or in any other mode.

4.67 Some important points to be noted with regard to issue of drafts are as follows:

- For drafts of small value (based on the cut-off level fixed by the bank), the advice regarding issue of draft may not be sent to the drawee branch.
- Some banks also fix a ceiling upto which the draft may be signed by a single official. Beyond this level, normally two officials have to sign the draft. Besides, the specimen signature, number of the official(s) signing the draft has to be mentioned on the draft.
- There is generally a ceiling (fixed by the RBI in consultation with the Central Government) upto which the drafts can be issued against deposit of cash. The ceiling may undergo revision from time to time.

4.68 At the end of the day, the counter staff works out the total amount of drafts issued on that day and the commission earned thereon. This figure is carried over to the Cash Book.

Issue of Mail Transfer/Telegraphic Transfer

4.69 These are two other modes of remittance of funds from one place to the other. The difference between the two is in the manner of transmission. Mail Transfer (MT) is sent by post to the paying branch whereas Telegraphic Transfer (TT) is sent by telegram (these days, some banks use fax also). MTs and TTs differ from drafts only in one respect. MTs/TTs are sent to the paying centre by the branch itself (under intimation to the customer) whereas draft is handed over to the customer who arranges to send it to the beneficiary. In terms of procedure, MTs/TTs are similar to draft.

Issue of Pay Orders/Banker's Cheques

4.70 These instruments are normally issued for local payments including local payments to be made by the issuing branch itself. The procedure is basically the same as for issue of drafts except that no advice is required.

Issue of Term Deposit/Call Deposits and Receipts and Similar Instruments

4.71 These instruments are issued in favour of the customers only and are akin to other accounts of the customers except that these are not running accounts (these days, however, some banks have developed hybrid products which contain features of term deposit, saving bank account and current account. For example, many banks have now started offering a facility of automatic transfer of the amount standing to the credit of the savings account of a customer to a fixed deposit account, subject to a certain minimum balance left therein. As and when the customer needs to withdraw an amount or issues an instrument of a value higher than the minimum balance in his account, the bank automatically transfers amount from the fixed deposit account to his savings account). Upto the point of receipt of credit voucher in the TDFR section, the procedure is same as that for credit to any other account of a customer. After receipt of the credit voucher, the procedure is generally on the following lines:

(a) The receipt is prepared in the bank's pre-printed standard format and contains the name of the account holder, the mode of payment of proceeds on maturity, the term of deposit, the interest rate, and the due date.

(b) In case the amount has been deposited under Re-investment Scheme, this fact is mentioned on the receipt. The maturity amount is also mentioned.

(c) Banks normally have separate sections in their Term Deposit registers, interest rate-wise and/or maturity period-wise, to record the issue of term deposit receipts in a chronological order.

(d) The official in charge of the term deposit section verifies the particulars on the receipt with reference to the deposit voucher, and signs the receipt which is then delivered to the depositor against acknowledgement.

(e) The banks maintain a Daily List to record the due dates of deposits as also the dates of payment of periodic interest on deposits, wherever applicable. Necessary entries are made in the list upon issuance of a term deposit receipt.

4.72 Instruments other than term deposit receipts (e.g., cash certificates) are entered in the relevant register in a similar manner.

Opening of Letters of Credit

4.73 Generally, this facility is provided by banks to their regular borrowers but there is no bar on extending this facility to other applicants also. The procedure for opening of letters of credit in either case is generally on the following lines:

(a) The applicant submits an application in the prescribed format to the branch wherein he mentions the name of the beneficiary, documents required from the beneficiary, and the expiry date of the validity of the letter of credit (LC) for the purpose of shipment as well as negotiation of documents by a bank.

(b) In case the bank agrees and issues the LC, it makes contra entries in its books. Necessary vouchers are prepared by the LC section. Normally, a composite voucher is used for these entries.

(c) The transaction is recorded in the LC Issued Register. In the case of customers who have been sanctioned regular LC limits (like a cash credit limit), to ensure that the outstanding LCs do not exceed the sanctioned limit, all issues of LCs are debited to the account (all payments or cancellations of LC are credited).

(d) LC opening charges are recovered from the customer, either by debit to his account or in cash.

(e) Banks generally maintain margin for each LC. It may be retained in any form – in current account, term deposit, lien on drawing power, etc.

(f) LC is prepared by the bank on pre-printed formats of the bank. Each LC has a distinctive number. The original (which is a negotiable copy) and one or two non-negotiable copies of the LC are sent to a bank (known as 'advising bank') for transmitting it to the beneficiary. Copies of the LC are given to the applicant also and at least one copy is retained on the branch records.

(g) The number of officials who have to sign the LC may differ from bank to bank.

4.74 In terms of issue procedure, there is hardly any difference between an inland LC and a foreign LC. However, foreign LCs can be issued only by branches authorised to undertake foreign exchange transactions. Also, foreign LCs outstanding at the year-end require re-statement in rupee terms.

Issue of Bank Guarantees

4.75 In terms of procedure, bank guarantees are similar to LCs. However, the original guarantee is also handed over to the applicant who submits it to the beneficiary. Also, bank guarantees are issued on non-judicial stamp papers whereas LCs are issued in bank's pre-printed formats.

Issue of Traveller's Cheques/Gift Cheques

4.76 There are prescribed application forms for these cheques and the procedure for issue is similar to issue of banker's cheques. However, in the case of Traveller's Cheques, the applicant has to sign on the cheque once in the presence of the bank's authorised official. The branch may issue Travellers' Cheques of its own bank and/or those of its correspondents in terms of an approved arrangement.

4.77 In each bank, there is a nodal office for Traveller's Cheques. Particulars of all cheques issued by the branch are required to be advised by the branch to the nodal office through the inter-office accounting system. The Branches do not normally have a Traveller's Cheques account in their General Ledger as they act merely as agent of the nodal office in issuing (and paying) Traveller's Cheques.

4.78 Gift cheques are payable by the issuing branch only. Each branch maintains a Gift Cheques account. All issues are credited to the account and details of the cheques entered in a register. Payments are debited to this account. For the sake of operational convenience, the Gift Cheques register is divided into separate sections, denomination-wise.

Payment of Drafts

4.79 The drafts issued by banks are invariably payable 'to order' and never 'to bearer' since the issuance of drafts as 'payable to bearer' would tantamount to issuing currency, which banks are not authorised to do.

4.80 When a draft is presented to the branch on which it is made payable (whether for payment in cash or transfer to an account at the same branch or through the clearing house), the instrument is sent to the Drafts Payment Section. The section usually maintains two kinds of Drafts Paid Registers:

(a) To record payment of drafts for which no advice is required from the issuing branch as per the bank's procedure.

(b) To record payment of drafts for which the aforesaid advice is required.

4.81 The counter staff enters the particulars in the relevant register after ensuring the *prima facie* correctness of the draft, particularly the drawee branch code number. In respect of drafts falling in category (b) above, though the advice from the issuing branch is required, the branch has to make payment of the draft even if it has not received its advice from the issuing branch till the time of payment. The advices received are marked off in the drafts paid register at the time of payment if advice has been received, or later, on receipt of the advice. For those entries in the register in respect of which the advice is not received, the matter is followed up with the issuing branch. After recording the particulars of the draft in the register, it is sent to the official in-charge along with the draft for verification of the correctness and for authorising the payment (in cash or by credit to the customer's account). The subsequent procedure is the same as that for other payment instruments. It may be mentioned here that separate registers are maintained for payment of drafts drawn by the correspondent banks.

4.82 Banks generally have a Drafts account to which all drafts issued are credited and all payments debited. Some banks have separate accounts for 'Drafts Issued' and 'Drafts Paid'.

4.83 Sometimes, the buyer of the draft may want to have it cancelled. This can be done only by the issuing branch. In addition to the usual procedures for payment of drafts, the following steps are also required to be taken:

(a) The fact that it is a case of cancellation is mentioned in the Drafts Paid Register and against the relative entry in the Drafts Issued Register.

(b) It is a common practice amongst banks to obtain a receipt from the buyer of the draft by endorsement on its reverse.

4.84 At the end of the day, a summary of the total drafts paid is prepared. This figure is carried over to the Cash Book.

Payment of MTs/TTs

4.85 As soon as the MTs are received by the branch, these are paid by crediting the account mentioned in the MT. These are entered in an MT paid register and the day's total of the register is debited to an inter-office account. The treatment of TTs is slightly different. The advice of remittance sent by telegram is followed by a written advice signed by the authorised officials of the issuing branch. Payment of TTs is also routed through the inter-office account. As the signed advices are generally not available when the telegraphic advice reaches the paying branch, the payment may be effected by debit to the Suspense Account or an Items in-Transit Account and the account of the beneficiary, stated in the TT, credited. Besides the above, the transaction is also recorded in TTs Paid Register. All entries in this register show the date of receipt of the signed advice from the issuing branch.

4.86 MTs and TTs are not paid in cash; they are credited to the accounts of the payees maintained at the branch; in case the payee does not maintain account with the branch, a Pay Order is issued in his favour.

4.87 The entry in Suspense Account/Items in-Transit Account is adjusted on receipt of advice from the issuing branch.

Payment of Banker's Cheques/Pay Orders

4.88 The procedure followed is similar to payment of any other cheque drawn on the branch, except that the date of payment is recorded against the original issue entry.

Payment of Term Deposit Receipts and Similar Instruments

4.89 These instruments are 'Not Transferable' and have to be paid strictly in accordance with the mandate of the deposit-holder received at the time of acceptance of the deposit or as modified subsequently by the deposit-holder. The deposit may be repaid before maturity (at the request of the account holder), on the date of maturity, or after the date of maturity. The salient features of the payment procedure are as under:

(a) The deposit receipt, duly discharged, has to be presented for payment. In case the receipt is in the custody of the branch (under lien for any loan or as margin for any facility), it is withdrawn by making necessary entries in the Safe Custody Ledger/Register.

(b) The deposit may be repaid in cash (subject to any ceiling on such cash payments, under statutory or regulatory requirements) or by way of a 'transfer' transaction. As these receipts are not negotiable, these are not routed through the clearing house but sent to the issuing branch for collection of proceeds.

(c) The 'transfer' transaction is either for renewal of the deposit or for credit in full or part to any account maintained at the branch, or for issue of draft /MT/TT/Pay order, etc.

(d) The payment is recorded as a debit to the relevant deposit account and the date of payment recorded against the original entry of issue. The principal amount of the deposit is debited to the deposit account to which it was credited at the time of issue. Interest paid is debited to the concerned provision account for the deposit if such an account is created by the bank or to the account in which such provision is held (amount of interest paid is net of TDS, if applicable). In this regard, it may be noted that generally, the branches create an Interest Provision Account for all interest-bearing deposits to which the amounts calculated at the rates advised by the Head Office are credited every month. This is done to arrive at the profit/loss of the branch and to calculate the bank's liability on an ongoing basis. All payments during the day are totalled and carried over to the Cash Book.

(e) Banks generally do not hold the matured deposits in their regular deposit accounts. On the due dates, those deposits which remain unpaid are transferred in a separate account, usually called as 'Overdue Deposits Account'. These deposits are eventually paid or renewed.

(f) For deposits paid before their scheduled maturity, interest is paid only for the actual period of deposit and not the contracted period. Also, banks may decide to levy some penalty for premature payment.

(g) Normally, for each renewal of the original deposit, banks issue a fresh deposit receipt. Of late, however, some banks have started the facility of automatic renewal of deposits on the due dates and may not issue any fresh receipt but just record the fact of renewal on the original receipt.

(h) The deposits are freely transferable at the request of the depositors from one branch of the bank to another. In such cases, the issuing branch transfers the deposit amount, together with the accrued interest amount held in its books, to the transferee branch along with an advice of transfer (the funds may be remitted by draft/TT/any other mode as per the Bank's procedure).

Payment of Recurring Deposits

4.90 Banks provide a Pass Book to the depositor wherein entries are made at the time of deposit or later, as demanded by the account holder. At the time of payment (before/on/after maturity), the depositor has to produce this Pass Book to the branch to record the fact of closure of the account. Generally, banks have a provision to recover from the interest payable on the deposit a specified sum for late deposit of any instalment under the scheme. At the time of payment, the principal amount deposited is debited to the Recurring Deposit Account and the interest paid is debited to the concerned interest provision account. The procedure for payment in cash/by transfer is the same as in the case of Term Deposits.

Payment of Call Deposits

4.91 Most of the call deposits are required by the customers for submission to various authorities like Excise & Customs, PWD, Railways, etc., in connection with their tenders/orders. The deposits are in the names of these authorities only and not in the names of the customers. For payment of such deposits to the customers, the banks demand a release letter or an authority letter from the authority in whose favour the deposit was issued. These deposits are, generally, non-interest bearing. The procedure for payment is the same as in the case of Term Deposits.

Payments under Letters of Credit

4.92 Payments under letters of credit involve:

(a) Payment of the bills by the branch named in the LC as the 'negotiating bank'. Such payment may be made even in a case where no such name is mentioned in the LC.

(b) Eventual payment of the bills by the LC opening branch to the negotiating bank.

4.93 In some cases, the same branch may act as both the LC opening bank and the negotiating bank, i.e., it opens the LC for customer 'A' in favour of 'B' and also negotiates bills under the same LC when presented by 'B' who may or may not be an existing customer of the branch. The procedure for payment of the bills, described below, is equally applicable to both the cases. However, for the sake of clear understanding, the terms 'Opening Bank' (OB) and the 'Negotiating Bank' (NB) have been used though it is recognised that in some cases, the same branch may perform the functions of both of them.

(a) The original LC is in the custody of the customer, i.e., the beneficiary of the LC. He may approach any bank to negotiate the documents if there is no NB designated in the LC. The bank may agree to the request or may refuse it. In case the NB has been designated, the customer has to approach that bank only. This bank cannot generally refuse negotiation because its name would have been mentioned only in accordance with an approved arrangement.

(b) The customer has to produce the original LC and all the documents stipulated in the LC to the NB.

(c) NB examines all the documents and compares them with what has been stipulated in the LC. NB also ensures that the shipment took place within the validity mentioned in the LC and that the documents have been presented for negotiation within the validity stipulated in the LC. If there is any difference in compliance with the terms and conditions mentioned in the LC, the OB may refuse to make payment to NB.

(d) In case NB observes certain discrepancies in the documents submitted by the customer, it may still decide to negotiate them at the risk of the customer. Such negotiations are referred to as 'negotiations under reserve' in the banking parlance. In such cases, NB obtains a written undertaking from the customer to make good the amount (together with bank charges) if payment is ultimately refused by OB. Another common practice for such bills is that before negotiation, NB brings the discrepancies to the notice of OB and seeks instructions. In turn, OB seeks the customer's instructions which are conveyed to NB.

(e) Once a decision to negotiate has been taken by the branch, it enters the particulars of the bills in a Bill Negotiation Register (generally, banks maintain a separate register for negotiation under LCs). A distinctive number is allotted to each negotiation which is recorded on each document of the bill. The date and amount of negotiation are mentioned on the reverse of the LC and signed by an authorised official. Charges on negotiation are to be borne by the party mentioned in the LC – it may be either the beneficiary or the opener of the LC. In case the beneficiary has to bear the charges, the bank will deduct these charges from the bill amount and pay only the net amount to the customer. In case the charges are to the opener's account, the NB will pay the bill amount to the customer and claim the bill amount plus the negotiation charges from OB. The account to be debited by NB at the time of negotiation is different in different situations, as under:

    (i) In case of demand LCs, where OB and NB are the same bank, the LC would generally state that NB should debit the OB through the inter-office account on negotiation. For usance LCs in this situation, the LCs normally authorise NB to debit the OB, through the inter-office account, on due date of the bill. In the latter case, the NB normally debits its own Bills account (may be called Bills Discounted account) at the time of negotiation – the entry is reversed on the due date by debiting OB through the inter-office account.

(ii) In case of LCs (both demand and usance) where OB and NB are different banks, the LC itself states the manner in which the NB should obtain reimbursement of the bills negotiated from the OB. The NB acts accordingly. Pending receipt of reimbursement, the NB generally keeps the debit in its own Bills Account.

4.94 After negotiation, the documents are sent by NB to OB for final payment. When the documents are received at the OB, the procedure followed is on the following lines:

(a) The designated section at the branch records receipt of bills in a specified register.

(b) The documents received from NB are compared with the terms of the LC. In case of any discrepancy, it is immediately brought to the notice of the NB as well as the opener. The branch seeks instructions of the customer whether he wants to accept the documents despite these discrepancies or not.

(c) In case the documents are discrepant and are not acceptable to the customer, OB returns the entire set of documents unpaid to NB. In turn, NB recovers the amount of bill, its own charges as also the charges levied by OB, if any, from the beneficiary of the LC. The fact of return is recorded by the OB in its registers.

(d) In case the bill is in order or the discrepancies are acceptable to the customer, OB recovers the amount of bill and the other charges, if any, from the customer.

(e) In addition to the above debit and credit entries, the contra entries made at the time of issue of LC are also reversed by the amount of LC utilised on payment of bills. This is done by way of a composite voucher. Besides, the amount and date of payment are recorded in the LC register and the Bill register.

(f) On expiry of the validity of the LC, the OB waits for a reasonable period from that date for receipt of negotiated documents from NB. In case no documents are received, the OB reverses the amount of unutilised LC in its contra accounts.

(g) In case the beneficiary does not want the bills to be negotiated and instead, wants these to be sent for collection by his bank, he may do so. The accounting procedure at OB in this case is broadly similar to negotiated bills.

Payments Under Bank Guarantees

4.95 The following procedure is followed where the customer fails to discharge his contractual obligations and the beneficiary invokes the guarantee:

(a) The section handling the guarantees business at the branch examines the notice of invocation to ascertain that it is strictly in accordance with the terms of the guarantee. The branches generally seek legal opinion on the issue either from inside or outside.

(b) In case the invocation is not in order, suitable reply is sent to the beneficiary.

(c) In case the invocation is in order, the amount demanded by the beneficiary, not exceeding the amount guaranteed, is remitted to the beneficiary. The contra entry in the Bank Guarantee Account, made at the time of issue of the guarantee, is reversed by the total amount of the guarantee if the guarantee has been treated as fully discharged by the beneficiary, notwithstanding that the amount actually paid is different. The branch, in turn, recovers the amount from the customer.

(d) In case the beneficiary does not want the bills to be negotiated and instead, wants these to be sent for collection by his bank, he may do so. The accounting procedure at OB in this case is broadly similar to that followed in the case of negotiated bills.

Payments Under Deferred Payment Guarantees

4.96 On due dates of instalments, the bank remits the principal and the interest due to the beneficiary. Procedurally, payments under deferred payment guarantees are similar to payments under the bank guarantees or under LC. One distinctive feature is that the bank's liability to the beneficiary and the corresponding liability of the customer to the bank get reduced with each payment. On each such payment, the contra entries are reversed by the amount paid.

Payment of Gift Cheques

4.97 These cheques are honoured by all branches of a bank irrespective of the branch which has issued them. In case the cheque is presented to the issuing branch for payment, the branch records the payment in its Gift Cheques Register. The date of payment is mentioned against the relative issue entry also. The other procedures are the same for as payment of any other cheque. The amount of gift cheques paid during a day is debited to the Gift Cheques Account.

4.98 In case the cheque is presented to any other branch of the bank, it is paid by that branch by way of a debit to the issuing branch through the inter-office account.

Payment of Traveller's Cheques

4.99 Mostly, these cheques are presented for payment in cash by the purchaser of the cheque. In some cases, where the hotels, merchant establishments, etc., accept these cheques in payment of their bills, they obtain signatures along with date from the customers and then deposit these cheques with their bank for payment.

4.100 When presented for payment in cash, these are presented to the paying cashier in whose presence the customer has to put his signatures with date. The cashier tallies these signatures with the first signatures appearing on the cheque (which were obtained in the issuing branch) and, on being satisfied about the genuineness of the transaction, makes the payment. In the process, he may also refer to the list of lost/stolen Traveller's Cheques available at the branch, which is received from the head office. The amount of all cheques paid during the day is debited to the nodal office designated for these cheques. In case payment of cheques is by way of a transfer transaction, the desk concerned records the particulars of payment in a register and the official in-charge authorises the credit voucher; the debit voucher is normally prepared at the end of the day for all Traveller's Cheques paid on that day.

4.101 It is possible in some cases that the customer may deposit the unused Traveller's Cheques with the issuing branch itself. In such cases also, the procedure is similar to that for other 'transfer' transactions.

Cash Transactions

4.102 Many of the transactions described above involve receipt or payment of cash by the bank. In describing such transactions above, the emphasis has been on the other aspect of each transaction rather than on cash receipt/payment. The following paragraphs deal with flow of cash transactions – receipts as well as payments – primarily from the angle of accounting for, and controls over, cash receipts and payments irrespective of the nature of transaction giving rise to cash receipt or cash payment.

4.103 'Receipt' and 'payment' of currency are two of the most important functions of a bank. 'Cashiers' and 'tellers' perform these functions. The tellers provide only limited services (types of services and monetary ceiling may differ from bank to bank) while cashiers have no such limitations. The tellers do not generally make payments out of loan accounts. Cash and other valuable items like security forms are kept in the strong room and held in the joint custody of two or more officials of the branch, one of whom is the Head Cashier and the other, normally, the Accountant.

4.104 Currency notes are packed in packets of 100 pieces each, irrespective of the denomination. A slip is put on each packet which carries the initials or signatures of the staff members who have verified and re-verified the quality and quantity of the notes, along with the date of such checking (the procedure may vary slightly among different banks). Coins are stocked in bags. These are weighed and then valued according to a specific weight-value ratio for each type of coin.

4.105 Depending upon the possession and ownership of cash, branches are divided into three categories:

(a) Currency Chest Branches: These branches hold cash as an agent of RBI. Each chest branch is linked to a currency office of RBI through a link branch of its own bank. Loose packets are not kept in the chest. Every day, the branch withdraws cash from and deposits cash into the chest according to its requirements. At the end of the day, the branch works out the net position as compared to the previous day's closing balance in the chest and sends an advice to link branch (the position of the repository branches is also included, as explained later). The balances in the chest are periodically verified by the bank's officials as well as by RBI officials. Even in a currency chest, the branch will maintain some cash in hand on its own account, though such balance may be nominal.

(b) Repository Branches: These branches carry smaller cash holding than the chest branches but act as a part of the chest. They are linked to a chest branch and report the net withdrawal/net deposit position each day to the link branch.

(c) Hand Balance Branches: These branches carry cash only as their own hand balances. The limit for peak holding at such branches on any day is fixed by their controlling authorities. Whenever the branch has any surplus cash, it deposits the amount with a currency chest branch.

Receipts

4.106 The steps involved in physical receipt of cash and its accounting are as follows:

(a) The cash tendered by the depositor is checked by the cashier for the genuineness of the notes and to cross check the number of notes as mentioned by the depositor in the pay-in-slip.

(b) If found in order, the cashier records the particulars of notes received and the account to be credited in the book maintained by him (usually called Cashier's Receipt Scroll). He then puts 'Cash Received' stamp on the pay-in-slip and the counterfoil and signs them; the counterfoil is returned to the depositor.

(c) The pay-in-slips are sent from the cash department to a desk which notes down all receipts of cash in the department in a jotting book. The total of this book thus reflects the total cash received at the branch during the day.

(d) After noting in the jotting book, the voucher is sent to the concerned desk for credit to the relevant account.

(e) After the day's transactions are over, all the receiving cashiers hand over the cash, which should agree with the total of cash receipt scroll, to the Head Cashier.

(f) Banks also deposit cash with other banks, usually for credit to their accounts. At times, the receiving branch is unable to cope up with the volume of work and does not count all the notes on the same day. In such circumstances, the uncounted amount is held as a 'Bond' system in which the depositing bank gives a written confirmation of the correctness of the amount and undertakes to make good the shortage, if found during the actual counting later. This amount may be counted at the convenience of both the banks in due course.

4.107 The steps involved in making cash payments and their accounting are as follows:

(a) All paying cashiers (including tellers) are given some amount of cash at the start of the day by the Head Cashier against acknowledgement for their expected requirements during the day. They may be given cash in instalments also during the course of the day. They receive instruments for payment either directly at the counter (for tellers) or instruments authorised for payment through the voucher books (for cashiers). They obtain the signatures/thumb impression of the person receiving the payment. Each payment is recorded in a payment scroll maintained by each paying cashier and teller. The instruments paid by the tellers are then sent to the concerned desks for debiting the relevant accounts and authorisation by the officials in-charge of the desks. The instruments paid by cashiers are sent to the desk which carried out the Day Book related work at the end of the day.

(b) After the day's transactions are over, the cashiers return the cash balance with them to the Head Cashier. The balance should agree with the books, i.e., cash received by the cashier less the total of his payment scroll.

4.108 The 'receipts' and 'payments' have been discussed above separately for the sake of a clear understanding. In practice, a single cashier may perform both the activities. Likewise, a single teller may receive cash, pay cash, issue drafts, pay Traveller's Cheques, and so on.

4.109 After accounting for all the cash received from the cashiers, the Head Cashier prepares a summary of the day's transactions and the cash balance register and signs them. If any excess cash is found during counting, the amount is held in a special account and is refunded to the genuine claimant on demand or if there is no such claimant, the bank treats it as income. However, shortage in cash has to be made good by the cashiers concerned and the matter has to be reported to the higher authorities.

4.110 The currency chest branches meet their requirement of notes by remittances from the RBI. They also send remittances of soiled notes in their custody to RBI from time to time. In case RBI comes across any shortage in the remittance sent to it during counting in the presence of a cashier from the remitting branch, it informs the branch which has to make good the amount.

Incomplete Records

4.111 In some situations, the auditor may find that certain accounting and other records are not up-to-date. In such a situation, the auditor should first ascertain the extent of arrears in house-keeping, and the areas in which accounting and other records are not up-to-date. In case it is found that the General Ledger, the main cash book, or the trial balances are in arrears or that they do not tally, the auditor should consider expressing a qualified opinion, adverse opinion or disclaimer of opinion, as may be appropriate in the circumstances. In case any subsidiary ledgers are in arrears, the auditor should consider the impact of such arrears on the financial statements of the bank. It may be pointed out that in the absence of balanced and up-to-date subsidiary ledgers, verification of transactions or of year-end balances may become difficult. In such cases also, the auditor should consider expressing a qualified opinion, adverse opinion or disclaimer of opinion, as may be appropriate in the circumstances. It may also be noted that in Long Form Audit Report (LFAR), the auditor has to make detailed observations on such arrears of house-keeping. Therefore, from this point of view also, it is important for the auditor to satisfy himself about the completeness of all records before submitting his audit report.

CIS Systems in Banks

4.112 CIS systems of different banks differ in terms of hardware configuration, software capabilities, levels of hardware and software security, and nature of transactions processed. It is, therefore, not possible to identify a single CIS system that would describe all the features of such systems in operation in different banks. However, the following description of the CIS system of a large bank illustrates the usual manner of computerised information processing and the various controls built into the CIS system. Auditor should check the accuracy, correctness of data and also see that data has been correctly transferred from the previous years audited statements and for this he need to go through the audit trail of modifications/change made. Most of the Banks are working on Core banking now a days and hence the accounting system under the same and the control in place for the same are very important from the bank's perspective as well as from auditors perspective.

Controls

4.113 The system provides for a number of controls which seek to ensure that the system is not put to unauthorised use, the transactions entered in the system are valid and accurate, and exceptional matters as well as other significant matters are reported on a timely basis. For example, the following controls seek to ensure that the system is not put to unauthorised use:

- A valid login name and password are essential to enter the system.
- A user can login from a specified workstation only.
- A minimum password length is required.
- The password needs to be changed at least once during a prescribed period.

- The maximum number of attempts to enter the system from a workstation is specified. Thus, if an incorrect password(s) is entered from a workstation, as soon as the number of attempts reaches the specified limit, the user is locked out and a message to this effect, identifying the workstation, is flashed on the system administrator's console/other workstations.
- Access to the system is available only between stipulated hours and specified days only.
- Individual users can access only specified directories and files.
- The access to various menus (such as opening of an account, closing of an account, change in limit or drawing power in a cash credit account, interest rate change, cheque book issue, etc.) is controlled through passwords. Thus, while an operator may enter the system using his login name and password, he cannot access the menus that have been password protected for use by systems administrator only.
- The access to systems software is restricted through password protection. (*The systems software contains several utilities such as copy, delete, etc. that can be used for unauthorised copying or deletion of files*.)
- Exception situations such as limit excess, reactivating dormant accounts, etc., can be handled only with a valid supervisory level password.
- A user timeout is prescribed. If the keyboard of a workstation remains inactive for the specified duration (say 30 seconds), the user has to re-enter the system using his password. This control prevents any unauthorised use when a workstation is left unattended.
- Wherever any rectification or alteration is carried out by more than one level of the officers, such alterations or changes are made as an additional entry and not by changing or deleting an existing recorded entry.
- Once the end-of-the-day process is over, the ledgers cannot be opened without a supervisory level password.
- The system maintains a record of all log-ins and log-outs. The access to this record is not possible without the systems administrator's password.

4.114 Similarly, the following controls seek to ensure the validity and accuracy of transactions entered in the system.

- The operation instructions such as single operation, joint operation, either or survivor operation, are flashed on the screen when the account is accessed.

- The system checks for cheque number range and stop payment instructions before processing a transaction.
- The system checks whether the amount to be withdrawn is within the drawing power.
- The system flashes a message if the balance in a lien account would fall below the lien amount after the processing of the transaction. The transaction processing is halted and can be proceeded with only with a supervisory password.
- If the transaction is sought to be posted to a dormant (or inoperative) account, the processing is halted and can be proceeded only with a supervisory password.

4.115 The branch manager is required to send a certificate to the controlling authority at stipulated intervals regarding the functioning of the entire computerised system including compliance with prescribed procedures and processes.

Structure

4.116 The system is multi-currency, on-line real time system which allows accounts to be maintained in a number of currencies. A separate General Ledger is maintained for each currency.

4.117 While the General Ledger (GL) provides the topmost level in aggregation of transactions and balances, the lowest level is a detail account which may be a customer's account or other account such as commission on drafts, locker rent, bill handling charges, etc. The number of levels between the GL and detail accounts is dependent on the requirements of the management and may differ from system to system. In the system under discussion, the GL (for each currency) is divided into a number of 'controls' each of which in turn is divided into a number of the 'memos'. A 'control' is similar to a General Ledger Account in a manual system, with the difference that unlike a GL account in the manual system to which debit and credit transactions can be posted directly, a control is merely a sub-division of the GL and is not an account. For example, 'Current Account' is one of the 'controls'. 'Memos' provide sub-divisions of a 'control'. For example, separate memos under 'Current Accounts' may be maintained for commercial and institutional customers' Current Accounts, agriculture-sector current accounts, and so on. The number of 'controls' that can be opened under General Ledger for each currency and the number of memos that can be opened under a control may differ from system to system (in the system under discussion, the maximum number of controls is 36 while the maximum number of memos under each control is 1296.). Detail accounts are opened under a memo. For example, all current accounts of C & I will be opened under the memo 'Current Account (C & I)'.

4.118 A transaction is posted to a detail account only. The detail account balances are updated as the transactions take place, i.e., on a real-time basis. The control and memo balances are updated only at the end of the day. All the books are balanced every day.

'Start-of-the-Day' Process

4.119 Each computerised branch has one or two designated officials to perform the role of the Systems Administrator. The computer operations everyday begin with a 'start-of-the-day' (SOD) process carried out by the System Administrator. Unless SOD is completed, the system cannot be used for data entry. Among the major activities undertaken by the system as part of SOD are changing the date, clearing the log files, diary processing interest application in those accounts where it is due on that day, deposits due for payment on the day, standing orders[5], and list of stopped cheques/drafts[6].

Recording of Transactions

4.120 As already stated, the transactions are processed on a real-time based on vouchers. The debit and credit aspects of a transaction have to be posted to the respective ledger accounts simultaneously in all cases. The accounts to which the credit aspect of a transaction is to be posted get updated simultaneously when the account to which the debit pertains is posted.

Single Transaction Update of Multiple Computer Files

4.121 A single transaction input into a CIS system may automatically update all records associated with the transaction. For example, if credit voucher for issue of a Fixed Deposit is input, information in the following types of records will get entered simultaneously and automatically:

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[5] Some customers give standing instructions to the bank to make certain remittances on pre-determined dates. The system will generate a list of those standing instructions which are to be carried out on that day.

[6] In some cases, the customers may have advised the bank not to make payments of certain cheques issued by them. These instructions are duly recorded in the system upon receipt from the customers. Besides, it may happen that the bank itself may stop payment of certain instruments, in particular drafts, if some draft forms are lost or stolen. Particulars of such instruments are entered in the system and these are treated as stopped instruments.

- FD day book
- Customer's account (if a running account for issue of FDs is maintained in terms of the Bank's system)
- Daily list (to record payment of periodic interest and repayment of principal)
- Classification of deposit into proper interest rate profile and maturity profile
- FD interest account

4.122 Single transaction update of multiple files ensures that all relevant records are kept up-to-date. However, it also implies that if one erroneous input is made, many records will contain errors.

Vulnerability of Data and Program Storage Media

4.123 Floppy disks, magnetic tapes, hard disks, etc. – the usual media on which data and programs are stored –are susceptible to intentional or accidental destruction. Portable media are also particularly prone to theft, loss, etc., as well as to computer virus. The vulnerability of CIS systems requires extensive internal controls against thefts, loss, and destruction or unauthorised alteration of programs and data.

On-line Checking

4.124 All transactions posted at a terminal by an operator need to be checked by a supervisor on-line as soon as practicable after its entry to ensure that the data has been correctly fed into the system. All checked transactions are marked by the supervisory with his ID. (Usually, the operator, while posting the voucher, indicates the ID of the supervisor who has to authenticate the entry. When the supervisor opens the screen, he will find 'yes/no' command against the entry under a suitable heading for authenticating it. If he presses 'y' the entry is taken as passed.)

'End-of-the-Day' Process

4.125 After all the transactions for the day have been inputed and passed by the supervisor concerned, the 'end-of-the-day' (EOD) process begins. EOD involves the following major activities:

- Verification of the integrity of all the transactions entered in the system by comparing the total of balances in detail accounts under each memo with the aggregate of the opening balance of memo and the transactions for the day. Similar checking is done for integrity of memos by comparing the total of all memos under a control with the updated balance of the control.

- Diary processing.
- Interest re-calculation and interest accrual.
- Standing orders.
- Generating statements of account.
- Generating various types of reports, including exception reports.
- Printing of logs.
- Daybook printing.

While the SOD or EOD processes are on, the system does not allow any data entry.

Backups

4.126 After EOD, the stipulated number of backups are taken on the prescribed media. The system provides for off-site backup of at least one copy of the updated data. The back up is required to be retained as part of the branch records as per the policy formulated by the bank for retention of records.

Exception Reports and Other Reports

4.127 The generation of exception reports is an important aspect of the system. These reports relate to cases which deserve the attention of appropriate levels of branch management. While most of these reports relate to operational aspects of transactions, some relate to the functioning of the CIS system. Besides, some other reports are also generated for the purposes of record. Some of the major reports generated by the system daily are:

- Debit/credit balance change
- Value dated before last rate change
- Value dated before last interest application date
- Maturity record deleted
- Automatically generated accounts
- Inactive accounts
- Dormant accounts reactivated
- Excess allowed over the limits/drawing power
- Irregular term loan accounts with number of arrears of instalments and

interest with amounts

- Debits to income head account
- Debits to head office accounts
- Overdue pre-shipment and post-shipment accounts
- Overdue bills and bills returned
- Withdrawals against clearings
- Time barred demand promissory notes
- Unchecked transactions
- Sign-on attempt from two terminals
- Exit to operating system
- Password errors
- Sign-on report
- Sign-off report
- Deposit accounts – debit balances
- Zero balance and non-zero accrued interest accounts[7]
- Debit balance accounts without interest rate
- Loans and advances – credit balances
- Temporary overdrafts allowed beyond the sanction period.
- Items pending in clearing.
- Inter-branch transactions with age-wise details.[8]

[7] This relates to closed advances account. Whenever an account is closed, it should be squared off together with the interest due thereon till the date of closure. It may sometimes happen that the account may be brought to nil balance but the accrued interest may remain unrealised. As the system calculates the accrued interest everyday as part of the SOD process, it will show the accounts of the above type as unusual.

[8] Banks have an 'inter-branch-items-in-transit' account wherein the entries are parked when a telegraphic advice is received from the other branch. These entries are reversed in the IBIT account by debit to 'Branch Clearing General Account' when the normal advice in the bank's prescribed format, duly signed, is received from the other branch by post. Such advices must be received within a reasonable time after the telegraphic advice. The intention behind the report in question is to keep a check on the receipt of written advices for such items kept in IBIT account. The age-wise details will show whether the entry has been outstanding in the IBIT account for less than 15 days, more than 30 days, more than 90 days or so on. Such entries require special attention because non or delayed receipt of advices may indicate fraud or other malpractices.

Computerised Accounting and Core Banking Solutions

4.128 In the preceding paragraphs, the conventional book keeping and manual accounting practises were discussed. The developments in the field of user-friendly systems and solutions have brought a sea change in the accounting atmosphere in the banking industry. Systems and solutions have been developed to cater to the banking requirements without compromising on the basic principle of integrity of information and recording of each and every transaction at any stage. Banks cannot afford to have an error level of even 0.0001% and hence the solutions have been developed to maintain the sterile levels.

4.129 These systems and solutions are generally audited, reviewed and examined at frequent intervals by the banks to ensure correctness of the data. The banks generally document such reviews and these documents would throw light on the effectiveness of the accounting system of the bank and reliability of its accounting data.

4.130 SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" lays down that the use of Information Technology (IT) affects the way control activities are implemented. From the auditor's perspective, controls over IT system are effective when they maintain the integrity of the information and the security of the data such systems process, and includes effective IT controls and application controls. In recent years, many banks have moved towards computerisation of their operations. The degree of computerisation, however, varies among different banks and also among various branches of the same bank. While some branches have been fully computerised, some others have been partly computerised while many others are non-computerised. In fully computerised branches, all the customers' transactions as well as internal transactions of the bank, which enter the books of the account of the branch, are routed through a computer system, which may comprise either a computer network or stand-alone personal computers.

4.131 It may be stated here that even in a fully computerised branch, some work is presently carried out manually, e.g., preparation of vouchers, preparation of letters of credit and guarantees, preparation of some returns and statements, etc. In partly computerised branches, generally the back-office work (i.e., the internal processing of transactions of the branch) is carried out on computers whereas the customers' transactions (i.e., the front-office work) are processed manually. Many of the banks in the private sector have networked all or most of their branches in the country; this has given them the capability of handling most of the transactions of their customers at any of the branches.

PART - II

II-1
Initial Considerations

1.01 This Chapter discusses the matters to be considered by a proposed central auditor/branch auditor upon receiving intimation of appointment. It also deals with aspects of preliminary work to be undertaken by the central/branch auditor before actually commencing the audit work.

Head Office

1.02 Most banks, especially those in public sector, appoint two or more firms of chartered accountants to act jointly as central auditors.

1.03 The letter sent by banks in connection with the appointment of central auditors typically contains the following:

- Particulars of other central auditors.
- Particulars of previous auditors.
- Procedural requirements to be complied with in accepting the assignment, e.g., letter of acceptance (the letter usually contains, *inter alia*, averment as to absence of disqualification for appointment and confirmation of present name, constitution and address of the auditor), declaration of fidelity and secrecy, etc.
- Scope of assignment which includes any special reports or certificates to be given by the central auditors in addition to the main report. Presently, the central auditors have to furnish the following reports/certificates in addition to their main report:
  a) Long form audit report.
  b) Report on compliance with SLR requirements.
  c) 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.
  d) Certificate on reconciliation of securities by the bank (both on its own investment account as well as PMS Banks' account).
  e) Certificate on compliance by the bank in key areas of prudential and other guidelines relating to such transactions issued by the RBI.

f) 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.

g) Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention.

h) Certificate in respect of custody of unused Bank Receipt forms and their utilisation.

i) Authentication of capital adequacy ratio and other ratios reported in the notes on accounts.

j) Certificate in respect of DICGC claims.

k) 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.

l) Report on instances of adverse credit-deposit ratio in the rural areas.

m) Asset liability management.

n) Certificate on Corporate Governance in case of banks listed on Stock Exchange. In some banks this certification may not be got done from the central auditors

- Basis of computation of audit fee and scale of travel and related allowances and conveyance charges and other expense reimbursement entitlements, if any.

Declaration of Indebtedness

1.04 The RBI has advised that the banks, before appointing their statutory central/circle/ branch auditors, should obtain a declaration of indebtedness in proforma 'A' given in Annexure to the Notification No. RBI/2004/161 Ref DBS.ARS No B.C. 09 /08.91.001/2003-04 dated April 20, 2004. In addition to this, the RBI has further advised the banks that no credit facility (including guaranteeing any facilities availed of by third party) should be availed of by the proprietor/any of the partners of the audit firm/members of his/their families or by firm/ company in which he/they are partners/directors.

Internal Assignments in Banks by Statutory Auditors

1.05 The RBI, vide its circular no. Ref. DBS. ARS. No. BC. 02/ 08.91.001/ 2008-09 dated December 31, 2008 on “Internal assignments in banks by statutory auditors", decides that the audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the bank during the same year. In case the firms are associated with internal assignment it should be ensured that they relinquish the internal assignment before accepting the statutory audit assignment during the year.

1.06 As the central auditors for private banks are appointed every year by their shareholders in the Annual General Meetings (AGM), each bank is required to obtain prior approval of the RBI in terms of the provisions of Section 30 (1A) of the Banking Regulation Act, 1949 before making appointment/re-appointment of the auditors.

Planning

1.07 Standard on Auditing (SA) 300 (Revised), "Planning an Audit of Financial Statements" requires that the auditor shall undertake the following activities prior to starting an initial audit:

(a) Performing procedures required by Revised SA 220, "Quality Control for an Audit of Financial Statements" regarding the acceptance of the client relationship and the specific audit engagement; and

(b) Communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements.

1.08 The purpose of the procedures is to identify and then assess the risk to the firm in accepting or continuing with an engagement. In addition to risks posed by the client, there is also a need to review the auditing firm's ability to perform the engagement. This would include the availability of appropriate qualified staff when the work is required, the need for specialised assistance, any conflicts of interest, and independence from the client. Standard on Auditing (SA) 220 (Revised), "Quality Control for an Audit of Financial Statements" establishes standards on the quality control, generally, and with regard to the work delegated to assistants on an individual audit.

1.09 The below-mentioned procedures, as applicable to Head Office, may also be applicable in case of audit of a Branch Office, modified to the extend relevant for the particular branch audit assignment.

Communication with Previous Auditor

1.10 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 in writing.

1.11 The objective of communicating with the previous auditor is that the proposed auditor may have an opportunity to know the reasons for the change in order to be able to safeguard his interest, the legitimate interest of the public, and the independence of the existing chartered accountant. When communicating with the previous auditor, the incoming auditor should primarily find out whether there is any professional or other reason why he should not accept the appointment.

1.12 Where the incoming auditor is informed by the previous auditor that he has been changed on account of having qualified his report, the incoming auditor should refuse to accept the audit if he feels that the previous auditor had qualified the report for good and valid reasons. The Code of Ethics, however, recognises that there is no rule, written or unwritten, which would prevent an auditor from accepting the appointment offered to him in these circumstances. In this regard, it may be noted that a member is prohibited from accepting the position of an auditor where the undisputed audit fee of the predecessor auditor has not been paid.

1.13 A mere posting of letter under certificate of posting is not sufficient to establish communication with the previous auditor unless there is some evidence to show that the letter has in fact reached the previous auditor. The incoming auditor should, therefore, communicate with the previous auditor in such a manner as to retain in his hands positive evidence of the delivery of the communication to the addressee. In the opinion of the Council of the Institute, communication by a letter sent 'Registered Acknowledgement Due' or by hand against a written acknowledgement would in the normal course provide such evidence.

1.14 It is desirable that a member, on receiving communication from the auditor who has been appointed in his place, should send a reply to him as soon as possible setting out in detail the reasons, which according to him, had given rise to the change and other attendant circumstances but without disclosing any information as regards the affairs of the bank which he is not competent to do.

1.15 The RBI has advised the banks that in order to enable the proposed auditors to comply with the requirement of communication with the previous auditor, they should mention the name and address of the previous auditor in the appointment letter. In case the appointment letter does not contain the requisite particulars about the previous auditor, the proposed auditor should send a written communication to the bank seeking relevant particulars and informing the bank that he would be in a position to accept the offer only after communicating with the previous auditor and considering the response received from him.

1.16 In case of joint auditors, each of the incoming auditors needs to communicate with each of the outgoing auditors.

Terms of Audit Engagements

1.17 Standard on Auditing (SA) 210 (Revised), "Agreeing the 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 beginning significant portions of fieldwork. It is imperative that the terms of the engagement are documented, in order 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.

1.18 When establishing the terms of engagement, the auditor must agree on its understanding with the client as to the objectives and scope of the audit engagement, the extent of management's responsibilities and its own responsibilities. This minimises the risk that the bank may rely on the auditors inappropriately to protect the entity against certain risks or to perform certain functions that the auditors consider to be the client's responsibility.

1.19 The form and content of audit engagement letter may vary for each bank, but it would generally include reference to following:

- The objective of the audit of financial statements.
- Management's responsibility for the financial statements.
- Management's responsibility for selection and consistent application of appropriate accounting policies, including implementation of the applicable accounting standards along with proper explanation relating to material departures from those accounting standards.
- Management's responsibility for assessment of the entity's ability to continue as a going concern.
- Management's responsibility for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the bank at the end of the financial year and of the profit or loss of the bank for that period.
- Management's responsibility for the maintenance of adequate accounting records and internal controls for safeguarding the assets of the company and for preventing and detecting fraud or other irregularities.
- The scope of the audit, including reference to the applicable legislation, regulations, and the pronouncements of the RBI and the ICAI.

- The fact that having regard to the test nature of an audit, persuasive rather than conclusive nature of audit evidence together with inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements, resulting from fraud, and to a lesser extent error, if either exists, may remain undetected.
- Unrestricted access to whatever records, documentation and other information requested in connection with the audit.
- The fact that the audit process may be subjected to a peer review under the Chartered Accountants Act, 1949.

1.20 The auditor may also include the following matters in the engagement letter:

- Arrangements regarding the planning and performing the audit.
- Expectation of receiving from management written confirmation concerning representations made in connection with the audit.
- Request for the bank to confirm the terms of the engagement by acknowledging receipt of the engagement letter.
- Description of any other letters or reports the auditor expects to issue to the bank.
- Basis on which fees are computed and any billing arrangements.
- A reference to any further agreements between the auditor and the client.

1.21 The following are certain specific aspects which need to be kept in mind while issuing an engagement letter in case of banks:

- The use and source of specialised accounting principles, with particular reference to any requirements under the law or regulations applicable to banks, e.g., the Banking Regulation Act, 1949, various RBI master circulars on matters, such as, provision for NPAs, classification and valuation of investments, etc.
- The contents and form of the financial statements (including disclosures) and auditors' report as laid down in the Banking Regulation Act, 1949 and various RBI circulars as well as the various special purpose reports required from the auditor in addition to the report on the financial statements.
- The nature of any special communication requirements or protocols that may exist between the auditor and the regulators, e.g., communication

directly by the auditor to the RBI in case of serious irregularities or material frauds observed during the course of the audit.

Initial Engagements

1.22 Standard on Auditing (SA) 510 (Revised), "Initial Audit Engagements-Opening Balances", paragraph 6 states that:

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

(a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;

(b) Determining whether the opening balances reflect the application of appropriate accounting policies; and

(c) Performing one or more of the following:

   (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;

   (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

   (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

1.23 The auditor needs to perform the audit procedures as mentioned in Revised SA 510 and if after performing that procedures, the auditor concludes that the opening balances contain misstatements which materially affect the financial statements for the current period and the effect of the same is not properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate.

Assessment of Engagement Risk

1.24 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 also in planning decisions if the audit is accepted.

1.25 The process of assessing engagement risk consists of identifying risk factors and exercising professional judgment to determine whether such factors, separately or in combination, are significant enough to require a special response. Prior to accepting an engagement, the auditor should obtain a preliminary knowledge of the banking industry and of the nature of ownership, management and operations of the bank to be audited.

1.26 For a prospective audit engagement, the auditor must assess engagement risk based on the information obtained from predecessor auditors, inquiries of senior management, those charged with governance, and other appropriate sources. For a continuing audit engagement, the auditor must assess engagement risk based on his experience with the bank and additional audit procedures performed in the previous audits.

1.27 For an audit engagement for which a higher engagement risk is assessed, the auditor should respond appropriately in planning and performing the audit. The auditor then needs to determine whether the increased engagement risk is pervasive to the audit engagement as a whole, as a result of one or more pervasive risks, or as a result of one or more specific risks.

1.28 The auditor would ordinarily need to document the assessment of engagement risk, factors identified as increasing engagement risk, and, if the additional information obtained during the engagement indicates a change in engagement risk, the auditor would need to document its considerations as to whether the planning decisions remain appropriate and the effect, if any, on the audit plan. A yearly assessment of engagement risk will ensure the firm's continuing independence and ability to act and that the engagement risk is still within the firm's pre-determined appetite for risk.

Establish the Engagement Team

1.29 The selection of the engagement team is a key activity in the development and execution of an effective and efficient audit plan. 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.

1.30 The audit engagement partner should be satisfied that the engagement team collectively has the appropriate capabilities, competence, and time to perform the audit engagement. The audit engagement partner should determine that the engagement team selected is appropriate for the audit engagement.

1.31 The audit engagement partner is also responsible for ensuring where additional technical assistance or specialised knowledge is required as a result of the nature and characteristics of the audit engagement. This may require the inclusion of one or more specialists, like, IT specialists, fair value specialists, etc. Other specialists with appropriate competencies can also be used, including but not limited to those related to fraud, exploratory data analysis, tax, industry, financial instruments and derivatives, legal, actuarial, post-employment benefits, etc.

Understanding the Bank and its Environment

1.32 Standard on Auditing (SA) 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" lays down that the auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.

1.33 In performing audit of a bank, the auditor should have or obtain knowledge of the business sufficient to enable him to identify and understand the events, transactions and practices that, in the auditor's judgment, may have a significant effect on the financial statements or on the examination or audit report. Such knowledge is used by the auditor in assessing inherent and control risks and in determining the nature, timing and extent of audit procedures. Understanding the bank and its environment is a continuous and cumulative process of gathering and assessing the information and relating the resulting knowledge to audit evidence and information at all stages of the audit. The auditor can obtain knowledge of the bank from a number of sources namely:

- Discussion with management of the bank.
- Discussion with internal/concurrent/other audit personnel and review of their audit reports.
- Discussion with other auditors and with legal and other advisors who have provided services to the bank or within the industry.
- Discussion with knowledgeable people outside the bank (for example, industry economists, industry regulators, customers and suppliers).
- RBI guidelines and other regulatory pronouncements.
- Documents produced by the bank (for example, minutes of meetings, annual reports, etc.).
- RBI inspection reports.

1.34 Understanding the business and using this information appropriately assists the auditor in assessing risks and identifying problems, planning and performing the audit effectively and efficiently, evaluating audit evidence, and providing better services to the bank.

Analytical Procedures

1.35 The auditor should also apply appropriate analytical procedures at the planning stage to assist him in understanding the business and in identifying the areas of potential risk. Analytical procedures include comparison of financial information with comparative information for a prior period or periods, with anticipated results, such as, budgets, and with similar industry information. Analytical procedures also include study of relationships among elements of financial information that are expected to form a predictable pattern. In the case of a bank, analytical procedures would primarily involve comparison of current year's information with comparable information for past years or with budgets and analysis of significant financial ratios and trends.

1.36 In addition to the various ratios in the context of branches, at the central level, the analysis of following ratios may also be useful:

- Net NPAs to total equity
- Large exposures to net owned funds
- Ratio of off-balance sheet items to total assets
- NPAs in investments to other investments
- Return on Assets
- Return on Risk-Weighted Assets
- Provision for depreciation in investments to total income
- Asset Liability relationship
- Accretion to Equity

1.37 The RBI has issued detailed guidelines to scheduled commercial banks, vide circular DBOD No. BP.BC.3/21.04.109/99 dated February 8, 1999, regarding framework of analysis of their balance sheets. This circular requires the banks to work out several financial ratios regarding asset quality, liquidity and earnings. The manner of working out these ratios as well as their significance have also been outlined in the circular. Many of these ratios may also be useful to the auditor though it must be remembered that the objective of an auditor's analysis of the ratios is basically not to evaluate the performance but to understand the business and identify areas where there is potential of misstatement of financial information. The auditor at the branch level may find the following ratios particularly useful for his purposes:

- Gross NPAs to Gross Advances
- Net NPAs to Net Advances
- Incremental NPAs to Opening Gross Advances

- Incremental NPAs to Opening Gross Standard Advances
- Provision for Loan Losses to Gross Advances
- Loan Loss Provisions and Write-offs to Gross Advances
- Provisions for Loan Losses to NPAs
- Gross NPAs (including NPAs in investments) to Total Assets
- Net NPAs (including NPAs in investments) to Total Assets
- Net Interest Income (NII)
- Net Interest Margin (NIM)
- Non-Interest Margin
- Profit Margin
- Profit Margin - adjusted net profit
- Interest expense ratio
- Non-interest expense ratio
- Provision for loan loss ratio
- Provision for depreciation in investment ratio
- Asset Utilisation Ratio
- Purchased fund to Total Assets

1.38 Having acquired sufficient knowledge of the business, each of the central auditors should develop an overall plan for the audit work allocated to him and also prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.

Review of Closing Instructions

1.39 Branches prepare their balance sheet, profit and loss account and other returns necessary for preparation of the financial statements of the bank as a whole in the format, and according to the instructions, communicated by the head office in the form of 'accounts closing instructions'. Considering the significance of these instructions, it is advisable that before these instructions are sent to branches, the central auditors review them to assess whether the instructions are sufficiently comprehensive, clear and adequate to facilitate the compilation of branch financial statements and other relevant data accurately and expeditiously. The central auditors should particularly examine whether the instructions are in consonance with the accounting policies of the bank which, in turn, are themselves appropriate In case any of the proposed instructions are inadequate or inappropriate, they may suggest the necessary changes to be made in this behalf.

Co-ordination with Bank Management

1.40 Co-ordination between the auditor and the bank management is essential for an effective audit. Experience, suggests that in many cases, the audit work gets delayed due to non-availability of books, records, etc. To minimise the possibility of such an occurrence, it is advisable that after accepting the appointment, the central auditor should send a formal communication to the bank management specifying the books, records, analyses and other information that the auditor would require in the course of his audit. Such a communication would enable the bank management to keep the requisite documents, information, etc., ready.

Relationship among Joint Auditors

1.41 The practice of appointing more than one auditor to conduct the audit of public sector banks is very common. Some private sector banks also appoint more than one firm as auditors. The joint auditors should mutually decide and divide the audit work amongst themselves. The division of work as well as the areas of work to be covered by all of them should be adequately documented and communicated to the entity. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors.

1.42 As per Standard on Auditing (SA) 299, "Responsibility of Joint Auditors", in respect of audit work divided, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible -

- in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;
- in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors. It may, however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;

- in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;
- for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and
- for ensuring that the audit report complies with the requirements of the relevant statute.

1.43 It is the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the area of work allocated to him. The issues such as appropriateness of using test checks or sampling should be decided by each joint auditor in relation to his own area of work. This responsibility is not shared by the other joint auditors. Thus, it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him. Similarly, the nature, timing and extent of the enquiries to be made in the course of audit as well as the other audit procedures to be applied are solely the responsibility of each joint auditor.

1.44 In the case of audit of large banks with several branches, including those required to be audited by branch auditors, the branch audit reports/returns may be required to be scrutinised by different joint auditors in accordance with the allocation of work. In such cases, it is the specific and separate responsibility of each joint auditor to review the audit reports/returns of the branches allocated to him and to ensure that they are properly incorporated into the accounts of the entity.

1.45 Generally, the joint auditors may arrive at an agreed report. However, where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express their own opinion through a separate report. A joint auditor is not bound by the views of the majority of the joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

Bank Branches

1.46 This section discusses the matters to be considered by a proposed branch auditor upon receiving intimation of appointment. It also deals with aspects of preliminary work to be undertaken by the branch auditor before actually commencing the audit work. The letter of appointment sent by banks to proposed branch auditors typically contains the following:

- Particulars of branch(s) to be audited and of the region/zone to which the branch reports.
- Particulars of central auditors.
- Particulars of previous auditors.
- Procedural requirements to be complied with in accepting the assignment, e.g., letter of acceptance, declaration of fidelity and secrecy, etc.
- *Scope of assignment*- This includes any special reports or certificates to be given by the branch auditor in addition to his main report, e.g., long form audit report and other specific reports and certificates.
- Basis of computation of audit fee, and scales of travel and related allowances and conveyance charges and other expense reimbursement entitlements, if any.

Co-ordination with Branch Management

1.47 Co-ordination between the auditor and the branch management is essential for an effective audit. To minimise the possibility of such an occurrence, it is advisable that immediately after accepting the appointment, the branch auditor should send a formal communication to the branch management specifying the books, records, analyses and other information that the auditor would require in the course of his audit. Such a communication would enable the branch management to keep the requisite documents, information, etc., ready.

Co-ordination between Branch Auditor and Central Auditor

1.48 The branch auditor's report on the financial statements examined by him is forwarded to the central auditor with a copy to the management of the bank. The central auditor, in preparing his report on the financial statements of the bank as a whole, deals with the branch audit reports in such manner as he considers necessary.

1.49 According to the Standard on Auditing (SA) 600, "Using the Work of Another Auditor", the auditor should consider whether the auditor's own participation is sufficient to be able to act as the principal auditor. For this purpose the auditor should consider:

(a) the materiality of the portion of the financial information which the principal auditor audits;

(b) the principal auditor's degree of knowledge regarding the business of the components;

(c) the risk of material misstatements in the financial information of the components audited by the other auditor; and

(d) the performance of additional procedures as set out in SA 600 regarding the components audited by other auditor resulting in the principal auditor having significant participation in such audit.

1.50 The central auditor (principal auditor) should perform procedures to obtain sufficient appropriate audit evidence, that the work of the branch auditor is adequate for the central auditor's purposes in the context of the specific assignment. The central auditor should ordinarily perform the following procedures:

(a) Advise the branch auditor of the use of the work and report of branch auditor. Auditor should arrange co-ordination at the planning stage of the audit. There should be mutual sharing of significant findings between them. The central auditor would inform the branch auditor of matters such as areas requiring special consideration, procedures for the identification of inter component transactions that may require disclosure and the time-table for completion of audit; and

(b) Advise the branch auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

1.51 The central auditor might discuss with the branch auditor the audit procedures applied or review a written summary of the branch auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The central auditor may also wish to visit the branch auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the central auditor's knowledge of the professional competence of the branch auditor. This knowledge may have been enhanced from the review of the previous audit work of the branch auditor.

1.52 The central auditor may conclude that it is not necessary to apply procedures such as those described in above paragraph because sufficient appropriate audit evidence has been previously obtained that acceptable quality control policies and procedures are complied with in the conduct of branch auditor's practice.

1.53 The central auditor should consider the significant findings of the branch auditor. The central auditor may consider it appropriate to discuss with the branch auditor and the management of the component, the audit findings or other matters affecting the financial information of the components. He may also decide that supplemental tests of the records or the financial statements of the component are necessary. Such tests may, depending upon the circumstances, be performed by the central auditor or the branch auditor.

1.54 In certain circumstances, the branch auditor may happen to be a person other than a professionally qualified auditor. This may happen, for instance, where a component is situated in a foreign country and the applicable laws permit a person other than a professionally qualified auditor to audit the financial statements of such component. In such circumstances, the procedures outlined above assume added importance.

1.55 The central auditor should document in his working papers the components whose financial information was audited by branch auditors; their significance to the financial information of the entity as a whole; the names of the branch auditors; and any conclusions reached that individual components are not material. The central auditor should also document the procedures performed and the conclusions reached. For example, the auditor would document the results of discussions with the branch auditor and review of the written summary of the branch auditor's procedures. However, the central auditor need not document the reasons for limiting the procedures in the circumstances described above, provided those reasons are summarised elsewhere in the documentation maintained by the central auditor. Where the branch auditor's report is other than unmodified, the central auditor should also document how he has dealt with or adverse opinion qualifications or adverse remarks contained in the branch auditor's report in framing his own report.

1.56 The branch auditor, knowing the context in which his work is to be used by the central auditor, should co-ordinate with the central auditor. For example, by bringing to the central auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc. He should ensure compliance with the relevant statutory requirements. Similarly, the central auditor should advise the branch auditor of any matters that come to his attention that he thinks may have an important bearing on the branch auditor's work.

1.57 When considered necessary by him, the central auditor may require the branch auditor to answer a detailed questionnaire regarding matters on which the central auditor requires information for discharging his duties. The branch auditor should respond to such questionnaire on a timely basis.

Reporting Considerations

1.58 When the central auditor concludes, based on his procedures, that the work of the branch auditor cannot be used and the central auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the branch auditor, the central auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of audit.

1.59 In all circumstances, if the branch auditor issues, or intends to issue, a modified auditor's report, the central auditor should consider whether the subject of the modification is of such nature and significance, in relation to the financial information of the entity on which the central auditor is reporting that it requires a modification of the central auditor's report.

Division of Responsibility

1.60 The central auditor would not be responsible in respect of the work entrusted to the branch auditors, except in circumstances which should have aroused his suspicion about the reliability of the work performed by the branch auditors.

1.61 When the central auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the branch auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the branch auditors have been included in the financial information of the entity, e.g., the number of divisions/branches/ subsidiaries or other components audited by branch auditors.

1.62 In case joint auditors have been appointed as central auditors, the branch auditors are advised to report only to the central auditor concerned who, in turn, considers the audited accounts and the branch auditors' report for the purpose of consolidation thereof and preparation of the report to be submitted by him jointly with other central auditors.

1.63 Standard on Auditing (SA) 600, “Using the Work of Another Auditor”, discusses the relationship between a principal auditor (i.e., the central auditor) who, when reporting on the financial statements of an entity, uses the work of another independent auditor (i.e., branch auditors or auditor of other components) with respect to the financial statements of one or more divisions or branches included in the financial statements of the entity.

Engagement and Quality Control Standards

1.64 The following is the list of Engagement and Quality Control Standards applicable to an audit of financial statements as on 01.01.2013, issued by the ICAI along with their effective dates:

Quality Control		
New Standard Number (SQC) (1-99)	**Standards on Quality Control (SQCs)**	**Date from which effective**
1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements	Effective for all engagements relating to accounting periods beginning on or after April 1, 2009.
Audits and Reviews of Historical Financial Information		
New Standard Number (SA) (100-999)	**Standards on Auditing (SAs)**	**Date from which effective**
100-199	**Introductory Matters**	
200-299	**General Principles and Responsibilities**	
200 (Revised)	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing	Effective for audits of financial statements for periods beginning on or after April 1, 2010.
210 (Revised)	Agreeing the Terms of Audit Engagements	Effective for audits of financial statements for periods beginning on or after April 1, 2010.
220 (Revised)	Quality Control for an Audit of Financial Statements	Effective for audits of financial statements for periods beginning on or after April 1, 2010.
230 (Revised)	Audit Documentation	Effective for audits of financial statements for periods beginning on or after April 1, 2009.
240 (Revised)	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements	Effective for audits of financial statements for periods beginning on or after April 1, 2009.
250 (Revised)	Consideration of Laws and	Effective for audits of

	Regulations in an Audit of Financial Statements	financial statements for periods beginning on or after April 1, 2009.
260 (Revised)	Communication with Those Charged with Governance	Effective for audits of financial statements for periods beginning on or after April 1, 2009.
265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	Effective for audits of financial statements for periods beginning on or after April 1, 2010.
299	Responsibility of Joint Auditors	Effective for all audits related to accounting periods beginning on or after April 1, 1996
300-499	**Risk Assessment and Response to Assessed Risks**	
300 (Revised)	Planning an Audit of Financial Statements	Effective for audits of financial statements for periods beginning on or after April 1, 2008.
315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment	Effective for audits of financial statements for periods beginning on or after April 1, 2008.
320 (Revised)	Materiality in Planning and Performing an Audit	Effective for audits of financial statements for periods beginning on or after April 1, 2010.
330	The Auditor's Responses to Assessed Risks	Effective for audits of financial statements for periods beginning on or after April 1, 2008.
402 (Revised)	Audit Considerations Relating to an Entity Using a Service Organisation	Effective for audits of financial statements for periods beginning on or after April 1, 2010.
450	Evaluation of Misstatements	Effective for audits of

	Identified during the Audit	financial statements for periods beginning on or after April 1, 2010.
500–599	**Audit Evidence**	
500 (Revised)	Audit Evidence	Effective for audits of financial statements for periods beginning on or after April 1, 2009.
501(Revised)	Audit Evidence - Specific Considerations for Selected Items	Effective for audits of financial statements for periods beginning on or after April 1, 2010.
505 (Revised)	External Confirmations	Effective for audits of financial statements for periods beginning on or after April 1, 2010.
510 (Revised)	Initial Audit Engagements—Opening Balances	Effective for audits of financial statements for periods beginning on or after April 1, 2010.
520 (Revised)	Analytical Procedures	Effective for audits of financial statements for periods beginning on or after April 1, 2010.
530 (Revised)	Audit Sampling	Effective for audits of financial statements for periods beginning on or after April 1, 2009.
540 (Revised)	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	Effective for audits of financial statements for periods beginning on or after April 1, 2009.
550 (Revised)	Related Parties	Effective for audits of financial statements for periods beginning on or after April 1, 2010.
560 (Revised)	Subsequent Events	Effective for audits of financial statements for

		periods beginning on or after April 1, 2009.
570 (Revised)	Going Concern	Effective for audits of financial statements for periods beginning on or after April 1, 2009.
580 (Revised)	Written Representations	Effective for audits of financial statements for periods beginning on or after April 1, 2009.
600-699	**Using Work of Others**	
600	Using the Work of Another Auditor	Effective for all audits related to accounting periods beginning on or after April 1, 2002
610 (Revised)	Using the Work of Internal Auditors	Effective for audits of financial statements for periods beginning on or after April 1, 2010.
620 (Revised)	Using the Work of an Auditor's Expert	Effective for audits of financial statements for periods beginning on or after April 1, 2010.
700-799	**Audit Conclusions and Reporting**	
700 (Revised)	Forming an Opinion and Reporting on Financial Statements	Effective for audits of financial statements for periods beginning on or after April 1, 2011[1].
705	Modifications to the Opinion in the Independent Auditor's Report	Effective for audits of financial statements for periods beginning on or after April 1, 2011.
706	Emphasis of Matter Paragraphs	Effective for audits of

[1] The Council of ICAI, in partial modification of the decision taken by it at its 291st meeting held in December 2009, has decided that the effective date/applicability of the three standards *viz* SA 700 (Revised), SA 705 and SA 706 be postponed by one year and consequently the said Standards shall now be effective/applicable for audits of financial statements for periods beginning on or after 1st April, 2012 (instead of audits of financial statements for periods beginning on or after 1st April, 2011 as was earlier decided).

	and Other Matter Paragraphs in the Independent Auditor's Report	financial statements for periods beginning on or after April 1, 2011.
710 (Revised)	Comparative Information - Corresponding Figures and Comparative Financial Statements	Effective for audits of financial statements for periods beginning on or after April 1, 2011.
720	The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements	Effective for audits of financial statements for periods beginning on or after April 1, 2010.
800-899	**Specialized Areas**	
800	Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks	Effective for audits of financial statements for periods beginning on or after April 1, 2011.
805	Special Considerations-Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement	Effective for audits of financial statements for periods beginning on or after April 1, 2011.
810	Engagements to Report on Summary Financial Statements	Effective for audits of financial statements for periods beginning on or after April 1, 2011.
New Standard Number (SRE) (2000-2699)	**Standards on Review Engagements (SREs)**	**Date from which effective**
2400 (Revised)	Engagements to Review Financial Statements	Applicable for reviews of financial statements for periods beginning on or after April 1, 2010.
2410	Review of Interim Financial Information Performed by the Independent Auditor of the Entity	Applicable for reviews of interim financial information for periods beginning on or after April 1, 2010.

Assurance Engagements Other Than Audits or Reviews of Historical Financial Information		
New Standard Number (SAE) (3000-3699)	**Standards on Assurance Engagements (SAEs)**	**Date from which effective**
3000-3399	**Applicable to all Assurance Engagements**	
3400-3699	**Subject Specific Standards**	
3400	The Examination of Prospective Financial Information	Effective in relation to reports on projections/ forecasts, issued on or after April 1, 2007
3402	Assurance Reports on Controls at a Service Organisation	Effective for assurance reports covering periods ending on or after April 1, 2011
Related Services		
New Standard Number (SRS) (4000-4699)	**Standards on Related Services (SRSs)**	**Date from which effective**
4400	Engagements to Perform Agreed-upon Procedures Regarding Financial Information	Applicable to all agreed upon procedures engagements beginning on or after April 1, 2004
4410	Engagements to Compile Financial Information	Applicable to all compilation engagements beginning on or after April 1, 2004

Special Audit Considerations in Foreign Banks

1.65 Audit of foreign banks operating in India, poses unique challenges compared to local banks in India. Foreign banks have different operating models compared to local banks, and, to a limited extent, they also operate in a different regulatory environment.

1.66 Foreign banks operate in India through branches and do not have a separate legal entity existence in India. However, for all practical purposes, the RBI regulates the functioning of its branches in India, with regards to scale and nature of business they undertake in India.

1.67 Foreign bank audit teams will have to alter their audit procedures so as to adjust to the operational structure of these banks. Some of the important elements related to foreign banks which has a bearing on their audit are listed and discussed below-

- *Management structure* – Banks normally have a CEO or a Country Head as the highest decision making authority based out of the country. This position, generally, reports into the regional management board or the global board as the case may be. Separately, to oversee the day to day affairs of the bank, there may exist a Chief Operating Officer (COO) or alternatively various sub committees with specific responsibilities. In comparison to a locally incorporated bank, the management structure of foreign banks is not very 'top' concentrated, i.e., it will be minus the various boards and committees.

  Special Audit consideration would be required to ensure that there is defined line of reporting and does not in any manner present a scenario for management override of controls, specifically in areas of financial reporting and regulatory aspects. Auditors should read through committee minutes/role definition documents to understand the functioning of these committees and individuals in order to understand the control environment within the bank.

- *Centralised operations* – Foreign banks operate with limited branch network in the country and operate in a structure wherein most of their operations are centralised, for e.g., accounts, human resources, legal, back office operations, risk management and other support functions. Bank branches operate as customer relationship windows and do not record substantial financial statements impacting transactions. This structure in a way negates, to some extent, dependencies of information from branches in the form of returns, MIS, etc., as most of the information is centrally available.

  In view of the above feature, a large part of the auditors work will have to be concentrated at these centralised operation hubs/locations, since transaction validation and recording are carried out at these centres. However, audit teams will have to evaluate individually how bank branches have been empowered to undertake financial transactions, in most scenarios branches would still operate as custodians of cash and warrants, so controls surrounding those would have to be verified.

- *High level of automation* – Almost all foreign banks are technologically advanced and use a high level of IT integration into their operations. These systems, in most instances, are similar to those being used by their branches globally. Due to technological advancements, foreign banks also offer products which are IT dependent, like any where banking, net banking, etc., these facilitate increase in the volumes of transaction processed. MIS, financial accounting, employee information, customer data, regulatory reports and others are completely integrated to the core banking application and are generated through the IT application.

  This kind of IT environment poses a huge amount of dependency on the IT system and application, as audit related information is directly generated through these applications. The auditor will have to adopt the same procedures as is required to be done for an audit in an automated environment, with special focus on change control, logical access, back up mechanism and disaster recovery programmes.

- *Cross border processing of data* - Due to cost-benefit and other considerations, in some instances, foreign banks, get certain financial or other information processed at one of their global centres, e.g., VAR computation, valuation of derivatives, MIS reports, etc. This processing of data out of the country is generally with specific consent from the RBI. RBI has issued instructions that pricing of structured products should be locally demonstrable at all times.

  For any financial reporting information which is processed out of the country, the auditor should ensure that adequate information and explanations are provided to them as part of their audit work. In all circumstances, documentary evidence as required for audit of a specific caption has to be made available locally, and local management has to take complete responsibility of the data made available.

- *Complex treasury operations and cross border deals* – Due to their existence in global financial centres and their expertise, foreign banks undertake complex treasury transactions (to the extent allowed by the RBI regulations). In most cases these transactions are undertaken back to back with their foreign branches and would be hedged from a local risk perspective. Additionally, banks also undertake and participate in international advisory and syndication transactions, in partnership with their international branches, which in effect generates fee revenue for the bank.

Special audit consideration would involve verification to ensure that these transactions are within the approvals granted by the RBI in transacting in derivative products. Transfer pricing considerations are an important element for verifying that the correct amount has been recognised as revenue/expenditure for participation in cross border transactions.

II-2

Risk Assessment and Internal Control

2.01 Banks have the following characteristics, which distinguish them from most other commercial enterprises.

- Custody of large volumes of monetary items, including cash and negotiable instruments, whose physical security has to be ensured. This applies to both the storage and the transfer of monetary items and makes banks vulnerable to misappropriation and fraud. They, therefore, need to establish formal operating procedures, well-defined limits for individual discretion and rigorous systems of internal control.
- Engage in a large volume and variety of transactions in terms of both number and value. This necessarily requires complex accounting and internal control systems and widespread use of Information Technology (IT).
- Normally, operate through a wide network of branches and departments which are geographically dispersed. This necessarily involves a greater decentralisation 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.
- Assume significant commitments without any transfer of funds. These items, commonly called 'off-balance sheet' items, may not involve accounting entries and, consequently, the failure to record such items may be difficult to detect.
- Engage in transactions that are initiated in one location, recorded in a different location and managed in yet another location.
- Transactions can often be directly initiated and completed by the customer without any intervention by the bank's employees, for example, over the Internet or through automatic teller machines (ATMs).
- An integral part of, or are linked to, national and international settlement systems and consequently could pose a systemic risk to the countries in which they operate.
- They are regulated by governmental authorities and the resultant

regulatory requirements often influence accounting and auditing practices in the banking sector.

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

- the particular nature of risks associated with the transactions undertaken by banks;
- 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; and
- the continuing development of new services and banking practices which may not be matched by the concurrent development of accounting principles and auditing practices.

The auditor should consider the effect of the above factors in designing his audit approach.

Identifying and Assessing the Risks of Material Misstatements

2.03 Standard on Auditing (SA) 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" 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. For this purpose, the auditor shall:

(a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;

(b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

(c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and

(d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

SA 315 requires the auditor to put specific emphasis on the risks arising out of the fraud, changes in regulatory environment, complex transactions, related party transactions, and abnormal business transactions.

Understanding the Bank and Its Environment including Internal Control

2.04 As per SA 315, the auditor's objective is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level. The said objective revolves around the following major steps:

- Identifying and assessing the risk of material misstatement through understanding the entity and its environment including internal control;
- Designing and performing further audit procedures that respond to assessed risks and reduce the risks of material misstatements in the financial statements to an acceptably low level; and
- Issuing a suitably worded audit report based on the audit findings.

2.05 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 so as to determine the operating effectiveness of the controls, and to address the specific risks. Further, documentation of the auditor's understanding of the bank and its environment provides an effective mechanism for accumulating and sharing knowledge and experience and briefing the same to all the members of the engagement team, particularly in case of multi-location audit engagements.

2.06 The audit engagement partner should appropriately be involved so as to achieve its basic objective of identifying and assessing the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels. The use of professional skepticism, and experience acquired during the course of other audits play a vital role in this process.

2.07 When obtaining an understanding of the bank and its environment, including its internal control, the auditor is required to:

- Obtain an understanding of the relevant industry, regulatory, and other external factors including the applicable financial reporting framework.

- Obtain an understanding of the nature of the bank, including:
  - (i) its operations;
  - (ii) its ownership and governance structures;
  - (iii) the types of investments that the bank has made and plans to make; and
  - (iv) the way that the entity is structured and financed;

  to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.
- Obtain an understanding of the bank's objectives and strategies, and the related business risks that may result in material misstatement of the financial statements.
- Obtain an understanding of the bank's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the bank's accounting policies are consistent with the applicable financial reporting framework and accounting policies prevalent in the banking industry.
- Obtain an understanding of the measurement and review of the bank's financial performance.
- Obtain an understanding of the bank's accounting process relevant to financial reporting.
- Obtain an understanding of the bank's internal control relevant to the audit.

2.08 Management may prepare a variety of information so as to operate the business more effectively and efficiently. The auditor may consider to use those information in identifying risks of material misstatements. Such information may be internally generated (e.g., budgets and strategic plans, monthly financial and operating reports) or externally generated (e.g., trade periodicals, analysts' reports on the banking industry or the bank).

2.09 While obtaining an understanding of the bank and its environment, including its internal control, the auditor should consider whether the information obtained during the course of audit indicates risks of material misstatement due to fraud. For this purpose, the following points assume importance:

- Understanding the bank's corporate governance structure. The RBI has laid down specific guidelines, which need to be complied with by the banks, with regard to the formation of various committees and determination of their specific functions, extent of audit coverage, etc. Apart from this, provisions of Clause 49 of the Listing Agreement need to be complied with by the listed banks.

- Obtaining and maintaining a record of the understanding of the products and services offered by the bank. The auditor should be aware of the variations in the basic deposit, loan and treasury services that are offered and continue to be developed and modified by the bank in response to market conditions and guidelines which are issued by the RBI from time to time. Similarly, the auditor should obtain an understanding of the nature of services rendered though instruments like LCs, guarantees, letters of comfort, forward and swap contracts, options and other similar instruments; the inherent risks arising as a result thereof; and also the auditing, accounting and disclosure implications thereof.
- The extent of use of service organisations needs to be evaluated, since it is the responsibility of the bank to ensure compliance with the rules and regulations, as well as to ensure that the service organisations have adequate internal controls.

2.10 The auditor may decide to visit the significant operating units of the bank, especially, in case of multi-location bank or multinational bank. This would enhance its understanding, and would also assist in the assessment of engagement risk, and identification of pervasive risks and specific risks. Such visits enable the auditor to interact with the local management so as to acquire understanding of their significant policies, and other relevant factors affecting the working of that particular operating unit.

2.11 In obtaining an understanding of the bank and its environment, the auditor, ordinarily, documents the following:

- pervasive risks and specific risks that have been identified;
- needs, expectations, and concerns of senior management and those charged with governance; and
- other relevant administrative matters.

Structure of overall internal control environment of a bank

2.12 The auditor should obtain an understanding of the control environment sufficient to assess management's attitudes, awareness and actions regarding internal control and their importance in the entity. Such an understanding would help to make a preliminary assessment of the adequacy of the accounting and internal control system as a basis for the preparation of the financial statements, and of the likely nature, timing and extent of audit procedures.

2.13 The overall control environment of a bank generally includes a mix of the following:

I. Board of Directors or senior management and its Committees

2.14 The organisational structure of a bank assists it in managing its responsibility of oversight and control. All banks usually have the following committees:

- *Executive Committee* – monitors the overall functioning of the bank and ensures compliance with laid down policies and procedures. This committee usually consists of the Chief Executive Officer, Chief Operating Officer and all business line heads.
- *Operations Committee* – reviews potential operational risks.
- *Asset Liability Committee* - monitors the capital and liquidity profile, maturity mismatches, core gap analysis, etc. of the bank.
- *Risk Committee* – entity-wide risk assessment and risk management by formulating appropriate strategies to mitigate the identified risks.

2.15 Banks also have an Audit Committee, Corporate Governance Committee and, Shareholder Grievance Committee. Further, function specific committees such as, the Investment Committee, Credit Committee, Information Technology Committee etc. also exist which report to the Board of Directors or the Executive Committee.

2.16 The Board of Directors or the Executive Committee of a bank is responsible for the strategic planning process of the bank such as identifying goals and objectives, formulating the strategies to attain the objectives, assessing performance of the bank against approved budgets. Thus, it sets the tone and operating style at the top and weaves the entire control environment in the bank.

II. Internal Audit

2.17 The internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operating. Banks generally have a well-organised system of internal audit. The internal audit is carried out either by a separate department within the bank or by independent firms of chartered accountants. Apart from these, the inspectors of RBI also review the system and transactions of important branches.

2.18 RBI has advised banks to adopt a framework for Risk-Based Internal Audit to ensure that the internal audit is undertaken in the bank in a risk focused manner. This would also facilitate in adoption of the Risk-based Supervision framework. Attention is invited to RBI circular DBS.CO.PP.BC. 14 /11.01.005/2003-04, dated June 26, 2004.

III. Revenue Audit

2.19 Revenue audit is usually conducted at large and medium-sized branches and is aimed at identifying cases of leakage of revenue due to wrong computation of interest, non-application of interest on time, application of incorrect rates of interest/exchange/commission, non-application of penal interest, non-recovery or short-recovery of service charges on guarantees and letters of credit, etc. This type of audit is also known as 'income and expenditure audit' or 'income leakage audit'.

IV. Branch Inspection

2.20 Such inspection is much broader in scope than revenue audit, and covers all important areas of functioning of the branch, including efficacy of systems and procedures, compliance with head office directions, customer service, maintenance of books and records, etc. Most banks have a fixed schedule of branch inspection.

V. Head Office Inspection

2.21 The inspection at head office level is aimed at evaluating the functions being carried out at the head office and covers, *inter alia*, investment and other treasury functions, functioning of the central stationery department, fixed assets (if centralised), inter-branch reconciliation, etc.

VI. Concurrent Audit

2.22 A system of concurrent audit at large and other selected branches has been in vogue in most of the banks for quite long. Recognising the importance of concurrent audit in the banking sector, the RBI, vide its circular no.BC.182/16.13.100/93-94 dated October 11, 1993, addressed to all scheduled commercial banks (except regional rural banks) formally advised such banks to institute an appropriate system of concurrent audit. The RBI also specified the minimum extent of banking operations to be covered under concurrent audit within a defined time-frame, and also suggested the areas to be covered by concurrent audit. Subsequently, vide its circular DOS No. B.C. 16/08-91-021/96 dated August 14, 1996 the RBI has made certain refinements in the scope of concurrent audit.

VII. Systems Audit

2.23 The bank carries out a systems audit periodically to assess the effectiveness of the hardware, software and operations to identify any changes required therein. The RBI, vide its circular no. DBS.CO.OSMOS.BC/ 11 /33.01.029/2003-04 dated April 30, 2004 on "Information System Audit - A review of Policies and Practices" advises the banks that:

i) The banks may adopt an Information System audit policy (if not done already) appropriate to its level of computerisation and review the same at regular intervals in tune with the industry best practices and guidelines issued by the RBI from time to time.

ii) Banks may adopt appropriate system and practices for conducting IS audit on annual basis covering all the critically important branches (in terms of nature and volume of business).

iii) Such audits should be preferably undertaken prior to the statutory audit so that the IS audit reports are available to the statutory auditors well in time, for examination and incorporating comments, if any, in the audit reports.

iv) The IS audit reports should be placed before the top management and the compliance should be ensured within the time frame, as outlined in the audit policy.

The report of RBI's Working Group on Information Security, Electronic Banking, Technology Risk Management and Cyber Frauds has recommended implementation of good level of controls in areas of IT Governance, Information Security, IT Operations, IT Outsourcing, IS Audit, Cyber Fraud, Business Continuity Planning, Customer Education and Legal Issues

VIII. Vigilance Function in banks

2.24 All banks have a vigilance department, though it may be assigned different names in different banks. Its functions include- to keep surveillance over the suspect staff/transactions, to look into cases of frauds/misappropriation/ connivance, etc. leading to loss to the bank. In the case of large non-performing assets, the department may be required to investigate and find out the reasons for the account becoming non-performing. The nature of findings of the vigilance department is of relevance to the auditor, particularly in evaluating the efficacy of internal controls.

IX. RBI Inspection

2.25 The RBI carries out inspection of Head Office functions and departments as well as branches under section 35 of the Banking Regulation

Act, 1949, to examine compliance by the bank of various policies and norms about credit and other functions laid down by the RBI from time to time. Besides, it also carries out inspection of currency chest branches to review chest balances and other functions being performed by the branch as an agent of the RBI. RBI inspections, however, are not in the nature of internal audit.

Understand the Bank's Accounting Process

2.26 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. In obtaining an understanding the accounting process, the auditor may seek to identify the significant flow of the transactions and significant application systems that are relevant to the accounting process.

2.27 When obtaining an understanding of the accounting process, the auditor, ordinarily, does not focus on the processes that relate to the effectiveness and efficiency of operations and compliance with laws and regulations, unless they impact the financial statements or their audit procedures. While obtaining the understanding of the significant flow of the transactions, the auditor should also obtain an understanding of the process of recording and processing of journal entries, and should also make inquiries about inappropriate or unusual activity relating to the processing of journal entries and other adjustments.

2.28 The auditor should also document its understanding of the accounting process, including the significant flow of transactions, the relevant computer processing environments or any other relevant information. Such documentation would ordinarily be either a narrative description, graphical representation (e.g., a flow chart), or a combination of the two. The following factors should be kept in mind while obtaining the understanding of the accounting process in case of banks:

- The need to process high volumes of transactions accurately within a short time which is met through large scale use of IT.
- The need to use electronic funds transfer or other telecommunication systems to transfer large sums of money.
- The conduct of operations in many locations with a resultant geographic dispersion of transaction processing and internal controls.

Structure of Internal Control Procedures in a bank

2.29 The specific internal control procedures to be followed in an enterprise depend on the nature, volume and complexities of its operations and the management's attitude towards control. However, as in the case of other enterprises, the internal control procedures relevant to assertions made in the financial statements of bank generally fall under the following categories:

I. Segregation and Rotation of Duties

2.30 One of the fundamental features of an effective internal control system is the segregation and rotation of duties in a manner conducive to prevention and timely detection of occurrence of frauds and errors. The functions typically segregated are authorisation of transactions; execution of transactions; physical custody of related assets; and maintenance of records and documents.

2.31 In the case of banks, the following measures are usually adopted:

- Work of one staff member is invariably supervised/checked by another staff member, irrespective of the nature of work.
- Banks have a system of rotation of job amongst staff members, which reduces the possibility of frauds and is also useful in detection of frauds and errors. Also, most banks usually have a process of giving "block" leave to its staff members wherein the employee stays away from work for at least a continuous period of 2 weeks.
- Banks invariably ensure dual responsibility and authorisation procedures. Any transaction put through in the banking system is invariably subject to verification and authentication by more than one staff member. For example, in case of treasury transactions such as purchase of a government security, the transaction is entered into on the NDS by the front office, however, the back end support function is responsible for confirming the transaction with the counterparty through an exchange of confirmation, prior to settlement of the transaction.

2.32 RBI has also *vide* its circulars and notifications propagated banks to establish effective segregation in its functions, for example, the master circulars on prudential norms for classification, valuation and operation of investment portfolio by banks , clearly advises banks to have functional separation of trading, settlement, monitoring and accounting activities.

II. Authorisation of Transactions

2.33 Authorisation may be general (i.e., it may relate to all transactions that conform to prescribed conditions referred to as routine transactions) or it may be specific with reference to a single transaction (non-routine transactions and accounting estimates). It is necessary to establish procedures which provide assurance that authorisations are issued by persons acting within the scope of their authority, and that the transactions conform fully to the terms of the authorisations. The following procedures are usually established in banks for this purpose:

- The financial and administrative powers of each official/each position are fixed and communicated to all persons concerned, For example, in a bank, procedures in relation to the settlement of transactions, reconciliation of nostro accounts and the payment system are clearly defined and documented in a manual. This reduces the risk that segregation of duties may be compromised or that transactions may not be settled in a systematic manner.
- All financial decisions at any level are required to be reported to the next higher level for confirmation/information. For example, in case of a money market transaction, if the dealer exceeds the pre-defined limits such as a position limit or counterparty limit, then the transaction has to be vetted and confirmed by the head dealer.
- Any deviation from the laid down procedures requires confirmation from/intimation to higher authorities.
- Branch managers have to send periodic confirmation to their controlling authority on compliance of the laid down systems and procedures.

III. Maintenance of Adequate Records and Documents

2.34 Accounting controls should ensure that the transactions are recorded at correct amount and in the accounting periods in which they are executed, and that they are classified in appropriate accounts. Moreover, recording of transactions should be such as would facilitate maintaining the accountability for assets. The procedures established in banks to achieve these objectives usually include the following:

- All records are maintained in the prescribed books and registers only. This ensures that all requisite particulars of a transaction are adequately recorded. Also, the work of finalisation of accounts is greatly facilitated. For example, deal slips pertaining to purchase and sale of securities along with the respective counterparty confirmations for the deals are filed together in the deal register.

- All branches of a bank have a unique code number which is circulated amongst all offices of the bank. This code number is required to be put on all important instruments.
- All books are to be balanced periodically and it is to be confirmed by an official. For example, in case of purchase and sale of security transactions, the banks periodically reconcile the security balance in the banks book vis-à-vis the balance in the custodian account (i.e., Subsidiary General Ledger or Demat account). It may be noted that the RBI vide its master circular DBOD No. BP. BC.13/21.04.141/2012-13 dated July 2, 2012 has also mandated that investment balances as per bank's book should be reconciled at quarterly intervals with the balances in the Public Debt Office's books. If the number of transactions warrant, such reconciliation should be undertaken more frequently, say on a monthly basis. This reconciliation should be periodically checked by the internal audit department.
- All inter-office transactions are to be reconciled within a specified time frame.

IV. Accountability for and Safeguarding of Assets

2.35 The accountability for assets starts at the time of their acquisition and continues till their disposal. The accountability for assets is achieved by maintenance of records of assets and their periodic physical verification. To safeguard the assets, it is also necessary that access to assets is limited to authorised personnel. This covers not only direct physical access, but also indirect access through the preparation or processing of documents that authorise the use or disposal of assets. The following are some of the important controls implemented by banks in this regard:

- Particulars of lost security forms are immediately advised to branches so that they can exercise caution.
- The specimen signatures of all officers are maintained in a book which is available in all branches. The officials approving the payment of the instruments drawn on their branches by other branches are required to confirm the signatures on the instruments with reference to the specimen signatures. Likewise, the branches have on record the specimen signatures of the authorised officials of approved correspondent banks also.
- The instruments which are evidence of remittances of funds above a cut-off level are to be signed by more than one official.

- Important financial messages, when transmitted electronically, are in code language/transcripted.
- Negative lists like stop-payment cheques are kept which may deal with the particular kind of transaction. There may be a caution list for advances also.
- Sensitive items like currency, valuables, draft forms, term deposit receipts, traveller's cheques and other such security forms are in the custody of at least two officials of the branch. (However, in the case of very small branches having only one official, single custody is also permitted.)
- All assets of the bank/charged to the bank are physically verified at specified intervals.

V. System Configuration and Account Mapping

2.36 Information technology (IT) has played a major role in providing a competitive edge to banks to differentiate themselves in the market place and to deliver their services more effectively at a lower cost.

VI. Independent Checks

2.37 Independent checks involve a periodic or regular review of functioning of the system by independent persons to ascertain whether the control procedures are being performed properly. Banks have an elaborate system of various forms of internal audit covering virtually every aspect of their functioning.

Operating Framework for Identifying and Dealing with Frauds@

2.38 All banks have policy and operating framework in place for detection, reporting and monitoring of frauds as also the surveillance/ oversight process in operation so as to prevent the perpetration of frauds. The Reserve Bank of India, based on the findings from certain forensic scrutinies conducted by it, vide its Circular No. DBS. CO.FrMC.BC.No.10/23.04.001/2010-11 date 31st May 2011, had identified certain areas wherein frauds had shown occurrence or increasing trend in banks. These areas include:-

- loans/ advances against hypothecation of stocks
- housing loans cases
- submission of forged documents including letters of credit
- escalation of overall cost of the property to obtain higher loan amount

@ Revised in 2013 edition.

- over valuation of mortgaged properties at the time of sanction
- grant of loans against forged FDRs
- over-invoicing of export bills resulting in concessional bank finance, exemptions from various duties, etc.
- frauds stemming from housekeeping deficiencies

2.39 RBI has accordingly prescribed the following guidelines to be incorporated by the banks in their operating framework for identifying and dealing with frauds:

2.40 The operating framework for tracking frauds and dealing with them should be structured along the following three tracks:

(i) Detection and reporting of frauds

(ii) Corrective action and

(iii) Preventive and punitive action

Detection and Reporting of Frauds

(a) The banks are required to have a set of prescribed procedures and criteria with which the events or transactions having serious irregularities are analysed and assessed to establish occurrence of fraud.

(b) The banks may define a 'fraud' based on the guidelines issued by RBI. While doing so, they may clearly demarcate/ distinguish the occurrence of an event on account of negligence '*in conduct of duty'* from '*collusion'* by the bank staff (with the borrowers and with an intention to cheat the bank).

(c) Care needs to be exercised while dealing with instances of 'willful default'. In this connection, a willful default would be deemed to have occurred if any of the following events is noted:

- The unit has defaulted in meeting its payment / repayment obligations to the lender even when it has the capacity to honour the said obligations.
- The unit has defaulted in meeting its payment / repayment obligations to the lender and has not utilised the finance from the lender for the specific purposes for which finance was availed of but has diverted the funds for other purposes.
- The unit has defaulted in meeting its payment / repayment obligations to the lender and has siphoned off the funds so that the funds have not been utilised for the specific purpose for which finance was availed of, nor are the funds available with the unit in the form of other assets.

- The unit has defaulted in meeting its payment / repayment obligations to the lender and has also disposed off or removed the movable fixed assets or immovable property given by him or it for the purpose of securing a term loan without the knowledge of the bank / lender.

(d) Further, the banks may also examine the 'intent' to defraud, irrespective of whether or not actual loss takes place. Keeping these key factors in mind, any action taken in collusion to derive undue/ unjust benefit or advantage should be termed as fraud.

(e) Accordingly, once a fraud is detected, a report must be prepared and submitted to the "Competent Authority".

- As a part of their overall policy and operating framework, the banks need to identify and designate the Competent Authority to whom such reports should be submitted.
- The fraud report should be a diagnostic assessment, clearly bringing out the causes of the fraud and identify whether the fraud occurred due to 'system failure' or 'human failure'.

Corrective Action

2.41 An important corrective step in a fraud is recovery of the amount siphoned off through the fraud. A structured scrutiny/ examination of events or transactions would lead to quick conclusion whether a fraud has occurred and the bank's funds have been siphoned off. Therefore, this exercise is the first critical step towards corrective action in the sense that it would lead to expeditious filing of police complaints, blocking/ freezing of accounts and salvaging funds from the blocked/ frozen accounts in due course.

2.42 Once a set of transactions is explicitly identified as fraudulent, the mandate for seizing and taking possession of related documents, issuance of suspension order/ order to proceed on leave to identified/ suspected employees would be easier thereby preventing them from destroying/ manipulating evidences or obstruction of investigations.

Preventive and Punitive Action

2.43 The preventive action as deemed necessary to address the 'system failure' and/ or punitive action as prescribed internally for 'human failure' should be initiated immediately and completed expeditiously by the banks.

2.44 Generally, in the current system driven environment in banks, wherever transactions occur in breach of/ overriding "Controls", they get reflected in the "end of day exception report". Accordingly, all such exception reports should be perused by the designated officials and a *post facto* authorization for the transactions accorded.

2.45 In certain cases the process may not have got duly implemented reflecting the poor internal control mechanisms. Therefore, banks should ensure that they bring in the needed refinement in this process and also specify the levels/ authority to whom the exception reports will be invariably submitted and the manner in which the authority will deal with the exception reports.

2.46 The entire gamut of the manner in which the exception reports are generated, transactions contained in the reports are examined/ scrutinised, and the reports submitted to higher authorities for necessary authorizations for breaches should be periodically subjected to review and oversight by the bank's management/ Board of Directors.

2.47 In addition to the above, banks have also been advised by RBI to take steps to put in place certain controls and disincentives in their HR processes and internal inspection/ audit processes as part of their fraud risk management framework. These include:

(a) For key and sensitive posts such as those in dealing rooms, treasury, relationship managers for high value customers, heads of specialized branches, etc., selecting only such officers who satisfy the "Fit and Proper" criteria. The appropriateness of such postings should be subjected to periodical review.

(b) Putting in place the "staff rotation" policy and policy for "mandatory leave" for staff. The internal auditors as also the concurrent auditors must be specifically required to examine the implementation of these policies and point out instances of breaches irrespective of apparent justifications for non-compliance, if any. The decisions taken / transactions effected by officers and staff not rotated/ availing leave as per policy should be subjected to comprehensive examination by the internal auditors/ inspectors including concurrent auditors. The findings thereon should be documented in a separate section of the audit/ inspection reports.

(c) Building up a database of officers/ staff identified as those having aptitude for investigation, data analysis, forensic analysis, etc. and expose them to appropriate training in investigations and forensic audit. For investigation of frauds, only such officers/ staff should be deployed through the "fraud investigation unit/ outfit".

Understanding the Risk Management Process

2.48 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:

- *Oversight and involvement in the control process by those charged with governance*: 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. Those charged with governance are also responsible for establishing a culture within the bank that emphasises commitment to internal controls and high ethical standards. Management is responsible for implementing the strategies and policies set by those charged with governance thereby ensuring that an adequate and effective system of internal control is established and maintained.
- *Identification, measurement and monitoring of risks*: Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria. This function is usually performed by the bank's Risk Committee or an independent risk management unit, which is also responsible for validating and stress testing the pricing and valuation models used by the front and back offices. Further, it also monitors risk management activities and evaluates the effectiveness of risk management models, methodologies and assumptions used. The mid office, which is responsible for identifying, measuring and reporting the risk associated with the transaction, within each function usually reports to the Risk Committee or the independent risk management unit. Thus, in this manner the bank's management monitors the overall risks surfaced by the bank.
- *Control activities*: 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.

  RBI has informed banks vide its master circular on 'Risk Management and Inter-bank Dealings' dated July 2, 2012, the risk management framework and reporting requirements with respect to certain categories of transactions such as, forward contracts and hedging transactions entered into by the bank with residents, managing of assets and liabilities of the bank and hedging the same, hedging of Tier I capital in case of foreign banks, etc.

For every bank in India, certain risk management limits such as, the net open position ('NOP') limit and aggregate gap limit ('AGL') are approved by the RBI after making an assessment of each bank overall risk appetite. Banks install checks in their daily processes to ensure that these limits are being adhered to at all times.

As part of regulatory reporting, banks are also required to report to the RBI a host of other risk management limits such as, single and group borrower limits (these limits give an indication of concentration risk), credit exposure for derivatives (this indicates the potential replacement cost of the derivative portfolio), capital market exposure of the bank, country risk exposure and exposure to sensitive sectors such as, real estate, etc.

- *Monitoring activities*: 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. Internal auditing should test the risk management process periodically to check whether management policies and procedures are complied with and whether the operational controls are effective. Both the risk management unit and internal auditing should have a reporting line to those charged with governance (i.e., the BOD or the Executive Committee) and management that is independent of those on whom they are reporting.
- *Reliable information systems*: 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.

Engagement Team Discussions

2.49 The engagement team should hold discussions to gain better understanding of banks and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. The discussion provides the following:

- An opportunity for more experienced engagement team members, including the audit engagement partner, to share their insights based on their knowledge of the bank and its environment.
- An opportunity for engagement team members to exchange information about the bank's business risks.
- An understanding amongst the engagement team members about affect of the results of the risk assessment procedures on other aspects of the audit, including decisions about the nature, timing, and extent of further audit procedures.

2.50 The discussion between the members of the engagement team and the audit engagement partner should be done on the susceptibility of the bank's financial statements to material misstatements. These discussions are ordinarily done at the planning stage of an audit. Specific emphasis should be provided to the susceptibility of the bank's financial statements to material misstatement due to fraud, that enables the engagement team to consider an appropriate response to fraud risks, including those related to engagement risk, pervasive risks, and specific risks. It further enables the audit engagement partner to delegate the work to the experienced engagement team members, and to determine the procedures to be followed when fraud is identified. Further, audit engagement partner may review the need to involve specialists to address the issues relating to fraud.

2.51 The engagement team discussion includes a discussion of the following matters:

- Errors that may be more likely to occur;
- The method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;
- Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;
- The need to maintain professional skepticism throughout the audit engagement; and
- The need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances).

2.52 On the matters relating to fraud, the engagement team discussion ordinarily includes the following:

- An exchange of ideas among engagement team members about how and where they believe the bank's financial statements may be susceptible to material misstatement due to fraud. Further, manner of involvement of the management, those charged with governance and others within the entity should also be discussed.

- Consideration of circumstances that might be indicative of fraud in the earnings of the bank; and the practices that might be followed by the bank's management to manage earnings that could lead to fraudulent financial reporting.
- Consideration of the external/internal factors affecting the bank that may create an incentive or pressure on management or others to commit fraud.
- Consideration of management's involvement in overseeing the employees having access to cash or other assets susceptible to misappropriation.
- Consideration of any unusual or unexplained changes in behaviour or lifestyle of management or employees that may have come to the attention of the engagement team.
- Consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.
- Selection of audit procedures to respond to the susceptibility of the fraud.
- Consideration of any allegations of fraud or suspected fraud that may have come to the auditor's attention.
- Consideration of the risk of management override of controls.

2.53 Further, the audit engagement partner should also consider matters to be communicated to the members of the Engagement Team not involved in the discussion. For multi-location audit engagements for which separate engagement teams are performing work under the supervision of audit engagement partners in separate locations, the auditor may hold multiple discussion that involve the members of the engagement team in each significant location.

2.54 With respect to the engagement team discussions, the auditor may document the following matters:

- discussion amongst the engagement team regarding the susceptibility of the material misstatement whether due to fraud or not; and
- significant decisions reached during the discussion amongst the engagement team regarding the susceptibility of the material misstatement whether due to fraud or not.

Establish the Overall Audit Strategy

2.55 Revised Standard on Auditing (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.

2.56 The overall audit strategy sets the scope, timing and direction of the audit as it guides the development of detailed audit plan. The establishment of the overall audit strategy involves:

- Identifying the characteristics of the audit engagement that define its scope, such as the financial reporting framework used (Third Schedule to the Banking Regulation Act, 1949), additional reporting requirements at various locations of the components of the bank prescribed by the RBI, etc.
- Ascertaining the reporting objectives of the audit engagement to plan the timing of the audit and the nature of the communications required, such as deadlines for interim and final reporting, key dates for expected communications with the management and with those charged with governance.
- Considering the important factors that will determine the focus of the engagement team's efforts, such as determination of appropriate audit materiality, preliminary identification of significant risks, preliminary identification of material components and significant account balances and disclosures.
- Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts.
- Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the bank is relevant.
- Ascertain the nature, timing and extent of resources necessary to perform the engagement.

2.57 The auditors should document the overall audit strategy, including any significant changes thereto. The documentation of the overall audit strategy records the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team. For example, the auditor may summarise the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit. Ordinarily, following are documented as part of establishing the overall audit strategy:

- Summarisation of significant matters relating to overall audit strategy.
- Significant risks identified.
- Other decisions considered necessary to properly plan the audit.

Develop the Audit Plan

2.58 Revised Standard on Auditing (SA) 300, "Planning an Audit of Financial Statements" deals with the auditor's responsibility to plan an audit of financial statements in an effective manner. It requires the involvement of all the key members of the engagement team while planning an audit. Before starting the planning of an audit, the auditor must perform the procedures as defined under Revised SA 220, "Quality Control for an Audit of Financial Statements" for reviewing the ethical and independence requirements. In addition to this, the auditor is also required to comply with the requirements of Revised SA 210, "Agreeing the Terms of Audit Engagement".

2.59 The auditor must establish overall audit strategy for developing an audit plan for the bank's financial statements as a whole, and at the assertion level for classes of transactions, account balances, and disclosures. To be efficient, the auditor must plan their audit by considering the inter-relationships amongst the various risk assessment procedures, planned control-reliance strategy, planned substantive procedures, and at the assertion level for classes of transactions, account balances, and disclosures so as to avoid unnecessary duplication of effort. This can further be summarised by preparing an audit planning memorandum detailing the various activities to be performed by an auditor while conducting an audit of a bank. The audit plan documents the nature, timing and extent of the planned audit procedures.

2.60 Ordinarily, to develop the audit plan the auditor would need to gather more detailed information about the bank and its environment, which will enable them to plan their audit procedures for each significant account balances and disclosure. The requisite detailed information may be obtained from the following:

- Obtaining an understanding of the bank and its environment, including the bank's internal control;
- Understanding the bank's accounting process;

- Performing a preliminary analytical review;
- Assessment of risk at the assertion level;
- Planning a Control-Reliance Strategy;
- Planning substantive procedures;
- In case of identified misstatements, obtaining reasonable assurance from the substantive procedures;
- Consider the expectations and concerns of management, which could impact the timing of the audit procedures. Further, in some cases, management may request the auditor to perform audit procedures on specific areas (e.g., controls) so as to provide assurance on the design, implementation, and operating effectiveness of those specific areas;
- Work performed by internal auditors;
- Statutory or other legal and regulatory requirements; and
- Using the work of an Expert.

2.61 The auditor could use the information gathered above to develop an effective audit plan that will appropriately respond to identified risks, and would also help in providing the necessary level of assurance.

2.62 Based on the assessment of engagement risk, pervasive risks, and specific risks at the assertion level for classes of transactions, account balances, and disclosures, the auditor should design audit procedures so as to obtain reasonable assurance about the identification and detection of all the material misstatement, whether due to fraud or not, to the financial statements taken as a whole, either individually or in combination with others.

2.63 In case of a bank having multiple locations or subsidiaries, the auditor may face challenges in gathering sufficient appropriate audit evidence so as to reduce the risk of material misstatement to an acceptably low level. Ordinarily, multiple locations audit engagement requires a more extensive and detailed audit plan than that required in case of an audit of single location entities.

2.64 In developing the audit plan, the auditor is also required to consider the nature, timing, and extent of audit procedures required under Standard on Auditing (SA) 540 (Revised), “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures” for fair value measurements and disclosures. For the performance of audit procedures related to fair value, the auditor may decide to use the work of an expert. In such a case, the auditor ordinarily involves the expert in the development of the audit plan for the fair value measurements and disclosures. Further, while using the work of an expert, the auditor is also required to follow the procedures given in Revised SA 620, "Using the Work of an Auditor's Expert".

2.65 The auditor must consider the appropriateness of the going concern assumption, based on their understanding of the bank and its environment and information obtained, while performing the preliminary engagement and planning activities.

2.66 When developing audit plan for an initial audit engagement, the auditor should consider the nature, timing, and extent of audit procedures that will need to be performed on the opening balances, as well as their effect on the current year's audit procedures if the auditor is unable to obtain sufficient appropriate audit evidence supporting the opening balances. In this regard, the auditor is also required to perform the procedures as given in SA 510 (Revised), "Initial Audit Engagements-Opening Balances".

2.67 In developing the audit plan, the auditor should ordinarily document the following:

- The overall audit strategy;
- Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes;
- Decisions impacting the nature, timing, and extent of audit procedures; and
- Audit plan, including any significant changes made during the audit engagement.

Audit Planning Memorandum

2.68 The auditor should summarise their 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.

2.69 The audit planning memorandum should be approved by the audit engagement partner. It ordinarily addresses the following matters:

- Assessment of and planned responses to the engagement risk, pervasive risks or specific risk at the assertion level for classes of transactions, account balances, and disclosures.
- Assessment of the initial conclusions in respect to the independence and potential conflict of interest.
- Other significant issues arising out of the planning activities, which may include the following:
  - Identified fraud risk factors;
  - Preliminary conclusions regarding the components of internal control;
  - Audit materiality;
  - IT environment of the bank and need to use the work of an expert; and
  - Changes in the bank's environment such as, changes in accounting policies or accounting process of the bank.

Determine Audit Materiality

2.70 SA 320 (Revised), "Materiality in Planning and Performing an Audit" defines the materiality in the context of an audit as financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;

- Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and

- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

The determination of audit materiality is a matter of professional judgment and is affected by the auditor's perception of the financial information needs of users of the financial statements.

2.71 SA 320 (Revised) also defines performance materiality as the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

2.72 When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures.

2.73 As per SA 450, "Evaluation of Misstatements Identified during the Audit", the auditor is required to accumulate misstatements identified during the audit, other than those that are clearly trivial. Further, it also requires an auditor to communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation and also request management to correct those misstatements. If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor should obtain an understanding of management's reasons for not making the corrections and should take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement. The auditor is also requires to reassess materiality determined in accordance with SA 320 (Revised) to confirm whether it remains appropriate in the context of the entity's actual financial results. Further, he should also determine whether uncorrected misstatements are material, individually or in aggregate. The auditor should communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication should identify material uncorrected misstatements individually. The auditor should request that uncorrected misstatements be corrected. The auditor should request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation.

Consider Going Concern

2.74 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[2]. The auditor needs to consider events and conditions relating to the going concern assumption when performing risk assessment procedures so as to make timely discussions with the management, review the management's plans, and resolution of any identified going concern issues. Audit procedures, which may indicate that there could be a question about a bank's ability to continue as a going concern for the foreseeable future including the following:

- Analysing and discussing cash flow, profit and other relevant forecasts with management;
- Analysing and discussing the entity's latest available interim financial statements;
    - Reading the terms of debentures and loan agreements and determining whether any have been breached;
    - Reading of minutes of meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties;
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds;
    - Evaluating the entity's plans to deal with unfilled customer orders;
    - Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern;
- Confirming the existence, terms and adequacy of borrowing facilities;

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[2] SA 570 (Revised), "Going Concern".

- Obtaining and reviewing reports of regulatory actions;
- Inquiry of the bank's legal counsel about existence of litigation and claims, and the reasonableness of management's assessments of their outcome and the estimate of their financial implications; and
- Determining the adequacy of support for any planned disposals of assets.

2.75 There are certain specific events or conditions, which could specifically cast a significant doubt on the ability of the bank to continue as a going concern:

- Rapid increase in the volume of derivative business without necessary controls being in place.
- Decline in the projected profitability, if the bank is at or near its minimum level of regulatory capital.
- Higher interest rates being paid on deposits and borrowing than the market rates.
- Actions taken or threatened by regulators that may have an adverse effect on the ability of the bank to continue as a going concern.
- High concentration of exposure to certain borrowers or industries.

Assess the Risk of Fraud including Money Laundering

2.76 As per SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor's objective are 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 skepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud. When obtaining an understanding of the bank and its environment, the auditor should make inquiries of management regarding the following:

- Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments.
- Management's process for identifying and responding to the risk of fraud in the bank, including any specific risks of fraud that management has identified or that have been brought to its attention; or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; and the internal control that management has established to address these risks.

- Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the bank.
- Management's communication, if any, to employees regarding its views on business practices and ethical behaviour.

2.77 As the management is responsible for the bank's internal control and for the preparation of the financial statements, it is appropriate for the auditor to make inquiries of management regarding its assessment of the risk of fraud and the controls in place to prevent and detect it. The auditor should make inquiries of management, internal auditor, and others within the bank, as appropriate, to determine whether they have knowledge of any actual, suspected, or alleged fraud affecting the bank. The nature, extent, and frequency of management's assessment are relevant to understanding of the bank's control environment. For example, the fact that management has not made an assessment of the risk of fraud may, in some circumstances, indicate the lack of importance that management places on internal control.

2.78 When the auditor makes inquiries about actual, suspected, or alleged fraud that the bank is investigating, he should consider whether any errors or fraud discovered or being investigated are indicators of an increased risk of material misstatement. The auditor should also make inquiries about the process the bank undertakes to respond to internal or external allegations of fraud affecting the bank.

2.79 When evaluating management's responses to inquiries, the auditors must maintain an attitude of professional skepticism, recognising that management is often in the best position to perpetrate fraud. Therefore, they must use professional judgment in deciding if it is necessary to corroborate responses to inquiries with other information. When responses to inquiries are inconsistent, they must seek to resolve the inconsistencies.

2.80 The auditor should obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the bank, and the internal control that management has established to address these risks. The auditor should make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected, or alleged fraud affecting the bank.

2.81 The auditor should make inquiries of those charged with governance in part to corroborate management's responses to the inquiries. When responses to these inquiries are inconsistent, they should obtain additional audit evidence to resolve the inconsistencies. Inquiries of those charged with governance may also assist in identifying risks of material misstatement due to fraud.

2.82 Some of the common fraud risk factors in deposit taking, dealing and lending activities areas are summarised hereunder:

	Deposit Taking	Dealing	Lending
Management and employee frauds	• Camouflage of depositors by hiding their identity in connection with funds transfer or money laundering. • Unrecorded deposits. • Theft of customer deposits particularly, from dormant accounts.	• Off market / related party deals whereby no checks are carried out on the prices at which deals are transacted or there are unusual activity levels with certain counterparties. • High level of business with particular brokers, including payment of abnormal commission. • False deals represented by unusual number of cancelled deals or unusually high number of unsettled transactions. • Delayed deal allocations represented by	• Loans to fictitious borrowers. • Transactions with connected companies. • Kick backs and inducements. • Selling recovered collateral at below market prices. • Bribes to obtain release of security or to reduce the amount claimed. • Theft or misuse of collateral held as security.

	Deposit Taking	Dealing	Lending
		no time stamping of deals or alterations or overwriting on deals sheets. • Exploiting weaknesses in matching procedures due to absence of proper guidelines.	
External Frauds	• Money Laundering. • Fraudulent instructions. • Counterfeit currency.	• Fraudulent custodial sales. • False information or documents regarding counterparties.	• Impersonation and false information on loan applications. • Fraudulent valuations. • Misappropriation of loan funds by agents / customers

2.83 Due to the nature of their business, banks are ready for targeting those who are engaged in the money laundering activities by which the proceeds of illegal acts are converted into proceeds from the legal acts. 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 RBI, vide its master circular no. DBOD. AML. BC. No. 11 /14.01.001/2012-13 dated July 2, 2012 on "Know Your Customer (KYC) norms/Anti-Money Laundering (AML) standards/Combating of Financing of Terrorism (CFT)/Obligation of banks under PMLA, 2002", have advised the banks to follow certain customer identification procedure for opening of accounts and monitoring transactions of a suspicious nature for the purpose of reporting it to appropriate authority. These policies, procedures and controls commonly extend to the following:

- *Customer acceptance policy*, i.e., criteria for accepting the customers.
- *Customer identification procedure*, i.e., procedures to be carried out while establishing a banking relationship; carrying out a financial transaction or when the bank has a doubt about the authenticity/veracity or the adequacy of the previously obtained customer identification data.
- A requirement to obtain customer identification (know your client).
- *Monitoring of transactions* – Banks are advised to set key indicators for risk sensitive (e.g., high turnover accounts or complex or unusal transactions accounts) accounts, taking note of the background of the customer, such as the country of origin, sources of funds, the type of transactions involved and other risk factors. Banks should also put in place a system of periodical review of risk categorisation of accounts and the need for applying enhanced due diligence measures. Such review of risk categorisation of customers should be carried out at a periodicity of not less than once in six months. In view of the risks involved in cash intensive businesses, accounts of bullion dealers (including sub-dealers) & jewellers, the banks are also advised to categorise these accounts as 'high risk' requiring enhanced due diligence. Further, the banks are also required to subject these 'high risk accounts ' to intensified transaction monitoring. High risk associated with such accounts should be taken into account by banks to identify suspicious transactions for filing Suspicious Transaction Reports (STRs) to FIU-IND.

  Further, banks should closely monitor the transactions in accounts of marketing firms (MLM Companies). In cases where a large number of cheque books are sought by the company, there are multiple small deposits (generally in cash) across the country in one bank account and where a large number of cheques are issued bearing similar amounts/dates, the bank should carefully analyse such data and in case they find such unusual operations in accounts, the matter should be immediately reported to Reserve Bank and other appropriate authorities such as Financial Intelligence Unit India (FIU-Ind) under Department of Revenue, Ministry of Finance.

Banks are advised to complete the process of risk categorization and compiling/updating profiles of all of their existing customers in a time-bound manner, and in any case not later than end-March 2013.

- *Closure of accounts*- In case of non-application of proper KYC measures, banks may decide to close the account of the particular customer after giving due notice to the customer.
- *Risk Management*- The Board of Directors of the bank should ensure that an effective KYC programme is put in place by establishing appropriate procedures and ensuring their effective implementation. It should cover proper management oversight, systems and controls, segregation of duties, training and other related matters. Responsibility should be explicitly allocated within the bank for ensuring that the bank's policies and procedures are implemented effectively. Concurrent/ Internal Auditors should specifically check and verify the application of KYC procedures at the branches and comment on the lapses observed in this regard. The compliance in this regard should be put up before the Audit Committee of the Board on quarterly intervals.
- Reporting to the authorities of suspicious transactions or of all transactions of a particular type, for example, cash transactions over a certain amount.

2.84 The RBI master circular also advised the banks to pay special attention to any money laundering threats that may arise from new or developing technologies including, internet banking that might favour anonymity, and take measures, if needed, to prevent their use in money laundering schemes. Further, banks are required to report all frauds to the RBI on a periodical basis. The auditors should review the same to get an idea of the nature and extent of frauds. "Money mules"[3] can be used to launder the proceeds of fraud schemes (e.g., phishing and identity theft) by criminals who gain illegal access to deposit accounts by recruiting third parties to act as "money mules." In some cases these third parties may be innocent while in others they may be having complicity with the criminals. In a money mule transaction, an individual with a bank account is recruited to receive cheque deposits or wire transfers and then transfer these funds to accounts held on behalf of another person or to other individuals, minus a certain commission payment. Money mules may be recruited by a variety of methods, including spam e-mails, advertisements on genuine recruitment web sites, social networking sites, instant messaging and advertisements in newspapers. When caught, these money mules often have their bank accounts suspended, causing inconvenience and potential financial

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[3] The RBI, vide its circular no. DBOD. AML. BC. No. 65/14 .01.001/2010-11 dated December 7, 2010 provides guidance on Operation of bank accounts & money mules.

loss, apart from facing likely legal action for being part of a fraud. Many a times the address and contact details of such mules are found to be fake or not up to date, making it difficult for enforcement agencies to locate the account holder. The operations of such mule accounts can be minimised if banks follow the guidelines contained in the Master Circular on Know Your Customer (KYC) norms /Anti-Money Laundering (AML) standards/ Combating of Financing of Terrorism (CFT)/Obligation of banks under PMLA, 2002. Banks are, therefore, required to strictly adhere to the guidelines on KYC/AML/CFT issued from time to time and to those relating to periodical updation of customer identification data after the account is opened and also to monitoring of transactions in order to protect themselves and their customers from misuse by such fraudsters.

Assess Specific Risks

2.85 The auditors should identify and assess the risks of material misstatement at the financial statement level which refers to risks that relate pervasively to the financial statements as a whole, and potentially affect many assertions. Risk of material misstatement at the assertion level for specific class of transactions, account balances and disclosures need to be considered because such consideration directly assists in determining the nature, timing and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence.

2.86 For this purpose, the auditor should perform the following:

- Identify risks throughout the process of obtaining an understanding of the bank and its environment, including applicable controls that relate to the risks, and by considering the account balances or disclosures in the financial statements.
- Pinpoint each risk to one or more assertions relating to the account balances or disclosures.
- Consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements.
- Document the identified and assessed risks of material misstatement at the assertion level.

2.87 Although there is always a risk of misstatement for each significant account balance and disclosure, a specific risk exists when the auditor recognises one or more factors that significantly increases the risk of material misstatement. This assessment is based on the nature of the risk, the likelihood of the occurrence of the risk, and the likely magnitude of any resulting misstatements.

2.88 The identification of specific risks, which arise on most audits, is a matter of professional judgment. The factors influencing the identification of specific risks may include the following:

- past misstatements strongly indicate about the likely occurrence of future misstatements;
- the application systems are unreliable;
- non-systematically processed transactions have a disproportionately higher likelihood of misstatement than those routine transactions that are processed by reliable application systems;
- the incidence of misstatements is greater in transactions relating to accounting estimates and adjustments at or near to the end of an accounting period (i.e., cut-offs and accruals); and
- the incidence of misstatements associated with unusual or complex transactions.

The greater the likelihood that the risk could result in a material misstatement of the financial statements, the greater the potential for that risk of material misstatement to be assessed as a specific risk.

2.89 The auditor's assessment of the risks of material misstatement at the assertion level is based on available audit evidence which may change during the course of the audit as and when further audit evidence is obtained indicating the change in the previously obtained audit evidence (e.g., when performing substantive procedures, the auditor may detect misstatements in amounts or frequency greater than that of consistent with their risk assessment). In these circumstances, the auditor needs to consider whether it is appropriate to revise the risk assessment procedures and modify the further planned audit procedures accordingly. The auditor is required to document the identified and assessed risks of material misstatement at the assertion level.

2.90 Most transactions involve more than one type of the risk identified, as mentioned in the Annexure-1 to this chapter. Furthermore, the individual risks set out above may be correlated with one another. For example, a bank's credit exposure in a securities transaction may increase as a result of an increase in the market price of the securities concerned. Similarly, non-payment or settlement failure can have consequences for a bank's liquidity position. The auditor therefore considers these and other risk correlations when analysing the risks to which a bank is exposed.

Risk Associated with Outsourcing of Activities

2.91 Further, 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, a number of risks associated with outsourcing of activities by banks and therefore, it is quintessential for the banks to effectively manage those risks. RBI's circular no. DBOD.BP.40/21.04.158/2006-07 dated November 3, 2006 contains extensive guidelines on managing the risks associated with the outsourcing of financial services by banks. The circular, however, also mandates that banks which choose to outsource financial services should not outsource core management functions including internal audit, compliance function and decision-making functions like, determining compliance with Know Your Customer ('KYC') norms for opening deposit accounts, according sanction for loans (including retail loans) and management of investment portfolio.

2.92 In addition to understanding the external factors that could indicate increased risk, the natures of risks arising from the bank's operations are also of significant importance. Factors that contribute significantly to operational risk include the following:

(a) The need to process high volumes of transactions accurately within a short time through the large-scale use of IT.

(b) The need to use electronic funds transfer (EFT) or other telecommunication system to transfer ownership of large sums of money, with the resultant risk of exposure to loss arising from payments to incorrect parties through fraud or error.

(c) The conduct of operations in many locations with a resultant geographic dispersion of transaction processing and internal controls. As a result:

   (i) there is a risk that the bank's worldwide exposure, customer-wise and product-wise may not be adequately aggregated and monitored; and

   (ii) control breakdowns may occur and remain undetected or uncorrected because of the physical separation between management and those who handle the transactions.

(d) The need to monitor and manage significant exposures that can arise over short timeframes. The process of clearing transactions may cause a significant build-up of receivables and payables during a day, most of which are settled by the end of the day. This is ordinarily referred to as intra-day payment risk. These exposures arise from transactions with customers and counterparties and may include interest rate, currency and market risks.

(e) The handling of large volumes of monetary items, including cash, negotiable instruments and transferable customer balances, with the resultant risk of loss arising from theft and fraud by employees or other parties.

(f) The inherent complexity and volatility of the environment in which banks operate, resulting in the risk of inappropriate risk management strategies or accounting treatment, in relation to such matters as the development of new products and services.

(g) Overseas operations are subject to the laws and regulations of the countries in which they are based as well as those of the country in which the parent entity has its headquarters. This may result in the need to adhere to differing requirements, thereby, leading to risk that operating procedures that comply with regulations in some jurisdictions do not meet the requirements of others.

Response to the Assessed Risks

2.93 SA 330, "The Auditor's Responses to Assessed Risks" deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with SA 315. Further, it 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. In designing the further audit procedures to be performed, the auditor should:

(a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:

    (i) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risk); and

    (ii) Whether the risk assessment takes into account the relevant controls (i.e., the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and

(b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk.

2.94 The auditor shall design and perform tests of controls and substantive procedures to obtain sufficient appropriate audit evidence, as to the operating effectiveness of relevant controls, and to detect material misstatements at the assertion level.

2.95 Banks usually use a wide range of quantitative tools and matrices to measure and monitor risks. Some of the commonly used tools to measure and monitor market risk are Value at Risk (VAR) and Stress Testing.

Value-at-risk ('VAR')

2.96 For a given portfolio, value-at-risk measures the potential future loss (in terms of market value) that, under normal market conditions, will not be exceeded, with a defined confidence level in a defined period. The value-at-risk for a total portfolio represents a measure of diversified market risk (aggregated using pre-determined correlations) in that portfolio. Banks calculate value-at-risk for both internal and regulatory reporting using a 99% confidence level.

Stress Testing

2.97 Globally, banks are increasingly relying on statistical models to measure and manage the financial risks to which they are exposed. These models are gaining credibility because they provide a framework for identifying, analysing, measuring, communicating and managing these risks. Since models cannot incorporate all possible risk outcomes and are generally not capable of capturing sudden and dramatic changes, banks supplement models with 'stress tests'. Internationally, stress testing has become an integral part of banks' risk management systems and is used to evaluate the potential vulnerability to some unlikely but plausible events or movements in financial variables. There are broadly two categories of stress tests used in banks, *viz.,* sensitivity tests and scenario tests. These may be used either separately or in conjunction with each other.

2.98 RBI, vide its circular no. DBOD. No. BP. BC.101 / 21.04.103/ 2006-07 dated June 26, 2007 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. The circular further requires that the framework should satisfy certain essential requirements as listed therein.

2.99 The circular also states that while traditionally stress tests are used in the context of managing market risks, these may also be employed in the management of credit risks, operational risks and liquidity funding risk. Banks should identify their major risks that should be subjected to stress tests.

2.100 Banks should stress the relevant parameters at least at three levels of increasing adversity – minor, medium, and major – with reference to the normal situation and estimate the financial resources needed by it under each of the circumstances to:

a) meet the risk as it arises and for mitigating the impact of manifestation of that risk;
b) meet the liabilities as they fall due; and
c) meet the minimum CRAR requirements.

Banks may apply stress tests at varying frequencies dictated by their respective business requirements, relevance and cost.

2.101 The results of the various stress tests should be reviewed by the senior management and reported to the Board. The circular emphasises that these results should be an essential ingredient of bank's risk management systems.

2.102 The remedial actions that banks may consider necessary to activate when the various stress tolerance levels are breached may include:

a) Reduction of risk limits;
b) Reduction of risks by enhancing collateral requirements, seeking higher level of risk mitigants, undertaking securitisation, and hedging;
c) Amend pricing policies to reflect enhanced risks or previously unidentified risks;
d) Augmenting the capital levels to enhance the buffer to absorb shocks;
e) Enhancing sources of funds through credit lines, managing the liability structure, altering the liquid asset profile, etc.

2.103 Stress tests should, as far as possible, be conducted on a bank-wide basis and should be adequately tailored to capture country or market or portfolio specific factors. Stress tests undertaken on a bank-wide basis enable the Board and senior management to assess the potential impact of the stress situations on the bank's earnings and capital position, and enable them to develop or choose appropriate strategies for mitigating and managing the impact of those situations. The framework also helps bank managements in understanding the bank's risk profile and adjusting it in accordance with their risk appetite. The stress test results should be considered while establishing and reviewing various policies and limits.

2.104 RBI requires the banks to put in place appropriate stress test policies and the relevant stress test framework for the various risk factors by September 30, 2007 as also to ensure that their formal stress testing frameworks, which are in accordance with these guidelines, are operational from March 31, 2008.

BASEL II framework

2.105 The new capital adequacy framework for banks seeks to arrive at significantly more risk-sensitive approaches to capital requirements of a bank. The revised Basel II framework attempts to promote more advanced risk management systems, align regulatory capital closer to economic capital and thus promote greater efficiency in the use of capital. The reader may refer to the chapter 1 of part V of the Guidance Note for the detailed guidance on the New Capital Adequacy Framework, i.e., Basel II.

Annexure 1

Risks Associated with the Banking Activities

The risks associated with the banking activities can be broadly categorised as follows:

(a) *Concentration risk*: Banking risks increase with the degree of concentration of a bank's exposure to any one customer, industry, geographic area or country. For example, a bank's loan portfolio may have large concentrations of loans or commitments to particular industries, and some, such as real estate, shipping and natural resources, may have highly specialized practices. Assessing the relevant risks relating to loans to entities in those industries may require knowledge of these industries, including their business, operational and reporting practices.

(b) *Country risk*: The risk of foreign customers and counterparties failing to settle their obligations because of economic, political and social factors of the counterparty's home country and external to the customer or counterparty.

(c) *Credit risk*: The risk that a customer or counterparty will not settle an obligation for full value, either when due or at any time thereafter. Credit risk, particularly from commercial lending, may be considered the most important risk in banking operations. Credit risk arises from lending to individuals, companies, banks and governments. It also exists in assets other than loans, such as investments, balances due from other banks and in off-balance sheet commitments. Credit risk also includes country risk, transfer risk, replacement risk and settlement risk.

(d) *Currency risk*: The risk of loss arising from future movements in the exchange rates applicable to foreign currency assets, liabilities, rights and obligations.

(e) *Fiduciary risk*: The risk of loss arising from factors such as failure to maintain safe custody or negligence in the management of assets on behalf of other parties.

(f) *Interest rate risk*: The risk that a movement in interest rates would have an adverse effect on the value of assets and liabilities or would affect interest cash flows.

(g) *Legal and documentary risk*: The risk that contracts are documented incorrectly or are not legally enforceable in the relevant jurisdiction in which the contracts are to be enforced or where the counterparties operate. This can include the risk that assets will turn out to be worthless or liabilities will turn out to be greater than expected because of inadequate or incorrect legal advice or documentation. In addition, existing laws may fail to resolve legal issues involving a bank; a court case involving a particular bank may have wider implications for the banking business and involve costs to it and many or all other banks; and laws affecting banks or other commercial enterprises may change. Banks are particularly susceptible to legal risks when entering into new types of transactions and when the legal right of the counterparty to enter into a transaction is not established.

(h) *Liquidity risk*: The risk of loss arising from the changes in the bank's ability to sell or dispose of an asset.

(i) *Modelling risk*: The risk associated with the imperfections and subjectivity of valuation models used to determine the values of assets or liabilities.

(j) *Operational risk*: The risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.

(k) *Price risk*: The risk of loss arising from adverse changes in market prices, including interest rates, foreign exchange rates, equity and commodity prices and from movements in the market prices of investments.

(l) *Regulatory risk*: The risk of loss arising from failure to comply with regulatory or legal requirements in the relevant jurisdiction in which the bank operates. It also includes any loss that could arise from changes in regulatory requirements. (In this context, the circular no. DBS.CO.PP.BC.6/11.01.005/2006-07 dated April 20, 2007 is also relevant. The circular lays down detailed requirements in respect of compliance related aspects such as compliance risk, responsibility of the Board of Directors, responsibility of the senior management, compliance policy, compliance structure, compliance principles, process and procedures, compliance programme, etc.)

(m) *Replacement/Performance risk*: The risk of failure of a customer or counterparty to perform the terms of a contract. This failure creates the need to replace the failed transaction with another counterparty at the current market price. This may result in a loss to the bank equivalent to the difference between the contract price and the current market price.

(n) *Reputational risk*: The risk of losing business because of negative public opinion and consequential damage to the bank's reputation arising from failure to properly manage some of the above risks, or from involvement in improper or illegal activities by the bank or its senior management, such as money laundering or attempts to cover up losses.

(o) *Settlement risk*: The risk that one side of a transaction will be settled without value being received from the customer or counterparty. This will generally result in the loss to the bank of the full principal amount.

(p) *Solvency risk*: The risk of loss arising from the possibility of the bank not having sufficient funds to meet its obligations, or from the bank's inability to access capital markets to raise required funds.

(q) *Transfer risk*: The risk of loss arising when a counterparty's obligation is not denominated in the counterparty's home currency. The counterparty may be unable to obtain the currency of the obligation irrespective of the counterparty's particular financial condition.

(r) *Volatility risk*: This is a type of market risk which specifically pertains to option positions. An increase in the volatility of the price of the instrument underlying the option will generally result in an increase in the value of any bought (long) option position. The opposite will apply for a decrease in volatility

II-3

Special Considerations in a CIS Environment

3.01 As per SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", the overall objective and scope of an audit does not change in a CIS environment. However, the use of a computer changes the processing, storage, retrieval and communication of financial information and may affect the accounting and internal control systems employed by the bank. Accordingly, CIS environment may affect:

- the procedures followed by the auditor in obtaining sufficient understanding of the accounting and internal control system;
- the auditor's evaluation of inherent risk and control risk through which the auditor assesses the audit risk; and
- the auditor's design and performance of tests of control and substantive procedures appropriate to meet the audit objective.

3.02 The auditor should evaluate, *inter alia*, the following factors to determine the effect of CIS environment on the audit:

- the extent to which the CIS environment is used to record, compile and analyse accounting information;
- the system of internal control in existence in the bank with regard to:
  - (i) flow of authorised, correct and complete data to the processing centre;
  - (ii) processing, analysis and reporting tasks undertaken; and
- the impact of computer-based accounting system on the audit trail that could otherwise be expected to exist in an entirely manual system.

3.03 As in today's environment all banks have embarked upon a large scale computerisation, which has resulted in changes in the processing and storage of information and affects the organisation and procedures employed by the entity to achieve adequate internal control. Thus, while the overall objective and scope of audit do not change simply because data is maintained on computers, the procedures followed by the auditor in his study and evaluation of the accounting system and related internal controls and the nature, timing and extent of his other audit procedures are affected in a CIS environment.

3.04 The control concerns arising from the use of IT by a bank are similar to those arising when IT is used by other organisations. However, the matters that are of particular concern to the auditor of a bank include the following:

- The use of IT to calculate and record, substantially, all of the interest income and interest expense, which are ordinarily two of the most important elements in the determination of a bank's earnings.
- The use of IT and telecommunications systems to determine the foreign exchange security and derivative trading positions, and to calculate and record the gains and losses arising from them.
- The extensive, and in some cases almost total, dependence on the records produced by IT because they represent only readily accessible source of detailed up-to-date information on the bank's assets and liability positions, such as, customer loan and deposit balances.
- The use of complex valuation models incorporated in the IT systems.
- The models used to value assets and the data used by those models are often kept in spreadsheets prepared by individuals on personal computers not linked to the bank's main IT systems and not subject to the same controls as applications on those systems.
- The use of different IT systems resulting in the risk of loss of audit trail and incompatibility of different systems.

3.05 EFT systems are used by banks both internally (for example, for transfers between branches and between automated banking machines and the computerised files that record account activity) and externally between the bank and other financial institutions (for example, through the SWIFT network) and also between the bank and its customers through the internet or other electronic commerce media.

3.06 The auditor obtains an understanding of the core IT, EFT and telecommunication applications and the links between those applications. The auditor relates this understanding to the major business processes or balance sheet positions in order to identify the risk factors for the organisation and therefore, for the audit. In addition, it is important to identify the extent of the use of self-developed applications or integrated systems, which will have a direct effect on the audit approach. (Self developed systems require the auditor to focus more extensively on the program change controls.)

3.07 When auditing in a distributed IT environment, the auditor obtains an understanding of where the core IT applications are located. If the bank's Wide Area Network (WAN) is dispersed over several countries, specific legislative rules might apply to cross-border data processing. In such an environment, audit work on the access control system, especially on the access violation system, is an important part of the audit.

Categorisation of Banks based on level of Computerisation

3.08 Banks may be divided into three board categorises based on the level of computerisation:

- Non-computerised banks
- Partially Computerised banks
- Fully computerised banks

3.09 Generally, private sector banks and foreign banks have got fully computerised environment. Most of the public sector banks also have achieved 100% computerisation. Special care is to be taken while doing the audit in a fully computerised environment (Core Banking Solution-CBS).

Responsibility of Central Auditor *vis-à-vis* Branch Auditor in fully computerised bank

3.10 Banks, which have high level of computerisation and centralisation, equally have a high level of decentralisation of processes and underlying activities, e.g., in case of advances, the credit processing and accounting are centralised but at the same time there could be separate teams carrying out various parts of credit processing and day-to-day monitoring at the central level; and each team is aware of the specific part of activity only. The central auditor's biggest challenge is to first get acquainted with all the decentralised processes and activities and then to co-ordinate with the relevant persons for the required information. Normally, the central auditor uses the work of an expert for reviewing the computerisation processes and systems, specially in case of core banking system. The findings and reservations, if any, of an expert should be communicated to the other joint auditors. Similarly, the central auditor may, if desires or feels necessary, communicate the findings and reservations, if any, of an expert to branch auditors to review certain specific aspects at the branch level. This will not only aid in enhancing the control review process of an audit but also enable the central auditor as well as the branch auditors to formulate their audit methodology and sampling techniques.

3.11 It may also be noted that foreign banks in India are largely guided by global policies, processes and systems (including IT systems) with some level of customisations to meet the local requirements. In some foreign banks, even the IT systems (hubs, servers, etc.) and monitoring thereof (periodic system audit, etc.) are centralised in other countries and no country-specific-process documentation and periodic validations are prescribed by that foreign bank. Therefore, the local IT teams may at the time of an audit, be not in a position to explain the basic configuration of accounting systems and how the local requirements are in-built in the global systems. In some other banks, the primary accounting records are maintained as per global reporting standards and the local financial statements are extracted from those records. Further, the scope of internal auditors and system auditors, etc., is decided on the global basis rather than on country basis. Such high level of globalisation poses big challenge for the local auditors and they have to largely rely on the past consistent globally accepted practices as well as make inquiries with the concerned global departments / functional officials through / with the help of the local officials to be satisfied about the adequacy of the IT environment.

3.12 Generally, the branch auditors do not have access to the overall IT policy, processes, controls and accounting procedures implemented by the bank. Moreover, the branch auditors confront following practical issues at fully computerised branches:

- Accounting manual, entries, calculations and framework is built in computerised accounting systems,
- Critical IT and manual controls,
- Periodical MIS and exception reports generated by the system,
- Documentation of critical processes performed for accounting and book keeping (IT and Manual),
- Access to primary records and entry level transactions,
- Audit sampling,
- Hard copies of transactions,
- Independent IT Audit at branches, etc.

3.13 The overall review of IT environment and of the computerised accounting system has to be taken up at central level. The management plays a more proactive role to ensure that the computerised accounting systems are working properly and effectively. It is for the central auditor to review whether the management is performing this role effectively. The roles and responsibilities of bank, the central auditor and the branch auditors can be enumerated as under:

Role and responsibilities of the Bank

3.14 Considering the importance of IT systems in the preparation and presentation of financial statement, it is imperative that the bank should share the detailed information about the following key aspects relating to IT environment of the bank with the central auditor at regular intervals:

- Overall IT Policy, structure and environment of the bank's IT system and changes/developments, if any, thereto.
- Data processing and data interface under various systems.
- Data integrity and data security.
- Business Continuity Plans and Disaster Recovery Plans.
- Accounting manual and critical accounting entries (including month-end and year-end) and the processes and involvement of IT systems.
- Controls over key aspects, such as, account codes and mapping thereof, use of various account heads including other assets and other liabilities, income recognition, expense booking, overdue identification, month-end and year-end procedures, valuation and re-valuation of various items of the financial statements, KYC, ALM, etc.
- Controls and recording of various e-banking and internet banking products.
- Manual processing of key transactions.
- MIS reports being generated and the periodicity thereof.
- Hard copies being generated and the periodicity thereof.
- Process of generating information related to various disclosures in the financial statements and the involvement of the IT systems.
- Major exception reports and the process of generation thereof.
- Major IT related issues (including frauds and failures) faced and resolved/unresolved during the year, such as, data/system corruption, system break-down, etc., having bearing on the preparation and presentation of financial statements.
- Significant observations of internal auditors, concurrent auditors, system auditors, RBI inspection and internal inspection, etc., related to computerised accounting and overall IT systems.
- Customer complaints related to mistakes in transactions (interest application, balances, etc.).
- In order to ensure that the technology deployed to operate the payment system/s authorised is/are being operated in a safe,

secure, sound and efficient manner and as per the process flow submitted by the bank for which Authorisation has been issued, banks are required to get a System Audit done by a firm of Chartered Accountants. The scope of the System Audit would include evaluation of the hardware structure, operating systems and critical applications, security and controls in place, including access controls on key applications, disaster recovery plans, training of personnel managing systems and applications, documentation, etc. The system auditor should also required to comment on the deviations, if any, in the processes followed from the process flow submitted to the Reserve Bank while seeking authorisation.[4]

Role and responsibilities of the central auditor

3.15 Based on the information received from the bank, the central auditor needs to review that:

- There is clear segregation of work to be undertaken at central level and branch level under the bank's IT system for accounting of transactions.
- A detailed note to be sent to the branch auditors explaining their roles and responsibilities in the light of what is stated above.
- Access to primary and subsidiary records is provided and use of data analysis tools is allowed at central and branch level.
- Test of controls and substantive checking of sample transactions is carried out at the central level and the results are shared with the branch auditors, if required.
- Based on the work undertaken, identify key issues to be taken up with the audit committee and the Board of the bank.
- Significant adverse observations in the periodic system audit reports are shared with the branch auditors, if required, and are also considered while framing the opinion of true and fair view.

Role and responsibilities of branch auditors

3.16 Based on the guidance and information received from the central auditor, the branch auditors need to ensure that:

- The roles and responsibilities are clearly understood and implemented.

[4] Kindly refer RBI circular No. DPSS.AD.No./ 1206/02.27.005/2009-2010 dated 7th December, 2009 on "System Audit of the Payment Systems operated under the PSS Act, 2007".

- To the extent possible, data analysis tools are used for better and effective audit.
- Test of controls and substantive checking of sample transactions is carried out at the branch level and the results are shared with the central auditor, if required.
- Significant observations having bearing on the true and fair view are reported to central auditor.
- Any other limitations on audit which are required to be reported to the central auditor.

Audit in a CIS environment

Expected Assessment of Inherent and Control Risks

3.17 The nature of banking operations is such that the auditor may not be able to reduce audit risk to an acceptably low level by the performance of substantive procedures alone. This is because of factors such as the following:

- The extensive use of IT and EFT systems, which means that much of the audit evidence is available only in electronic form and is produced by the bank's own IT systems.
- The high volume of transactions entered into by banks, which makes reliance on substantive procedures alone impracticable.
- The geographic dispersion of banks' operations, which makes obtaining sufficient coverage extremely difficult.
- The difficulty in devising effective substantive procedures to audit complex trading transactions.

3.18 In most situations, the auditor will not be able to reduce audit risk to an acceptably low level unless management has instituted an internal control system that allows the auditor to be able to assess the level of inherent and control risks as less than high. The auditor obtains sufficient appropriate audit evidence to assess the level of inherent and control risks.

3.19 Audit procedures will have to be adopted as the circumstances warrant and in respect of each account, different procedures may be necessary. An illustrative checklist on audit considerations in a CIS environment is given as **Annexure 1** to this Chapter. Further, an illustrative checklist on Bank Audit in computerised environment, which is divided in two parts, viz., Part I deals with bank audit in computerised environment and part II deals with automatic teller machines is given as **Annexure 2** to this Chapter.

3.20 As an auditor, the principal objective in undertaking an audit in a CIS environment is to evaluate the effectiveness of controls. Controls are those acts which the organisation should implement to minimise the events and circumstances whose occurrence could result in a loss to the bank. There are mainly four types of controls.

A. *Deterrent controls* - Deterrent Controls are designed to deter people, internal as well as external, from doing undesirable activities. For example, written policies including the punitive measures may deter people from doing undesired activities.

B. *Preventive Controls* - Preventive Controls prevent the cause of exposure from occurring or at least minimise the probability of unlawful event taking place. For example, security controls at various levels like hardware, software, application software, database, network, etc.

C. *Detective Controls* - When a cause of exposure has occurred, detective controls report its existence in an effort to arrest the damage further or minimise the extent of the damage. Thus, detective controls limit the losses if an unlawful event has occurred.

D. *Corrective Controls* - Corrective Controls are designed to recover from a loss situation. For example, Business Continuity Planning is a corrective control. Without corrective controls in place the bank has risk of loss of business and other losses due to its inability to recover essential IT based services, information and other resources after the disaster has taken place.

3.21 The auditor should obtain a preliminary understanding of the various controls put in place by the management and then test and evaluate whether the controls are operating effectively. The auditor should discuss the methodology adopted by the bank in implementing controls and their monitoring with the Head of the IT department and the Head of the audit department. These discussions will enable the auditor to get a view on the manner in which the bank has implemented controls. Based on these discussions, the auditor should interact with the various officials of the bank to determine whether they are sensitised to the control expectations of the management considering the technology deployed. If this sensitisation level is low, the auditor should expand audit procedures to form his audit opinion.

Security Control Aspects

3.22 The following are the key security control aspects that an auditor needs to address when undertaking audit in a computerised bank:

- Ensure that authorised, correct and complete data is made available for processing.
- Ensure 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 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 all modules in the software are implemented.
- Exception reports are a major audit tool. The auditor should verify that exceptional transaction reports are being authorised and verified on a daily basis by the concerned officials.
- Verify that the account master and balance cannot be modified/amended/altered except by the authorised personnel.
- Verify that all the general ledger accounts codes authorised by Head Office are in existence in the system.
- Verify that balance in general ledger tallies with the balance in subsidiary book.
- Verify that important passwords, like database administrator and branch manager's password are kept in sealed cover with branch manager, so that in case of emergency and the absence of any of them the passwords could be used to run the system properly.
- Verify that the bank takes daily and monthly backups. The backup media should be duly labelled and indexed properly and should be maintained under joint custody.
- Verify that backup register is maintained and updated.
- Verify that the backup media is stored in fireproof cabinet secured with lock and key and also that the off-site backups are preserved for the emergency.
- Verify that the anti-virus software of latest version is installed in

servers/PCs of branches to prevent data corruption, and is being regularly updated for new viruses.

- Verify that access to the computer room is restricted to authorised persons only.

Outsourcing of Financial Services by Banks

3.23 Outsourcing is a worldwide phenomenon, finding presence in every industry, including the banking industry. Business enterprises now stress on deploying the human, physical and financial resources available with them on the areas of the core competence of the business and outsource the non core areas. For example, in manufacturing enterprises, whose core competence lies in manufacturing of the relevant product, it is very common to find the accounting function having been outsourced to specialised service providers. Similarly, the customer complaint redressal function is also normally now outsourced by enterprises. Banks too of late have been outsourcing a number of their services, such as, applications processing (loan origination, credit card), document processing, marketing and research, supervision of loans, data processing and back office related activities, etc.

3.24 With a view to ensure that the banks adequately address the risks associated with outsourcing of some of their activities (especially financial services) by banks as also to bring such outsourced activities under the regulatory purview and protect the interests of the customers, the RBI, vide its circular no. DBOD.BP.40/21.04.158/2006-07 dated November 3, 2006 on “Managing the Risks and Code of Conduct in Outsourcing of Financial Services by Banks.”

3.25 The circular defines “outsourcing” as “a bank’s use of a third party (either an affiliated bank within a corporate group or an bank that is external to the corporate group) to perform activities on a continuing basis that would normally be undertaken by the bank itself, now or in the future 'Continuing basis' would include agreements for a limited period.

3.26 The said circular contains detailed requirements in respect of the various aspects related to outsourcing, including:

- Activities that should not be outsourced
- Material outsourcing
- Bank’s role and regulatory and supervisory requirements
- Risk management practices for outsourced financial services
- Role of Board of Directors and senior management

- Evaluation of risks
- Evaluating the capability of the service provider
- Outsourcing agreement
- Confidentiality and security
- Responsibility of DSA/ DMA/ Recovery Agents
- Business continuity and management of disaster recovery plan
- Monitoring of outsourced activities
- Redressal of grievances related to outsourced services
- Reporting of transactions to Financial Intelligence Unit
- Off-shore outsourcing of financial services
- Self assessment/ proposed outsourcing arrangements

3.27 Further, paragraph 5.9.3 of the circular envisages that regular audits either by the internal auditors or external auditors of the bank should assess the adequacy of the risk management practices adopted in overseeing and managing the outsourcing arrangement, the bank's compliance with its risk management framework and the requirements of these guidelines. The auditor should accordingly undertake procedures necessary to meet these requirements. The scope of the audit procedures should, however, be within the requirements of the Revised SA 402, "*Audit Considerations relating to an Entity Using a Service Organisation*".

Stress Testing

3.28 The central statutory auditor of the bank should examine whether the bank has implemented the "stress testing" framework to manage its risks, as prescribed in the RBI's circular. He/ she should also review the results of the stress tests undertaken by the bank under this framework since the results can be reflective of the bank's vulnerability to certain unlikely but plausible events or movements in financial variables. The review of the results of stress tests assumes added importance since "vulnerability" of the bank is usually measured with reference to impact on its profitability and/ or capital adequacy. In fact, augmenting the bank's capital is one of the remedial actions that may be taken by the bank on the basis of results of stress test. The auditor should, therefore, also review the remedial action taken pursuant to the stress test. The auditor, for this purpose, among other things, should also review the various assumptions and basis of assumptions used by the bank for the purposes of the stress test. The RBI circular on stress test specifically requires banks to maintain proper documentation in this respect and also make it available for verification by the auditors.

3.29 The RBI requires the banks to put in place appropriate stress test policies and the relevant stress test framework for the various risk factors by September 30, 2007 as also to ensure that their formal stress testing frameworks, which are in accordance with these guidelines, are operational from March 31, 2008.

Use of Electronic mode of Payment for large value transactions

3.30 The RBI, vide its circular no. DPSS No. 1407 / 02.10.02 / 2007-2008 dated March 10, 2008, mandates the banks to make large value payments of Rs.1 crore and above through electronic payment mechanism only with time frame as under:

(i) All payment transactions of Rs. 1 crore and above between the RBI regulated entities, such as, banks, primary dealers and NBFCs – from 1st April 2008

(ii) All payments of Rs. 1 crore and above in RBI regulated markets, such as, money market, Government securities market and foreign exchange market –from 1st April 2008

Opening and Operation of Accounts and Settlement of Payments for Electronic Payment Transactions Involving Intermediaries

3.31 The use of Electronic/Online Payment modes for payments to merchants for goods and services like bill payments, online shopping etc. has been gaining popularity in the country. The increased facilitation by banks and prepaid payment instrument issuers of the use of electronic modes by customers for payments to merchants generally involves the use of intermediaries like aggregators and payment gateway service providers. Further, Electronic Commerce and Mobile Commerce (e-commerce and m-commerce) service providers have also been acting as intermediaries by providing platforms for facilitating such payments. In most existing arrangements involving such intermediaries, the payments made by customers (for settlement of e-commerce/m-commerce/bill payment transactions), are credited to the accounts of these intermediaries, before the funds are transferred to the accounts of the merchants in final settlement of the obligations of the paying customers. Any delay in the transfer of the funds by the intermediaries to the merchants account will not only entail risks to the customers and the merchants but also impact the payment system. With a view to safeguard the interests of the customers and to ensure that the payments made by them are duly accounted for by the intermediaries receiving such payments and remitted to the accounts of the merchants who have supplied the goods and services without undue delay, it is considered necessary to frame the guidelines for the safe and orderly conduct of these transactions. Accordingly, RBI *vide* its circular no. DPSS.CO.PD.No.1102 /02.14.08/ 2009-10 dated November 24, 2009 has issued guidelines for opening and operation of accounts and settlement of payments for electronic payment transactions involving intermediaries. The salient features of the guidelines are as follows:

- Maintaining of accounts for collection of payments - All accounts opened and maintained by banks for facilitating collection of payments by intermediaries from customers of merchants, shall be treated as internal accounts of the banks. While it is left to the banks to decide on the exact nomenclature of such accounts it shall be ensured that such accounts are not maintained or operated by the intermediaries. Banks shall ensure that the process of converting all the existing accounts maintained and operated by intermediaries for the purpose covered in these guidelines shall be completed within three months of issuance of these directions. The permitted credits/debits in these accounts are also set out in the said circular.
- Settlement - The final settlements of funds to the merchants are presently guided by business practices followed by the intermediaries/merchants. In order to increase the efficiency of the payment process, it is necessary that banks transfer funds to the ultimate beneficiaries with minimum time delay. It is therefore mandated that banks shall implement the following settlement cycle for all final settlements to merchants. This settlement arrangement shall be implemented within three months of issuance of this circular:
  - All payments to merchants which do not involve transfer of funds to nodal banks shall be effected within a maximum of T+2 settlement cycle (where T is defined as the day of intimation regarding the completion of transaction).
  - All payments to merchants involving nodal banks shall be effected within a maximum of T+3 settlement cycle.
- Treatment of balances by banks - As the funds held in the accounts would be in the nature of outside liability of the bank, the balances in these accounts shall be reckoned as such for the purpose of computation of Net Demand and Time Liabilities of the bank.
- Concurrent Audit - Banks shall subject these accounts to concurrent audit and a certificate to the effect that these accounts are operated in accordance with these directions shall be submitted to Department of

Payment and Settlement System, Reserve Bank of India, on a quarterly basis. Further, RBI, vide its circular no. DPSS.CO.OSD. No. 1448/06.08.001/ 2010-2011 dated December 28, 2010 requires the banks to forward a covering letter from the bank certifying that the quarterly certificate from the concurrent auditor being furnished to the RBI on the operations of the intermediaries' accounts includes all the intermediaries accounts maintained with the bank.

E –Banking

3.32 E-banking may be defined as the automated delivery of new and traditional banking products and services directly to customers through electronic, interactive communication channels. E-banking includes the systems that enable financial institution customers, individuals or businesses, to access accounts, transact business, or obtain information on financial products and services through a public or private network, including the internet. Customers access e-banking services using an intelligent electronic device, such as, a personal computer (PC), personal digital assistant (PDA), automated teller machine (ATM), kiosk, mobile phones etc.

E-banking Risks

Transaction/ Operations Risk

3.33 Transaction/Operations risk arising from fraud, processing errors, system disruptions, or other unanticipated events shows the bank's inability to deliver products or services. This risk exists in each product and service offered. The level of transaction risk is affected by the structure of the bank's processing environment, including the types of services offered and the complexity of the processes and supporting technology.

3.34 In most instances, e-banking activities will increase the complexity of the bank's activities and the quantity of its transaction/operations risk, especially if the bank is offering innovative services that have not been standardised. Since customers expect e-banking services to be available 24x7, banks should ensure their e-banking infrastructures contain sufficient capacity and redundancy to ensure reliable service availability.

3.35 The auditor must ensure that in order to mitigate transaction/operations risk the bank has put in place effective policies, procedures, and controls to meet the new risk exposures introduced by e-banking. The basic internal controls would include segregation of duties, dual controls, and reconcilements. Information security controls, in particular, become more significant requiring additional processes, tools, expertise and testing.

Credit Risk

3.36 Generally, the bank's credit risk is not increased by the mere fact that a loan is originated through an e-banking channel. However, the bank should ensure that additional precautions are to be put in place when originating and approving loans electronically, including assuring management information systems effectiveness by preparing a track of the performance of portfolios originated through e-banking channels. The following aspects of on-line loan origination and approval tend to make risk management of the lending process more challenging. If not properly managed, these aspects can significantly increase credit risk.

- Verifying the customer's id for on-line credit applications and executing an enforceable contract;
- Monitoring and controlling the growth, pricing, and ongoing credit quality of loans originated through e-banking channels;
- Monitoring and oversight of third-parties operations doing business as agents or on behalf of the banks;
- Valuing collateral and perfecting liens over a potentially wider geographic area; and
- Collecting loans from individuals over a potentially wider geographic area.

Compliance/ Legal Risk

3.37 Compliance and legal issues arise out of the rapid growth in usage of e-banking services and the differences between the electronic and paper-based processes. E-banking is a new delivery channel where the laws and rules governing the electronic delivery of certain financial products or services may be ambiguous or still evolving. Specific regulatory and legal challenges include:

- Uncertainty over the legal jurisdictions applicable to the transaction taken place through e-banking;
- Delivery of credit and deposit related disclosures/notices as required by law or regulation;
- Retention of required compliance documentation for on-line advertising, applications, statements, disclosures, notices; and
- Establishment of legally binding electronic agreements.

3.38 Banks offering e-banking services, both informational and transactional, assume a higher level of compliance risk because of the changing nature of the technology, the speed at which errors can be replicated, and the frequency of regulatory changes to address e-banking issues. The potential for violations is further heightened by the need to ensure consistency between paper and electronic advertisements, disclosures and notices.

Mobile Banking

3.39 Mobile banking involves undertaking banking transactions using mobile phones by bank customers that involve credit/debit to their accounts. It also covers accessing the bank accounts by customers for non-monetary transactions like, balance enquiry, stop payment instruction of cheques, transactions enquiry, location of the nearest ATM/branch, etc.

3.40 With a view to ensure that the banks adequately address the risks associated with mobile banking, the RBI, has issued Operative Guidelines for Banks in relation to Mobile banking transactions in India (RBI circular no. DPSS.CO.No.619/02.23.02/ 2008-09 dated October 8, 2008 on "Mobile Banking transactions in India - Operative Guidelines for Banks"). All licensed banks which have implemented the core banking solutions are permitted to provide mobile banking services. Further, only Indian rupee based domestic services can be provided and cross border transfers are strictly prohibited. The aforesaid guidelines contain detailed requirements in respect of various aspects related to mobile banking, including:

- Regulatory and supervisory issues.
- Registration of customers for mobile services.
- Technology and security standards.
- Inter-operability.
- Clearing and settlement for inter-bank funds transfer transactions.
- Customer complaints and grievance redressal mechanism.
- Transaction limits.
- Board approvals.
- Approval of RBI.

3.41 In carrying out an audit of mobile banking transactions, the auditor is primarily concerned about the following namely, authentication procedures, understanding the information security framework, compliances with regulatory requirements, etc. The bank needs to obtain prior approvals of the RBI before commencement of mobile banking services in India.

Authentication procedures for mobile banking transactions - All transactions affecting an account including those which lead to an account being debited or credited should be allowed only after authentication of the mobile number and the MPIN associated with it. Further, the accounts allowed to be transacted through mobile banking should be correctly linked with the mobile phones so as to safeguard against spoofing of the phone numbers. The auditor needs to ensure that the bank has put in place a system of document based registration with relevant details and with mandatory physical presence of the customers, before commencing mobile banking services.

Information Security framework- The auditor needs to ensure that the bank has proper infrastructure and information security policy put in place since information security is of paramount importance and critical to the business of mobile banking services and its underlying operations. Therefore, technology used for mobile banking should be secure and should be able to ensure confidentiality, integrity, availability and authenticity. Proper level of encryption should be implemented for communicating between the customer, mobile service provider and the bank. The banks need to ensure that proper security checks have been made to ascertain the security levels of the service providers. The payment authorisation message from the user's mobile phone should be securely encrypted and checked for tampering by the service provider or the bank. It should not be possible for any interceptor to change the contents of the message. The statutory auditor should, accordingly, undertake procedures necessary to ensure compliance with these requirements.

Compliance with Regulatory Guidelines- It needs to be ensured that the guidelines on KYC norms, anti money laundering, risks and controls in computers and telecommunications, etc., issued by the RBI which apply mobile banking should also be adhered to. The auditor also needs to ensure that the transaction limit, as stipulated by the RBI, is adhered to and imposed on all mobile banking transactions.

Annexure 1

An Illustrative Checklist on Audit Considerations in CIS environment

The checklist is only illustrative in nature. Members are expected to exercise their professional judgement while using the checklist, depending upon facts and circumstances of each case.

While carrying out the audit in fully computerised environment, it is important to note that the primary audit objective does not undergo change, it is only the approach and methodology that undergoes a change. For achieving the primary objective in each of the aspects of the financial statements – balance sheet, profit and loss account, financial disclosures, notes to accounts, and special purpose certificates, the auditors must consider the following broad suggestions-

- Clearly identify and document the underlying audit objective and also the significant inherent risks (accounting, compliance, etc.) involved in each of the area.
- Gain an understanding of the IT system in use, flow of activities/processes, data interface, flow of accounting entries, regular and exception reports generated on daily basis, critical manual processes and controls.
- Understand and document the processes involved and IT systems used for month end and year end financial closures and data extractions.
- Identify sample size and carry out test of controls and substantive checking.
- Document process and results.
- Form an opinion.

The following indicative checklist can be used (centralised and decentralised) while undertaking the audit in fully computerised environment:

Sr. No.	Particulars	Yes/No/NA	Comments
A	**Basic Approach and Methodology – Centralised**		
i.	Have you understood the overall IT Policy, Structure and environment of the bank and the relation thereof to the preparation and		

Sr. No.	Particulars	Yes/No/NA	Comments
	presentation of financial statements?		
ii.	Have you obtained sufficient appropriate information about the total IT systems in use and the area covered therein?		
iii.	Have you obtained flow charts of activities in relation to data entry, recording, processing, storage and interface in each of the systems? Obtain a list of unprocessed transactions as at the year end.		
iv.	Have you gathered information about the critical IT and manual controls in relation to data processing and data interface, in general, and accounting and preparation and presentation of financial statements in particular?		
v.	Have you reviewed the process documents for all the critical processes having bearing on recording of transactions and preparation and presentation of financial statements? In case the processes are not documented, have you ensured that written representation explaining the whole process has been taken on record?		
vi.	Have you reviewed the work done by other agencies, such as, internal auditors, concurrent auditors, internal inspectors and system auditors in relation to IT processes and systems? Have you documented significant observations, if any, made by any of the above agencies?		
vii.	Have you enquired about the major breakdowns/corruption in system/data during the year having bearing on the preparation and presentation of financial statements and how the same were resolved? Obtain details of unresolved issues, if any, as at the year end.		
viii.	Have you identified the samples for test of controls and substantive checking? Have you documented the process of sampling and the details of sample selected? Have you taken screen shots of the relevant accounts/data		

Sr. No.	Particulars	Yes/No/NA	Comments
	used in sampling?		
ix.	Have you compared the outcome of testing with the financial records? Are you satisfied with the results of test of controls and substantive checking? If not, have you taken some more samples for further testing?		
x.	If you are not satisfied with the results, has this been escalated to concerned officials and those issues have been resolved.		
xi.	Are there any unresolved issues and have you noted the same for final reporting?		
xii.	Have you documented the entire audit process and significant observation at all stages?		
xiii.	Have you obtained written representations from the management on all the required matters?		
B	**System of accounting and record keeping – Centralised**		
i.	Have you understood the process of creating head of accounts? Are there adequate controls on creating new heads of accounts and closing unused heads of account? Obtain a list of accounts heads created and closed during the year?		
ii.	Have you understood the nature and title of all the account heads used in preparation and presentation of financial statements? Obtain written note on basic purpose and usage of all head of accounts and their mapping/linkage with main heads of financial statements.		
iii.	Have you understood process of recording transactions in all the heads of accounts including routing/intermediary accounts? Obtain a list of all the routing accounts and purpose and usage thereof? Review the balances held and the ageing of these accounts as at the year end.		
iv.	Have you understood the concept of out of the book entries passed at the year end for		

Sr. No.	Particulars	Yes/No/NA	Comments
	the purpose of financial closure and subsequent accounting/reversal thereof? Obtain a list of common OBE passed the year end. Have you reviewed the OBE passed at year end and also subsequent accounting and reversal thereof till the date of signing?		
v.	Have you ensured that the balances as the general ledger are tallied with the balances as per the sub-systems used for recording primary transactions? In case of significant differences, ensure that the same are reported in the audit report as qualification?		
vi.	In respect of financial information required for disclosures in the notes to accounts and also for special purpose certificate, have you understood the process of compiling information and the underlying systems used? Obtain all the back up papers used for generating such financial information.		
C	**Certain specific aspects – Decentralised**		
i.	In case of deposits have you understood the process for compliance with KYC? Please carry out test check of certain cases and document the test results.		
ii.	In case of deposits have you understood various types of deposits and carried out test check to ensure interest accrual, application, year end provisions, TDS calculations, etc., are correct? (In view of voluminous records/accounts, many a times, it is not possible to compare the results of test of controls and substantive checking for year end interest accrual with the books of account as individual customer level data is not generated.) Please document the process and test results.		
iii.	In case of advances have you understood various types of facilities being offered, the process of monitoring the limits and interest accrual and application (including year end provisions) in accounts under various types		

Sr. No.	Particulars	Yes/No/NA	Comments
	of facilities? Special care needs to be taken while monitoring the excesses/over-limits in case of fungible/interchangeable limits. Special care also needs to be taken for new age products being offered by various banks, such as, Channel Financing, Business Banking, Small and Medium Enterprises Financing, Gold Loans, etc. (In view of voluminous records/accounts, many a times, it is not possible to compare the results of test of controls and substantive checking for year end interest accrual with the books of account as individual customer level data is not generated.) Please document the process and test results.		
iv.	In case of advances have you understood the process of identifying non-performing assets (NPA) under various types of facilities (cash credit, overdraft, term loan, packing credit, bill purchase and discounting) and segments (wholesale and retail)? Special care need to be taken while reviewing the overdue or DPD (days past due) reports provided by the banks, as many banks have filtration process before final reports are generated. (In case private sector and foreign banks, the retail assets are categorised under various products and monitored accordingly for asset classification and security-wise classification. Even the NPA norms (which are generally more stringent than RBI norms) and security-wise classification is decided on product level basis and applied accordingly.		
v.	Have you understood the process of identifying NPA borrower-wise and not facility-wise? (In case of private sector banks and foreign banks, due to voluminous data, such identification is either not done or is done at a time lag and in some case, the customer data in retail portfolio is not matched with wholesale portfolio for this purpose. Further, special care need to be		

Sr. No.	Particulars	Yes/No/NA	Comments
	taken in case of new age products as, in some banks, these facilities may not fall within wholesale and retail portfolio for the purpose of monitoring.) Please document the process and test results.		
vi.	In case of foreign currency assets and liabilities, have you understood the process of revaluation (as per Accounting Standard (AS) 11 /FEDAI guidelines) periodically and at the year end, as the case may be? Please document the process and results.		
vii.	In case of sundry assets and liabilities, have you understood the usage, process of clearance of outstanding items, periodic ageing and reporting and provisioning of old items? (In case of fully computerised banks, some of these heads of account are used as routing accounts and have specified frequency for periodic clearance.) Please document the process and test results.		
viii.	In case of day to day operating expenses, have you understood the process of accounting, payments, TDS calculation and year end provisioning? (In case of private sector banks, the accounting and payment of expenses is centralised and generally there is substantial time gap between receipt of goods/services, receipt of bill and accounting thereof. Special care need to be taken for provision for expenses as at the year end. Further in case of payments to staff, many banks do not provide access to staff records due to confidentiality. In such cases, please ensure that alternate audit approach is used to verify aggregate payments instead of merely relying on representation by the management or outsourced service provider.) Please document the process and test results.		
ix.	In case of fixed assets have you understood the process of the entire process of purchasing fixed assets and the		

Sr. No.	Particulars	Yes/No/NA	Comments
	capitalisation and amortisation thereof? (Due to voluminous transactions and internal processes involved in purchase of fixed assets, many banks follow the practice of capitalising the assets (largely in case of it assets) on the date of payment rather than date on which asset is ready for use or date on which asset is put to use. Such practices must be corrected.) Please document the process and test results.		
x.	Have you understood the process of maturity-wise classification of assets and liabilities of the bank? (In many banks it is not possible to compare the results of test check carried out in this regard with the actual classification, as it is in-built in the basic system and moreover, the account level information is not readily available.) Please document the process and test results.		
xi.	In case of data migration from one platform to another platform have you ensured that the same was error free and there are no pending issues having bearing on the preparation and presentation of financial statements?		
xii.	In case of errors spotted during the audit, have you enquired about the primary reason/s and specific pattern/s, if any for the errors? (In computerised accounting, due to automated data processing, it is quite likely that there are some primary reasons and some patterns behind the errors which, if not detected, could lead to serial misstatement in the financial statements.) Please document the process and test results.		

Annexure 2

I. Bank Audit in Computerised Environment

An Illustrative Checklist

This Annexure is divided in two parts, viz., Part I deals with Bank Audit in Computerised Environment while Part II deals with Automatic Teller Machines. The checklist is only illustrative in nature. Members are expected to exercise their professional judgement while using the checklist, depending upon facts and circumstances of each case.

Existing Installation

Auditors need to verify the system software and version being operated at the Branch. It is advised to obtain the licensed copy of the software along with the documentation provided by the vendor and compare the same with the software running in the live environment. To carry out verification, auditor may look into the following:

a) The software register to check whether all the softwares in use is entered and maintained desktop-wise.

b) Note the Name and Version of software currently in use.

c) It is the latest version of the software authorised by the Central Office of the Bank to be used.

d) Installation of the Software is in accordance with the directions issued by the Central Office.

e) All the modules of the software are properly installed and are working. If any module is not in use presently, reason has to be ascertained and documented.

f) Physical verification of the copies of the softwares, documentation and manuals was carried out by Internal / Concurrent / Statutory Auditors.

g) The existence of Annual Maintenance Contract is in operation and was duly renewed on the expiry date.

Purchases

Computerisation is a constant process of development and improvement over the previous technology. In this process Banks also upgrade their hardware's and softwares installed to improve efficiency and provide better service to the customers. There has being a phase of such improvements, where branches operating on Automatic Ledger Posting Machines (ALPM) where upgraded to semi-computerised branches and then to fully computerised branches. The fully computerised branches are now in the process of being upgraded to fully networked branches. The phase is not over and there are still ALPM branches, which are in the process of upgradation. Auditors, in many branches might come across the purchases made for new softwares during the concerned Financial Year. To achieve the desired level of satisfaction that the purchase process was in accordance with the guidelines of the Central Office and installation was carried out under the supervision of the appropriate person. Auditor may verify the following:

a) Software register is duly updated with new purchases.

b) Purchase Order was duly filed and purchase was properly authorised and software was obtained from authorised vendor only.

c) The license of the software, warranty obtained and registration with the manufacturer is completed.

d) Installation was inspected and completed in the prescribed order.

e) Purchase was at reasonable value.

Logical Access Controls

To ascertain that assets are safeguarded and data integrity is maintained by the computer system, auditors may verify the following:

a) Does security policy address specific capabilities of operating systems and require that the available security features be implemented?

b) Is there a security officer appointed in writing?

c) Does the security officer ensure that available features have been implemented?

d) Is there a process in place for granting access levels?

e) Do users have only the minimum access level needed to do their job?

f) Are Users' access restricted to specific applications, menus within applications, files, and servers?

g) Is file maintenance a separate access privilege?

h) Is maintenance restricted to a minimum number of persons and is it properly approved and reviewed?

i) Is the password file encrypted?

j) Are methods in place to detect security violations?

k) Can security restrictions be overridden?

l) Are access levels periodically reviewed by the internal auditor?

m) Are procedures implemented to limit access to workstations after normal working hours?

n) Is modem access protected by a secure system, such as call back?

o) Are modem numbers changed periodically?

Password Controls

There are few fundamental problems in maintaining the integrity of the Password, they are:

i. Users for their convenience write down the password, as they are hard to remember.

ii. Users to reduce the burden of remembering cumbersome passwords, opt for easy to use passwords, which are also easy to guess.

iii. Users in routine do not change their passwords at regular intervals.

iv. Users fail to appreciate the importance of having password and consequences of its being compromised.

v. Passwords in Banks change hands very fast for the convenience of work.

vi. Certain Access Control Mechanism requires users to enter multiple passwords.

vii. Certain System Software does not store password in the encrypted form.

viii. Passwords are not changed / deleted on the transfer / retirement of the operator / officer in the Master Record of the System Software.

ix. Passwords are transmitted in clear test form, especially in Wide Area Network (WAN).

Auditors are required to take extra caution in verifying the integrity of passwords in the Branches. Following issues should be looked into to establish the integrity:

a) Password Register for the updating with the changes.

b) Passwords secrecy is maintained by the following officers of the Bank:

   i. Branch Manager

   ii. System Administrator

   iii. Users

   iv. Authorised Persons

c) The critical passwords, for accepting sensitive jobs are known only to Branch Manager or System Administrator. Sensitive jobs include:

   i. To enter operating systems.

   ii. To take back-ups.

   iii. To monitor disk space.

   iv. To create/edit Master Records.

d) The Operating System Password is kept under Dual Control of Branch Manager and System Administrator. The password should be protected in a sealed cover and opened in the presence of at least two persons. It should be changed at once on being opened.

Day Start-up Activities

Following areas require the attention of the auditor:

(a) Verify that day start-up Activities of a computer system is carried out either by the Branch Manager or System Administrator. It should be properly documented and signed in the register maintained.

(b) Verify the time of commencement of day-start-up activities. It should not be carried out prior to the banking hours.

(c) Verify that all the security checks are performed as per the prescribed guidelines from the Central Office of the Bank.

(d) Verify that banking date is verified daily and check sum facility is used regularly.

Transaction Controls

Following are the areas the auditor may verify along with going through the manuals in relation to data base management:

a. Date is authorised either by Branch Manager or System Administrator.

b. The control exists in the software to check that the entries pertaining to current date would be only accepted. There should not be any provision to feed back dated or future dated entries.

c. In the case of non-usage of terminals, terminals are logged-off.

d. Register for recording of problems in the software and the suitable action taken.

e. For only physically present users of the computer system, the requisite terminal/user account is enabled, else the account remains disabled.

f. Special batch reports are printed, checked, authenticated and duly filed.

Personnel Controls

To discourage misuse of funds and such practices, it is important to implement Personnel Controls. Auditor may verify the following to establish that efficient and effective personnel management practices are followed:

a. The technical competence of the employees of the bank, operating the computer system.

b. Whether adequate training was imparted to the employees in connection with the operations of the software, presently being used in the bank.

c. The segregation of duties among the bank employees and the process of monitoring the performance of each employee.

d. Authorization for amounts entered by the operators are clearly defined and documented.

e. Job rotation is carried out at regular intervals.

Day End Activities

Keeping in view, the serious effects on the system software, auditor may scrutinize the entries on and around the various closing dates of the Bank. This verification can be conducted by going through the exceptional report or Supplementary generated by the system software. Besides this, auditor should also verify that following activities are carried out regularly and documented:

a. Day end activities are carried out by either the Branch Manager or System Administrator and are properly documented.

b. Supplementary are checked and special users are deleted.

c. The following functions are completed at the day end:

   i. Minimum balances calculated.

   ii. Products calculated for Current Account (Debit balances)

   iii. Mandatory reports generated.

   iv. Fall back procedures activated.

   v. Day end back up taken.

   vi. Recording of entries in back-up register.

   vii. Recording in Log Books.

   viii. Filing of reports.

   ix. Shutting down of complete computer system.

d. The data back-ups taken are in safe custody and properly documented.

e. Server Room is properly locked and the keys are kept only with authorised person.

f. The generation of following documents:

   i. Access log

   ii. Supplementary

   iii. Audit Trail

   iv. Transaction number is given for each transaction entered.

g. After the business hours of the bank computer operators perform the following functions:

   i. Supplementary Report is printed either by Branch Manager or System Administrators and filed.

   ii. Cash Denomination Report is printed and filed.

   iii. Vouchers are tallied and signed either by Branch Manager or System Administrator.

Parameter/ Master File

Parameters/ Master is quantity constant but could vary for different cases. In banks, we come across various types of accounts with different guidelines to operate them. In a Parameter/ Master File, all the relevant information related to that particular account is feeded and stored. The information would relate to Rate of Interest to be applied, Penal Interest to be charged, Commission Rates, Operation Limits in case of loans, Nature of operation of account, single / jointly etc. This exercise is carried out at the first stage of implementation of computerisation of the Branch. Thereafter, the system software behaves according to the Parameters enforced currently are as per latest circulars. It important to check that Parameter/ Master File if accessible to the operators should only be in read-only format, else it would invite undesirable modifications, which would lead to revenue leakage and misuse of funds. Whenever any alterations are to be made in the Parameter/ Master File, printouts of the file prior to the changes and after the changes should be taken and documented in safe custody of Branch Manager. Auditor should verify the following:

a. Authorised personnel mark all the Bank Holidays into the software in the beginning of the Financial Year.

b. Operation limits and authorisation levels are defined clearly for the operators and supervisors.

c. The parameters for Interest and Bank Charges are defined in accordance with the relevant rates and guidelines. The file is updated as and when changes are announced.

d. Printouts of parameter file are taken out before and after changes are given effect and documented.

e. The safe custody of the printouts with Branch Manager and alterations are entered into “Parameter Register”.

e-Banking / Internet Banking Procedures

1. Identify the bank’s current and planned e-Banking activities and review the bank’s public Internet Websites. Consider whether the bank provides the following types of services:

   a. Telephone banking

   b. Retail Internet banking services

   c. Corporate/ wholesale Internet banking services

   d. Internet services provider (ISP)

   e. Brokerage services over the Internet

   f. Insurance service over the Internet

g. Trust services over the Internet

h. Account aggregation

i. Electronic bill payment

j. Other activities (e.g. Web portals, financial calculators, cross-marketing arrangements and alliances, unique services, etc.)

2. Review prior audit reports related to e-Banking, including compliance, information technology, and other examination areas that may be relevant.

3. Determine if material changes have been made to e-Banking products, services, or operations since the last examination and if any significant changes are planned in the near future.

4. Determine if the bank operates the Web site(s), e-Banking system(s) or core data processing system(s) internally and whether any activities are outsourced to a vendor. Identify the location of the following operations:

   a. Design and maintenance of the bank's public Web site or home page.

   b. Computer/ server for the bank's public Web site.

   c. Development and maintenance of the bank's electronic banking system(s).

   d. Computer/ server for the bank's e-Banking system(s).

   e. Customer service (e.g., call center) for electronic banking services.

   f. Electronic bill payment processing or other ancillary services.

5. If the bank operates the e-Banking system or core data processing system in-house, review the topology (schematic diagram) of the systems and networks, and determine whether there is a direct, on-line connection between the bank's core processing systems and the electronic banking system.

6. If the bank operates the e-Banking system or core data processing system in-house, review the transaction processing flows between the e-Banking system and the bank's core processing systems and identify key control points. Determine whether information is exchanged in a real-time, batch (overnight), or hybrid processing mode. In case the bank uses the services

of any professional agency for any part of the work, the auditor should apply the standards laid down in Revised SA 402, "Audit Considerations Relating to an Entity Using a Service Organisation".

7. Determine the adequacy of risk management for e-Banking activities given the level of risk to the institution. Following procedures are to be valuated:

    a. Adequacy of policies and procedures governing e-Banking activities.

    b. Adequacy of internal controls and security for e-Banking activities.

    c. Adequacy of audit coverage for e-Banking activities.

    d. Adequacy of monitoring and compliance efforts.

    e. Adequacy of vendor and outsourcing management.

    f. Adequacy of Board and management oversight.

8. Determine the impact of any deficiencies on the financial condition of the organization.

9. Determine the extent of supervisory attention needed to ensure that any weaknesses are addressed and that associated risk is adequately managed.

Adequacy of Internal Controls:

1. Are updates and changes to the bank's public website(s) are made only by authorised staff and subject to dual verification?

2. Are website information and links to other websites regularly verified and reviewed by the bank for:

a. Accuracy and functionality?

b. Potential reputational, compliance, and legal risk?

c. Appropriate disclaimers?

3. Do operating policies and procedures include:

    a. Procedures for, and controls, over opening new customer accounts submitted via electronic channels to verify potential customer identity and financial condition?

    b. Procedures for administering access to the electronic banking system (e.g., customer passwords, PINs, account numbers)?

c. Requirements for review of or controls over wire transfers or other large transfers initiated through the electronic banking system for potentially suspicious activity?

d. Appropriate authorizations for electronic debits initiated against accounts at other institutions, if such transfers are allowed?

e. Depending on the type of account, dollar limits on transactions over a given time period initiated through the electronic banking service?

f. Reconcilement and accounting controls over transactions initiated through the electronic banking system, including electronic bill payment processing?

4. Do written information security policies and procedures address electronic banking products and services?

5. Are business recovery procedures adequate? Consider whether the procedures address:

   a. Events that could affect the availability of the electronic banking system, such as system outages, natural disasters, or other disruptions?

   b. Planned recovery times that are consistent with the degree of importance of the electronic banking activities to the institution?

   c. Has management established an incident response plan to handle potential system security breaches, website disruptions, malicious tampering with the Web site, or other problem situations?

6. Has the bank or service provider implemented a firewall to protect the bank's Web site?

7. Are ongoing monitoring and maintenance arrangements for the firewall in place to ensure the firewall is properly maintained and configured?

8. If the bank uses a turnkey e-Banking software package or outsources to a service provider:

   a. Are bank staff are familiar with key controls detailed by the vendor's security and operating manuals and training materials?

   b. Are workstations that interface with the service provider's system for administrative procedures or transfer of files and data are kept in a secure location with appropriate password or other access control, dual verification procedures, and other controls?

9. Does the bank's administration of access to the e-Banking system by bank staff and customers include:

   a. Procedures to ensure that only appropriate staff is authorised to access e-Banking systems and data, including access to any workstations connected to a remote system located at a service provider?

   b. The length and composition of passwords and PINs?

   c. Encryption of passwords and PINs in transit and storage?

   d. The number of unsuccessful logon attempts before the password is suspended?

   e. Procedures for resetting customer passwords and PINs?

   f. Automatic logoff controls for user inactivity?

10. Have security vulnerability assessments and penetration tests of e-Banking systems been conducted and results reviewed by the bank?

11. Has the bank or its service provider established:

    a. An intrusion detection system for e-Banking applications?

    b. Procedures to detect changes in e-Banking files and software?

    c. Measures to protect the e-Banking system from computer viruses?

    d. Procedures for ensuring on an ongoing basis that e-Banking applications, operating systems, and related security infrastructure incorporate "patches" and upgrades that are issued to address known security vulnerabilities in these systems?

12. If e-mail is used to communicate with customers, are communications encrypted or does the bank advise customers and not to send confidential information via e-mail?

13. Are adequate summary-level reports are made available to management to allow monitoring of:

    a. Web-site usage?

    b. Transaction volume?

c. System problem logs?

d. Exceptions?

e. Unreconciled transactions?

f. Other customer or operational issues?

14. Has management established adequate procedures for monitoring and addressing customer problems regarding e-Banking products and services?

15. Does management accurately reports its primary public web-site address on the Report of Condition?

16. Have required Suspicious Activity Reports involving e-Banking, including any computer intrusions, been filed?

17. Is each significant vendor, service provider, consultant, or contractor relationship involved in development and maintenance of the e-Banking services covered by a written, signed contract? Depending on the nature and criticality of the services, do contracts specify:

    a. Minimum service levels and remedies or penalties for non-performance?

    b. Liability for failed, delayed, or erroneous transactions processed by the service provider and other transactions where losses may be incurred (e.g. insufficient funds).

    c. Contingency plans, recovery times in the event of a disruption, and responsibility for back-up of programs and data.

    d. Data ownership, data usage, and compliance with the bank's information security policies.

    e. Access by the bank to the service provider's financial information and results of audits and security reviews.

    f. Insurance to be maintained by the service provider.

18. Has legal counsel has reviewed the contracts to ensure they are legally enforceable and that they reasonably protect the bank from risk?

19. Has the bank ensured that any service provider responsible for hosting or maintaining the bank's web-site has implemented:

    a. Controls to protect the bank's Web site from unauthorized alteration and malicious attacks?

b. Procedures to notify the bank in the event of such incidents?

c. Regular back-up of the bank's Web-site information?

20. Depending on the nature and criticality of the services, does the bank conduct initial and periodic due diligence reviews of service providers, including:

a. Reviewing the service provider's standards, policies and procedures relating to internal controls, security, and business contingency to ensure they meet the bank's minimum standards?

b. Monitoring performance relative to service level agreements and communicating any deficiencies to the service provider and to bank management?

c. Reviewing reports provided by the service provider relating to response times, availability/ downtime, exception reports, and capacity reports and communicating any concerns to bank management and the vendor?

d. Periodically reviewing the financial condition of the service provider and determining whether back-up arrangements are warranted as a result?

e. Conducting on-site audits of the service provider if appropriate based on the level of risk?

f. Ensuring the bank staff receives adequate training and documentation from the vendor or service provider?

21. If the bank operates a turnkey e-banking software package:

a. Is software held under an escrow agreement?

b. Has the bank established procedures to ensure that relevant program files and documentation held under the software escrow agreements are kept current and complete?

22. If a vendor maintains the bank's electronic banking system, does the bank monitor on-site or remote access of the bank's systems by the vendor, through activity logs or other measures?

Evaluation of Operation System

1. Obtain or prepare logical and physical diagrams of the operating system and attached local and wide area networks.

2. Document the operating system domain(s), identifying the Primary Domain Controller (PDC), Backup Domain Controller, and any other operating system servers or significant operating system workstations participating in the domain.

3. Using the information obtained in the prior steps, document the server and directory location of the significant application programs and data within the network; document the flow of transactions between systems and nodes in the network.

4. Using the Server Manager utility, review all trusted domains assigned to the audit domain and include these trusted domains within the audit scope.

5. Assess whether the trusted domains are under the same physical and administrative control and are logically located within the same sub-network.

6. Determine that router filtering is being used to prevent external network nodes from spoofing the IP address of a trusted domain.

User Security

Determine that the user log in identification and authentication process are properly configured and that users are assigned to operating system groups which are consistent with their job requirements for system access:

1. Obtaining the documented security policies and procedures for the operating system server environment. Use the User Manager utility to display the global log in accounts security parameters and review and assess the following settings:

    a. Forcibly disconnect remote users (forces users to log off the system after a predetermined limit of time).

    b. Minimum password age in days

    c. Maximum password age in days

    d. Minimum password length

    e. Password uniqueness (number of past passwords disallowed for future use)

f. Account lockout after X number of bad log on attempts

g. Account lockout—reset the bad log on count after X number of minutes

h. Accounting lockout duration—require administrator to unlock or automatically unlock after X number of minutes.

i. User must log on to change password (may allow or restrict users with expired passwords from logging on and changing the password themselves or requiring an administrator to change the password for them)

2. Determine that the Administrator (super user) and Guest accounts have passwords assigned to them (by attempting to log on without providing a password). Also ascertain that the Administrator account password is well controlled and used/ known by only the system administrator and one backup person.

3. Using the User Manager utility, review the following account properties settings active in each user's individual profile, which may override the global account policy:

   a. Full name (should be used to facilitate ID management)

   b. Description (job, department, etc.)

   c. Change password at next log in (should be used for new users' initial log in)

   d. User cannot change password (forces administrator to manage the password; may be used for vendor and other third-party accounts)

   e. Password never expires (may be used to override the global restriction in the Accounts Policy)

   f. Account disabled

   g. Account locked out

   h. Groups (cross-reference to group's audit procedures)

   i. Profile (each user should have a home directory, path statement, and log in script)

   j. Hours (log in time restrictions)

k. Log on to (restricts workstations from which the user may log in from)

l. Account (specifies local or global and may specify an expiration date)

4. Using the User Manager utility, review and assess User Rights assigned to groups and individual users.

5. Use the user manager utility, review and access User Rights assigned to groups and individual users.

6. Use the User Manager utility to view and assess membership in the sensitive built-in groups: Administrators, Domain Administrators, Account Operators. Assess the appropriateness of users assigned to these groups.

7. Using the User manager utility, document user membership in groups used to grant access to resources with audit significance (application program and data directories and files), cross-reference to review file system security audit steps, and assess appropriateness of each user's membership in groups.

File System Security

To ensure that significant system and application program and data resources are protected from unauthorized access and modifications.

1. Review the file system directory trees to ensure that only operating system file systems are used on servers within the audit scope (since any other file system type, DOS or other, cannot be controlled by operating system security with the exception of operating system share security).
2. Using the File Manager directory tree directory tree utility, list out the Security Permissions for all system directories and significant application programs and directories; perform the following:

   a. Determine that the owner of all operating system directories is the Administrator account

   b. Determine that application program and data directories are owned by a restricted application owner account of the operating system Administrator account

   c. Review and assess permissions assigned to groups and individual accounts, noting that Full Control (all permissions) and Change (Read, Write, Execute, and Delete) permissions are restricted to authorized users (cross-reference groups to earlier step, identifying users with the groups they belong to)

d. Determine that Change permissions and Take Ownership permissions are restricted to Administrative accounts and groups

e. Using the File Manager directory, identify all shared directories (directories made available to users the network). Review and assess Share permissions assigned to these directories on a group or user basis.

Operating System Audit and Logging

To determine whether adequate detective controls have been configured and that the information generated by these controls is being reviewed and followed upon:

1. Using the User Manager utility, review the Audit Policy options in effect for the domain (and server, if applicable). Normally, all failure conditions should be audited.
2. Using the Event Viewer utility, review the audit log for suspicious events and follow up on these events with the security administrator.

Operating System Services

To ensure that only necessary, secure services are active in the operating system environment:

1. From the control panel, click on the services option and review all active or dormant services. Identify the purpose and necessity of each. Unnecessary services should be disabled.
2. Ensure that each service, logs on as on account other than the system account unless the service requires the system account. Audit the permissions granted to each service account.
3. Determine that each service account has the advanced user right, called logon as a service.

Operating System Networking

To determine that the network and network services are protected against unauthorized access and use:

1. Identify all necessary netbios services offered on each server. Access the propriety of each and if it is running as a non-privileged service account, unless the service requires the system account.
2. Review router configurations for routers that connect the operating system network to external networks. Ensure that the TCP/UDP ports 137, 138 and 139 are blocked or altered to restrict Netbios traffic coming into and going out of the network.
3. Identify all active, native, and third-party TCP/IP network services active on the operating system server. Audit the security of each service.

The Operating System Registry

To review the security over system and program control parameters in the operating system registry:

1. Review the operating system directory and file permissions over system and program control parameters in the operating system registry.
2. View the registry permission for the major system and program keys and sub keys to ensure the following:
   a. The administrators' local group owns each key
   b. The owner group and system global group have full access permissions.
   c. The global group called everyone, has restricted special access permissions.

II. Automatic Teller Machines

More than two decades have elapsed since the introduction of ATMs by Banks in India. Initially, these were installed by larger co-operative Banks and the new private sector Banks. Today, ATM service is offered by even small co-operative Banks making such a service sin-qua-non of Banking in India. Seemingly technical in nature, it houses one of the primary assets of the Bank – cash which has to be recognized by the auditor in his scope of work. While verification of cash in the ATM is one aspect, the operational efficacy should be responsive to the policy of the Bank and the standard operating procedures including the directives of the Reserve Bank of India.

Few ATM frauds are reported till date but this has no implication on their occurrence. Banking business deals with money and ATM is one part of its service. The auditor needs to view this service with the same critical eye as any manual cash management. Following aspects of internal control in relation to ATMs may be ascertained and evaluated by the auditor:

Pre-installation Stage

1. Board's sanction of ATM installation service.
2. ATM installation complies with the strategic Information Technology plan of the Bank.
3. Purchase of ATMs need to be driven through the same formality of a purchase of asset of the Bank like flotation of tenders, etc.
4. Location of the ATMs both branch attached as well as independent locations should be finalized to achieve the aim of Bank's investment in this service.
5. All requisite permissions and licenses should be obtained by the Bank including communication to the Reserve Bank of India.
6. Environmental preparations should be made considering legal, security and operational issues. Environmental policy should be also set in writing to permit standard environment with sufficient provision to permit customization necessitated by location peculiarities.
7. The estate department of the Bank or an independent architect should certify to the Estate department about the quality and appropriateness of translation of set policy at each of the ATM location.
8. Cash replenishment policy needs to be finalized before operating any the ATMs. This can be a set policy or a contingent policy determined by the number of ATMs units set up by the Bank. Cash replenishment can either managed by the Bank itself or it can be outsourced. With the Bank itself it can either be done by a Central or Regional office or a nodal equivalent branch in which case, the ATM cash balance is reflected in the books of this Branch. The various alternatives should be evaluated and selected.
9. If the cash management of ATMs is to be outsourced, similar procedure should be adopted by invitation of either open tenders or inviting tenders.
10. Insurance of cash in ATMs should be negotiated with insurance companies and if the number of ATMs is numerous, select insurance companies may be invited to bid.
11. Application software should be able to communicate with the ATM software and this delicate requirement should be specifically mentioned in the agreement with the ATM vendor and application vendor since their co-operation is essential at this stage.
12. ATM software, its operation and reflection in the main application should be

software tested either internally or through a professional firm before operations commence.

13. Cash replenishment policy should be set ensuring the maximum limit set per ATM is not exceeded.

Operational stage

1. Is the security manual in place describing the security measures to ensure at the time of replenishing cash in the ATMs?
2. Are all the staff involved in cash transfers screened thoroughly and their photos and prints taken? In case of a contract, does the service vendor follow similar formalities? This should be periodically checked by the Bank and this point needs to be have been specifically made in the agreement with him.
3. Is the process of allocation of ATM cards secure?
   a. Are the Personal Identification numbers (PIN) generated randomly?
   b. Are the PIN cards printed in a manner that no staff is able to read them without tearing open the seal?
   c. Are the cards and PIN numbers sent separately? Popular delivery mode is delivery of card only through a courier agency. The PIN number is physically delivered through the branch. In case the PIN number is also to be delivered, it should be given on a later date and that too through another courier agency.
   d. Courier agency should be under separate contract to fulfill the extra formality of identification confirmation of the person accepting the card with the strict instruction to hand over the card only to the person to whom the card is allotted.
   e. Bin filling exercise should be done in the presence of at least two persons who should not only supervise each other to ensure correct denominations are inserted in the correct bins.
   f. User report if available on the 'special service ATM card' should be obtained and filed for future reference. This should ideally record the time and date of opening the ATM machine presumably to replenish it. Along with this, the cash balance after replenishment should also be printed.
   g. Cash shortages should be thoroughly investigated with full reference to the server report compared with the ATM's log available on site of ATM.

h. All cards should be changed after a period say 2 years to allot cards to only regular users thus diminishing risk of the cards of non users.

4. whether surprise checks are carried out by the vendor or the Bank's departmental officer to ensure the amount and time of currency replenished as reflected in the register is accurately recorded?
5. Whether schedules of currency replenishment are not static and are changed on each occasion randomly to ensure that there is no definitive pattern?
6. Whether ATMs providing additional service like refilling phone cards or e-transfers etc. are system audited periodically?
7. Whether the bank has a system to thoroughly report and investigate complaints regarding non-performance of services?
8. Whether Cash in ATM and Cash in transit insurance is kept alive at all times?

PART - III

III-1
Advances

1.01 Lending constitutes a major activity of the bank. The banking business revolves primarily around garnering funds through acceptance of deposits for the purpose of onward lending. As a corollary, advances generally constitute the largest item on the assets side of the balance sheet of a bank and are a major source of its income. Further, the RBI also closely regulates the lending activity of banks. Lending, therefore, constitutes one of the major areas of concern for the auditors.

1.02 Amounts disclosed in the balance sheet under the head 'advances' comprise–

(a) money lent by the bank to its customers and interest accrued and due thereon {net of amount shown in (d)};(including guarantees/Letters of credit devolved on Bank);@

(b) debit balances in deposit accounts;

(c) amount of participation on risk-sharing basis under inter-bank participation schemes in capacity as a participating bank; and

(d) amount receivable from Government of India under the Agricultural Debt Waiver Scheme 2008. Reference should also be made to the RBI's Circular no. DBOD. No. BP. BC. 9/21.04.048/2012-13 dated July 2, 2012 on "Prudential Norms on Income Recognition, Asset Classifications and Provisioning pertaining to Advances" (The circular is given in the CD along with the Guidance Note).

1.03 The amount to be included in respect of (c) above is net of the amount allotted to other banks under inter-bank participation schemes on risk-sharing basis (this aspect is discussed in detail later in this Chapter).

Balance Sheet Disclosure

1.04 The Third Schedule to the Act requires classification of advances made by a bank from three different angles, *viz.*, nature of advance, nature and extent of security, and place of making advance (i.e. whether in India or outside India). Accordingly, the advances are to be classified in Schedule 9 to the balance sheet as follows.

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A. (i) Bills purchased and discounted
   (ii) Cash Credits, Overdrafts and Loans repayable on demand
   (iii) Term loans

B. (i) Secured by tangible assets
   (ii) Covered by bank/government guarantees
   (iii) Unsecured

C. I. Advances in India
      (i) Priority sectors
      (ii) Public sector
      (iii) Banks
      (iv) Others
   II. Advances outside India
      (i) Due from banks
      (ii) Due from others
      (iii) Bills purchased and discounted
      (iv) Syndicated loans
      (v) Others

The amount receivable from Government of India under Agricultural Debt Waiver Scheme, 2008 should be reflected in Schedule 9 (Advances) of the Balance sheet.

1.05 The Notes and Instructions for compilation of balance sheet, issued by the RBI, provide the following with regard to presentation of advances.

Classification Based on Nature of Advance (Section A)

1.06 Different classifications under section A will be as follows:

(a) In classification under section 'A', all outstandings – in India as well as outside – less provisions made, will be classified under three heads as indicated and both secured and unsecured advances will be included under these heads.

(b) Outstandings in credit card operations should be shown as part of advances under the head 'cash credits, overdrafts and loans repayable on demand' (instead of clubbing these under 'other assets' in Schedule 11).

(c) Term loans will be loans not repayable on demand and would include overdue instalments.

(d) All interest bearing loans and advances granted by the bank to its employees should be shown as part of advances.

Classification Based on Nature and Extent of Security (Section B)

1.07 Different classifications under section B will be as follows:

(a) All advances or part of advances, which are secured[1] by tangible assets, whether in India or outside India, may be shown under the heading 'secured by tangible assets'. Advances against book debts may be included under the head 'secured by tangible assets', and presented in Schedule 9 (Advances) as follows:

"B Secured by tangible assets" (includes advances against book debt)

(b) Advances in India and outside India to the extent they are covered by guarantees of Indian and foreign governments and Indian and foreign banks and DICGC and ECGC are to be included under the head 'advances – covered by bank/government guarantees'.

(c) Unsecured advances will include advances not classified under (i) & (ii) of section B.

Classification based on Place of Making Advances (Section C)

1.08 Advances to sectors, which for the time being are classified as priority sectors according to the instructions of the RBI, are to be classified under the head 'priority sectors'. Such advances should be excluded from item C.I. (ii), viz., 'advances to public sector'. Advances to Central and State Governments and other government undertakings including government companies and corporations which are, according to the statutes, to be treated as public sector companies, are to be included in the category 'public sector'. All advances to the banking sector including co-operative banks will come under the head 'banks'. All the remaining advances will be included under the head 'others'; typically this category will include non-priority advances to the private, joint and co-operative sectors.

General

1.09 In general, it may be noted that the gross amount of advances including refinance but excluding rediscount and provisions made to the satisfaction of auditors should be shown as advances. Consortium advances would be shown net of share from other participating banks/institutions.

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1 A 'secured advance', according to section 5(n) of the Banking Regulation Act, 1949 means an advance made on the security of assets the market value of which is not at any time less than the amount of such advance.

Commonly Used Terms and Operational Aspects

1.10 As mentioned earlier, advances are to be classified in the balance sheet from three different angles:

(a) nature of advance;

(b) nature and extent of security; and

(c) place of making the advance (i.e. whether in India or outside India) and sectoral distribution of advances.

1.11 Before discussing the audit procedures relating to advances, it would be useful to understand the salient features of various types of advances made by banks, nature of securities accepted by banks and mode of creation of security, and the sectoral distribution of bank credit. Also, in view of the reporting requirements under the long-form audit report, it would be useful to understand the steps generally involved in extending bank credit (i.e. making advances) and subsequent supervision and monitoring thereof. A number of technical terms are used in the context of operations of banks, familiarity with which is also necessary for the auditor as explained in the following paragraphs.

Demand Loans

1.12 A demand loan is an advance of a fixed amount repayable on demand. The entire amount is paid to the borrower in a single transaction. The repayment of demand loans may be either in one lump sum or by instalments. Interest is calculated on the basis of daily outstandings and applied at stipulated periodic intervals usually not exceeding a calendar quarter, e.g. cash credit (Hypo) is Demand Loan.[@]

Bills Purchased and Discounted

1.13 Bills purchased refer to demand bills and cheques whereas bills discounted refer to usance (time) bills. Banks purchase/discount only *bona fide* trade bills and not accommodation bills. The limit granted for discounting/purchase of bills is determined based on the scale of operations of the customer and his credit-worthiness. Banks can discount usance bills of any maturity, which is normally, decided in Loan Policy of the Bank.

Funded and Non-funded Credit Facilities

1.14 Funded credit facilities are those where there is an actual transfer of funds from the bank to the borrower whereas non-funded facilities are those, which do not involve such a transfer. Examples of funded facilities are term loan, cash credit and overdraft. Examples of non-funded facilities are letters of

[@] Revised in 2013 Edition.

credit, bank guarantees, etc. A non-funded facility may subsequently turn into a funded facility, e.g., where the bank makes payment under a letter of credit issued by it.

Primary and Collateral Securities

1.15 The term 'primary security' refers to the security acquired by the borrower with bank finance or the one against which credit has been extended by the bank. Primary security is the principal security for an advance. A collateral security, on the other hand, is additional security, which provides a cushion to the bank in case of need. Banks accept various types of assets as collateral security.

Personal Security of Guarantor

1.16 The personal security of guarantor comprises a guarantee by a third party for payment of outstandings in the event of default by the borrower. No charge is created on the guarantor's movable or immovable assets. The personal security of guarantor can be enforced only through the competent Court of law.

Fixed and Floating Charges

1.17 A fixed charge (also called 'specific charge') is a charge on some specific and ascertained assets. The creator of the charge (i.e., the borrower) cannot deal with the asset without the specific consent of the holder of the charge (i.e., the lender). A floating charge, on the other hand, is an equitable charge on the assets, present as well as future. A floating charge attaches to assets whose condition varies from time to time in the ordinary course of business (e.g., work-in-process). A floating charge crystallises (i.e., becomes a fixed charge) when money becomes repayable and the holder of the charge (i.e., lender) takes necessary steps for the enforcement of the security.

Gilt-edged Securities

1.18 The term refers to securities issued or guaranteed by the Central Government or a State Government. From the bank's angle, they are amongst the safest securities.

Margin

1.19 Banks do not provide finance to the extent of the full value of the assets charged to them under a credit facility. A suitable margin, depending upon the risk perception of the bank, is deducted from the value of the charged assets to take care of any downward fluctuations in the market value of the assets. For example, in case of advances against shares, banks are required to maintain a uniform margin of 50 per cent on all advances/financing of IPOs/issue of guarantees on behalf of stockbrokers and market markers. A minimum cash margin of 25 per cent (within the margin of 50%) shall be maintained in respect of guarantees issued by banks for capital market operations. For all other types of advances, margin band is prescribed in the Loan policy of the bank, which are in the range of 5% to 50%.[@]

Government-sponsored Schemes

1.20 The Government of India has formulated a number of schemes to overcome the problems of poverty and unemployment in the country. While the Government itself grants subsidies in these schemes, a major portion of the funds required to implement the schemes is provided by the banking system. Such schemes are called 'government-sponsored schemes'. Scheme-wise physical and financial targets are fixed for each branch and they are expected to meet these targets.

Insurance of Bank's Deposits and Loans

1.21 Depending upon its policy in the matter from time to time, a bank may obtain insurance for its deposits and advances from the Deposit Insurance and Credit Guarantee Corporation (DICGC) or any other such body. Export Credit Guarantee Corporation (ECGC) guarantees the export credit.

Refinance/Subsidy

1.22 Reserve Bank of India, Industrial Development Bank of India (IDBI), Export-Import Bank of India (EXIM Bank), National Bank for Agriculture and Rural Development (NABARD) and Small Industries Development Bank (SIDBI) are major agencies providing refinance to banks, generally for loans extended to specified sectors. The refinance obtained by a bank from refinancing agencies represents borrowings of the bank. A bank may decide not to avail of refinance in some cases, depending upon the liquidity position of the Bank.[@] The application for obtaining refinance may be made to the agency concerned either by the branches or by another office, depending on the policy of the bank. The claims, however, are not usually lodged by the branches themselves but are routed through the head office or the zonal office.

1.23 The banks, and in some cases, the borrowers, are entitled to subsidies on their loans, particularly in the case of loans granted under government-sponsored schemes. The branches have to lodge claims in the prescribed formats with the designated authority, generally through head office.

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The procedure to be followed for availing of the subsidy may differ from scheme to scheme.

System of Base Rate

1.24 The RBI vide its Circular No. DBOD. No. Dir. BC 88 /13.03.00/2009-10 dated April 9, 2010 on "Guidelines on the Base Rate" has required the banks to switch over from benchmark prime lending rate (BPLR) system to the system of Base Rate. The BPLR system, introduced in 2003, fell short of its original objective of bringing transparency to lending rates. This was mainly because under the BPLR system, banks could lend below BPLR. For the same reason, it was also difficult to assess the transmission of policy rates of the RBI to lending rates of banks. The Base Rate system is aimed at enhancing transparency in lending rates of banks and enabling better assessment of transmission of monetary policy. Accordingly, the following guidelines are issued for implementation by banks:

- The Base Rate system has replaced the BPLR system with effect from July 1, 2010. Base Rate shall include all those elements of the lending rates that are common across all categories of borrowers. Banks may choose any benchmark to arrive at the Base Rate for a specific tenor that may be disclosed transparently. Banks are free to use any other methodology, as considered appropriate, provided it is consistent and is made available for supervisory review/scrutiny, as and when required.
- Banks may determine their actual lending rates on loans and advances with reference to the Base Rate and by including such other customer specific charges as considered appropriate.
- The actual lending rates charged may be transparent and consistent and be made available for supervisory review/scrutiny, as and when required.
- All categories of loans should henceforth be priced only with reference to the Base Rate. However, the following categories of loans could be priced without reference to the Base Rate: (a) DRI advances (b) loans to banks' own employees including retired employees[@] (c) loans to banks' depositors against their own deposits.
- Changes in the Base Rate shall be applicable in respect of all existing loans linked to the Base Rate, in a transparent and non-discriminatory manner.
- Reserve Bank of India will separately announce the stipulation for export credit.

- Banks are required to review the Base Rate at least once in a quarter with the approval of the Board or the Asset Liability Management Committees (ALCOs) as per the bank's practice. Since transparency in the pricing of lending products has been a key objective, banks are required to exhibit the information on their Base Rate at all branches and also on their websites. Changes in the Base Rate should also be conveyed to the general public from time to time through appropriate channels. Banks are required to provide information on the actual minimum and maximum lending rates to the Reserve Bank on a quarterly basis, as hitherto.
- The Base Rate system would be applicable for all new loans and for those old loans that come up for renewal. Banks, however, should not charge any fee for such switch-over.[@]
- In line with the above Guidelines, banks may announce their Base Rates after seeking approval from their respective ALCOs/ Boards.
- RBI, vide its circular no. DBOD. Dir.BC. 81 /13.03.00/2010-11 dated February 21, 2011 advises that lending of subsidised loans by Government of India, Ministry of New and Renewable Energy (MNRE) under a scheme on financing of Off-Grid and Decentralised Solar (Photovoltaic and Thermal) applications as part of the Jawaharlal Nehru National Solar Mission (JNNSM) to entrepreneurs at interest rates not exceeding five per cent where refinance of two per cent from Government of India is available, would not be considered to be a violation of our Base Rate Guidelines.

Prudential Exposure Limits

Single and Group Borrower Limits

1.25 With a view to achieve a better risk management and avoidance of concentration of credit risk, the RBI from time to time, prescribes, limits on exposure of a bank to individual borrowers and groups of borrowers in India. The Master Circular No. DBOD. No. Dir. BC. 3/13.03.00/2012-13, dated July 2, 2012 on "Exposure Norms", lays down the ceiling on exposure to individual/group borrowers in relation to bank's capital fund as defined under capital adequacy standards (Tier-I and Tier-II Capital) (The Circular has been given in the CD along with this Guidance Note). The ceiling on exposure to individual borrowers is 15 per cent of capital funds and 40 per cent in the case of a borrower group. However, exposure to borrowers belonging to a group

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may exceed the exposure norms of the 40 per cent of the bank's capital funds by an additional 10 per cent, provided the additional credit exposure is on account of extension of credit for infrastructure projects. Exposure to single borrower may also exceed by 5 per cent, provided the additional exposure is on account of infrastructure projects. The definition of infrastructure lending and the items included under the infrastructure sector is given in Annexure I of the said Master Circular. Derivative Products such as Forward Rate Agreements and Interest Rate Swaps are also captured for computing exposure by applying the conversion factors to notional principal amounts. Banks should also include forward contracts in foreign exchange and other derivative products like currency swaps, options etc., at their replacement cost value in determining individual / group borrower exposure. The Master Circular on Exposure Norms contains guidelines on calculation of the credit exposure in derivative products.

1.26 With effect from May 29, 2008, the exposure limit in respect of single borrower has been raised to twenty five percent of the capital funds, only in respect of Oil Companies who have been issued Oil Bonds (which do not have SLR status) by Government of India.

1.27 In addition to the exposure limit as permitted above, banks may, in exceptional circumstances, with the approval of their Boards, consider enhancement of the exposure to a borrower upto a further 5 per cent of capital funds subject to the borrower consenting to the banks making appropriate disclosures in their Annual Reports. Such exposures where the bank has exceeded the prudential exposure limit should be appropriately disclosed in the "Notes to Accounts" to the Balance Sheet.

Sector Specific Limit

1.28 Apart from limiting the exposures to an individual or a borrower group as indicated above, banks may also consider fixing internal limits for aggregate commitments to specific sectors, e.g. textiles, jute, tea, etc., so that the exposures are evenly spread over various sectors. These limits could be fixed by the banks having regard to the performance of different sectors and the risks perceived. The limits so fixed may be reviewed periodically and revised, as necessary.

Lending to NBFCs

1.29 The exposure (both lending and investment, including off balance sheet exposures) of a bank to a single NBFC / NBFC-AFC (Asset Financing Companies) should not exceed 10% / 15% respectively, of the bank's capital funds as per its last audited balance sheet. Banks may, however, assume exposures on a single NBFC / NBFC-AFC up to 15%/20% respectively, of their capital funds provided the exposure in excess of 10%/15% respectively, is on account of funds on-lent by the NBFC / NBFCAFC to the infrastructure sector. Exposure of a bank to Infrastructure Finance Companies (IFCs) should not exceed 15% of its capital funds as per its last audited balance sheet, with a provision to increase it to 20% if the same is on account of funds on-lent by the IFCs to the infrastructure sector. Further, banks may also consider fixing internal limits for their aggregate exposure to all NBFCs put together. Infusion of capital funds after the published balance sheet date may also be taken into account for the purpose of computing exposure ceiling. Banks should obtain an external auditor's certificate on completion of the augmentation of capital and submit the same to the Reserve Bank of India (Department of Banking Supervision) before reckoning the additions to capital funds.

Lending Under Consortium Arrangements

1.30 The exposure limit will also be applicable to lending under consortium arrangements.

Bills Purchased/Discounted under Letter of Credit

1.31 In cases where the bills discounting/purchasing/negotiating bank and LC issuing bank are different entities, bills purchased/ discounted/ negotiated under L/C (where payment to the beneficiary is not “under reserve”) is to be treated as an exposure on L/C issuing bank and not on borrower. In the case of negotiations “under reserve”, the exposure will be treated as an exposure on the borrower. However, in cases where the bills discounting/purchasing/negotiating bank and LC issuing bank are part of the same bank, i.e. where LC is issued by the Head Office or branch of the same bank, then the exposure should be taken on the third party/borrower and not on the LC issuing bank. In the case of negotiations ‘under reserve’, the exposure should be treated as on the borrower.[@]

Unhedged Foreign Currency Exposure of Corporates[@]

1.32 To ensure that each bank has a policy that explicitly recognises and takes account of risks arising out of foreign exchange exposure of their clients, foreign currency loans above US $10 million, or such lower limits as may be deemed appropriate *vis-à-vis* the banks’ portfolios of such exposures, should be extended by banks only on the basis of a well laid out policy of their Boards with regard to hedging of such foreign currency loans. Further, the policy for hedging, to be framed by their Boards, may consider, as appropriate for convenience, excluding the following:

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- Where forex loans are extended to finance exports, banks may not insist on hedging but assure themselves that such customers have uncovered receivables to cover the loan amount.
- Where the forex loans are extended for meeting forex expenditure.

1.33 Banks are also advised that the Board policy should cover unhedged foreign exchange exposure of all their clients including Small and Medium Enterprises (SMEs). Further, for arriving at the aggregate unhedged foreign exchange exposure of clients, their exposure from all sources including foreign currency borrowings and External Commercial Borrowings should be taken into account.

1.34 Banks which have large exposures to clients should monitor and review on a monthly basis, through a suitable reporting system, the unhedged portion of the foreign currency exposures of those clients, whose total foreign currency exposure is relatively large (say, above US $25 million or its equivalent). The review of unhedged exposure for SMEs should also be done on a monthly basis. In all other cases, banks are required to put in place a system to monitor and review such position on a quarterly basis.

1.35 In the case of consortium/multiple banking arrangements, the lead role in monitoring unhedged foreign exchange exposure of clients, as indicated above, would have to be assumed by the consortium leader/bank having the largest exposure.

Lending for Real Estate

1.36 Banks are required to frame comprehensive prudential norms relating to the ceiling on the total amount of real estate loans, single/group exposure limits for such loans, margins, security, repayment schedule and availability of supplementary finance and the policy should be approved by the banks' Boards. While appraising loan proposals involving real estate, banks should ensure that the borrowers have obtained prior permission from government / local governments / other statutory authorities for the project, wherever required. In order that the loan approval process is not hampered on account of this, while the proposals could be sanctioned in the normal course, the disbursements should be made only after the borrower has obtained requisite clearances from the government authorities.

1.37 RBI has also required that the banks' Boards may also consider incorporation of aspects relating to adherence to National Building Code (NBC) in their policies on exposure to real estate. The information regarding the NBC can be accessed from the website of Bureau of Indian Standards (www.bis.org.in). Banks should also adopt the National Disaster Management Authority (NDMA) guidelines and suitably incorporate them as part of their loan policies, procedures and documentation.[@]

Lending for Establishing SEZs

1.38 The banks' exposure to entities for setting up Special Economic Zones (SEZs) or for acquisition of units in SEZs which includes real estate would be treated as exposure to commercial real estate sector for the purpose of risk weight and capital adequacy from a prudential perspective. Banks would, therefore, have to make necessary provisions, and also assign appropriate risk weights for such exposures, as per the existing guidelines. This exposure may be treated as exposure to infrastructure sector only for the purpose of exposure norms which provide some relaxations to the Infrastructure sector.

Equipment Leasing, Hire Purchase and Factoring Services

1.39 Banks are permitted by the RBI to undertake leasing, hire purchase and factoring services departmentally. Where banks undertake these services departmentally, they are required to maintain a balanced portfolio of equipment leasing, hire purchase and factoring services *vis-à-vis* the aggregate credit. Their exposure to each of these activities should not exceed 10 percent of total advances.

Financing of Joint Ventures

1.40 Banks are allowed to extend Credit/Non-Credit Facilities (*viz.* Letters of Credit and Guarantees) to Indian Joint Ventures/Wholly-owned Subsidiaries abroad and Step-down Subsidiaries, which are wholly owned by the overseas subsidiaries of Indian corporates. Banks are also permitted to provide at their discretion, buyer's credit/acceptance finance to overseas parties for facilitating export of goods & services from India. The above exposure will, however, be subject to a limit of 20 percent of banks' Unimpaired Capital Funds (Tier I and Tier II Capital), subject to the conditions prescribed in the Master Circular dated July 2, 2012 on Exposure Norms. (The Circular has been given in the CD along with the Guidance Note).

1.41 The above exposure will, however, be subject to a limit of 20 percent of banks' unimpaired capital funds (Tier I and Tier II capital), subject to the following conditions:[@]

i. Loan will be granted only to those joint ventures where the holding by the Indian company is more than 51%.

ii. Proper systems for management of credit and interest rate risks arising out of such cross border lending are in place.

[@] Revised in 2013 Edition.

iii. While extending such facilities, banks will have to comply with Section 25 of the Banking Regulation Act, 1949, in terms of which the assets in India of every banking company at the close of business on the last Friday of every quarter shall not be less than 75 percent of its demand and time liabilities in India.

iv. The resource base for such lending should be funds held in foreign currency accounts such as FCNR(B), EEFC, RFC, etc. in respect of which banks have to manage exchange risk.

v. Maturity mismatches arising out of such transactions are within the overall gap limits approved by RBI.

vi. Adherence to all existing safeguards / prudential guidelines relating to capital adequacy, exposure norms etc. applicable to domestic credit / non-credit exposures.

vii. The set up of the step-down subsidiary should be such that banks can effectively monitor the facilities granted by them.

1.42 Further, the loan policy for such credit / non-credit facility should be, inter alia, in keeping with the following:[@]

(a) Grant of such loans is based on proper appraisal and commercial viability of the projects and not merely on the reputation of the promoters backing the project. Non-fund based facilities should be subjected to the same rigorous scrutiny as fund-based limits.

(b) The countries where the joint ventures / wholly owned subsidiaries are located should have no restrictions applicable to these companies in regard to obtaining foreign currency loans or for repatriation, etc. and should permit non-resident banks to have legal charge on securities / assets abroad and the right of disposal in case of need.

1.43 Banks should also comply with all existing safeguards/prudential guidelines relating to capital adequacy, and exposure norms indicated in paragraph 1.25 above.

Exemptions from Exposure Norms

1.44 Exemptions from exposure norms are discussed below:

(a) *Rehabilitation of Sick/Weak Industrial Units* - The ceilings on single/group exposure limits are not applicable to existing/additional credit facilities (including funding of interest and irregularities) granted to weak/sick industrial units under rehabilitation packages.

[@] Revised in 2013 Edition.

(b) *Food credit* - Borrowers, to whom limits are allocated directly by the Reserve Bank for food credit, will be exempt from the ceiling.

(c) *Guarantee by the Government of India* - The ceilings on single/group exposure limit would not be applicable where principal and interest are fully guaranteed by the Government of India.

(d) *Loans against own term deposits* - Loan and advances granted against the security of bank's own term deposits may be excluded from the purview of the exposure ceiling to the extent that the bank has a specific lien on such deposits.

(e) *Exposure on NABARD* - The ceiling on single/group borrower exposure limit will not be applicable to exposure assumed by banks on NABARD. The individual banks are free to determine the size of the exposure to NABARD as per the policy framed by their respective Board of Directors. However, banks may note that there is no exemption from the prohibitions relating to investments in unrated non-SLR securities prescribed in terms of the Master Circular on Prudential Norms for Classification, Valuation and Operations of Investment Portfolio by Banks, as amended from time to time.

1.45 Exposure includes credit exposure (funded and non-funded credit limits) and investment exposure (including underwriting and similar commitments). The sanctioned limits or outstandings, whichever are higher, shall be reckoned for arriving at the exposure limit. However, in the case of fully drawn term loans, where there is no scope for re-drawal of any portion of the sanctioned limit banks may reckon the outstanding as the exposure.

Nature of Advances

1.46 Banks provide advances to their customers in various forms like, cash credit, term loans, overdrafts, and purchase or discounting of bills. The principal features of various types of advances are briefly described below.

Cash Credit

1.47 Cash credit facility is provided mainly to individuals or enterprises engaged in manufacturing and trading activities to enable them to meet the gap in their working capital requirements and is repayable on demand. The amount of cash credit facility to be sanctioned to a unit is need-based and is worked out as per well-defined parameters in each bank; the guidelines of the RBI may also affect the quantum of the facility in some cases. The cash credit facility is generally granted against the security of stocks of goods, standing crops, bills / book debts representing genuine sales – all belonging to the borrower. These assets are 'primary' security for the advance.

1.48 In addition to the primary security, banks generally also obtain collateral security.

1.49 Charge is created in favour of the bank on the specific assets owned by one or more of the following:

- the borrower;
- all or some of the partners of the borrowing firm in their personal capacity;
- all or some of the directors of the borrowing company (usually the promoters) in their personal capacity; and
- third party(ies) who has/have to also guarantee the advance.

1.50 The most common form of the collateral security are immovable properties. The following are some other securities, which may be obtained as collateral securities:

- movable fixed assets like machinery, vehicles;
- deposit receipts/certificates like the term deposit receipts, gilt-edged securities, National Savings Certificates (NSCs), Kisan Vikas Patras, Indira Vikas Patras, certificates of mutual funds; and
- life insurance policies, shares of companies, gold / silver. It may be noted that under section 20 of the Banking Regulation Act, 1949 banks cannot lend against the security of their own shares.

1.51 One distinctive feature is that while mortgaged properties and movable fixed assets invariably remain in the possession of the borrower even though charged to the bank, other forms of collateral securities, stated above, are in the physical custody of the bank.

1.52 As regards the quantum of the collateral security to be obtained in relation to the amount secured thereby, there are no hard and fast rules. The sanctioning authorities enjoy considerable freedom in this regard. Nevertheless, the following points are noteworthy.

- In determining the quantum of collateral security, the sanctioning authorities have to adhere to any guidelines/norms of the bank concerned.
- Reserve Bank directions prohibit banks from obtaining any collateral security for advances up to a specified cut-off level for specified segments of borrowers. These directions, however, undergo modifications from time to time.

1.53 The cash credit advances are generally on 'floating' interest rate basis. The rate is reset periodically, depending upon any changes in the bank's prime lending rate / spread in relation to the class of borrower / risk perception about the borrower.

1.54 There may be cases where the cash credit is not secured by any primary security. There may or may not be any collateral security in such cases.

1.55 It is a common practice among banks to obtain guarantees for repayment of cash credit facilities. The guarantors may be either directly connected with the borrowing entity (e.g., partners in the case of a partnership firm / directors in the case of a company / holding company for a subsidiary company) or they may be independent persons (individuals – singly or jointly, companies, etc.) who are considered 'good' for the amount involved. Banks prepare reports (called 'opinion reports' in some banks) about the credit worthiness of the guarantors at the time of stipulating their guarantees and update these reports periodically – annually or at the time of review of the credit facility.

Working Capital Demand Loan

1.56 In compliance of RBI directions, banks presently grant only a small part of the fund-based working capital facilities to a borrower by way of a running cash credit account; a major portion is in the form of a Working Capital Demand Loan (WCDL). The minimum period of WCDL, which is basically a non-operable account, keeps on changing. WCDL is granted for a fixed period on the expiry of which it has to be liquidated, renewed or rolled over. Some banks levy interest on WCDL at rates different from those applicable to the running cash credit account.

Loans

1.57 Loans are repayable in instalments spread over a period of time. However, if there is a default in meeting the commitments by the borrower, the bank has the right to demand repayment of the entire loan outstanding, including the instalments which have not yet fallen due for payment. The amount and periodicity of repayment is fixed at the time of sanction and is duly recorded in the loan documents. Both, the amount and the periodicity, may be uniform throughout the life of the loan, or either or both of them may differ from instalment to instalment. Besides, repayment schedule may either be drawn only for the principal amount in which case periodic interest has to be paid by the borrower separately as and when due, or a schedule may be fixed with 'equated monthly instalments' which also includes the amount of interest likely to be applied to the account during its entire tenure at the rate of interest applicable at the time of sanction/documentation/first disbursement. Loans with repayment periods beyond 36 months are usually called 'term loans' whereas loans with repayment period of upto 36 months are called 'demand loans'. However, both term loans and demand loans are similar in many respects: both have pre-determined repayment schedule, the disbursal is by way of a limited number of debits, and cheque books are not issued. The basic difference between the two is that term loans are for acquisitions of capital assets, which then become the security for the loan, i.e., end use of funds is fixed. The demand loans, on the other hand, are granted against the existing securities, which are readily realisable, e.g., term deposits, gold and shares.

1.58 It may be noted that the prudential norms of the Reserve Bank (discussed later in this Chapter) include demand loans under the expression 'term loans'.

1.59 The interest rate for loans may be either on 'fixed' terms in which event the rate contracted originally holds good during the entire currency of the loan, or it may be on 'floating' terms which means that the rate may undergo changes at unspecified periods on happening of certain events as outlined in the loan agreement. This aspect is a subject matter of negotiation between the bank and the borrower.

1.60 The term/demand loans are generally extended for the following purposes:

- For acquisition of fixed assets like land and building, plant and machinery, furniture, vehicles, implements, houses, consumer durables, etc.
- For meeting expenses on education / medical treatment of self/dependants.
- For meeting other personal expenses.
- For meeting deficit in the net working capital requirements as assessed by the bank.
- For Marketing / Launching / Branding.[@]

1.61 The primary securities for loans are:

- Assets created out of the loan if it is for procurement of any fixed assets.
- Deposit receipts/certificates like the term deposit receipts, NSCs, Kisan Vikas Patras, Indira Vikas Patras, certificates of mutual funds.
- Life insurance policies, shares of companies and other similar scrips, bonds, gold, silver.

[@] Revised in 2013 Edition.

1.62 The collateral securities for loans are:

- Liens on any monies belonging to the borrower and / or guarantors, e.g., lien on credit balances in deposit accounts.
- A charge on the existing fixed assets of the borrower and / or the guarantor, not created out of the loan.
- Any deposit receipts / certificates / policies / goods listed above under 'primary' securities.

1.63 Besides the primary and collateral securities, banks may also obtain guarantees to secure their loans, as discussed earlier under the head 'cash credit'.

1.64 Banks give general purpose loans also, i.e., without stipulating any end-use of funds, on the strength of a suitable collateral security (normally mortgage of immovable properties), or even without security based on the credit worthiness of the borrower (e.g., credit card outstandings).

1.65 It may be mentioned that by its very nature, the cash credit account may, at times, show credit balances in which case it becomes a deposit for the bank, akin to a current account. However, the term loan and demand loan accounts are highly unlikely to show any credit balances.

Foreign Currency Loans

1.66 Banks are authorised to lend in foreign currency. These loans are given as per the EXIM Policy and guidelines issued by Reserve Bank of India from time to time. Foreign Currency Loans may be in nature of Term loans or Working Capital loans.

Overdrafts

1.67 Overdraft facility is granted to a current account holder. Under the arrangement, the customer can draw upto an agreed sum in addition to his credit balance in the account. The overdraft facility may be either secured or clean (i.e., without security) and does not generally carry a repayment schedule. The most common form of security for an overdraft arrangement is term deposit receipts issued by the same branch where the overdraft is availed of. In some cases, overdraft facility may be granted by a branch against the term deposit receipts issued by other branches of the bank. In such cases, care is taken to ensure that the branch which has issued the term deposit receipt confirms in writing to the lending branch that it has noted a lien on the deposit in favour of the latter in its records. Overdrafts may also be granted against other securities like life insurance policies, shares, bonds, NSCs, Kisan Vikas Patras, Indira Vikas Patras, etc. Banks do not, however, accept the term deposit receipts of other banks as security in view of the general lien of the bank issuing the term deposit receipt over the deposit. Personal loans are also given to individuals with good track record and found creditworthy in the judgement of banks. These are demand loans, which are in the nature of clean loans and generally carry no security.

Bills

1.68 While the cash credit finance against stocks is intended to be used for financing the pre-sales stages, i.e., procurement of raw materials, their processing and conversion into finished goods to bring them into saleable condition as well as to carry reasonable quantities of these goods lying in various stages, the finance against bills is meant to finance the actual sale transactions. The finance against bills can be in any of the below mentioned form:

- Purchase of bills by the bank if these are payable 'on demand'.
- Discounting of bills by the bank if these are usance (or time) bills.
- Advance against bills under collection from the drawees, whether sent for realisation through the bank or sent directly by the drawer to the drawees.

1.69 A unique kind of facility under this head is advances against bills drawn on public sector undertakings / government departments which do not accept bills. In such cases, pre-receipted challans are submitted by the borrower to the bank as an evidence for availing finance there against (a pre-receipted challan establishes genuine movement of goods and ensures that the funds of the bank are used for sanctioned purposes only). This facility is commonly known in the banking sector as 'government bills facility' or 'supply bills facility'. It may also be mentioned that the purchase / discounting of bills may be either under a letter of credit issued by another bank (which ensures the realisation of the bill amount) or without a letter of credit. In case of dishonour of bills, banks have the right to recover the amount from the drawer with penalty, additional interest, etc.

1.70 Bills may be either 'documentary', i.e., accompanied by the original documents of title to the goods, or 'clean', i.e., without the original documents of title to the goods. In the case of documentary bills, the bank releases the documents of title to the drawee only against payment (in the case of demand bills purchased) or against acceptance (in the case of usance bills discounted). On release of documents of title after acceptance of usance bills, these also assume the nature of clean bills.

1.71 The RBI has issued guidelines for regulation of discounting and rediscounting of bills (Ref. Para 2.3.9 of the Master Circular No.

DBOD.No.Dir.BC.4/13.03.00/2012-13 ,dated July 02, 2012) "Loans and Advances-Statutory and other Restrictions".

Export Credit

1.72 Exporters are also granted facilities in the form of cash credit and bills only but, being of a special nature, require a separate mention here. These facilities extended to exporters are in the form of 'pre-shipment credit' and 'post-shipment credit'. In the first category, fall all advances required to finance the production cycle – from procurement of raw materials to bringing them to the port for despatch. It also includes financing of working capital expenses towards rendering of services. The advance is given either on the basis of individual order obtained, or the customer is sanctioned an export packing credit (EPC) limit and the advances are disbursed on production of individual orders; in the latter case, EPC becomes a running account. The exporter usually adjusts the account by drawing bills of exchange on the foreign buyer, which are discounted by the bank under the letter of credit and the proceeds collected from the foreign bank. The post-shipment credit relates to financing of bills raised on the overseas buyer upon shipment of goods/ services. Another feature of export credit is that the advance may be granted in Indian Rupees or a designated foreign currency. In the latter case, the loan is disbursed in a foreign currency but, for the purpose of accounting, converted into rupees. The export credit is granted at concessional rates of interest. The pre-shipment credit has to be liquidated out of the export proceeds only and cannot be adjusted out of rupee funds (except where the raw materials required for processing exceed the FOB value of the contract, in which the excess advance has to be repaid within a maximum of 30 days from the date of advance). The export proceeds have normally to be received within 180 days from the date of shipment. The period can be extended in genuine cases, with the approval of the bank (within the discretion available to it under the regulations in force at the relevant time) or of the RBI, as permitted by the Exchange Control Manual and the operating instructions issued by the Reserve Bank from time to time. The pre-shipment credit can be granted at any branch unless the bank itself has placed any restrictions on the branch undertaking this activity. However, the bills representing the export proceeds can be handled only by branches permitted to act as authorised foreign exchange dealers as they involve handling transactions in a foreign currency and reporting to Reserve Bank.

1.73 Pre-shipment credit granted in a foreign currency is called 'Packing Credit in Foreign Currency' (PCFC) advance and has to be repaid out of the export bills discounted under the Export Bills Rediscounting (EBR) scheme. Each bank designates a few select branches to handle PCFC and EBR transactions; all branches are not authorised to deal with these facilities. The

Rupee Export credit is also allowed to be shared between export order holders and manufacturer of the goods to be exported. Similarly, bank may extend PCFC also to the manufacturer on the basis of disclaimer from the export order holder through his bank. PCFC granted to the manufacturer can be repaid by transfer of foreign currency from the export order holder by availing of PCFC or by discounting of bills. It should be ensured that no double financing is involved in the transaction and total period of packing credit is limited to the actual cycle of production of the exported goods The facility may be extended where the banker or the leader of consortium of banks is the same for both the export order holder and the manufacturer or, the banks concerned agree to such an arrangement where the bankers are different for export order holder and manufacturer. The sharing of export benefits will be left to the mutual agreement between the export order holder and the manufacturer. (Ref.: Para 5.1.11 of the Master Circular No. DBOD No.DIR.BC.06/04.02.002/2012-13 dated July 02, 2012, “Rupee/Foreign Currency Export Credit & Customer Service to Exporter”). PCFC may be made available to both the supplier of EOU/EPZ/SEZ unit and the receiver of EOU / EPZ / SEZ unit and PCFC for supplier EOU / EPZ / SEZ unit will be for supply of raw material/components of goods which will be further processed and finally exported by receiver EOU / EPZ / SEZ unit. The PCFC extended to the supplier EOU/EPZ/SEZ unit will have to be liquidated by receipt of foreign exchange from the receiver EOU/EPZ/SEZ unit, for which purpose, the receiver EOU/EPZ/SEZ unit may avail of PCFC. The stipulation regarding liquidation of PCFC by payment in foreign exchange will be met in such cases not by negotiation of export documents but by transfer of foreign exchange from the banker of the receiver EOU/EPZ/SEZ unit to the banker of supplier EOU/EPZ/SEZ unit. Thus, there will not normally be any post-shipment credit in the transaction from the supplier EOU/EPZ/ SEZ unit’s point of view. In all such cases, it has to be ensured by banks that there is no double financing for the same transaction. Needless to add, the PCFC to receiver EOU/EPZ/SEZ unit will be liquidated by discounting of export bills. (Ref.: Para 5.1.12 of the Master Circular No DBOD No.DIR.BC.06/04.02.002/2012-13 dated July 02, 2012, “Rupee/Foreign Currency Export Credit & Customer Service to Exporter”).

1.74 Under the Foreign Trade Policy 2009-2014, firms/companies dealing in purchase/sale of rough or cut and polished diamonds, diamond studded jewellery, with good track record of at least - two years in import or export of diamonds with an annual average turnover of Rs. 3 crore or above during the preceding three licensing years (from April to March) are permitted to carry out their business through designated Diamond Dollar Accounts (DDAs). Under the DDA Scheme, it would be in order for banks to liquidate PCFC granted to a DDA holder by dollar proceeds from sale of rough, cut and polished diamonds by him to another DDA holder@.

1.75 In regard with facility of rediscounting with recourse or without recourse it is recognized that it will be difficult to get without recourse facility from abroad under BAF or any other facility. The bills may therefore be rediscounted `with recourse'. However, if an AD is in a position to arrange `without recourse' facility on competitive terms, it is permitted to avail itself of such a facility. (Ref.: Para 6.1.5 of the Master Circular No. DBOD No.DIR.BC.06/04.02.002/2012-13 dated July 02, 2012, "Rupee/Foreign Currency Export Credit & Customer Service to Exporter".)

1.76 Gold Cardholders are given preference and additional benefits for grant of packing credit in foreign currency. For detailed scheme refer Para 8.1.3 of the Master Circular No. DBOD No.DIR.BC.06/04.02.002/2012-13 dated July 02, 2012, "Rupee/Foreign Currency Export Credit & Customer Service to Exporter".

Security

1.77 A brief reference has been made in the preceding section to the types of securities commonly accepted by banks for granting different kinds of credit facilities. In this section, the aspect will be examined in greater detail.

Mode of Creation of Security

1.78 Depending on the nature of the item concerned, creation of security may take the form of a mortgage, pledge, hypothecation, assignment, or set-off.

Mortgage

1.79 Mortgage has been defined under section 58 of the Transfer of Property Act, 1882, as "the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced by way of loan, an existing or future debt, or the performance of an engagement which may give raise to a pecuniary liability".

1.80 Mortgages are of several kinds but the most important are the Registered@ Mortgage and the Equitable Mortgage. A Registered Mortgage can be affected by a registered instrument called the 'Mortgage Deed' signed by the mortgagor. It registers the property to the mortgagee as a security. Equitable mortgage, on the other hand, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof.

@ Revised in 2013 Edition

Pledge

1.81 A pledge is defined under section 172 of the Indian Contract Act, 1872, as "the bailment of goods as security for payment of a debt or performance of a promise." A pledge thus involves bailment or delivery of goods by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance. The legal ownership of the goods remains with the pledger while the lending banker gets certain defined interests in the goods. The pledge of goods constitutes a specific (or fixed) charge. The pledger has the right of getting back the pledged goods after repaying to the bank its dues in full. Subsequent advances made to the pledger by the bank are also covered by a pledge of goods, unless there is a contract to the contrary. Under section 171 of the Indian Contract Act, 1872 a banker can retain as security for a general balance of accounts any goods bailed to him. In case of sale of pledged goods in the event of default by the borrower, if the sale proceeds are not sufficient to cover the dues of the bank, a civil suit can be brought against the borrower or the guarantor within the prescribed period of limitation for recovery of the shortfall. In a pledge, the bank has all the liabilities and responsibilities of a bailee of goods. The bank may be held responsible for not carrying out their obligations as bailee.

Hypothecation

1.82 The term 'hypothecation' is not defined in law. In commercial parlance, the term refers to the creation of an equitable charge (i.e., a charge created not by an express enactment but by equity and reason), which is created in favour of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower. Neither ownership nor possession is transferred to the bank. However, the borrower holds the physical possession of the goods as an agent/trustee of the bank. The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker on the basis of which the drawing power of the borrower is fixed. From the view point of the lending bank, hypothecation is more risky than pledge since the borrower can dispose of the hypothecated assets or pledge them or create another hypothecation on them without the knowledge of the bank, specially in the case of borrowers other than companies where there is no requirement for registration of charge.

Assignment

1.83 Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favour of another person. Only actionable claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment. An assignment gives the assignee absolute right over the moneys/debts assigned to him. The transfer of debt, right or property is subject to all the liabilities and equity to which the transferor was subject on the date of transfer. In other words, the assignee cannot get a better title than that of the assignor.

Set-off

1.84 Set-off is a statutory right of a creditor to adjust, wholly or partly, the debit balance in the debtor's account against any credit balance lying in another account of the debtor. A lending bank has the right of set-off in the absence of an agreement, express or implied, to the contrary with the borrower. The right of set-off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and in the same right (i.e., the capacity of the account holder in both the accounts should be the same). Thus, where a person obtains a loan from a bank and also deposits certain moneys with the bank in a deposit account in his capacity as a trustee, the right of set-off cannot be exercised. Similarly, a bank has no right to combine a borrower's personal account with a joint account of the borrower and another person. For the purpose of set-off, all the branches of a bank are treated as one single entity. The right of set-off can be exercised in respect of time-barred debts also.

1.85 In case of pledge, while the ownership remains with the borrower, the pledged goods are in the effective possession of the bank although they are stored in the godowns in the borrower's premises. The locks on the godowns belong to the bank and the key is in effective custody of a responsible official of the branch[2]. The deposits into, and deliveries from, the godowns are made in the presence of a godown-keeper of the bank. All such operations on the godowns are duly recorded in the records of the bank.

Types of Securities

1.86 Banks accept a wide range of tangible assets and instruments as security for advances. However, a security offered by a borrower does not

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[2] The credit facilities extended on these terms are sometimes called 'lock-and-key' facilities.

offset the lack of integrity of the borrower. It is often said that security does not make a bad loan a good loan but makes a good loan a better one.

1.87 The characteristics of a good security from the viewpoint of the lending bank are marketability, easy ascertainability of value, stability of value, and transferability/transportability.

1.88 The most common types of securities accepted by banks are the following:

Stock Exchange Securities and Other Instruments

1.89 Stock exchange securities include shares, debentures and bonds in which dealings take place on a stock exchange. These securities are easily marketable; their market value is readily ascertainable; it is easy to ascertain the title of the depositor; and they are easy to pledge. In addition to stock exchange securities, banks also make advances against such instruments as gilt-edged securities, National Savings Certificates, Kisan Vikas Patras, Indira Vikas Patras, Gold Bonds, etc. (It may be noted that the banks are not allowed to provide loans to companies for buy back of shares / securities having regard to the requirements of the Master Circular No. DBOD.No.Dir.BC.4/13.03.00/2012-13, dated July 02, 2012 on “Loans and Advances-Statutory and Other Restrictions”.

1.90 The securities are usually in the possession of the bank. Wherever the shares are held as security by a bank (whether as primary or as collateral security), banks are required to have them transferred in their own names if the loan amount exceeds the ceiling prescribed by RBI. The ceiling may be different for shares in dematerialised form and those in physical form. In other cases, (i.e. where the loan amount does not exceed the prescribed ceiling), banks accept the aforesaid securities subject to the following conditions:

(a) in the case of shares, if they are accompanied by blank transfer deeds duly signed by the person (normally, the borrower) in whose name they are registered; in case of shares held in dematerialised form, authorisation slips should be obtained from the borrower and should be passed on to relevant depository participant who immediately marks those shares as pledged or:

(b) if the bank holds a general power of attorney from the person (normally, the borrower) in whose name they are registered.

1.91 If the person in whose name the securities are registered is other than the borrower, the bank has to particularly satisfy itself that the person has a good title to the security. The bank also obtains a letter of renunciation from the person in whose name the securities are registered.

1.92 When shares offered as security are under promoters' quota, banks require the promoters to provide an undertaking not to dispose of these shares during the tenure of the loan.

1.93 In the case of advances against bearer securities (Kisan Vikas Patras/ Indira Vikas Patras), banks obtain independent confirmation of the genuineness of the certificates from issuing authorities. In the case of bearer securities, only possession by the bank is sufficient.

1.94 In the case of government paper and inscribed stock, however, the banks should get them registered in their own name while accepting them as security.

1.95 Before accepting shares as security, the lending bank has to ensure that the provisions of section 19 of the Banking Regulation Act, 1949 are not contravened. This section prohibits a banking company (as also a nationalised bank, State Bank of India, a subsidiary of State Bank of India, and a Regional Rural Bank) from holding shares in any company, whether as pledge, mortgagee or absolute owner, of an amount exceeding thirty per cent of the paid up share capital of that company or thirty per cent of its own paid-up share capital and reserves, whichever is less.

1.96 Banks often insist that borrowers issue 'mandates' in their favour for collection of dividends, etc. Such mandates serve the purpose of providing evidence about the borrower's continuing ownership of the scrips by regular receipt of dividends, and also reduce the amount of outstanding advance.

1.97 Lodging of stock exchange securities against a loan amounts to a pledge. It may be noted that under section 125 of the Companies Act, 1956, pledge of any moveable property by a company does not require registration with the Registrar of Companies.

1.98 Advances against partly paid-up shares, loans to proprietorship and partnership firms against security of shares and debentures and financing of *badla* transactions are under restriction and for which detailed master circular on bank finance against shares and debentures issued on 28th August 1998 be referred.

Goods

1.99 Goods constitute a significant proportion of the securities taken by banks. They are either the stock-in-trade of its trading customers or the finished products of manufacturers. Raw materials, work-in-process, etc., are also accepted as security, but generally, they form part of a floating charge. Banks should have a system in place to ensure that the borrower does not take advantage of double financing on same stock, i.e., in respect of unpaid stocks.

1.100 Goods may be either hypothecated to, or pledged with, the bank. As mentioned earlier, in case of hypothecation of goods, banks obtain periodic statements from the borrowers, declaring the quantity and value of the goods on the basis of which the drawing power of the borrowers is fixed. The officers of the lending bank pay regular visits to godowns or factories of the borrowers to inspect them and to check the correctness of records maintained by the borrowers on the basis of which, the periodic statements are prepared by them. They also check the value of the goods in stock with reference to sale bills, market quotations, in case of large advances, the inventory are subject to inspection and verification (stock audit) by external agency at stipulated intervals. The branch auditor may go through the same for determining existence and adequacy of security and also to determine the irregularity in the account, if any.

1.101 Stock registers are maintained by the godown keepers of the lending bank in respect of goods pledged with the bank. The godowns are regularly inspected by the inspectors and other officers of the bank. When goods are brought into the godown, the godown keeper has to satisfy himself, by appropriate test checks, regarding the quantity and quality of goods. Banks have to exercise care to ensure that frauds are not perpetrated against them by pledging packages not containing the specified goods and later on holding them responsible for the goods supposed to have been pledged according to the documents.

1.102 The goods are insured against fire and other risks involved and the insurance policies are either in the name of, or endorsed in favour of, the bank.

1.103 In case the borrower is a company, the bank has to ensure that charge on the goods hypothecated is registered with the Registrar of Companies.

Documents of Title to Goods

1.104 A document of title to goods is a negotiable or quasi-negotiable instrument. According to section 2(4) of the Sale of Goods Act, 1930, a document of title is any document used in the ordinary course of business as proof of the possession or control of goods, or authorising or purporting to authorise, either by endorsement or by delivery, the possessor of the document to transfer or receive the goods represented thereby. Documents of title include:

- Bill of lading
- Railway receipt
- Transporter's receipt
- Dock warrant
- Warehouse-keeper's certificate
- Wharfinger's receipt
- Warrant or order for delivery of goods

1.105 Before being pledged with the bank, these documents have to be appropriately endorsed in favour of the bank.

1.106 In the case of bills of lading, railway receipts, etc., where goods are to be cleared for pledging them with the bank, the clearing is usually done through the clearing agents designated by the bank for this purpose.

Gold Ornaments and Bullion

1.107 Gold ornaments are accepted by banks as security on the basis of assayer's certificate regarding the content, purity and weight of gold and the value thereof. Valuation, however, keeps changing as a result of market fluctuations. Loans are given only on the basis of gold content of ornaments, no regard being had to labour charges. RBI has directed banks to give preference to hallmarked jewellery for granting advances *vide* its Master Circular No. DBOD.No.Dir.BC.4/13.03.00/2012-13 on Loan and Advances-Statutory and Other Restrictions dated July 2, 2012. Banks should also decide on the margin and rates of interest thereon.

1.108 Gold and silver bars with mint seals impressed thereon are also accepted by banks generally from bullion traders. Banks should not grant loans against Gold Bullion. Banks should desist from granting advances to silver bullion dealers which are likely to be utilized for speculative purposes and bank should also desist from giving loans to finance *badla* transactions in silver.

Life Insurance Policies

1.109 Life insurance policies have to be assigned in favour of the bank and such assignment has to be registered with the insurer. The surrender value of the policies is taken as the basis of valuation.

Bank's Own Deposit Certificates

1.110 Term deposit certificates, (including cash certificates), issued by the bank are often accepted as security for loans.

1.111 As mentioned earlier, banks do not generally make advances against deposit certificates of another bank owing to the other bank's general lien. Banks should not grant loans against Certificate of Deposits.

Hire Purchase Documents

1.112 Banks also provide finance to persons selling goods on hire purchase basis. Generally, in a hire purchase, the seller sells the goods on the condition that the purchaser will pay the price in specified instalments and the property in goods will not pass to the purchaser until the payment of the last instalment. The hire purchase price includes interest also and is, therefore, higher than the cash price. The purchasers have to execute agreements giving effect to the above conditions; they also execute promissory notes in respect of the instalments.

1.113 The seller endorses the promissory notes executed by the purchasers in favour of the bank. He also executes a Deed of Hypothecation in respect of the goods, which are in possession of the purchasers but are still the property of the seller.

1.114 Calculation of drawing power is also important in these advances. It is normally a certain percentage (say, 75 per cent) of the cash price of the goods as reduced by the instalments, which have already fallen due. The basis of calculation is specified in the agreement with the borrower.

1.115 Banks also make advances to leasing companies. In case of such advances, leasing companies often create charge on the leased assets in favour of the bank and also enter into an agreement enabling the bank to appropriate the lease rentals under certain circumstances.

Plantations

1.116 Advances are made to agriculturists such as tea gardeners to finance their growing crops. When the produce is harvested, processed and sold, the money is repaid to the bank.

1.117 The basis of calculating the amount of the advance is the estimated crop of the season. This depends upon the area under cultivation, expected yield, etc. Separate advances are made for each season's crop.

1.118 The crop to be produced is hypothecated to the bank. Generally, the fixed assets of the plantation are also mortgaged with the bank as collateral security.

1.119 Finance is taken from the bank to incur expenditure on the crop. As such, the amount of the advance increases as the crop grows. When the crop is despatched to the brokers for auction, the arrangement generally is that they will act as agents of the bank and hand over the sale proceeds only to the bank.

Immovable Property

1.120 Before advancing money on mortgage of immovable property, the lending bank has to satisfy itself that the borrower has a clear and unencumbered title to the property, and that the property is marketable and adequately insured. In respect of advances to public companies against the mortgage of a block of assets, it is essential that the provisions of section 293(1)(a) of the Companies Act, 1956 need to be kept in view[3].

Trust Receipts

1.121 A trust receipt (or 'trust letter') is a document signed by the borrower under which he obtains (or keeps) possession of the goods constituting the security 'in trust' for the bank. At times, the bank may sanction a trust receipt facility as a part of the cash credit arrangement to the borrower. This facility is sanctioned when the advance is granted against stocks, which are yet to be received by the borrower or against stocks which are being dispatched by the borrower but for which payment will be received later. The facility is allowed only to sound parties and the arrangement is expected to be for a short period. The bank needs to take special care where the amount is outstanding for an unduly long period, say three months or more.

Third Party Guarantees

1.122 Advances covered only by the personal guarantee of third parties (except banks and government) in addition to the personal security of the borrower are not 'secured' advances and would be classified as 'unsecured' in the balance sheet.

1.123 A contract of guarantee is defined under section 126 of the Indian Contract Act, 1872 as "a contract to perform the promise or discharge the liability of a third person in case of his default."

1.124 The guarantee bond executed by the guarantor in favour of the bank may be in bank's own prescribed form or otherwise. Such bonds are generally executed by holding companies, overseas customers, overseas principals, insurance companies, etc. A letter of continuity is also obtained from the guarantor.

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[3] Under section 293(1)(a) of the Companies Act, 1956, the board of directors of a public company, or of a private company which is a subsidiary of a public company, cannot sell, lease or otherwise dispose of the whole or substantially the whole or any one or more undertakings of the company without the consent of the company in general meeting.

1.125 Banks sometimes also require the guarantor to give a collateral security. In such a case, the advance ceases to be an unsecured advance to the extent of the value of the security.

Banker's General Lien

1.126 Besides the above securities, which are created by an agreement between the borrower and the bank, a lending bank also has a general lien under the law. A lien represents the right of retaining the goods/securities unless a debt due by a debtor is paid to the creditor (retainer), provided there is no agreement, express or implied, to the contrary. A lien is a statutory right, which does not require any separate agreement. Under section 171 of the Indian Contract Act, 1872, a banker may, in the absence of an agreement to the contrary, retain as security for a general balance of account, any goods and securities bailed to him. This is called banker's general lien. Two conditions necessary for creating such lien are:

(a) the securities must have been placed in his hands as a banker by his customers; and

(b) they are not specifically appropriated.

1.127 Examples of securities over which a banker has general lien are credit balance in any other account, bonds and coupons deposited for collection, securities allowed to remain in the banker's hands after repayment of a secured advance, etc. Examples of securities on which a banker does not have a general lien are securities deposited for safe custody, money deposited or earmarked for a specific purpose, documents executed for a special purpose, etc. Lien is applicable even in respect of the borrower's obligations as a surety. The banker's right of general lien over the security is not barred by the law of limitation and can be exercised in the case of unenforceable or time-barred debts also.

Negative Lien

1.128 The term 'negative lien' is commonly used to refer to an undertaking given by the borrower to the bank that he (i.e., borrower) will not create any charge such as lien, pledge, hypothecation, or mortgage, over his immovable and moveable properties and assets including uncalled capital without the prior permission of the bank. A negative lien relates to goods, securities, etc. which are not in the possession of the bank. Negative lien does not require registration with the Registrar of Companies or similar other authorities.

Sectoral Distribution

1.129 Advances are required to be classified, *inter alia*, into those in India and those outside India, with further sub-classification under each category.

One such sub-classification that merits discussion from an auditor's perspective is advances in India to priority sectors[4].

1.130 Priority sector advances include –

- Advances for agriculture and other allied activities – RBI, vide its circular no. RPCD.CO.Plan.BC. 51 /04.09.01/2010-11 dated February 2, 2011 on "Classification of loans against gold jewellery" clarifies that loans sanctioned to NBFCs for on-lending to individuals or other entities against gold jewellery, are not eligible for classification under agriculture sector. Similarly investments made by banks in securitised assets originated by NBFCs, where the underlying assets are loans against gold jewellery, and purchase/assignment of gold loan portfolio from NBFCs are also not eligible for classification under agriculture sector.
- SHG- Bank linkage Programme: RBI vide its master circular no. RPCD. FID. BC.No. 04 / 12.01.033/ 2012-13 dated July 02, 2012 to scale up the SHGs linkage programme and make it sustainable, advised banks that they may consider lending to SHGs as part of their mainstream credit operations both at policy and implementation level. They may include SHG linkage in their corporate strategy/plan, training curriculum of their officers and staff and implement it as a regular business activity and monitor and review it periodically.
- In order to enable the banks to report their SHG lending without difficulty, it was decided that the banks should report their lending to SHGs and/or to NGOs for on-lending to SHGs/members of SHGs under the new segment, *viz*. 'Advances to SHGs' irrespective of the purposes for which the members of SHGs have been disbursed loans. Lending to SHGs should be included by the banks as part of their lending to the weaker sections (under priority section).
- As per operational guidelines of NABARD, SHGs may be sanctioned savings linked loans by banks (varying from a saving to loan ratio of 1:1 to 1:4). However, in case of matured SHGs, loans may be given beyond the limit of four times the savings as per the discretion of the bank. The flexibility allowed to the banks in respect of margin, security norms, etc. under the pilot project continues to be operational under the linkage programme even beyond the pilot phase. [@]
- Advances to minority communities

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[4] The RBI has issued a master circular no. RPCD. CO. RRB.BC.No. 6 /03.05.33/2012-13 dated July 2, 2012 on "Lending to Priority Sector" (The circular is given in the CD along with the Guidance Note).

[@] Revised in 2013 Edition.

- Advances to micro/small/medium scale enterprises[5]
- Advances to small road transport operators
- Advances to retail traders and small business enterprises
- Advances to professionals and self employed
- Advances sanctioned to state sponsored organisations for scheduled castes/scheduled tribes
- Educational loans upto the prescribed limit – RBI, vide its circular no. RPCD. SME & NFS. BC.No. 69/06.12.05 /2009-10 dated April 12, 2010 on “Collateral Free Loans - Educational Loan Scheme”, clarifies that banks must not, mandatorily, obtain collateral security in the case of educational loans upto Rs. 4 lakh.
- Housing loans upto prescribed limits[6]
- Funds provided to RRBs
- Micro credit[7]
- Any other priority sector advances, such as SEPUP (Self-Employment Programme for Urban Poor), PMRY (Prime Minister's Rozgar Yojana), SEEUY (Self-Employment Scheme for Educated Unemployed Youth) SGSY (Swarnajayanti Gramswaraj Swarojgar Yojana)[8], SJSRY (Swarnajayanti Sahakari Rozgar Yojana).

1.131 Priority sector advances generally carry an interest rate, which is lower than the normal rate of interest on lending to other sectors. These advances are also known as DRI advances, i.e., advances on which differential rate of interest is applicable. Under the Reserve Bank of India’s guidelines, a significant proportion of the total advances of banks are to be made to priority

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[5] The RBI has issued a master circular no. RPCD.MSME & NFS. BC. No. 11/06.02.31/2012-13 dated July 2, 2012 on “Lending to Micro, Small and Medium Enterprises (MSME) Sector” (The Circular is given in the CD along with the Guidance Note). Also refer to the circular no. RPCD.SME & NFS.BC.No.79/06.02.31/2009-10 dated May 6, 2010 on “Working Group to Review the Credit Guarantee Scheme for Micro and Small Enterprises (MSEs) – Collateral free loans to MSEs”.

[6] Attention is also invited to circular no. DBOD. No.BP.BC. 69 /08.12.001/2010-11 dated December 23, 2010 on “Housing Loans by Commercial Banks – LTV Ratio, Risk Weight and Provisioning”, circular no. RPCD.MSME & NFS. BC.No. 30 /06.11.01/ 2012-13 dated September 18, 2012 on “Scheme of 1% interest subvention on housing loans up to Rs. 15 lakh” and Master circular no. DBOD. No.DIR.BC.07/08.12.001/2012-13 dated July 2, 2012 on “Housing Finance”.

[7] The RBI has issued a master circular no. RPCD.MFFI.BC.No. 05/12.01.001/2010-11 dated July 1, 2010 on “Micro Credit”.

[8] Attention is the reader is drawn to a master circular No. RPCD. GSSD. BC. No.1/09.01.01/2012-13 dated July 2, 2012 on “Priority Sector Lending - Special Programmes - Swarnajayanti Gram Swarozgar Yojana (SGSY)” and Circular No. RPCD.GSSD .BC.No.30 /09.01.01/2010 -11 dated December 15, 2010 on “Swarnajayanti Gram Swarozgar Yojana (SGSY) - Group Life Insurance Scheme”.

sectors. These advances may be made against security or against guarantees provided by the government, or otherwise depending on the particular scheme under which the advances are made. Depending upon the nature and type of facilities extended, the bank may get subsidy from the Government to fully or partly offset the shortfall in interest rate and/or get indemnified for bad debts for the whole or a portion of such advances.

Nature of Borrowing Arrangements

1.132 The following paragraphs explain the different ways in which a banking arrangement can be tied up by a borrower.

Sole Banking

1.133 In this arrangement, the borrower obtains credit from a single bank. This is the simplest form of tie-up and is operationally convenient for both the lender and the borrower. Most of the banking tie-ups in India are of this type because the quantum of bank finance in an individual case is usually small. Depending on the nature and extent of credit facility offered, the lending bank itself may stipulate that the borrower will not avail of finance from another bank.

Consortium Arrangement

1.134 In this type of arrangement, the number of lending banks is more than one. The lending banks form a formal consortium. Salient features of the arrangement are:

- The consortium has a formal leader, called the 'lead bank' (normally, the bank with the largest exposure).
- The consortium frames and adopts its own ground rules for conducting its business with the borrower.
- There is a common set of loan documents, which is obtained by the lead bank on behalf of other participating banks also.
- The lead bank is responsible for overall monitoring.
- The member banks of the consortium have rights over the security in an agreed proportion.
- The borrower maintains direct business relationship with all member banks of the consortium.

Multiple Banking

1.135 In this type of arrangement, there is no formal arrangement amongst the lending banks. Each of them has its set of loan documents, securities and mode of lending, independent of other lending banks. The borrower has to deal with each of the banks separately.

1.136 The RBI, *vide* its Circular No. DBOD No. BP. BC.46/ 08.12.001/2008-09 dated September 19, 2008 on "Lending under Consortium Arrangement/Multiple Banking Arrangements", encourages the banks to strengthen their information back-up about the borrowers enjoying credit facilities from multiple banks as under:

(i) At the time of granting fresh facilities, banks may obtain declaration from the borrowers about the credit facilities already enjoyed by them from other banks, as prescribed in the RBI Circular No. DBOD.No.BP.BC.94 /08.12.001/2008-09 dated December 08, 2008 on "Lending under Consortium Arrangement/Multiple Banking Arrangements". In the case of existing lenders, all the banks may seek a declaration from their existing borrowers availing sanctioned limits of Rs.5.00 crore and above or wherever, it is in their knowledge that their borrowers are availing credit facilities from other banks, and introduce a system of exchange of information with other banks as indicated above.

(ii) Subsequently, banks should exchange information about the conduct of the borrowers' accounts with other banks in the format given in the RBI Circular No. DBOD.No.BP.BC.94/08.12.001/2008-09 dated December 08, 2008 on "Lending under Consortium Arrangement/Multiple Banking Arrangements" at least at quarterly intervals.

(iii) Obtain regular certification by a professional, preferably a Company Secretary, regarding compliance of various statutory prescriptions that are in vogue, as per specimen given in the RBI Circular No. DBOD.No.BP.BC.94 /08.12.001/2008-09 dated December 08, 2008 on "Lending under Consortium Arrangement/Multiple Banking Arrangements".

(iv) Make greater use of credit reports available from a credit information company which has obtained Certificate or Registration from RBI and of which the bank is a member.[@]

(v) The banks should incorporate suitable clauses in the loan agreements in future (at the time of next renewal in the case of existing facilities) regarding exchange of credit information so as to address confidentiality issues.

Loan Syndication

1.137 Though a common phenomenon abroad, the concept is relatively new to India and is yet to gain ground. In this system, there is an 'arranger'. Banks or subsidiary of the Bank which scouts banks or other institutions willing to

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finance a unit on terms and conditions proposed by the unit. The arranger obtains offers from the various prospective lenders and arranges to firm up the financing arrangement in consultation with the borrower. It is the responsibility of the arranger to get the documentation done.

Inter-bank Participation Certificates

1.138 Besides consortium lending, banks also enter into arrangements with other banks under inter-bank participation schemes. However, as far as the borrower is concerned, the arrangements are made by the banks independently of the borrower and have no effect on his relationship with the bank from which he has borrowed the funds.

1.139 Inter-bank participations are of two types– (a) participation on risk-sharing basis, and (b) participation on non-risk-sharing basis.

Participation on Risk-sharing Basis

1.140 Under participation on risk-sharing basis, a bank participating in the scheme (referred to as the 'issuing bank') allots a portion of the outstanding in the cash credit limit or loan sanctioned by it to a borrower to one or more of other banks which is/are willing to accept the same [referred to as the 'participating bank(s)] at par. The participating bank(s) do not make any independent appraisal of the borrower or of the guarantor(s); they rely on such appraisal made by the issuing bank. The rate of interest on the participation certificates is a matter of negotiation between the issuing bank and the participating bank(s) subject to a minimum rate as may be prescribed by the RBI from time to time. The participating bank(s) is/are entitled to share in the proceeds of realisation and/or receipt of moneys from the borrower to the extent of their respective participations.

1.141 From the viewpoint of the issuing bank, the amount of inter-bank participation certificates represents advances transferred to participating bank(s) and reduces the aggregate advances by that amount. The participating bank(s) treat the amount of the participations as part of their advances. Such transactions are not reflected by the issuing bank in the individual borrower's account. At the end of the accounting period, the amount of outstanding certificates is netted off by the issuing bank in the general ledger against advances outstanding.

1.142 The issuing bank maintains a register to record the particulars of the participations, the participation certificates issued outstandings, those fully repaid on maturity, those partially repaid, and those still unpaid.

1.143 In case of any shortfall in realisation or receipt, the participant bank(s) bear the loss pro-rata along with the issuing bank.

Participation on Non-risk-sharing Basis

1.144 A non-risk-sharing participation is similar to the participation on risk-sharing basis except that the question of sharing the realisation pro-rata in case of default does not arise. The issuing bank has to honour the participation certificates on maturity and has to pay the full amount due in respect of such certificates including interest and other charges irrespective of any event of default. For the issuing bank, the participation certifications under this scheme represent its borrowings, whereas for the participating bank(s), the participation certificates under this scheme too represent advances.

Procedure for Sanction, Disbursement, Supervision and Renewal of Advances

1.145 Each bank has its own procedures for sanctioning, disbursing, supervising and renewing advances. However, despite some differences, the following steps are more or less common to all banks.

Sanction

1.146 The starting point is the receipt of a formal request from the applicant. The request may be in the form of a standard format of the bank or in the form of a letter in which case the bank requests the intending borrower to furnish the standard format duly filled in. All applications are entered in a Loan Applications Received Register (the exact nomenclature may vary from bank to bank). Some supporting documents are required to be furnished along with the application. The main examples are (it may be emphasised that all the documents may not be applicable to all the applicants):

Documents Applicable to All Types of Applicants

1.147 Documents applicable to all types of applicants are as under:

- DIC registration certificate. (DIC is the District Industries Centre set up by respective State Governments in each district to promote the growth of industries, primarily Micro and Small Enterprises, (MSE) in the district. Each new MSE unit has to register itself with the local DIC upon which it gets a registration certificate. This registration may help the unit in getting some facilities like priority allotment of land to the unit by the government, etc.)
- Approval / licence from the competent authority to set up the unit (wherever such approval/licence is required).

- 'No objection certificate' from Pollution Control Board/other designated government authorities for a particular type of activity.
- 'No objection certificate' from other banks/ financial institutions. Where an existing borrower of a bank approaches another bank for grant of additional assistance, the other bank will demand a 'No Objection Certificate' from the former bank. In the case of small loans, mostly under the government-sponsored schemes, the banks require 'No Dues Certificate' from other local banks in the area (unless obtaining of the certificate has been waived specifically in the scheme) to ensure that the beneficiary is neither a defaulter of another bank nor is he availing of subsidy from the government for more than one loan.
- Sanction from the local body, e.g., municipal corporation, Electricity Board, Water Department, etc. for providing necessary facilities.
- Balance sheet and profit and loss account for the preceding three years with break-up of various items. The break-up relates to such information as the following:
    - Ageing analysis of debtors.
    - Ageing analysis of raw materials, work-in-process and finished goods.
    - Components of 'other income'.
    - Bills discounted under limits or LCs, bank-wise.
    - Promoters' / associates' shareholding.
    - Details of dues to / from associate concerns on account of business relationships or as loans and advances.
    - Security deposits taken from dealers /given to suppliers.
    - Lists of debtors and creditors.
    - Details of advances given to suppliers.
    - Repayment schedules for various loans raised by the applicant.
- Sales tax registration certificate.
- PAN for income tax.
- Proof of identity, e.g. voters' identity card, telephone bill, passport.
- Proof of ownership of land and building belonging to the unit.
- Bio-data of the promoters of the unit and details of their assets and liabilities.
- Details of pending litigation against the unit or against its promoters.
- Particulars about the proposed guarantors, including details of their assets and liabilities.
- Details of accounts with other banks, if any.

- Project report.
- Details of tie-ups with suppliers of raw materials and buyers of finished goods as well as with providers of technology, if there are any such formal arrangements.
- Particulars of associate concerns / holding company / subsidiary company/ collaborators.
- Market survey report, if conducted by or on behalf of the unit.
- Quotations from the vendors/detailed estimates of the various components of cost of the project.
- Particulars of dealers/consignment agents appointed by the unit.
- Approval for raising equity from foreign investors/external commercial borrowings.
- Sanction letters of other participating lenders.
- Particulars of proposed collateral securities, (including Title clearance / Valuation Reports).@
- Approval of RBI in case of Foreign Currency Loans.

Documents applicable to companies only

1.148 Documents applicable to companies only are as under:

- Copy of certificate of incorporation.
- Copy of memorandum and articles of association.
- Copy of certificate of commencement of business (only in the case of a public limited company). This is obtained keeping in view section 149 of the Companies Act, 1956, which provides that contracts entered into by a public limited company before the issue of certificate of commencement of business are provisional only and not binding on the company until the date when it becomes entitled to commence business.
- Resolution passed by the shareholders (in appropriate cases). Under section 293(1)(d) of the Companies Act, 1956, the board of directors of a public company or a private company which is a subsidiary of a public company cannot borrow in excess of the limits specified therein except under the authority of a resolution passed by the shareholders in a duly convened general meeting. The resolution should specify, inter alia, the total amount upto which the directors are authorised to borrow.
- Copy of the resolution of the board of directors. The bank has to

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satisfy itself that the resolution has been passed at a duly convened meeting of the board in accordance with the provisions of the Act and the articles of association and that the resolution contains the following:

  - Name(s) of the person(s) authorised to operate the account.
  - Names of the directors/persons who are authorised to execute the security documents on behalf of the company.

- Authorising the borrowing and stating the important terms and conditions thereof such as limit on borrowing, security, rate of interest, etc.
- Particulars of registration with Securities and Exchange Board of India.
- Copy of prospectus or statement in lieu of prospectus.
- Approval of Foreign Investment Promotion Board, wherever applicable, in case of Foreign Companies setting up business in India or Joint Venture Projects.
- Secretarial Audit Report or Company Secretary's Due Diligence Report[@]

Document Applicable to Partnership Firms Only

1.149 Documents applicable to partnership firms only are as under:

- Partnership deed (in the case of a partnership firm). Where the firm has been constituted without a written partnership deed, banks usually insist on obtaining a written declaration about the existence of the partnership, signed by all the partners.
- The documents obtained from the applicant are analysed by the Loan Manager / Officer at the branch who may seek additional information / clarifications from the applicant on various issues.
- Firm Registration Certificates from the Registrar of Firms.

Assessment of Credit Worthiness of Borrower

1.150 Credit scoring is a system used to assess the credit worthiness and capacity to repay the loan and meet other obligations. Ascertain whether Credit Scoring system has been accessed by the banks to assess the credit worthiness and capacity of a borrower to repay his loan and advances and also discharge his other obligations in respect of credit facility availed or to be availed by him particularly in view of Credit Information Companies (Regulation) Act, 2005 (CICRA).

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1.151 The proposal is evaluated in the context of the directions of the RBI including prudential exposure limits and the bank's own risk management guidelines. Besides, the proposal is appraised on the following parameters to ensure that it is technically feasible, economically viable and commercially acceptable (the degree of scrutiny depends largely on the amount of the advance):

- Performance of the unit vis-a-vis other similar units.
- Conduct of its accounts with the lenders.
- Experience, competence and profile of the management of the unit.
- Guarantees and collateral securities offered.
- Trend and ratio analysis to see that the unit's growth is healthy, financials are sound, liquidity is comfortable and the promoters have a reasonable stake in the unit.
- Availability of inputs for production.
- Market.
- Technology in use.
- Unit's capability to achieve the projected operating and performance levels and to service the debt.
- Applicability of norms/benchmarks relating to scale of finance, e.g., Nayak Committee recommendations for SSI units, scale of finance fixed by the bank for agricultural finance to be extended in the local area, etc.
- Latest Govt. policy about particular industry / Locational restriction, etc.[@]

1.152 If the official concerned finds the proposal acceptable, he prepares a detailed appraisal note and submits it along with necessary supporting documents and its recommendations to the authority having powers to sanction it. Each official who has been vested with powers to sanction advances has a monetary ceiling upto which he can sanction advances to the specified kind of borrowers (like individuals, partnerships, companies, etc.) and/or for the specified activities (like agriculture, industry, professional education, business, etc.) and / or for the type of facility (term loan, overdraft, cash credit, etc.). Such powers are properly documented and circulated by the bank to all its offices. The officials at the branch can sanction only those advances, which fall within their delegated powers. For advances, which require to be sanctioned by higher authorities, the branch has to carry out the appraisal and send the proposal along with its recommendations to its controlling office for necessary

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sanction. As and when the advance is sanctioned by the competent authority (which could be an official, a committee of officials or the board of directors of the bank, depending on the amount involved), the fact of sanction along with detailed terms and conditions of the sanction are communicated by the controlling office to the branch. It is the responsibility of the branch to complete the formalities for disbursement of the advance.

Disbursement

1.153 After the sanction of the advance, the branch communicates the terms and conditions of the sanction to the applicant and obtains their consent for the arrangement. Thereafter, the documents as prescribed by the bank are obtained, charges created and, if required, the bank's charge over the unit's assets noted with the authorities concerned, e.g., Registrar of Companies, Road Transport Authority, insurance company, land records authority, & CERSAI, etc. In the case of an advance to a partnership firm, while the account is opened in the trade name of the firm, the security documents are got executed from the partners in both their individual capacity (i.e., without mentioning the name of the firm or affixing the stamp of the firm) and in their capacity as partners of the firm. This is to ensure that the advance may be recovered from the assets of the firm as well as from the individual assets of the partners.

1.154 After the above formalities have been completed, the advance is released in the following manner:

- Term loans (granted generally for acquisition of fixed assets) are disbursed on the basis of quotations/ proforma invoices obtained by the borrower from the vendors and submitted to the bank either along with the application or later. Banks generally stipulate a stated percentage of the cost to be met by the borrower from his own funds. Once the borrower provides his contribution to the bank, the branch debits the Term Loan account with the balance amount and pays the amount to the vendor directly along with a letter stating the purpose of the funds. The term loan may be released in one or more instalments. As and when the asset is received by the borrower, the bank officials inspect it, record the particulars in their books, and obtain copies of the final invoices for their record from the borrower.
- There may be instances where, on business considerations, the borrower has already acquired the asset. In such a case, he submits the documentary evidence to the branch and seeks reimbursement to the extent permissible. The branch officials inspect the asset and books of account of the borrower and, if satisfied, credit the eligible

amount to the borrower's account (current / cash credit, as desired by the borrower) by debiting his term loan account.

- Cash credit advances are released on the basis of the stock statements relating to the security (which may be book debts, stock-in-trade, etc.) submitted by the borrower as per the periodicity laid down in the terms of sanction. The branch officials verify the statements (in some cases, tangible securities like stock-in-trade are also physically verified) and calculate what is called the 'drawing power' based on the stocks of the security held by the borrower and the margin prescribed in the sanction. This 'drawing power' is noted in the Cash Credit Ledger and is a guide to the official concerned while authorising debits to the account.
- In the case of loans of very small amount, banks may grant composite advances, which are a mixture of term loan and cash credit. The term loan component is repayable in instalments over a period of time whereas cash credit is a running account.
- The procedures of many banks require the branch manager to periodically submit a certificate to the controlling authority (i.e., regional or zonal office) that all disbursements during the relevant period have been made only after completion of the necessary formalities.

Monitoring and Supervision

1.155 The following are the procedures usually adopted by banks for monitoring and supervision of advances after disbursement:

- Regular inspection of the borrower's assets and books. The main purposes of inspection are as follows:
  - ➢ To ensure that the amounts disbursed have been utilised for purposes for which the advance was sought.
  - ➢ To check that the borrower has not acquired / disposed of any asset – fixed or current – without the consent / knowledge of the bank, depending upon the terms of the advance. Acquisition of fixed assets has two-fold effect on the banks: first, it increases the borrower's requirement for working capital if the asset is for production, and second, it may amount to diversion of short-term funds (e.g., proceeds from sale of stocks) which, from the viewpoint of the bankers, is not a sign of financial prudence.
  - ➢ To cross-check the figures declared in the stock statements with the books maintained by the borrower (including excise

and other statutory records, if applicable) as well as to physically verify the stock items, to the extent possible.

- To check that the unit has been working on projected levels particularly in the areas of sales and production, the plant or machinery is not lying idle, and the general working of the unit is satisfactory.
- To ensure that the borrower has not availed of finance against stocks for which it has itself not made the payment.
- To ensure that the borrower has not availed of finance from any other lender unauthorisedly and that it has not opened any deposit accounts with others.
- To ensure that the borrower has not made any investment in, or advances to, its associates without the bank's approval, if such approval is required as per the terms of the loan or otherwise diverted the funds.
- To check that there is a regular turnover of stocks that the unit does not carry any obsolete, unusable stocks. Generally, banks place a limit on the age of stocks which are eligible for bank finance; the items older than such limit are not financed. Similarly, in the case of book debts, debts outstanding beyond a specified period are also not eligible for bank finance.
- To ensure that the borrower continues to be engaged in the activity for which the loan has been granted.

- Periodic review of the progress in implementation of the project.
- Review of the conduct of the account.
- Obtaining and scrutinising stock statements.
- Obtaining other relevant financial data periodically and analysis of the data. Banks obtain information at monthly / quarterly / half yearly / yearly intervals about on the levels of sales, production, profit, cash accruals, break up of assets and liabilities, cash flows etc. The analysis covers the following points:
    - Comparison of the data with the projections contained in the appraisal note to find out the deviations, the reasons thereof, and the corrective action to be taken, wherever necessary.
    - Comparison of the unit's performance, on an on-going basis, with other similar units.
    - Ratio analysis based on the provisional data submitted by the unit to find out the liquidity and solvency position and any diversion of short-term resources towards long term uses.

- Observing the credits to the account.

- Whenever the above analysis indicates weaknesses in operations, or the need for additional documentation or security, a dialogue is held with the borrower, with consequent follow-up.
- RBI, vide its circular no. DBS.CO.PPD.BC.No. 5 /11.01.005/2010-11 dated January 14, 2011 on "End Use of Funds - Monitoring" to evaluate and strengthen the efficacy of the existing machinery in the banks for post-sanction supervision and follow-up of advances. According to the circular the systems and procedures may include the following:

  (i) Meaningful scrutiny of the periodical progress reports and operating/financial statements of the borrowers;

  (ii) Regular visits to the assisted units and inspection of securities charged/ hypothecated to the banks;

  (iii) Periodical scrutiny of the books of accounts of the borrowers;

  (iv) Introduction of stock audits depending upon the extent of exposure;

  (v) Obtention of certificates from the borrowers that the funds have been utilised for the purposes approved and in case of incorrect certification, initiation of prompt action as may be warranted, which may include withdrawal of the facilities sanctioned and legal recourse as well. In case a specific certification regarding diversion/siphoning of funds is desired from the auditors of the borrowers, a separate mandate may be awarded to them and appropriate covenants incorporated in the loan agreements; and

  (vi) Examination of all aspects of diversion of funds during internal audit/ inspection of the branches and at the time of periodical reviews.

  Effective monitoring of the end use of funds lent is of critical importance in safeguarding a bank's interest. Further, this would also act as a deterrent for borrowers to misuse the credit facilities sanctioned, and in the process, help build a healthy credit culture in the Indian banking system.

Renewal of Advances

1.156 Working capital advances are generally granted for one year at a time and require renewal if the borrower wants continuation of the facility beyond that period at the same level, reduced level or increased level, depending upon the unit's needs, its ratios, the bank's perception of risk and so on. Loans repayable over a period of time in instalments are not renewed. However, some banks have a system of reviewing these loans from time to time primarily with the objective of risk evaluation and interest rate resetting.

1.157 The procedure described above for sanction of advances is also followed, to the extent applicable, for renewal of advances already granted to an applicant.

Restrictions on Advances

1.158 The master circular no. DBOD.No.Dir.BC.4/13.03.00/2012-13 dated July 2, 2012, “Loans and Advances- Statutory and other Restrictions” issued by the RBI contains detailed requirements and guidelines in respect of statutory and other restrictions on loans and advances by banks (The Circular is given in the CD along with the Guidance Note).

Statutory Restrictions

Advances against Bank’s own Shares

1.159 In terms of Section 20(1) of the Banking Regulation Act 1949, a bank cannot grant any loan or advance against the security of its own shares.

Advances to Bank's Directors

1.160 Section 20(1) of the Banking Regulation Act, 1949 also lays down the restrictions on loans and advances to the directors and the firms in which they hold substantial interest.

1.161 Banks are prohibited from entering into any commitment for granting any loans or advances to or on behalf of any of its directors, or any firm in which any of its directors is interested as partner, manager, employee or guarantor, or any company (not being a subsidiary of the banking company or a company registered under Section 25 of the Companies Act, 1956, or a Government company) of which, or the subsidiary or the holding company of which any of the directors of the bank is a director, managing agent, manager, employee or guarantor or in which he holds substantial interest, or any individual in respect of whom any of its directors is a partner or guarantor. There are certain exemptions in this regard.There are certain exemptions given in the aforesaid Master Circular in this regard.

1.162 For the above purpose, the term 'loans and advances' shall not include the following:[@]

[@] Revised in 2013 Edition.

(a) loans or advances against Government securities, life insurance policies or fixed deposit;
(b) loans or advances to the Agricultural Finance Corporation Ltd;
(c) such loans or advances as can be made by a banking company to any of its directors (who immediately prior to becoming a director, was an employee of the banking company) in his capacity as an employee of that banking company and on the same terms and conditions as would have been applicable to him as an employee of that banking company, if he had not become a director of the banking company. The banking company includes every bank to which the provisions of Section 20 of the Banking Regulation Act, 1949 apply;
(d) such loans or advances as are granted by the banking company to its Chairman and Chief Executive Officer, who was not an employee of the banking company immediately prior to his appointment as Chairman/Managing Director/CEO, for the purpose of purchasing a car, personal computer, furniture or constructing/ acquiring a house for his personal use and festival advance, with the prior approval of the RBI and on such terms and conditions as may be stipulated by it;
(e) such loans or advances as are granted by a banking company to its wholetime director for the purpose of purchasing furniture, car, Personal Computer or constructing/acquiring house for personal use, festival advance with the prior approval of RBI and on such terms & conditions as may be stipulated by it;
(f) call loans made by banking companies to one another;
(g) facilities like bills purchased/discounted (whether documentary or clean and sight or usance and whether on D/A basis or D/P basis), purchase of cheques, other non-fund based facilities like acceptance/co-acceptance of bills, opening of L/Cs and issue of guarantees, purchase of debentures from third parties, etc.;
(h) line of credit/overdraft facility extended by settlement bankers to National Securities Clearing Corporation Ltd.(NSCCL) / Clearing Corporation of India Ltd. (CCIL) to facilitate smooth settlement; and
(i) a credit limit granted under credit card facility provided by a bank to its directors to the extent the credit limit so granted is determined by the bank by applying the same criteria as applied by it in the normal conduct of the credit card business.

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1.163 Purchase of or discount of bills from directors and their concerns, which is in the nature of clean accommodation, is reckoned as 'loans and advances' for the purpose of Section 20 of the Banking Regulation Act, 1949.

1.164 The above mentioned Master Circular on Loans and Advances – Statutory and Other Restrictions also provides that while extending non-fund based facilities such as guarantees, L/Cs, acceptance on behalf of directors and the companies/firms in which the directors are interested. It should be ensured that:

(a) adequate and effective arrangements have been made to the satisfaction of the bank that the commitments would be met by the openers of L/Cs, or acceptors, or guarantors out of their own resources;

(b) the bank will not be called upon to grant any loan or advance to meet the liability consequent upon the invocation of guarantee; and

(c) no liability would devolve on the bank on account of L/Cs/ acceptances.

Restrictions on Power to Remit Debts

1.165 Section 20A of the Banking Regulation Act, 1949 stipulates that notwithstanding anything to the contrary contained in Section 293 of the Companies Act, 1956, a banking company shall not, except with the prior approval of the Reserve Bank, remit in whole or in part any debt due to it by -

- any of its directors, or
- any firm or company in which any of its directors is interested as director, partner, managing agent or guarantor, or
- any individual, if any of its directors is his partner or guarantor.

Any remission made in contravention of the provisions stated above shall be void and have no effect.

Restriction on Holding Shares in Companies[@]

1.166 In terms of Section 19(2) of the Banking Regulation Act, 1949, banks should not hold shares in any company except as provided in sub-section (1) whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30 percent of the paid-up share capital of that company or 30 percent of its own paid-up share capital and reserves, whichever is less.

1.167 Further, in terms of Section 19(3) of the Banking Regulation Act, 1949, the banks should not hold shares whether as pledgee, mortgagee or absolute

[@] Revised in 2013 Edition.

owner, in any company in the management of which any managing director or manager of the bank is in any manner concerned or interested.

1.168 Accordingly, while granting loans and advances against shares, statutory provisions contained in Sections 19(2) and 19(3) should be strictly observed.

Restrictions on Credit to Companies for Buy-back of their Securities

1.169 In terms of Section 77A(1) of the Companies Act, 1956, companies are permitted to purchase their own shares or other specified securities out of their:

- Free reserves, or
- Securities premium account, or
- Proceeds of any shares or other specified securities,

subject to compliance of various conditions specified in the Companies (Amendment) Act, 1999. Therefore, banks should not provide loans to companies for buy-back of shares/securities.

Regulatory Restrictions

Granting Loans and Advances to relatives of Directors

1.170 Without prior approval of the Board or without the knowledge of the Board, no loans and advances should be granted to relatives of bank's Chairman/Managing Director or other Directors, Directors (including Chairman/Managing Director) of other banks and their relatives, Directors of Scheduled Co-operative Banks and their relatives, Directors of Subsidiaries/Trustees of Mutual Funds/Venture Capital Funds set up by the financing banks or other banks. However, banks may grant loan or advance to or on behalf of spouses of their Directors in cases where the spouse has his/her own independent source of income arising out of his/her employment or profession and the facility so granted is based on standard procedures and norms for assessing the creditworthiness of the borrower. Such facility should be extended on commercial terms. Further, the banks are also required to comply with the guidelines of RBI as prescribed in its Master Circular in regard to grant of loans and advances to the relatives of their directors and directors of other banks and their relatives.[@]

1.171 There are some restrictions imposed by Master Circular DBOD.No.Dir.BC.4/13.03.00/2012-13 on “Loan and Advances- Statutory and Other Restrictions” for granting loan and advances aggregating or above to specified limit.

[@] Revised in 2013 Edition.

Restrictions on Grant of Loans and Advances to Officers and the Relatives of Senior Officers of Banks

1.172 The statutory regulations and/or the rules and conditions of service applicable to officers or employees of public sector banks indicate, to a certain extent, the precautions to be observed while sanctioning credit facilities to such officers and employees and their relatives. In addition, the following guidelines are required to be followed by the banks with reference to the extension of credit facilities to officers and the relatives of senior officers:@

(j) Loans & advances to officers of the bank; - No officer or any Committee comprising, *inter alia*, an officer as member, shall, while exercising powers of sanction of any credit facility, sanction any credit facility to his/her relative. Such a facility shall ordinarily be sanctioned only by the next higher sanctioning authority. Credit facilities sanctioned to senior officers of the financing bank should be reported to the Board.

(ii) Loans and advances and award of contracts to relatives of senior officers of the bank proposals for credit facilities to the relatives of senior officers of the bank sanctioned by the appropriate authority should be reported to the Board. Further, when a credit facility is sanctioned by an authority, other than the Board to -

- any firm in which any of the relatives of any senior officer of the financing bank holds substantial interest, or is interested as a partner or guarantor; or
- any company in which any of the relatives of any senior officer of the financing bank holds substantial interest, or is interested as a director or as a guarantor,
- such transaction should also be reported to the Board.

(iii) The term 'Credit Facility' will not include loans or advances against-

a) Government securities

b) Life Insurance policies

c) Fixed or other deposits

d) Temporary overdrafts for small amount i.e. upto Rs. 25,000/-, and

e) Casual purchase of cheques up to Rs. 5,000/- at a time.

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(iv) Credit facility will also not include loans and advances such as housing loans, car advances, consumption loans, etc. granted to an officer of the bank under any scheme applicable generally to officers.

(v) The term 'substantial interest' shall have the same meaning assigned to it in Section 5(ne) of the Banking Regulation Act, 1949.

These guidelines are contained in the Master Circular on Loans and Advances – Statutory and Other Restrictions dated July 2, 2012.

Restrictions on Grant of Financial Assistance to Industries Producing / Consuming Ozone Depleting Substances (ODS)

1.173 The banks should not extend finance for setting up of new units consuming/producing ODS. In this connection, a reference may be made to the circular No. FI/12/96-97 dated 16.02.96 issued by Industrial Development Bank of India to banks advising that no financial assistance should be extended to small/medium scale units engaged in the manufacture of the aerosol units using Chloro Fluro Carbon (CFC) and that no refinance would be extended to any project assisted in this sector.

Restriction on Advances against Sensitive Commodities under Selective Credit Control (SCC)

1.174 With a view to preventing speculative holding of essential commodities with the help of bank credit and the resultant rise in their prices, in exercise of powers conferred by Section 21 & 35A of the Banking Regulation Act, 1949, the Reserve Bank of India, issues, from time to time, directives to all commercial banks, stipulating specific restrictions on bank advances against specified sensitive commodities. The commodities, generally treated as sensitive commodities are the following:

(a) food grains i.e. cereals and pulses,

(b) selected major oil seeds indigenously grown, viz. groundnut, rapeseed/mustard, cottonseed, linseed and castorseed, oils thereof, vanaspati and all imported oils and vegetable oils,

(c) raw cotton and kapas,

(d) sugar/gur/khandsari,

(e) cotton textiles which include cotton yarn, man-made fibres and yarn and fabrics made out of man-made fibres and partly out of cotton yarn and partly out of man-made fibres.

1.175 Commodities presently under the Selective Credit Control include:

a) Buffer stock of sugar with Sugar Mills
b) Unreleased stocks of sugar with Sugar Mills representing
   - levy sugar, and
   - free sale sugar

1.176 RBI's Master Circular on "Loan and Advances- Statutory and Other Restrictions" contains detailed guidelines in relation to commodities exempted from "Sensitive Commodities" list and from Selective Credit Control, and other related issues.

Restriction on payment of commission to staff members including officers

1.177 Section 10(1)(b)(ii) of Banking Regulation Act, 1934, stipulates that a banking company shall not employ or continue the employment of any person whose remuneration or part of whose remuneration takes the form of commission or a share in the profits of the company. Further, clause (b) of Section 10(1)(b)(ii) permits payment of commission to any person who is employed only otherwise than as a regular staff. Therefore, banks should not pay commission to staff members and officers for recovery of loans.

Restrictions on offering incentives on any banking products[@]

1.178 Banks are also not permitted to offer any banking products, including online remittance schemes etc., with prizes /lottery/free trips (in India and/or abroad), etc., or any other incentives having an element of chance, except inexpensive gifts costing not more than Rs. 250/-, as such products involve non-transparency in the pricing mechanism. Such products, if offered, by banks are considered as violation of the extant guidelines and the banks concerned are liable for penal action.

Restrictions on Other Loans and Advances

Loans and Advances Against Shares, Debentures and Bonds

1.179 Banks are required to strictly observe regulatory restrictions on grant of loans and advances against shares, debentures and bonds which are detailed in the July, 2010 Master Circular on 'Bank Finance Against Shares and Debentures'. The restrictions, *inter alia*, on Loans and Advances – Statutory and Other Restrictions loans and advances against shares and debentures, are:

(a) No loans to be granted against partly paid shares.

[@] Revised in 2013 Edition.

(b) No loans to be granted to partnership/proprietorship concerns against the primary security of shares and debentures.

1.180 RBI's Master Circular on "Loans and Advances - Statutory and Other Restrictions" contains guidelines for granting Loan and Advances against Shares, Debentures and Bonds as follows:

Advances to individuals@

1.181 Banks may grant advances against the security of shares, debentures or bonds to individuals subject to the following conditions:

(i) **Purpose of the Loan:** Loan against shares, debentures and bonds may be granted to individuals to meet contingencies and personal needs or for subscribing to new or rights issues of shares / debentures / bonds or for purchase in the secondary market, against the security of shares / debentures / bonds held by the individual.

(ii) **Amount of advance:** Loans against the security of shares, debentures and bonds should not exceed the limit of Rs. 10 lakhs per individual if the securities are held in physical form and Rs. 20 lakhs per individual if the securities are held in dematerialised form.

(iii) **Margin:** Banks should maintain a minimum margin of 50 percent of the market value of equity shares / convertible debentures held in physical form. In the case of shares / convertible debentures held in dematerialised form, a minimum margin of 25 percent should be maintained. These are minimum margin stipulations and banks may stipulate higher margins for shares whether held in physical form or dematerialized form. The margin requirements for advances against preference shares / nonconvertible debentures and bonds may be determined by the banks themselves.

(iv) **Lending policy:** Each bank should formulate with the approval of their Board of Directors a Loan Policy for grant of advances to individuals against shares / debentures / bonds keeping in view the RBI guidelines. Banks should obtain a declaration from the borrower indicating the extent of loans availed of by him from other banks as input for credit evaluation. It would also be necessary to ensure that such accommodation from different banks is not obtained against shares of a single company or a group of companies. As a prudential measure, each bank may also consider laying down appropriate aggregate sub-limits of such advances.

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Advances to Share and Stock Brokers/ Commodity Brokers@

1.182

(i) Banks and their subsidiaries are not permitted undertake financing of 'Badla' transactions. However, share and stock brokers/commodity brokers may be provided need based overdraft facilities / line of credit against shares and debentures held by them as stock in trade. A careful assessment of need based requirements for such finance should be made taking into account the financial position of the borrower, operations on his own account and on behalf of clients, income earned, the average turnover period of stocks and shares and the extent to which the broker's funds are required to be involved in his business operations. Large scale investment in shares and debentures on own account by stock and share brokers with bank finance, should not be encouraged. The securities lodged as collateral should be easily marketable. The ceiling of Rs. 10 lakhs / Rs. 20 lakhs for advances against shares/debentures to individuals is not applicable in the case of share and stock brokers / commodity brokers and the advances would be need based. Banks may grant working capital facilities to stock brokers registered with SEBI and who have complied with capital adequacy norms prescribed by SEBI / Stock exchanges to meet the cash flow gap between delivery and payment for DVP transactions undertaken on behalf of institutional clients *viz.* FIs, FIIs, mutual funds and banks, the duration of such a facility will be short and would be based on an assessment of the financing requirements keeping in view the cash flow gaps, the broker's funds required to be deployed for the transaction and the overall financial position of the broker. The utilisation is to be monitored on the basis of individual transactions. Further, Banks may institute adequate safeguards and monitoring mechanisms. A uniform margin of 50 per cent is required to be applied on all advances / financing of IPOs / issue of guarantees on behalf of share and stockbrokers. A minimum cash margin of 25 per cent (within the margin of 50%) shall be maintained in respect of guarantees issued by banks for capital market operations. The above minimum margin will also apply to guarantees issued by banks on behalf of commodity brokers in favour of commodity exchanges *viz*. National Commodity & Derivatives Exchange (NCDEX), Multi Commodity Exchange of India Ltd. (MCX) and National Multi Commodity Exchange of India Ltd. (NMCEIL), in

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lieu of margin requirements as per the commodity exchange regulations. These margin requirements will also be applicable in respect of bank finance to stock brokers by way of temporary overdrafts for DVP transactions. Banks may issue guarantees on behalf of share and stock brokers/commodity brokers in favour of stock exchanges in lieu of security deposit to the extent it is acceptable in the form of bank guarantee as laid down by stock exchanges. Banks may also issue guarantees in lieu of margin requirements as per stock exchange regulations. The bank should assess the requirement of each applicant borrower, observe usual and necessary safeguards including the exposure ceilings.

(ii) The requirement relating to transfer of shares in bank's name in respect of shares held in physical form mentioned at Sl. No. (ix) of paragraph 2.3.1.8 of the aforesaid Circular would not apply in respect of advances granted to share and stock brokers provided such shares are held as security for a period not exceeding nine months. In the case of dematerialised shares, the depository system provides a facility for pledging and banks may avail themselves of this facility and in such cases there will not be need to transfer the shares in the name of the bank irrespective of the period of holding. The share and stock brokers are free to substitute the shares pledged by them as and when necessary. In case of a default in the account, the bank should exercise the option to get the shares transferred in its name.

(iii) Banks can grant advances only to share and stock brokers registered with SEBI and who comply with capital adequacy norms prescribed by SEBI / Stock Exchanges.

Bank Finance for Market Makers[@]

1.183 Banks may provide need based finance to meet the genuine credit requirements of approved Market Makers. For this purpose, they should lay down appropriate norms for financing them including exposure limits, method of valuation, etc. They should also follow the guidelines given below:

a) Market Makers approved by stock exchange would be eligible for grant of advances by scheduled commercial banks.

b) Market Making may not only be for equity but also for debt securities including State and Central Government securities.

[@] Revised in 2013 Edition.

c) Banks should exercise their commercial judgement in determining the need based working capital requirements of Market Markers by taking into account the Market Making operations.

d) A uniform margin of 50 per cent shall be applied on all advances / financing of IPOs / issue of guarantees on behalf of market makers. A minimum cash margin of 25 per cent (within the margin of 50%) shall be maintained in respect of guarantees issued by banks for capital market operations.

e) Banks may accept, as collateral for the advances to the Market Makers, scrips other than the scrips in which the market making operations are undertaken.

f) Banks should ensure that advances provided for Market Making are not diverted for investment in shares other than the scrip earmarked for Market Making purpose. For this purpose, a suitable follow-up and monitoring mechanism must be evolved.

g) The ceiling of Rs.10 lakhs / Rs.20 lakhs for advances against shares/debentures to individuals will not be applicable in the case of Market Makers.

1.184 Each bank should lay down a detailed loan policy for granting advances to Stock Brokers and Market Makers and also a policy for grant of guarantees on behalf of brokers which should keep in view the general guidelines given in para 2.3.1. 8 and include, inter alia, the following:

- Purpose and use of such advances / guarantees
- Pricing of such advances
- Control features that specifically recognise the unique characteristics and risks of such financing
- Method of valuation of collateral
- Frequency of valuation of shares and other securities taken as collateral Frequency of valuation of shares may at least be once in a quarter.
- Guidelines for transfer of shares in bank's name
- Maximum exposure for individual credits (within the RBI prescribed prudential Single Borrower Limit). The Board may also consider laying down a limit on the aggregate exposure of the bank to this sector.
- The aggregate portfolio, its quality and performance should be reviewed and put up at least on a half-yearly basis to the Board.

Advances to other borrowers against shares / debentures / bonds

1.185 In this regards, banks may refer to para 2.4.7 of the Master Circular on Exposure Norms dated July 2, 2012. The text of the circular is given in the CD.

Bank Loans for Financing Promoters Contribution

1.186 The promoters' contribution towards the equity capital of a company should come from their own resources and the bank should not normally grant advances to take up shares of other companies. However, banks are permitted to extend loans to corporates against the security of shares (as far as possible in dematerialised form) held by them to meet the promoters' contribution to the equity of new companies in anticipation of raising resources subject to the following terms and conditions, in addition to the general guidelines given in para 2.3.1.8 of the Master Circular on Exposure Norms dated July 2, 2012.

i) The margin and period of repayment of the loans may be determined by the banks.

ii) Loans sanctioned to corporates against the security of shares (as far as possible, demat shares) for meeting promoters' contribution to the equity of new companies in anticipation of raising resources, should be treated as a bank's investments in shares which would thus come under the ceiling of 40 percent of the bank's net worth as on March 31 of the previous year prescribed for the bank's total exposure including both fund based and non-fund based to capital market in all forms. These loans will also be subject to individual/group of borrowers exposure norms as well as the statutory limit on shareholding in companies, as detailed in the Master Circular on Exposure Norms dated July 2, 2012.

iii) Banks may extend financial assistance to Indian companies for acquisition of equity in overseas joint ventures / wholly owned subsidiaries or in other overseas companies, new or existing, as strategic investment, in terms of a Board approved policy, duly incorporated in the loan policy of the banks. Such policy should include overall limit on such financing, terms and conditions of eligibility of borrowers, security, margin, etc. While the Board may frame its own guidelines and safeguards for such lending, such acquisition(s) should be beneficial to the company and the country. The finance would be subject to compliance with the statutory requirements under Section 19(2) of the Banking Regulation Act, 1949.

(iv) Under the refinance scheme of Export-Import Bank of India, the banks may sanction term loans on merits to eligible Indian promoters for acquisition of equity in overseas joint ventures / wholly owned subsidiaries, provided the term loans have been approved by the EXIM Bank for refinance.

v) The restriction on grant of bank advances for financing promoters' contribution towards equity capital would also extend to bank finance to activities related to such acquisitions like payment of non compete fee, etc.

Further, these restrictions would also be applicable to bank finance to such activities by overseas branches / subsidiaries of Indian banks.

vi) With the approval of the Board of Directors, the banks should formulate internal guidelines with appropriate safeguards for this purpose.

Advances against Units of Mutual Funds

1.187 Banks may refer to para 2.4.6 of the Master Circular on Exposure Norms dated July 2, 2012.

Advances Against Money Market Mutual Funds

1.188 All the guidelines issued by the Reserve Bank of India on Money Market Mutual Funds (MMMF) have been withdrawn and the banks are to be guided by the SEBI Regulations in this regard. However the banks/ FIs which are desirous of setting up MMMFs would, however, have to take necessary clearance from the RBI for undertaking this additional activity before approaching SEBI for registration.

Advances to Agents/Intermediaries Based on Consideration of Deposit Mobilisation

1.189 Banks should desist from being party to unethical practices of raising of resources through agents/intermediaries to meet the credit needs of the existing/prospective borrowers or from granting loans to the intermediaries, based on the consideration of deposit mobilisation, who may not require the funds for their genuine business requirements.

Loans Against Certificate of Deposits (CDs)

1.190 Banks cannot grant loans against CDs. Furthermore, they are also not permitted to buy-back their own CDs before maturity. On a review it has been decided to relax these restrictions on lending and buy back, until further notice, only in respect of CDs held by mutual funds. While granting such loans to the mutual funds, banks should keep in view the provisions of paragraph 44(2) of the SEBI (Mutual Funds) Regulations, 1996. Further, such finance if extended to equity-oriented mutual funds, will form part of banks' capital market exposure, as hitherto.

Finance for and Loans/Advances against Indian Depository Receipts (IDRs)@

1.191 Banks are not permitted to grant any loan / advance for subscription to Indian Depository Receipts (IDRs). Further, no loans/ advances can be granted against security / collateral of IDRs issued in India.

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Bank Finance to Non-Banking Financial Companies (NBFCs)

1.192 The RBI, vide its Master Circular No. DBOD.BP.BC.No.27 /21.04.172/2012-13 on Bank Finance to Non-Banking Financial Companies (NBFCs) dated July 2, 2012 provides as follows:

1.193 The ceiling on bank credit linked to Net Owned Fund (NOF) of NBFCs has been withdrawn in respect of all NBFCs which are statutorily registered with RBI and are engaged in principal business of asset financing, loan, factoring and investment activities. Accordingly, banks may extend need based working capital facilities as well as term loans to all NBFCs registered with RBI and engaged in infrastructure financing, equipment leasing, hire-purchase, loan, factoring and investment activities.

1.194 In the light of the experience gained by NBFCs in financing second hand assets, banks may also extend finance to NBFCs against second hand assets financed by them.

1.195 Banks may formulate suitable loan policy with the approval of their Boards of Directors within the prudential guidelines and exposure norms prescribed by the Reserve Bank to extend various kinds of credit facilities to NBFCs subject to the condition that the activities indicated in the Master Circular are not financed by them.

1.196 In respect of NBFCs which do not require to be registered with RBI, *viz.*:

- i) Insurance Companies registered under Section 3 of the Insurance Act, 1938;
- ii) Nidhi Companies notified under Section 620A of the Companies Act, 1956;
- iii) Chit Fund Companies carrying on Chit Fund business as their principal business as per Explanation to Clause (vii) of Section 45-I(bb) of the Reserve Bank of India Act, 1934;
- iv) Stock Broking Companies / Merchant Banking Companies registered under Section 12 of the Securities & Exchange Board of India Act; and
- v) Housing Finance Companies being regulated by the National Housing Bank (NHB) which have been exempted from the requirement of registration by RBI],

banks may take their credit decisions on the basis of usual factors like the purpose of credit, nature and quality of underlying assets, repayment capacity of borrowers as also risk perception, etc.

1.197 Banks are prohibited from providing credit for the following activities of NBFCs:

(i) Bills discounted/rediscounted by NBFCs, except for rediscounting of bills discounted by NBFCs arising from the sale of –

   (a) commercial vehicles (including light commercial vehicles), and

   (b) two-wheeler and three-wheeler vehicles, subject to the following conditions:

   - the bills should have been drawn by the manufacturers on dealers only.
   - the bills should represent genuine sale transactions as may be ascertained from the chassis/engine numbers.
   - before rediscounting the bills, banks should satisfy themselves about the bonafides and track record of NBFCs which have discounted the bills.

(ii) Investments of NBFCs both of current and long term nature, in any company/entity by way of shares, debentures, etc. However, Stock Broking Companies may be provided need-based credit against shares and debentures held by them as stock-in-trade.

(iii) Unsecured loans/inter-corporate deposits by NBFCs to/in any company.

(iv) All types of loans/advances by NBFCs to their subsidiaries, group companies/entities.

(v) Finance to NBFCs for further lending to individuals for subscribing to Initial Public Offerings (IPOs) and for purchase of shares from secondary market.

Bank Finance to Residuary Non-Banking Companies (RNBCs)

1.198 Residuary Non-Banking Companies (RNBCs) are also required to be mandatorily registered with RBI. In respect of such companies registered with RBI, bank finance would be restricted to the extent of their Net Owned Fund (NOF).

Bridge loans / interim finance to NBFCs

1.199 Banks should not grant bridge loans of any nature, or interim finance against capital / debenture issues and / or in the form of loans of a bridging nature pending raising of long-term funds from the market by way of capital, deposits, etc. to all categories of Non-Banking Financial Companies, i.e., equipment leasing and hire-purchase finance companies, loan and investment companies and also Residuary Non-Banking Companies (RNBCs). Banks should strictly follow these instructions and ensure that these are not circumvented in any manner whatsoever by purport and / or intent by sanction of credit under a different nomenclature like unsecured negotiable notes, floating rate interest bonds, etc., as also short-term loans, the repayment of which is proposed / expected to be made out of funds to be or likely to be mobilised from external / other sources and not out of the surplus generated by the use of the asset(s).

Advances against collateral security of shares to NBFCs

1.200 Shares and debentures cannot be accepted as collateral securities for secured loans granted to NBFCs borrowers for any purpose.

Restriction on Guarantees for placement of funds with NBFCs

1.201 Banks should not execute guarantees covering inter-company deposits / loans thereby guaranteeing refund of deposits / loans accepted by NBFCs / firms from other NBFCs / firms. The restriction would cover all types of deposits / loans irrespective of their source, including deposits / loans received by NBFCs from trusts and other institutions. Guarantees should not be issued for the purpose of indirectly enabling the placement of deposits with NBFCs.

Bank Finance to Equipment Leasing Companies

1.202 Banks should not enter into lease agreements departmentally with equipment leasing companies as well as other Non-Banking Financial Companies engaged in equipment leasing.

Bank Finance to Factoring Companies

1.203 Banks are permitted to extend financial assistance to support the factoring business of Factoring Companies which comply with the following criteria:[@]

(a) The companies qualify as factoring companies and carry out their business under the provisions of the Factoring Regulation Act, 2011 and Notifications issued by the Reserve Bank in this regard from time to time.

(b) They derive at least 75 per cent of their income from factoring activity.

(c) The receivables purchased / financed, irrespective of whether on 'with recourse' or 'without recourse' basis, form at least 75 per cent of the assets of the Factoring Company.

(d) The assets / income referred to above would not include the assets / income relating to any bill discounting facility extended by the Factoring Company.

(e) The financial assistance extended by the Factoring Companies is secured by hypothecation or assignment of receivables in their favour.

[@] Revised in 2013 Edition.

Restrictions regarding investments made by banks in securities / instruments issued by NBFCs@

1.204 Banks should not invest in Zero Coupon Bonds (ZCBs) issued by NBFCs unless the issuer NBFC builds up sinking fund for all accrued interest and keeps it invested in liquid investments / securities (Government bonds).

1.205 Banks are permitted to invest in Non-Convertible Debentures (NCDs) with original or initial maturity up to one year issued by NBFCs. However, while investing in such instruments banks should be guided by the extant prudential guidelines in force, ensure that the issuer has disclosed the purpose for which the NCDs are being issued in the disclosure document and such purposes are eligible for bank finance in terms of instructions given in the preceding paragraphs.

Advances Against Fixed Deposit Receipts (FDRs) Issued by Other Banks

1.206 Banks are prohibited from sanctioning advances against FDRs/ or other term deposits of other banks.

Advances Against Bullion/Primary Gold

1.207 Banks are prohibited from granting any advance against bullion/ primary gold. However, specially minted gold coins sold by banks cannot be treated as "bullion" or "primary gold" and hence there is no objection to the bank granting loans against the coins. Such loans to be granted by the bank, may be covered under the policy framed by the bank's Board, in terms of our circular DBOD.No. BC. 138/21.01.023/94 dated November 22, 1994. Further, while granting advances against the gold coins, they may ensure, without fail that the end use of the funds is for approved, non- speculative purposes.@ Banks are also required to desist from granting advances to silver bullion dealers which are likely to be utilised for speculative purposes.

Loans for Acquisition of KVPs

1.208 The grant of loans for acquiring/investing in KVPs does not promote fresh savings and, rather, channelises the existing savings in the form of bank deposits to small savings instruments and thereby defeats the very purpose of such schemes. Banks should therefore ensure that no loans are sanctioned for acquisition of/investing in Small Savings Instruments including Kisan Vikas Patras.

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Advances against Gold Ornaments & Jewellery[@]

1.209 Hallmarking of gold jewellery ensures the quality of gold used in the jewellery as to caratage, fineness and purity. Therefore, banks would find granting of advances against the security of such hallmarked jewellery safer and easier. Therefore, banks while considering granting advances against jewellery may keep in view the advantages of hallmarked jewellery and decide on the margin and rates of interest thereon.

Advances against Gold (Metal) Loans

1.210 Banks nominated to import gold as per extant instructions of RBI may extend Gold (Metal) Loans to domestic jewellery manufacturers, who are not exporters of jewellery, subject to the condition that any gold loan borrowing or other non-funded commitments taken by them for the purpose of providing gold loans to domestic jewellery manufacturers will be taken into account for the purpose of the overall ceiling (presently 50 % of Tier I capital) (c.f. FED Master Circular No.14/2010-11 dated July 1, 2010) in respect of aggregate borrowing for non-export purposes. The Gold Loans extended to exporters of jewellery would continue to be out of the 50% ceiling. The Gold (Metal) Loans provided by banks will be subject to the following conditions:

(i) The tenor of the Gold (Metal) Loans, which nominated banks are permitted to extend to domestic jewellery manufacturers who are not exporters of jewellery, may be decided by the nominated banks themselves provided the tenor does not exceed 180 days and the banks' policy with regard to tenor and monitoring of end use of gold loan is documented in the banks' loan policy and strictly adhered to by the banks. The above guidelines will be reviewed in the light of experience gained, and the performance of the banks in regard to monitoring the end-use of gold loans will be an important factor in deciding upon their future requests for annual renewal of authorization to import gold / silver.

(ii) Interest charged to the borrowers should be linked to the international gold interest rate.

(iii) The gold borrowings will be subject to normal reserve requirements.

(iv) The loan will be subject to capital adequacy and other prudential requirements.

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(v) Banks should ensure end-use of gold loans to jewellery manufacturers and adhere to KYC guidelines.

(vi) Any mismatch arising out of the gold borrowings and lendings should be within the prudential risk limits approved by the nominated bank's Board.

(vii) The banks should carefully assess the overall risks on granting gold loans and lay down a detailed lending policy with the approval of the Board.

1.211 Presently, nominated banks can extend Gold (Metal) Loans to exporters of jewellery who are customers of other scheduled commercial banks, by accepting stand-by letter of credit or bank guarantee issued by their bankers in favour of the nominated banks subject to authorised banks' own norms for lending and other conditions stipulated by RBI. Banks may also extend the facility to domestic jewellery manufacturers, subject to the following conditions:

(i) The stand-by LC / BG shall be extended only on behalf of domestic jewellery manufacturers and shall cover at all times the full value of the quantity of gold borrowed by these entities. The stand-by LC / BG shall be issued by scheduled commercial banks in favour of a nominated bank (list appended) only and not to any other entity which may otherwise be having permission to import gold.

(ii) The bank issuing the stand-by LC / BG (only inland letter of credit / bank guarantee) should do so only after carrying out proper credit appraisal. The bank should ensure that adequate margin is available to it at all times consistent with the volatility of the gold prices.

(iii) The stand-by LC / BG facilities will be denominated in Indian Rupees and not in foreign currency.

(iv) Stand-by LC / BG issued by the non-nominated banks will be subject to extant capital adequacy and prudential norms.

(v) The banks issuing stand-by LC / BG should also carefully assess the overall risks on granting these facilities and lay down a detailed lending policy with the approval of their Board.

1.212 The nominated banks may continue to extend Gold (Metal) Loans to jewellery exporters subject to the following conditions:

- The exposure assumed by the nominated bank extending the Gold (Metal) Loan against the stand-by LC / BG of another bank will be deemed as an exposure on the guaranteeing bank and attract appropriate risk weight as per the extant guidelines.

- The transaction should be purely on back-to-back basis i.e. the nominated banks should extend Gold (Metal) Loan directly to the customer of a non-nominated bank, against the stand-by LC / BG issued by the latter.
- Gold (Metal) Loans should not involve any direct or indirect liability of the borrowing entity towards foreign suppliers of gold.
- The banks may calculate their exposure and compliance with prudential norms daily by converting into Rupee the gold quantity by crossing London AM fixing for Gold / US Dollar rate with the rupee-dollar reference rate announced by RBI.

2.213 Banks should recognise the overall risks in extending Gold (Metal) Loans as also in extending SBLC / BG. Banks should lay down an appropriate risk management / lending policy in this regard and comply with the recommendations of the Ghosh Committee and other internal requirements relating to acceptance of guarantees of other banks to obviate the possibility of frauds in this area.

1.214 Nominated banks are not permitted to enter into any tie up arrangements for retailing of gold / gold coins with any other entity including non-banking financial companies / co-operative banks / non-nominated banks.

***Loans and advances to Real Estate Sector*@**

1.215 While appraising loan proposals involving real estate, banks should ensure that the borrowers have obtained prior permission from government / local governments / other statutory authorities for the project, wherever required. In order that the loan approval process is not hampered on account of this, while the proposals could be sanctioned in normal course, the disbursements should be made only after the borrower has obtained requisite clearances from the government authorities.

***Loans and advances to Micro and Small Enterprises (MSEs)* @**

1.216 MSE units having working capital limits of up to Rs. 5 crore from the banking system are to be provided working capital finance computed on the basis of 20 percent of their projected annual turnover. The banks should adopt the simplified procedure in respect of all MSE units (new as well as existing).

***Working Capital Finance to Information Technology and Software Industry*@**

1.217 Following the recommendations of the "National Task force on Information Technology and Software development", Reserve Bank has framed

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guidelines for extending working capital to the said industry. Banks are, however, free to modify the guidelines based on their own experience without reference to the Reserve Bank of India to achieve the purpose of the guidelines in letter and spirit. The salient features of these guidelines are set forth below:

(i) Banks may consider sanction of working capital limits based on the track record of the promoters group affiliation, composition of the management team and their work experience as well as the infrastructure.

(ii) In the case of the borrowers with working capital limits of up to Rs 2 crore, assessment may be made at 20 percent of the projected turnover. However, in other cases, the banks may consider assessment of MPBF on the basis of the monthly cash budget system. For the borrowers enjoying working capital limits of Rs 10 crore and above from the banking system the guidelines regarding the loan system would be applicable.

(iii) Banks can stipulate reasonable amount as promoters' contribution towards margin.

(iv) Banks may obtain collateral security wherever available. First/ second charge on current assets, if available, may be obtained.

(v) The rate of interest as prescribed for general category of borrowers may be levied. Concessional rate of interest as applicable to pre-shipment/post-shipment credit may be levied.

(vi) Banks may evolve tailor-made follow up system for such advances. The banks could obtain quarterly statements of cash flows to monitor the operations. In case the sanction was not made on the basis of the cash budgets, they can devise a reporting system, as they deem fit.

Guidelines for bank finance for PSU disinvestments of Government of India@

1.218 In terms of RBI circular DBOD No. Dir. BC .90/13.07.05/98 dated August 28, 1998, banks have been advised that the promoters' contribution towards the equity capital of a company should come from their own resources and the bank should not normally grant advances to take up shares of other companies. Banks were also advised to ensure that advances against shares were not used to enable the borrower to acquire or retain a controlling interest in the company/companies or to facilitate or retain inter-corporate investment. It is clarified that the aforesaid instructions of the 1998 circular would not apply in the

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case of bank finance to the successful bidders under the PSU disinvestment programme of the Government, subject to the following:

- Banks' proposals for financing the successful bidders in the PSU disinvestment programme should be approved by their Board of Directors.
- Bank finance should be for acquisition of shares of PSU under a disinvestment programme approved by Government of India, including the secondary stage mandatory open offer, wherever applicable and not for subsequent acquisition of the PSU shares. Bank finance should be made available only for prospective disinvestments by Government of India.
- The companies, including the promoters, to which bank finance is to be extended should have adequate net worth and an excellent track record of servicing loans availed from the banking system.
- The amount of bank finance thus provided should be reasonable with reference to the banks' size, its net worth and business and risk profile.

1.219 In case the advances against the PSU disinvestment is secured by the shares of the disinvested PSUs or any other shares, banks should follow RBI's extant guidelines on capital market exposures on margin, ceiling on overall exposure to the capital market, risk management and internal control systems, surveillance and monitoring by the Audit Committee of the Board, valuation and disclosure, etc. In this regard, banks may be guided by the Master Circular on Exposure Norms dated July 2, 2012.

1.220 Stipulation of lock-in period for shares

i) Banks should, while deciding to extend finance to the borrowers who participate in the PSU disinvestment programme, advise such borrowers to execute an agreement whereby they undertake to:

(a) Produce the letter of waiver by the Government for disposal of shares acquired under PSU disinvestment programme during the lock-in period, or

(b) Include a specific provision in the documentation with the Government permitting the pledgee to liquidate the shares during the lock-in period, in case of shortfall in margin requirement or default by the borrower.

(ii) Banks may extend finance to the successful bidders even though the shares of the disinvested company acquired/ to be acquired by the successful bidder are subjected to a lock-in period/ other such restrictions which affect their liquidity, subject to fulfillment of following conditions:

(a) The documentation between the Government of India and the successful bidder should contain a specific provision permitting the pledgee to liquidate the shares even during lock-in period that may be prescribed in respect of such disinvestments, in case of shortfall in margin requirements or default by the borrower.

(b) If the documentation does not contain such a specific provision, the borrower (successful bidder) should obtain waiver from the Government for disposal of shares acquired under PSU disinvestment programme during the lock-in period.

1.221 As per the terms and conditions of the PSU disinvestments by the Government of India, the pledgee bank will not be allowed to invoke the pledge during the first year of the lock-in period. During the second and third year of the lock-in period, in case of inability of the borrower to restore the margin prescribed for the purpose by way of additional security or non-performance of the payment obligations as per the repayment schedule agreed upon between the bank and the borrower, the bank would have the right to invoke the pledge. The pledgee bank's right to invoke the pledge during the second and third years of the lock-in period, would be subject to the terms and conditions of the documentation between Government and the successful bidder, which might also cast certain responsibilities on the pledge banks.

1.222 RBI has also clarified that the concerned bank must make a proper appraisal and exercise due caution about creditworthiness of the borrower and the financial viability of the proposal. The bank must also satisfy itself that the proposed documentation, relating to the disposal of shares pledged with the bank, are fully acceptable to the bank and do not involve unacceptable risks on the part of the bank.

1.223 Further, in terms of IECD Circular No. 10/ 08.12.01/ 2000- 2001 dated 8 January 2001, banks are precluded from financing investments of NBFCs in other companies and inter-corporate loans / deposits to/ in other companies. The position has been whereby SPVs which comply with the following conditions would not be treated as investment companies and therefore would not be considered as NBFCs:

a) They function as holding companies, special purpose vehicles, etc., with not less than 90 per cent of their total assets as investment in securities held for the purpose of holding ownership stake,

b) They do not trade in these securities except for block sale,

c) They do not undertake any other financial activities, and

d) They do not hold/accept public deposits.

1.224 SPVs, which satisfy the above conditions, would be eligible for bank finance for PSU disinvestments of Government of India.

1.225 In this context, it may be mentioned that Government of India, Ministry of Finance (DEA), Investment Division, *vide* its Press Note dated July 8, 2002, on guidelines for Euro issues, has permitted an Indian company utilizing ADR/GDR/ECB proceeds for financing disinvestment programme of the Government of India, including the subsequent open offer. Banks may, therefore, take into account proceeds from such ADR/GDR/ECB issues, for extending bank finance to successful bidders of the PSU disinvestment programme.

***Financing Housing Projects*@**

226 During the recent period, housing sector has emerged one of the biggest loan portfolios of banks. The focus of the RBI, therefore, is to ensure orderly growth of this portfolio. The Master Circular No. DBOD. No.DIR.BC.07/08.12.001/2012-13 dated July 2, 2012 on Housing Finance provides guidance in respect of the housing finance provided by the banks. Banks could deploy their funds under the housing finance allocation in any of the three categories as per the norms provided in the Master Circular, i.e.

- Direct Finance,
- Indirect Finance,
- Investment in Bonds of NHB/HUDCO, or combination thereof.

.227 The Master Circular also contains a number of guidelines for this purpose, including conditions wherein a bank cannot extend credit for housing purposes. These conditions are as follows:

(i) In case of *lending to housing intermediary agencies*, the banks are also required to ensure that the former have complied with the guidelines of the National Housing Board (NHB). In terms of the NHB guidelines, a housing finance companies' total borrowings, whether by way of deposits, issue of debentures/ bonds, loans and advances from banks or from financial institutions including any loans obtained from NHB, should not exceed 16 times of their net owned funds (i.e., paid up capital and free reserves less accumulated balance of loss, deferred revenue expenditure and intangible assets.)

(ii) Banks are also not permitted to extend fund based or non fund based facilities to private builders for acquisition of land even as part of a housing project.

(iii) Banks cannot grant finance for construction of buildings meant purely for Government/Semi-Government offices, including Municipal and

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Panchayat offices. However, banks may grant loans for activities, which will be refinanced by institutions like NABARD.

(iv) *Projects undertaken by public sector entities* which are not corporate bodies (i.e. public sector undertakings which are not registered under Companies Act or which are not Corporations established under the relevant statute) also cannot be financed by banks. Even in respect of projects undertaken by corporate bodies, as defined above, banks should satisfy themselves that the project is run on commercial lines and that bank finance is not in lieu of or to substitute budgetary resources envisaged for the project. The loan could, however, supplement budgetary resources if such supplementing was contemplated in the project design. Thus, in the case of a housing project, where the project is run on commercial lines, and the Government is interested in promoting the project either for the benefit of the weaker sections of the society or otherwise, and a part of the project cost is met by the Government through subsidies made available and/or contributions to the capital of the institutions taking up the project, the bank finance should be restricted to an amount arrived at after reducing from the total project cost the amount of subsidy/capital contribution receivable from the Government and any other resources proposed to be made available by the Government.

(v) Banks had, in the past, sanctioned term loans to Corporations set up by Government like State Police Housing Corporation, for construction of residential quarters for allotment to employees where the loans were envisaged to be repaid out of budgetary allocations. As these projects cannot be considered to be run on commercial lines, it would not be in order for banks to grant loans to such projects.

(vi) In terms of the orders of the Delhi High Court, banks can also not grant loans in respect of:

- Properties which fall in the category of *unauthorised colonies* unless and until they have been regularised and development and other charges paid.
- Properties which are *meant for residential use but* which the applicant intends to *use for commercial purposes* and declares so while applying for the loan.

1.228 Banks should not grant finance for construction of buildings meant purely for Government/Semi-Government offices, including Municipal and Panchayat offices. However, banks may grant loans for activities, which will be refinanced by institutions like NABARD. Projects undertaken by public sector entities which are not corporate bodies (i.e. public sector undertakings which are not registered under Companies Act or which are not corporations established under the relevant statute) may not be financed by banks. Even in respect of projects undertaken by corporate bodies, as defined above, banks should satisfy themselves that the project is run on commercial lines and that bank finance is not in lieu of or to substitute budgetary resources envisaged for the project. The loan could, however, supplement budgetary resources if such supplementing was contemplated in the project design.

Loan to Value (LTV) ratio[@]

1.229 In order to prevent excessive leveraging, the LTV ratio in respect of housing loans should not exceed 80 per cent. However, for small value housing loans i.e. housing loans up to Rs. 20 lakh (which get categorized as priority sector advances), the LTV ratio should not exceed 90 per cent.

Financing of Infrastructure Projects

1.230 The RBI has revised the definition of Infrastructure Lending *vide* Circular No. RBI/2012 13/297/DBOD.BP.BC.No 58/08.12.014/2012-13 dated 20/11/2012[@] on "Second Quarter Review of Monetary Policy 2012-13- Definition of 'Infrastructure Lending'"

1.231 The revised definition of 'infrastructure lending' will be effective from the date of this circular. The exposure of banks to projects under sub-sectors which were included under the previous definition of infrastructure, but not included under the revised definition, will continue to get the benefits under 'infrastructure lending' for such exposures till the completion of the projects. However, any fresh lending to those sub-sectors from the date of this circular will not qualify as 'infrastructure lending'.

1.232 The definition of Infrastructure Lending would include credit facility extended by Lenders (i.e Banks & Selected AIFIS) to a borrower for exposure in the following infrastructure sub-sectors will qualify as 'infrastructure lending'

<u>List of sub-sectors for 'Infrastructure Lending'</u>

Sl.No.	Category	Infrastructure sub-sectors
1.	Transport	i. Roads and bridges ii. Ports iii. Inland Waterways iv. Airport v. Railway Track, tunnels, viaducts, bridges[1]

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		vi. Urban Public Transport (except rolling stock in case of urban road transport)
2.	Energy	i. Electricity Generation ii. Electricity Transmission iii. Electricity Distribution iv. Oil pipelines v. Oil/Gas/Liquefied Natural Gas (LNG) storage facility[2] vi. Gas pipelines[3]
3.	Water & Sanitation	i. Solid Waste Management ii. Water supply pipelines iii. Water treatment plants iv. Sewage collection, treatment and disposal system v. Irrigation (dams, channels, embankments etc) vi. Storm Water Drainage System
4.	Communication	i. Telecommunication (Fixed network)[4] ii. Telecommunication towers
5.	Social and Commercial Infrastructure	i. Education Institutions (capital stock) ii. Hospitals (capital stock)[5] iii. Three-star or higher category classified hotels located outside cities with population of more than 1 million iv. Common infrastructure for industrial parks, SEZ, tourism facilities and agriculture markets v. Fertilizer (Capital investment) vi. Post harvest storage infrastructure for agriculture and horticultural produce including cold storage vii. Terminal markets viii. Soil-testing laboratories ix. Cold Chain[6]

1. Includes supporting terminal infrastructure such as loading/unloading terminals, stations and buildings

2. Includes strategic storage of crude oil

3. Includes city gas distribution network

4. Includes optic fibre/cable networks which provide broadband / internet

5. Includes Medical Colleges, Para Medical Training Institutes and Diagnostics Centres

6. Includes cold room facility for farm level pre-cooling, for preservation or storage of agriculture and allied produce, marine products and meat.

1.233 In view of the critical importance of the infrastructure sector and high priority being accorded for development of various infrastructure services, Banks/FIs are free to finance technically feasible, financially viable and bankable projects undertaken by both public sector and private sector undertakings subject to the following conditions:

i. The amount sanctioned should be within the overall ceiling of the prudential exposure norms prescribed by RBI for infrastructure financing.

ii. Banks/ FIs should have the requisite expertise for appraising technical feasibility, financial viability and bankability of projects, with particular reference to the risk analysis and sensitivity analysis.

iii. In respect of projects undertaken by public sector units, term loans may be sanctioned only for corporate entities (i.e. public sector undertakings registered under Companies Act or a Corporation established under the relevant statute). Further, such term loans should not be in lieu of or to substitute budgetary resources envisaged for the project. The term loan could supplement the budgetary resources if such supplementing was contemplated in the project design. While such public sector units may include Special Purpose Vehicles (SPVs) registered under the Companies Act set up for financing infrastructure projects, it should be ensured by banks and financial institutions that these loans/investments are not used for financing the budget of the State Governments. Whether such financing is done by way of extending loans or investing in bonds, banks and financial institutions should undertake due diligence on the viability and bankability of such projects to ensure that revenue stream from the project is sufficient to take care of the debt servicing obligations and that the repayment/servicing of debt is not out of budgetary resources. Further, in the case of financing SPVs, banks and financial institutions should ensure that the funding proposals are for specific monitorable projects. It has been observed that some banks have extended financial assistance to State PSUs which is not in accordance with the above norms. Banks/FIs are, therefore, advised to follow the above instructions scrupulously, even while making investment in bonds of sick State PSUs as part of the rehabilitation effort.

iv. Banks may also lend to SPVs in the private sector, registered under the Companies Act for directly undertaking infrastructure projects which are financially viable and not for acting as mere financial intermediaries. Banks may ensure that the bankruptcy or financial difficulties of the parent/ sponsor should not affect the financial health of the SPV.

Guidelines of the Reserve Bank of India on Income Recognition, Asset Classification, Provisioning and Other Related Matters

1.234 In its report submitted in 1992, the Committee on Financial System set up by the RBI under the Chairmanship of Mr. M. Narasimham made several recommendations concerning accounts of banks. The Committee recommended that a policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Likewise, the classification of assets should be done on the basis of objective criteria which would ensure a uniform and consistent application of norms. As regards provisioning, the Committee recommended that provisions should be made on the basis of classification of assets under different categories. The recommendations of the Committee were accepted by the Reserve Bank with some modifications. Vide its Circular No. BP.BC.129/21.04.043-92 dated April 27, 1992, the Reserve Bank issued guidelines to be followed by all scheduled commercial banks (excluding regional rural banks) for income recognition, asset classification, provisioning and other related matters. These guidelines (commonly referred to as 'prudential guidelines' or 'prudential norms') have since been modified in several respects through various circulars of the Reserve Bank. The latest Master Circular No. DBOD.No.BP.BC.9/ 21.04.048/2012-13 issued on July 2, 2012 on 'Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances". The salient points of the guidelines as presently in force are discussed below.

Non-Performing Assets

1.235 Under the guidelines, income recognition, and provisioning in respect of a credit facility are based on its status of classification as performing or non-performing. A credit facility becomes non-performing "when it ceases to generate income for a bank". Detailed guidelines have been laid down for determining the status of different kinds of credit facilities (term loans, cash credits and overdrafts, bills purchased and discounted, and other credit facilities) as performing or non-performing. These are discussed below.

Criteria for Classification of Various Types of Credit Facilities

1.236 In line with the international best practices and to ensure greater transparency, the RBI has directed the banks to adopt the '90 days' overdue' norm for identification of NPAs from the year ending March 31, 2004.

1.237 Banks have been charging interest at monthly rests, from April 1, 2002. However, the banks were advised that the date of classification of an advance as NPA would not be changed on account of charging of interest at monthly rests. Banks should, therefore, continue to classify an account as NPA only if the interest charged during any quarter is not serviced fully within 90 days from the end of the quarter.

1.238 An account should be treated as *'out of order'* if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'. Further, any amount due to the bank under any credit facility is *'overdue'* if it is not paid on the due date fixed by the bank.

1.239 The following criteria are to be applied for determining the status of various types of credit facilities:

(a) *Term Loans:* A term loan is treated as a non-performing asset (NPA) if interest and/or instalment of principal remain overdue for a period of more than 90 days.

(b) *Cash Credits and Overdrafts:* A cash credit or overdraft account is treated as NPA if it remains out of order as indicated above.

(c) *Bills Purchased and Discounted:* Bills purchased and discounted are treated as NPA if they remain overdue and unpaid for a period of more than 90 days.

(d) *Securitisation:* The asset is to be treated as NPA if the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated February 1, 2006.

(e) *Agricultural Advances*: A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons and, a loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

1.240 As per the guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops. The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made applicable to agricultural term loans availed of by him.

1.241 The above norms should be made applicable to all direct agricultural advances as listed in the Master Circular on Lending to Priority Sectors dated July 02, 2012. In respect of all other agricultural loans, identification of NPAs would be done on the same basis as non-agricultural advances, which, at present, is the 90 days delinquency norm.

Classification Norms relating to NPAs

Temporary Deficiencies

1.242 The classification of an asset as NPA should be based on the record of recovery. Bank should not classify an advance account as NPA merely due to the existence of some deficiencies which are temporary in nature such as non-availability of adequate drawing power based on the latest available stock statement, balance outstanding exceeding the limit temporarily, non-submission of stock statements and non-renewal of the limits on the due date, etc. In the matter of classification of accounts with temporary deficiencies, banks have to follow the following guidelines:

(a) Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets, since current assets are first appropriated in times of distress. Drawing power is required to be arrived at based on current stock statement. Proper computation of drawing power is imperative as the advances are to be checked with reference thereto, e.g. in case of current assets comprising stock, drawing power is to be computed by the reduction of sundry creditors comprising of unpaid stocks before application of margin, in case of advance against book debts which are current and within the stipulated period would be reckoned. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months.

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

(c) A working capital borrowing account will become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days even though the unit may be working or the borrower's financial position is satisfactory.

(d) Regular and ad hoc credit limits need to be reviewed/ regularised not later than three months from the due date/date of ad hoc sanction. In case of constraints such as non-availability of financial statements and other data from the borrowers, the branch should furnish evidence to show that renewal/ review of credit limits is already on and would be completed soon. In any case, delay beyond six months is not considered desirable as a general discipline. Hence, an account where the regular/ ad hoc credit limits have not been reviewed/ renewed within 180 days from the due date/ date of ad hoc sanction will be treated as NPA.

Regularisation Near About Balance Sheet

1.243 The asset classification of borrower accounts where a solitary or a few credits are recorded before the balance sheet should be handled with care and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA. In other genuine cases, the banks must furnish satisfactory evidence to the Statutory Auditors/Inspecting Officers about the manner of regularisation of the account to eliminate doubts on their performing status.

Asset Classification to be Borrower-wise not Facility-wise

1.244 All facilities granted to a borrower and investment made in securities issued by the borrower will have to be treated as NPA/NPI and not the particular investment/facility once any or a part of the facility/investment has become irregular. In case of debits arising out of devolvement of letters of credit or invoked guarantees are parked in a separate account, the balance outstanding in that account also should be treated as a part of the borrower's principal operating account for the purpose of application of prudential norms on income recognition, asset classification and provisioning. The following are given in the master circular in this regard:

(i) The bills discounted under LC favouring a borrower may not be classified as a Non-performing advance (NPA), when any other facility granted to the borrower is classified as NPA. However, in case documents under LC are not accepted on presentation or the payment under the LC is not made on the due date by the LC issuing bank for any reason and the borrower does not immediately make good the amount disbursed as a result of discounting of concerned bills, the outstanding bills discounted will immediately be classified as NPA with effect from the date when the other facilities had been classified as NPA.

(ii) The overdue receivables representing positive mark-to-market value of a derivative contract will be treated as a non-performing asset, if these remain unpaid for 90 days or more. In case the overdues arising from forward contracts and plain vanilla swaps and options become NPAs, all other funded facilities granted to the client shall also be classified as nonperforming asset following the principle of borrower-wise classification as per the existing asset classification norms. Accordingly, any amount, representing positive mark-to-market value of the foreign exchange derivative contracts (other than forward contract and plain vanilla swaps and options) that were entered into during the period April 2007 to June 2008, which has already crystallised or might crystallise in future and is / becomes receivable from the client, should be parked in a separate account maintained in the name of the client / counterparty. This amount, even if overdue for a period of 90 days or more, will not make other funded facilities provided to the client, NPA on account of the principle of borrower-wise asset classification, though such receivable overdue for 90 days or more shall itself be classified as NPA, as per the extant IRAC norms. The classification of all other assets of such clients will, however, continue to be governed by the extant IRAC norms.

(iii) If the client concerned is also a borrower of the bank enjoying a Cash Credit or Overdraft facility from the bank, the receivables mentioned at item.

(iv) Above may be debited to that account on due date and the impact of its non-payment would be reflected in the cash credit / overdraft facility account. The principle of borrower-wise asset classification would be applicable here also, as per extant norms.

(v) In cases where the contract provides for settlement of the current mark-to-market value of a derivative contract before its maturity, only the current credit exposure (not the potential future exposure) will be classified as a non-performing asset after an overdue period of 90 days.

(vi) As the overdue receivables mentioned above would represent unrealised income already booked by the bank on accrual basis, after 90 days of overdue period, the amount already taken to 'Profit and Loss a/c' should be reversed.

Advances to PACS/FSS ceded to Commercial Banks

1.245 In case of advances granted under the on-lending system, however, only the particular credit facility granted to Primary Agricultural Credit Societies (PACSs) or Farmers Service Societies (FSSs), which is in default for a period of two crop seasons in case of short duration crops and one crop season in case of long duration crops, as the case may be, after it has become due will be classified as NPA and not all the credit facilities sanctioned subject to such conditions as specified in the RBI's master circular no. DBOD.No.BP.BC.9/21.04.048/2012-13 dated July 2, 2012 on Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances (The circular is given in the CD along with the Guidance Note).

Erosion in Value of Securities/ Frauds Committed by Borrowers

1.246 In respect of accounts where there are potential threats for recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers, such accounts need not go through the stages of asset classification. In such cases, the asset should be straightaway classified as doubtful or loss asset, as appropriate. Further,

(i) Erosion in the value of securities by more than 50% of the value assessed by the bank or accepted by RBI inspection team at the time of last inspection, as the case may be, would be considered as "significant", requiring the asset to be classified as doubtful straightaway and provided for adequately.

(ii) The realisable value of security as assessed by bank/approved valuers/RBI is less than 10% of the outstanding in the borrowal accounts, the existence of the security should be ignored and the asset should be classified as loss asset. In such cases the asset should either be written off or fully provided for.

Government Guaranteed Advances

1.247 The credit facilities backed by guarantees of central government though overdue may be treated as NPA only when the government repudiates its guarantee when invoked. This exemption from classification of Central Government guaranteed advances as NPA is not for the purpose of recognition of income. In case of State Government guaranteed loans, this exemption will not be available and such account will be NPA if interest / principal / other dues remain overdue for more than 90 days.

Advances Under Consortium

1.248 Consortium advances should be based on the record of recovery of the respective individual member banks and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account should be treated as not serviced in the books of the other member banks and therefore, an NPA.

1.249 The banks participating in the consortium, therefore, need to arrange to get their share of recovery transferred from the lead bank or to get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

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

1.250 Advances against Term Deposits, NSCs eligible for surrender, KVP/IVP and life policies need not be treated as NPAs, provided adequate margin is available in the accounts. Advance against gold ornaments government securities and all other securities are not covered by this exemption.

Agricultural Advances Affected by Natural Calamities

1.251 Paragraph 4.2.13 of the Master Circular deals elaborately with the classification and income recognition issues due to impairment caused by natural calamities. Banks may decide on their own relief measures, *viz.,* conversion of the short term production loan into a term loan or reschedulement of the repayment period and the sanctioning of fresh short-term loan, subject to the guidelines contained in RBI's circular No. RPCD. No. PLFS.BC.3/05.04.02/2012-13, dated July 2, 2012. In such cases the NPA classification would be governed by such rescheduled terms.

1.252 In such cases of conversion or re-schedulement, the term loan as well as fresh short-term loan may be treated as current dues and need not be classified as NPA. The asset classification of these loans would thereafter be governed by the revised terms & conditions and would be treated as NPA if interest and/or instalment of principal remains overdue for two crop seasons for short duration crops and for one crop season for long duration crops. For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not 'long duration" would be treated as "short duration" crops.

1.253 While fixing the repayment schedule in case of rural housing advances granted to agriculturist under Indira Awas Yojana and Golden Jubilee Rural Housing Finance Scheme, banks should ensure that the interest/ instalment payable on such advances are linked to crop cycles.

Advances Granted Under Rehabilitation Packages Approved by BIFR/Term Lending Institutions

1.254 In respect of advances under rehabilitation package approved by BIFR/term lending institutions, the provision should continue to be made in respect of dues to the bank on the existing credit facilities as per their classification as sub-standard or doubtful asset. This classification cannot be upgraded by the bank unless the package of renegotiated terms has worked satisfactorily for a period of one year. As regards the additional facilities sanctioned as per package finalised by BIFR and/or term lending institutions, the income recognition, asset classification norms would apply after a period of one year from the date of disbursement.

Post Shipment Supplier's Credit

1.255 In respect of post-shipment credit extended by the banks covering export of goods to countries for which the ECGC's cover is available, EXIM Bank has introduced a guarantee-cum-refinance programme whereby, in the event of default, EXIM Bank will pay the guaranteed amount to the bank within a period of 30 days from the day the bank invokes the guarantee after the exporter has filed claim with ECGC.

1.256 Accordingly, where the credit extended by banks are guaranteed by EXIM Bank, the extent to which payment has been received from EXIM bank on guarantee the advance may not be treated as NPA.

Takeout Finance

1.257 Takeout finance is the product emerging in the context of the funding of long-term infrastructure projects. Under such an arrangement, the bank or financial institution financing infrastructure projects will have an arrangement with any financial institution for transferring to the latter the outstanding in respect of such financing in their books on a predetermined basis. In view of the time-lag involved in taking-over, the possibility of a default in the meantime cannot be ruled out. The norms of asset classification will have to be followed by the concerned bank/financial institution in whose books the account stands as balance sheet item as on the relevant date. If the lending institution observes that the asset has turned NPA on the basis of the record of recovery, it should be classified accordingly. The lending institution should not recognise income on accrual basis and account for the same only when it is paid by the borrower/ taking over institution (if the arrangement so provides). The lending institution should also make provisions against any asset turning into NPA pending its take over by taking over institution. As and when the asset is taken over by the taking over institution, the corresponding provisions could be reversed. However, the taking over institution, on taking over such assets, should make provisions treating the account as NPA from the actual date of it becoming NPA even though the account was not in its books as on that date.

Export Project Finance

1.258 Where the actual importer has paid the dues to the bank abroad and the proceeds have not been made good to the bank granting finance due to any political reasons, such account need not be classified as NPA if the bank is able to establish through documentary evidence that the importer has cleared the dues in full. The account will, however, have to be considered as NPA if at the end of one year from the date the amount was deposited by the importer in the bank abroad, the amount has not still been remitted to the bank.

Net Worth of Borrower/Guarantor or Availability of Security

1.259 Since income recognition is based on recoveries, net worth of borrower/guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise. Likewise, the availability of security guarantee is not relevant for determining whether or not an account is NPA.

Project Finance Under Moratorium Period

1.260 In the case of bank finance given for industrial projects or for agricultural plantations etc., where moratorium is available for payment of interest, payment of interest becomes due after the moratorium or gestation period is over, and not on the date of debit of interest. Therefore, such amounts of interest do not become overdue and hence the accounts do not become NPA, with reference to the date of debit of interest. They become overdue after due date for payment of interest as per the terms of sanction and consequently NPA norms would apply to those advances from that due date.

Advances to Staff

1.261 Interest bearing staff advances as a banker should be included as part of advances portfolio of the bank. In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards. Such loans/advances should be classified as NPA only when there is a default in repayment of instalment of principal or payment of interest on the respective due dates. The staff advances by a bank as an employer and not as a banker are required to be included under the sub-head 'Others' under the schedule of Other Assets.

NPA Management[@]

1.262 The RBI has issued a circular no. DBOD.No.BP.BC/ 42/21.04.048/2012-13 dated September 14, 2012 on "NPA Management – Requirement of an Effective Mechanism and Granular Data". The circular stresses the importance of effective mechanism and granular data on NPA management in the banks and provides as follows:

- Asset quality of banks is one of the most important indicators of their financial health. However, it has been observed that existing MIS on the early warning systems of asset quality, needed improvement. Banks are, therefore, advised that they should review their existing IT and MIS framework and put in place a robust MIS mechanism for early detection of signs of distress at individual account level as well as at segment level (asset class, industry, geographic, size, etc.). Such early warning signals should be used for putting in place an effective preventive asset quality management framework, including a transparent restructuring mechanism for viable accounts under distress within the prevailing regulatory framework, for preserving the economic value of those entities in all segments.
- The banks' IT and MIS system should be robust and able to generate reliable and quality information with regard to their asset quality for effective decision making. There should be no inconsistencies between information furnished under regulatory/statutory reporting and the banks' own MIS reporting. Banks are also advised to have system generated segment-wise information on non-performing assets and restructured assets which may include data on the opening balances, additions, reductions (upgradations, actual recoveries, write-offs etc.), closing balances, provisions held, technical write-offs, etc.

Income Recognition

On Advances Granted

1.263 Banks recognise income (such as interest, fees and commission) on accrual basis, i.e., as it is earned. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection. In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognise

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income on non-performing assets until it is actually realised. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realised should be reversed or provided for. Further,

i. Interest income on advances against term deposits, NSCs, IVPs, KVPs and life policies may be taken to income account on the due date, provided adequate margin is available in the accounts.

ii. Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit.

iii. If Government guaranteed advances become NPA, the interest on such advances should not be taken to income account unless the interest has been realised.

Reversal of Income

1.264 If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

1.265 In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

1.266 Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognised as income in the previous year(s).

On Leased Assets

1.267 The finance charge component of finance income [as defined in 'AS 19 – Leases] on the leased asset which has accrued and was credited to income account before the asset became non-performing, and remaining unrealised, should be reversed or provided for in the current accounting period.

On Take-out Finance

1.268 In the case of take-out finance, if based on record of recovery, the account is classified by the lending bank as NPA, it should not recognise income unless realised from the borrower/taking-over institution (if the arrangement so provides).

On Partial Recoveries in NPAs

1.269 In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner. The appropriate policy to be followed is to recognise income as per AS 9 when certainty attaches to realisation and accordingly amount reversed/derecognised or not recognised in the past should be accounted.

1.270 Interest partly/fully realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.

Memorandum Account

1.271 On an account turning NPA, banks should reverse the interest already charged and not collected by debiting Profit and Loss account, and stop further application of interest. However, banks may continue to record such accrued interest in a Memorandum account in their books. For the purpose of computing Gross Advances, interest recorded in the Memorandum account should not be taken into account.

Classification of Advances

1.272 The guidelines require banks to classify their advances into four broad categories for the purpose of provisioning as follows.

(a) ***Standard assets***

A standard asset is one which does not disclose any problems and which does not carry more than normal risk attached to the business. Such an asset is not a non-performing asset.

(b) ***Sub-standard assets***

With effect from March 31, 2005, a sub-standard asset is one which has remained NPA for a period less than or equal to 12 months. In such cases, the current net worth of the borrower/ guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the bank in full.

(c) ***Doubtful assets***

With effect from March 31, 2005, an asset is classified as doubtful if it has remained in the sub-standard category for a period of 12 months. Such an asset has all the inherent weaknesses as in a doubtful asset and an added characteristic that the weaknesses make the collection or liquidation in full highly improbable or questionable.

(d) ***Loss assets***

A loss asset is one where loss has been identified by:

(a) the bank; or

(b) the internal or external auditors; or

(c) the RBI inspection

but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

1.273 It may be noted that the above classification is meant for the purpose of computing the amount of provision to be made in respect of advances. The balance sheet presentation of advances is governed by the Third Schedule to the Banking Regulation Act, 1949, which requires classification of advances altogether differently.

Upgradation of Loan Accounts Classified as NPAs

1.274 If arrears of interest and/principal are paid by the borrower in the case of loan accounts classified as NPAs, the account should no longer be treated as non-performing and may be classified as 'standard' accounts. Upgradation of a restructured/ rescheduled/CDR accounts is governed by the restructuring / reschedulement/CDR norms as discussed later in the Chapter.

Provisioning for Loans and Advances

1.275 The RBI's Master Circular of July 2, 2012 on Income Recognition, Asset Classification and Provisioning Pertaining to Advances contains the principles to be followed by the bank in calculating the provisions required for the NPAs in conformity with the prudential norms. The circular also requires the bank to take into consideration aspects such as time lag between an account becoming an NPA, its recognition as such, realisation of security and the erosion over time in the value of security charged to the bank, while calculating the required amount of provision. The specific requirements of the Master Circular in respect of provisioning are as follows:

(a) ***Loss assets***

1.276 The entire amount should be written off. If the assets are permitted to remain in the books for any reason, 100 percent of the outstanding should be provided for.

(b) ***Doubtful assets***

1.277 The provisioning for doubtful assets under loans and advances is as under:

(i) Full provision to the extent of the unsecured portion should be made. In doing so, the realisable value of the security available, to which the bank has a valid recourse, should be determined on a realistic basis. DICGC/ECGC cover is also taken into account (this aspect is discussed in detail later in this Chapter).

(ii) In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 25% to 100% of secured portion depending upon the period for which the asset has remained doubtful. In case the advance covered by CGTSI guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per the extant guidelines on provisioning for non-performing advances.

Period for which the advance has been considered as doubtful	*% of provision on secured portion*
Upto 1 year	25
More than 1 year and upto 3 years	40
More than three years	100

Valuation of Security: With a view to bringing down divergence arising out of difference in assessment of the value of security, in cases of NPAs with balance of Rs. 5 crore and above, stock audit at annual intervals by external agencies appointed as per the guidelines approved by the Board is mandatory in order to enhance the reliability on stock valuation. Collaterals, such as immovable properties charged in favour of the bank are required to be got valued once in three years by valuers appointed as per the guidelines approved by the Board of Directors.

(c) ***Sub-standard assets***[@]

1.278 A general provision of 15% on total outstanding should be made without making any allowance for DICGC/ECGC cover and securities available. Unsecured exposures, which are identified, as sub-standard would attract an additional provision of 10%. (i.e. total 25% of total outstanding). However, in view of certain safeguards such as escrow accounts available in respect of

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infrastructure lending, infrastructure loan accounts which are classified as sub-standard will attract a provisioning of 20 per cent instead of the aforesaid prescription of 25 per cent. To avail of this benefit of lower provisioning, the banks should have in place an appropriate mechanism to escrow the cash flows and also have a clear and legal first claim on these cash flows. The provisioning requirement for unsecured 'doubtful' assets is 100 per cent. Unsecured exposure' is defined as an exposure (including all funded and non-funded exposures) where realisable value of the tangible security properly charged to the bank, as assessed by bank/approved valuers/RBI inspectors, is not more than 10%, *ab initio*, of the outstanding exposure. 'Exposure' includes all funded and non-funded exposures (including underwriting and similar commitments). 'Security' means tangible security properly discharged to the bank and will not include intangible securities like guarantees (including State government guarantees), comfort letters, etc.

1.279 In order to enhance transparency and ensure correct reflection of the unsecured advances in Schedule 9 of the banks' balance sheet, the following RBI requirements are applicable from the financial year 2009-10 onwards:

a) For determining the amount of unsecured advances for reflecting in schedule 9 of the published balance sheet, the rights, licenses, authorisations, etc., charged to the banks as collateral in respect of projects (including infrastructure projects) financed by them, should not be reckoned as tangible security. Hence such advances shall be reckoned as unsecured.

b) However, banks may treat annuities under build-operate-transfer (BOT) model in respect of road / highway projects and toll collection rights, where there are provisions to compensate the project sponsor if a certain level of traffic is not achieved, as tangible securities subject to the condition that banks' right to receive annuities and toll collection rights is legally enforceable and irrevocable.

c) Banks should also disclose the total amount of advances for which intangible securities such as charge over the rights, licenses, authority, etc. has been taken as also the estimated value of such intangible collateral. The disclosure may be made under a separate head in "Notes to Accounts". This would differentiate such loans from other entirely unsecured loans.

1.280 This would require the segregation of the intangibles taken as collateral security in secured loans. As per the existing instructions of RBI, in the Balance Sheet of the banks, the amounts comprising Debtors (though not tangible assets), charged as security are grouped as secured by tangible assets and disclosure is made with a remark in parenthesis in the Schedule 9, without any quantification of the advances covered by security of Debtors. The amounts comprising the intangibles as per the RBI's Master Circular on Income recognition and Asset Classification Norms, will need to be culled out of the secured exposures and quantified to be reflected as unsecured advances; which would also require corresponding reclassification of advances for the earlier year. More importantly, in case of NPAs, the unsecured portion would attract a higher provision, when segregated from the secured portion.

(d) ***Standard Assets***

1.281 The bank requires to make a general provision for standard assets at the following rates for the funded outstanding on global loan portfolio basis. Therefore, w.e.f. November 5, 2009, RBI has revised[9] the general provision towards standard assets as follows:

a) Direct advances to Agricultural and Small and Micro Enterprises (SMEs) sectors - 0.25%

b) Advances to Commercial Real Estate (CRE) sector – 1.00%

c) Housing loans extended at teaser rates and restructured advances – 2.00%[@]

d) All other loans and advances not included in (a) (b) and (c) above - 0.40% (these include Asset Finance Companies as defined by RBI from time to time)

1.284 It is clarified that the Medium Enterprises will attract 0.40% standard asset provisioning. The definition of the terms Micro Enterprises, Small Enterprises, and Medium Enterprises shall be in terms of Master Circular RPCD.MSME & NFS. BC. No. 11/06.02.31/2012-13 dated July 2, 2012 on Lending to Micro, Small & Medium Enterprises (MSME) Sector. [@]

1.285 While the provisions on individual portfolios are required to be calculated at the rates applicable to them, the excess or shortfall in the provisioning, vis-a-vis the position as on any previous date, should be determined on an aggregate basis. If the provisions required to be held on an

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[9] Prior to the above revision, the Master Circular prescribed the following rates of provision on Standard Assets:

(i) Direct advances to agricultural and SME sectors at 0.25%

(ii) Residential housing loans beyond Rs.20 lakhs – 1%

(iii) Advances to specific sectors i.e., personal loans (including credit car receivables), loans and advances qualifying as capital market exposures, commercial real estate and loans and advances to non deposit taking systemically important NBFCs 2%

(iv) All other advances not included at (i), (ii) and (iii) above -0.40%

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aggregate basis are less than the provisions held as on November 15, 2008, the provisions rendered surplus should not be reversed to P&L account but should continue to be maintained at the level existed as on November 15, 2008. In case of shortfall determined on aggregate basis, the balance should be provided for by debit to P&L account.[@]

1.286 The provisions on standard assets should not be reckoned for arriving at net NPAs. The provisions towards Standard Assets need not be netted from gross advances but included as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions - Others' in Schedule 5 of the balance sheet.

Provisioning requirements for derivative exposures

1.287 Credit exposures computed as per the current marked to market value of the contract, arising on account of the interest rate & foreign exchange derivative transactions, and gold, shall also attract provisioning requirement as applicable to the loan assets in the 'standard' category, of the concerned counterparties. All conditions applicable for treatment of the provisions for standard assets would also apply to the aforesaid provisions for derivative and gold exposures.

Provisioning for housing loans at teaser rates[@]

1.288 Some banks had introduced the practice of sanctioning housing loans at teaser rates, i.e., at comparatively lower rates of interest in the first few years, after which rates are reset at higher rates. This practice raised concern as some borrowers may find it difficult to service the loans once the normal interest rate, which is higher than the rate applicable in the initial years, becomes effective. Further, it was also observed by RBI that many banks at the time of initial loan appraisal, did not take into account the repaying capacity of the borrower at normal lending rates. Therefore, in view of the higher risk associated with such loans, the standard asset provisioning on the outstanding amount has been increased by RBI from 0.40 per cent to 2.00 per cent with immediate effect. The provisioning on these assets would revert to 0.40 per cent after one year from the date on which the rates are reset at higher rates if the accounts remained 'standard'.

Restructured Advances[@]

1.289 Further, Restructured accounts classified as standard advances attract a provision of 2 per cent in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances would attract a provision of 2 per cent for the period covering moratorium and two years; and restructured accounts classified as non-

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performing advances, when upgraded to standard category would attract a provision of 2 per cent in the first year from the date of upgradation.

Provisioning Norms for Leased Assets@

1.290 i) Substandard assets

a) 15 percent of the sum of the net investment in the lease and the unrealised portion of finance income net of finance charge component. The terms 'net investment in the lease', 'finance income' and 'finance charge' are as defined in 'AS 19 Leases' issued by the ICAI.

b) Unsecured lease exposures which are identified as 'substandard' would attract additional provision of 10 per cent, i.e., a total of 25 per cent.

ii) Doubtful assets

1.291 100 percent of the extent to which, the finance is not secured by the realisable value of the leased asset. Realisable value is to be estimated on a realistic basis. In addition to the above provision, provision at the following rates should be made on the sum of the net investment in the lease and the unrealised portion of finance income net of finance charge component of the secured portion, depending upon the period for which asset has been doubtful:

Period for which the advance has remained in 'doubtful' category	Provision requirement (%)
Up to one year	25
One to three years	40
More than three years	100

iii) Loss assets

1.292 The entire asset should be written off. If for any reason, an asset is allowed to remain in books, 100 percent of the sum of the net investment in the lease and the unrealised portion of finance income net of finance charge component should be provided for.

Provisioning Coverage Ratio@

1.293

I. Provisioning Coverage Ratio (PCR) is essentially the ratio of provisioning to gross non-performing assets and indicates the

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extent of funds a bank has kept aside to cover loan losses.

II. From a macro-prudential perspective, RBI had required that the banks should build up provisioning and capital buffers in good times i.e. when the profits are good, which can be used for absorbing losses in a downturn. This was aimed at enhancing the soundness of individual banks, as also the stability of the financial sector. It was, therefore, decided that banks should augment their provisioning cushions consisting of specific provisions against NPAs as well as floating provisions, and ensure that their total provisioning coverage ratio, including floating provisions, is not less than 70 per cent. Accordingly, banks were advised to achieve this norm not later than end-September 2010.

1.294 RBI has further advised the banks that:

a. the PCR of 70 percent may be with reference to the gross NPA position in banks as on September 30, 2010;

b. the surplus of the provision under PCR vis-a-vis as required as per prudential norms should be segregated into an account styled as "countercyclical provisioning buffer", computation of which may be undertaken as per the format given in Annex – 3 to the RBI's Master Circular no. DBOD.NO.BP.BC.9/21.04.048/2012-13 of 2nd July 2012 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning to Advances"; and

c. this buffer will be allowed to be used by banks for making specific provisions for NPAs during periods of system wide downturn, with the prior approval of RBI.

iv. The PCR of the bank should be disclosed in the Notes to Accounts to the Balance Sheet.

Accounting and Provisioning Norms for Equipment Leasing Activity

1.295 While the accounting and provisioning norms discussed above shall also apply in respect of equipment leasing activities. The bank should follow the Accounting Standard 19 on "Leases" in accounting for lease transactions.

Provisioning for Certain Specific Types of Advances

1.296 The guidelines also deal with provisioning for certain specific types of advances as follows.

Advances Granted Under Rehabilitation Packages Approved by BIFR/ Term Lending Institutions

1.297 In respect of advances under rehabilitation package approved by BIFR/term lending institutions, banks are required to continue with the provision to be made in respect of dues to the bank on the existing credit facilities as per their classification as substandard or doubtful asset. As regards the additional facilities sanctioned as per package finalised by BIFR and/or term lending institutions, provision on additional facilities sanctioned need not be made for a period of one year from the date of disbursement.

1.298 In respect of additional credit facilities granted to SSI units which are identified as sick [as defined in Section IV (Para 2.8) of RPCD circular RPCD.PLNFS.BC. No 83 /06.02.31/20042005 dated 1 March 2005] and where rehabilitation packages/nursing programmes have been drawn by the banks themselves or under consortium arrangements, no provision need be made for a period of one year.

1.299 Advances against term deposits, NSCs eligible for surrender, IVPs, KVPs, gold ornaments, government & other securities and life insurance policies.

1.300 The above type of advances would attract provisioning requirements as applicable to their asset classification status.

Advances Guaranteed by ECGC

1.301 In the case of advances guaranteed by ECGC, provision should be made only for the balance in excess of the amount of such guarantee. Further, while arriving at the provision required to be made for doubtful assets, realisable value of the securities should first be deducted from the outstanding balance in respect of the amount guaranteed by these Corporations and then provision should be made. (For examples on calculation of the provision, refer the Master Circular on Income Recognition, Asset Classification and Provisioning Pertaining to Advances, dated July 2, 2012)[@]

Advance covered by Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) guarantee

1.302 In case the advance covered by CGTMSE guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for

[@] Revised in 2013 Edition.

as per the extant guidelines on provisioning for non- performing advances. (For illustrative examples of provisioning in case of advances covered by CGTSI guarantee, refer the paragraph 5.9.5 of the Master Circular No. DBOD.No.BP.BC.9/21.04.048/2012-13 on Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances, dated July 2, 2012.)[@]

Disclosures

1.303 The information with respect to NPAs required to be disclosed under "Notes to Accounts" in the financial statements of banks is discussed in the chapter "Disclosure requirement in Financial Statements".

Restructuring / Reschedulement of Loans (Including Under Corporate Debt Structuring (CDR) Scheme)

1.304 The RBI, vide it master circular no. DBOD.BP.BC.No.9/21.04.048/2012-13 dated July 2, 2012 issued prudential guidelines on restructuring of advances by banks (The circular is given in the CD along with the Guidance Note). The Guidelines also contain the organisational framework for restructuring of advances under consortium/ multiple banking/ syndication arrangements, i.e., the CDR mechanism.

1.305 The above mentioned Prudential Guidelines of RBI harmonise the prudential norms for all types of debt restructuring mechanisms, except those restructured on account of natural calamities, which would continue to be covered by the guidelines issued by the Rural Planning and Credit Delivery (RPCD). Accordingly, with the issuance of these prudential guidelines, the CDR mechanism would also be available to the corporates engaged in non industrial activities, if they are otherwise eligible for restructuring as per the criteria laid down for the purpose. The other main requirements of these prudential guidelines have been discussed in the following paragraphs.

Eligibility criteria for restructuring of advances

1.306 Banks may restructure the accounts classified under 'standard', 'sub-standard' and 'doubtful' categories.

1.307 Banks can not reschedule / restructure / renegotiate borrowal accounts with retrospective effect. While a restructuring proposal is under consideration, the usual asset classification norms would continue to apply. The process of re-classification of an asset should not stop merely because restructuring proposal is under consideration. The asset classification status as on the date of approval of the restructured package by the competent authority would be relevant to decide the asset classification status of the account after restructuring / rescheduling / renegotiation. In case there is undue delay in sanctioning a restructuring package and in the meantime the asset classification status of the account undergoes deterioration, it would be a matter of supervisory concern.

1.308 Normally, restructuring can not take place unless alteration / changes in the original loan agreement are made with the formal consent / application of the debtor. However, the process of restructuring can be initiated by the bank in deserving cases subject to customer agreeing to the terms and conditions.

1.309 No account can be taken up for restructuring by the banks unless the financial viability is established and there is a reasonable certainty of repayment from the borrower, as per the terms of restructuring package. The viability should be determined by the banks based on the acceptable viability benchmarks determined by them, which may be applied on a case-by-case basis, depending on merits of each case. The parameters may, for example, include:

- Return on Capital Employed
- Debt Service Coverage Ratio
- Gap between the Internal Rate of Return and Cost of Funds and the amount of provision required in lieu of the diminution in the fair value of the restructured advance.

1.310 The accounts not considered viable should not be restructured and banks should accelerate the recovery measures in respect of such accounts. Any restructuring done without looking into cash flows of the borrower and assessing the viability of the projects / activity financed by banks would invite supervisory concern/ action.

1.311 While the borrowers indulging in frauds and malfeasance will continue to remain ineligible for restructuring, banks may review the reasons for classification of the borrowers as wilful defaulters specially in old cases where the manner of classification of a borrower as a wilful defaulter was not transparent and satisfy itself that the borrower is in a position to rectify the wilful default. For such accounts, the restructuring under the CDR Mechanism can be carried out only with the approval of the Core Group.

1.312 BIFR cases are not eligible for restructuring without the express approval of the BIFR. CDR Core Group in the case of advances restructured under CDR Mechanism, the lead bank in the case of SME Debt Restructuring Mechanism and the individual banks in other cases, may consider the proposals for restructuring in such cases, after ensuring that all the formalities in seeking the approval from BIFR are completed before implementing the package.

Asset Classification Norms

1.313 The stages at which the restructuring/rescheduling/ renegotiation of the terms of loan agreement could take place are as under:

(a) before commencement of commercial production/operation;

(b) after commencement of commercial production/operation but before the asset has been classified as sub standard; and

(c) after commencement of commercial production/operation and after the asset has been classified as sub standard or doubtful.

1.314 The accounts classified as 'standard assets' should be immediately re-classified as 'sub-standard assets' upon restructuring (except for in certain cases) (Also refer para 1.339).

1.315 The non-performing assets, upon restructuring, would continue to have the same asset classification as prior to restructuring and slip into further lower asset classification categories as per extant asset classification norms with reference to the pre-restructuring repayment schedule (except for in certain cases) (Also refer para 1.339).

1.316 Any additional finance may be treated as ‘standard asset’, up to a period of one year after the first interest/principal payment, whichever is earlier, falls due under the approved restructuring package. However, in case of accounts where the pre-restructuring facility was classified as “sub-standard” and “doubtful”, interest income on the additional finance should be recognized on cash basis only. If the restructured asset does not qualify for upgradation at the end of the above specified one year period, the additional finance shall be placed in the same asset classification category as the restructured debt.

Upgradation of Accounts

1.317 All restructured accounts which have been classified as non-performing assets upon restructuring, would be eligible for up-gradation to the ‘standard’ category after observation of ‘satisfactory performance’ during the ‘specified period’. (Annex-5 of the said Circular).

1.318 In case, however, satisfactory performance after the specified period is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule.

Subsequent Restructuring

1.319 In case a restructured asset, which is a standard asset on restructuring, is subjected to restructuring on a subsequent occasion, it should be classified as sub-standard. If the restructured asset is a sub-standard or a doubtful asset and is subjected to restructuring, on a subsequent occasion, its asset classification will be reckoned from the date when it became NPA on the first occasion. However, such advances restructured on second or more occasions may be allowed to be upgraded to standard category after one year from the date of first payment of interest or repayment of principal whichever falls due earlier in terms of the current restructuring package subject to satisfactory performance.

Income Recognition Norms

1.320 Interest income in respect of restructured accounts classified as 'standard assets' is to be recognised on accrual basis and that in respect of the accounts classified as 'non-performing assets' is to be recognised on cash basis.

Provisioning Norms

Normal provisions

1.321 Banks are required to hold provision against the restructured advances as per the existing provisioning norms.

Provision for diminution in the fair value of restructured advances

1.322 Reduction in the rate of interest and /or reschedulement of the repayment of principal amount, as part of the restructuring, will result in diminution in the fair value of the advance. Such diminution in value is an economic loss for the bank and will have impact on the bank's market value of equity. It is, therefore, necessary for banks to measure such diminution in the fair value of the advance and make provisions for it by debit to Profit & Loss Account. Such provision should be held in addition to the provisions as per existing provisioning norms as indicated above, and in an account distinct from that for normal provisions. Provisions for diminution of fair value of restructured advances, both in respect of Standard Assets as well as NPAs, made on account of reduction in rate of interest and / or reschedulement of principal amount are permitted to be netted from the relative asset.

1.323 The erosion in the fair value of the advance should be computed as the difference between the fair value of the loan before and after restructuring. Fair value of the loan before restructuring will be computed as the present value of cash flows representing the interest at the existing rate charged on the advance before restructuring and the principal, discounted at a rate equal to the bank's BPLR or Base Rate[10] as on the date of restructuring plus the appropriate term

[10] This change has been introduced as a result of the introduction of Base Rate System w.e.f. July 1, 2010 vide circular DBOD.No.Dir.BC.88/13.03.00/2009-10 dated April 9, 2010 on 'Guidelines on the Base Rate'.

premium and credit risk premium for the borrower category on the date of restructuring. Fair value of the loan after restructuring will be computed as the present value of cash flows representing the interest at the rate charged on the advance on restructuring and the principal, discounted at a rate equal to the bank's BPLR / Base Rate as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring.

1.324 In the case of working capital facilities, the diminution in the fair value of the cash credit /overdraft component may be computed as indicated in para above, reckoning the higher of the outstanding amount or the limit sanctioned as the principal amount and taking the tenor of the advance as one year. The term premium in the discount factor would be as applicable for one year. The fair value of the term loan components(Working Capital Term Loan and Funded Interest Term Loan) would be computed as per actual cash flows and taking the term premium in the discount factor as applicable for the maturity of the respective term loan components.

1.325 In the event any security is taken in lieu of the diminution in the fair value of the advance, it should be valued at Re.1/- till maturity of the security. This will ensure that the effect of charging off the economic sacrifice to the Profit & Loss account is not negated.

1.326 The diminution in the fair value may be re-computed on each balance sheet date till satisfactory completion of all repayment obligations and full repayment of the outstanding in the account, so as to capture the changes in the fair value on account of changes in BPLR/Base Rate, term premium and the credit category of the borrower. Consequently, banks may provide for the shortfall in provision or reverse the amount of excess provision held in the distinct account.

1.327 If due to lack of expertise/ appropriate infrastructure, a bank finds it difficult to ensure computation of diminution in the fair value of advances extended by small/rural branches, as an alternative to the methodology prescribed above for computing the amount of diminution in the fair value, banks will have the option of notionally computing the amount of diminution in the fair value and providing there for, at five percent of the total exposure, in respect of all restructured accounts where the total dues to bank(s) are less than rupees one crore till the financial year ending March 2013. The position would be reviewed thereafter.

1.328 The total provisions required against an account (normal provisions plus provisions in lieu of diminution in the fair value of the advance) are capped at 100% of the outstanding debt amount.

Prudential Norms for Conversion of Principal into Debt/Equity

Asset Classification Norms

1.329 A part of the outstanding principal amount can be converted into debt or equity instruments as part of restructuring. The debt/equity instruments so created will be classified in the same asset classification category in which the restructured advance has been classified. Further, movement in the asset classification of these instruments would also be determined based on the subsequent asset classification of the restructured advance.

Income Recognition Norms

Standard Accounts

1.330 In the case of restructured accounts classified as 'standard', the income, if any, generated by these instruments may be recognised on accrual basis.

Non-Performing Accounts

1.331 In the case of restructured accounts classified as non-performing assets, the income, if any, generated by these instruments may be recognised only on cash basis.

Valuation and Provisioning Norms

1.332 These instruments should be held under Available For Sale (AFS) and valued as per usual valuation norms. Equity classified as standard asset should be valued either at market value, if quoted, or at break-up value, if not quoted (without considering the revaluation reserve, if any,)which is to be ascertained from the company's latest balance sheet. In case the latest balance sheet is not available the shares are to be valued at Rs 1. Equity instrument classified as NPA should be valued at market value, if quoted, and in case where equity is not quoted, it should be valued at Re. 1. Depreciation on these instruments should not be offset against the appreciation in any other securities held under the AFS category.

Prudential Norms for Conversion of Unpaid Interest into 'Funded Interest Term Loan' (FITL), Debt or Equity Instruments

Asset Classification Norms

1.333 The FITL/debt or equity instrument created by conversion of unpaid interest will be classified in the same asset classification category in which the restructured advance has been classified. Further, movement in the asset classification of FITL/ debt or equity instruments would also be determined based on the subsequent asset classification of the restructured advance.

Income Recognition Norms

1.334 The income, if any, generated by these instruments may be recognised on accrual basis, if these instruments are classified as 'standard', and on cash basis in the cases where these have been classified as a non-performing asset.

1.335 The unrealised income represented by FITL/Debt or equity instrument should have a corresponding credit in an account styled as "Sundry Liabilities Account (Interest Capitalisation)".

1.336 In the case of conversion of unrealised interest income into equity, which is quoted, interest income can be recognised after the account is upgraded to standard category at market value of equity, on the date of such up gradation, not exceeding the amount of interest converted into equity.

1.337 Only on repayment in case of FITL or sale/redemption proceeds of the debt/equity instruments, the amount received will be recognised in the P&L Account, while simultaneously reducing the balance in the "Sundry Liabilities Account (Interest Capitalisation)".

Valuation and Provisioning Norms

1.338 Valuation and provisioning norms would be as discussed in para 1.332 above. The depreciation, if any, on valuation may be charged to the Sundry Liabilities (Interest Capitalisation) Account.

Special Regulatory Treatment for Asset Classification

1.339 The special regulatory treatment for asset classification, in modification to the provisions in this regard stipulated in paragraphs1.313 to 1.316 above, will be available to the borrowers engaged in important business activities, subject to compliance with certain conditions as enumerated in para 1.345 below . Such treatment is not extended to the following categories of advances:

i. Consumer and personal advances.

ii. Advances classified as Capital market exposures.

iii. Advances classified as commercial real estate exposures.

1.340 The asset classification of these three categories of accounts as well as that of other accounts which do not comply with the conditions enumerated in paragraph 1.345 below , will be governed by the prudential norms in this regard described in paragraphs 1.314 to 1.315 above.

1.341 However, the RBI, vide its circular no. DBOD.BP.BC.No. 74 /21.04.132/2010-11 dated January 19, 2011 on "Credit Support to Micro Finance Institutions (MFIs)" observed that bank loans to MFIs are mostly unsecured but to avail of the regulatory asset classification benefits under the present restructuring guidelines of RBI, the accounts have to be fully secured. As far as the banks' exposures to MFIs were concerned, the banks stressed on the need to work out an interim arrangement involving, inter alia, rescheduling of exposures to MFIs subject to certain covenants such as MFIs agreeing to reduce their leverage and growth projections. Considering the fact that the current problems afflicting the Micro Finance Institutions (MFIs) sector are not necessarily on account of any credit weakness per-se but are mainly due to environmental factors, it has been decided that the special regulatory asset classification benefit could be extended to restructured MFI accounts, which are standard at the time of restructuring, even if they are not fully secured. This relaxation is granted purely as a temporary measure and would be applicable to Standard MFI accounts restructured by banks up to March 31, 2011. The other conditions specified in the circular no. DBOD.No.BP.BC.No.37/21.04.132/2008-09 dated August 27, 2008 on "Prudential Guidelines on Restructuring of Advances by Banks" for getting the special asset classification benefits would remain unchanged. It is advised that a consortium approach for restructuring may be preferred and all the banks financing a MFI unit should come together and decide on the course of action to be pursued for that unit. Banks are advised that they should endeavour to recycle the collections to MFIs so as to ensure that the intended 'holding on' operation is successful.

Elements of special regulatory framework

1.342 The special regulatory treatment has the following two components:

(i) Incentive for quick implementation of the restructuring package.

(ii) Retention of the asset classification of the restructured account in the pre-restructuring asset classification category

Incentive for quick implementation of the restructuring package

1.343 As stated in paragraph 1.307 during the pendency of the application for restructuring of the advance with the bank, the usual asset classification norms would continue to apply. The process of reclassification of an asset should not stop merely because the application is under consideration. However, as an incentive for quick implementation of the package, if the approved package is implemented by the bank as per the following time schedule, the asset classification status may be restored to the position which existed when the reference was made to the CDR Cell in respect of cases covered under the CDR Mechanism or when the restructuring application was received by the bank in non-CDR cases:

(i) Within 120 days from the date of approval under the CDR Mechanism.

(ii) Within 90 days from the date of receipt of application by the bank in cases other than those restructured under the CDR Mechanism.

Asset Classification Benefits

1.344 Subject to the compliance with the undernoted conditions in addition to the adherence to the prudential framework laid down in the Master Circular:

(i) In modification to paragraph 1.314 an existing 'standard asset' will not be downgraded to the sub-standard category upon restructuring.

(ii) In modification to paragraph 1.315 during the specified period, the asset classification of the sub-standard/doubtful accounts will not deteriorate upon restructuring, if satisfactory performance is demonstrated during the specified period.

1.345 However, these benefits will be available subject to compliance with the following conditions:

i) The dues to the bank are ‘fully secured’ as defined in the prudential guidelines. The condition of being fully secured by tangible security will not be applicable in the following cases:

   (a) SSI borrowers, where the outstanding is up to Rs.25 lakh.

   (b) Infrastructure projects, provided the cash flows generated from these projects are adequate for repayment of the advance, the financing bank(s) have in place an appropriate mechanism to escrow the cash flows, and also have a clear and legal first claim on these cash flows.

   (c) Dues of Micro Finance Institutions (MFIs) restructured up to March 31, 2011.

ii) The unit becomes viable in 10 years, if it is engaged in infrastructure activities, and in 7 years in the case of other units.

iii) The repayment period of the restructured advance including the moratorium, if any, does not exceed 15 years in the case of infrastructure advances and 10 years in the case of other advances. The aforesaid ceiling of 10 years would not be applicable for restructured home loans; in these cases the Board of Director of the banks should prescribe the maximum period for restructured advance keeping in view the safety and soundness of the advances. Lending to individuals meant for acquiring residential property which are fully secured by mortgages on residential property that is or will be occupied by the borrower or that is rented are risk weighted as under the new capital adequacy framework, provided the LTV is not more than 75% , based on board approved valuation policy. However, the restructured housing loans should be risk weighted with an additional risk weight of 25 percentage points to the risk weight prescribed already.

iv) Promoters' sacrifice and additional funds brought by them should be a minimum of 15% of banks' sacrifice.

v) Based on the representations received from Banks and Indian Banks' Association that a corporate under stress finds it difficult to bring in the promoters share of sacrifice and additional funds upfront on some occasions, RBI decided that:

   a) The promoter's sacrifice and additional funds required to be brought in by the promoters should generally be brought in upfront. However, if banks are convinced that the promoters face genuine difficulty in bringing their share of the sacrifice immediately and need some extension of time to fulfill their commitments, the promoters could be allowed to bring in 50% of their sacrifice, i.e. 50% of 15%, upfront and the balance within a period of one year.

   b) However, in case the promoters fail to bring in their balance share of sacrifice within the extended time limit of one year, the asset classification benefits derived by banks will cease to accrue and the banks will have to revert to classifying such accounts as per the asset classification norms specified under Assets Classification Norms prescribed by the Master Circular.

c) Promoter's contribution need not necessarily be brought in cash and can be brought in the form of de-rating of equity, conversion of unsecured loan brought by the promoter into equity and interest free loans.

RBI further clarified that contribution by the promoter need not necessarily be brought in cash and can be brought in the form of de-rating of equity, conversion of unsecured loan brought by the promoter into equity and interest free loans.

v) Personal guarantee is offered by the promoter except when the unit is affected by external factors pertaining to the economy and industry.

vi) The restructuring under consideration is not a 'repeated restructuring' as defined in the prudential guidelines.

1.346 The basic objective of restructuring is to preserve economic value of units and not ever greening of problem accounts.@

Disclosures@

1.347 Banks are required to disclose information relating to number of accounts and amount of advances restructured, and the amount of diminution in the fair value of the restructured advances in the "Notes on Accounts" to the Balance Sheet. The information would be required for advances restructured under CDR Mechanism, SME Debt Restructuring Mechanism and other categories separately. The information required to be disclosed and the manner in which the disclosure is required is stated in RBI's recent Circular:- RBI/2012-13/409, DBOD.BP.BC.No.80/21.04.132/2012-13 dated 31.1.2013 on "Disclosure Requirements on Advances Restructured by Banks and Financial Institutions".

1.348 Particulars of Accounts Restructured (Rs. in Crore)

@ Revised in 2013 edition.

Disclosure of Restructured Accounts

(Rs. in Crore)

Sl No	Type of Restructuring →		Under CDR Mechanism					Under SME Debt Restructuring Mechanism					Others					Total				
	Asset Classification → Details ↓		Standard	Sub-Standard	Doubtful	Loss	Total	Standard	Sub-Standard	Doubtful	Loss	Total	Standard	Sub-Standard	Doubtful	Loss	Total	Standard	Sub-Standard	Doubtful	Loss	Total
1	Restructured Accounts as on April 1 of the FY (opening figures)*	No. of borrowers																				
		Amount outstand-ing																				
		Provision thereon																				
2	Fresh restructuring during the year	No.of borrowers																				
		Amount outstand-ing																				
		Provision thereon																				

3	Upgradations to restructured standard category during the FY	No. of borrowers																				
		Amount outstand-ing																				
		Provision thereon																				
4	Restructured standard advances which cease to attract higher provisioning and / or additional risk weight at the end of the FY and hence need not be shown as restructured standard advances at the beginning of the next FY	No. of borrowers																				
		Amount outstand-ing																				
		Provision thereon																				
5	Downgradations of restructured accounts during the FY	No. of borrowers																				
		Amount outstand-ing																				
		Provision thereon																				

6	Write-offs of restructured accounts during the FY	No. of borrowers																				
		Amount outstand-ing																				
		Provision thereon																				
7	Restructured Accounts as on March 31 of the FY (closing figures*)	No. of borrowers																				
		Amount outstand-ing																				
		Provision thereon																				

Instructions – For the purpose of disclosure in the above Format, the following instructions are required to be followed:

(i) Advances restructured under CDR Mechanism, SME Debt Restructuring Mechanism and other categories of restructuring should be shown separately.

(ii) Under each of the above categories, restructured advances under their present asset classification, i.e., standard, sub- standard, doubtful and loss should be shown separately.

(iii) Under the 'standard' restructured accounts; accounts, which have objective evidence of no longer having inherent credit weakness, need not be disclosed. For this purpose, an objective criteria for accounts not having inherent credit weakness is discussed below:

(a) As regards restructured accounts classified as standard advances, in view of the inherent credit weakness in such accounts, banks are required to make a general provision higher than what is required for otherwise standard accounts in the first two years from the date of restructuring. In case of moratorium on payment of interest / principal after restructuring, such advances attract the higher general provision for the period covering moratorium and two years thereafter.

(b) Further, restructured standard unrated corporate exposures and housing loans are also subjected to an additional risk weight of 25 percentage point with a view to reflect the higher element of inherent risk which may be latent in such entities (cf. paragraph 5.8.3 of circular DBOD.No.BP.BC.90/20.06.001/2006-07 dated April 27, 2007 on 'Prudential Guidelines on Capital Adequacy and Market Discipline - Implementation of the New Capital Adequacy Framework' and paragraph 4 of circular DBOD.No.BP.BC.76/21.04.0132/2008-09 dated November 3, 2008 on 'Prudential Guidelines on Restructuring of Advances by Banks' respectively).

(c) The aforementioned [(a) and (b)] additional/ higher provision and risk weight cease to be applicable after the prescribed period if the performance is as per the rescheduled programme. However, the diminution in the fair value will have to be assessed on each balance sheet date and provision should be made as required.

(d) Restructured accounts classified as sub-standard and doubtful (non-performing) advances, when upgraded to standard category also attract a general provision higher than what is required for otherwise standard accounts for the first year from the date of upgradation, in terms of extant guidelines on provisioning requirement of restructured accounts. This higher provision ceases to be applicable after one year from the date of upgradation, if the performance of the account is as per the rescheduled programme. However, the diminution in the fair value will have to be assessed on each balance sheet date and provision made as required.

(e) Once the higher provisions and/or risk weights (if applicable and as prescribed from time to time by RBI) on restructured standard advances revert to the normal level on account of satisfactory performance during the prescribed periods as indicated above, such advances, henceforth, would no longer be required to be disclosed by banks as restructured standard accounts in the "Notes on Accounts" in their Annual Balance Sheets. However, banks should keep an internal record of such restructured accounts till the provisions for diminution in fair value of such accounts are maintained.

(iv) Disclosures should also indicate the intra category movements both on upgradation of restructured NPA accounts as well as on slippage. These disclosures would show the movement in restructured accounts during the financial year on account of addition, upgradation, downgradation, write off, etc.

(v) While disclosing the position of restructured accounts, banks must disclose the total amount outstanding in all the accounts / facilities of borrowers whose accounts have been restructured along with the restructured part or facility. This means that even if only one of the facilities / accounts of a borrower has been restructured, the bank should also disclose the entire outstanding amount pertaining to all the facilities/ accounts of that particular borrower.

(vi) Upgradation during the year (SI No. 3 in the Disclosure Format) means movement of 'restructured NPA' accounts to 'standard asset classification from substandard or doubtful category' as the case may be. These will attract higher provisioning and / or risk weight' during the 'prescribed period' as prescribed from time to time. Movement from one category into another will be indicated by a (-) and a (+) sign respectively in the relevant category.

(vii) Movement of Restructured standard advances (Sr. No. 4 in the Disclosure Format) out of the category into normal standard advances will be indicated by a (-) sign in the column "Standard".

(viii) Downgradation from one category to another would be indicated by (-) ve and (+) ve sign in the relevant categories.

(ix) Upgradation, downgradation and write-offs are from their existing asset classifications.

(x) All disclosures are on the basis of current asset classification and not 'pre-restructuring' asset classification.

Organisational Framework for Restructuring of Advances under Consortium/Multiple Banking/ Syndication Arrangements

A. Corporate Debt Restructuring (CDR) Mechanism

1.349 A Corporate Debt Restructuring system has been evolved for restructuring of the corporate debts of viable entities facing problems, which are outside the purview of BIFR, DRT and other legal proceedings, for the benefit of all concerned. In particular, the framework will aim at preserving viable corporates that are affected by certain internal and external factors and minimize the losses to the creditors and other stakeholders through an orderly and coordinated restructuring programme.

1.350 The CDR Mechanism has been designed to facilitate restructuring of advances of borrowers enjoying credit facilities from more than one bank / Financial Institution (FI) in a coordinated manner. The CDR Mechanism is an organizational framework institutionalized for speedy disposal of restructuring proposals of large borrowers availing finance from more than one banks / FIs. This mechanism will be available to all borrowers engaged in any type of activity subject to the following conditions:

a) The borrowers enjoy credit facilities from more than one bank / FI under multiple banking / syndication / consortium system of lending.

b) The total outstanding (fund-based and non-fund based) exposure is Rs.10 crore or above.

1.351 CDR system in the country will have a three tier structure:

- CDR Standing Forum and its Core Group
- CDR Empowered Group
- CDR Cell

1.352 One of the main features of the restructuring under CDR system is the provision of two categories of debt restructuring under the CDR system.

Accounts, which are classified as 'standard' and 'substandard' in the books of the creditors, will be restructured under the first category (Category 1). Accounts which are classified as 'doubtful' in the books of the creditors would be restructured under the second category (Category 2).

Category 1 CDR system

1.353 It is applicable only to accounts classified as 'standard' and 'sub-standard'. There may be a situation where a small portion of debt by a bank might be classified as doubtful. In that situation, if the account has been classified as 'standard'/ 'substandard' in the books of at least 90% of creditors (by value), the same would be treated as standard / substandard, only for the purpose of judging the account as eligible for CDR, in the books of the remaining 10% of creditors. There is no requirement of the account / company being sick, NPA or being in default for a specified period before reference to the CDR system. However, potentially viable cases of NPAs will get priority. This approach would provide the necessary flexibility and facilitate timely intervention for debt restructuring. Prescribing any milestone(s) may not be necessary, since the debt restructuring exercise is being triggered by banks and financial institutions or with their consent.

Category 2 CDR System

1.354 There has been instances where the projects have been found to be viable by the lenders but the accounts could not be taken up for restructuring under the CDR system as they fell under 'doubtful' category. Hence, a second category of CDR applies to such cases where the accounts have been classified as 'doubtful' in the books of creditors, and if a minimum of 75% (by value) and 60% (by number) of the lenders satisfy themselves of the viability of the account and consent for such restructuring, subject to the following conditions:

(i) It will not be binding on the creditors to take up additional financing worked out under the debt restructuring package and the decision to lend or not to lend will depend on each creditor bank/FI separately. In other words, under the proposed second category of the CDR mechanism, the existing loans will only be restructured and it would be up to the promoter to firm up additional financing arrangement with new or existing creditors individually.

(ii) All other norms under the CDR mechanism such as the standstill clause, asset classification status during the pendency of restructuring under CDR, etc. will continue to apply.

1.355 All CDR approved packages must incorporate creditors' right to accelerate repayment and borrowers' right to prepay. The right of recompense should be based on certain performance criteria to be decided by the Standing Forum.

Following are the general provisions relating to operation of the CDR system, as prescribed by the RBI:

(a) ***Eligibility criteria***

(i) The scheme does not apply to accounts involving only one financial institution or one bank. The CDR mechanism covers only multiple banking accounts/syndication/consortium accounts of corporate borrowers engaged in any type of activity with outstanding fund-based and non-fund based exposure of Rs.10 crore and above by banks and institutions.

(ii) Corporates indulging in frauds and malfeasance even in a single bank are ineligible for restructuring under CDR mechanism. The CDR Core group, however, may review the reasons for classification of the borrower as wilful defaulter specially in old cases where the manner of classification of a borrower as a wilful defaulter was not transparent and satisfy itself that the borrower is in a position to rectify the wilful default provided he is granted an opportunity under the CDR mechanism. Such exceptional cases may be admitted for restructuring with the approval of the Core Group only. The Core Group may ensure that cases involving frauds or diversion of funds with *malafide* intent are not covered.

(iii) The accounts where recovery suits have been filed by the creditors against the company, may be eligible for consideration under the CDR system provided, the initiative to resolve the case under the CDR system is taken by at least 75% of the creditors (by value) and 60% of creditors (by number).

(iv) BIFR cases are not eligible for restructuring under the CDR system. However, large value BIFR cases may be eligible for restructuring under the CDR system if specifically recommended by the CDR Core Group. The Core Group shall recommend exceptional BIFR cases on a case to case basis for consideration under the CDR system. It should be ensured that the lending institutions complete all the formalities in seeking the approval from BIFR before implementing the package.

(b) ***Reference to CDR System***

(i) Reference to Corporate Debt Restructuring System could be triggered by (i) any or more of the creditor who have minimum 20% share in either working capital or term finance, or (ii) by the concerned corporate, if supported by a bank or financial institution having stake as in (i) above.

(ii) Though flexibility is available whereby the lenders could either consider restructuring outside the purview of the CDR system or even initiate legal proceedings where warranted, banks/FIs should review all eligible cases where the exposure of the financial system is more than Rs 100 crore and decide about referring the case to CDR system or to proceed under the new SRFAESI Act, 2002 or to file a suite in DRT etc.

(c) Legal Basis

i. CDR is a non-statutory mechanism which is a voluntary system based on Debtor- Creditor Agreement (DCA) and Inter-Creditor Agreement (ICA). The Debtor-Creditor Agreement (DCA) and the Inter-Creditor Agreement (ICA) shall provide the legal basis to the CDR mechanism. The debtors shall have to accede to the DCA, either at the time of original loan documentation (for future cases) or at the time of reference to Corporate Debt Restructuring Cell. Similarly, all participants in the CDR mechanism through their membership of the Standing Forum shall have to enter into a legally binding agreement, with necessary enforcement and penal clauses, to operate the System through laid down policies and guidelines. The ICA signed by the creditors will be initially valid for a period of 3 years and subject to renewal for further periods of 3 years thereafter. The lenders in foreign currency outside the country are not a part of CDR system. Such creditors and also creditors like GIC, LIC, UTI, etc., who have not joined the CDR system, could join CDR mechanism of a particular corporate by signing transaction to transaction ICA, wherever they have exposure to such corporate.

ii. The Inter-Creditor Agreement would be a legally binding agreement amongst the creditors, with necessary enforcement and penal clauses, wherein the creditors would commit themselves to abide by the various elements of CDR system. Further, the creditors shall agree that if 75 per cent of creditors by value and 60 per cent of the creditors by number, agree to a restructuring package of an existing debt (i.e., debt outstanding), the same would be binding on the remaining creditors. Since Category 1 CDR Scheme covers only standard and sub-standard accounts, which in the opinion of 75 per cent of the creditors by value and 60 per cent of creditors by number, are likely to become performing after introduction of the CDR package, it is expected that all other creditors (i.e., those outside the minimum 75 per cent by value and 60 per cent by number) would be willing to participate in the entire CDR package, including the agreed additional financing.

iii. In order to improve effectiveness of the CDR mechanism a clause may be incorporated in the loan agreements involving consortium / syndicate accounts whereby all creditors, including those which are not members of the CDR mechanism, agree to be bound by the terms of the restructuring package that may be approved under the CDR mechanism, as and when restructuring may become necessary.

iv. One of the most important elements of Debtor-Creditor Agreement would be 'stand still' agreement binding for 90 days, or 180 days by both sides. Under this clause, both the debtor and creditor(s) shall agree to a legally binding 'stand-still' whereby both the parties commit themselves not to take recourse to any other legal action during the 'stand-still' period, this would be necessary for enabling the CDR System to undertake the necessary debt restructuring exercise without any outside intervention, judicial or otherwise. However, the stand-still clause will be applicable only to any civil action either by the borrower or any lender against the other party and will not cover any criminal action. Further, during the stand-still period, outstanding foreign exchange forward contracts, derivative products, etc., can be crystallised, provided the borrower is agreeable to such crystallisation. The borrower will additionally undertake that during the stand-still period the documents will stand extended for the purpose of limitation and also that he will not approach any other authority for any relief and the directors of the borrowing company will not resign from the Board of Directors during the stand-still period.

(d) ***Additional finance***

(i) Additional finance, if any, is to be provided by all creditors of a ‘standard’ or ‘substandard account’ irrespective of whether they are working capital or term creditors, on a pro-rata basis. In case for any internal reason, any creditor (outside the minimum 75 per cent and 60 per cent) does not wish to commit additional financing, that creditor will have an option in accordance with the provisions of (e) below.

(ii) The providers of additional finance, whether existing creditors or new creditors, shall have a preferential claim, to be worked out under the restructuring package, over the providers of existing finance with respect to the cash flows out of recoveries, in respect of the additional exposure.

(e) ***Exit option***

(i) A creditor (outside the minimum 75 per cent and 60 per cent) who for any internal reason does not wish to commit additional finance have an exit option. At the same time, in order to avoid the "free rider" problem, it is necessary to provide some disincentive to the creditor who wishes to exercise this option. Such creditors can either (a) arrange for its share of additional finance to be provided by a new or existing creditor, or (b) agree to the deferment of the first year's interest due to it after the CDR package becomes effective. The first year's deferred interest as mentioned above, without compounding, will be payable along with the last installment of the principal due to the creditor.

(ii) In addition, the exit option would also be available to all lenders within the minimum 75 percent and 60 percent provided the purchaser agrees to abide by restructuring package approved by the Empowered Group. The exiting lenders may be allowed to continue with their existing level of exposure to the borrower provided they tie up with either the existing lenders or fresh lenders taking up their share of additional finance.

(iii) The lenders who wish to exit from the package would have the option to sell their existing share to either the existing lenders or fresh lenders, at an appropriate price, which would be decided mutually between the exiting lender and the taking over lender. The new lenders shall rank on par with the existing lenders for repayment and servicing of the dues since they have taken over the existing dues to the exiting lender.

(iv) In order to bring more flexibility in the exit option, One Time Settlement can also be considered, wherever necessary, as a part of the restructuring package. If an account with any creditor is subjected to One Time Settlement (OTS) by a borrower before its reference to the CDR mechanism, any fulfilled commitments under such OTS may not be reversed under the restructured package. Further payment commitments of the borrower arising out of such OTS may be factored into the restructuring package.

B. Debt Restructuring Mechanism for Small and Medium Enterprises (SMEs)

1.356 Apart from CDR Mechanism, RBI has also prescribed a separate scheme for restructuring of loans availed by Small and Medium Enterprises (SMEs). Unlike in the case of CDR Mechanism, the operational rules of the mechanism have been left to be formulated by the banks concerned. This mechanism will be applicable to all the borrowers which have funded and non-funded outstanding up to Rs.10 crore under multiple/consortium banking arrangement. Major elements of these arrangements are as under:

(i) Under this mechanism, banks may formulate, with the approval of their Board of Directors, a debt restructuring scheme for SMEs within the prudential norms laid down by RBI. Banks may frame different sets of policies for borrowers belonging to different sectors within the SME if they so desire.

(ii) While framing the scheme, banks may ensure that the scheme is simple to comprehend and will, at the minimum, include parameters indicated in these guidelines.

(iii) The main plank of the scheme is that the bank with the maximum outstanding may work out the restructuring package, along with the bank having the second largest share.

(iv) Banks should work out the restructuring package and implement the same within a maximum period of 90 days from date of receipt of requests.

(v) The SME Debt Restructuring Mechanism will be available to all borrowers engaged in any type of activity.

(vi) Banks may review the progress in rehabilitation and restructuring of SMEs accounts on a quarterly basis and keep the Board informed.

Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SRFAESI), 2002

Securitisation of Standard Assets

1.357 After the enactment of the Securitization and Reconstruction of Financial Asset and Enforcement of Security Interest Act, 2002, banks have got significant power to possess the securities of defaulting borrower. Banks can now take possession of the assets from borrower and convert the same in Security Receipts. In the process of securitisation, assets are sold to a bankruptcy remote special purpose vehicle (SPV) in return for an immediate cash payment. The cash flow from the underlying pool of assets is used to service the securities issued by the SPV. Securitisation thus follows a two-stage process. In the first stage, there is sale of single asset or pooling and sale of pool of assets to a 'bankruptcy remote' special purpose vehicle (SPV) in return for an immediate cash payment and in the second stage repackaging and selling the security interests representing claims on incoming cash flows from the asset or pool of assets to third party investors by issuance of tradable debt securities. Thus, the non-performing asset of the banker is taken out of the balance sheet of the bank and converted into Security Receipts.

1.358 Securitised asset should be derecognised in the books of the bank, if and only if, either by a single transaction or by a series of transactions taken as a whole, the bank loses control of the contractual rights that comprise the securitised asset. The bank loses such control if it surrenders the rights to benefits specified in the contract. Determining whether the bank has lost control of the securitised asset depends both on the bank’s position and that of the SPV. Consequently, if the position of either the bank or the SPV indicates that the bank has retained control, the bank should not remove the securitised asset from its balance sheet.

1.359 For enabling the transferred assets to be removed from the balance sheet of the originator in a securitisation structure, the isolation of assets or ‘true sale’ from the originator to the SPV is an essential prerequisite. In case the assets are transferred to the SPV by the originator in full compliance with all the conditions of true sale, the transfer would be treated as a 'true sale' and originator will not be required to maintain any capital against the value of assets so transferred from the date of such transfer. The effective date of such transfer should be expressly indicated in the subsisting agreement. In the event of the transferred assets not meeting the "true-sale" criteria the assets would be deemed to be on the balance sheet of the originator and accordingly the originator would be required to maintain capital for those assets.

1.360 These Security Receipts are treated as non-SLR security (Investment) in the books of subscribing bank as per RBI guidelines. In the absence of ready market for the Security Receipts, the subscribing bank needs to value Security Receipts on the basis of Net Asset Value to be declared by Securitising Company on a quarterly basis.

Further, when a bank sells the non-performing assets to securitising company, if the sale value of assets is less than the Net book Value, i.e., books value of advances less provisions, the shortfall needs to be debited to Profit & Loss Account. However, in case the sale value being higher, excess provision can not be reversed and is kept to meet the shortfall/ loss on account of other non-performing assets.

Setting up of Central Electronic Registry under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002

1.361 Pursuant to the announcement made by the Finance Minister in the budget speech for 2011-12, Government of India, Ministry of Finance notified the establishment of the Central Registry. The objective of setting up of Central Registry is to prevent frauds in loan cases involving multiple lending from different banks on the same immovable property. This Registry has become operational on March 31, 2011. The Central Registry of Securitisation Asset Reconstruction and Security Interest of India (CERSAI), a Government Company licensed under section 25 of the Companies Act 1956 has been incorporated for the purpose of operating and maintaining the Central Registry under the provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act).

2. It may be noted that initially transactions relating to securitization and reconstruction of financial assets and those relating to mortgage by deposit of title deeds to secure any loan or advances granted by banks and financial institutions, as defined under the SARFAESI Act, are to be registered in the Central Registry. The records maintained by the Central Registry will be available for search by any lender or any other person desirous of dealing with the property. Availability of such records would prevent frauds involving multiple lending against the security of same property as well as fraudulent sale of property without disclosing the security interest over such property. It may be noted that under the provisions of Section 23 of the SARFAESI Act, particulars of any charge creating security interest over property is required to be filed with the Registry within 30 days from the date of creation.[Ref. Circular No. DBOD.Leg. No. BC. 86/09.08.011/2010-11 Dated April 21, 2011 on “Setting up of Central Electronic Registry under the SARFESAI Act, 2002”]

Projects Under Implementation

1.362 For all projects financed by the FIs/ banks after 28th May, 2002, the date of completion of the project should be clearly spelt out at the time of financial closure of the project.

Project Loans

1.363 There are occasions when the completion of projects is delayed for legal and other extraneous reasons like delays in Government approvals etc. All these factors, which are beyond the control of the promoters, may lead to delay in project implementation and involve restructuring / reschedulement of loans by banks. Accordingly, the following asset classification norms would apply to the project loans before commencement of commercial operations. These guidelines will, however, not be applicable to restructuring of Advances classified as Commercial Real Estate exposures; Advances classified as Capital Market exposure; and Consumer and Personal Advances which will continue to be dealt with in terms of the extant provisions..

1.364 For this purpose, all project loans have been divided into the following two categories:

a. Project Loans for infrastructure sector

b. Project Loans for non-infrastructure sector

'Project Loan' would mean any term loan which has been extended for the purpose of setting up of an economic venture. Banks must fix a Date of Commencement of Commercial Operations (DCCO) for all project loans at the time of sanction of the loan / financial closure (in the case of multiple banking or consortium arrangements).

Project Loans for Infrastructure Sector

1.365(i) A loan for an infrastructure project will be classified as NPA during any time before commencement of commercial operations as per record of recovery (90 days overdue), unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (v) below.

(ii) A loan for an infrastructure project will be classified as NPA if it fails to commence commercial operations within two years from the original DCCO, even if it is regular as per record of recovery, unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (v) below.

(iii) If a project loan classified as 'standard asset' is restructured any time during the period up to two years from the original date of commencement of commercial operations (DCCO), in accordance with the provisions of Part B of this Master Circular, it can be retained as a standard asset if the fresh DCCO is fixed within the following limits, and further provided the account continues to be serviced as per the restructured terms.

(a) Infrastructure Projects involving court cases

Up to another 2 years (beyond the existing extended period of 2 years i.e total extension of 4 years), in case the reason for extension of date of commencement of production is arbitration proceedings or a court case.

(b) Infrastructure Projects delayed for other reasons beyond the control of promoters

Up to another 1 year (beyond the existing extended period of 2 years i.e. total extension of 3 years), in other than court cases.

(iv) It is re-iterated that the dispensation in para 4.2.15.3 (iii) is subject to adherence to the provisions regarding restructuring of accounts as contained in the Master Circular which would inter alia require that the application for restructuring should be received before the expiry of period of two years from the original DCCO and when the account is still standard as per record of recovery.

1.366 The other conditions applicable would be:

a. In cases where there is moratorium for payment of interest, banks should not book income on accrual basis beyond two years from the original DCCO, considering the high risk involved in such restructured accounts.

b. Banks should maintain provisions on such accounts as long as these are classified as standard assets as under:

Until two years from the original DCCO	0.40%
During the third and the fourth years after the original DCCO.	2.00%

(v) For the purpose of these guidelines, mere extension of DCCO will also be treated as restructuring even if all other terms and conditions remain the same.

Project Loans for Non-Infrastructure Sector

1.367(i) A loan for a non-infrastructure project will be classified as NPA during any time before commencement of commercial operations as per record of recovery (90 days overdue), unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (v) below.

(ii) A loan for a non-infrastructure project will be classified as NPA if it fails to commence commercial operations within six months from the original DCCO, even if is regular as per record of recovery, unless it is restructured and becomes eligible for classification as 'standard asset' in terms of paras (iii) to (v) below.

(iii) In case of non-infrastructure projects, if the delay in commencement of commercial operations extends beyond the period of six months from the date of completion as determined at the time of financial closure, banks can prescribe a fresh DCCO, and retain the "standard" classification by undertaking restructuring of accounts in accordance with the provisions contained in this Master Circular, provided the fresh DCCO does not extend beyond a period of twelve months from the original DCCO. This would among others also imply that the restructuring application is received before the expiry of six months from the original DCCO, and when the account is still "standard" as per the record of recovery.

1.368 The other conditions applicable would be:

a. In cases where there is moratorium for payment of interest, banks should not book income on accrual basis beyond six months from the original DCCO, considering the high risk involved in such restructured accounts.

b. Banks should maintain provisions on such accounts as long as these are classified as standard assets as under :

Until the first six months from the original DCCO	0.40%
During the next six months	2.00%

(iv) For this purpose, mere extension of DCCO will also be treated as restructuring even if all other terms and conditions remain the same.

Other Issues

1.369(i) All other aspects of restructuring of project loans before commencement of commercial operations would be governed by the provisions of Part B of Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances. Restructuring of project loans after commencement of commercial operations will also be governed by these instructions.

(ii) Any change in the repayment schedule of a project loan caused due to an increase in the project outlay on account of increase in scope and size of the project, would not be treated as restructuring if:

(a) The increase in scope and size of the project takes place before commencement of commercial operations of the existing project.

(b) The rise in cost excluding any cost-overrun in respect of the original project is 25% or more of the original outlay.

(c) The bank re-assesses the viability of the project before approving the enhancement of scope and fixing a fresh DCCP.

(d) On re-rating, (if already rated) the new rating is not below the previous rating by more than one notch.

(iii) These guidelines would apply to those cases where the modification to terms of existing loans, as indicated above, are approved by banks from the date of this circular.

Income recognition

1.370 (i) Banks may recognise income on accrual basis in respect of the projects under implementation, which are classified as 'standard'.

(ii) Banks should not recognise income on accrual basis in respect of the projects under implementation which are classified as a 'substandard' asset. Banks may recognise income in such accounts only on realisation on cash basis. Consequently, banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognised as income in the previous year(s). As regards the regulatory treatment of 'funded interest' recognised as income and 'conversion into equity, debentures or any other instrument' banks should adopt the following:

a) Funded Interest: Income recognition in respect of the NPAs, regardless of whether these are or are not subjected to restructuring/ rescheduling/ renegotiation of terms of the loan agreement, should be done strictly on cash basis, only on realisation and not if the amount of interest overdue has been funded. If, however, the amount of funded interest is recognised as income, a provision for an equal amount should also be made simultaneously. In other words, any funding of interest in respect of NPAs, if recognised as income, should be fully provided for.

b) Conversion into equity, debentures or any other instrument: The amount outstanding converted into other instruments would normally comprise principal and the interest components. If the amount of interest dues is converted into equity or any other instrument, and income is recognised in consequence, full provision should be made for the amount of income so recognised to offset the effect of such income recognition. Such provision would be in addition to the amount of provision that may be necessary for the depreciation in the value of the equity or other instruments, as per the investment valuation norms. However, if the conversion of interest is into equity which is quoted, interest income can be recognised at market value of equity, as on the date of conversion, not exceeding the amount of interest converted to equity. Such equity must thereafter be classified in the "available for sale" category and valued at lower of cost or market value. In case of conversion of principal and /or interest in respect of NPAs into debentures, such debentures should be treated as NPA, *ab initio*, in the same asset classification as was applicable to loan just before conversion and provision made as per norms. This norm would also apply to zero coupon bonds or other instruments which seek to defer the liability of the issuer. On such debentures, income should be recognised only on realization basis. The income in respect of unrealised interest which is converted into debentures or any other fixed maturity instrument should be recognized only on redemption of such instrument. Subject to the above, the equity shares or other instruments arising from conversion of the principal amount of loan would also be subject to the usual prudential valuation norms as applicable to such instruments.

Provisioning

1.371 While there will be no change in the extant norms on provisioning for NPAs, banks which are already holding provisions against some of the accounts, which may now be classified as 'standard', shall continue to hold the provisions and shall not reverse the same.

Provisioning Norms

Normal provisions

1.372 Banks will hold provision against these advances as per the existing provisioning norms.

Income Recognition

1.373 The banks may recognise income on accrual basis in respect of the three categories of projects under implementation which are classified as 'standard'. RBI, however, prohibits banks from recognising income on accrual basis in respect of the above three categories of projects under implementation which are classified as a 'substandard' asset. Banks may recognise income in such accounts only on realisation on cash basis. However, in case of uncertainties related to such income, members should consider the compliance with revenue recognition norms explained in AS 9, Revenue Recognition

Reserve for Exchange Rate Fluctuations Account (RERFA)

1.374 When exchange rate movements of Indian rupee turn adverse, the outstanding amount of foreign currency denominated loans (where actual disbursement was made in Indian Rupee) which become overdue goes up correspondingly, with its attendant implications of provisioning requirements. Such assets should not normally be revalued. In case such assets need to be revalued as per requirement of accounting practices or for any other requirement, the following procedure may be adopted:

- The loss on revaluation of assets has to be booked in the bank's Profit & Loss Account.
- Besides the provisioning requirement as per Asset Classification, banks should treat the full amount of the Revaluation Gain relating to the corresponding assets, if any, on account of Foreign Exchange Fluctuation as provision against the particular assets.

Provisioning For Country Risk

1.375 Banks are required to make provisions, with effect from the year ending 31 March 2003, on the net funded country exposures on a graded scale ranging from 0.25 to 100 percent according to the risk categories mentioned below. To begin with, banks are required to make provisions as per the following schedule:

Risk Category	*ECGC Classification*	*Provisioning requirement (per cent)*
Insignificant	A1	0.25
Low	A2	0.25
Moderate	B1	5
High	B2	20
Very high	C1	25
Restricted	C2	100
Off-credit	D	100

1.376 Banks are required to make provision for country risk in respect of a country where its net funded exposure is one per cent or more of its total assets. The provision for country risk shall be in addition to the provisions required to be held according to the asset classification status of the asset. In the case of 'loss assets' and 'doubtful assets', provision held, including provision held for country risk, may not exceed 100% of the outstanding. Banks may not make any provision for 'home country' exposures i.e. exposure to India. The exposures of foreign branches of Indian banks to the host country should be included. Foreign banks shall compute the country exposures of their Indian branches and shall hold appropriate provisions in their Indian books. However, their exposures to India will be excluded. Banks may make a lower level of provisioning (say 25% of the requirement) in respect of short-term exposures (i.e. exposures with contractual maturity of less than 180 days).

1.377 Provisioning norms for sale of financial assets to Securitisation Company (SC) / Reconstruction company (RC) –

(i) When a bank / FI sells its financial assets to SC/ RC, on transfer the same will be removed from its books.

(ii) If the sale of financial assets to SC/RC, is at a price below the net book value (NBV) (i.e. book value less provisions held), the shortfall should be debited to the profit and loss account of that year.

(iii) If the sale is for a value higher than the NBV, **the excess provision** will not be reversed but will be utilised to meet the shortfall/loss on account of sale of other financial assets to SC/RC.

(iv) When banks/ FIs invest in the security receipts/ pass-through certificates issued by SC/RC in respect of the financial assets sold by them to the SC/RC, the sale shall be recognised in books of the banks / FIs at the lower of:

- the redemption value of the security receipts/ pass-through certificates, and
- the NBV of the financial asset.

The above investment should be carried in the books of the bank / FI at the price as determined above until its sale or realization, and on such sale or realization, the loss or gain must be dealt with in the same manner as at (ii) and (iii) above.

Other Aspects

1.378 Certain other important aspects of the guidelines relating to provisioning are discussed below.

Floating Provisions

Principle for Creation and Utilisation of Floating Provisions by Banks

1.379 RBI mandates banks to hold floating provisions in respect of “Advances” as well as “Investments” separately. The Master Circular of July 2, 2012 on Income Recognition, Asset Classification and Provisioning Pertaining to Advances, requires the Board of Directors of banks to lay down a policy regarding the level to which floating provisions can be created. The floating provisions should not be used for making specific provisions as per the extant prudential guidelines in respect of nonperforming assets or for making regulatory provisions for standard assets. The floating provisions can be used only for contingencies under extraordinary circumstances for making specific provisions in impaired accounts after obtaining board’s approval and with prior permission of RBI. The boards of the banks should lay down an approved policy as to what circumstances would be considered extraordinary.

1.380 RBI has clarified that the extra-ordinary circumstances refer to losses which do not arise in the normal course of business and are exceptional and non-recurring in nature. These extra-ordinary circumstances could broadly fall under three categories *viz*.,

- *General* - situations where bank is put unexpectedly to loss due to events such as civil unrest or collapse of currency in a country. Natural calamities and pandemics may also be included in the general category.
- *Market* - includes events such as a general melt down in the markets, which affects the entire financial system.
- *Credit* - Among the credit category, only exceptional credit losses are

to be considered as an extra-ordinary circumstance.

1.381 In terms of the Agricultural Debt Waiver and Debt Relief Scheme, 2008, lending institutions shall neither claim from the Central Government, nor recover from the farmer, interest in excess of the principal amount, unapplied interest, penal interest, legal charges, inspection charges and miscellaneous charges, etc. All such interest / charges will be borne by the lending institutions. In view of the extraordinary circumstances in which the banks are required to bear such interest / charges, banks are allowed, as a one time measure, to utilise, at their discretion, the Floating Provisions held for 'advances' portfolio, only to the extent of meeting the interest / charges referred to above.

1.382 Floating provisions cannot be reversed by credit to the profit and loss account. They can only be utilised for making specific provisions in extraordinary circumstances as mentioned above. Until such utilisation, these provisions can be netted off from gross NPAs to arrive at disclosure of net NPAs. Alternatively, they can be treated as part of Tier II capital within the overall ceiling of 1.25 % of total risk weighted assets.

1.383 Banks should make comprehensive disclosures on floating provisions in the “notes on accounts” to the balance sheet on (a) opening balance in the floating provisions account, (b) the quantum of floating provisions made in the accounting year, (c) purpose and amount of draw down made during the accounting year, and (d) closing balance in the floating provisions account.

1.384 A bank may voluntarily make specific provisions for advances at rates which are higher than the rates prescribed under existing regulations, to provide for estimated actual loss in collectible amount, provided such higher rates are approved by the Board of Directors and consistently adopted from year to year. Such additional provisions are not to be considered as floating provisions.

Write-off of NPAs

1.385 The banks should either make full provision as per the guidelines or writeoff the advances and claim the tax benefits as are applicable, by evolving appropriate methodology in consultation with their auditors/tax consultants. Recoveries made in such accounts should be offered for tax purposes as per the rules. Banks may write-off advances at Head Office level, even though the advances are still outstanding in the branch books. At the branch level, provision requirement as per classification norms shall be made and in respect of loss assets 100% provision shall be made. There can be partial write off relating to the borrower's account in head office.

Interest Suspense Account

1.386 As mentioned earlier, the guidelines prohibit recognition of income on non-performing assets until it is actually realised. In order to comply with guidelines while ensuring at the same time that legal remedies against defaulting borrowers are not adversely affected and that proper control is exercised over non-performing advances, many banks adopted the practice of recording interest on non-performing advances to a separate account which is usually styled as 'Interest Suspense Account'. The balance in this account represents interest on non-performing advances debited to the respective borrowers' accounts in accordance with the terms of the agreement but not recognised as income. For purposes of balance sheet presentation, the gross advances portfolio is arrived at after deducting the credit balance in Interest Suspense Account from the total advances as per the ledgers. When the advances are identified as NPAs and banks chooses not to further debit the borrower in the manner aforesaid, the interest on contractual basis is to be computed and recorded as unapplied interest in the memoranda records. The amounts held in Interest Suspense Account should not be reckoned as part of provisions for the purpose of computing the provision for NPAs. Amounts lying in the Interest Suspense Account should be deducted from the advances concerned and provisions should be made on the balances remaining after such deduction.

Guidelines on Sale/Purchase of NPAs

1.387 The Master Circular on Advances require the Board of Directors of the banks to lay down policy in respect of the aspects relating to sale/ purchase of NPAs, including:

(a) Non-performing financial assets that may be purchased/ sold;

(b) Norms and procedure for purchase/ sale of such financial assets;

(c) Valuation procedure to be followed to ensure that the economic value of financial assets is reasonably estimated based on the estimated cash flows arising out of repayments and recovery prospects;

(d) Delegation of powers of various functionaries for taking decision on the purchase/ sale of the financial assets etc.; and

(e) Accounting policy.

1.388 RBI also casts a responsibility on the Board to satisfy itself that the bank has adequate skills to purchase non-performing financial assets and deal with them in an efficient manner which will result in value addition to the bank. The Board also needs to ensure that appropriate systems and procedures are in place to effectively address the risks that a purchasing bank would assume while engaging in this activity.

1.389 Banks should, while selling NPAs, work out the net present value of the estimated cash flows associated with the realisable value of the available securities net of the cost of realisation. The sale price should generally not be lower than the net present value so arrived.

1.390 The estimated cash flows are normally expected to be realised within a period of three years and at least 10% of the estimated cash flows should be realised in the first year and at least 5% in each half year thereafter, subject to full recovery within three years.

1.391 A bank may purchase/sell non-performing financial assets from/to other banks only on 'without recourse' basis, i.e., the entire credit risk associated with the non-performing financial assets should be transferred to the purchasing bank/Asset Recovery Company (ARC). The selling bank should ensure that the effect of the sale of the financial assets should be that the asset is taken off its books and after the sale there should not be any known liability devolving on the selling bank.

1.392 Banks should ensure that subsequent to sale of the non-performing financial assets to other banks,/ARC. they do not have any involvement with reference to assets sold and do not assume operational, legal or any other type of risks relating to the financial assets sold. Consequently, the specific financial asset should not enjoy the support of credit enhancements / liquidity facilities in any form or manner.

1.393 Each bank should make its own assessment of the value offered by the purchasing bank for the financial asset and decide whether to accept or reject the offer.

1.394 Under no circumstances can a sale to other banks be made at a contingent price whereby in the event of shortfall in the realisation by the purchasing banks, the selling banks would have to bear a part of the shortfall.

1.395 A non-performing asset in the books of a bank is eligible for sale to other banks only if it has remained a nonperforming asset for at least two years in the books of the selling bank.

1.396 Further, NPAs can be sold to other banks only on cash basis. The entire sale consideration should be received upfront and the asset can be taken out of the books of the selling bank only on receipt of the entire sale consideration.

1.397 A non-performing financial asset should be held by the purchasing bank in its books at least for a period of 15 months before it is sold to other banks.

Banks should not sell such assets back to the bank, which had sold the NPFA.

1.398 Banks are also permitted to sell/buy homogeneous pool within retail non-performing financial assets, on a portfolio basis provided each of the non-performing financial assets of the pool has remained as non-performing financial asset for at least 2 years in the books of the selling bank. The pool of assets would be treated as a single asset in the books of the purchasing bank.

1.399 The selling bank should pursue the staff accountability aspects as per the existing instructions in respect of the non-performing assets sold to other banks.

1.400 Prudential norms for banks for the purchase/sale transactions issued by RBI, from time to time, should be adhered to.

1.401 As per the Master Circular on Prudential Norms on Advances dated July 2, 2012, if the sale is in respect of Standard Asset and the sale consideration is higher than the book value, the excess provisions may be credited to Profit and Loss Account. (b) Excess provisions which arise on sale of NPAs can be admitted as Tier II capital subject to the overall ceiling of 1.25% of total Risk Weighted Assets. Accordingly, these excess provisions that arise on sale of NPAs would be eligible for Tier II status.

Asset Classification Norms

1.402 The asset classification norms for sale/purchase of NPAs are as follows:

(i) The non-performing financial asset purchased, may be classified as 'standard' in the books of the purchasing bank for a period of 90 days from the date of purchase. Thereafter, the asset classification status of the financial asset purchased, shall be determined by the record of recovery in the books of the purchasing bank with reference to cash flows estimated while purchasing the asset which should be in compliance with requirements as discussed in preceding paragraphs.

(ii) The asset classification status of an existing exposure (other than purchased financial asset) to the same obligor in the books of the purchasing bank will continue to be governed by the record of recovery of that exposure and hence may be different.

(iii) Where the purchase/sale does not satisfy any of the prudential requirements prescribed in these guidelines the asset classification status of the financial asset in the books of the purchasing bank at the time of purchase shall be the same as in the books of the selling bank. Thereafter, the asset classification status will continue to be determined with reference to the date of NPA in the selling bank.

(iv) Any restructure/reschedule/rephrase of the repayment schedule or the estimated cash flow of the non-performing financial asset by the purchasing bank shall render the account as a non-performing asset.

Provisioning Norms

Books of Selling Bank

1.403 The provisioning norms for books of selling bank are as under:

(i) When a bank sells its nonperforming financial assets to other banks, the same will be removed from its books on transfer.

(ii) If the sale is at a price below the net book value (NBV) (i.e., book value less provisions held), the shortfall should be debited to the profit and loss account of that year.

(iii) If the sale is for a value higher than the NBV, the excess provision shall not be reversed but will be utilised to meet the shortfall/ loss on account of sale of other non performing financial assets.

Books of Purchasing Bank

1.404 The provisioning norms for books of purchasing bank are as under:

The asset shall attract provisioning requirement appropriate to its asset classification status in the books of the purchasing bank.

Accounting of Recoveries

1.405 Any recovery in respect of a non-performing asset purchased from other banks should first be adjusted against its acquisition cost. Recoveries in excess of the acquisition cost can be recognised as profit.

Capital Adequacy

1.406 For the purpose of capital adequacy, banks should assign 100% risk weights to the non-performing financial assets purchased from other banks. In case the nonperforming asset purchased is an investment, then it would attract capital charge for market risks also.

Exposure Norms

1.407 The purchasing bank will reckon exposure on the obligor of the specific financial asset. Hence these banks should ensure compliance with the prudential credit exposure ceilings (both single and group) after reckoning the exposures to the obligors arising on account of the purchase.

Disclosure Requirements

1.408 Banks which purchase nonperforming financial assets from other banks shall be required to make the following disclosures in the Notes on Accounts to their Balance sheets:

A. Details of nonperforming financial assets purchased: (Amounts in Rupees crore)

1. (a) No. of accounts purchased during the year

   (b) Aggregate outstanding

2. (a) Of these, number of accounts restructured during the year

   (b) Aggregate outstanding

B. Details of nonperforming financial assets sold: (Amounts in Rupees crore)

1. No. of accounts sold

2. Aggregate outstanding

3. Aggregate consideration received

C. The purchasing bank shall furnish all relevant reports to RBI, Credit Information Company which has obtained Certificate of Registration from RBI and of which the bank is a member etc. in respect of the nonperforming financial assets purchased by it.

Auditor's Report in Case of Bank Borrowers

1.409 The RBI vide its circular number DBOD.No. CAS(COD)BC.146/27-77 dated December 22, 1977 had prescribed that all borrowers having credit limit of Rs.10 lakh and above from the banking system should get their annual accounts audited by chartered accountants. The RBI vide its circular DBOD.No.BP.BC. 33/21.04.018/2002-03 dated October 21, 2002 has authorised the Board of Directors of banks to fix a suitable cut off limit with reference to the borrowing entity's overall exposure on the banking system, over which audit of accounts of borrower by chartered accountants would be mandatory.

Audit Approach and Procedures

1.410 Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.

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

a. Amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.

b. Advances represent amount due to the bank.

c. Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.

d. There are no unrecorded advances.

e. The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.

f. The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.

g. Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

1.412 The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

- examining the validity of the recorded amounts;
- examining loan documentation;
- reviewing the operation of the accounts;
- examining the existence, enforceability and valuation of the security;
- checking compliance with RBI norms including appropriate classification and provisioning; and
- carrying out appropriate analytical procedures.

1.413 In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis. The accounts identified to be problem accounts however need to be examined in detail unless the amount involved is insignificant. The extent of sample checking would also depend on the auditor's assessment of efficacy of internal controls. What constitutes a 'large advance' would need to be determined in the context of volume of operations of the branch. As a general rule, however, an advance may be considered to be a large advance if the year-end balance is in excess of Rs.2 crore or 5% of the aggregate year-end advances of the branch, whichever is less.

1.414 Advances which are sanctioned during the year or which are adversely commented by RBI inspection team, concurrent auditors, bank's internal inspection, etc. should generally be included in the auditor's review.

Evaluation of Internal Controls over Advances

1.415 The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, *inter alia*, the following:

- The bank should make an advance only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank. The sanction for an advance should specify, among other things, the limit of borrowing, nature of security, margin to be kept, interest, terms of repayment etc. It also needs to be ensured that the loans sanctioned are as per the Loan Policy of the bank and adhere to the regulatory (RBI) norms unless a specific exemption is taken in this regard.
- All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- The compliance with the terms of sanction and end use of funds should be ensured.
- Sufficient margin as specified in the sanction letter should be kept against securities taken so as to cover for any decline in the value thereof. The availability of sufficient margin needs to be ensured at regular intervals.
- If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and the effective control of such securities be retained as a part of documentation.
- All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.
- In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipt. The godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.
- Surprise checks should be made in respect of hypothecated goods not in the physical possession of the bank.
- As soon as any increase or decrease takes place in the securities or their value, proper entries should be made in the Drawing Power Book and Daily Balance Book. These entries should be checked by an officer.

- The accounts should be kept within both the drawing power and the sanctioned limit.
- All the accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the controlling authority regularly.
- The operation of each advance account should be reviewed at least once a year, and at more frequent intervals in the case of large advances.

Computation of Drawing Power/Limits in respect of stocks hypothecated

1.416 In respect of credit facilities against hypothecation of stocks (inventories) being the primary security, the Bank's system of appraisal for determining the maximum permissible finance to borrowers and fixing of limits, inter alia, should generally take into consideration the level of sundry creditors (comprising 'unpaid for' stocks). The sanction is expected to be in tune with the appraisal so made. While sanctioning such credit facility, the bank is expected to stipulate in the documents, that for computing the Drawing Power, the value of declared stocks is to be considered only net of the stipulated margin; and that the declared stocks shall not cover the borrower's liability outstanding by way of unpaid for stocks (whether in the form of sundry creditors for purchases or covered by LCs/ guarantees/ co-acceptances). The Bank should also insist on such information from borrowers.

1.417 The Reserve Bank of India has been issuing guidelines on the treatment of unpaid stocks while arriving at the drawing power available in the borrowal accounts. The thrust of the guidelines is avoidance of double financing on the unpaid stocks, if such stocks are taken as eligible for computation of drawing power.

1.418 The matter having been re-examined by Reserve Bank of India, vide directive No. IECD.No.32/08.10.01/92-93 dated 28th April, 1993 had advised as under:-

- Banks may continue permitting drawing for working capital purpose based on the statements received under the quarterly / monthly information system depending on the regularity / reliability of such information or on the basis of monthly stock statements.
- Banks should ensure the compliance with the Selective Credit Control directives in force in respect of financing sensitive commodities.

1.419 By way of explanation it was added that maximum permissible Bank finance which is arrived at on the basis of the need based build-up of current assets and current liabilities are already adjusted to the extent of trade credits estimated/ projected by the borrowers for the purpose of re-aligning the above mentioned build-up of the current assets. In the circumstances, if the data revealed by the quarterly/ monthly statements do not indicate any divergence from the estimated/projected levels of the sundry creditors, there is no need to separately deduct the unpaid stocks from the value of the stocks as mentioned in the stock statements. The relevant statement for the purpose will be QIS- 1 on the basis of which the quarterly operative limits are fixed. However, if the levels of the sundry creditors as mentioned in QIS-1 exceed the value accepted at the time of appraisal of the credit requirements, the drawing power will have to be adjusted to the extent of such excess amount i.e. in this case the value of unpaid –stocks will be required to be deducted from the gross value of stocks as furnished in the stock statements for the purpose of arriving at the drawing power.

1.420 The auditor should review the policy of the bank in this regard for any inherent weakness in the credit system, where the stringency in appraisal, is relaxed while sanctioning the advances, having consequential effect on monitoring and supervision, and may have effect on the classification status of the Borrower, where the drawing power falls short of the outstanding.

1.421 Banks usually consider credit facilities by way of Hypothecation of stocks and a charge on the sundry debtors. The Drawing Power is required to be computed net of the stipulated margin, based on and applied to the total eligible current assets comprising:

- Net Value of Stock as stated above, and
- Net Value of Debtors (i.e. eligible Trade Debtors Less Bills Discounted with Bank). The bank usually prescribes the conditions as to what comprise eligible trade debtors, and stipulates the period for debts being considered as current and good on which the margin is computed.

1.422 For the purposes of classification of advances, the computation of drawing power based on realistic value of hypothecated stocks (net of unpaid for stocks, whether covered by LCs/ Guarantees/ Co-acceptances or otherwise) and margin as stipulated, is vital, particularly in cases of default, and in border-line cases where the health status of borrowers may be in question, to gauge slippages.

1.423 Due care is required to be exercised by the auditor in case of

- Documents retained in original at centralised offices where these are not available at the branches that are advised the figures of drawing power; and
- consortium advances, where the bank, not being the leader, gets the related figures of drawing power from the leader bank, without the related evidence of computation or appropriateness of the drawing power.

The auditor needs to look into this aspect to ensure that there is no slippage of the account into NPA classification.

Long Form Audit Report

1.424 The auditor has to comment on various specific issues as mentioned in the Long Form Audit Report of the bank. While evaluating the efficacy of internal controls over advances, the auditor should particularly examine those aspects on which he is required to comment in his long form audit report. Thus, he should examine, *inter alia*, whether the loan applications are complete and in prescribed form; procedural instructions regarding grant/ renewal/enhancement of facilities have been complied with; sanctions are within delegated authority and disbursements are as per terms of the sanction; documentation is complete; and supervision is timely, effective and as per prescribed guidelines. The auditor can gather the requisite evidence by examining relevant documents (such as loan application forms, supporting documentation, sanctions, security documents, etc.) and by obtaining information and explanations from the branch management in appropriate cases. The detailed directives / guidance with regard to such issues are given in a separate Chapter on Long Form Audit Report. The auditors must familiarise themselves with those issues and guidance relating to the same and should cover the same during the regular course of audit of advances.

Examining the Validity of Recorded Amounts

1.425 The auditor should ascertain the status of balancing of subsidiary ledgers relating to advances. The total of balances in the subsidiary ledgers should agree with the control accounts in the General Ledger. The auditor should also tally the total of the statement of advances with the balances as per general ledger/ subsidiary ledgers. He should also cross-check the balances of the advances selected for examination as listed in the statement of advances with the balances in the relevant advance accounts in the subsidiary ledgers. Banks often obtain balance confirmation statements from borrowers periodically. Such statements have a dual advantage in preventing disputes by the customer and extending the period of limitation by reference to the date of confirmation. Wherever available, such confirmations may be seen.

1.426 These days most of the banks have their 'advances' statements generated through the system. The auditor should ensure that the fields which system copies from last year are the same and he should take extra care in relation with the date of NPA and date of becoming doubtful asset as these facts have great bearing on the provisioning. The auditor should obtain audit trail from the bank to verify whether there are any changes or not.

Examination of Loan Documents

1.427 As indicated earlier, the documents relating to advances would be affected by the legal status of the borrower and the nature of security. Thus, where the borrower is a company, loan documents would include certificate of incorporation, memorandum and articles of association, certificate of commencement of business (in the case of public limited companies), resolution of board of directors, and resolution of shareholders [in cases covered by section 293(1)(d) of the Companies Act, 1956], etc. Where the borrower is a partnership firm, loan documents would include copy of partnership deed. Where the security is in the form of mortgage, apart from mortgage deed (in the case of English Mortgage) or letter of intent to create mortgage (in the case of Equitable Mortgage), the evidence of registration of the charge with the Registrar of Companies would also form part of loan documentation if the borrower is a company. Each bank has its own set of rules regarding the documents to be obtained from various types of borrowers and in respect of different kinds of securities. The formats of many of the documents are also prescribed. The auditor should evaluate the adequacy of the loan documents in the context of the rules framed by the bank in this regard.

Centralisation and location of original loan documents at Loan Processing Centres

1.428 Of late, there is an increasing propensity in banks to process the loans and advances, including appraisal, sanction, documentation, initial disbursements, etc. at Loan Processing Centres/Offices (by whatever name called) and to execute and physically hold all the documents at such locations, that may not be in very close proximity to the branch, where the borrowal accounts are maintained/serviced. The Branch places reliance only on the Sanction letters, on the presumption that all the required legal and documentation formalities are correct and complete at the centralized location.

1.429 In the absence of the original documents (or even authenticated copies thereof) on an updated basis, the auditor would need to request the management for the files identified for examination by him. The branch auditor must be satisfied on the authenticity and terms of the sanction (in case the sanction letters are only computer generated but not authenticated), the completeness of the records, duly updated, for all accounts where the sanction was so conveyed; and further whether the number of accounts and amounts recorded at such centres tally with the corresponding data at the branch. It needs to be confirmed as to whether there are any cheques held by such centres that remain unbanked affecting the borrowal account balance. Reference must also be made to any adverse observations in the related monitoring/supervisory report on the documentation aspects at the centralized location.

Review of Operation of Account

1.430 The auditor should review the operation of the advance accounts. In doing so, an intelligent scrutiny of the operation of the account should be carried out to see that the limit is not generally exceeded; that the account is not becoming stagnant; that the customer is not drawing against deposits which are not free from lien; that the account is not window-dressed by running down overdrafts at the year end and again drawing further advances in the new year, etc.

1.431 The auditor should also examine whether there is a healthy turnover in the account. It should be seen that the frequency and the amounts of credits in the account are commensurate with the sanctioned limit and the nature and volume of business of the borrower. Any unusual items in the account should be carefully examined by the auditor. If the auditor's review indicates any unhealthy trends, the account should be further examined. The auditor's examination should also cover transactions in the post-balance sheet date period. Large transactions in major accounts particularly as at the year-end may be looked into, to identify any irregularities in these accounts. A written note/explanation may be obtained from the management as regards any major irregularities which may have a bearing on his report.

1.432 The auditor may also review the following to assess the recoverability of advances:

(a) Periodic statements submitted by the borrowers indicating the extent of compliance with terms and conditions.

(b) Latest financial statements of borrowers.

(c) Reports on inspection of security.

(d) Auditors' reports in the case of borrowers enjoying aggregate credit limits of Rs. 10 lakh or above for working capital from the banking system.

1.433 The auditor should satisfy himself that interest is being charged on all performing accounts regularly. He should compare the rate of interest with the agreement and the sanction and with the credit rating reports where the rate of interest is linked to credit rating. In case the interest rate is to be revised based on the changes in PLR / BPLR/Base Rate of the bank, it needs to be ensured that the rate of interest to be charged form the borrower is suitably revised as and when there are changes in PLR/BPLR/Base Rate. Calculation of interest should be test-checked. The auditor should examine that interest not received on any account, which is a non-performing asset as per the guidelines of the RBI, has not been recognised as income. It may be noted that interest accrued but not due on advances does not form part of advances.

1.434 The penal interest in case of delayed submission of stock statements, non-creation of security overdrawn accounts etc., needs to be charged as per sanctioned terms and norms of the bank. The compliance of the same should be checked in detail by the auditors.

1.435 In the case of advances covered by guarantees of DICGC/ECGC/CGTS, in case of default the auditor should examine whether appropriate steps have been taken for lodging of claims for guarantees in accordance with the applicable procedure. The claims declined by DICGC/ECGC/CGTS should not be considered as recoverable while calculating the provisions against the respective advances.

1.436 In respect of consortium advances, the auditor should particularly examine–

(a) compliance with the limits stipulated by the consortium in lending moneys to the borrower;

(b) the bank's monitoring of securities like stocks, etc., which are in its custody/charge; and

(c) follow-up with lead bank on pending issues.

1.437 Apart from the usual audit procedures applicable in respect of advances, the auditor should examine whether the bank has correctly classified the inter-bank participation certificates. In the case of participations on risk-sharing basis, the auditor should examine whether any loss has devolved on the bank as on the balance sheet date and, if so, whether adequate provision in respect of such loss has been made.

Verification of Security against Advances

1.438 From the view point of security, advances are to be classified in the balance sheet in the following manner:

(a) Secured by tangible assets

(b) Covered by bank/government guarantees

(c) Unsecured

1.439 An advance should be treated as secured to the extent of the value of the security on the balance sheet date. If only a part of the advance is covered by the value of the security as at the date of the balance sheet, that part only should be classified as secured; the remaining amount should be classified as unsecured.

1.440 As mentioned earlier, the Reserve Bank has specified that advances against book debts may be included under the head 'secured by tangible assets'.

1.441 The following points are relevant for classifying the advances based on security.

(a) Government guarantees include guarantees of Central/State Governments and also advances guaranteed by Central/State Government owned corporations and financial institutions like IDBI, IFCI, ICICI, State Financial Corporations, State Industrial Development Corporations, ECGC, DICGC,CGTS, etc.

(b) Advances covered by bank guarantees also include advances guaranteed against any negotiable instrument, the payment of which is guaranteed by a bank.

(c) Advances covered by bank/government guarantees should be included in unsecured advances to the extent the outstanding in these advances exceed the amount of related guarantees.

(d) While classifying the advances as secured, the primary security should be applied first and for the residual balance, if any, the value of collateral security should be taken into account. If the advance is still not fully covered, then, to the extent of bank/government guarantees available, the advance should be classified as 'covered by bank/government guarantee'. The balance, if any, remaining after the above classification, should be classified as 'unsecured'.

(e) There may be situations where more than one facility is granted to a single borrower and a facility is secured, apart from primary and collateral securities relating specifically to that facility, by the residual value of primary security relating to any other credit facility (or facilities) granted to the borrower. In such a case, in the event of shortfall in the value of primary security in such a credit facility, the residual value of primary security of the other facility (or facilities, as the case may be) may be applied first to the shortfall and the value of collateral securities should be applied next.

(f) In the case of common collateral security for advances granted to more than one borrower, if there is a shortfall in value of primary security in any one or more of the borrowal accounts, the value of collateral security may be applied proportionately to the shortfall in each borrowal account.

(g) Loans/overdrafts against drafts/pay orders/bankers' cheques may be classified as covered by bank guarantees, as payments are guaranteed by banks.

(h) Advances covered by ECGC/DICGC,CGTS guarantees should be treated as covered by guarantees to the extent of guarantee cover available. The amount already received from DICGC/ECGC/CGTS and kept in sundry creditors account pending adjustment should be deducted from advances.

(i) An account which is fully secured but the margin in which is lower than that stipulated by the bank should nevertheless be treated as fully secured for the purposes of balance sheet presentation.

(j) All documentary bills under delivery-against-payment terms (i.e., covered by RR/Airway Bill/Bill of lading) for which the documents are with the bank as on the balance sheet date should be classified as 'secured'.

(k) Documentary bills under delivery-against-acceptance terms which remain unaccepted as at the close of 31st March (i.e., for which the documents of title are with the bank on this date) should be classified as secured. All accepted bills should be classified as 'unsecured' unless collaterally secured.

(l) Cheques purchased including self-cheques (i.e., where the drawer and payee are one and the same) should be treated as unsecured.

(m) Advances against supply bills, unless collaterally secured, should be classified as unsecured even if they have been accepted by the drawees.

1.442 In examining whether an advance is secured and, if so, to what extent, the auditor is concerned with determining –

(a) whether the security is legally enforceable, i.e., whether the necessary legal formalities regarding documentation, registration, etc., have been complied with;

(b) whether the security is in the effective control of the bank; and

(c) to what extent the value of the security, assessed realistically, covers the amount outstanding in the advance.

1.443 The auditor should examine the following aspects in respect of advances classified as 'secured':

(a) Documents executed are complete and in force.

(b) Where documents have not been renewed, the limitation period has not expired.

(c) Evidence is available as to the market value of the security.

(d) Evidence is available that –

    (i) hypothecated/pledged goods are the property of the borrowers and are not old/obsolete or otherwise unsaleable;

    - advances against book debts of borrowers are related to their current debts and not old/doubtful debts; and
    - Stocks hypothecated/pledged are paid stocks owned by the borrower.

(e) In the case of companies, the charge is appropriately registered with the Registrar of Companies and a certificate of registration of charge or other evidence of registration is held.

(f) Borrowers are regular in furnishing the requisite information regarding the value of security lodged with the bank.

(g) In respect of the second charge being available in respect of certain assets, the amount of the lender(s) enjoying the first charge on such asset be worked out and only the residuary value, if any, available for second charge holders, be considered.

1.444 The following paragraphs deal with the different types of securities against advances generally accepted by banks and the manner in which the auditor should verify them.

Stock Exchange Securities and Other Securities

1.445 The auditor should verify stock exchange securities and their market value in the same manner as in the case of investments. The auditor should examine whether the securities have been registered or assigned in favour of the bank, wherever required. If the securities have been lodged for registration/assignment and the amounts involved are material, the auditor should insist on production of evidence of lodgement, e.g., certificates/acknowledgements from the companies concerned.Now a days shares are in Demat Form.

1.446 As already discussed, advances by a banking company against its own shares are prohibited under section 20 of the Banking Regulation Act, 1949. A contravention of this provision may warrant a qualification in the auditor's report.

1.447 In addition to any directions of the RBI under section 21 of the Banking

Regulation Act, 1949 banks generally have their own lists of approved and unapproved securities[11]. Advances are generally made against approved securities only. Unapproved securities should be accepted only with a special sanction of the appropriate authority. Advances made against unapproved securities are, nevertheless, to be classified as secured advances in the same manner as those against approved securities.

1.448 It sometimes happens that a quoted security may not have frequent transactions on the stock exchange and the quotation included in the official quotations may be that of a very old transaction. In such a case, the auditor should satisfy himself as to the market value by scrutiny of balance sheet, etc., of the company concerned, particularly if the amount of advance made against such security is large.

1.449 Banks do not generally make advances against partly paid securities. If, however, any such shares are accepted by the bank as security and these are registered in the name of the bank, the auditor should examine whether the issuing company has called up any amount on such securities and, if so, whether the amount has been in time by the borrower/bank.

Goods

1.450 In respect of hypothecated goods, the auditor should check the quantity and value of goods hypothecated with reference to the statement received from the borrower. He should also examine the reasonableness of valuation. Letter of hypothecation should also be examined by the auditor. If the value of the goods is higher than the amount mentioned in the letter of hypothecation, the bank's security is only to the extent of the latter.

1.451 The auditor should also check nature of goods hypothecated/pledged. If the goods are of perishable nature, it will not have market value.

1.452 In respect of goods pledged with the bank, the auditor should check the statement received from the borrower regarding the quantity and value of goods pledged by him. He should test check the godown registers and the valuation of the goods. If there is any outstanding delivery order against the goods as on the balance sheet date, the same should be deducted from the total quantity in hand in ascertaining the value of the goods constituting the security. The auditor may also examine the key movement register to verify the movement of goods inwards and/or outwards.

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[11] It may be mentioned that the expression 'approved securities' here refer to those securities which can be accepted as security for an advance generally, i.e. having to undergo special sanction procedures. The use of this term in the present context should be distinguished from its definition in section 5(a) of the Banking Regulation Act.

1.453 Sometimes, goods are in the possession of third parties, such as clearing and forwarding agents, transporters, brokers, warehouse-keepers, etc. If these parties have given an undertaking to the bank that they will hand over the goods or sale proceeds thereof to the bank only, i.e., they have 'attorned' to the bank the advances made against such goods should be considered as secured. In such cases, certificates should be obtained by the bank from such third parties regarding quantities on hand on balance sheet date. The valuation of such goods should be checked by the auditor.

1.454 In case the borrower is a company, the auditor should examine the certificate of registration of charge on the goods hypothecated with the Registrar of Companies. It may be mentioned that in case of pledge of goods, registration of charge is not necessary.

Gold Ornaments and Bullion

1.455 The auditor should inspect and weigh (on a test basis) the ornaments on the closing date. He should also see the assayer's certificate regarding the net gold content of the ornaments and their valuation. Valuation should also be checked with reference to the current market price of gold.

1.456 In respect of gold and silver bars, the auditor should inspect the bars on a test basis and see that the mint seals are intact. The weights mentioned on the bars may generally be accepted as correct.

Life Insurance Policies

1.457 The auditor should inspect the policies and see whether they are assigned to the bank and whether such assignment has been registered with the insurer. The auditor should also examine whether premium has been paid on the policies and whether they are in force. Certificate regarding surrender value obtained from the insurer should be examined. The auditor should particularly see that if such surrender value is subject to payment of certain *premia*, the amount of such *premia* has been deducted from the surrender value.

1.458 It should be ensured that policies are assignable in banks favour.In certain types of policies the assignment to third party are restricted.

Bank's Own Deposit Certificates

1.459 The auditor should inspect such certificates and examine whether they have been properly discharged and whether the lien of the bank is noted on the face of the certificates as well as in the relevant register of the bank and also in CBS

Hire-purchase Documents

1.460 These advances may be classified as secured against the hypothecation of goods. Where there is no hypothecation, the advance will be classified as unsecured.

Plantations

1.461 These advances are classified as secured against the crop and/or the fixed assets (viz. mortgage of land) of the plantation. The auditor should examine the agreement and the title deeds. Regarding the estimate of the crop, he may examine the record of the garden for the last few years. He should also ascertain whether the crop is properly insured against natural calamities and other disasters such as hail, etc.

1.462 Auditor should keep in mind that where moratorium is available for payment of interest in such plantation projects, the payment of interests becomes due only after the moratorium or gestation period is over and in such a case the account will become NPA in case interest is not recovered after the due date of such interest after moratorium period, if specifically mentioned in the sanction letter..

Immovable Property

1.463 The auditor should inspect the title deed, the solicitor's/advocate's opinion taken by the bank in respect thereof, and the mortgage deed. For valuation, he may rely upon the architect's or valuer's report (which should be taken atleast once in three years) after carrying out appropriate audit procedures to satisfy himself about the adequacy of the work of the architect/valuer for his purpose.[12] He should also examine the insurance policies.

1.464 In some cases, banks make advances against immovable properties where the title deeds are not in the name of the borrower. For example, an advance may be given against the security of a flat in a co-operative group housing society, the title deeds of which may not be in the name of the borrower. In such cases, the auditor should examine the evidence regarding the right or interest of the borrower in the property mortgaged, e.g., power of attorney, share certificate of co-operative group housing society, 'no objection certificate' from the society/lessor (in the case of leasehold properties) for offering the property as security, etc.

1.465 In case the bank has accepted third party property as a security. The

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[12] Reference may be made in this regard to Standards on Auditing (SA) 620, "Using the Work of an Auditor's Expert".

owner of the property should also execute guarantee bond in bank's favour.

The mortgage value in bank's favour should be equal/in excess of loan amount covered by such mortgage.

Reliance on / review of other reports

1.466 The auditor should take into account the adverse comments, if any, on advances appearing in the following:

- Previous audit reports.
- Latest internal inspection reports of bank officials.
- Reserve Bank's latest inspection report.
- Concurrent / Internal audit report.
- Report on verification of security.
- Any other internal reports specially related to particular accounts.
- Manager's charge-handing-over report when incumbent is changed.

The above reports should be reviewed in detail. The Statutory Central Auditors must review the Annual Financial Inspection report of RBI relating to the bank and ensure that the variations in provisions, etc. reported by RBI have been properly considered by the bank management.

Third Party Guarantees

1.467 The auditor should examine the guarantee bonds and the demand promissory notes in order to verify the third party liability. He should satisfy himself that the guarantee is in force as at the date of the balance sheet. In the absence of a provision to the contrary, a guarantee terminates by revocation or upon death of the surety. The surety is also discharged (unless there is a specific covenant to the contrary) if the creditor arranges with the principal debtor for compromise, or agrees to give time or agrees not to sue him, without consulting the surety. If any variation is made in the terms of the contract between the principal debtor and the creditor without the surety's consent, it discharges the surety as to transactions subsequent to the variation. The guarantee forms used by banks normally seek to ensure the continuing obligation of the guarantor in spite of these contingencies If such clause is absent then Auditor has to see that acknowledge to debt from the borrower as well as guarantor is obtained by the Bank.

Verification of Bills Purchased and Discounted

1.468 The auditor should familiarise himself with the guidelines issued by the RBI and the policies framed by the bank itself regarding the discounting and rediscounting of bills. The auditor should ascertain that the policy framed by the bank conforms to the requirements laid down by the RBI.

1.469 Bills purchased and discounted have to be shown separately in the balance sheet as a part of 'advances'. Further, under the head 'advances outside India' in the balance sheet, bills purchased and discounted outside India have to be shown separately. This category will include bills covering export of goods, bills discounted by foreign branches of the bank and payable in their respective countries, etc.

1.470 Banks purchase or discount bills of exchange drawn or endorsed by their customers. The bank credits the amount of the bill to its customer after deducting the discount. The total amount of such bills is shown as an asset in the balance sheet.

1.471 In certain eligible cases, the bills purchased or discounted by the bank may be rediscounted by it with the RBI IDBI/SIDBI. Such bills would not be included under advance but would constitute a contingent liability.

1.472 Bills purchased and discounted by the bank are generally drawn on outstation parties and are, therefore, sent by the bank to its branches or agents for collection immediately after their receipt. They are generally not in the possession of the bank on the closing date. The auditor therefore has to rely upon the Register of Bills Purchased and Discounted and the party-wise Register of Bills maintained by the bank. The auditor should examine these registers and satisfy himself that:

(a) all the outstanding bills have been taken in the balance sheet;

(b) all the details, including the nature of the bills and documents, are mentioned in the register and that the bills have been correctly classified;

(c) the bills purchased or discounted from different parties are in accordance with the agreements with them and the total of outstanding bills of each party is not in excess of the sanctioned limit; and

(d) the bills are not overdue. If there are any overdue bills, the auditors should ascertain the reasons for the delay and the action taken by the bank.

1.473 The auditor should examine whether registers of bills purchased and discounted are properly maintained and the transactions are recorded therein correctly. He should examine whether the bills and the documents accompanying the bills are properly endorsed and assigned in favour of the bank. In checking the bills, it should be ensured that the bills are held along with the documents of title. In the case of documentary bills, it should be ensured that the related RRs/TRs are held along with the invoices/ hundies / bills and that these have not been parted with. Wherever such RRs/TRs are not held on record, the fact should be duly considered by the auditor. The auditor should also examine bills collected subsequent to the year-end to obtain assurance regarding completeness and validity of the recorded bill amounts.

Other Aspects

1.474 Sometimes, a customer is sanctioned a cash credit limit at one branch but is authorised to utilise such overall limit at a number of other branches also, for each of which a sub-limit is fixed. In such a case, the determination of status of the account as NPA or otherwise should be determined at the limit-sanctioning branch with reference to the overall sanctioned limit/drawing power, and not by each of the other branches where a sub-limit has been fixed. The auditor of the limit-sanctioning branch should examine whether it receives particulars of all transactions in the account at sub-limit branches and whether the status of the account has been determined by considering the total position of operation of the account at all concerned branches. As far as sub-limit branches are concerned, they should follow the classification adopted by the limit-sanctioning branch.

1.475 The auditor should examine that any advances made by a banking company otherwise than in the course of banking business, such as, prepaid expenses, advance for purchase of assets, etc., is not included under the head 'advances' but is included under 'other assets'.

1.476 The amounts of advances in India and those outside India are to be shown separately in the balance sheet. This classification will depend upon where the advance was actually made and not where it has been utilised. Generally speaking, figures of Indian branches will be shown as advances in India and figures of foreign branches as advances outside India.

1.477 The auditor should examine whether any loan has been granted in violation of the statutory limitations contained in section 20 of the Banking Regulations Act, 1949. If any such loan has been granted the report will have to be drafted with suitable qualifications, as the transaction would be *ultra vires*.

1.478 It may also be examined whether the bank has a system of ensuring the end use of the funds granted as compared with the purpose of sanction. The reports submitted by the inspectors/officers in this regard should be reviewed to form opinion on the quality of the asset and also to consider reporting any matter in the LFAR.

1.479 Adverse features in a borrower's account are required to be reported in LFAR and hence during the course of verification all material information should be noted and documented in appropriate format. Following is an illustrative but not an exhaustive format:

1. Name of the Borrower.
2. Constitution.
3. Sanctioned limits as on Balance Sheet date.

4. Any change in limit during the year.
5. Terms of sanction.
6. Details of fulfilment of terms of sanction.
7. Details of Loan documents and observations on the same.
8. Balance outstanding as at balance sheet date.
9. Classification as per bank.
10. Whether classification requires a change.
11. If so the reasons for the differing view and the impact of the same.
12. Whether necessary changes made in Memorandum of Changes.
13. Observations on the conduct of the account.
14. Deficiencies noted in the account.
15. Availability of security.
16. Timely submission of stock statement and other statements.

Verification of Provision for Non-performing assets

1.480 An important aspect of audit of advances relates to their classification and provisioning. This implies that a proper provision should be made in respect of advances where the recovery is doubtful. As mentioned earlier, 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, its subsidiaries, and regional 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.

1.481 The accounting entry for provision in respect of debts that are doubtful of recovery is usually made at the head office level and is not recorded in the books at the branch level. The amount of provision to be made at the head office level is based largely on the classification of various advances into standard, sub-standard, doubtful and loss categories. The auditor should carefully examine whether the classification made by the branch is appropriate. In doing so, he should particularly examine the classification of advances where there are threats to recovery. The auditor should also examine whether the secured and the unsecured portions of advances have been segregated correctly and provisions have been calculated properly.

1.482 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 sources1.379 or not. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA. In other genuine cases, the banks must furnish satisfactory evidence to the Statutory Auditors about the manner of regularisation of the account to eliminate doubts on their performing status.

1.483 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 of significant importance to determine the classification and hence specific care be taken in this regard.

Drawing Power Calculation

1.484 Working capital borrowal account, drawing power calculated from stock statement older than 3 months has to be considered as "irregular" (overdue). If such "irregular" continues for 90 days, account has to be classified as NPA, even though the account is otherwise operated regularly.

1.485 The stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinised in detail.

1.486 The audited Annual Report submitted by the borrower should be scrutinised properly. The monthly stock statement of the month for which the audited accounts are prepared and submitted should be compared and the reasons for deviations, if any, should be ascertained.

1.487 It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

1.488 The stock audit should be carried out by the bank for all accounts having funded exposure of more than Rs.5 crores. Auditors can also advise for stock audit in other cases if the situation warrants the same. Branches should obtain the stock audit reports from lead bank or any other member , as decided in consortium in the cases where the Bank is not leader of the consortium of working capital. The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power.

1.489 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.

Limits not reviewed

1.490 Accounts where regular/*ad hoc* limits are not reviewed within 180 days from the due date/date of adhoc sanction, have to 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.

Erosion of Security

1.491 In case of accounts where erosion of security has taken place or fraud has been committed by borrower, the same should be straightaway classified as doubtful or loss without waiting for the period as per IRAC norms; specifically –

(a) where value of security has eroded by more than 50%, account should be classified as 'doubtful'; and

(b) where realisable value of security is less than 10% of the outstanding amount, account should be classified as 'loss'.

1.492 In these cases, the unsecured portion of loan should be provided fully and on the secured portion, the same should be provided as per the classification given to the account.

1.493 For this purpose, even the standard accounts should be reviewed to check if there is any major erosion in the value of security provided by the borrower. The reports submitted by the branches to their controlling authorities and RBI should be checked to verify if any account has been reported as fraud case.

Government Guaranteed Advances

1.494 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 realised. 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 w.e.f. year ended 31st March, 2006.

1.495 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

1.496 A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons. A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

1.497 For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops, would be treated as "short duration" crops. The crop season for each crop, which means the period up to harvesting of the crops raised would be as determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made applicable to agricultural term loans availed of by him. The above norms should be made applicable to all direct agricultural advances listed in Master Circular on lending to priority sector, RPCD. No.Plan.BC.10 /04.09.01/ 2011-2012 dated July 2, 2012. In respect of agricultural loans, other than those specified in the circular, identification of NPAs would be done on the same basis as non-agricultural advances, which, at present, is the 90 days delinquency norm.

1.498 Special concessions have been given to -

(i) Relief measures in drought affected areas for kharif crops during the financial year 2002-03

(ii) Agricultural loans granted upto 31st March, 2004 in districts declared as 'calamity affected'.

(iii) Where natural calamities impair the repaying capacity of agricultural borrowers, banks may decide on their own as a relief measure conversion of the short-term production loan into a term loan or re-schedulement of the repayment period; and the sanctioning of fresh short-term loan, subject to guidelines contained in RBI circular RPCD. No.PLFS.BC.3/ 05.04.02/2012-13 dated July 2, 2012. In such cases of conversion or re-schedulement, the term loan as well as fresh short-term loan may be treated as current dues and need not be classified as NPA. The asset classification of these loans would thereafter be governed by the revised terms & conditions and would be treated as NPA if interest and/or instalment of principal remains overdue for two crop seasons for short duration crops and for one crop season for long duration crops.

Agricultural Debt Waiver and Debt Relief Scheme(ADWDRS), 2008

1.499 While presenting the Finance Bill 2008 in Parliament on 29th February, 2008 the then Finance Minister announced a debt waiver and debt relief scheme for farmers, for implementation by, inter alia, all scheduled commercial banks (SCBs), and Local Area Banks (LABs). The detailed scheme announced by the Government of India was communicated to the SCBs and LABs vide our circular RPCD.No.PLFS.BC.72/05.04.02/2007-08 dated May 23, 2008. The guidelines pertaining to Income Recognition, Asset Classification and Provisioning, and Capital Adequacy as applicable to the loans covered by the captioned scheme, are discussed below. Auditors should carefully go through the same and examine whether they have been applied properly by the bank.

1.500 In terms of paragraph 2 (ix) (a) of the Annexure to the circular RPCD.No.PLFS.BC.73 /05.04.02/2007-08 dated May 30, 2008, on Agricultural Debt Waiver and Debt Relief Scheme, 2008, lending institutions shall neither claim from the Central Government, nor recover from the farmer, interest in excess of the principal amount, unapplied interest, penal interest, legal charges, inspection charges and miscellaneous charges, etc. All such interest / charges will be borne by the lending institutions. In view of the extraordinary circumstances in which the banks are required to bear the interest/charges, RBI has allowed the banks to utilise, at their discretion, the Floating Provisions held for 'Advances' portfolio, only to the extent of meeting the interest /charges referred above.

1.501 In the case of NPA loans, no interest will be applied from the date when the loan account was classified as NPA. Hence, interest on loans classified as NPA for any period after it is so classified can neither be claimed from the Government nor from the farmer. Unapplied interest on NPA loans are neither to be claimed from the Government nor from the farmer.

1.502 The debt waiver/debt relief admissible on the eligible amount paid after 29.02.2008 should be credited to the account of the borrower by September 30, 2008.

1.503 The eligible amount outstanding as on 29.02.2008 qualifies for debt waiver/debt relief. Hence, any amount written off after 29.2.2008 which would, otherwise, have been eligible for reimbursement under the Scheme, will qualify for reimbursement.

1.504 As advised *vide* the circular RPCD.No.PLFS.BC.72 /05.04.02/2007-08 dated May 23, 2008, while the entire 'eligible amount' shall be waived in the case of a small or marginal farmer, in the case of 'other farmers', there will be a onetime settlement scheme (OTS) under which the farmer will be given a rebate of 25 per cent of the 'eligible amount' subject to the condition that the farmer repays the balance of 75 per cent of the 'eligible amount'.

1.505 Norms for the accounts subjected to debut waiver include:

- As regards the small and marginal farmers eligible for debt waiver, the amount eligible for waiver as prescribed in the said circular, pending receipt from the Government of India, may be transferred by the banks to a separate account named Amount receivable from Government of India under Agricultural Debt Waiver Scheme 2008.
- The balance in this account should be reflected in Schedule 9 (Advances) of the Balance sheet. The balance in this account may be treated by the banks as a 'performing' asset, provided adequate provision is made for the loss in Present Value (PV) terms (9.56% as prescribed in the Master Circular), computed under the assumption that such payments would be received from Government of India in the following installments:
    - 32% of the total amount due by September 30, 2008,
    - 19% by July 31, 2009,
    - 39% by July 2010, and
    - Remaining 10% by July 2011.

      Thus the entire debt relief amount should be recovered from Central Govt and Balance Sheet from 31.3.2013 onward should not show any receivables under Debt Relief Scheme: If the bank is still showing some balance receivable for Agri. Debt Relief the reasons for the same should be ascertained. In case any amount shown outstanding for rejection of the claim, due cognizance needs to be taken by the auditor.
- However, the provision required under the current norms for standard assets, need not be provided for in respect of the balance in this account. The prudential provisions held in respect of the NPA accounts for which the debt waiver has been granted may be reckoned for meeting the provisions required on PV basis.
- In case, however, the amount of prudential provision held is more than the amount of provision required on PV basis, such excess provision may be reversed in a phased manner.

- This phased reversal may be effected in the proportion of 32%, 19%, 39%, and 10% during the years ended March 2009, 2010, 2011 and 2012, respectively, only after the installments due from the Government, for the relative years, have been received.
- On receipt of the final instalment from the Government, the provision made for loss in PV terms may be transferred to the General Reserves, below the line.

1.506 Norms for the accounts subjected to the Debt Relief are as follows:

1 Under the scheme, in the case of 'other' farmers, the farmer will be given a rebate of 25% of the 'eligible amount' by the Government by credit to his account, provided the farmer pays the balance of 75% of the 'eligible amount'.

2 The Scheme provides for payment of share of 75% by such farmers in three instalments and the first two instalments shall be for an amount not less than one-third of the farmer's share.

3 The last date of payment of the three instalments are fixed as September 30, 2008, March 31, 2009 and June 30, 2009, respectively.

4 Where the farmers covered under the Debt Relief Scheme have given the undertaking, agreeing to pay their share under the OTS, their relevant accounts may be treated by banks as 'standard'/ 'performing' provided (a) adequate provision is made by the banks for the loss in PV terms for all the receivables due from the borrowers as well as the Government; and (b) such farmers pay their share of the settlement within one month of the due dates. However, no grace period is allowed for the last installment and the entire share of the farmer is payable by June 30, 2009.

Provisioning for Standard Assets

1.507 The accounts subject to debt relief would stand classified as standard assets after receipt of the aforesaid undertaking from the borrowers. Accordingly, such accounts would also attract the prudential provisioning as applicable to standard assets. For computing the amount of loss in PV terms under the Scheme, the cash flows receivable from the farmers, as per the repayment schedule, as well as from the government should be discounted to the present value. It may be assumed in this context that the Government's contribution would be received by June 30, 2010. The discount rate to be applied for the purpose should be the interest rate at which the loan was granted including the element of interest subsidy, if any, available from the Government. The prudential provisions held in respect of the NPA accounts, for which the debt waiver has been granted, may be reckoned for meeting the provisions required on PV basis as well as for the standard assets (pursuant to classification of these loans as standard) and shortfall, if any, may be provided for. Thus, the total provisions held would comprise the provisions required on PV basis, provision for standard assets and excess prudential provisions, if any, towards NPA.

1.508 *Provisioning in case of down-gradation of accounts*: The accounts subject to Debt Relief Scheme would be classified as standard / performing assets only if the farmers pay their share of the settlement within one month of the pre-specified due dates. In case, however, the payments are delayed by the farmers beyond one month of the respective due dates, the outstanding amount in the relevant accounts of such farmers shall be treated as NPA. The asset classification of such accounts shall be determined with reference to the original date of NPA, (as if the account had not been treated as performing in the interregnum based on the aforesaid undertaking). On such down-gradation of the accounts, additional provisions as per the extant prudential norms should also be made. For meeting this additional provisioning requirement, the excess prudential provisions, if any, held; the amount of provisions held for standard assets together with the provision made on PV basis, all in respect of such downgraded account, could be reckoned.

1.509 *Reversal of excess prudential provisions* : In case the amount of the prudential NPA-provisions held are larger than the aggregate of the provision required on PV basis and for the standard assets (pursuant to classification of these loans as standard), such excess prudential provision should not be reversed but be continued to be held till the earlier of the two events, *viz*., (a) till the entire outstanding of the borrower stands repaid – at which point, the entire amount could be reversed to the P/L account; or (b) when the amount of such excess provision exceeds the amount outstanding on account of the repayments by the borrower – at which point, the amount of provision in excess of the outstanding amount could be reversed to the P/L account.

Norms for granting of fresh loans to the borrowers covered under the ADWDRS

1.510 Norms for granting of fresh loans to the borrowers covered under the ADWDRS are as follows:

1. A small or marginal farmer will become eligible for fresh agricultural loans upon the eligible amount being waived, in terms of the circular RPCD.No.PLFS.BC.72/05.04.02/2007-08 dated May 23, 2008. The fresh loan may be treated as "performing asset", regardless of the asset classification of the loan subjected to the Debt Waiver, and its subsequent asset classification should be governed by the extant IRAC norms.

2. In case of "other farmers" eligible for fresh short-term production loans and investment loans, as provided for in the circular RPCD.No.PLFS.BC.72/05.04.02/2007-08 dated May 23, 2008, these fresh loans may be treated as "performing assets", regardless of the asset classification of the loan subjected to the Debt Relief, and its subsequent asset classification should be governed by the extant IRAC norms.

Norms for the Capital Adequacy for the loans under the ADWDRS@

1.511 Norms for the Capital Adequacy for the loans under the ADWDRS are as follows:

The amount outstanding in the account styled as "Amount receivable from Government of India under Agricultural Debt Waiver Scheme 2008" shall be treated as a claim on the Government of India and would attract zero risk weight for the purpose of capital adequacy norms. However, the amount outstanding in the accounts covered by the Debt Relief Scheme shall be treated as a claim on the borrowers and risk weighted as per the extant norms. This treatment would apply under the Basel I as well as Basel II Frameworks.

Subsequent Modifications to the Prudential Norms

Interest payment by the GOI

1.512 The Government of India has subsequently decided to pay interest on the 2nd, 3rd, and 4th instalments, payable by July 2009, July 2010, and July 2011 respectively, at the prevailing Yield to Maturity Rate on 364-day Government of India Treasury Bills. The interest will be paid on these instalments from the date of the reimbursement of the first instalment (i.e. November 2008) till the date of the actual reimbursement of each instalment. In view of the above, it has been decided that the banks need not make any provisions for the loss in Present Value (PV) terms for moneys receivable only from the Government of India, for the accounts covered under the Debt Waiver Scheme and the Debt Relief Scheme.

Change in installment schedule of "other farmers" under the Debt Relief Scheme

1.513 The Government of India has extended the last date of payment of 75% of overdue portion by the 'other farmer' under Debt Relief Scheme (under ADWDR) up to June 30, 2010. The eligible "other farmers" may be allowed to repay this amount in one or more instalments up to June 30, 2010. The banks will not charge any interest on the eligible amount for the period from February 29, 2008 to June 30, 2009. However, they may charge normal rate of interest on the eligible amount from July 01, 2009 up to the date of settlement. Further, no interest shall be paid by the Government of India to the lending institutions for this extension under the Scheme while reimbursing the 25% amount to the lending institutions as per the delayed reimbursement schedule. Attention of the reader is invited to the circular RPCD.No.PLFS.BC. 24 /05.04.02/2008-09 dated September 4, 2008, which states that the "Final" claims pertaining to "Debt Relief" arising till December 31, 2009 (including the cases settled through the Grievances Redressal Mechanism operating till January 31, 2010) may be submitted to this Department by June 30, 2010 in the prescribed format duly certified by the Central Statutory Auditors, as stated in the said circular.

1.514 Further, as no interest shall be paid by Government of India to the lending institutions for the six month extension period of the Scheme while reimbursing 25% amount to the lending institutions, RBI vide its circular no. RPCD. No. PLFS.BC. 66 /05.04.02/2009-10 dated April 8, 2010 advised the banks to forward a separate claim to this Department in respect of "Debt Relief" cases that may be settled during the period January 1, 2010 to June 30, 2010 (including the cases settled through the Grievances Redressal Mechanism operating from February 1, 2010 to July 31, 2010), duly certified by the Central Statutory Auditors, in the manner stated in the circular dated September 4, 2008 mentioned above. The latter may be clearly marked as "Additional Final Claims – Debt Relief - Not Eligible for Interest" and should reach this office latest by June 30, 2011.

1.515 The Government of India has also advised that the banks / lending institutions are allowed to receive even less than 75% of the eligible amount under OTS provided the banks / lending institutions bear the difference themselves and do not claim the same either from the Government or from the farmer. The Government will pay only 25% of the actual eligible amount under debt relief.

1.516 In case, however, the payments are delayed by the farmers beyond June 30, 2010, the outstanding amount in the relevant accounts of such farmers shall be treated as NPA. The asset classification of such accounts shall be determined with reference to the original date of NPA, (as if the account had not been treated as performing in the interregnum based on the aforesaid undertaking). On such down-gradation of the accounts, additional provisions as per the extant prudential norms should also be made.

1.517 In case of 'other farmers' eligible for debt relief, after the 'other farmer' has paid his entire share of 75%, banks may open an account for Debt Relief Scheme, similar to the one opened for the receivables from GOI under the Debt Waiver Scheme, and bearing the nomenclature "Amount receivable from

Government of India under Agricultural Debt Relief Scheme 2008". This amount may also be reflected in Schedule 9 (Advances) of the Balance Sheet.

Lending under Consortium Arrangement / Multiple Banking Arrangements

1.518 In order to strengthen the information sharing system among banks in respect of the borrowers enjoying credit facilities from multiple banks, the banks are required to obtain regular certification by a professional, preferably a Company Secretary, Chartered Accountants or Cost Accountants regarding compliance of various statutory prescriptions that are in vogue, as per specimen given in Annexure III (Part I and II), to the RBI Circular No. DBOD.No. BP.BC.110/08.12.001/2008-09 dated February 10, 2009. Annexure III is reproduced hereunder:

Part: I

DILIGENCE REPORT

To
The Manager, ___________________ (Name of the Bank)

I/We have examined the registers, records, books and papers of-------------- Limited having its registered office at…………………………………………………… as required to be maintained under the Companies Act, 1956 (the Act) and the rules made there under, the provisions contained in the Memorandum and Articles of Association of the Company, the provisions of various statutes, wherever applicable, as well as the provisions contained in the Listing Agreement/s, if any, entered into by the Company with the recognized stock exchange/s for the half year ended on…………… . In my/our opinion and to the best of my/our information and according to the examination carried out by me/us and explanations furnished to me/us by the Company, its officers and agents. I/We report that in respect of the aforesaid period:

1. The management of the Company is carried out by the Board of Directors comprising of as listed in Annexure …., and the Board was duly constituted. During the period under review the following changes that took place in the Board of Directors of the Company are listed in the Annexure …., and such changes were carried out in due compliance with the provisions of the Companies Act, 1956.
2. The shareholding pattern of the company as on ---- was as detailed in Annexure ….
During the period under review the changes that took place in the shareholding pattern of the Company are detailed in Annexure…….:

3. The company has altered the following provisions of
   (i) The Memorandum of Association during the period under review and has complied with the provisions of the Companies Act, 1956 for this purpose.
   ii) The Articles of Association during the period under review and has complied with the provisions of the Companies Act, 1956 for this purpose.
4. The company has entered into transactions with business entities in which directors of the company were interested as detailed in Annexure….. .
5. The company has advanced loans, given guarantees and provided securities amounting to Rs. _______to its directors and/or persons or firms or companies in which directors were interested, and has complied with Section 295 of the Companies Act, 1956.
6. The Company has made loans and investments; or given guarantees or provided securities to other business entities as detailed in Annexure .and has complied with the provisions of the Companies Act, 1956.
7. The amount borrowed by the Company from its directors, members, financial institutions, banks and others were within the borrowing limits of the Company. Such borrowings were made by the Company in compliance with applicable laws. The break up of the Company's domestic borrowings were as detailed in Annexure.
8. The Company has not defaulted in the repayment of public deposits, unsecured loans, debentures, facilities granted by banks, financial institutions and non-banking financial companies.
9. The Company has created, modified or satisfied charges on the assets of the company as detailed in Annexure…. Investments in wholly owned Subsidiaries and/ or Joint Ventures abroad made by the company are as detailed in Annexure ……
10. Principal value of the forex exposure and Overseas Borrowings of the company as on ……….. are as detailed in the Annexure under';
11. The Company has issued and allotted the securities to the persons-entitled thereto and has also issued letters, coupons, warrants and certificates thereof as applicable to the concerned persons and also redeemed its preference shares/debentures and bought back its shares within the stipulated time in compliance with the provisions of the Companies Act,1956 and other relevant statutes.
12. The Company has insured all its secured assets.

13. The Company has complied with the terms and conditions, set forth by the lending bank/financial institution at the time of availing any facility and also during the currency of the facility
14. The Company has declared and paid dividends to its shareholders as per the provisions of the Companies Act, 1956.
15. The Company has insured fully all its assets.
16. The name of the Company and/ or any of its Directors does not appear in the defaulters' list of Reserve Bank of India.
17. The name of the Company and or any of its Directors does not appear in the Specific Approval List of Export Credit Guarantee Corporation.
18. The Company has paid all its Statutory dues and satisfactory arrangements had been made for arrears of any such dues.
19. The funds borrowed from banks/financial institutions have been used by the company for the purpose for which they were borrowed.
20. The Company has complied with the provisions stipulated in Section 372 A of the Companies Act in respect of its Inter Corporate loans and investments.
21. It has been observed from the Reports of the Directors and the Auditors that the Company has complied with the applicable Accounting Standards issued by the Institute of Chartered Accountants in India.
22. The Company has credited and paid to the Investor Education and Protection Fund within the stipulated time, all the unpaid dividends and other amounts required to be so credited.
23. Prosecutions initiated against or show cause notices received by the Company for alleged defaults/offences under various statutory provisions and also fines and penalties imposed on the Company and or any other action initiated against the Company and /or its directors in such cases are detailed in Annexure….. .
24. The Company has (being a listed entity) complied with the provisions of the Listing Agreement.
25. The Company has deposited within the stipulated time both Employees' and Employer's contribution to Provident Fund with the prescribed authorities.

Note: The qualification, reservation or adverse remarks, if any, are explicitly stated may be stated at the relevant paragraphs above place(s).

Place:

Signature:

Date:

Name of Company Secretary/Firm: C.P. No.:

Part II

CERTIFICATIONS OF BORROWAL COMPANIES BY CHARTERED ACCOUNTANTS / COMPANY SECRETARIES/ COST ACCOUNTANTS

i. Terms of reference for stock audit are to be spelt out clearly by the Banks, so that the Chartered Accountants can give focused attention to such areas.

ii. End-use verification of funds lent, if certified by Statutory Auditors, will be a good comfort to the Banks.

iii. As Banks quite often deal with unlisted companies, disclosure requirements for such companies above a specific turnover may be made akin to those for listed companies, viz. consolidated balance sheet, segmental reporting etc. Information on large shareholding also will be useful.

iv. Further, the following additional certification either from Chartered Accountant or Company Secretary or Cost Accountants may also be thought of :-

   (a) Company Directors not figuring in defaulters list (RBI/ECGC)/willful defaulters list etc.)

   (b) Details of litigation above a specified cut off limit.

   (c) A specific certificate, probably from the Company Secretary, regarding compliance with Sec. 372 (a) of the Companies Act.

   (d) Details of creation/ modification/satisfaction of charges on the assets of the company, position regarding insurance, show cause notices received, finds and penalties awarded.

v. As regards rotation of Auditors, for the sake of operational convenience, it is suggested they may be changed once every 5 years instead of every 3 years.

vi. In order to avoid concentration, group companies may have different Statutory/ Internal Auditors in case group turnover exceeds Rs.100 crores.

<u>The branch auditors may obtain for each account covered, information as per the following format for a review</u>:

Information on Compliance of RBI Circular DBOD.No. BP.BC.110/08.12.001/2008-09 relating to lending under consortium/ multiple lending arrangements

Name of the borrower:____________________:Branch______________

Status as at ____________

Particulars	Remarks (Amount Rs. In lacs)
1 Nature and extent of credit facilities ***a. Funded*** ***b. Non Funded***	Funded: Bank's share % Other banks' share % Rs. Rs. *Term Loans* *Cash credit* *Overdrafts* *Bills* Total
2. Balances as at the period end	*Term Loans* *Cash credit* *Overdrafts* *Bills* Total
3.Status of the unfunded facilities	
4. Defaults, if any	
5. Classification status of borrower *(tick as applicable)*	Standard ( ) Sub standard ( ) Doubtful ( ) Loss( )
6. whether due diligence report	Yes ( ) No ( )

obtained Date of the report	
7. Major adverse observations in the Report	
8. Action taken on the report	

1.519 The LFAR should include non compliance of the RBI Circular, indicating the cases in which the reports have not been obtained for review by the auditors.

1.520 Accounts under Consortium arrangements may, notwithstanding that these are classified as Standard, due to servicing thereof in a Bank, may nonetheless be intrinsically weak or may even be NPA in other participating bank(s) , including on the basis of the certificate/report as aforesaid. The auditor should consider this aspect and classify the account appropriately based on facts and circumstances, particularly based on any serious adverse remarks/comments in the certificate issued pursuant to the RBI circular.

Provisioning Towards Standard Assets

1.521 The auditor should check the latest RBI Circulars in this regard. The provisions need to be checked in detail with the statement of advances. The provisions 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.

Retail Assets

1.522 Many banks have been very aggressive in sanctioning of retail loans lately. The retail assets in various banks at present form a significant part of their portfolio. As there are large numbers of accounts in these cases, the same poses a challenge for the auditors. The classification and provisioning towards the same should, however, be done as in case of other assets.

1.523 There may be a large number of accounts under retail assets, which have been restructured/rescheduled during respective years including repetitive rephasements. The process of the bank to report / record all such reschedulement/restructuring needs to be reviewed and adequacy of the same should be checked. In case of restructuring of consumer and personal advances, the same should immediately be treated as sub standard. The accounts are treated as restructured when the bank, for economic or legal reasons relating to borrower's financial difficulty, grants to the borrower concessions that the bank would otherwise not consider. The HO of the bank should instruct properly to branches in this regard.

1.524 In case of housing loans, if the restructuring of the account is approved, then the classification of the account can be restored to the position which existed when the restructuring application was received by the bank provided:

- the cases are restructured within 90 days of the receipt of application,
- the dues to the bank are fully secured from tangible assets,
- the repayment period is within the limits fixed by the Board of Directors of the bank in this regard, and
- the restructuring is for the first time only.

Restructuring of cases

1.525 RBI has given revised guidelines for treatment of restructured accounts by its circular dated August 27, 2008. The provisions of this Circular has been discussed earlier in the Chapter. The auditor should verify compliance with the requirements of the said circular.

1.526 Once the bank receives an application/proposal in respect of an account for restructuring, it implies that the account is intrinsically weak. Thereby during the time the account remains pending for restructuring, the auditors need to take a view whether provision needs to be made in respect of such accounts pending approval for restructuring.

Funding of Interest

1.527 In addition, the auditor should also consider the fact that during the course of restructuring/rescheduling in any manner, the interest element, in addition to the principal may also be rescheduled by the bank. This reschedulement of interest may be with or without sacrifice. In some cases future interest may also be funded apart from the principal. In such cases, the auditor should examine whether the RBI's requirements with regard to provisioning for sacrifice have been complied with by the bank. In case of interest sacrifice, the model prescribed by RBI includes calculation and provisioning for sacrifice on future interest as well. The auditor should examine the terms of funding of interest and if the same is in the nature of moratorium for payment of interest, then the interest would become due only after the moratorium period is over. The funded interest cannot be recognised as income if the account is treated as NPA.

Sacrifice of interest

1.528 In respect of sacrifice of interest, the auditor should examine whether:

(a) Interest sacrifice involved in the amount of interest has been written off or provided for by debit to Profit & Loss account and held in a distinct account.

(b) Sacrifice is recomputed on each balance sheet date till satisfactory completion of all repayment obligations and full repayment of the outstanding in the account, so as to capture the changes in the fair value on account of changes in BPLR/ Base Rate, term premium and the credit category of the borrower and the consequent shortfall in provision or reversal of the amount of excess provision has been held in the distinct account.

(c) In the event any security is taken against interest sacrifice, the same has been valued at Re.1/- till maturity of the security.

- As per RBI norms, the interest sacrifice in all the restructured cases needs to be worked out including for Working Capital Loans. In the case of working capital facilities**,** the diminution in the fair value of the cash credit /overdraft component may be computed reckoning the higher of the outstanding amount or the limit sanctioned as the principal amount and taking the tenor of the advance as one year. The term premium in the discount factor would be as applicable for one year. The fair value of the term loan components (Working Capital Term Loan and Funded Interest Term Loan) would be computed as per actual cash flows and taking the term premium in the discount factor as applicable for the maturity of the respective term loan components The process of identifying such interest sacrifice in case of working capital loans needs to be looked upon in detail.

1.529 In case the bank has agreed to convert existing/future exposure to the borrower in to Funded Interest Term Loan, such interest should be parked under sundry liabilities and should not be reckoned as income**.**

Upgradation of Account

1.530 The auditor should examine all the accounts upgraded during the year to ensure that the upgrading of each account is strictly in terms of RBI guidelines.

1.531 Auditor has to ensure that any upgrading of accounts classified as 'Sub-Standard' or 'Doubtful' category wherein restructuring / rephasement of principal or interest has taken place should be upgraded to the 'Standard Asset' category only after a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms, subject to satisfactory performance during the period. The total amount becoming due during this period of one year should be recovered and there should be no overdues to make it eligible for upgradation. If the amount which has become due during this one year period is on a lower side vis a vis total amount outstanding, the other aspects of the account, *viz* financial performance, availability of security, operations in account, etc., should be reviewed in detail and only if found satisfactory, the account should be upgraded.

1.532 Reschedulement of recovery cannot give the advance a better classification than the previous one. NPA accounts can be upgraded to Performing Accounts, provided all overdue are adjusted or atleast reduced to a period of less than 90 days.

1.533 Upgradation within the NPA category is not permitted i.e. a Doubtful account cannot be made Sub-standard even if the overdue are reduced to less than 12 months.

Other Aspects

1.534 Separate norms for classification have been prescribed for accounts covered under schemes for 'Restructuring / Rescheduling of Loans', 'Corporate Debt Restructuring (CDR)' or 'Small & Medium Enterprises (SME)'. The auditors should go though the same to see whether these have been properly applied by the bank.

1.535 Projects under implementation have also been brought under the NPA norms, with a separate set of guidelines for classification. In cases of substantial time overrun in the projects under implementation, the asset classification, income recognition and provisioning should be done as per RBI master circular in this regard.

1.536 For all accounts classified as 'Doubtful', it is essential to determine a)- the existence of primary and collateral securities properly charged to the Bank, b) – its present value through approved valuer (once in 3 years) and c) - inspection (periodical). In case of NPAs with balance of Rs.5 crores and above, stock audit at annual interval by external agency is mandatory.

1.537 Suit filed/decreed accounts should generally be classified as doubtful, unless there is a strong justification to show it is Sub-standard.

1.538 Once an account has been classified as NPA, all the facilities granted to the borrower will be treated as NPA except in respect of Primary Agricultural Credit Societies (PACS)/ Farmers Service Societies (FSS). Also, in respect of additional facilities sanctioned as per package finalised by BIFR and/ or term lending institutions, provision may be made after a period of one year from the date of disbursement in respect of additional facilities sanctioned under the rehabilitation package. The original facilities granted would however continue to be classified as sub–standard/ doubtful, as the case may be.

1.539 Till the time the account is identified as NPA, income is recognised irrespective of whether realised or not. Where an account is identified as NPA during the year, unrealised income should not be recognised for the year. Also, interest accrued and credited to income account in the previous year should be reversed or provided for if the same is not realised.

Method of appropriation of recoveries against principal, interest etc, and analysis of the potential loss of revenue@

1.540 Attention is drawn to Part A of the latest Reserve Bank of India Master Circular (DBOD.No.BP.BC.9/21.04.048/2012-13 dated July 2, 2012), relating to Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances.

1.541 As per the prudential norms followed by banks, when a borrower is classified as Non Performing Asset (NPA):

a. Income (comprising charges and interest), to the extent recorded and recognized as revenue at contractual rates/basis (while the account was classified as "standard"), but remaining unrealized for past periods, is expected to be derecognized, usually by transfer to a separate account called "Interest Suspense" or similar account. This is done by reversal of the amount of the revenue, without reversing the debit in the borrower's account.

b. Further charges and interest recoverable at the contractual rates/basis (beyond the date on which the borrower was classified as NPA), are not recognized and a memorandum record thereof is maintained for future reference (for recoveries/waiver etc.).

(RBI has no objection to the banks using their own discretion in debiting interest to an NPA account taking the same to Interest Suspense Account or maintaining only a record of such interest in proforma accounts); however most banks follow the above-mentioned procedure.

1.542 The above action of the banks is based on the following guidelines covered by Para 3.2 of Part A of the said Master Circular, reproduced hereunder:

> *"3.2 Reversal of income*
>
> *3.2.1 If any advance, including bills purchased and discounted, becomes NPA, the entire interest accrued and credited to income*

@ Revised in 2013 Edition.

account in the past periods, should be reversed if the same is not realised. This will apply to Government guaranteed accounts also.

3.2.2 In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed with respect to past periods, if uncollected."

1.543 The RBI has guided the banks to adopt an accounting principle and exercise the right of appropriation of recoveries in a uniform and consistent manner, in the absence of any clear agreement between the bank and the borrower in this regard. Para 3.3 of Part A of the said Master Circular is reproduced hereunder:

"3.3 Appropriation of recovery in NPAs

3.3.1 Interest realised on NPAs may be taken to income account provided the credits in the accounts towards interest are not out of fresh/ additional credit facilities sanctioned to the borrower concerned.

3.3.2 In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e. towards principal or interest due), banks should adopt an accounting principle and exercise the right of appropriation of recoveries in a uniform and consistent manner."

1.544 If the debits arising out of devolvement of letters of credit or invoked guarantees are parked in a separate account, the balance outstanding in that account also should be treated as a part of the borrower's principal operating account for the purpose of application of prudential norms on income recognition, asset classification and provisioning.

1.545 The list of borrowers' accounts, where classification made as at the end of the previous year has been changed to a better classification or where there is reversal of provisions, should be taken from the branch officials alongwith the reasons for the same. These cases would need to be reviewed in detail to ensure correctness.

1.546 The bank is supposed to take details of net worth of Borrowers/ Guarantors at the time of original loan proposal and review / renewal of the same. For example, in case of Flat/ building, the detailed address, area of building / Flat should be noted, and in case of LIC policies, the number of LIC Policy could be taken. Similarly, in case of NSCs / KVPs / other investments, the distinctive nos. of such instruments, maturity date and details of issuing authority should be taken. The auditors should review the same.

1.547 The valuation of assets is important from the aspect of finding out the realisable value of assets and especially in case of NPA cases. Auditors should review the method used by the bank/valuers while valuing the assets. The valuation method used should reflect the realisable value of the assets rather than replacement cost. Further, the resolution cost / time cost for realising such assets should also be deducted while working out the net realizable value of the assets. In case of depreciable assets whose valuation was not carried out in the current financial year, adequate provision for depreciation needs to be made for the period from the date of valuation to the reporting date. The old stock and debtors should also not be considered for valuation purposes. Generally, the debtors outstanding beyond six months are not considered for valuation purposes.

1.548 The bank needs to closely monitor borrowal accounts, both as regards the funded and non-funded facilities. This is imperative in borderline cases where slippages due to persistent irregularities and deficiencies are observed, and in any case where the borrower is required to be classified as NPA. The off-balance sheet items / non-funded facilities are also to be recognised as credit facilities and involve risk of loss, which, on fructification, is recorded / provided in the same manner as the loss arising out of funded exposures. The same needs to be scrutinized in detail to verify if any amount is expected to be crystallised against the same. In case of expected liabilities, provisions against the same should be made as per AS-29 on Contingent Liabilities.

1.549 Any receivable representing positive mark-to-market value of a derivative contract, if overdue for a period of 90 days or more, is required to be treated as non-performing asset.

1.550 The bank is not supposed to account unrealised interest in NPA Accounts in the books of accounts. The unrealised interest in NPA accounts is generally termed as unapplied interest. The detail of unapplied interest is supposed to be maintained in Memorandum record. Though it is not to be recognised as income, it is of paramount importance that complete details with regard to the unapplied interest for each individual account is maintained in all NPA cases. Proper emphasis needs to be given to this aspect for adequate control on the receivables and recovery. Auditors should review the system to ensure that there are no mistakes in the same.

Audit Procedure for Accounts falling under CDR Programme

1.551 Following audit procedures are to be carried out to assess / gain an understanding about the borrower account.

(a) Review the present classification of the account under IRAC norms adopted by the bank and corresponding provision made in the books of accounts, if any. If the account is already treated as NPA in the books of the bank, the same cannot be upgraded only because of the CDR package.

(b) Review the Debtor- Creditor Agreement (DCA) and Inter Creditor Agreement (ICA) with respect to availability of such agreements and necessary provisions in the agreement for reference to CDR cell in case of necessity, penal clauses, stand-still clause, to abide by the various elements of CDR system etc., (DCA may be entered into at the time of original sanction of loan or at the time of reference to CDR).

(c) Auditor has to ascertain the terms of rehabilitation along with the sacrifices, if any, assumed in the rehabilitation program to verify whether such sacrifices have been accounted in the books of accounts of the lender. Ascertain whether any additional financing / conversion of loan into equity have been envisaged in the rehabilitation / restructuring program.

1.552 There are two Categories of CDR system namely Category 1 CDR system and Category 2 CDR system. Category 1 CDR system covers borrower accounts classified as 'Standard' and 'Sub-Standard' assets whereas Category 2 CDR system covers advances classified as 'Doubtful' asset. Corporates classified as willful defaulter, indulging in fraud or misfeasance even in a single bank will not be considered for CDR scheme. Auditor needs to ascertain whether the borrower account falls under Category 1 CDR system or Category 2 CDR system or classified as willful defaulter, fraud etc.,

1.553 Auditor should also ascertain whether account has been referred to BIFR, as such cases are not eligible for restructuring under CDR system. Large value BIFR cases may be eligible for restructuring under CDR if specifically recommended by CDR core group. Auditor has to verify the necessary approvals / recommendations by CDR core group if auditor comes across any BIFR cases.

1.554 Auditor has to ensure that accounts wherein recovery suits have been filed, the initiative to resolve under CDR system is taken by at least by 75% of the creditors by value and 60% in number provided the account meets the basic criteria for becoming eligible under CDR mechanism.

Treatment of accounts restructured under CDR program: Classification and Provisioning

1.555 The criteria for classification of accounts will be on the basis of record of recovery as per the existing prudential norms. The asset classification will be as per the lender bank's record of recovery and will be bank specific.

1.556 The auditor should ensure that the lender has applied the usual asset classification norms pending outcome of the account with the CDR Cell. The asset classification status should be restored to the position, which existed at the time of reference to the cell if the restructuring under the CDR system takes place.

1.557 The auditor should also ensure that in case a standard asset has been restructured second or more time, it has been downgraded to "substandard" asset.

1.558 The auditor should also ensure that proper disclosure in the Notes to Accounts in respect of CDR of SME undertaken by the bank during the year, as prescribed in the RBI's circular, has been made.

Sale/ Purchase of NPAs

1.559 In case of a sale/ purchase of NPAs by the bank, the auditor should examine the policy laid down by the Board of Directors in this regard relating to procedures, valuation and delegation of powers.

1.560 The auditor should also examine that:

(i) only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years.

(ii) the assets have been sold/ purchased "without recourse' only.

(iii) subsequent to the sale of the NPA, the bank does not assume any legal, operational or any other type of risk relating to the sold NPAs.

(iv) the NPA has been sold at cash basis only.

(v) the bank has not purchased an NPA which it had originally sold.

1.561 In case of sale of an NPA, the auditor should also ensure that:

(i) on the sale of the NPA, the same has been removed from the books of the account.

(ii) the short fall in the net book value has been charged to the profit and loss account.

(iii) where the sale is for a value higher than the NBV, no profit is recognised and the excess provision has not been reversed but retained to meet the shortfall/ loss on account of sale of other non-performing financial assets.

1.562 Similarly, in case of purchase of NPAs, the auditor should verify that:

(i) the NPA purchased has been subjected to the provisioning requirements appropriate to the classification status in the books of the purchasing bank.

(ii) any recovery in respect of an NPA purchased from other banks is first adjusted against its acquisition cost and only the recovered amount in excess of the acquisition cost has been recognised as profit.

(iii) for the purpose of capital adequacy, banks has assigned 100% risk weights to the NPAs purchased from other banks.

III-2
Investments

2.01 Investments are assets held by an enterprise for earning income by way of:

(a) Dividends, interest and rentals, or

(b) For capital appreciation, or

(c) For other benefits to the investing enterprise.

2.02 A unique feature of investments of banks is that a large proportion of the investments are made in pursuance of the requirement to maintain a certain minimum level of 'liquid assets' as required under statute. Investments that qualify as liquid assets can be made only in certain types of securities called 'approved securities'.

2.03 Apart from the above, the directions issued by the RBI from time to time also affect the quantum of investments, the nature of assets in which investments are made, and the extent of investment in a particular type of instrument or in a particular company/group of companies.

2.04 Investments of banks generally consist of the following:

(i) Securities of the Central and State Governments and other approved securities;

(ii) Shares (both equity as well as preference);

(iii) Debentures and bonds;

(iv) Subsidiaries/ joint ventures

(v) Financial derivatives; and

(vi) Other investments, such as, Commercial Papers, Certificate of Deposits, Security Receipts, Pass Through Certificates, Units of Mutual Funds, Venture Capital Funds and Real Estate Funds.

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

2.05 Banks may also make investments on behalf of customers or, subject to regulatory requirements in force, under portfolio management schemes.

Such assets held by a bank in pursuance of such activities are held in trust and are therefore not to be considered as its investments.

2.06 Normally, branches of banks are not allowed to make investments without the permission of the head office.

Important Terms

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

Approved Securities

2.08 Section 5(a) of the Banking Regulation Act, 1949 defines 'approved securities' to mean securities in which a trustee may invest money under clauses (a) to (d) and (f) of section 20 of the Indian Trusts Act, 1882. Approved securities comprise primarily the securities issued or guaranteed by the Central or State Government, or any other security expressly authorised by the Central Government by notification in the official gazette.

Bank Receipt (BR)

2.09 Bank receipt is acknowledgement from the selling bank to the buying bank that the former has received payment for certain securities, which it will deliver within a certain time. BR is non-transferable and can be issued by banks and certain specified institutions only.

Collateralised Borrowing and Lending Obligation

2.10 A money market product developed by Clearing Corporation of India Ltd. (CCIL) for the benefit of the entities who have either been phased out from inter-bank call money market or have been given restricted participation in terms of ceiling on call borrowing and lending transactions and who do not have access to the call money market. CBLO is a discounted instrument available in electronic book entry form for the maturity period ranging from one day to ninety days (can be made available up to one year as per RBI guidelines). The CBLO transactions can be undertaken on Negotiated Dealing System (NDS) only. CBLO is –

(i) an obligation by the borrower to return the money borrowed, at a specified future date;

(ii) an authority to the lender to receive money lent, at a specified future date with an option/privilege to transfer the authority to another person for value received; and

(iii) an underlying charge on securities held in custody (with CCIL) for the amount borrowed/lent.

Government Security

2.11 A government security is an instrument issued by the Central or a State Government, which is redeemable after a fixed period and may either be coupon bearing or issued at discount to face value. Further, Government of India has issued a General Clarification F. No.-4(13)-W&M/2008 dated October 8, 2008 for issue of Government securities, which is also appended to the RBI circular no. IDMD. 1800/08.01.01./2008-09 dated October 10, 2008.

Liquidity Adjustment Facility (LAF)

2.12 A monetary tool used by the RBI for injecting liquidity or absorption of the liquidity from the banking system. The LAF is operationalised through Repo and Reverse Repo route.

Negotiated Dealing System (NDS)

2.13 It is an electronic platform for facilitating dealing in Government Securities and Money Market Instruments. It is closed user group network open only for its members. The members of this network could be only those participants who are maintaining either a current account of SGL account with the RBI. NDS acts like stock exchanges in respect of Government Securities and money market instruments.

NDS OM

2.14 Negotiated Dealing System (RBI-NDS-GILTS-Order Matching Segment), NDS-OM for short, is an electronic order matching trading module for Government securities on its Negotiated Dealing System. The system is purely order-driven with all orders being matched based on strict price/time priority and the executed trades flowing straight to CCIL in a ready-for-settlement stage. The NDS-OM system is an order matching system wherein identification of the parties is not revealed. CCIL is the central counterparty to each trade done on the system. The NDS-OM system has been made available as an additional facility to the participants and the participants continue to have the option of using the current reporting and trading platform of the NDS. The settlement of both types of transactions are however, integrated. Attention of the reader may be drawn on RBI Circular No. IDMD. DOD. No. 5893/10.25.66/2007-08 dated May 25, 2008 on “NDS-Order Matching (OM) System-Access through the CSGL Route” and RBI Circular No. DPSS. CO. No. 528/04.04.009/2008-09 dated September 22, 2008 on “Access Criteria for National Payment Systems”.

Portfolio Management Scheme (PMS)

2.15 In a portfolio management scheme, the bank administering the scheme makes investments on behalf of clients for a 'management fee'. This is a fiduciary activity in which the profit or loss from the transactions belongs to the client. A bank can perform the services of PMS only after obtaining prior approval of RBI and only after getting itself registered with Securities and Exchange Board of India (SEBI).

Prudential Exposure Limits

2.16 The RBI from time to time prescribes the limits up to which investments in any one type of security or in any industry group or in any one company/group of companies, etc., can be made by a bank. These limits are known as "Prudential Exposure Limits". Reference to Master Circular on Exposure Norms (DBOD. No.Dir.BC. 3/13.03.00/2012-13 dated July 2, 2012) can be made for the Prudential Exposure Limits prescribed by the RBI.

Ready-forward Transactions or Repo

2.17 Ready-forward or Repo transactions are arrangements for current sale of securities and their simultaneous re-purchase at a future date at a price fixed at the time of sale. From the viewpoint of the other party, the transaction involves current purchase and subsequent resale of the securities concerned. In substance, a ready forward transaction involves financing of the bank that sells and agrees to repurchase the securities subsequently from the other party to the transaction. From the viewpoint of such other party, the difference between its current purchase price and subsequent resale price represents the yield on the transaction.

Repo Constituents' SGL Account (RC SGL Account)

2.18 A SGL account of a bank maintained with RBI with authorisation to RBI to act as custodian on its behalf, where the securities delivered by RBI under Repo is held.

Reverse Ready-forward Transactions or Reverse Repo

2.19 Reverse Ready-forward or Reverse Repo transactions are arrangements for current purchase of securities and their simultaneous re-sale at a future date at a price fixed at the time of purchase. In substance, a reverse ready forward transaction involves temporary deployment of the funds by the bank that purchases the securities and agrees to sell the securities subsequently to the other party to the transaction. The difference between its current purchase price and subsequent resale price represents the yield on the transaction.

Reverse Repo Constituents' SGL Account (RRC SGL Account)

2.20 A SGL account of a bank maintained with RBI with authorisation to RBI to act as custodian on its behalf, where the securities to be delivered to RBI under Reverse Repo is held.

Subsidiary General Ledger (SGL)

2.21 This is a ledger maintained by the Public Debt Office (PDO) of RBI in which accounts of different banks are maintained regarding their holding of select government securities. On a purchase or a sale of the securities, the transaction is recorded when the purchasing bank sends to PDO the Subsidiary General Ledger Form (SGL Form), signed on behalf of both the transferor and the transferee banks. In case the transaction is transacted at NDS, the CCIL, as central counter party, issues instructions to debiting/crediting of the SGL accounts with PDO. PDO acts like a depository in respect of government securities.

Treasury Bills

2.22 Treasury bills are government securities representing obligations, which mature in one year or less and are issued at a discount to the face value.

Yield-to-Maturity (YTM)

2.23 This is the average annual compounded rate of return on a security (taking into account both the interest and the redemption value), which the investor will earn if he holds it till maturity. YTM rates are published by the PDAI/FIMMDA at periodical intervals.

Legal Requirements

2.24 Section 24 of the Banking Regulation Act, 1949 (hereinafter referred to as 'the Act') requires every banking company to maintain in cash, gold or unencumbered approved securities, a percentage of its total demand and time liabilities[@] in India to such extent as may be prescribed from time to time by RBI.

2.25 Approved securities lodged with another institution for an advance or any other credit arrangement is unencumbered to the extent to which funds have not been availed of or drawn against such security.

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

[@] Revised in 2013 Edition.

2.27 If a bank desires to employ more funds in investments than is required to comply with the requirements of section 24 aforesaid, it may make such investments in any type of securities subject to the legal and regulatory requirements in this regard. The main considerations in making such investments would be yield, safety and liquidity.

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

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

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

2.31 In case of banking companies, section 49 of the Companies Act, 1956 is also relevant. This section provides that all investments made by a company on its own behalf shall be made and held by it in its own name, except in the following cases:

(a) If the company appoints or nominates a person as director of another company, qualification shares in the latter company may be held in the joint names of the company and such person or in the name of such person.

(b) Shares in a subsidiary may be held in the name(s) of the company's nominee(s) to the extent necessary to ensure the minimum number of members as required by law.

(c) Investments may be deposited with the bankers of the company for collection of dividend or interest.

(d) Investments may be deposited with, or transferred to, or held in the name of, the State Bank of India or a scheduled bank to facilitate transfer thereof, subject to the conditions laid down in this behalf.

(e) Investments may be deposited with, or transferred to, any person by way of security for repayment of a loan or performance of an obligation undertaken by the company.

(f) Investments in the form of securities may be held in the name of a depository.

2.32 In respect of investments not held in the company's own name as per the exceptions made under section 49, a register has to be maintained by the company, stating therein the nature, value and other particulars of the shares or securities, and the name of the banker or the person in whose custody they are held.

2.33 Section 372A of the Companies Act, 1956, which imposes certain restrictions on the purchase of shares in other companies, does not apply to a banking company.

2.34 The provisions of section 292 of the Companies Act, 1956, also need to be noted. This section provides that normally, the power to invest the funds of a company shall be exercised by its board of directors only by means of resolutions passed at meetings of the Board. The section, however, permits the Board, by means of a resolution passed at a meeting, to delegate this function to a committee of directors, managing director, manager or any other principal officer of the company or, in the case of a branch office, to a principal officer of the branch office provided that such a resolution for delegation specifies the amount up to which the investments may be made and the nature of the investments.

Balance Sheet Disclosure

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

I. *Investments in India in*

(i) Government securities

(ii) Other approved securities

(iii) Shares

(iv) Debentures and Bonds

(v) Subsidiaries and/or joint ventures

(vi) Others (to be specified)

II. *Investments outside India in*

(i) Government securities (including local authorities)

(ii) Subsidiaries and/or joint ventures abroad

(iii) Other investments (to be specified)

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

(a) gross value of investments in India and outside India;

(b) aggregate of provisions for depreciation, separately on investments in India and outside India; and

(c) net value of investments in India and outside India.

(d) Movement of provisions held towards depreciation on investments including opening balance by adding provisions made during the year and after deducting write-off/ write-back of excess provisions during the year.

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

2.38 For disclosures relating to investments in notes on accounts, please refer Chapter 11 of Part III of the Guidance Note.

Guidelines of the RBI regarding transactions in Securities

2.39 The Reserve Bank of India has issued the Master Circular No. DBOD No. BP. BC.13/21.04.141/2012-13 dated July 2, 2012 on "Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks". (This circular is given in the CD along with the Guidance Note), consolidating instructions/guidelines issued to banks on matters regarding prudential norms for classification, valuation and operation of Investment portfolio of banks. The salient points arising from the circular are discussed below.

Investment policy

2.40 Banks are required to frame their investments policy and obtain the Board's approval. The investment policy may be suitably framed / amended to include Primary Dealer (PD) activities also. Within the overall framework of the investment policy, the PD business undertaken by the bank will be limited to dealing, underwriting and market–making in Government Securities. Investments in Corporate/ PSUs/ FIs bonds, Commercial Papers, Certificate of Deposits, debt mutual funds and other fixed income securities will not be deemed to be part of PD business. Such policies should be implemented to ensure that the operations in securities are conducted in accordance with sound and acceptable business practices. Within the policy framework, banks may undertake primary dealers' activities in Government Securities. The policy may specially contain the followings for the bank to undertake such transactions:

a) Sale of a government security already contracted for purchase, provided:
   - The purchase contract is confirmed prior to the sale;
   - The purchase contract is guaranteed by CCIL or the security is contracted for purchase from RBI;
   - The sale transaction will settle either in the same settlement cycle as the preceding purchase contract or in subsequent settlement cycle so that the delivery obligation under the sale contract is met by the securities acquired under the purchase contract; and
   - Securities purchased from RBI through Open Market Operations, no sale transactions should be contracted prior to receiving confirmation of the allotment from RBI.

b) Scheduled commercial banks (other than RRBs and LABs) and Primary Dealers can short sell Government securities in accordance with conditions prescribed by the RBI in the above-mentioned Master Circular.

c) Transactions on "when issued" basis in Central Government dated securities, in accordance with conditions prescribed by the RBI in the above mentioned Master Circular.

d) Contract for sale of allotted securities in the auction of primary securities of Government in accordance with conditions prescribed by the RBI in the above-mentioned Master Circular.

e) The settlement of all outright secondary market transactions in Government Securities is on a standardised T+1 basis.

f) All the transactions put through by a bank, either on outright basis or on ready-forward basis, and whether through the mechanism of SGL (Subsidiary General Ledger) Account or Bank Receipt (BR), should be reflected on the same day in its Investment Account and accordingly for SLR (statutory liquidity ratio) purpose, wherever applicable. With a view to bringing in uniformity in the methodology of accounting for investments in Government securities, banks should follow 'Settlement Date' accounting for recording purchase and sale of transactions in Government securities.

g) The brokerage on the deal payable to brokers should be clearly indicated on the notes/memorandum put up to the top management and a separate account of brokerage paid, broker-wise, should be maintained.

h) BRs should be in the format prescribed by the Indian Banks' Association (IBAs) and should strictly follow the related guidelines issued by the IBA. BRs should cover only its own sale transactions, and not those of its PMS or of other constituents, including brokers.

i) Due care to be taken while acting as agents for their broker clients for carrying out transactions in securities on behalf of brokers.

j) Any return of SGL form from the PDO (Public Debt Office of the RBI) for want of sufficient balance in the account should be immediately brought to the notice of RBI with details of the underlying transactions.

Investments in Shares/debenture

2.41 Banks opting to invest in shares/debentures to observe the following guidelines:

(i) Build up adequate expertise in equity research and establish equity research facility.

(ii) Formulate transparent policy and procedure for investment in shares as approved by its board.

(iii) Investment committee is to be set up by the bank's board for direct investments and such committee should be held accountable for the investments made by the bank.

2.42 With the approval of respective Boards, banks should clearly lay down the broad investment objectives to be followed while undertaking transactions in securities on their own investment account and on behalf of clients, clearly define the authority to put through deals, procedure to be followed for obtaining the sanction of the appropriate authority, procedure to be followed while putting through deals, various prudential exposure limits and the reporting system.

While laying down such investment policy guidelines, banks should strictly observe Reserve Bank's detailed instructions on the following aspects in the above-mentioned Master Circular:

a Separate Trading of Registered Interest and Principal Securities (STRIPS)
b Ready Forward (buy back) deals
c Transactions through Subsidiary General Ledger A/c
d Use of Bank Receipts
e Retailing of Government securities
f Internal Control System
g Dealings through Brokers
h Audit, Review and Reporting
i Non- SLR investments

2.43 The aforesaid instructions will be applicable mutatis mutandis, to the subsidiaries and mutual funds established by banks, except where they are contrary to or inconsistent with, specific regulations of SEBI and RBI governing their operations.

STRIPS

2.44 Stripping is a process of converting periodic coupon payments of an existing Government security into tradable zero-coupon securities, which will usually trade in the market at a discount and are redeemed at face value. For instance, stripping a five-year Govt security would yield 10 coupon securities (representing the coupons), maturing on the respective coupon dates and one principal security representing the principal amount, maturing on the redemption date of the five-year security. Reconstitution is the reverse process of stripping, where, the Coupon STRIPS and Principal STRIPS are reassembled into the original Government security. Detailed guidelines outlining the process of stripping/reconstitution and other operational procedures regarding transactions in STRIPS are given in the Master Circular.

Ready Forward (buy back) Deals

2.45 No bank shall undertake inter-bank ready forward transactions other than in treasury bills (of all maturities) and dated securities of the Government of India and State Governments.

2.46 Ready forward contracts in the above-mentioned securities may be entered into by:

i. Persons or entities maintaining a Subsidiary General Ledger (SGL) account with RBI, Mumbai and

ii. Following categories of entities who do not maintain SGL accounts with the RBI but maintain gilt accounts (i.e gilt account holders) with a bank or any other entity (i.e. the custodian) permitted by the RBI to maintain Constituent Subsidiary General Ledger (CSGL) account with its Public Debt Office, Mumbai:

   a. Any scheduled bank,

   b. Any primary dealer authorised by the RBI,

   c. Any non-banking financial company registered with the RBI, other than Government companies as defined in Section 617 of the Companies Act, 1956,

   d. Any mutual fund registered with the SEBI,

   e. Any housing finance company registered with the National Housing Bank,

   f. Any insurance company registered with the Insurance Regulatory and Development Authority,

   g. Any non-scheduled Urban Co-operative bank,

   h. Any listed company, having a gilt account with a scheduled commercial bank, subject to the following conditions:

      1. The minimum period for Reverse Repo (lending of funds) by listed companies is seven days. However, listed companies can borrow funds through repo for shorter periods including overnight;

      2. Where the listed company is a 'buyer' of securities in the first leg of the repo contract (i.e. lender of funds), the custodian through which the repo transaction is settled should block these securities in the gilt account and ensure that these securities are not further sold or rerepoed during the repo period but are held for delivery under the second leg; and

      3. The counterparty to the listed companies for repo / reverse repo transactions should be either a bank or a Primary Dealer maintaining SGL Account with the RBI.

i. Any unlisted company which has been issued special securities by the Government of India and having gilt account with a scheduled commercial bank; subject to the following conditions in addition to the conditions stipulated for listed company:

   1. The eligible unlisted companies can enter into ready forward transactions as the borrower of funds in the first leg of the repo contract only against the collateral of the special securities issued to them by the Government of India; and

   2. The counterparty to the eligible unlisted companies for repo transactions should be either a bank or a Primary Dealer maintaining SGL account with the Reserve Bank.

2.47 All persons or entities specified at (ii) above can enter into ready forward transactions among themselves subject to the following restrictions:

i. An SGL account holder may not enter into a ready forward contract with its own constituent. That is, ready forward contracts should not be undertaken between a custodian and its gilt account holder,

ii. Any two gilt account holders maintaining their gilt accounts with the same custodian (i.e., the CSGL account holder) may not enter into ready forward contracts with each other, and

iii. Cooperative banks may not enter into ready forward contracts with the non-banking financial companies. This restriction would not apply to repo transactions between Urban Co-operative banks and authorised Primary Dealers in Government Securities.

2.48 All ready forward contracts shall be reported on the Negotiated Dealing System (NDS). In respect of ready forward contracts involving gilt account holders, the custodian (i.e., the CSGL account holder) with whom the gilt accounts are maintained will be responsible for reporting the deals on the NDS on behalf of the constituents (i.e. the gilt account holders).

2.49 All ready forward contracts shall be settled through the SGL Account / CSGL Account maintained with the RBI, Mumbai, with the Clearing Corporation of India Ltd. (CCIL) acting as the central counter party for all such ready forward transactions.

2.50 The custodians should put in place an effective system of internal control and concurrent audit to ensure that:

i. ready forward transactions are undertaken only against the clear balance of securities in the gilt account,

ii. all such transactions are promptly reported on the NDS, and

iii. other terms and conditions referred to above have been complied with.

2.51 The RBI regulated entities can undertake ready forward transactions only in securities held in excess of the prescribed Statutory Liquidity Ratio (SLR) requirements.

2.52 No sale transaction shall be put through, in the first leg of a ready forward transaction by CSGL constituent entities without actually holding the securities in the portfolio.

2.53 Securities purchased under the ready forward contracts shall not be sold during the period of the contract except by entities permitted to undertake short selling,

2.54 Double ready forward deals in any security are strictly prohibited.

2.55 The guidelines for uniform accounting for Repo / Reverse Repo transactions are furnished later in this chapter.

Transactions through SGL

2.56 All transactions in government securities for which SGL facility is available are to be put through SGL accounts only. Procedural instructions regarding SGL transactions laid down by RBI should be strictly adhered to. Significant ones are the following:

(i) SGL transfer forms issued should under no circumstances bounce for want of balance. Banks would attract penal action for failure to comply with this policy.

(ii) SGL transfer forms received by the purchasing banks should be deposited in their SGL accounts immediately. While in cases of OTC trades, the settlement has to be only on 'spot' delivery basis as per Section 2(i) of the Securities Contracts (Regulations) Act, 1956, in cases of deals on the recognised Stock Exchanges; settlement should be within the delivery period as per their rules, bye laws and regulations. In all cases, participants must indicate the deal/trade/contract date in Part C of the SGL Form under 'Sale date'. Where this is not completed the SGL Form will not be accepted by the RBI.

(iii) No sale should be effected by way of return of an SGL form held by the bank.

(iv) SGL transfer forms should be in standard format as prescribed by RBI and printed on semi-security paper of uniform size and serially numbered and there should be an adequate control system to account for each SGL form.

(v) Two authorised bank officials whose signatures should be recorded with the respective Public Debt Office (PDO) of RBI and with other banks should sign SGL transfer forms.

Use of Bank Receipts

2.57 Banks should not issue BRs under any circumstance in respect of transactions in government securities for which SGL facility is available. No BR should be issued covering transactions relating to PMS client or other constituents' accounts including brokers. In the case of other securities, BRs may be issued for bank's own ready transactions under the following circumstances:

(i) The issuer is yet to issue the scrips and the bank holds the allotment advice; or

(ii) The underlying security is physically held at different centre and the bank is in a position to physically transfer the security and effect delivery within a short period; or

(iii) The underlying security has been lodged for transfer/interest payment and the bank holds necessary records of such lodgements, and it would be in a position to effect physical delivery of the security within a short period.

2.58 No BR should be issued on the basis of a BR of another bank held by the bank, and no transaction should be made on the basis of a mere exchange of BRs held by the bank.

a. BRs should not remain outstanding for more than fifteen days and should be redeemed only by actual delivery. If the BR is not redeemed by delivery of scrips within 15 days, the BR should be deemed as dishonoured and the issuing bank has to report to RBI the fact, explaining the reasons thereof.

b. All BRs should be in a standard format, on semi-security paper, and serially numbered. There should be an adequate control system to account for each BR form. BRs are to be signed by two authorised officials of the bank, whose signatures should be recorded with other banks. Separate registers for BRs issued and BRs received should be maintained and the same should be systematically used for follow-up purpose.

c. There should a proper system for custody of unused BRs and their utilisation. The central auditors should review the existence and operations of the control over unused BRs. Central auditors are required to furnish annual certificate to Regional Office of Department of Banking Supervision of RBI to this effect.

d. Any violation of the guidelines would attract penal consequences as prescribed by the master circular.

Retailing of Government securities

2.59 It is permitted with non-banking clients provided the retailing is on an outright basis and on the basis of ongoing market rates/yield curves of secondary market operations. Further, there should be no restrictions on the period between sale and purchase.

Internal Control System

2.60 Banks should establish an internal control system, which should, in particular, cover the following areas:

(i) There should be a clear functional separation of the (a) trading, (b) settlement, monitoring and control, and (c) accounting activities. Similarly, there should be a functional separation of trading and back-office functions relating to bank's own investments, PMS Clients and other constituents (including brokers') accounts. External auditors should separately audit PMS clients' accounts.

(ii) A deal slip should be prepared by the trading desk for every transaction entered into containing prescribed details. The deal slip should contain data relating to nature of the deal, name of the counter-party, whether it is a direct deal or through a broker, and if through a broker, name of the broker, details of security, amount, price, contract date and time. The deal slips should be serially numbered and controlled separately to ensure that each deal slip is properly accounted for. On completion of deal, the dealer should immediately pass the slip to back office for recording and processing. There should be a system of issuing confirmation to counterparty and receiving written confirmation from the counterparty on a timely basis. In respect of transactions on NDS-OM, counterparty confirmation is not required as CCIL is the central counterparty to all deals. The deals in Government security transactions in OTC market that are mandated to be settled through CCIL by reporting on the NDS, are not required to be confirmed physically as OTC deals depend on electronic confirmation by the back offices of both the counterparties on NDS system like the NDS-OM deals. However, all government securities transactions, other than those matched on NDS-OM, will continue to be physically confirmed by the back offices of the counterparties, as hitherto.

(iii) Once a deal has been concluded, there should not be any substitution of the counterparty. Likewise, the security sold/purchased in the deal should also not be substituted by another security.

(iv) On the basis of the voucher passed by the back-office (which should be made after verification of actual contract notes received from the brokers/counterparty, and confirmation by the counterparty), the accounts section should independently record the transactions.

(v) In the case of transactions relating to PMS and other constituents, the relative records should give a clear indication that they do not belong to the bank's own Investment Account.

(vi) Proper records of SGL transfer forms issued/received should be maintained. The balances as per the bank's books should be reconciled at quarterly intervals with the balances in the books of PDO. The reconciliation may be made more frequently if the number of transactions so warrants. The reconciliation should be periodically checked by internal audit department.

(vii) Any bouncing of the SGL transfer forms needs to be reported immediately to the Department of Banking Supervision of the RBI by the buying bank.

(viii) A record of BRs issued/received should be maintained.

(ix) A system for verification of the authenticity of the BRs and SGL transfer forms received from the other banks and confirmation of authorised signatories should be put in place.

(x) Banks should not draw cheques on their account with the RBI for third party transactions, including inter-bank transactions. For such transactions, bankers' cheques/ pay orders should be issued.

(xi) A system of reporting to the top management on weekly basis, giving details of transactions in securities, bouncing of SGL forms, BRs outstanding for more than one month etc., should be instituted.

(xii) In case of investment in shares, the surveillance and monitoring of investment should be done by the Audit Committee of the Board, which shall review in each of its meetings, the total exposure of the bank to capital market both fund based and non-fund based, in different forms as stated above and ensure that the guidelines issued by RBI are complied with and adequate risk management and internal control systems are in place.

(xiii) The Audit Committee should keep the Board informed about the overall exposure to capital market, the compliance with the RBI and Board guidelines, adequacy of risk management and internal control systems.

(xiv) In order to avoid any possible conflict of interest, it should be ensured that the stockbrokers as directors on the Boards of banks or in any other capacity, do not involve themselves in any manner with the Investment Committee or in the decision with regard to making investments in shares, etc., or advances against shares.

(xv) The internal audit department should audit the transactions in securities on an ongoing basis, monitor the compliance with the laid down management policies and prescribed procedures and report the deficiencies directly to the management of the bank.

(xvi) The banks' managements should ensure that there are adequate internal control and audit procedures for ensuring proper compliance of the instructions in regard to the conduct of the investment portfolio. The banks should institute a regular system of monitoring compliance with the prudential and other guidelines issued by the RBI. The banks should get compliance in key areas certified by their statutory auditors and furnish such audit certificate to the Regional Office of Department of Banking Supervision of RBI under whose jurisdiction the HO of the bank falls.

Dealings through Brokers

2.61 Banks should follow the following guidelines as prescribed in the above-mentioned Master Circular:

(i) Transactions between banks should not be put through the broker's account.

(ii) The brokerage on the deal payable to brokers should be clearly indicated on the notes/memorandum put up to the top management.

(iii) A separate account of brokerage paid, broker-wise, should be maintained. Further, a record of broker-wise details deals and brokerage paid should also be maintained.

(iv) The role of the broker should be restricted to that of bringing the two parties to the deal together.

(v) While negotiating the deal, the broker is not obliged to disclose the identity of the counterparty to the deal. On conclusion of the deal, he should disclose the counterparty and his contract note should clearly indicate the name of the counterparty. It should also be ensured by the bank that the broker note contains the exact time of the deal. Their back offices may ensure that the deal time on the broker note and the deal ticket is the same. The bank should also ensure that their concurrent auditors audit this aspect.

(vi) On the basis of the contract note disclosing the name of the counterparty, settlement of deals between banks, viz. both fund settlement and delivery of security should be directly between the banks and the broker should have no role to play in the process.

(vii) Panel of brokers as approved by top management to be constituted and should be reviewed annually based on criteria laid down by the Board for their empanelment including creditworthiness, market reputation, etc., of the brokers.

(viii) The business through brokers should be distributed among the panel and a limit of 5% of the total transactions entered by the bank through brokers during a year has been specified in respect of an individual approved broker. This limit should cover both the business initiated by a bank and the business offered/ brought to the bank by a broker. Banks should ensure that the transactions entered into through individual brokers during a year normally do not exceed this limit. However, if for any reason it becomes necessary to exceed the aggregate limit for any broker, the specific reasons therefor should be recorded, in writing, by the authority empowered to put through the deals. Further, the board should be informed of this, post facto. However, the norm of 5% is not applicable to banks' dealings through primary dealers.

(ix) Inter bank securities transactions should not be entered through a broker unless such transactions are undertaken on NSE, BSE or OTCEI.

(x) Concurrent auditors who audit the treasury operations should scrutinise the business done through brokers and report to the appropriate authority in accordance with the Master Circular.

Audit, Review and Reporting

2.62 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 copy of the review reports should be put up to banks' boards within a month i.e by end-April and end-October. A copy of the review report put up to the Bank's Board, should be forwarded to RBI by 15 November and 15 May respectively.

2.63 The concurrent 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 audit report of internal auditor 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.

Non- SLR investments

Appraisal

2.64 Banks have made significant investment in privately placed unrated bonds and, in certain cases, in bonds issued by corporates who are not their borrowers. While assessing such investment proposals on private placement basis, in the absence of standardised and mandated disclosures, including credit rating, banks may not be in a position to conduct proper due diligence to take an investment decision. Thus, there could be deficiencies in the appraisal of privately placed issues.

Disclosure requirements in offer documents

2.65 The risk arising from inadequate disclosure in offer documents should be recognised and banks should prescribe minimum disclosure standards as a policy with Board approval. In this connection, RBI had constituted a Technical Group comprising officials drawn from treasury departments of a few banks and experts on corporate finance to study, inter alia, the methods of acquiring, by banks, of non-SLR investments in general and private placement route, in particular, and to suggest measures for regulating these investments. The Group had designed a format containing the minimum disclosure requirements as well as certain conditionalities regarding documentation and creation of charge for private placement issues, which may serve as a 'best practice model' for the banks. The details of the Group's recommendations are given in the Annex III to the Master Circular and banks should have a suitable format of disclosure requirements on the lines of the recommendations of the Technical Group with the approval of their Board.

Internal assessment

2.66 With a view to ensuring that the investments by banks in issues through private placement, both of the borrower customers and non-borrower customers, do not give rise to systemic concerns, it is necessary that banks should ensure that their investment policies duly approved by the Board of Directors are formulated after taking into account the following aspects:

(a) The Boards of banks should lay down policy and prudential limits on investments in bonds and debentures including cap and on private placement basis, sub limits for PSU bonds, corporate bonds, guaranteed bonds, issuer ceiling, etc.

(b) Investment proposals should be subjected to the same degree of credit risk analysis as any loan proposal. Banks should make their own internal credit analysis and rating even in respect of rated issues and should not entirely rely on the ratings of external agencies. The appraisal should be more stringent in respect of investments in instruments issued by non-borrower customers.

(c) Strengthen their internal rating systems which should also include building up of a system of regular (quarterly or half-yearly) tracking of the financial position of the issuer with a view to ensuring continuous monitoring of the rating migration of the issuers/issues.

(d) As a matter of prudence, banks should stipulate entry-level minimum ratings/ quality standards and industry-wise, maturity-wise, duration-wise, issuer-wise etc. limits to mitigate the adverse impacts of concentration and the risk of illiquidity.

(e) The banks should put in place proper risk management systems for capturing and analysing the risk in respect of these investments and taking remedial measures in time.

2.67 Some banks / FIs have not exercised due precaution by reference to the list of defaulters circulated / published by RBI while investing in bonds, debentures, etc., of companies. Banks may, therefore, exercise due caution, while taking any investment decision to subscribe to bonds, debentures, shares etc., and refer to the 'Defaulters List' to ensure that investments are not made in companies / entities who are defaulters to banks / FIs. Some of the companies may be undergoing adverse financial position, turning their accounts to sub-standard category due to recession in their industry segment, like textiles. Despite restructuring facility provided under RBI guidelines, the banks have been reported to be reluctant to extend further finance, though considered warranted on merits of the case. Banks may not refuse proposals for such investments in companies whose director's name(s) find place in the 'Defaulter Companies List' circulated by RBI, at periodical intervals and particularly in respect of those loan accounts, which have been restructured under extant RBI guidelines, provided the proposal is viable and satisfies all parameters for such credit extension.

Prudential Guidelines on investment in Non-SLR Securities

2.68 The above-mentioned Master Circular lays down the following guidelines in respect of investment in non-SLR securities:

(i) Definitions of terms specific to this topic are specified in Annexure IV of the above-mentioned Master Circular.

(ii) These guidelines cover banks' investments in non-SLR securities issued by corporates, banks, FIs and State and Central Government sponsored institutions, SPVs etc, including, capital gains bonds, bonds eligible for priority sector status. The said guidelines will also apply to investments both in the primary market as well as the secondary market.

(iii) These prudential guidelines do not apply to a bank's investment in:

- Securities directly issued by the Central and State Governments, which are not reckoned for SLR purposes.
- Equity shares.
- Units of equity oriented mutual fund schemes, viz. those schemes where any part of the corpus can be invested in equity.
- Equity/debt instruments issued by Venture capital funds.
- Commercial Paper.
- Certificates of Deposit.
- Non Convertible Debentures (NCDs) with original or initial maturity up to one year issued by corporates (including NBFCs)

(iv) No investments should be made in non-SLR securities of original maturity of less than one-year except in commercial paper and certificate of deposits and NCDs with original or initial maturity up to one year issued by corporates (including NBFCs), which are covered under RBI guidelines. However, while investing in such NCDs banks should be guided by the extant prudential guidelines in force, ensure that the issuer has disclosed the purpose for which the NCDs are being issued in the disclosure document and such purposes are eligible for bank finance (refer to para 5 and 7 of Master Circular DBOD.BP.BC.No.27/21.04.172/2012-13 dated July 2, 2012 on Bank Finance to Non-Banking Financial Companies).

(v) Banks should ensure that the funds proposed to be raised through non-SLR securities are not intended to be used for financing activities which banks are precluded from extending credit facilities.

(vi) No investments in unrated non-SLR securities should be made. However, a bank may invest in unrated bonds of companies engaged in infrastructure activities; within the ceiling of 10% for unlisted non-SLR securities (refer point (vii) below). Debt securities which comply with SEBI requirement and carrying credit rating of not less than Investment grade from a credit rating agency registered with SEBI would only be eligible.

(vii) Investments in unlisted non-SLR securities shall not exceed 10% of its total investment in non-SLR securities as on 31st March of the previous year.

(viii) The unlisted non-SLR securities in which banks may invest up to the limits specified above, should comply with the disclosure requirements as prescribed by the SEBI for listed companies. Further, as there is a time lag between issuance and listing of securities, investment in non-SLR debt securities (both primary and secondary market) by banks where the security is proposed to be listed on the Exchange(s) may be considered as investment in listed security at the time of making investment. However, if such security is not listed within the period specified, the same will be reckoned for the 10 per cent limit specified for unlisted non-SLR securities. In case such investments included under unlisted non-SLR securities lead to a breach of the 10 per cent limit, the bank would not be allowed to make further investment in non-SLR securities (both primary and secondary market) as also in unrated bonds issued by companies engaged in infrastructure activities till such time bank's investment in unlisted non- SLR securities comes within the limit of 10 per cent.

(ix) Investment in unlisted non-SLR securities may exceed the above-mentioned limit by 10% provided the investment is on account of securitisation papers issued for infrastructure projects, or unrated bonds of companies engaged in infrastructure activities or bonds/debentures of securitisation companies and reconstruction companies registered with RBI. In other words, investments exclusively in securities specified in this paragraph could be up to the maximum permitted limit of 20% of non-SLR investment.

(x) The total investment by banks in liquid/short term debt schemes (by whatever name called) of mutual funds with weighted average maturity of portfolio of not more than 1 year, will be subject to a prudential cap of 10 per cent of their net worth as on March 31 of the previous year. The weighted average maturity would be calculated as average of the remaining period of maturity of securities weighted by the sums invested.

(xi) Investments in Security Receipts issued by Securitisation companies and Reconstruction companies registered with RBI and investments in Asset Backed Securities and Mortgage Backed Securities rated at or above minimum investment grade and Investments in unlisted convertible debentures will not be reckoned as 'unlisted non-SLR securities' for computing compliance with the prudential limits. However, investments in unlisted convertible debentures would be treated as "Capital Market Exposure".

(xii) Investments in RIDF/SIDBI not to be reckoned as part of numerator as well as denominator for computing compliance with the prudential limit of 10% of its total non-SLR securities.

(xiii) Investment in mutual fund schemes in units, which have an exposure to unlisted securities of less than 10% of the corpus fund, will be on par with listed securities. For computing the 10% of the corpus, Treasury Bills, CBLO, Repo/Reverse Repo, and bank deposits is not to be included in the numerator.

(xiv) The denominator of non-SLR investments would include four categories in Schedule 8 to the Balance Sheet, *viz.*, shares, bonds & debentures, subsidiaries/joint ventures and others.

(xv) Banks whose investment in unlisted non-SLR securities are within the prudential limit of 10 per cent of its total non-SLR securities as on March 31, of the previous year may make fresh investment in such securities and up to the prudential limits.

(xvi) Board should ensure that their investment policies are formulated after taking into consideration all the relevant issues relating to non- SLR securities as mentioned in the Master Circular. Banks should put in place proper risk management systems for capturing and analysing the risk in respect of non-SLR investment and taking remedial measures in time. Banks should also put in place appropriate systems to ensure that investment in privately placed instruments is made in accordance with the systems and procedures prescribed under respective bank's investment policy.

(xvii) Boards should review at least at quarterly intervals the following aspects of non-SLR investment:

- Total business (investment and divestment) during the reporting period.
- Compliance with the prudential limits prescribed by the Board for non-SLR investment.
- Compliance with the prudential guidelines issued by RBI on non-SLR securities.
- Rating migration of the issuers/ issues held in the bank's books and consequent diminution in the portfolio quality.

- Extent of non-performing investments in the non-SLR category.

(xviii) In order to help in the creation of a central database on private placement of debt, a copy of all offer documents should be filed with a Credit Information company, which has obtained Certificate of Registration from RBI and of which the bank is a member, by the investing banks. Further, any default relating to interest/ instalment in respect of any privately placed debt should also be reported to a credit information company, which has obtained Certificate of Registration from RBI and of which the bank is a member, by the investing banks along with a copy of the offer document.[@]

(xix) Please refer Chapter 11 of Part III of the Guidance Note regarding the disclosures required in respect of non-SLR investments.

Trading and Settlement in debt securities

2.69 All trades with the exception of the spot transactions, in a listed debt security, shall be executed only on the trading platform of a stock exchange. The banks should ensure compliance with RBI and SEBI guidelines. In addition to complying with the SEBI guidelines, banks should ensure that all spot transactions in listed and unlisted debt securities are reported on the NDS and settled through the CCIL from a date to be notified by RBI. All OTC trades in corporate bonds shall necessarily be cleared and settled through the NSCCL or ICCL as per the norms specified by the NSCCL and the ICCL from time to time, with effect from December 01, 2009.

Repo in Corporate Debt Securities

2.70 Eligible entities as per detailed guidelines given in Annex I-E can undertake repo in corporate debt securities which are rated ‘AA’ or above by the rating agencies, that are held in the security account of the repo seller, in demat form. However, Commercial Papers (CPs), Certificates of Deposit (CDs) and other instruments including Non-Convertible Debentures (NCDs) of less than one year of original maturity, shall not be eligible securities for undertaking repo in corporate debt securities.

General Aspects

2.71 Banks should also observe the following:

(i) Banks should at the end of every accounting year furnish ‘Statement of the Reconciliation of Bank's Investments (held in own Investment account, as also under PMS)’, duly certified by its statutory auditors, to RBI within one month from the close of the accounting year. Banks in the letters of

[@] Revised in 2013 edition.

appointment, issued to its statutory auditors, may suitably include the aforementioned requirement of reconciliation. (Annexure VI to the Master Circular contains the format and instructions).

(ii) Custodial functions on behalf of merchant bank subsidiaries should also be subjected to same safeguards as would be applicable to other constituents.

(iii) The general powers vested in banks to operate PMS and similar schemes have been withdrawn. No bank can, therefore, restart or introduce any new PMS or similar scheme in future without obtaining specific prior approval of the RBI. However, bank-sponsored NBFCs are allowed to offer discretionary PMS to their clients, on a case-to-case basis. Applications in this regard should be submitted to the Department of Banking Operations and Development Further, the RBI has also prescribed certain conditions in the Master Circular to be observed by the banks operating PMS or other similar schemes with the specific prior approval of RBI.

(iv) PMS clients' accounts should be subjected by banks to a separate audit by external auditors.

(v) Banks should note that violation of RBI instructions will be viewed seriously and will invite deterrent action against the banks, which will include raising of reserve requirements, withdrawal of facility of refinance from the RBI and denial of access to money markets, apart from prohibition from undertaking PMS activity.

vi) Further, the aforesaid instructions will apply, mutatis mutandis, to the subsidiaries of banks except where they are contrary to specific regulations of the RBI or SEBI, governing their operations.

vii) Banks / merchant banking subsidiaries of banks operating PMS or similar scheme with the specific prior approval of the RBI are also required to comply with the guidelines contained in the SEBI (Portfolio Managers) Rules and Regulations, 1993 and those issued from time to time.

Transactions in Government Securities

2.72 To minimise chances of fraudulent transactions in the guise of Government Securities transactions, the RBI has accelerated the following measures for further reducing the scope of trading in physical forms:

- For banks which do not have SGL account with RBI, only one gilt account can be opened.

- In case the gilt accounts are opened with a scheduled commercial bank, the account holder has to open a designated funds account (for all gilt account related transactions) with the same bank.
- The entities maintaining the gilt/designated funds accounts will be required to ensure availability of clear funds in the designated funds accounts for purchases and of sufficient securities in the gilt account for sales before putting through the transactions.
- No transactions by the bank should be undertaken in physical form with any broker.
- Banks should ensure that brokers approved for transacting in Government securities are registered with the debt market segment of NSE/BSE/OTCEI.

Classification of Investments

2.73 Banks are required to classify their entire investments portfolio into three categories: held-to-maturity, available-for-sale and held-for-trading.

(i) Held-to-maturity (HTM)

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

(ii) Held-for-trading (HFT)

This category would comprise securities acquired by the bank with the intention of trading, i.e., to benefit from short-term price/interest rate movements.

(iii) Available-for-sale (AFS)

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

2.74 Banks should decide the category of the investment at the time of acquisition and the decision should be recorded on the investment proposal/deal slip.

2.75 The banks will have the freedom to decide on the extent of holdings under HFT and AFS. This will be decided by them after considering various aspects such as basis of intent, trading strategies, risk management capabilities, tax planning, manpower skills, capital position.

HTM Category-Broad Guidelines

2.76 The RBI has prescribed the following guidelines with regard to HTM category:

(i) Investments under this category should not normally exceed 25 per cent of the total investments of the bank, however, this limit can be exceeded, provided-

   (a) the excess comprises only SLR securities, and

   (b) the total SLR securities held in the HTM category is not more than 25 per cent of their DTL as on the last Friday of the second preceding fortnight.

(ii) The following securities are to be classified under HTM but are not to be reckoned while applying the ceiling of 25 per cent:

   - Re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in their investment portfolio. This will not include re-capitalisation bonds of other banks acquired for investment purposes.
   - Investment in subsidiaries and joint ventures (A Joint Venture would be one in which the bank, along with its subsidiaries, holds more than 25 percent of the equity).
   - Investment in the long-term bonds (with a minimum residual maturity of seven years) issued by companies engaged in infrastructure activities. The minimum residual maturity of seven years should be at the time of investment in these bonds. Once invested, banks may continue to classify these investments under HTM category even if the residual maturity falls below seven years subsequently.[@]

(iii) Banks may hold the following securities under HTM category:

   (a) SLR securities upto 25 per cent of DTL as on the last Friday of the second preceding fortnight.

   (b) Non-SLR securities included under HTM as on September 2, 2004. No fresh non-SLR securities are permitted to be included under HTM except:

      - Fresh re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in investment portfolio. This will not include re-capitalisation bonds of other banks acquired for investment purposes.

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- Fresh investment in the equity of subsidiaries and joint ventures (A joint venture would be one in which bank, along with its subsidiaries, holds more than 25 per cent of the equity).
- RIDF/ SIDBI /RHDF deposits.

(c) Investment in long-term bonds (with a minimum residual maturity of seven years) issued by companies engaged in infrastructure activities.

(iv) Profit on sale of HTM category investments should first be credited to Profit & Loss account and thereafter appropriated to 'Capital Reserve Account'. It is clarified that the amount so appropriated would be net of taxes and amount required to be transferred to Statutory Reserves. Loss is to be charged to Profit & Loss Account. As regards, the 'Special Reserves' created by banks under Section 36(1) (viii) of Income Tax Act, 1961, only the net amount of such Reserves (net of tax payable) should be taken into account for the purpose of Tier-I capital.

(v) The debentures/ bonds must be treated in the nature of an advance when:

- The debenture/bond is issued as part of the proposal for project finance and the tenure of the debenture is for a period of three years and above

Or

- The debenture/bond is issued as part of the proposal for working capital finance and the tenure of the debenture/ bond is less than a period of one year

And

- Bank has a significant stake i.e.10% or more in the issue

And

- Issue is part of a private placement, i.e. the borrower has approached the bank/FI and not part of a public issue where the bank/FI has subscribed in response to an invitation.

Since, no fresh non-SLR securities are permitted to be included in the HTM, these investments should not be held under HTM category and they should be subjected to mark- to-market discipline. They would be subjected to prudential norms for identification of non-performing investment and provisioning as applicable to investments.

Held for Trading

2.77 The broad RBI guidelines are as follows:

(i) These securities are to be sold within 90 days.

(ii) Profit/loss is recognised in the Profit & Loss Account.

Available for Sale

2.78 Profit/loss on sale of investments under this category is recognised in the Profit & Loss Account.

Shifting Among Categories

2.79 Banks may shift investments to/from held-to-maturity category with the approval of the board of directors once a year. Such shifting would normally be allowed at the beginning of the accounting year. No further shifting to/from this category would be allowed during the remaining part of the accounting year.

2.80 If the value of sales and transfers of securities to/from HTM category exceeds 5 per cent of the book value of investments held in HTM category at the beginning of the year, banks should disclose the market value of the investments held in the HTM category and indicate the excess of book value over market value for which provision is not made. This disclosure is required to be made in 'Notes to Accounts' in banks' audited Annual Financial Statements. However, the one-time transfer of securities to/from HTM category with the approval of Board of Directors permitted to be undertaken by banks at the beginning of the accounting year and sales to the Reserve Bank of India under pre-announced OMO auctions will be excluded from the 5 per cent cap.

2.81 Banks may shift investments from available-for-sale category to held-for-trading category with the approval of their board of directors/ALCO /Investment Committee. In case of exigencies, such shifting may be done with the approval of the Chief Executive of the bank/head of the ALCO, but should be ratified by the board of directors/ALCO.

2.82 Shifting of investments from Held for Trading category to Available for Sale category is not permitted except under exceptional circumstances only with the approval of board/ALCO/Investment Committee.

2.83 Shifting of investments from one category to another should, under all circumstances, be done at the lowest of-

(i) book value; or

(ii) market value on the date of transfer.

2.84 In other words, in cases where the market value is higher than the book value at the time of transfer, the appreciation should be ignored and the security should be transferred at the book value. In cases where the market value is less than the book value, the provision against depreciation held against this security (including the additional provision, if any, required based on valuation done on the date of transfer) should be adjusted to reduce the book value to the market value and the security should be transferred at the market value.

Transfer of securities from HTM to AFS / HFT category

2.85 The provisions relating to Transfer of securities from HTM to AFS / HFT category are as follows:

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

(b) If the security was originally placed in the HTM category at a premium, it may be transferred to the AFS / HFT category at the amortised cost. After transfer, these securities should be immediately re-valued and resultant depreciation, if any, may be provided.

In the case of transfer of securities from AFS to HFT category or vice-versa, the securities need not be re-valued on the date of transfer and the provisions for the accumulated depreciation, if any, held may be transferred to the provisions for depreciation against the HFT securities and vice-versa.

Valuation

Held-to-Maturity Securities

2.86 Investments classified under held-to-maturity category need not be marked to market. They should be carried at acquisition cost unless it is more than the face value, in which case the premium should be amortised over the period remaining to maturity. The banks should reflect the amortised amount in 'Schedule 13 – Interest Earned: Item II – Income on Investments', as a deduction. However, the deduction need not be disclosed separately. The book value of the security should be reduced by the amount amortised during the relevant accounting period.

2.87 Any diminution in the value of investments in subsidiaries/joint ventures included under held-to-maturity category should be provided for. Such diminution should be determined and provided for each investment individually.

2.88 *Recognition of permanent diminution in the value of investments in banks' subsidiaries/joint ventures* - In the absence of any specific instructions on the method of assessment/measurement of permanent diminution, RBI has observed that banks are not making any attempt to determine whether there is any permanent diminution in their strategic equity investments held under HTM or AFS categories. The need to determine whether impairment has occurred is a continuous process and the need for such determination will arise in the following circumstances:

a. On the happening of an event which suggests that impairment has occurred. This would include:
   i. company has defaulted in repayment of its debt obligations.
   ii. loan amount of the company with any bank has been restructured.
   iii. credit rating of the company has been downgraded to below investment grade.
b. When the company has incurred losses for a continuous period of three years and the net worth has consequently been reduced by 25% or more.
c. In the case of new company or a new project when the originally projected date of achieving the breakeven point has been extended i.e., the company or the project has not achieved break-even within the gestation period as originally envisaged.

2.89 When the need to determine whether impairment has occurred arises in respect of a subsidiary, joint venture or a material investment, RBI, vide its circular no. DBOD. No. BP.BC.79 /21.04.141/2010-11 dated January 31, 2011 requires the banks to obtain a valuation of the investment by a reputed/qualified valuer and make provision for the impairment, if any. These guidelines would be applicable with immediate effect.

Available-for-Sale Securities

2.90 The individual scrip in the available-for-sale-category should be marked to market at quarterly or at more frequent intervals. Securities shall be valued scrip-wise and depreciation or appreciation shall be aggregated for each classification of balance sheet disclosure. Foreign investments under this category shall be valued scrip-wise and depreciation/ appreciation shall be aggregated for five classifications (viz. Government securities (including local authorities), Shares, Debentures & Bonds, Subsidiaries and/or joint ventures abroad and other investments (to be specified)). Further, the investment in a particular classification, both in domestic and foreign securities, may be aggregated for the purpose of arriving at net depreciation/appreciation of investments under that category. While the net depreciation under each of the classifications should be recognised and fully provided for, the net appreciation under any of the classifications should be ignored[1]. Net depreciation required to be provided for in any one classification should not be reduced on account of net appreciation in any other classification. The banks may continue to report the foreign securities under three categories (Government securities (including local authorities), Subsidiaries and/or joint ventures abroad and other investments (to be specified)) in the balance sheet. The guidelines state that the book value of the individual securities would not undergo any change after marking to market.

Held-for-Trading Securities

2.91 The individual scrips in the held-for-trading category should be marked to market at monthly or at more frequent intervals and provided for as in the case of those in the available-for-sale category. The book value of the individual securities in this category would also not undergo any change after marking to market.

Market Value

2.92 The '*market value'* for the purpose of periodical valuation of investments included in the Available for Sale and Held for Trading categories would be the market price of the scrip as available from the trades/ quotes on the stock exchanges, SGL account transactions, price list of RBI, prices declared by Primary Dealers Association of India (PDAI) jointly with the Fixed Income Money Market and Derivatives Association of India (FIMMDA) periodically.

[1] The guidelines thus permit offsetting gains in respect of some investments marked-to-market within a category against losses in respect of other investments marked-to-market in that category. The guidelines do not, however, permit offsetting of gains and losses across different categories. Also, it appears that in respect of investments outside India also, net appreciation or depreciation will have to be determined for each category in which such investments are presented in the balance sheet.

Valuation of Unquoted SLR Securities

2.93 The RBI has prescribed the following in respect of valuation of unquoted SLR Securities:

(i) *Central Government Securities* are to be valued at prices/YTM rates put out by PDAI/FIMMDA at periodicals intervals.

(ii) *6% Capital Indexed Bonds and Treasury Bills* are to be valued at cost as defined in the relevant circulars of RBI.

(iii) *Treasury Bills* should be valued at carrying cost. Carrying cost represents purchase cost and accrued interest on Treasury Bills till the valuation date.[@]

(iv) *State Government Securities* are to be valued by applying YTM method by marking it up by 25 basis points above the yields of Central Government securities of equivalent maturity put out by PDAI/FIMMDA periodically.

(v) *Other "Approved" Securities* are to be valued by applying YTM method by marking it up by 25 basis points above the yields of Central Government securities of equivalent maturity put out by PDAI/FIMMDA periodically.

Valuation of Unquoted Non-SLR Securities

2.94 RBI has prescribed the following procedure for valuation of unquoted non-SLR Securities

(i) Special non-SLR securities issued by Government of India to the beneficiary entities may be valued at a spread of 25 basis points above the corresponding yield on Government of India securities,. Currently, such special securities comprise Oil Bonds, Fertiliser Bonds, bonds issued to the State Bank of India during their rights issue, Unit Trust of India, Industrial Finance Corporation of India Ltd., Food Corporation of India, Industrial Investment Bank of India Ltd., the erstwhile Industrial Development Bank of India and the erstwhile Shipping Development Finance Corporation.

(ii) The market value of all debentures/bonds except those in the nature of advances should be determined on YTM basis. Debentures/bonds of different companies having different ratings should be valued with appropriate mark-up over the YTM rates for Central Government securities put out by PDAI/ FIMMDA periodically. The mark-up should be graded by the bank concerned according to the ratings assigned to the

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debentures/bonds by the rating agencies subject to the following:

- The rate used for the YTM for rated debentures/bonds should be at least 50 basis points above the rate applicable to a Government of India securities of equivalent maturity
- The rate used for the YTM for unrated debentures/ bonds should not be less than the rate applicable to rated debentures/bonds of equivalent maturity. The mark-up for the unrated debentures/ bonds should appropriately reflect the credit risk borne by the bank.
- Where the debenture/bond is quoted and there have been transactions within 15 days prior to the valuation date, the value adopted should not be higher than the rate at which the transaction is recorded on the stock exchange.

(iii) *Zero coupon bonds* should be shown at carrying cost, i.e., acquisition cost plus discount accrued at the rate prevailing at the time of acquisition, which may be marked to market with reference to the market value. In the absence of market value, the zero coupon bonds may be marked to market with reference to the present value of the zero coupon bond. The present value may be calculated by discounting the face value using the Zero Coupon Yield Curve with appropriate mark up as per the zero coupon spreads put out by FIMMDA periodically. In case the bank is still carrying the zero coupon bonds at acquisition cost, the discount accrued on the instrument should be notionally added to the book value of the scrip, before marking it to market. Attention of the reader is drawn on circular no. DBOD No. BP.BC. 44 / 21.04.141/ 2010-11 dated September 29, 2010 on "Prudential norms on Investment in Zero Coupon Bonds". In the terms of the said circular, for the long term Zero Coupon Bonds (ZCBs) issued by corporates including those issued by Non-Banking Financial Companies (NBFCs), the issuers are not required to pay any interest or installments till the maturity of bonds. As a result, the credit risk in such investments would go unrecognized till the maturity of bonds and this risk could especially be significant in the case of long term ZCBs. Such issuances and investments if done on a large scale could pose systemic problems. Accordingly, the RBI, vide its above circular, requires the following:

- Banks should henceforth not invest in ZCBs unless the issuer builds up sinking fund for all accrued interest and keeps it invested in liquid investments/securities (Government bonds), and
- Banks should put in place conservative limits for their investments in ZCBs.

(iv) The market value of *preference shares* should be determined on YTM basis. Preference shares issued by different companies having different ratings should be valued with appropriate mark-up over the YTM rates for Central Government securities put out by PDAI/FIMMDA periodically. The mark-up should be graded by the bank concerned according to the ratings assigned to the preference shares by the rating agencies subject to the following:

(a) The YTM rate should not be lower than the coupon rate/YTM for a Government of India loan of equivalent maturity.

(b) The rate used for the YTM for unrated preference shares should not be less than the rate applicable to rated preference shares of equivalent maturity. The mark-up for unrated preference shares should appropriately reflect the credit risk borne by the bank.

(c) Preference shares acquired as part of the project finance may be valued at their par value for a period of two years after commencement of production or five years after subscription, whichever is earlier.

(d) Where investment in preference shares is as part of rehabilitation, the YTM rate should not be lower than 1.5% above the coupon rate/YTM for Government of India loan of equivalent maturity.

(e) Where preference dividends are in arrears, no credit should be taken for accrued dividends. Further, the value determined on YTM basis should be discounted by at least 15% if arrears are for one year, and more if arrears are for more than one year. The depreciation/provision required in respect of such preference shares should not be set-off against appreciation in respect of other performing preference shares. This requirement implies that for the purposes of valuation, preference shares would need to be classified into (i) those where dividends are in arrears, and (ii) others.

(f) The preference shares should not be valued above its redemption value.

(g) When a preference share has been traded on stock exchange within 15 days prior to the valuation date, the value should not be higher than the price at which the share was traded.

(v) The *equity shares* in the bank's portfolio should be marked to market preferably on a daily basis, but at least on a weekly basis. The market value of equity shares for which current quotations are not available or where the shares are not quoted on stock exchanges should be taken at their break-up value (without considering 'revaluation reserves', if any). The break-up value should be ascertained from the company's latest balance sheet, but the date of the balance sheet should not be more than one year prior to the date of valuation. In case the latest balance sheet of a company is not available, its shares should be valued at Re. 1 per company.

(vi) Investment in quoted mutual fund units should be valued as per Stock Exchange quotations. The market value of *unquoted mutual fund units* should be determined on the basis of the latest repurchase price declared by the mutual fund in respect of the particular scheme. In the case of funds with a lock-in period, where repurchase price/market quote is not available, net asset value (NAV) can be taken as the market value. If NAV is not available, the units could be valued at cost till the end of the lock-in period. Wherever the repurchase price is not available, the NAV of the respective scheme can be considered to be the market value.

(vii) Commercial paper and Certificate of Deposits should be valued at carrying cost.

(viii) Investment in RRB's is to be valued at carrying cost on consistent basis.

Valuation of Securities Issued by SC/RC

2.95 Securities (Security Receipts and Pass Through Certificates (PTCs)) issued by Securitisation and Reconstruction Companies in consideration of purchase of financial assets are to be initially recognised at lower of redemption value or net book value of the financial assets (book value of the financial asset sold less provisions held). These securities should be valued at initially recognised amount until its sale/realisation, and on such sale or realisation, the loss or gain must be dealt with as under:

(i) If the sale to SC/RC is at a price below the NBV, the shortfall should be debited to the profit and loss account of that year.

(ii) If the sale is for a value higher than the net book value, the excess provision will not be reversed but will be utilised to meet the shortfall/loss on account of sale of other financial assets to SC/RC. All instruments received by banks from SC/RC as sale consideration for financial assets sold to them and also other instruments issued by SC/RC in which banks invest will be in the nature of non-SLR securities. Accordingly, the valuation, classification and other norms applicable to investment in non-SLR instruments prescribed by RBI from time to time would be applicable to bank's/Financial Institution's investment in debentures/bonds/ security receipts/PTCs issued by SC/RC. However, if any of the above instruments issued by SC/RC is limited to the actual realisation of the financial assets assigned to the instruments in the concerned scheme the bank/Financial Institution shall reckon the Net Asset Value (NAV), obtained from SC/RC from time to time, for valuation of such investments.

Valuation of Investment in VCFs

2.96 Quoted Investments in VCF are to be held under AFS category and marked to market preferably on daily basis but at least on weekly basis in line with valuation norms for equity shares.

2.97 Unquoted shares/bonds/units of VCF made after August 23, 2006 are to be held under HTM category for the initial period of three years and valued at cost during this period. The period of three years is to be reckoned for each disbursement separately. The transfer of those investments in VCF which have completed three years under HTM to AFS category would be carried out at the beginning of the year. Investments in VCF made upto August 23, 2006 would be done at existing norms.

2.98 After the three year period, the unquoted investments in VCF which has been transferred to AFS category are to be valued as follows:

(i) Units: In the case of investments in the form of units, the valuation will be done at the Net Asset Value (NAV) shown by the VCF in its financial statements. Depreciation, if any, on the units based on NAV has to be provided at the time of shifting the investments to AFS category from HTM category and also on subsequent valuations which should be done at quarterly or more frequent intervals based on the financial statements received from the VCF. At least once in a year, the units should be valued based on the audited results. However, if the audited balance sheet/ financial statements showing NAV figures are not available continuously for more than 18 months as on the date of valuation, the investments are to be valued at Rupee 1.00 per VCF.

(ii) Equity: In the case of investments in the form of shares, the valuation can be done at the required frequency based on the break-up value (without considering 'revaluation reserves', if any) which is to be ascertained from the company's (VCF's) latest balance sheet (which should not be more than 18 months prior to the date of valuation). Depreciation, if any on the shares has to be provided at the time of shifting the investments to AFS category and also on subsequent valuations which should be done at quarterly or more frequent intervals. If the latest balance sheet available is more than 18 months old, the shares are to be valued at Rupee 1.00 per company.

(iii) Bonds: The investment in the bonds of VCFs, if any, should be valued as per valuation norms for classification, valuation and operation port-folio by bank issued by RBI from time to time.

Valuation of Investment acquired on conversion of loans

2.99 Investments acquired on conversion of loans should be classified under Available for Sale category. The investments should be valued following the valuation criteria applicable to the type of instrument except that:

(i) Quoted equity shares should be valued at market value

(ii) Unquoted equity shares, acquired on conversion of standard assets, should be valued at break- up value and in case such shares are acquired on conversion of non-performing assets, it should be valued at Re 1 per company till the time the asset is restored/upgraded to standard asset, in which case it is to be valued at break-up value.

Non-Performing Investments

2.100 A non performing investment (NPI), similar to a non-performing advance (NPA), is one where

(i) Interest/ instalment (including maturity proceeds) is due and remains unpaid for more than 90 days.

(ii) The above would apply mutatis-mutandis to preference shares where the fixed dividend is not paid. If the dividend on preference shares (cumulative or non-cumulative) is not declared/paid in any year it would be treated as due/unpaid in arrears and the date of balance sheet of the issuer for that particular year would be reckoned as due date for the purpose of asset classification.[@]

(iii) In the case of equity shares, in the event the investment in the shares of any company is valued at Re.1 per company on account of the non-availability of the latest balance sheet.

(iv) If any credit facility availed by the issuer is NPA in the books of the bank, investment in any of the securities, including preference shares issued by the same issuer would also be treated as NPI and vice versa. However, if only the preference shares are classified as NPI, the investment in any of the other performing securities issued by the same issuer may not be classified as NPI and any performing credit facilities granted to that borrower need not be treated as NPA.

(v) The investments in debentures/bonds, which are deemed to be in the

[@] Revised in 2013 edition.

nature of advance would also be subjected to NPI norms as applicable to investments.

(vi) In case of conversion of non-performing loans into equity, debentures, bonds, etc., such instruments should be treated as NPI ab-initio in the same asset classification in which the relevant non-performing loans were classified and provision should be made as per the norms.

2.101 The guidelines specified above for identification of NPI will apply to state government guaranteed securities also.

2.102 Bank should make appropriate provisions for such NPIs by way of depreciation in the value of the investment. The banks should not set-off the depreciation requirement in respect of these non-performing securities against the appreciation in respect of other performing securities.

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

2.103 The Master Circular specifies the following guidelines with respect to IFR and IRA:

(i) Banks have been advised to build reserves towards investment fluctuation, of a minimum 5% of the investment portfolio within 5 years period.

(ii) To ensure smooth transition to Basel II norms, banks have been advised to build adequate reserve towards capital charge for market risks in a phased manner over a two year period as follows:

  (a) In respect of securities included in the HFT category, open gold position limit, open foreign exchange position limit, trading positions in derivatives and derivatives entered into for hedging trading book exposures by March 31, 2005; and

  (b) In respect of securities included in the AFS category by March 31, 2006.

(iii) Banks which have maintained capital of at least 9 per cent of the risk weighted assets for both credit risk and market risks for both HFT (items as indicated at (a) above) and AFS category may treat the balance in excess of 5 per cent of securities included under HFT and AFS categories, in the IFR, as Tier I capital. Banks satisfying the above were allowed to transfer the amount in excess of the said 5 per cent in the IFR to Statutory Reserve

(iv) Banks are allowed to consider balance held in IFR as Tier I capital subject to the conditions specified in the Master Circular. For the purpose of treatment of IFR as Tier I capital, banks may transfer the balance in the IFR 'below the line' in the P&L appropriation account to statutory reserve, general reserve or balance of Profit and Loss Account.

(v) Provisions created for depreciation on investments in the AFS and HFT categories if found excessive should be credited to the Profit & Loss Account and equivalent amount (net of taxes, if any and net of transfer to Statutory Reserve as applicable to such excess provision) should be appropriated to an Investment Reserve Account in Schedule 2 – "Reserves and Surplus" under the head "Revenue and Other Reserves" and would be eligible for inclusion under Tier II within the overall ceiling of 1.25% of total risk weighted assets prescribed for general provisions/ Loss Reserves.

(vi) The Investment Reserve Account can be utilised in the manner prescribed in the Master Circular.

(vii) The amounts debited to the P&L Account for provision should be debited under the head "Expenditure -Provisions & Contingencies". The amount transferred from the Investment Reserve Account to the P&L Account should be shown as "below the line" item in the Profit and Loss Appropriation Account after determining the profit for the year. Provision towards any erosion in the value of an asset is an item of charge on the profit and loss account and hence should appear in that account before arriving at the profit for the accounting period. Adoption of the following would not only be adoption of a wrong accounting principle but would, also result in a wrong statement of the profit for the accounting period:

(a) the provision is allowed to be adjusted directly against an item of reserve without being shown in the profit and loss account, or

(b) a bank is allowed to draw down from the Investment Reserve Account before arriving at the profit for the accounting period (i.e., above the line), or

(c) a bank is allowed to make provisions for depreciation on investment as a below the line item, after arriving at the profit for the period,

Hence none of the above options are permissible.

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

Accounting for Repo/Reverse Repo Transactions

2.104 The following accounting scheme is to be followed for accounting of repo and reverse repo transactions in government securities and corporate debt securities except under the Liquidity Adjustment Facility (LAF) with RBI.

2.105 Market participants may undertake repos from any of the three categories of investments, viz., Held For Trading, Available For Sale and Held To Maturity.

2.106 The economic essence of a repo transaction, viz., borrowing (lending) of funds by selling (purchasing) securities shall be reflected in the books of the repo participants, by accounting the same as collateralized lending and borrowing transaction, with an agreement to repurchase, on the agreed terms. Accordingly, the repo seller, i.e., borrower of funds in the first leg, shall not exclude the securities sold under repo but continue to carry the same in his investment account (please see the illustration given in the Annex to the Master Circular) reflecting his continued economic interest in the securities during the repo period. On the other hand, the repo buyer, i.e., lender of funds in the first leg, shall not include the securities purchased under repo in his investment account but show it in a separate sub-head (please see the Annex to the Master Circular). The securities would, however, be transferred from the repo seller to repo buyer as in the case of normal outright sale/purchase transactions and such movement of securities shall be reflected using the Repo/Reverse Repo Accounts and contra entries. In the case of repo seller, the Repo Account is credited in the first leg for the securities sold (funds received), while the same is reversed when the securities are repurchased in the second leg. Similarly, in the case of repo buyer, the Reverse Repo Account is debited for the amount of securities purchased (funds lent) and the same is reversed in the second leg when the securities are sold back.

2.107 The first leg of the repo transaction should be contracted at prevailing market rates. The reversal (second leg) of the transaction shall be such that the difference between the consideration amount of first and second legs should reflect the repo interest.

2.108 The other accounting principles to be followed while accounting for repos/reverse repos are as under:

(i) The repo seller shall continue to accrue the coupon/discount on the securities sold under repo even during the repo period while the repo buyer shall not accrue the same. In case the interest payment date of the security offered under repo falls within the repo period, the coupons received by the buyer of the security should be passed on to the seller on the date of receipt as the cash consideration payable by the seller in the second leg does not include any intervening cash flows.

(ii) After the second leg of the repo/reverse repo transaction is over:

(a) the difference in the consideration amounts of the first leg and the second leg should be reckoned as Repo Interest Income/Expenditure in the books of the buyer / seller respectively;

(b) the balance outstanding in the Repo interest Income/Expenditure account should be transferred to the Profit and Loss account as an income or expenditure.

(iii) As regards repo/reverse repo transactions outstanding on the balance sheet date, only the accrued income/expenditure till the balance sheet date should be taken to the Profit and Loss account. Any repo income/expenditure for the subsequent period in respect of the outstanding transactions should be reckoned for the next accounting period.

(iv) The repo seller shall continue to mark to market the securities sold under repo transactions as per the investment classification of the security. To illustrate, in case the securities sold by banks under repo transactions are out of the Available for Sale category, then the mark to market valuation for such securities should be done at least once a quarter. For entities do not follow any investment classification norms, the valuation for securities sold under repo transactions may be in accordance with the valuation norms followed by them in respect of securities of similar nature.

(v) The accounting methodology to be followed is given below. While market participants, Participants using more stringent accounting principles may continue using the same principles. Further, to obviate disputes arising out of repo transactions, the participants may consider entering into bilateral Master Repo Agreement as per the documentation finalised by Fixed Income Money Market and Derivatives Association of India (FIMMDA). The Master Repo Agreement finalised by FIMMDA is not mandatory for repo transactions in Government Securities settling through a Central Counter Party (CCP) [eg. Clearing Corporation of India Limited (CCIL)], having various safeguards like haircut, MTM price, margin, Multilateral netting, closing out, right to set off, settlement guarantee fund/ collaterals, defaults, risk management and dispute resolution/ arbitration etc. However, Master Repo Agreement is mandatory for repo transactions in Corporate Debt Securities, which are settled bilaterally without involving a CCP.[@]

2.109 The RBI has recommended accounting methodology for uniform accounting of Repo/Reverse Repo transaction, which is as under:

(i) The following accounts may be opened, viz.

(a) Repo Account,

(b) Repo Interest Expenditure Account,

(c) Reverse Repo Interest Income Account,

(d) Reverse Repo Account,

(e) Reverse Repo Interest Receivable Account

(f) Repo Interest Payable Account

(ii) In addition to the above, the following 'contra' accounts may also be maintained, viz.:

a. Securities Sold under Repo Account,

b. Securities Purchased under Reverse Repo Account,

c. Securities Receivable under Repo Account and

d. Securities Deliverable under Reverse Repo Account.

(iii) In a repo transaction, the securities should be sold in the first leg at market related prices and re-purchased in the second leg at the same prices. The consideration amount in the second leg would, however, include the repo interest. The sale and repurchase should be reflected in the Repo Account. Though the securities are not excluded from the repo seller's investment account and not included in the repo buyer's investment account, the transfer of securities shall be reflected by using the necessary contra entries.

(iv) In a reverse repo transaction, the securities should be purchased in the first leg at prevailing market prices and sold in the second leg at the same prices. The consideration amount in the second leg would, however, include the repo interest. The purchase and sale should be reflected in the Reverse Repo Account. The balances in the Reverse

[@] Revised in 2013 edition.

Repo Account shall not be a part of the Investment Account for balance sheet purposes but can be reckoned for SLR purposes if the securities acquired under reverse repo transactions are approved securities.

(v) In case the interest payment date of the securities sold under repo falls within the repo period, the coupons received by the buyer of the security should be passed on to the seller on the date of receipt as the cash consideration payable by the seller in the second leg does not include any intervening cash flows.

(vi) To reflect the accrual of interest in respect of the outstanding repo transactions at the end of the accounting period, appropriate entries should be passed in the Profit and Loss account to reflect Repo Interest Income / Expenditure in the books of the buyer / seller respectively and the same should be debited / credited as an expenditure payable/income receivable. Such entries passed should be reversed on the first working day of the next accounting period.

(vii) Repo seller continues to accrue coupon/discount as the case may be, even during the repo period while the repo buyer shall not accrue the same.

(viii) Illustrative examples relating to Repo and Reverse Repo are given in Annex – VIII.2 to the Master Circular.

(ix) Banks shall classify the balances in Repo A/c under Schedule 4 under item I (ii) or I (iii) as appropriate. Similarly, the balances in Reverse Repo A/c shall be classified under Schedule 7 under item I (ii) a or I (ii) b as appropriate. The balances in Repo interest expenditure A/c and Reverse Repo interest income A/c shall be classified under Schedule 15 (under item II or III as appropriate) and under Schedule 13 (under item III or IV as appropriate) respectively. The balance sheet classification for other participants shall be governed by the guidelines issued by the respective regulators.

Treatment for Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)

2.110 The provisions relating to Treatment for Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) are as follows:

(i) *Government securities* - The regulatory treatment of market repo transactions in Government securities will continue as hitherto, i.e., the funds borrowed under repo will continue to be exempt from CRR/SLR computation and the security acquired under reverse repo shall continue to be eligible for SLR.

(ii) *Corporate debt securities* - In respect of repo transactions in corporate debt securities, as already advised vide IDMD.DOD.05/11.08.38/2009-10 dated January 8, 2010,

a. The amount borrowed by a bank through repo shall be reckoned as part of its DTL and the same shall attract CRR/SLR.

b. The borrowings of a bank through repo in corporate bonds shall be reckoned as its liabilities for reserve requirement and, to the extent these liabilities are to the banking system, they shall be netted as per clause (d) of the explanation under section 42(1) of the RBI Act, 1934. Such borrowings shall, however, be subject to the prudential limits for inter-bank liabilities.

Income Recognition

2.111 The banks may book income in the following manner:

(i) 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, provided interest is serviced regularly and as such is not in arrears.

(ii) Banks may book income from Government securities and bonds and debentures of corporate bodies on accrual basis, where interest rates on these instruments are predetermined and provided interest is serviced regularly and is not in arrears.

(iii) Dividend on shares may be booked on accrual basis provided it is approved by the corporate body in its Annual General Meeting and the owner's right to receive dividend is established.

(iv) Income from units of mutual funds should be booked on cash basis.

Acquisition Charges

2.112 Costs such as brokerage, fees, commission or taxes incurred at the time of acquisition of securities in the available-for-sale and held-to-maturity categories should be recognised immediately as expenses.

Broken-period Interest

2.113 Banks should not capitalise the Broken Period Interest paid to seller as part of cost, but treat it as an item of expenditure under Profit and Loss Account in respect of investments in Government and other approved securities. It is to be noted that the above accounting treatment does not take into account taxation implications and hence the banks should comply with the requirements of Income Tax Authorities in the manner prescribed by them.

Dematerialised Holding

2.114 With effect from October 31, 2001, banks, FIs, PDs and SDs are permitted to make fresh investments and hold bonds and debentures, privately placed or otherwise, only in dematerialised form. Outstanding investments in scrip forms have to be converted into dematerialised form by June 30, 2002. As regards equity instruments, banks were required to convert all their equity holding in scrip form into dematerialised form by December 31, 2004.

Investment in Zero Coupon Bonds issued by Corporates

2.115 In view of high credit risk involved in long term Zero Coupon Bonds (ZCBs) issued by corporates (including those issued by NBFCs) banks should not invest in such ZCBs unless the issuer builds up sinking fund for all accrued interest and keeps it invested in liquid investments/securities (Government bonds). Further, banks should also put in place conservative limits for their investments in ZCBs.

Exposure Limits

2.116 The RBI, vide its Master Circular No. DBOD. No.Dir.BC. 3/13.03.00/2012-13 of July 2, 2012 on "Exposure Norms" (This circular is given in CD enclosed along with this book) provides requirements in respect of exposure limits for banks. The provisions of the said circular in so far as they relate to bank's exposure to capital markets are discussed below.

2.117 Banks' capital market exposures would include both direct exposures and indirect exposures. The aggregate exposure (both fund and non-fund based) of banks to capital markets in all forms would include the following:

(i) direct investment in equity shares, convertible bonds, convertible debentures and units of equity-oriented mutual funds the corpus of which is not exclusively invested in corporate debt;

(ii) advances against shares/bonds/debentures or other securities or on clean basis to individuals for investment in shares (including IPOs/ESOPs), convertible bonds, convertible debentures, and units of equity-oriented mutual funds;

(iii) advances for any other purposes where shares or convertible bonds or convertible debentures or units of equity oriented mutual funds are taken as primary security;

(iv) advances for any other purposes to the extent secured by the collateral security of shares or convertible bonds or convertible debentures or units of equity oriented mutual funds, i.e., where the primary security other than shares/convertible bonds/convertible debentures/units of equity oriented mutual funds does not fully cover the advances;

(v) secured and unsecured advances to stockbrokers and guarantees issued on behalf of stockbrokers and market makers;

(vi) loans sanctioned to corporates against the security of shares/bonds/debentures or other securities or on clean basis for meeting promoter's contribution to the equity of new companies in anticipation of raising resources;

(vii) bridge loans to companies against expected equity flows/issues;

(viii) underwriting commitments taken up by the banks in respect of primary issue of shares or convertible bonds or convertible debentures or units of equity oriented mutual funds. With effect from April 16, 2008, banks may exclude their own underwriting commitments, as also the underwriting commitments of their subsidiaries, through the book running process for the purpose of arriving at the capital market exposure of the solo bank as well as the consolidated bank.

(ix) financing to stockbrokers for margin trading;

(x) all exposures to Venture Capital Funds (both registered and unregistered).

2.118 On a solo basis, Bank's exposure in capital markets (both fund and non-fund based) should not exceed 40% of its net worth as on 31st March of previous year. Within this overall ceiling, direct investments in shares, convertible bonds/debentures, units of equity oriented mutual funds and all exposures to venture capital funds (VCFs) should not exceed 20% of its net worth.

2.119 On consolidated basis also, 40% limit of its consolidated net worth would apply and aggregate direct exposure of consolidated investments in shares, convertible bonds/debentures, units of equity oriented mutual funds and all exposures to venture capital funds (VCFs) should not exceed 20% of its consolidated net worth. Further, for this purpose consolidated bank means 'group of entities, which include a licensed bank, which may or may not have subsidiaries.

2.120 Net worth would comprise of Paid-up capital plus Free Reserves including Share Premium but excluding Revaluation Reserves, plus Investment Fluctuation Reserve and credit balance in Profit & Loss account, less debit balance in Profit and Loss account, Accumulated Losses and Intangible Assets. No general or specific provisions should be included in computation of net worth.

Infusion of capital through equity shares, either through domestic issues or overseas floats after the published balance sheet date, may also be taken into account for determining the ceiling on exposure to capital market. Banks should obtain an external auditor's certificate on completion of the augmentation of capital and submit the same to the Reserve Bank of India (Department of Banking Supervision) before reckoning the additions, as stated above.

2.121 The following items would be excluded from the aggregate exposure ceiling of 40 per cent of net worth and direct investment exposure ceiling of 20 per cent of net worth (wherever applicable):

(i) Banks' investments in own subsidiaries, joint ventures, sponsored Regional Rural Banks (RRBs) and investments in shares and convertible debentures, convertible bonds issued by institutions forming crucial financial infrastructure such as NSDL, CDSL, NSCCL, NSE, CCIL, CIBIL, MCX, NCDEX, NMCEIL, NCMSL and other All India Financial Institutions as given in Annex 3 to the Master Circular on Exposure Norms. After listing, the exposures in excess of the original investment (i.e. prior to listing) would form part of the Capital Market Exposure. Further, RBI, vide its circular no. DBOD. No. Dir. BC. 41 /13.03.00/2010-11 dated September 21, 2010 on "Items excluded from Capital Market Exposure" decided to include the National Payments Corporation of India. (NPCI) and United Stock Exchange of India Ltd. (USEIL) as part of institutions forming crucial financial infrastructure. Accordingly, banks' investments in NPCI and USEIL will also be excluded from the aggregate Capital Market Exposure ceiling of 40 percent of net worth and direct investment ceiling of 20 percent of net worth, till they are listed. After listing, the exposure in excess of the original investment (i.e. prior to listing) would form part of the Capital Market Exposure;

(ii) Tier I and Tier II debt instruments issued by other banks;

(iii) Investment in Certificate of Deposits (CDs) of other banks;

(iv) Preference Shares;

(v) Non-convertible debentures and non-convertible bonds;

(vi) Units of Mutual Funds under schemes where the corpus is invested exclusively in debt instruments;

(vii) Shares acquired by banks as a result of conversion of debt/overdue interest into equity under Corporate Debt Restructuring (CDR) mechanism;

(viii) Term loans sanctioned to Indian promoters for acquisition of equity in overseas joint ventures/wholly owned subsidiaries under the refinance scheme of Export Import Bank of India; and

(ix) Effective from April 16, 2008, underwriting commitments, as also the underwriting commitments of bank's subsidiaries, through the book running process.

(x) Promoters' shares in the SPV of an infrastructure project pledged to the lending bank for infrastructure project lending.

Computation of Exposure

2.122 For computing the exposure to the capital markets, loans/advances sanctioned and guarantees issued for capital market operations would be reckoned with reference to sanctioned limits or outstanding, whichever is higher. However, in the case of fully drawn term loans, where there is no scope for re-drawal of any portion of the sanctioned limit, banks may reckon the outstanding as the exposure. Further, banks' direct investment in shares, convertible bonds, convertible debentures and units of equity-oriented mutual funds would be calculated at their cost price.

Intra-day Exposures

2.123 At present, there are no explicit guidelines for monitoring banks' intra-day exposure to the capital markets, which are inherently risky. The RBI has decided that the Board of each bank should evolve a policy for fixing intra-day limits and put in place an appropriate system to monitor such limits, on an ongoing basis. The position will be reviewed at a future date.

Enhancement in limits

2.124 Banks having sound internal controls and robust risk management systems can approach the Reserve Bank for higher limits together with details thereof.

Specific Exposure Limits

2.125 *Advances against shares to individuals* - Loans against security of shares, convertible bonds, convertible debentures and units of equity oriented mutual funds to individuals from the banking system should not exceed the limit of Rs.10 lacs per individual if the securities are held in physical form and Rs. 20 lacs per individual if the securities are held in demat form.

2.126 *Financing of IPOs* - Banks may grant advances to individuals for subscribing to IPOs. Loans/advances to any individual from the banking system against security of shares, convertible bonds, convertible debentures, units of equity oriented mutual funds and PSU bonds should not exceed the limit of Rs.10 lacs for subscribing to IPOs. The corporates should not be extended credit by banks for investment in other companies' IPOs. Similarly, banks should not provide finance to NBFCs for further lending to individuals for IPOs. Finance extended by a bank for IPOs should be reckoned as an exposure to capital market. Follow-on Public Offers (FPOs) will also be included under IPO.

2.127 *Bank finance to assist employees to buy shares of their own companies* - Banks may extend finance to employees for purchasing shares of their own companies under Employees Stock Option Plan (ESOP) to the extent of 90% of the purchase price of the shares or Rs.20 lacs, whichever is lower. Such finance would be treated as capital market exposure within the overall limit of 40% of their net worth, irrespective of the fact whether the securities are purchased through an IPO or from secondary market. These instructions will not be applicable for extending financial assistance by banks to their own employees for acquisition of shares under ESOPs/ IPOs, as banks are not allowed to extend advances including advances to their employees / Employees' Trusts set up by them for the purpose of purchasing their own banks' shares under ESOPs / IPOs or from the secondary market. This prohibition will apply irrespective of whether the advances are secured or unsecured.

2.128 Banks should obtain a declaration from the borrower indicating the details of the loans / advances availed against shares and other securities specified above, from any other bank/s in order to ensure compliance with the ceilings prescribed for the purpose.

2.129 *Advances against shares to Stock Brokers & Market Makers* - Banks are free to provide credit facilities to stockbrokers and market makers on the basis of their commercial judgment, within the policy framework approved by their Boards. However, the Board of each bank should fix, within the overall ceiling of 40 percent of their net worth as on March 31 of the previous year, a sub-ceiling for total advances to-

(i) all the stockbrokers and market makers (both fund based and non-fund based, i.e., guarantees); and

(ii) to any single stock broking entity, including its associates/ interconnected companies.

Further, banks should not extend credit facilities directly or indirectly to stockbrokers for arbitrage operations in Stock Exchanges.

2.130 *Bank financing to individuals against shares to joint holders or third party beneficiaries* - While granting advances against shares held in joint names to joint holders or third party beneficiaries, banks should be circumspect and ensure that the objective of the regulation is not defeated by granting advances to other joint holders or third party beneficiaries to circumvent the above limits placed on loans/advances against shares and other securities specified above.

2.131 *Advances against units of mutual funds*@- While granting advances against units of mutual funds, the banks should adhere to the following guidelines:

(i) The units should be listed in the stock exchanges or repurchase facility for the units should be available at the time of lending.

(ii) The units should have completed the minimum lock-in-period stipulated in the relevant scheme.

(iii) The amount of advances should be linked to the Net Asset Value (NAV) / repurchase price or the market value, whichever is less and not to the face value of the units.

(iv) Advances against units of mutual funds (except units of exclusively debt oriented mutual funds) would attract the quantum and margin requirements as are applicable to advances against shares and debentures. However, the quantum and margin requirement for loans/ advances to individuals against units of exclusively debt-oriented mutual funds may be decided by individual banks themselves in accordance with their loan policy.

(v) The advances should be purpose oriented taking into account the credit requirement of the investor. Advances should not be granted for subscribing to or boosting up the sales of another scheme of a mutual fund or for the purchase of shares/ debentures/ bonds etc.

2.132 *Advances to other borrowers against shares/debentures/bonds* - The question of granting advances against primary security of shares and debentures including promoters' shares to industrial, corporate or other borrowers should not normally arise. However, such securities can be accepted as collateral for secured loans granted as working capital or for other productive purposes from borrowers other than NBFCs. In such cases, banks should accept shares only in dematerialised form. Banks may accept shares of promoters only in dematerialised form wherever demat facility is available. In the course of setting up of new projects or expansion of existing business or for the purpose of raising additional working capital required by units other than NBFCs, there may be situations where such borrowers may not able to find the required funds towards margin, in anticipation of mobilising of long-term resources. In such cases, there would be no objection to the banks' obtaining collateral security of shares and debentures by way of margin. Such arrangements would be of a temporary nature and may not be continued beyond a period of one year. Banks have to satisfy themselves regarding the capacity of the borrower to raise the required funds and to repay the advance within the stipulated period.

2.133 *Bank Loans for Financing Promoters' Contributions*@ - Loans sanctioned to corporates against the security of shares (as far as possible demat shares) for meeting promoters' contribution to the equity of new companies in anticipation of raising resources would come under the ceiling of 40 percent of the bank's net worth as on March 31 of the previous year prescribed for the bank's total exposure including both fund based and non fund based to capital market in all forms. These loans will also be subject to individual/group of borrowers exposure norms as well as the statutory limit on shareholding in companies, as detailed above. RBI, vide its Master Circular No. DBOD.Dir.BC.90/13.07.05/98 dated August 28, 1998 on 'Bank Finance against Shares and Debentures', clarifies that promoters' contribution towards the equity capital of a company should come from their own resources and banks should not normally grant advances to take up shares of other companies (A few exceptions have been made viz. allowing banks to extend financial assistance to Indian companies for acquisition of equity in overseas joint ventures / wholly owned subsidiaries or in other overseas companies, to successful bidders for acquisition of shares of the PSUs under the Government of India's disinvestment programme, etc.). Further, RBI vide its circular no. DBOD.No.BP.BC. 42 /21.04.141/2010-11 dated September 27, 2010 on "Bank loans for financing promoters contribution" extended the restriction on grant of bank advances for financing promoters' contribution towards equity capital to bank finance to activities related to such acquisitions like payment of non compete fee, etc. and also be applicable to bank finance to such activities by overseas branches/subsidiaries of Indian banks.

2.134 *Bridge Loans* - Banks have been permitted to sanction bridge loans to companies for a period not exceeding one year against expected equity flows/issues. Such loans should be included within the ceiling of 40 percent of the banks' net worth as on March 31 of the previous year prescribed for total exposure, including both fund-based and non-fund based exposure to capital market in all forms. Banks should formulate their own internal guidelines with the approval of their Board of Directors for grant of such loans, exercising due caution and attention to security for such loans. Banks may also extend bridge loans against the expected proceeds of Non-Convertible Debentures, External Commercial Borrowings, Global Depository Receipts and/or funds in the nature of Foreign Direct Investments, provided the banks are satisfied that the borrowing company has already made firm arrangements for raising the aforesaid resources/funds.

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2.135 *Investments in Venture Capital Funds (VCFs)* - Banks' exposures to VCFs (both registered and unregistered) will be deemed to be on par with equity and hence will be reckoned for compliance with the capital market exposure ceilings (both direct and indirect).

2.136 *Margins on advances against shares/ issue of guarantees*- A uniform margin of 50 per cent shall be applied on all advances / financing of IPOs / issue of guarantees on behalf of stockbrokers and market markers. A minimum cash margin of 25 per cent (within the margin of 50%) shall be maintained in respect of guarantees issued by banks for capital market operations. These margin requirements will also be applicable in respect of bank finance to stock brokers by way of temporary overdrafts for DVP transactions.

2.137 *Disinvestment Programme of the Government of India*- In the context of the Government of India's programme of disinvestments of its holdings in some public sector undertakings (PSUs), banks can extend finance to the successful bidders for acquisition of shares of these PSUs. If on account of banks' financing acquisition of PSU shares under the Government of India's disinvestment programmes, any bank is likely to exceed the regulatory ceiling of 40 per cent of its net worth as on March 31 of the previous year, such requests for relaxation of the ceiling would be considered by RBI on a case by case basis, subject to adequate safeguards regarding margin, bank's overall exposure to capital market, internal control and risk management systems, etc. The relaxation would be considered in such a manner that the bank's exposure to capital market in all forms, net of its advances for financing of acquisition of PSU shares, shall be within the regulatory ceiling of 40 per cent. RBI would also consider relaxation on specific requests from banks in the individual / group credit exposure norms on a case by case basis, provided that the bank's total exposure to the borrower, net of its exposure due to acquisition of PSU shares under the Government of India disinvestments programme, should be within the prudential individual/ group borrower exposure ceiling prescribed by RBI.

2.138 *Financing for Acquisition of Equity in Overseas Companies*[@] - Banks may extend financial assistance to Indian companies for acquisition of equity in overseas joint ventures / wholly owned subsidiaries or in other overseas companies, new or existing, as strategic investment, in terms of a Board approved policy, duly incorporated in the loan policy of the banks. Such policy should include overall limit on such financing, terms and conditions of eligibility of borrowers, security, margin, etc. While the Board may frame its own guidelines and safeguards for such lending, such acquisition(s) should be beneficial to the company and the country. The finance would be subject to compliance with the statutory requirements under Section 19(2) of the Banking Regulation Act, 1949.

2.139 *Refinance Scheme of Export Import Bank of India* **-** Under the refinance scheme of Export Import Bank of India (EXIM Bank), the banks may sanction term loans on merits to eligible Indian promoters for acquisition of equity in overseas joint ventures / wholly owned subsidiaries, provided that the term loans have been approved by the EXIM Bank for refinance.

2.140 *Arbitrage Operations -* Banks should not undertake arbitrage operations themselves or extend credit facilities directly or indirectly to stockbrokers for arbitrage operations in Stock Exchanges. While banks are permitted to acquire shares from the secondary market, they should ensure that no sale transaction is undertaken without actually holding the shares in their investment accounts.

2.141 *Margin Trading -* Banks may extend finance to stockbrokers for margin trading. The Board of each bank should formulate detailed guidelines for lending for margin Trading. The finance extended for margin trading should be within the overall ceiling of 40% of net worth prescribed for exposure to capital market. A minimum margin of 50 per cent should be maintained on the funds lent for margin trading. The shares purchased with margin trading should be in dematerialised mode under pledge to the lending bank. The bank should put in place an appropriate system for monitoring and maintaining the margin of 50% on an ongoing basis. The bank's Board should prescribe necessary safeguards to ensure that no "nexus" develops between inter-connected stock broking entities/ stockbrokers and the bank in respect of margin trading. Margin trading should be spread out by the bank among a reasonable number of stockbrokers and stock broking entities. The Audit Committee of the Board should monitor periodically the bank's exposure by way of financing for margin trading and ensure that the guidelines formulated by the bank's Board, subject to the above parameters, are complied with. Further, Banks are required to disclose the total finance extended for margin trading in the "Notes on Account" to their Balance Sheet.

Risk Management and Internal Control System

2.142 Banks desirous of making investment in equity shares/ debentures, financing of equities and issue of guarantees etc., within the above ceiling, should observe the following guidelines:

- Investment Policy - The banks should formulate transparent policy and procedure for investment in shares etc., with the approval of their Board. Further, the banks should build up adequate expertise in equity research by establishing a dedicated equity research department, wherever warranted by their scale of operations.

- Investment Committee - The decision in regard to direct investment should be taken by an Investment Committee set up by the bank's Board. The Investment Committee should be held accountable for all investments made by the bank.
- Risk Management - Banks should ensure that their exposure to stockbrokers is well diversified in terms of number of broker clients, individual inter-connected broking entities. Further, while sanctioning advances to stockbrokers, the banks should take into account the track record and credit worthiness of the broker, financial position of the broker, operations on his own account and on behalf of clients, average turnover period of stocks and shares, the extent to which broker's funds are required to be involved in his business operations, etc. Also while processing proposals for loans to stockbrokers, banks should obtain details of facilities enjoyed by the broker and all his connected companies from other banks. Also while granting advances against shares and debentures to other borrowers, banks should obtain details of credit facilities availed by them or their associates / inter-connected companies from other banks for the same purpose (i.e. investment in shares etc.) in order to ensure that high leverage is not built up by the borrower or his associate or inter-connected companies with bank finance.
- Audit Committee - The surveillance and monitoring of investment in shares / advances against shares shall be done by the Audit Committee of the Board, which shall review in each of its meetings, the total exposure of the bank to capital market both fund based and non-fund based, in different forms and ensure that the guidelines issued by RBI are complied with and adequate risk management and internal control systems are in place. The Audit Committee shall keep the Board informed about the overall exposure to capital market, the compliance with the RBI and Board guidelines, adequacy of risk management and internal control systems. In order to avoid any possible conflicts of interest, it should be ensured that the stockbrokers as directors on the Boards of banks or in any other capacity, do not involve themselves in any manner with the Investment Committee or in the decisions in regard to making investments in shares, etc., or advances against shares.
- Valuation and Disclosure - Equity shares in a bank's portfolio - as primary security or as collateral for advances or for issue of

guarantees and as an investment - should be marked to market preferably on a daily basis, but at least on weekly basis. Banks should disclose the total investments made in equity shares, convertible bonds and debentures and units of equity oriented mutual funds as also aggregate advances against shares in the “Notes on Account” to their balance sheets.

2.143 *Cross holding of capital among banks/financial institutions* - Banks'/Financial Institutions' investment in the following instruments, which are issued by other banks/Financial Institutions and are eligible for capital status for the investee bank/Financial Institution, should not exceed 10 percent of the investing bank's capital funds (Tier I plus Tier II):

(i) Equity shares;

(ii) Preference shares eligible for capital status;

(iii) Subordinated debt instruments;

(iv) Hybrid debt capital instruments; and

(v) Any other instrument approved in the nature of capital.

2.144 Banks / Financial Institutions could acquire any fresh stake in a bank's equity shares only upto 5% of the investee bank's equity capital. It is clarified that a bank’s/FI’s equity holdings in another bank held under provisions of a Statute will be outside the purview of the ceiling prescribed above. Banks’ / FIs’ investments in the equity capital of subsidiaries are at present deducted from their Tier I capital for capital adequacy purposes. Investments in the instruments issued by banks / FIs which are listed above, which are not deducted from Tier I capital of the investing bank/ FI, will attract 100 percent risk weight for credit risk for capital adequacy purposes. Further, the RBI, vide its Circular No. DBOD. No. PSBD. BC. 53/16.13.100/2008-09 dated October 8, 2008 on Investment in the equity of a bank by other banks or their group entities, has clarified the following:-

- The aggregate 'proprietary' holdings of a bank and its group entities should be limited to 5% of the investee bank's paid-up capital.
- 'Fiduciary' holdings of an AMC belonging to the group (through PMS and MF) would not be reckoned for the purpose of the 5% limit.
- However, the investee bank should approach RBI for acknowledgement if the total holdings of the group (including fiduciary holdings) are at 5% or more of the bank's paid-up capital.
- The AMC should not exercise voting rights on its holdings in the investee bank. An undertaking to this effect may be furnished by the AMC to the investee bank, which may be kept with the bank for verification during inspections.

- The AMC should not have any Board representation in the investee bank.

Margin Requirements

- Banks' Exposure to Commodity Markets - In terms of extant instructions, banks may issue guarantees on behalf of share and stock brokers in favour of stock exchanges in lieu of margin requirements as per stock exchange regulations. While issuing such guarantees banks should obtain a minimum margin of 50 percent. A minimum cash margin of 25 percent (within the above margin of 50 percent) should be maintained in respect of such guarantees issued by banks. The above minimum margin of 50 percent and minimum cash margin requirement of 25 percent (within the margin of 50 percent) will also apply to guarantees issued by banks on behalf of commodity brokers in favour of the national level commodity exchanges, viz., National Commodity & Derivatives Exchange (NCDEX), Multi Commodity Exchange of India Limited (MCX) and National Multi-Commodity Exchange of India Limited (NMCEIL), in lieu of margin requirements as per the commodity exchange regulations.
- Banks' exposure in respect of Currency Derivatives segment - The provisions with respect to capital market exposure including the related provisions with regard to maintenance of 50% margin as well as intra-day monitoring are not applicable to banks' exposure to brokers under the currency derivatives segment.

Limits on exposure to unsecured guarantees and unsecured advances

2.145 The instruction that banks have to limit their commitment by way of unsecured guarantees in such a manner that 20 percent of the bank's outstanding unsecured guarantees plus the total of outstanding unsecured advances do not exceed 15 percent of total outstanding advances has been withdrawn to enable banks' Boards to formulate their own policies on unsecured exposures. Simultaneously, all exemptions allowed for computation of unsecured exposures also stand withdrawn.

2.146 With a view to ensuring uniformity in approach and implementation, 'unsecured exposure' is defined as an exposure where the realisable value of the security, as assessed by the bank /approved valuers / Reserve Bank's inspecting officers, is not more than 10 percent, ab-initio, of the outstanding exposure. 'Exposure' shall include all funded and non-funded exposures (including underwriting and similar commitments). 'Security' will mean tangible security properly charged to the bank and will not include intangible securities like guarantees, comfort letters, etc.

2.147 For determining the amount of unsecured advances for reflecting in schedule 9 of the published balance sheet, the rights, licenses, authorisations, etc., charged to the banks as collateral in respect of projects (including infrastructure projects) financed by them, should not be reckoned as tangible security. Banks, may however, treat annuities under build-operate –transfer (BOT) model in respect of road/highway projects and toll collection rights where there are provisions to compensate the project sponsor if a certain level of traffic is not achieved, as tangible securities,subject to the condition that banks' right to receive annuities and toll collection rights is legally enforceable and irrevocable.

'Safety Net' Schemes for Public Issues of Shares, Debentures, etc.

2.148 'Safety Net' Schemes - Reserve Bank had observed that some banks/their subsidiaries were providing buy-back facilities under the name of 'Safety Net' Schemes in respect of certain public issues as part of their merchant banking activities. Under such schemes, large exposures are assumed by way of commitments to buy the relative securities from the original investors at any time during a stipulated period at a price determined at the time of issue, irrespective of the prevailing market price. In some cases, such schemes were offered suo motto without any request from the company whose issues are supported under the schemes. Apparently, there was no undertaking in such cases from the issuers to buy the securities. There is also no income commensurate with the risk of loss built into these schemes, as the investor will take recourse to the facilities offered under the schemes only when the market value of the securities falls below the pre-determined price. Banks/their subsidiaries have therefore been advised that they should refrain from offering such 'Safety Net' facilities by whatever name called.

2.149 *Provision of buy back facilities* - In some cases, the issuers provide buy-back facilities to original investors up to Rs. 40,000/- in respect of non-convertible debentures after a lock-in period of one year, to provide liquidity to debentures issued by them. If, at the request of the issuers, the banks or their subsidiaries find it necessary to provide additional facilities to small investors subscribing to new issues, such buy-back arrangements should not entail commitments to buy the securities at pre-determined prices. Prices should be determined from time to time, keeping in view the prevailing stock market prices for the securities. Commitments should also be limited to a moderate proportion of the total issue in terms of the amount and should not exceed 20 percent of the owned funds of the banks/their subsidiaries. These commitments will also be subject to the overall exposure limits which have been or may be prescribed from time to time.

2.150 *Loans extended by banks to Mutual Fund* – RBI vide its circular no. DBOD. Dir. BC. 57/13.03.00/2007-2008 dated December 14, 2007 on "Banks' Exposure to Capital Market – Loans extended by banks to Mutual Funds and issue of Irrevocable Payment Commitments (IPCs)" states that in terms of paragraph 44(2) of the SEBI (Mutual Funds) Regulations, 1996, a mutual fund are not permitted to borrow except to meet temporary liquidity needs of the mutual funds for the purpose of repurchase, redemption of units or payment of interest or dividend to the unit holders and, further such borrowing shall not exceed 20% of the net asset of the scheme and for a duration not exceeding six months. Such finance, if extended to equity-oriented Mutual Funds, will form part of banks' capital market exposure.

2.151 *Irrevocable Payment Commitments (IPCs) issued to various stock exchanges at the request of MFs for their secondary market purchases*[@]- RBI vide its circular no. DBOD. Dir. BC. 57/13.03.00/2007-2008 dated December 14, 2007 on "Banks' Exposure to Capital Market – Loans extended by banks to Mutual Funds and issue of Irrevocable Payment Commitments (IPCs)" states that Banks issue Irrevocable Payment Commitments (IPCs) in favour of stock exchanges on behalf of mutual funds to facilitate the transactions done by these clients. IPCs are in the nature of non-fund based credit facility for purchase of shares and are to be treated at par with guarantees issued for the purpose of capital market operations. Such exposure of banks forms part of their Capital Market Exposure. RBI vide its circular no. DBOD.Dir.BC. 32 /13.03.00/2010-11 dated July 30, 2010 provides a transition period upto September 30, 2010 to enable banks to comply with the above requirements. Further, RBI vide its circular no. DBOD.Dir.BC.46 /13.03.00/2010-11 dated September 30, 2010 read with RBI circular no.: DBOD.Dir.BC. 3/13.03.00/2012-13 dated July 2, 2012 on " Exposure Norms" decided to put in place adequate risk mitigation mechanism to protect the banks from the adverse movements in the equity prices and the possibility of default by domestic mutual funds/FIIs, while ensuring that there is no undue disruption in the functioning of the capital market in the country. Accordingly, it has been decided as under:

Beginning from 1st November 2010:

i. Only those custodian banks would be permitted to issue IPCs who have a clause in the Agreement with their clients which gives them an inalienable right over the securities to be received as payout in any settlement; However, in cases where transactions are pre-funded i.e. there are clear

INR funds in the customer's account and, in case of FX deals, the bank's nostro account has been credited before the issuance of the IPC by custodian banks, the requirement of the clause of inalienable right over the security to be received as pay out in the agreement with the clients will not be insisted upon the maximum risk to the custodian banks issuing IPCs would be reckoned at 50% on the assumption of downward price movement of the equities bought by FIIs/ Mutual Funds on the two successive days from the trade date (T) i.e., on T+1 and T+2, of 20% each with an additional margin of 10% for further downward movement.

(ii) Accordingly the potential risk on T+1 would be reckoned at 50% of the settlement amount and this amount would be reckoned as Capital Market Exposure (CME) at the end of T+1 if margin payment / early pay in does not come in.

(iii) In case there is early pay in on T+1, there will be no exposure. T+1, would mean 'end of day' (EOD) as per Indian Time. Thus, funds received after EOD as per Indian Time, will not be reckoned as early pay-in on T+1. CME will have to be computed accordingly.

(iv) In case margin is paid in cash on T+1, the CME would be reckoned at 50% of settlement price minus the margin paid.

(v) In case margin is paid on T+1 by way of permitted securities to FIIs / Mutual Funds, the CME would be reckoned at 50% of settlement price minus the margin paid plus haircut prescribed by the Exchange on the securities tendered towards margin payment.

(vi) The IPC will be treated as a financial guarantee with a Credit Conversion Factor (CCF) of 100. However, capital will have to be maintained only on exposure which is reckoned as CME because the rest of the exposure is deemed to have been covered by cash/securities which are admissible risk mitigants as per Basel II. Thus capital is to be maintained on the amount taken for CME and the risk weight would be 125% thereon.

2.152 Further, vide RBI circular no. DBOD.Dir.BC.52 /13.03.00/2010-11 dated October 28, 2010, custodian banks have expressed operational difficulties in complying with the requirement of incorporating a clause in the agreement with their clients which gives them an inalienable right over the securities to be received as payout in any settlement before November 1, 2010. Accordingly, it has been decided to grant an additional period of two months i.e. upto December 31, 2010, to the custodian banks to fulfil this requirement. It is also clarified that in cases where transactions are pre-funded i.e. there are clear INR funds in the customer's account and, in case of FX deals, the bank's nostro account has been credited before the issuance of the IPC by custodian banks, the requirement of the clause of inalienable right over the security to be received as payout in the agreement with the clients will not be insisted upon.

Audit Approach and Procedures

2.153 The auditor's primary objective in audit of investments is to satisfy himself as to their existence and valuation. Examination of compliance with statutory and regulatory requirements is also an important objective in audit of investments in as much as non-compliance may have a direct and material impact on the financial statements. The latter aspect assumes special significance in the case of banks where investment transactions have to be carried out within the numerous parameters laid down by the relevant legislation and directions of the RBI. The auditor should keep this in view while designing his audit procedures relating to investments.

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

2.155 Considering that the investments comprise a substantial portion of a bank's balance sheet, a combination of test of operating effectiveness of controls, along with substantive audit procedures (including substantive analytical procedures) would be necessary in order for the auditor to conclude effectively on the completeness, accuracy and existence of the banks' investments and associated balances.[@]

Internal Control Evaluation and Review of Investment Policy

2.156 The auditors should familiarise themselves with the instructions issued by the RBI regarding transactions in investment securities. They should review the investment policy of the bank to ascertain that the policy conforms, in all material respects, to the RBI's guidelines as well as to any statutory provisions applicable to the bank. While examining the internal controls over investments (including those on SGL forms and BRs), the auditor should particularly examine whether the same are in consonance with the guidelines of the RBI He should also judge their efficacy. By efficacy, it is meant that not only the auditor would check the operating effectiveness of various internal controls but also at the first place check and evaluate the design of such controls. The auditor should satisfy himself that investments made by the bank are in

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accordance with the laid down investment policy. A review of the reports on concurrent audit of treasury transactions and follow-up action taken by the management thereon may be useful to the auditor. The auditor should also review the half yearly review of portfolio by the Board of the bank and also review annual inspection report of the RBI carried out under Section 35 of the Act.

Separation of Investment Functions

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

Examination of Reconciliation[@]

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

Inspection of Documents

2.159 The auditor should ascertain whether the investments made by the bank are within its authority. In this regard, the auditor should examine whether the legal requirements governing the bank, in so far as they relate to

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investments, have been complied with and the investments made by the bank are not *ultra virus* the bank. Apart from the above, the auditor should also 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.

2.160 The auditor should satisfy himself that the transactions for the purchase/sale of investments are supported by due authority and documentation. The acquisition/disposal of investments should be verified with reference to the broker's contract note, bill of costs, receipts and other similar evidence. The auditor should pay special attention to ascertaining whether the investments have been purchased or sold cum-dividend/ex-dividend, cum-interest/ex-interest, cum-right/ex-right, or cum-bonus/ex-bonus. He should check whether appropriate adjustments in this regard have been made in the cost/sales value of securities purchased or sold. The auditors should also check the segregation of duties within the bank staff in terms of booking of trades, approving of such trade, settlement and accounting (generally termed as front office, middle office and back office functions' segregation).[@]

2.161 In the case of a right issue, the offer to the bank contained in the letter of rights should be examined. Where the rights have been renounced or otherwise disposed off or not exercised, the auditor should examine the relevant decision of the appropriate authority in this behalf, as also that the sale proceeds, if any, have been duly accounted for. Similarly, the auditor should examine the relevant documents in the case of detachable warrants. He should also examine that these have been properly accounted for.

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

Physical Verification[@]

2.163 The auditor should verify the investment scrips physically at the close of business on the date of the balance sheet. In exceptional cases, where physical verification of investment scrips on the balance sheet date is not possible, the auditor should carry out the physical verification on a date as near to the balance sheet date as possible. In such a case, he should take into consideration any adjustments for subsequent transactions of purchase, sale, etc. He should take particular care to see that only genuine investments are produced before him, and that securities held by the bank on behalf of others

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(e.g., those held as security against loans and advances) are not shown to him as the bank's own investments. To ensure this, the auditor should require that all investment scrips in the possession of the bank – whether belonging to it or to borrowers or to constituents under PMS or otherwise – should be produced before him simultaneously. The auditor should keep them under his control until he completes his checking. In the current environment, where the banks generally have their investment securities in dematerialised form, the importance of independent audit confirmation requests multiplies.

2.164 Normally, the investments of a bank are held by the bank itself or the Public Debt Office (PDO) of the RBI or a depository (in the case of dematerialised securities other than government securities). The auditor should verify the investments held with PDO, custodians and the depository, at the close of business on the date of the balance sheet. The auditor should circulate independent investments' balance confirmation requests to the custodian and other constituents (for example, RBI for SLR securities). Furthermore, an auditor should design sufficient alternative audit procedures in situations where the independent confirmation are not received back (after reasonable follow up procedures) before the auditor signs off on the banks' financial statements. These alternative procedures should also be designed in such a way that independent data points are used for corroborating investment balances. An example would be a scenario where the auditor uses its own computer systems to log in and verify investment balances held by the bank though online portal. If not possible, the auditor gets the bank personnel download the investment statement in its own presence.

2.165 In terms of testing completeness of investments balances at the reporting date, the auditor should carefully devise cut-off procedures. This should be designed after understanding the bank's procedures for ensuring the appropriate period of accounting for investments. As mentioned above, the banks should follow 'Settlement Date' accounting for recording transactions in government securities.

2.166 To facilitate the work of verification, the auditor may advise the bank to list out investments held in physical form separately from those held in dematerialised form with the PDO or with a depository.

2.167 Investments are normally dealt with at the head office and not at the branches. However, sometimes, for realisation of interest etc., and other similar purposes, some of the investment scrips may be held at branch offices. In such cases, the auditor should examine the records maintained at the head office to record details of scrips held at other locations and request the respective branch auditors to physically verify such scrips as a part of their audit. The auditor should obtain a written confirmation to this effect from the branch auditors. In case the verification has been done on a date other than the balance sheet date, a statement showing the reconciliation of the investments held at the time of physical verification with the investments held as on the balance sheet date should also be obtained from the branch auditors. The branch auditors should also be requested to report whether adequate records are maintained by the branch for the securities held by it on behalf of the head office.

2.168 The auditor may specifically request the branch auditors to examine and report any cases of non-receipt of income against investments for a long period or of scrips being held without being redeemed long after the redemption date, as these situations might be indicative of the scrips being forged or otherwise unrealisable.

2.169 In case the investment scrips are held at an unaudited branch, the auditor should request the management to obtain the scrips at the head office for his examination.

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

2.171 In respect of dealings in government securities through SGL account, confirmation of balances should be obtained from the Public Debt Office of the RBI. In respect of investments held by a custodial or depository organisation, the auditor should examine whether there is an effective system of periodic reconciliation of balances as per the records of the bank and those as per the records of the custodial or depository organisation. The auditor should also examine the certificate / holding statement issued by such organisation confirming the year-end holding of the bank.

2.172 In respect of scripless dealings in investments through the OTC Exchange of India, the auditor should verify the interim and other acknowledgements issued by dealers as well as the year-end confirmation certificates of the depository organisation.

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

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

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

2.176 If certain securities are held in the names of nominees, the auditor should examine whether there are proper transfer deeds signed by the holders and also an undertaking from them that they hold the securities on behalf of the bank.

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

Examination of classification and shifting[@]

2.178 The auditor should examine whether the shifting of the investments to/from HTM category is carried out only once during a financial year and is duly approved by the Board of Directors of the bank. The auditor should also examine whether the shifting of investments from AFS to HFT is duly approved by the Board of Directors / ALCO / Investment Committee. In case of

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exigencies the shifting from AFS to HFT may be done with the approval of Chief Executive of the Bank/ Head of ALCO, but should be ratified by the Board of Directors later. Overall, the auditor should ensure the compliance of the RBI guidelines, issued from time to time, in this regard.

2.179 The auditor should also keep a close eye on sale of investments made by the bank out of its 'held to maturity' portfolio. Such sales are now required to be disclosed in the annual financial statements of the banks.

Examination of accounting and valuation

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

2.181 The auditor should examine the method of accounting followed for investments in the light of the guidelines issued by the RBI and also the accounting policies adopted by the bank in respect of' investments. The auditor should examine the appropriateness of accounting policies followed by the bank. In case any of the accounting policies are not appropriate, the auditor should consider the effect of adoption of such policy on the financial statements and, consequently, on his audit report. In this regard, it may be noted that Accounting Standard (AS) 13, "Accounting for Investments", does not apply to banks. However, notwithstanding this position, the following aspects of guidelines issued by the RBI are not in consonance with the generally accepted accounting principles relating to investments:

(i) Non-inclusion of incidental charges such as brokerage in the cost of available-for-sale and held-to-maturity securities.

(ii) Non-recognition of a decline, other than temporary, in the value of securities under held-to-maturity category except those representing investments in subsidiaries and joint ventures.

(iii) Charging of broken period interest (interest accrued up to the time of acquisition on the securities purchased) to the Profit and Loss Account.

2.182 According to RBI guidelines, in respect of shares which are unquoted or for which current quotations are not available, the market value has to be determined on the basis of the latest audited balance sheet of the company.

This might create a problem in the case of new companies whose first annual reports are not yet available. It appears that in such a situation, it would be appropriate to value the shares at cost except where the evidence available indicates the probability of the cost not being fully recoverable. In the latter case, the relevant investment should be written down to recoverable amount; in the case of a held-to-maturity investment, this should be done only if the decline in value is other than temporary. The auditor should examine the rationale behind management's assessment whether the decline in value is temporary or otherwise and also the basis for quantification of the loss.[@]

2.183 RBI guidelines require that individual scrips in the available-for-sale category should be marked to market at quarterly or more frequent intervals. It is further required that net depreciation in respect of each of the categories in which investments are presented in the balance sheet should be provided for while any similar net appreciation should be ignored. Where scrips in the available-for-sale category are marked to market during the course of the year, there may be net depreciation in respect of some of the aforesaid categories. A question arises about the treatment of such deprecation where the market valuation of the relevant scrips at the balance sheet date shows that such depreciation has been fully or partly offset due to increase in market values of the scrips. In other words, whether such increase should be considered as a net appreciation or ignored

2.184 As far as annual accounts are concerned, the figure of net depreciation or net appreciation in respect of each balance sheet category needs to be worked out on the basis of the total value of investments in that category at the end of the current year and as at the end of the previous year. Accordingly, the net appreciation in the value of investments in a category subsequent to its interim valuation during the year would need to be recognised. If this position is not adopted, the profit or loss for the year as well as balance sheet valuation of investments may change depending upon the frequency of valuations of investments. Interest on investments classified under held-for-trading category assumes importance. In determining the market value of debt securities under held-to-maturity and available-for-sale categories, interest accrued up to the balance sheet date should be reduced from the market price, if the market price includes the accrued interest, to avoid its double counting - first as accrued interest and secondly as a part of market value.

2.185 The auditor should examine the process of valuation followed by the Bank. The auditor should perform checks to examine that the market rates taken

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by the bank for valuation of investment securities are in accordance with the RBI guidelines. The auditor should also examine the accounting entries passed for marked to market loss, to ascertain, whether RBI guidelines pertaining to netting off have been followed. Further, the auditor should include investment from each class of investment in its sampling technique so as to ensure that the valuation policy of all classes of investments get validated. Particular focus should be on investments which involve management judgement or are not simple rule based valuations (preference shares and pass through certificates). While the auditor checks the valuation of investment securities across products in line with RBI prescribed methodology, he should also carefully focus on assessing the appropriateness of inputs used in various valuation models / formulae. This would include a check of:[@]

- Use of appropriate cash flows (for instruments such as PTCs)
- Use of appropriate risk free rates (depending on maturity of instrument)
- Use of appropriate spreads
- Use of appropriate 'ratings' for bonds
- Arithmetical accuracy of a valuation (using a re-performance technique)

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

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

2.188 The auditor should examine whether the profit or loss on sale of investments has been computed properly. Accounting Standard (AS) 13, "Accounting for Investments", requires that the carrying amount of investments disposed of should be determined on the basis of the average carrying amount of the total holding of the particular investment scrip. The carrying amount of investments disposed off should be determined consistently on similar basis.

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

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

2.191 Subject to what is stated above, the auditor should examine compliance by the bank with the guidelines of the RBI relating to valuation of investments.

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

2.193 A change in the method of valuation of investments constitutes a change in accounting policy and adequate disclosure regarding the fact of the change along with its financial effect should be made in the balance sheet.

Income from investments[@]

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

2.195 Some of the typical audit procedures would include:

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

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- Assessing the dividend recognition policy of bank keeping in mind the revenue recognition principles of Accounting Standard 9, Revenue Recognition.
- Re-computation of interest income on investments and checking the treatment of broken period interest.

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

2.197 There may be cases where the certificates of tax deduction at source (TDS) received along with the dividend/interest on investments are found missing. This increases the incidence of tax on the bank. The auditor should see that there is a proper system for recording and maintenance of TDS certificates received by the bank.

Special-purpose Certificates Relating to Investments

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

(i) Certificate on reconciliation of securities by the bank (both on its own Investment Account as well as PMS clients' account). The reconciliation is to be presented in a given format.

(ii) Certificate on compliance by the bank in key areas of prudential and other guidelines relating to such transactions issued by the Reserve Bank of India.

The auditor may consider relying on the work done during the course of audit for the purposes of such certificates.[@]

Dealings in Securities on Behalf of Others

2.199 Apart from making investments on its account, a bank may also deal in securities on behalf of its customers only with the prior approval from RBI. These activities of banks are in the nature of trust or fiduciary activities. The accounting implications of the trust activities of banks may be noted:

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2.200 “Banks commonly act as trustees and in other fiduciary capacities that result in holding or placing of assets on behalf of individuals, trusts, retirement benefit plans and other institutions. Provided the trustee or similar relationship is legally supported, these assets are not assets of the bank and, therefore, are not included in its balance sheet. If the bank is engaged in significant trust activities, disclosure of that fact and indication of the extent of those activities is made in its financial statements because of the potential liability if it fails in its fiduciary duties. For this purpose, trust activities do not encompass safe custody functions”.

2.201 The auditor should examine whether bank’s income from such activities has been recorded and is fairly stated in the bank’s financial statements. The auditor also needs to consider whether the bank has any material undisclosed liability from a breach of its fiduciary duties, including the safekeeping of assets.

III-3
Cash, Balances with RBI and Other Banks, and Money at Call and Short Notice

3.01 Cash, Balances with RBI and Other Banks, and Money at Call and Short Notice constitutes important items of balance sheet of a bank. Of these items, only a few large branches in each bank handle the transactions relating to money at call and short notice. As such, this item may not appear on the balance sheets of most branches of a bank.

Balance Sheet Disclosure

3.02 The Third Schedule to the Banking Regulation Act, 1949, requires the following disclosures to be made in the balance sheet regarding cash, balances with RBI, balances with other banks, and money at call and short notice.

Cash and Balances with Reserve Bank of India

I. Cash in hand (including foreign currency notes)

II. Balances with Reserve Bank of India
  - (i) in Current Account
  - (ii) in Other Accounts

Balances with Banks and Money at Call and Short Notice

I. In India
  - (i) Balances with other banks
    - (a) in Current Accounts
    - (b) in Other Deposit Accounts
  - (ii) Money at call and short notice
    - (a) with banks
    - (b) with other institutions

II. Outside India
  - (i) in Current Accounts
  - (ii) in Other Deposit Accounts
  - (iii) Money at call and short notice

Cash Reserve

3.03 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.

3.04 Section 18 of the Banking Regulation Act, 1949, requires every banking company, other than a scheduled bank, to maintain in India by way of cash reserve with itself, or by way of balance in a current account with the RBI, or by way of net balance in current accounts, or in one or more of the aforesaid ways, a sum equivalent to at least 4 per cent (three per cent upto 8 February 2013)[@] of the total of its demand and time liabilities in India as on the last Friday of the second preceding fortnight. For this purpose –

(a) the term 'demand liabilities' includes liabilities which must be met on demand and the term 'time liabilities' means liabilities which are not demand liabilities [section 5(f) of the Banking Regulation Act]. Further, the expression 'liabilities in India' does not include –
   (i) the paid up capital or the reserves or any credit balance in the profit and loss account of the banking company;
   (ii) any advance taken by the banking company from the Reserve Bank or from the Development Bank or from the Export-Import Bank of India or from the Industrial Reconstruction Bank of India or from the National Housing Bank or from the National Bank or from the Small Industries Development Bank of India;
   (iii) in the case of a Regional Rural Bank, also any loan taken from its sponsor bank [Explanation to section 18(1)];

(b) the expression 'net balance in current accounts' means the excess of the aggregate of the credit balances in current account maintained by the banking company with State Bank of India or a subsidiary of State Bank or a corresponding new bank over the aggregate of the credit balances in current account held by the said banks with the banking company;

(c) in computing the liabilities, the aggregate of liabilities of the banking company to the State Bank of India and its subsidiaries, a corresponding new bank, regional rural banks, other banking companies, co-operative banks and other financial institutions notified by the Central Government

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in this behalf shall be reduced by the liabilities of all such banks and financial institutions to the banking company.

3.05 RBI has issued a Master Circular no. DBOD.No.Ret. BC. 22/12.01.001/2012-13 dated July 2, 2012 on Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) (The circular is given in the CD along with the Guidance Note). The circular provides guidance on computation of Demand and Time Liabilities by banks.

3.06 Sub-section (1) of section 42 of the Reserve Bank of India Act, 1934, requires every scheduled commercial bank to maintain with the RBI an average daily balance of 4.75 per cent (Master Circular no. DBOD. No.Ret. BC.22/12.01.001/2012-13 dated July 2, 2012 on Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)) of the total of its net demand and time liabilities in India (NDTL) on a fortnightly basis. The said percentage can be increased by the RBI by notification up to twenty. The aforesaid section also lays down the manner of calculating the amount of average daily balance to be maintained by a bank. If the average daily balance held at the RBI by a scheduled bank during any fortnight is below the minimum prescribed by or under sub-section (1) or sub-section (1A), such scheduled bank shall be liable to pay to the RBI in respect of that fortnight penal interest at a rate of three per cent, above the bank rate on the amount by which such balance with the Bank falls short of the prescribed minimum, and if during the next succeeding fortnight such average daily balance is still below the prescribed minimum the rates of penal interest shall be increased to a rate of five per cent, above the bank rate in respect of that fortnight and each subsequent fortnight during which the default continues on the amount by which such balance at the RBI falls short of the prescribed minimum.[@]

3.07 Sub-section (1A) of section 42 of the Reserve Bank of India Act, 1934, empowers the RBI to require every scheduled bank to maintain with the Bank an additional average daily balance calculated with reference to the excess of the total of the demand and time liabilities of the bank as per the return furnished by it to the RBI under sub-section (2) of section 42 over the total of its demand and time liabilities at the close of business on the date specified in the notification. The additional balance required to be maintained cannot, however, be more than the aforesaid excess. Also, the aggregate of the deposits required to be maintained under sub-sections (1) and (1A) of section 42 cannot be more than twenty per cent of the total of the demand and time liabilities of the bank as per the return furnished under sub-section (2) of

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section 42. At present no incremental CRR is required to be maintained by the banks

3.08 To enable the RBI to monitor compliance with the above requirements, sub-section (2) of section 42 of the Reserve Bank of India Act, 1934, requires every scheduled bank to furnish to the RBI a return showing the amount of its demand and time liabilities and other prescribed particulars as at the close of business on each alternate Friday (commonly referred to as the 'reporting Friday'). The return has to be sent within seven days of the date to which it relates.

3.09 The term 'liabilities' for purposes of section 42 of the Reserve Bank of India Act, 1934, excludes those liabilities as are excluded from 'liabilities in India' under section 18 of the Banking Regulation Act, 1949, (see paragraph 3.04 above). Besides, in the case of a state co-operative bank, certain other items are also not included in liabilities. The liabilities to other banks and notified financial institutions referred to in section 18 of the Banking Regulation Act, 1949, are to be taken at net amount as in the case of banking companies, except that in the case of a state co-operative bank, any liability of another co-operative bank to the bank is not to be deducted in working out the net aggregate liability to other banks and notified financial institutions.

3.10 The deposits made by a scheduled bank with RBI under sub-sections (1) and (1A) of section 42 of the Reserve Bank of India Act, 1934, are commonly referred to as 'statutory deposit' and 'additional statutory deposit' respectively.

Statutory Liquidity Ratio

3.11 Section 24 of the Banking Regulation Act, 1949 requires that every banking company shall maintain in India in cash, gold or unencumbered approved securities an amount of which shall not, at the close of business on any day, be less than such percentage not exceeding forty, as the RBI may from time to time specify, of the total of its demand and time liabilities in India as on the last Friday of the second preceding fortnight. This is referred to as 'statutory liquidity ratio'.

3.12 The RBI's Master Circular no. DBOD. No. Ret. BC. 23/12.01.001/2010-11 dated July 2, 2012 on Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) also contains procedure of computation of demand and time liabilities for SLR. The said Master Circular also requires the statutory auditors to verify and certify that all items of outside liabilities, as per the bank's books had been duly compiled by the bank and correctly reflected under DTL/NDTL in the fortnightly/monthly statutory returns submitted to RBI for the financial year.

Balances with Reserve Bank of India, Balances with Other Banks

3.13 Banks maintain accounts with RBI and other Banks. Generally only select branches maintain account with RBI. The branches also maintain accounts with other banks.

Money at Call and Short Notice

3.14 Money at call and short notice represents short-term investment of surplus funds in the money market. Money lent for one day is money at 'call' while money lent for a period of more than one day and up to fourteen days is money at 'short notice'. The lender bank does not get any security for money lent at call or short notice. The participants of call and short-term money market are all scheduled commercial banks (excluding RRBs), all co-operative banks other than land development banks and all primary dealers, both as borrowers and lenders. Non-bank institutions are not permitted to participate in call/notice money with effect from August 6, 2005. Scheduled commercial banks usually borrow from this market to meet the requirements relating to cash reserve or statutory liquidity ratio. The decisions to borrow from, or lend in, the market are taken usually at the head office level and communicated to select branches for effecting the borrowing/lending.

3.15 RBI vide its Master Circular no. IDMD.PCD.03/14.01. 01/2012-13 dated July 2, 2012 on "Call/Notice Money Market Operations" (The circular is given in the CD along with the Guidance Note) provides the detailed guidelines on the prudential limits in respect of both outstanding and lending transactions in call/notice money market for banks and PDs. The said circular also requires the eligible participant to adopt the documentation suggested by FIMMDA from time to time, and to report the call/market money deals within 15 minutes irrespective of the size of the deal.

Audit Approach and Procedures

Cash

3.16 The auditor should count the balance of cash on hand. As far as possible, the auditor should visit the branch at the close of business on the last working day of the year or before the commencement of business on the next day for carrying out the physical verification of cash. If, for any reason, the auditor is unable to do so, he should carry out the physical verification of cash as close to the balance sheet date as possible. It is sometimes arranged by the branch to deposit a large portion of its cash balance with the RBI or the State Bank of India or any other bank on the closing day, in which case, the work of the auditor is reduced substantially; however, the auditor must request the branch to provide sufficient appropriate evidence for the same.

3.17 Care should be taken to ensure that if cash is kept separately in different departments or at different locations (e.g. at extension counters), all the balances are verified by the auditor simultaneously. He should also ensure that there is no movement of cash till the counting is over.

3.18 The auditor should evaluate the effectiveness of the system of internal controls in branch regarding daily verification of cash, maintenance of cash related registers and vault register, custody of cash, custody of keys, daily cash holding and retention limit of the branch, etc. The auditor should ensure that a global policy has been taken for safety of cash from theft or burglary and such policy is effective.

3.19 For physically verifying the cash-on-hand, the auditor may proceed as below:

(a) Physically verify the cash-on-hand. The extent of verification would depend upon the auditor's assessment of the efficacy of internal control system including adherence to cash retention limits fixed by the head office, mode of custody of cash (whether single or joint), and frequency of cash verification by branch officials and/or by internal or concurrent auditors. Normally, in a bank, 100 notes of each denomination and thereafter 10 packets of 100 notes each are bundled together. Wherever sample checking is conducted, it is advisable that number of bundles of 100's is fully counted. Besides, the number of notes in samples of bundles of old notes of different denominations may also be checked, the sample size for larger denomination notes being higher than that in the case of smaller denomination notes. The number of notes in a small sample of bundle of new notes of larger denominations (say, Rs. 100 or more) may also be counted. In any event, care should be taken to ensure that all bundles produced for audit verification are properly sealed. Loose/soiled notes should be counted in full. Coins may be counted, or weighed and converted into monetary value as per RBI guidelines.

(b) Obtain a certificate indicating denomination-wise cash balance as per physical verification.

3.20 Notes/coins in sealed packets may be accepted based on a written representation from the branch management and cross-checked with subsequent entries in the books of account.

3.21 The cash balance as physically verified should be agreed with the balance shown in the cash book and the cash balance book. When the physical verification of cash is carried out by the auditor before or after the date of the balance sheet, the auditor should work forward/backward (as the case may be) to reconcile the results of his verification with the cash balance at the balance sheet date as shown by the books.

3.22 Foreign currency notes should also be verified by actual inspection. When incorporating them in the balance sheet, they should be converted at the market rate prevailing on the closing day as notified by the Foreign Exchange Dealers' Association of India (FEDAI) in accordance with the accounting policy followed by the bank.

3.23 Special care needs to be exercised in cases where the branch operates currency chest and/or Small Coin Deposits. In respect of currency chest operations, the branch merely acts as on agent of the RBI to facilitate the distribution of bank notes and rupee coins. The balance in currency chest at any point of time is the property of the RBI and not of the bank. Therefore, while the auditor may not physically count the balance in currency chest at the year-end, he needs to take sufficient safeguards to ensure that currency chest balance is not mixed up in the cash balances produced to him for physical verification. Also, it should be recognised that the bank may be contingently liable for any shortfall in the currency chest balance. Accordingly, the branch auditor should pay special attention to the system of operation of currency chest transactions, recording of such transactions, method and frequency of counting of cash, and reconciliation with the link office. The auditor should perform compliance tests to evaluate the effectiveness of the system of operation of currency chest. He should examine whether the system is such that the transactions relating to deposits into and withdrawals from, currency chest are recorded promptly. In case the relevant transactions are required to be communicated to a link office of the bank (which maintains the account of RBI) for the purpose of reporting the same to the RBI, the auditor should evaluate the effectiveness of the system of reporting in terms of timeliness and accuracy.

Reporting of Currency Chest Transactions and Penal Measures for non compliance

3.24 In terms of the Master Circular No. DCM(CC) No.G - 2 /03.35.01/2012-13 dated July 2, 2012 on "Levy of Penal Interest for Delayed Reporting/Wrong Reporting/Non-Reporting of Currency Chest Transactions and Inclusion of Ineligible Amounts in Currency Chest Balances", the banks are required to report the minimum amount of deposit into/withdrawal from currency chest of Rs.1,00,000/- and thereafter, in multiples of Rs.50,000/-. Further, the banks are obliged to follow the instructions with regarding timely reporting of Currency Chest Transactions by the banks for branches to which Currency chests are attached; and non compliance of the RBI instructions invite Levy of Penal Interest for delayed reporting/wrong reporting/non-reporting of Currency Chest transactions and penal measures for cases involving shortages/inclusion of counterfeit bank notes in chest balances/ chest remittances.

3.25 All currency chest transactions (deposits into /withdrawals from currency chest) at the branch concerned, must be reported through ICCOMS on the same day by 9 PM [by uploading data through the Secured Website (SWS)] to the link office to which the branch is attached for this purpose. Each Link office must, in turn, report to the RBI Issue Office concerned, latest by 11 PM on the same day, the consolidated net position for all the linked branches on value date basis; except in certain exceptional circumstances, like during strike period and on account of genuine difficulties faced by chests especially in hilly/remote areas and other chests affected by natural calamities, etc., where the default may be acceptable to the RBI, at its discretion.

3.26 The said circular covers:

a. Levy of penal interest for delays
b. Wrong reporting and levy of penal interest
c. Maximum penal interest to be charged
d. Penal interest for inclusion of ineligible amounts in the currency chest balances
e. Rate of penal interest (to be levied at the rate of 2% over the prevailing Bank Rate for the period of delayed reporting/wrong reporting/non-reporting /inclusion of ineligible amounts in chest balances).
f. Levy of penal interest in respect of currency chests at treasuries

3.27 The operation of currency chests attached to the various branches of the bank, affects the balances in accounts of RBI maintained by the bank at the designated branches; and it is imperative that the transactions on value date basis are recorded (as it affects the cash balance and that with RBI, on the day of the cash withdrawal from or deposit into the currency chest). Designated branches that maintain the RBI account should pass the entries the day of the transaction for currency chest attached to it; and as the Link Office for other branches operating Currency chests, based on inward communication from such other branches linked to it.

3.28 Due to any delays in communication by such branches to the Link

Office, the amount required to be debited or credited to RBI Account, remains in a nominal account (Inter branch Adjustments) and affects the RBI account balance in the books of the Link Office. On line communication system should remedy this to ensure recording of entries at the designated Link Office, simultaneously as they take place at all currency chest branches.

3.29 The auditor should ensure that the account of the RBI at the designated branch maintaining the RBI Account has incorporated all the currency chest transactions on a value date basis as at the year end. He should also enquire as to whether the Bank has received any communication from RBI regarding any defaults in the operation of the currency chests, that may have penal consequences and whether during the year, any penalties have been levied on this account.

3.30 RBI Master Circular No. DCM (NE) No. G- 1 /08.07.18/2012-13 on "Facility for Exchange of Notes and Coins" dated July 2, 2012 requires that all designated bank branches should display at their branch premises, at a prominent place, a board indicating the availability of note exchange facility with the legend, "Mutilated notes are Accepted And Exchanged Here". Banks should ensure that all their designated branches provide facilities for exchange of notes and coins. The branches should ensure that the note exchange facility is not cornered by private money changers / professional dealers in defective notes.

3.31 The auditor should verify that the banks have not stapled the notes. Some banks in spite of RBI's instructions continue to follow the practice of stapling of note packets. This practice, apart from damaging notes, reduces the life span of notes and renders it difficult for customers to open note packets easily. Banks should do away with stapling of any note packets and instead secure them with paper bands. Further, RBI has issued Master Circular DCM(FNVD) No. G- /16.01.05/ 2012-13 on "Detection and Impounding of Counterfeit Notes" dated July 2, 2012, which provides operational guidance on detection and impounding of Counterfeit notes.

Statutory Liquidity Ratio

3.32 RBI vide its circulars DBOD No. 761-A/08/07/003/93 dated February 8, 1993 and DBOD No. 829/08.07.003/93 dated February 20, 1993, has required all banks to advise their statutory central auditors to verify the compliance of statutory liquidity ratio on twelve odd dates in different months not being Fridays. This aspect is discussed in detail in Chapter 4 of Part V of the Guidance Note.

Balance With RBI

3.33 In a bank, only a few select branches are designated to have account with the RBI. Thus, this item would not appear in the balance sheet of every branch. The following procedures are, therefore, applicable only to branches having account with the RBI.

3.34 The auditor should understand the bank's reconciliation process and test controls around the process which may include management review controls such as maker checker for preparation of reconciliations, procedures followed for the subsequent clearance of reconciling items between bank's ledger and bank statement etc. The auditor should send independent audit confirmation for accounts maintained with RBI. Where the independent confirmation is not received, the auditor should perform alternate audit procedures such as downloading the bank statement from website in auditor's presence, obtaining the bank statements when bank statements are received by e-mail and obtain sufficient evidence for authenticity of e-mail etc., to gain sufficient comfort over the bank balance.[@] The auditor should also verify the ledger balances in each account with reference to the bank confirmation certificates / statement and reconciliation statements as at year end. The auditor should review the reconciliation statements. He should pay special attention to the following items appearing in the reconciliation statements:

(i) cash transactions remaining unresponded;

(ii) revenue items requiring adjustments/write-offs; and

(iii) old outstanding balances remaining unexplained/ unadjusted for significant period .

3.35 The auditor should obtain a written explanation from the management as to the reasons for old outstanding transactions in bank reconciliation statements remaining unexplained/ unadjusted for significant period.

Balance With Banks (Other than Reserve Bank of India)

3.36 The auditor should also apply the procedures described in paragraphs above in examining the balances with banks other than RBI. While reviewing the reconciliation statements, the auditor should pay particular attention to the following:

(a) 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. This should be particularly observed when the bills collected, etc., are credited with net amount and entries for commission, etc., are not made separately in the statement of account.

[@] Revised in 2013 Edition.

(b) Examine that no cheque sent or received in clearing is outstanding. As per the practice prevalent among banks, any cheques returned unpaid are accounted for on the same day on which they were sent in clearing or on the following day.

(c) Examine that all bills or outstanding cheques sent for collection and outstanding as on the closing date have been credited subsequently.

3.37 The auditor should also examine the large transactions in inter-bank accounts, particularly towards the year-end, to ensure that no transactions have been put through for window-dressing.

3.38 In respect of balances in deposit accounts, original deposit receipts should be examined in addition to confirmation certificates obtained from banks in respect of outstanding deposits. Balances in deposit accounts are usually (though not necessarily) in round figures. Where such balances are in odd figures, the auditor should enquire whether the account concerned is actually of the nature of a deposit account.

3.39 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

3.40 The auditor should examine whether there is a proper 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 lendings in inter-bank call money market, should also be examined.

3.41 Call loans should be verified with the certificates of the borrowers and the call loan receipts held by the bank. The auditor should examine whether the aggregate balances comprising this item as shown in the relevant register tally with the control accounts as per the general ledger. He should also 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.

3.42 Like deposits with banks, moneys at call and short notice are also usually (though not necessarily) in round figures. Any odd balances should, therefore, put the auditor to enquiry.

3.43 The auditor should also examine that money market borrowing[@] or

[@] Revised in 2013 Edition.

lending for more than 14 days are not classified under this head, but are classified as 'deposits' or 'advances', depending on the nature of lending and the parties to whom the moneys have been lent.

3.44 It may be noted that as per the directions of the RBI, banks cannot pay any brokerage on deposit and call loans, except to the extent specified in paragraph 8(e) of the RBI circular dated July 22, 1974.

3.45 The auditor should examine whether interest has been properly accrued and accounted for on year-end outstanding balances of money at call and short notice.

III-4
Fixed and Other Assets

Fixed Assets

4.01 Fixed assets comprise premises and other fixed assets such as furniture and fixtures, motor vehicles, office equipment, computers, other intangible assets such as application software and other computer softwares, etc.

4.02 In the case of most banks, fixed assets can be purchased by the head office, regional/zonal offices and branches up to the monetary ceiling specified (though purchase of land and buildings is usually centralised) for themselves as also for offices within their control. However, banks generally prefer to centralise the function of obtaining insurance and obtain a comprehensive policy for assets at numerous locations (to avail the benefit of rebate on bulk business). Fixed assets, particularly furniture and fixture, consumer durables, etc. are provided by banks to the staff and the account for the same is maintained at the office where the employee is posted. For disposal of fixed assets, powers are delegated to various levels in the bank.

4.03 As far as maintenance of records relating to fixed assets is concerned, practices vary among banks. In some banks, the offices acquiring the fixed assets have to maintain proper records including the provision of depreciation thereon whereas in case of some banks, the same is being done at Head Office. In such a case, the acquisitions, disposals, etc. are advised by the branch/other office concerned to the head office through the inter-branch accounting mechanism. A variant of this practice involves the recording of depreciation by branches and other offices based on the advice received from the head office. In recent times, some of the banks have installed Fixed Asset Management Softwares and the information relating to purchase, sale of fixed assets and depreciation thereon (in some cases) is accounted for with the help of such a software. This is usually done at a centralized HO level and reports are generated at branches and/or regional/Zonal offices.[@]

Balance Sheet Disclosure

4.04 The Third Schedule to the Banking Regulation Act, 1949 requires fixed assets to be classified into two categories in the balance sheet, *viz.,* Premises

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[@] Revised in 2013 Edition.

and Other Fixed Assets. Though not specifically mentioned under the Banking Regulation Act, 1949, the assets taken on lease and intangible assets should be shown separately for proper classification and disclosure and also to comply with the requirements of the Accounting Standards (ASs).

4.05 As per the Notes and Instructions for compilation of balance sheet, issued by the RBI, premises wholly or partly owned by the banking company for the purpose of business including residential premises should be shown under the head, 'Premises'. Furniture and fixtures, motor vehicles, office equipments, computers and all other fixed assets except premises should be shown under the head 'Other Fixed Assets'.

4.06 The original cost of fixed assets as on 31st March of the preceding year, additions thereto and deductions therefrom during the year, and total depreciation written off to date are to be disclosed in the financial statements. The Notes and Instructions for Compilation of Balance Sheet, issued by the RBI, require that where sums have been written-off on reduction of capital or revaluation of assets, every balance sheet after the first balance sheet subsequent to the reduction or revaluation should show the revised figures for a period of five years with the date and amount of revision made.

4.07 No rates of depreciation on fixed assets have been prescribed by the Banking Regulation Act, 1949. The provisions of the Schedule XIV to the Companies Act, 1956, should, therefore, be kept in mind in this respect especially in so far as the banking companies are concerned. Banking Regulation Act, 1949 requires that the auditor should examine whether the rates of depreciation are appropriate in the context of the expected useful lives of the respective fixed assets. In respect of computers and data processing equipments, RBI has directed that depreciation should be provided over three year period. With respect to fixed assets held at foreign offices/branches, depreciation is to be provided as per the regulations/norms of the respective countries.

4.08 An immovable property acquired by the bank in satisfaction of debts due should be included under the head 'fixed assets', if it is held by the bank for its own use.

4.09 The Third Schedule to the Banking Regulation Act, 1949, does not specifically deal with disclosure of land. Land is generally shown under the heading 'premises'.

Other Assets

4.10 The following items broadly are to be disclosed under the head 'Other Assets':

- Inter-office adjustments (net)
- Interest accrued
- Tax paid in advance/tax deducted at source
- Stationery and stamps
- Non-banking assets acquired in satisfaction of claims
- Others

4.11 As per RBI Circular no. DBOD.BP.BC.24/21.04.048 of March 30, 1999, credit card outstanding is not to be included under 'Other Assets'. Instead, they have to be shown as part of advances.

4.12 As per RBI circular DBOD.BP.BC.83/21.01.002/2000-01 of February 28, 2001, all loans and advances given to staff, which are non-interest bearing should be included in item 'Others' under 'Other Assets' and should not be reflected as 'Advances'.

Audit Approach and Procedures*

Fixed Assets

4.13 In carrying out the audit of fixed assets, the auditor is concerned, primarily, with obtaining evidence about their ownership,@ existence and valuation. For this purpose, the auditor should review the system of internal controls relating to fixed assets, particularly the following:

- Control over expenditures incurred on fixed assets acquired or self constructed;
- Accountability and utilisation controls; and
- Information controls for ensuring availability of reliable information about fixed assets.

4.14 The branch auditor should ascertain whether the accounts in respect of fixed assets are maintained at the branch or centrally. Similarly, the auditor should ascertain the location of documents of title or other documents evidencing ownership of various items of fixed assets. The procedures described in the following paragraphs would be relevant only to the extent the accounts and documents of title, etc., relating to fixed assets are maintained at the branch. Where the acquisition, disposal, etc., of fixed assets take place at branches / other offices, but accounting of fixed assets is done at the head office, the branch auditor should examine whether acquisitions, disposals, etc. effected at the branch during the year have been properly communicated to the head office.

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* Attention of the readers are also invited to the Guidance Note on Property, Plant and Equipment issued by ICAI and published in the March, 2011 issue of the Journal.

@ Revised in 2013 Edition.

Premises

4.15 The auditor should verify the opening balance of premises with reference to schedule of fixed assets, ledger or fixed assets register. Acquisition of new premises should be verified with reference to authorisation, title deeds, record of payment, etc. Self-constructed fixed assets should be verified with reference to authorisation from appropriate authority[@] and documents such as, contractors' bills, work order records, record of payments and completion certificate. The auditor should also examine whether the balances as per the fixed assets register reconcile with those as per the ledger and the final statements.

4.16 In the case of leasehold premises, capitalisation and amortisation of lease premium, if any, should be examined. Any improvements to leasehold premises should be amoritsed over their balance residual life.

4.17 In case the title deeds are held at the head office or some other location, the branch auditor should obtain a written representation to this effect from the branch management and should bring this fact to the notice of the Statutory Central Auditor through a suitable mention in his report. This fact should also be brought in the Long Form Audit Report (LFAR).

4.18 Where premises are under construction, it should be seen that they are shown under a separate heading, e.g., 'premises under construction'. Advances to contractors may be shown as a separate item under the head 'fixed assets' or under the head 'other assets'. It should be ensured that where the branch has obtained the licence to commence business and is ready for use then the same is not shown as "premises under construction". In such cases even if all the bills/ documents from the contractors/suppliers are not received, at the year end, an estimate of the expenditure thereon should be made and capitalised on a provisional basis.

4.19 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 Accounting Standard (AS) 10, "Accounting for Fixed Assets"[1]. The auditor should also check the impairment, if any, by applying the principles laid down in Accounting Standard (AS) 28, "Impairment of Assets".

[@] Revised in 2013 Edition.

[1] AS 10 is being revised to bring it in line with the current International Accounting Standard (IAS) 16, "Property, Plant and Equipment".

4.20 The auditor should specifically keep in mind the provisions of section 9 of the Banking Regulation Act, 1949, which prohibit a banking company from holding any immovable property, howsoever acquired (i.e., whether acquired by way of satisfaction of claims or otherwise), for a period exceeding seven years from the date of acquisition, except such as is required for its own use. The auditor should specifically examine that no immovable properties other than those required for the own use of the bank have been included in fixed assets (own use would cover use by employees of the bank, e.g., residential premises provided to employees). The branch auditor should also obtain a written representation to the above effect from the branch management.

Other Fixed Assets

4.21 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.

4.22 In recent years, banks have incurred substantial expenditure on computer hardware and software. Computer hardware qualifies the definition of a 'fixed asset' as given in AS 10, "Accounting for Fixed Assets". Computer software that is essential for the functioning of the hardware (e.g., operating system) can be considered an integral part of the related hardware. The expenditure incurred on acquisition and installation of the hardware (as also on any systems software considered to be an integral part of the related hardware) should be capitalised in accordance with the principles laid down in AS 10, "Accounting for Fixed Assets", and depreciated over the remaining useful life of the hardware. Hardware and software are susceptible to faster rate of technical obsolescence; hence the auditor must take into consideration this fact while verifying the provision for depreciation on these assets. The same, however, should not be depreciated for a period of more than three years.

4.23 Application software is not an integral part of the related hardware and is treated as an intangible asset. Accordingly, the same should be accounted for as per Accounting Standard (AS 26), "Intangible Assets". The treatment of expenditure on applications software, whether acquired from outside or developed in-house, would also be similar. However, in estimating the useful life of applications software, the rapid pace of changes in software as also the need for periodic modification/ upgradation of software to cater to changes in nature of transactions, information needs etc. need special consideration. As far as expenditure during the stage of in-house development of software is concerned, the same needs to be accounted for in accordance with AS 26, "Intangible Assets", according to which expenditure incurred during the research phase should not be capitalised as part of cost of intangibles. While capitalising the development phase expenditure, due consideration should be given to Paragraph 44 of the said Standard. While conducting the audit of intangible assets, the auditor should also consider the guidelines given by RBI by way of Circular No.DBOD.No.BP.BC.82/21.04.018/2003-04, dated April 30, 2004, which broadly states as follows:

- It may be difficult to estimate the useful life of computer software which has been customised for the bank's use and is expected to be in use for some time. It is observed that the detailed recognition and amortisation principle in respect of computer software prescribed in **Appendix A** to the Standard adequately addresses these issues and may be followed by banks.
- Intangible assets recognised and carried in the balance sheet of banks in compliance with AS 26 will attract provisions of Section 15(1) of the Banking Regulation Act, 1949 in terms of which banks are prohibited from declaring any dividend until all its capital expenditures (including preliminary expenses, organisation expenses, share-selling commission, brokerage, amount of loss incurred and any other item of expenditure not represented by tangible assets) have been completely written-off. The intangible assets which would be created in the books of banks consequent upon the adoption of AS 26 would generally represent payments made by enterprises towards acquisition of assets which may not be tangible like, corporate computer software, brand equity etc. and would not be in the nature of deferred revenue expenditure like expenses incurred to raise capital, expenses incurred for launching any new products etc. All these items are intangible assets. Therefore, any expenditure incurred towards these intangible items would attract the provisions of Banking Regulation Act, 1949 and for carrying any such item in the books; banks would have to seek exemption from Section 15(1) of the Banking Regulation Act, 1949, from the Government.

4.24 Many a time, fixed assets like furniture, office equipments, etc., are transferred from one branch to another. The auditor should examine whether accumulated depreciation in respect of such assets is also transferred. It may be noted that the consolidated accounts of the bank would not be affected by such transfers. In recent times, the fixed asset management softwares are in use. The auditor has to ensure the reasonableness of the internal controls with respect to recording such inter branch transfer of assets. @

4.25 It should be examined whether fixed assets have been properly classified. Fixed assets of similar nature only should be grouped together. For example, items like safe deposit vaults should not be clubbed together with the office equipments or the theft alarm system of the bank.

Common Procedures

4.26 In respect of fixed assets sold during the year, a copy of the sale deed, if any, and receipt of the sale value should be examined by the auditor. In such a case, it should also be seen that the original cost and accumulated depreciation on the assets sold have been correctly adjusted. Profit earned or loss incurred on such sales should also be checked.

4.27 The auditor should examine whether any expenditure incurred on a fixed asset after it has been brought to its working condition for its intended use, has been dealt with properly. According to AS 10, "Accounting for Fixed Assets", such expenditure should be added to the book value of the fixed asset concerned only if it increases the future benefits from the asset beyond its previously assessed standard of performance.

4.28 The auditor at head office level should examine if the consolidated fixed assets schedule matches in all respect and all the transfers' ins/outs, are tallied. A broad check on the depreciation amount *vis-a-vis* the gross block of assets must be reviewed with special emphasis on the computer hardware/software.

Leased Assets

4.29 RBI's Circular No. DBOD No.FSC.BC.70/24.01.001/99 dated July 17, 1999 deals with accounting and provisioning norms to be followed by banks undertaking leasing activity. The auditor, in respect of leased assets, should also have regard to the requirements of AS 19, "Leases".

Impairment of Assets

4.30 AS 28 prescribe the procedures that an enterprise should apply to ensure that its assets are carried at not more than their recoverable amount. An asset is treated as carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and this Standard requires the

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enterprise to recognise an impairment loss. This Standard also prescribes when an enterprise should reverse an impairment loss and it prescribes certain disclosures for impaired assets. This Standard requires that an enterprise should assess at each balance sheet date whether there is any indication that an asset may be impaired. The impairment loss if recognised shall be debited in the profit and loss account provided no revaluation reserve exists at that date in relation to the asset, and if it exists, the loss should first be debited to revaluation reserve. After debiting the revaluation reserve, if still there is impairment loss then the same should be debited to profit and loss account. RBI's circular on compliance with Accounting Standards, issued in April 2004 states as follows in respect of AS 28:

- The Standard would not apply to investments, inventories and financial assets such as loans and advances and may generally be applicable to banks in so far as it relates to fixed assets.
- Banks may also take into account the following specific factors while complying with the Standard:
  - Paragraphs 7 and 8 of the Standard have clearly listed the triggers which may indicate impairment of the value assets. Hence, banks may be guided by these in determining the circumstances when the Standard is applicable to banks and how frequently the assets covered by the Standard need to be reviewed to measure impairment.
  - In addition to the assets of banks which are specifically identified above, *viz.,* financial assets, inventories, investment, loans and advances etc to which the Standard does not apply, the Standard would apply to financial lease assets and non banking assets acquired in settlement of claims only when the indications of impairment of the entity are evident.

Other Assets

4.31 The branch auditor may carry out the audit of various items appearing under the head 'other assets' in the following manner.

Inter-Office Adjustments

4.32 The balance in the inter-branch accounts, if in debit, is to be shown under this head. The inter-branch accounts are generally sub-divided into segment or specific areas, e.g., 'Demand Drafts Paid', 'Inter-branch Remittances', 'Head Office Account', etc. The net aggregate of all such accounts should be shown under this head. The approach to be followed by the auditor for checking the Inter Office Adjustments/Inter Branch Account is dealt separately in Chapter 13 of Part III on "Inter-office Transactions".

Interest Accrued

4.33 The main components of this item are interest accrued but not due on investments and advances and interest due but not collected on investments. As banks normally debit the borrower's account with interest due on the balance sheet date, there would not usually be any amount of interest accrued but not due on advances on balance sheet date.[@] On the other hand, interest on government securities, debentures, bonds, etc. which accrues from day to day should be calculated and brought into account, in so far as it has accrued on the date of the balance sheet. The auditor should examine this item in the usual manner, i.e., by reference to terms of payment of interest, rate of interest, period elapsed till the date of balance sheet, etc.

4.34 The auditor should 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. Dividends recognised as income but not received may be included in the residuary sub-head of 'others'. Dividends and interest on investments would be recognised in the books of the branch only if it is handling the work relating to investments or receipt of income on investments.

Tax Paid in Advance/Tax Deducted at Source

4.35 Generally, this item is dealt with at the head office level only and would, therefore, not appear in the balance sheet of a branch, except that tax deducted at source on fixed deposits and other products/services is handled at the branch level. The procedures to be followed by the branch auditor for verification of tax deducted at source by the branch would be similar to those in an audit of other types of entities. The branch auditor needs to 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.

4.36 At Head Office level, the availability of all the TDS Certificates, submission of the same with Income Tax Department/claim of the same in Income Tax returns filed should be checked to ensure the justification of the claim towards such certificates.

Stationery and Stamps

4.37 Internal controls over stationery of security items (like term deposit receipts, drafts, pay orders, cheque books, traveller's cheques, gift cheques,

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etc.) assume special significance in the case of banks as their loss or misuse could eventually lead to misappropriation of the most valuable physical asset of a bank, *viz*., cash. The branch auditor should study and evaluate the existence, effectiveness and continuity of internal controls over these items in the normal course of his audit. It may be noted that the branch auditor is required to specifically comment on the adequacy of the relevant internal controls in his LFAR.

4.38 The item "Stationery and Stamps" should include only exceptional items of expenditure on stationery like, bulk purchase of security paper, loose leaf or other ledgers, etc., which are shown as quasi-asset to be written off over a period of time. In other words, the normal expenditure on stationery may be treated as an expense in the profit and loss account, while unusually heavy expenditure may be treated as an asset to be written off based on issue/consumption. At the branch level, the expenditure on latter category may not appear since a considerable part of the stationery is supplied to branches by the head office.

4.39 The auditor should physically verify the stationery and stamps on hand as at the year-end, especially stationery of security items. Any shortage should be inquired into as it could expose the bank to a potential loss from misuse. The auditor should examine whether the cost of stationery and stamps consumed during the year has been properly charged to the profit and loss account for the year in the context of the accounting policy/instructions from the head office regarding treatment of cost of stationery and stamps.

Non-Banking Assets Acquired in Satisfaction of Claims

4.40 Under this heading, will be included, those immovable properties/tangible assets, which the bank has acquired in satisfaction of debts due or its other claims and are being held with the intention of being disposed of.

4.41 While examining this item, the auditor should specifically keep in mind the provisions of section 9 of the Banking Regulation Act, 1949, which prohibit a banking company from holding any immovable property, however acquired (i.e. whether acquired by way of satisfaction of claims or otherwise), except such as is required for its own use, for any period exceeding seven years from the date of acquisition thereof. During this period, the bank may deal or trade in any such property for the purpose of facilitating the disposal thereof. The RBI has the power to extend the aforesaid period in a particular case up to another five years. (It may be noted that the aforesaid section is applicable to banking companies only and not to other types of banks like nationalised banks.)

4.42 Except when held for its own use, AS 10, "Accounting for Fixed Assets", would not be applicable on those fixed assets which are held with the bank in satisfaction of claim. At the date of acquisition, the assets should be recorded at amount lower of the net book value of the advance or net realisable value of asset acquired. At each balance sheet date, net realisable value of such assets may be re-assessed and necessary adjustments may be made.

4.43 The auditor should verify such assets with reference to the relevant documentary evidence, e.g., terms of settlement with the party, order of the Court or the award of arbitration, etc. The auditor should verify that the ownership of the property is legally vested in the bank's name.@ If there is any dispute or other claim about the property, the auditor should examine whether the recording of the asset is appropriate or not. In case the dispute arises subsequently, the auditor should examine whether a provision for liability or disclosure of a contingent liability is appropriate, keeping in view the requirements of AS 29 "Provisions, Contingent Liabilities and Contingent Assets".

Others

4.44 This is the residual heading, which will include items not specifically covered under other sub-heads, e.g., claims which have not been received, debit items representing additions to assets or reductions in liabilities which have not been adjusted for technical reasons or want of particulars, etc., receivables on account of government business, prepaid expenses, Accrued income other than interest (e.g., dividend declared but not received) may also be included under this head. The audit procedures relating to some of the major items included under this head are discussed below.

Non-Interest Bearing Staff Advances

4.45 The auditor should examine non-interest bearing staff advances with reference to the relevant documentation and the bank's policy in this regard. The availability, enforceability and valuation of security, if any, should also be examined. It needs to be ensured that the same relates to employees on the roll of the bank on the date of the preparation of financial statements.

Security Deposits

4.46 Security deposits with various authorities (e.g., on account of telephone, electricity, etc.,) and with others (e.g., deposits in respect of premises taken on rent) should be examined with reference to documents containing relevant terms and conditions, and receipts obtained from the parties concerned. The auditor should verify that the deposits have not become due as per the terms and conditions. If it is so, then the recoverability

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of the same needs to be looked into in detail and appropriate provision should be suggested against the amount where recovery is in doubt..

Suspense Account

4.47 'Suspense' account is another item included under 'other assets'. Ideally, where accounts are maintained properly and on a timely basis, the suspense account may not arise. However, in a practical situation, suspense account is often used to temporarily record certain items such as the following:

(i) amounts temporarily recorded under this head till determination of the precise nature thereof or pending transfer thereof to the appropriate head of account;

(ii) debit balances arising from payment of interest warrants/ dividend warrants pending reconciliation of amounts deposited by the company concerned with the bank and the payment made by various branches on this account;

(iii) amounts of losses on account of frauds awaiting adjustment.

4.48 The auditor should pay special attention to any unusual items in suspense account. He should obtain from the management, details of old outstanding entries/age-wise balances along with narrations in suspense account. The auditor should also verify the reasons for such delay in adjusting the entries. Where the outstanding balances comprised in suspense account require a provision/write-off, the auditor should examine whether the necessary provision has been made/written off..

Prepaid Expenses

4.49 The auditor should verify prepaid expenses in the same manner as in the case of other entities. The auditor should examine whether the basis of allocation of expenditure to different periods is reasonable. The auditor should particularly examine whether the allocation of discounting and rediscounting charges paid by the bank to different accounting periods is in consonance with the accounting policy followed for the bank as a whole.

Miscellaneous Debit Balances on Government Account

4.50 Miscellaneous debit balances on government account in respect of pension, public provident funds, compulsory deposit scheme payments, etc., for which the branch obtains reimbursement from the government through a designated branch, are also included under the head 'others'. The auditor should review the ageing statements pertaining to these items. He should particularly examine the recoverability of old outstanding items. The auditor should also examine whether claims for reimbursement have been lodged by the branch in accordance with the relevant guidelines, terms and conditions. The net balances of the amount recoverable at the Head Office level should also be taken along with the age-wise analysis of the same. In case of old outstanding balances without any confirmation or proper justification of the same, should be provided for in the accounts.

4.51 The residual item of "Others" in Other Assets generally constitutes a significant amount in the Balance Sheet of the bank. The Head Office auditors should obtain the head wise details of the same along with the previous year figures. The age-wise details of the major outstanding should also be obtained, wherever, feasible. Further, the major variance as compared to the previous year figures should also be enquired into and reasons for the same should be recorded and reviewed. In case any amount seems doubtful of recovery, appropriate provisions against the same should be made.

III-5
Borrowings and Deposits

Borrowings

5.01 Borrowings usually take place only at head office of the bank. In case of exception there is a borrowing at few designated branches authorised in this behalf by the head office or other controlling authority either generally or specifically in respect of a particular borrowing. As such, this item generally does not figure in the balance sheets of most branches of the bank.

Balance Sheet Disclosure

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

I. *Borrowings in India*
   - (i) Reserve Bank of India
   - (ii) Other Banks
   - (iii) Other Institutions and Agencies

II. *Borrowings outside India*

RBI vide its circular no. DBOD.BP.BC No.81/ 21.01.002/2009-10 dated March 30, 2010 on “Classification in the Balance Sheet - Capital Instruments” advised that the following classification may be adopted in the balance sheet from the financial year ending March 31, 2010 under Schedule 4 – Borrowings:

1. Innovative Perpetual Debt Instruments (IPDI)
2. Hybrid debt capital instruments issued as bonds/debentures
3. Perpetual Cumulative Preference Shares (PCPS)
4. Redeemable Non-Cumulative Preference Shares (RNCPS)
5. Redeemable Cumulative Preference Shares (RCPS)
6. Subordinated Debt

5.03 The total amount of secured borrowings included under the above heads is to be shown by way of a note to the relevant schedule (Schedule 4). 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.

5.04 RBI, Export-Import Bank of India (EXIM Bank), National Bank for Agriculture and Rural Development (NABARD) and Small Industries Development Bank of India (SIDBI) are the major agencies providing refinance to banks, generally for loans extended to specified sectors. Borrowings from Reserve Bank of India include refinance obtained by the bank from the RBI. Similarly, borrowings from other banks include refinance obtained by the bank from commercial banks, co-operative banks, etc. Refinance obtained by the bank from EXIM Bank, NABARD, SIDBI and other similar institutions and agencies is to be included under 'borrowings from other institutions and agencies'. This head will also include the bank's liability against participation certificates on non-risk sharing basis issued by it to participating banks.

5.05 Credit balances of Vostro and Nostro accounts are also to be included under the head borrowings.

5.06 'Borrowings outside India' include borrowings of Indian branches abroad as well as borrowings of foreign branches. Funds raised by foreign branches by way of certificates of deposit, notes, bonds, etc. have to be classified as 'deposits' or as 'borrowings' depending upon documentation. The 'Notes and Instructions for Compilation' of balance sheet and profit and loss account, issued by the RBI, clarify that since refinance obtained by a bank from the RBI and various institutions is to be shown under the head 'borrowings', the related advances should be shown on the assets side at the gross amount.

5.07 Money at call or short notice taken by the bank is also shown under this head. RBI through its "Master Circular no. IDMD.PCD.03 /14.01.01/2012-13 on "Call-Notice Money Market Operations" dated July 2, 2012(The Circular is given in the CD along with the Guidance Note) has set down the prudential limit for transactions in call/notice money market. In terms of the said circular, on a fortnightly average basis, the borrowings should not exceed 100 percent of the capital funds (i.e., sum of Tier I and Tier II capital) of latest audited balance sheet. However, banks are allowed to borrow a maximum of 125 percent of their capital funds on any day, during a fortnight.

Inter Bank Liabilities (IBL)

5.08 Liability side management has its own merits from the point of view of financial stability. Controlling the concentration risk on the liability side of banks is, therefore, as important as controlling the concentration risk on asset side. More particularly, uncontrolled IBL may have systemic implications, even if, the individual counterparty banks are within the allocated exposure.

5.09 Further, uncontrolled liability of a larger bank may also have a domino effect. In view of this, it has become important to put in place a comprehensive framework of liability management so that banks are aware of the risks inherent in following a business model based on large amount of IBL and the systemic risks such a model may entail. In order to reduce the extent of concentration on the liability side of the banks, the following guidelines have been prescribed by the RBI (applicable from April 1, 2007) *vide* its circular no. DBOD.BP.BC.66/ 21.01.002/2006-07 of March 6, 2007.

(a) The IBL of a bank should not exceed 200% of its net worth as on 31st March of the previous year. However, individual banks may, with the approval of their Boards of Directors, fix a lower limit for their inter-bank liabilities, keeping in view their business model.

(b) The banks whose CRAR is at least 25% more than the minimum CRAR (9%) i.e. 11.25% as on March 31, of the previous year, are allowed to have a higher limit up to 300% of the net worth for IBL.

(c) The limit prescribed above will include only fund based IBL within India (including inter-bank liabilities in foreign currency to banks operating within India). In other words, the IBL outside India are excluded.

(d) The above limits will not include collateralised borrowings under CBLO and refinance from NABARD, SIDBI etc.

(e) The existing limit on the call money borrowings prescribed by RBI will operate as a sub-limit within the above limits.

(f) Banks having high concentration of wholesale deposits should be aware of potential risk associated with such deposits and may frame suitable policies to contain the liquidity risk arising out of excessive dependence on such deposits.

Deposits

5.10 Deposits represent the most important source of funds for a bank. Deposits are received from a large number of constituents, generally in small amounts.

Balance Sheet Disclosure

5.11 Deposits are required to be classified in the balance sheet under the following heads.

A. I. *Demand Deposits*
- (i) From Banks
- (ii) From Others

II. *Savings Bank Deposits*

III. *Term Deposits*

(i) From Banks

(ii) From Others

B. I. *Deposits of branches in India*

II. *Deposits of branches outside India*

Types of Deposits

5.12 Deposits accepted by banks are primarily of two types – those repayable on demand (demand deposits) and those repayable after a fixed term (term deposits), though in this case also, the deposits may be repaid prematurely at the request of the depositor.

Demand Deposits

5.13 Current accounts are the most common form of demand deposits of banks. Though savings bank deposits are also, in substance in the nature of demand deposits, the Third Schedule to the Banking Regulation Act, 1949, does not consider them demand deposits. This may, perhaps, be due to the fact that withdrawals from savings bank accounts in excess of the limits prescribed by the bank can be made only with prior notice to the bank.

5.14 Current accounts can be opened in the names of individuals, associations of persons, corporate bodies, trusts, societies, etc., i.e., for all kinds of customers. The operations on current accounts opened in joint names may be joint, single, by either holder or by surviving holder, depending on the mode of operation chosen by the account holders. The salient features of this type of accounts are:

- There is no restriction on the quantum of funds withdrawn by the account holder at any one time.
- There is no restriction on the number of transactions in the account during any period of time.
- No interest is payable on this deposit except where it may be specifically permitted by the bank / RBI.

Savings Bank Deposits

5.15 Savings accounts are generally in the names of individuals – either singly or jointly, and sometimes, in the names of institutions which are specifically approved by the RBI for maintaining savings bank accounts with banks. In terms of RBI's guidelines, no bank can open a savings bank account for government departments, municipal corporations, municipal committees, any political party, or any trade, business or professional concern, whether such concern is a proprietary or a partnership firm or a company or an association. As in the case of current accounts, savings bank accounts can also be opened in joint names.

5.16 The salient features of this type of accounts are:

- Banks place restrictions on the maintenance of minimum balance (separate for cheque book and without cheque book), amount of funds that can be withdrawn by the account holder at any point to time. Beyond this cut-off level, banks require the depositors to give notice of a specified period for withdrawal of the amount.
- Banks also place restrictions on the number of withdrawals from the account during a stated period of time, usually one year. For the number of withdrawals beyond this number, banks have the right to levy service charges. The intention behind putting this restriction is to ensure that the savings bank accounts (on which the account holder is entitled to payment of interest) are used to promote genuine savings and are not used as substitutes for current accounts (on which the account holder usually does not get interest).
- Interest is payable as per the RBI guidelines in force. In the past, interest was paid annually but now, banks pay interest at quarterly / half-yearly intervals on daily outstanding balances.

5.17 In the case of both current and savings bank accounts, if there are no operations on the account by the account holder during a prescribed period (such period may vary from bank to bank), such accounts are identified as 'dormant' or 'inoperative' accounts and may be transferred to a separate ledger. Further, transactions in these accounts are allowed only with authority of the official designated by the bank for this purpose.

Term Deposits

5.18 Term deposits (known by different nomenclature in different banks) are repayable after a specified period of time. The minimum period of these deposits, at present, is 7 days. The salient features of this kind of deposits are given below:

- Interest is payable at periodic intervals to the depositors or as per their instructions.
- In case a depositor so desires, the periodic interest can be reinvested in fresh term deposits. Such schemes are generally called 'reinvestment plans'. In this case, the interest payable is compounded at the specified intervals and the resultant maturity value is indicated on the deposit receipt at the time of issuing the receipt. The head offices of banks issue maturity value charts for the guidance of their branches from time to time.

5.19 Recurring deposit accounts are an important variant of term deposit. In a recurring deposit, a specified sum is deposited at regular intervals, generally once a month, for a pre-determined period. On the expiry of this period, the maturity proceeds, which are known at the time of opening the account, are repaid to the depositors or as per their instructions. No recurring deposit is accepted under FCNR(B) Scheme. Some of the banks are offering fixed / flexible recurring deposit accounts in recent times where the customer choose amount of deposit each time based on their convenience.

5.20 Cash certificates and certificates of deposit (CD), in demat form or otherwise, are two other variants of term deposits. Cash certificates are issued at discounted value, e.g., a certificate with face value of Rs. 100 and term of 5 years may be issued at, say, Rs. 49. The certificates of deposit are short-term negotiable money market instruments and are issued in only dematerialised form or as a Usance Promissory Note. However, according to the Depositories Act, 1996, investors have the option to seek certificate in physical form. Accordingly, if investor insists on physical certificate, the bank may inform the Chief General Manager, Financial Markets Department, Reserve Bank of India, Central Office, Fort, Mumbai - 400 001 about such instances separately. Further, issuance of CDs will attract stamp duty. In this regard, the RBI has issued Master Circular No. IDMD.PCD. 05/14.01.03/2012-13 on “Guidelines for Issue of Certificates of Deposit” dated July 2, 2012. CDs may be issued at a discount on face value. The rate of interest thereon is negotiable with the depositor and may vary on a daily basis. The maturity period of CDs issued by banks should not be less than 7 days and not more than one year. Banks are allowed to issue CDs on floating rate basis provided the methodology of compiling the floating rate is objective, transparent and market-based. The issuing bank / FI is free to determine the discount / coupon rate. The interest rate on floating rate CDs would have to be reset periodically in accordance with a pre-determined formula that indicates the spread over a transparent benchmark. Minimum amount of a CD should be Rs. 1 lakh, i.e., the minimum deposit that could be accepted from a subscriber should not be less than Rs. 1 lakh and in the multiples of Rs. 1 lakh thereafter. Issuance of CDs attracts stamp duty. There is no grace period for repayment of CDs. If maturity date happens to be on holiday it should be paid on the immediately preceding working day. Banks may, therefore, so fix the period of deposit that the maturity date does not coincide with a holiday to avoid loss of discount / interest rate.All OTC trades in CDs shall be reported within 15 minutes of the trade on the FIMMDA reporting platform.

5.21 In respect of term deposits, banks issue Deposit Receipts. These receipts are not negotiable, and therefore, deposits cannot be transferred without the consent of the bank. Certificates of deposits are, however, transferable. CDs held in physical form are transferable by endorsement and delivery. CDs in dematerialised form can be transferred as per the procedure applicable to other demat securities. There is no lock-in period for CDs. Banks / FIs cannot grant loans against CDs. Furthermore, they cannot buy-back their own CDs before maturity. However, the Reserve Bank may relax these restrictions for temporary periods through a separate notification.

5.22 Banks should include the amount of CDs in the fortnightly return under Section 42 of the Reserve Bank of India Act, 1934 and also separately indicate the amount so included by way of a footnote in the return. Further, banks / FIs should report the data on issuance of CDs on the web-based module under the Online Returns Filing System (ORFS) within 10 days from the end of the fortnight to which it pertains.

5.23 Banks normally allow repayment of the deposits before the due date; however, the rate of interest paid to the depositor in case of premature repayment is lower than the rate contracted initially. In recent time, some of the banks have announced no deduction in rate of interest in case of premature withdrawal of deposit. Auditor has to verify the scheme of fixed deposits thoroughly. If a depositor does not take repayment on the date of expiry, the interest ceases to run from the date, though the bank continues to be a debtor of the depositor. A matured deposit can be renewed by the depositor for a further period. Where a deposit is renewed some time after its maturity, banks generally allow interest from the date of maturity rather than from the date of renewal. In other words, the renewal is given a retrospective effect. In case the deposit is matured and not renewed by the customer, the interest same as saving bank rate is provided on the same as per RBI Guidelines.

5.24 Rate of interest payable on fixed deposits as well as other deposits depends on current economic conditions, decided by banks from time to time Interest rates are regulated by an Inter-Bank Agreement which is revised from time to time. The rate of interest on certificates of deposits is negotiable with the depositor, especially in the case of bulk/wholesale deposits.

5.25 Following are important issues in respect of different category of accounts which auditor must consider:

(a) FCNR Accounts

- Maintenance of position viz. details of deposits – tallying the position with reference to branches periodically.
- System of reporting to the position maintenance office by the

branches including "C" category branch.

- Applicability of notional rate.
- Revaluation is done every reporting Friday for CRR purposes.
- Provisions/payment of interest on a regular basis to reflect the due liability.
- Is it debited to the proper Head of accounts?
- Random check of interest as interest is charged every month based on LIBOR.
- How the payment is effected-expeditiously?
- On payment whether the liability is reversed.
- Method of reconciliation of Nostro account with FCNR (B).
- It should not be revalued and taken to profit and loss.
- Many banks have a separate Nostro account for FCNR (B) balances converted on a notional basis.

Further, RBI, vide its Master Circular No. DBOD.No.Dir.BC.8/13.03.00/2012-13 dated July 2, 2012 on "Instructions relating to deposits held in FCNR (B) Accounts", provides guidance on the interest rates on deposits held in FCNR (B) accounts. The Circular further prohibit the banks to:

i. accept or renew a deposit over five years;

ii. discriminate in the matter of rate of interest paid on the deposits, between one deposit and another accepted on the same date and for the same maturity, whether such deposits are accepted at the same office or at different offices of the bank, except on the size group basis. The permission to offer varying rates of interest based on size of the deposits will be subject to the following conditions:

   a. Banks should, at their discretion, decide the currency-wise minimum quantum on which differential rates of interest may be offered. For term deposits below the prescribed quantum with the same maturity, the same rate should apply.

   b. The differential rates of interest so offered should be subject to the overall ceiling prescribed.

   c. Interest rates paid by the bank should be as per the schedule and not subject to negotiation between the depositor and the bank.

iii. pay brokerage, commission or incentives on deposits mobilized under FCNR(B) Scheme in any form to any individual, firm, company, association, institution or any other person.

iv. employ/ engage any individual, firm, company, association, institution or any other person for collection of deposit or for selling any other deposit linked products on payment of remuneration or fees or commission in any form or manner.

v. accept interest-free deposit or pay compensation indirectly.

(b) Resident Foreign Currency Accounts

- Exporters having good track record to open foreign currency account with banks.
- RBI will permit.
- Unit located in SEZ may hold an account in Foreign Currency.
- Diamond Dollar Accounts may be opened with permission from RBI to transact business in Foreign Currency.
- The returning Indians can have their foreign currency accounts to be covered into RFC same feature as of FCNR.

(c) EEFC account

- Non-interest bearing – No credit facilities against the security of the balances.
- 100% of inward remittance for Status Holder Exports, professional service rendered in personal capacity.
- 100% of EOU, STP and EHTP 50% for other payments received from a unit DTA for goods supplied to SEZ.

(d) Non-resident Bank Accounts

- Name of such accounts and type of arrangement.
- Funding of these accounts – bonafide transactions – freely convertible balance.
- System of monitoring overseas bank not to take a speculative view on rupees.
- Forward purchase/sale of foreign currencies against rupee for funding is prohibited – offer two ways quote is also prohibited.
- Temporary overdrawals to overseas branch/ correspondent not to exceed Rs. 500.00 lakh in aggregate in all overseas branch/correspondent in the books of the bank.
- Purpose is essential.
- Period not to exceed 5 days.
- Statement to be sent to Forex Market Division of RBI.

Further, RBI, vide its Master Circular No. DBOD.No.Dir.BC.1/13.03.00/2012-13 dated July 2, 2012 on "Interest Rates on Rupee Deposits held in Domestic, Ordinary Non-Resident (NRO) and Non-Resident (External) (NRE) Accounts" provides guidance on the interest rates on rupee deposits held in Domestic, Ordinary Non-Resident (NRO) and Non-Resident (External) (NRE) Accounts. The Circular further prohibit the banks to:

(a) pay interest on Current Account except on the current account of a Regional Rural Bank sponsored by them and In the case of balances lying in current account standing in the name of a deceased individual depositor/sole proprietorship concern, interest should be paid only from 1st May, 1983, or from the date of death of the depositor, whichever is later, till the date of repayment to the claimant/s at the rate of interest applicable to savings deposit as on the date of payment.

(b) pay countervailing interest on any current accounts maintained with it by its borrowers;

(c) discriminate in the matter of interest paid on deposits, between one deposit and another, accepted on the same date and for the same maturity, whether such deposits are accepted at the same office or at different offices of the bank, except in respect of fixed deposit schemes specifically for resident Indian senior citizens offering higher and fixed rates of interest as compared to normal deposits of any size, and bulk deposits of Rs. 1 crore and above [RBI Circular No. DBOD.No.Dir.BC.74/13.03.00/2012-13 on Interest Rates on and Premature Withdrawal of Rupee Term Deposits] on which varying rates of interest may be permitted. The permission to offer varying rates of interest is subject to the conditions prescribed in the above RBI Circular.

(d) pay brokerage in the form of commission or gift or incentives on deposits in any manner or in any other form to any individual, firm, company, association, institution or any other person except as prescribed in the above RBI Circular.

(e) employ/engage any individual, firm, company, association, institution or any other person for collection of deposit or for selling any other deposit linked products on payment of remuneration or fees or commission in any form or manner, except to the extent permitted in the above RBI Circular.

(f) launch prize/lottery/free trips (in India and/or abroad), etc. oriented deposit mobilisation schemes. It is clarified that banks should not offer any banking products, including online remittance schemes, with prizes /lottery/free trips (in India and/or abroad), etc. or any other incentives having an element of chance, except inexpensive gifts costing not more than Rs. 250/-, as such products involve non-transparency in the pricing mechanism and therefore go against the spirit of the guidelines. Such products, if offered, by banks would be considered as violation of the extant guidelines and the banks concerned would be liable for penal action.

(g) resort to unethical practices of raising of resources through agents/third parties to meet the credit needs of the existing/prospective borrowers or to grant loans to the intermediaries based on the consideration of deposit mobilisation.

(h) issue any advertisement/literature soliciting deposits from public highlighting only the compounded yield on term deposits without indicating the actual rate of simple interest offered by the bank for the particular period. Simple rate of interest per annum for the period of deposit should be indicated invariably.

(i) pay interest on margin money held in current account.

(j) pay interest on "deposit at call" receipts issued by it to the tenderers (contractors) for submission to Government Departments/Semi-Quasi Government bodies, local bodies, etc. against the money held in current account.

(k) accept interest-free deposit other than in current account or pay compensation indirectly.

(l) accept deposits from/at the instance of private financiers or unincorporated bodies under any arrangement which provides for either issue of deposit receipt/s favouring client/s of private financiers or giving of an authority by power of attorney, nomination or other-wise, for such clients receiving such deposits on maturity.

(m) grant advances against fixed deposit receipts or other term deposits of other banks.

(n) (i) open a savings deposit account in the name of Government departments/bodies depending upon budgetary allocations for performance of their functions/Municipal Corporations or Municipal Committees/ Panchayat Samitis/State Housing Boards/Water and Sewerage/Drainage Boards/State Text Book Publishing Corporations/ Societies/ Metropolitan Development Authority / State/ District Level Housing Co-operative Societies, etc. or any political party or any trading/business or professional concern, whether such concern is a proprietary or a partnership firm or a company or an association.(ii) The above prohibition will not apply in the case of organisations/agencies listed in the above RBI Circular.

(o) granting fresh loans or renewing existing loans in excess of Rupees twenty (20) lakh against NR(E)RA and FCNR(B) deposits either to the depositors or third parties. As announced in the paragraph 111 of the Annual Policy Statement 2009-10, the existing cap of Rs. 20 lakh was enhanced to Rs. 100 lakh on loans against security of funds held in NR(E)RA and FCNR(B) deposits either to the depositors or third parties. Accordingly, banks should not grant fresh loans or renew existing loans in excess of Rupees hundred (100) lakh against NR(E)RA deposits, either to depositors or to third parties, with effect from April 28, 2009. Banks should not undertake artificial slicing of the loan amount to circumvent the ceiling. As per the RBI circular no. RBI/2012-13/247 A. P. (DIR Series) Circular No. 44 dated October 12, 2012 on Foreign Exchange Management (Deposit) Regulations, 2000-Loans to Non Residents / third parties against security of Non Resident (External) Rupee Accounts [NR (E) RA] / Foreign Currency Non Resident (Bank) Accounts [FCNR (B)] Deposits, this ceiling of Rs 100 lakhs has been removed. Banks may now grant loans to depositor/ third party without any limit subject to usual margin requirements. These provisions will come into effect immediately, i.e., from October 12, 2012.[@]

Further, paragraph 2.11 of the master circular No. DBOD.No.Dir.BC.1/13.03.00/2012-13 dated July 2, 2012 on “Interest Rates on Rupee Deposits held in Domestic, Ordinary Non-Resident (NRO) and Non-Resident(External) (NRE) Accounts also provides the guidelines with respect to the conversion of a term deposit, a deposit in the form of daily deposit or a recurring deposit for reinvestment in term deposit and states that a bank, on a request from the depositor, should allow conversion of a term deposit, a deposit in the form of daily deposit or recurring deposit, to enable the depositor to immediately reinvest the amount lying in the aforesaid deposits with the same bank in another term deposit. On a review and in order to facilitate better asset-liability management (ALM), with effect from April 20, 2010, banks are permitted to formulate their own policies towards conversion of deposits.

(e) Rupee Accounts (Exchange House)

- Accounts opening require approval from RBI.
- Trade transaction per transaction upto Rs.2.00 lakh is permitted.
- Reconciliation issues and concurrent auditor overseas report.

@ Revised in 2013 Edition.

- Debits/claims outstanding as the branches pending receipt of the credit.
- Method of value dating the transactions and overdraft arisen thereon.
- Collection of overdue interest for such over drawn balances.

Unclaimed Deposits/ Inoperative Accounts

5.26 As per RBI Circular no. DBOD No. Leg.BC.34/ 09.07.005/2008-09 dated August 22, 2008 on “Unclaimed Deposits/in operative accounts in Banks”. A bank is required to make an annual review of accounts in which there are no operations (other than crediting of periodic interest or debiting of service charges) for more than one year. A savings as well as current account should be treated as inoperative/ dormant if there are no transactions in the account for over a period of two years.[@] In case any reply is given by the account holder giving the reasons for not operating the account, banks should continue classifying the same as an operative account for one more year within which period the account holder may be requested to operate the account. However, in case the accountholder still does not operate the same during the extended period, banks should classify the same as inoperative account after the expiry of the extended period.[@] If a Fixed Deposit Receipt matures and proceeds are unpaid, the amount left unclaimed with the bank will attract savings bank rate of interest.

Accounting

5.27 Banks may account the CDs at issue price under the Head “CDs issued” and show the same under “Deposits”. Accounting entries towards discount will be same as in case of ‘Cash Certificate’. Banks should maintain a register of CDs issued with complete particulars.

5.28 The Bank will maintain “CD Redemption Account” represented by specific ISIN.

Combinations of Demand and Term Deposits

5.29 Although the above are the basic types of deposits, these days, most of the banks are also offering combinations of two or more of them. These blended products are known by different names in different banks.

Procedural Aspects

5.30 Some banks use a single application form for opening various types of accounts, *viz.,* Savings, Current and Term Deposits while some others adopt the system whereby, for each type of account, a different type of form is used.

[@] Revised in 2013 Edition.

The form essentially provides for particulars of the account holder(s), mode of operation on the account, term of the deposit (if applicable), signatures of the account holder(s), photograph of the account holder(s) etc. In the case of partnership firms, a copy of the partnership deed and in the case of companies, copies of the memorandum and articles of association, certificate of incorporation and resolution passed by the board for opening the account/making the deposit are obtained. Particulars of all new accounts opened are recorded in a register.

Guidelines on Banks' Asset Liability Management Framework – Interest Rate Risk

5.31 RBI, vide its circular no. DBOD. No. BP. BC. 59 / 21.04.098/ 2010-11 dated November 4, 2010 provides the Guidelines on Banks' Asset Liability Management Framework – Interest Rate Risk (The circular is given in the CD enclosed with the Guidance Note). Interest rate risk is the risk where changes in market interest rates affect a bank's financial position. Changes in interest rates impact a bank's earnings (i.e. reported profits) through changes in its Net Interest Income (NII). Changes in interest rates also impact a bank's Market Value of Equity (MVE) (hereinafter 'equity' would mean 'networth' unless indicated otherwise) through changes in the economic value of its interest rate sensitive assets, liabilities and off-balance sheet positions. The interest rate risk, when viewed from these two perspectives, is known as 'earnings perspective' and 'economic value perspective', respectively. The earlier guidelines (DBOD. BP. BC. 8 / 21.04.098/ 99 dated February 10, 1999) to banks indicated approach to interest rate risk measurement from the 'earnings perspective' using the Traditional Gap Analysis (TGA). To begin with, the TGA was considered as a suitable method to measure Interest Rate Risk. Reserve Bank had also indicated then its intention to move over to modern techniques of Interest Rate Risk measurement like Duration Gap Analysis (DGA), Simulation and Value at Risk over a period of time, when banks acquire sufficient expertise and sophistication in acquiring and handling MIS. In this context, it is clarified that Duration Gap Analysis (DGA) is aimed at providing an indication of the interest rate risk to which the bank is exposed. Accordingly, the estimated drop in MVE as a result of the prescribed shock applied would indicate the economic impact on the banks' equity should the shock scenario materialise but would not be an accounting loss as banking book is not marked to market. The revised guidelines furnished in Annex to the said circular were effective from April 1, 2011. Banks were advised to start full-fledged test runs on these guidelines with effect from January 1, 2011 with a view to enable them to gain more experience in the operation of the revised framework. The salient features of the guidelines are as follows:

- Banks shall adopt the DGA for interest rate risk management in addition to the TGA followed presently.
- The framework, both DGA and TGA, should be applied to the global position of assets, liabilities and off-balance sheet items of the bank, which are rate sensitive. Banks should compute their interest rate risk position in each currency applying the DGA and TGA to the rate sensitive assets/ liabilities/ off balance sheet items in that currency, where either the assets, or liabilities are 5 per cent or more of the total of either the bank's global assets or global liabilities. The interest rate risk position in all other residual currencies should be computed separately on an aggregate basis.
- Keeping in view the level of computerisation and the current MIS in banks, adoption of a uniform ALM System for all banks may not be feasible. The proposed guidelines have been formulated to serve as a benchmark for banks. Banks which have already adopted more sophisticated systems may continue their existing systems but should also adopt the DGA and TGA as supervisory reporting/ disclosure frameworks.
- Banks should adopt the modified duration gap approach while applying the DGA to measure interest rate risk in their balance sheets from the economic value perspective. In view of the evolving state of computerisation and MIS in banks, a simplified framework has been suggested, which allows banks to:

  (a) group rate sensitive assets, liabilities and off balance sheet items under the broad categories indicated in Appendix I under various time buckets; and

  (b) compute Modified Duration (MD) of these categories of assets/ liabilities and off-balance sheet items using the suggested common maturity, coupon and yield parameters.

- Measurement of interest rate risk with the above method is an approximation. Hence banks which have the capability to compute the weighted average MD of their assets and liabilities based on the MD of each item of Rate Sensitive Asset (RSA) / Rate Sensitive Liability (RSL) may do so.

- Each bank should set appropriate internal limits for interest rate risk based on its risk bearing and risk management capacity, with prior approval of its Board / Risk Management Committee of the Board.
- Banks should compute the potential decrease in earnings and fall in MVE under various interest rate scenarios.
- In addition to extant frequency of supervisory reporting of interest rate sensitivity as per Traditional Gap Analysis (TGA), banks shall submit a report on interest rate sensitivity as per DGA in the stipulated format with effect from June 30, 2011 on a quarterly basis till March 31, 2012 and monthly with effect from April 30, 2012.

It is clarified that the framework prescribed in the said circular is aimed at determining the impact on the MVE of the bank arising from changes in the value of interest rate sensitive positions across the whole bank i.e. both in the banking and trading books. This requirement is in addition to the existing guidelines for assessing capital adequacy requirement for interest rate sensitive positions in the trading book and banking book (under Pillar II) separately. For the purpose of capital adequacy trading and banking books are treated separately because generally no offset of positions between the banking book and trading book is considered due to different accounting/valuation norms. After gaining significant experience with the methodology laid down in the circular, banks may consider switching over to this methodology for management of interest rate risk in the banking book under Pillar II. As per extant guidelines on management of interest rate risk in the banking book under Pillar II, banks where the economic value of the banking book declines by more than 20% of the MVE as a result of a standardised interest rate shock of 200 basis points are considered outlier from supervisory perspective. However, no such calibration is envisaged at this stage for decline in the MVE based on the impact of the standardised interest rate shock of 200 basis points on the entire balance sheet, under the guidelines on banks' ALM contained in the circular.

Know Your Customer Requirements (KYC)@

5.32 Reserve Bank of India vide its circular no. DBOD. AML. BC. No. 11 /14 .01.001/2012-13 dated July 2, 2012 namely "Master Circular – Know Your Customer (KYC) norms/Anti-Money Laundering (AML) standards/Combating of Financing of Terrorism (CFT)/Obligation of banks under PMLA, 2002" (The

@Revised in 2013 Edition.

Circular is given in the CD along with the Guidance Note) has laid down certain guidelines to prevent banks from being used, intentionally or unintentionally, by criminal elements for money laundering or terrorist financing activities. The guidelines prescribed in this circular, popularly known as KYC guidelines, also enable banks to know/understand their customers and their financial dealings better which in turn help them manage their risks prudently.

These guidelines contain detailed requirements for banks in respect of customer acceptance policy, customer identification procedures, monitoring of transactions and risk management. The key features of these KYC guidelines are as follows:

- The bank should develop a clear Customer Acceptance Policy laying down explicit criteria for acceptance of customers. It should cover the following aspects of customer relationship in the bank –
  - No account is opened in anonymous or fictitious/benami name. [Ref: Government of India Notification dated June 16, 2010 Rule 9, sub-rule (1C) - Banks should not allow the opening of or keep any anonymous account or accounts in fictitious name or account on behalf of other persons whose identity has not been disclosed or cannot be verified].
  - Parameters of risk perception in terms of nature of business activity, location of customer and his clients, mode of payments, volume of turnover, social and financial status, etc.
  - Documentation requirements and other information to be collected in respect of different categories of customers depending on perceived risk and requirements of PML Act, 2002 and instructions/ guidelines issued by RBI from time to time.
  - Not to open an account or close an existing account where the bank is unable to apply appropriate customer due diligence measures i.e. bank is unable to verify the identity and /or obtain documents required as per the risk categorisation due to non cooperation of the customer or non reliability of the data/information furnished to the bank. It is, however, necessary to have suitable built in safeguards to avoid harassment of the customer. For example, decision by a bank to close an account should be taken at a reasonably high level after giving due notice to the customer explaining the reasons for such a decision.
  - Circumstances, in which a customer is permitted to act on

behalf of another person/ entity.

- Preparation of profile of each new customer based on risk categorisation.
- Necessary checks before opening a new account so as to ensure that the identity of the customer does not match with any person with known criminal background or with banned entities such as individual terrorists or terrorist organisations etc.

- The Circular also contains indicative guidelines for application of customer identification procedures in case of following:
  - Walk-in Customers
  - Salaried employees
  - Trust/Nominee or fiduciary accounts
  - Accounts of Companies and firms
  - Clients accounts opened by professional intermediaries.
  - Accounts of Politically Exposed Person (PEPs) resident outside India
  - Accounts of non-face to face customers
  - Accounts of proprietary concerns
- Other features of KYC are as under:
  - Small Deposits Account (balances not exceeding Rs. 50, 000/- in all their accounts taken together and total credit in all accounts not expected to increase Rs. 1,00,000/- in a year) may be opened even in cases if a person is not able to produce the requisite documents subject to certain conditions mentioned in the circular. If at any point of time, the balances in all his/her accounts with the bank (taken together) exceeds Rupees Fifty Thousand (Rs. 50,000/-) or total credit in the account exceeds Rupees One Lakh (Rs. 1,00,000/-) in a year, no further transactions will be permitted until the full KYC procedure is completed.
  - Review of risk categorization of customers should be carried out at a periodicity of not less than once in six months.
  - KYC procedure is also applicable in issuing the Credit cards, Debit cards, Smart cards & Gift cards.
  - KYC guidelines are also applicable to branches and majority owned subsidiaries located abroad.
  - KYC Guidelines also require that in case of correspondent banking (provision of banking services by one bank to another

bank), the correspondent bank should ensure that the respondent bank is able to provide the relevant customer identification data immediately on request. Further, banks should refuse to enter into a correspondent relationship with a 'shell bank', i.e., a bank which is incorporated in a country where it has no physical presence and is unaffiliated to any regulated financial group.

- KYC Guidelines also deal with Wire Transfers, both Cross-border wire transfers and Domestic wire transfers.

Small Accounts

a) In terms of Rule 2 clause (fb) of the Notification 'small account' means a savings account in a banking company where-

(i) the aggregate of all credits in a financial year does not exceed rupees one lakh;

(ii) the aggregate of all withdrawals and transfers in a month does not exceed rupees ten thousand; and

(iii) the balance at any point of time does not exceed rupees fifty thousand.

b) Rule (2A) of the Notification lays down the detailed procedure for opening 'small accounts'. Banks are advised to ensure adherence to the procedure provided in the Rules for opening of small accounts.

Operation of Bank Accounts & Money Mules

a) It has been brought to our notice that "Money Mules" can be used to launder the proceeds of fraud schemes (*e.g.,* phishing and identity theft) by criminals who gain illegal access to deposit accounts by recruiting third parties to act as "money mules." In some cases these third parties may be innocent while in others they may be having complicity with the criminals.

b) In a money mule transaction, an individual with a bank account is recruited to receive cheque deposits or wire transfers and then transfer these funds to accounts held on behalf of another person or to other individuals, minus a certain commission payment. Money mules may be recruited by a variety of methods, including spam e-mails, advertisements on genuine recruitment web sites, social networking sites, instant messaging and advertisements in newspapers. When caught, these money mules often have their bank accounts suspended, causing inconvenience and potential financial loss, apart from facing likely legal action for being part of a fraud. Many a times the address and contact details of such mules are found to be fake or not up to date, making it difficult for enforcement agencies to locate the account holder.

c) The operations of such mule accounts can be minimised if banks follow the guidelines on opening of accounts and monitoring of transactions contained in this Master Circular. Banks are, therefore, advised to strictly adhere to the guidelines on KYC/AML/CFT issued from time to time and to those relating to periodical updation of customer identification data after the account is opened and also to monitoring of transactions in order to protect themselves and their customers from misuse by such fraudsters.

5.33 Further, the RBI, through this circular has also laid the obligations of the banks in terms of the Rules notified under the Prevention of Money Laundering Act (PMLA), 2002. The main requirements of the said circular are as follows:

A. Maintenance of records of transactions:

(i) all cash transactions of the value of more than rupees ten lakh or its equivalent in foreign currency;

(ii) all series of cash transactions integrally connected to each other which have been valued below rupees ten lakh or its equivalent in foreign currency where such series of transactions have taken place within a month and the aggregate value of such transactions exceeds rupees ten lakh;

(iii) all transactions involving receipts by non-profit organisations of value more than rupees ten lakh or its equivalent in foreign currency;

(iv) all cash transactions where forged or counterfeit currency notes or bank notes have been used as genuine and where any forgery of a valuable security or a document has taken place facilitating the transaction;

(v) all suspicious transactions whether or not made in cash and by way of as mentioned in the Rules.

B. Information to be preserved:

(i) the nature of the transactions;

(ii) the amount of the transaction and the currency in which it was denominated;

(iii) the date on which the transaction was conducted; and

(iv) the parties to the transaction.

C. Maintenance and Preservation of records:

(i) Evolve a system for proper maintenance and preservation of account information in a manner that allows data to be retrieved easily and quickly whenever required or when requested by the competent authorities.

(ii) Maintain for at least ten years from the date of cessation of transaction between the bank and the client, all necessary records of transactions, both domestic or international, which will permit reconstruction of individual transactions.

(iii) Ensure that records pertaining to the identification of the customer and his address (e.g. copies of documents like passports, identity cards, driving licenses, PAN card, utility bills etc.) obtained while opening the account and during the course of business relationship, are properly preserved for at least ten years after the business relationship is ended.

(iv) Examine and Record the findings at branch as well as Principal Officer level relating to background pertaining to all complex, unusual large transactions including all documents/office records/memorandums, and all unusual patterns of transactions and purpose thereof. Such records and related documents should be made available to help auditors in their day-to-day work relating to scrutiny of transactions and also to Reserve Bank/other relevant authorities. These records are required to be preserved for ten years.

D. Reporting to Financial Intelligence Unit-India:

(i) Report information relating to cash and suspicious transactions to the Director, Financial Intelligence Unit-India (FIU-IND).

(ii) In this regard, FIU-IND has prescribed eight reporting formats ,viz., Cash Transaction Report, Summary of CTR, Electronic File Structure – CTR, Suspicious Transactions Report, Electronic File Structure – STR, Counterfeit Currency Report (CCR), Summary of CCR and Electronic File Structure – CCR.

(iii) Where all the branches are not fully computerized, the Principal Officer of the bank should cull out the transaction details from branches which are not yet computerized and suitably arrange to feed the data into an electronic file with the help of the editable electronic utilities of CTR/STR as have been made available by FIU-IND in their website

(iv) As a part of transaction monitoring mechanism, banks should put in place an appropriate software application to throw alerts when the transactions are inconsistent with risk categorization and updated profile of customers.

(v) The RBI vide its Circular No. DBOD.AML. BC. No.11/14 .01.001/2012-13 dated July 2, 2012 on “Know Your Customer (KYC) norms / Anti-Money Laundering (AML) standards/ Combating of Financing of Terrorism (CFT)/Obligation of banks under PMLA, 2002” requires banks to subject cash intensive businesses, accounts of bullion dealers (including sub-dealers) & jewellers' as high risk accounts ' to intensified transaction monitoring. High risk associated with such accounts should be taken into account by banks to identify suspicious transactions for filing Suspicious Transaction Reports (STRs) to FIU-IND.

Closure of deposit accounts

5.34 For closing of a deposit account, an application from the account holder(s) is obtained. It is generally called Account Closure Form in some banks, however in most of the banks there is no standardised format used for account closure. The approval for closure of the account is given by the official designated in this behalf by the bank. Unused cheque leaves are obtained from the account holder(s) and usually destroyed. A ‘NIL’ balance confirmation is obtained from the account holder(s). The particulars of all closed accounts are recorded in a register.

Records

5.35 Banks maintain registers/ledgers for different types of term deposits. Besides stating the dates of issue and expiry, name of the depositor, amount, etc., columns are also provided for interest accrued upto the half-yearly closing dates. In the case of fixed deposits and certificates of deposit, interest accrued is calculated as per the specified rates. In the case of cash certificates, the total amount payable as interest is divided proportionately over the life of the certificate. Alternatively, a notional rate of compound interest is computed which would give the required yield at the time of expiry and accrued interest at the time of closing is calculated at that rate. Any minor difference arising between such calculation and the actual amount payable is adjusted at the time of payment. If a depositor takes back the deposit before its due date, any difference between the interest accrued and interest actually paid is written back and deducted from the total interest payable for that period. When a deposit is renewed, the interest is either paid to the depositor or merged in the amount of the new deposit. In the register of deposits, the old deposit is shown as repaid and a fresh entry is made for the new deposit. In the Day Book of the bank also, contra entries are passed in respect of the deposits renewed.

Audit Approach and Procedures

Borrowings

5.36 Borrowings from RBI, other banks/financial institutions, etc. should be verified by the auditor with reference to confirmation certificates and other supporting documents such as, application form, sanction letter, agreements, correspondence, etc. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties / lenders may assist the auditor in obtaining audit evidence that the auditor requires to respond to significant risks of material misstatement. The auditor is required to comply with the requirements of Standard on Auditing (SA) 505 (Revised), "External Confirmations" which contains guidance on designing and performing external confirmation procedures to obtain relevant and reliable audit evidence.

5.37 The auditor should also examine whether a clear distinction has been made between 'rediscount' and 'refinance' for disclosure of the amount under the above head since rediscount does not figure under this head.

5.38 The auditor should examine whether borrowings of money at call and short notice are properly authorised. The rate of interest paid/payable on, as well as duration of such borrowings should also be examined by the auditor.

5.39 The auditor should similarly 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.

5.40 The auditor should examine whether the amount shown in the branch accounts is properly classified based on security or otherwise.

Deposits

5.41 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.

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

Current Accounts

5.43 The auditor should verify the balances in individual accounts on a test check basis and should also examine whether the balances as per subsidiary ledgers tally with the related control accounts in the General Ledger. In case of any differences, the auditor should examine the reconciliation prepared by the branch in this regard.

5.44 Some banks have a procedure for obtaining confirmation of balances periodically. The auditor should examine whether the procedure laid down in this behalf has been followed consistently throughout the year. He should also examine, on a test check basis, the confirmations received.

5.45 The auditor should ensure that debit balances in current accounts are not netted out on the liabilities side but are appropriately included under the head 'advances'.

5.46 Inoperative accounts are a high risk area of frauds in banks. While examining current accounts, the auditor should specifically cover in his sample some of the inoperative accounts revived / closed during the year. The auditor should also ascertain whether inoperative accounts are 'revived' only with proper authority. For this purpose, the auditor should identify cases where there has been a significant reduction in balances compared to the previous year and examine the authorisation for withdrawals. Ratio analysis and comparatives can be used to select / identify such variation.

Savings Bank Deposits

5.47 The auditor should verify the balances in individual accounts on a test check basis and should also examine whether the balances as per subsidiary ledgers tally with the related control accounts in the General Ledger. In case of any differences, the auditor should examine the reconciliation prepared by the branch in this regard.

5.48 The auditor should also check the calculation of interest on a test check basis. In case of branch under Core Banking Solution (CBS) the product sheet for calculation of interest on saving bank account can be obtained in selected sample and can verify the calculation. In case of manual branches the calculation can be verified as per the work sheets.

5.49 As in the case of current accounts, the auditor should pay special attention to inoperative savings bank accounts.

Term Deposits

5.50 While evaluating the internal controls over term deposits, the auditor should specifically examine whether the deposit receipts and cash certificates are issued serially and all of them are accounted for in the registers. The auditor should also satisfy himself that there is a proper control over the unused forms of deposit receipts and cash certificates to prevent their misuse.

5.51 As stated earlier, the rate of interest on Certificates of Deposits (CDs) is negotiable with the depositor. This area is quite sensitive. The auditor should bear this fact in mind while examining the efficacy of prescribed internal controls with regard to rates of interest on CDs.

5.52 The auditor should verify the deposits with reference to the relevant registers. The auditor should also examine, on a test check basis, the registers with the counter-foils of the receipts issued and with the discharged receipts returned to the bank. The reconciliation of subsidiary records for various types of term deposits with the related control accounts in the General Ledger should be examined. The auditor should also examine whether provision has been made for interest accrued on the deposits up to the date of the balance sheet. Auditor should ensure that proper provision for interest payable on deposits is made.

5.53 In some cases, banks employ some persons as 'collectors' to collect the deposits from depositors, e.g., in case of recurring deposits. In such cases, the auditor should specifically examine the efficacy of the internal control procedures for reconciling the records of the bank with those of the collectors.

5.54 Term deposits from banks are usually (though not necessarily) in round figures. Any odd balances in term deposits should, therefore be selected by the auditor for verification on a sample basis. ,

Deposits Designated in Foreign Currencies

5.55 In the case of deposits designated in a foreign currency, e.g., foreign currency non-resident deposits, the auditor should examine whether they have been converted into Indian rupees at the rate notified in this behalf by the head office. The auditor should also examine whether any resultant increase or decrease has been taken to the profit and loss account. It may also be seen that interest on deposits has been paid on the basis of 360 days in a year. Further, in case of conversion of FCNR (B) deposits into NRE deposits or *vice versa* before maturity has been subjected to the provisions relating to premature withdrawal.

Interest Accrued But Not Due

5.56 The auditor should examine that interest accrued but not due on deposits is not included under the relevant deposits but is shown under the head 'other liabilities and provisions'.

Overall Reconciliation

5.57 The procedures of banks usually provide for periodic correlation of outstanding deposits with the cost of deposits. The auditor should ascertain from the management whether such an exercise has been carried out and if so, he should review the same. The auditor should examine that interest accrued but not due has also been considered for this purpose.

Window-dressing

5.58 There are several ways in which the deposits of a bank may be inflated for purposes of balance sheet presentation. For example, some of the constituents may be allowed overdraft on or around the date of the balance sheet, the overdrawn amounts may be placed as deposits with the bank, and further advances may be given on the security of the deposit receipts, thus inflating deposits as well as advances. The transactions may be reversed immediately after the close of the year. Where the auditor comes across transactions, which indicate the possibility of window-dressing, he may report the same in his long form audit report. In appropriate cases, the auditor should consider making a suitable qualification in his main audit report also.

Know Your Customers Norms[@]

5.59 RBI has issued instructions to all banks to implement without fail certain procedural norms on KYC. Failure would attract levy of penalty and if penalty has been levied the same is to be disclosed in the notes to accounts. In view of the nature of the directive the audit procedure may be suitably adopted to enquire the system of implementation and review of other reports in respect of this area. The auditor should examine that an adequate there exists proper procedure in place to ensure that framework relating to 'Know Your Customer' and Anti-Money Laundering measures is formulated and put in place by the bank.

[@] Revised in 2013 Edition.

III-6

Capital, Reserves and Surplus

Capital

Balance Sheet Disclosure

6.01 The following particulars have to be given in respect of share capital in the balance sheet.

(a) For Banks Incorporated in India

Authorised Capital	(shares of Rs.__ each)
Issued Capital	(shares of Rs.__ each)
Subscribed Capital	(shares of Rs.__ each)
Called-up Capital	(shares of Rs.__ each)
Less: Calls unpaid	
Add: Forfeited shares	

(In case of Nationalised Banks capital owned by Central Government as on the date of balance sheet including contribution from Government, if any, for participating in World Bank Projects should be shown separately.)

(b) For Banks Incorporated Outside India

(i) Capital (the amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head).

(ii) Amount of deposit kept with the RBI under section 11(2) of the Banking Regulation Act, 1949.

RBI vide its circular no. DBOD.BP.BC No.81/ 21.01.002/2009-10 dated March 30, 2010 on "Classification in the Balance Sheet - Capital Instruments" advised that under the Schedule 1-Capital, Perpetual Non-Cumulative Preference Share (PNCPS) should be sub – classified in the balance sheet from the financial year ending March 31, 2010.

6.02 Circumstances permit, items which can be combined may be shown under one head, for instance, 'Issued and Subscribed Capital'.

6.03 In case of banking companies incorporated outside India, the amount of deposit kept with the RBI under section 11(2) of the Act has to be shown under this head; the amount, however, should not be extended to the outer column.

6.04 The RBI's Master Circular no. DBOD.BP.BC No.14/21.04.018/2012-13 dated July 2, 2012 on "Disclosure in Financial Statements – Notes to Accounts (The Circular is given in the CD along with the Guidance Note)" lays down the certain aspects to be disclosed in respect of capital for the current as well as the previous year, which have been covered by Chapter 11 of Part III of the Guidance Note on ''Disclosure Requirements in financial Statements''.

Capital Adequacy

6.05 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.

6.06 Adequacy of capital of banks has been the subject matter of consideration by banking authorities around the world for several decades. For example, in 1975, the Bank of England published the conclusions of a Joint Working Party which had been formed by the Bank along with several clearing banks to examine the nature of capital and of liquidity of banks and to develop principles for examining their adequacy. The paper outlined two ratios for assessing the adequacy of capital: 'free resources ratio' and 'risk asset ratio'. The *free resources ratio* related current liabilities to capital resources excluding the part of capital devoted to financing infrastructure and other non-banking assets. The *risk asset* ratio related the risk of losses inherent in the assets of the business of banks to the capital available to absorb such losses. The paper argued that the risk asset ratio was more useful.

6.07 The risk asset measure has since received wide international acceptance as the basis for measuring the capital adequacy of banks. 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. It was also adopted by all the twenty-five countries that were either full members of the Organisation for Economic Co-operation and Development or had special lending arrangements under the International Monetary Fund's general borrowing procedures.

6.08 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 prescribed minimum capital standards for risk-based capital were to apply to banks on a transitional basis beginning at the yearend 1990 and were to be fully in place by end 1992.

Capital Adequacy Measures in India

6.09 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 different 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 No. DBOD.No.BP.BC. 15. /21.01.002/2012-13 dated July 2, 2012 on "Prudential Norms on Capital Adequacy-Basel-I Framework" (The Circular is given in the CD along with the Guidance Note) provides the guidelines to be followed by banks for capital adequacy. Some of the important aspects of the circular are covered below.

6.10 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 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.

When returns of the investors of the capital issues are counter guaranteed by the bank, such investments will not be considered as Tier I/II regulatory capital for the purpose of capital adequacy.

The 2012 Master Circular on Prudential Norms on Capital Adequacy - Basel I Framework has introduced a new concept of 'Capital Charge for Credit

Default Swaps'. Readers may refer to the Circular for detailed guidelines in this regard. (The Circular is given in the CD along with the Guidance Note)

The 2012 Master Circular on Prudential Norms on Capital Adequacy and Market Discipline – New Capital Adequacy Framework (NCAF) has introduced a new concept of 'Capital Adequacy Requirement for Credit Default Swap (CDS) Positions in the Banking Book'. Readers may refer to the Circular for detailed guidelines in this regard. (The Circular is given in the CD along with the Guidance Note)

Components of Capital

6.11 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. The following table shows the components of the Capital Funds for Indian *vis a vis* foreign banks operating in India.

	Indian Banks	**Foreign Banks operating in India**
Tier I Capital	Paid up capital (ordinary shares)	Interest free funds from Head Office[2]
	Statutory reserves	Statutory reserves kept in Indian books
	Other disclosed free reserves, if any	Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India
	Innovative perpetual debt instruments eligible for inclusion as Tier I capital	Innovative Instruments eligible for inclusion as Tier I capital
	Perpetual non-cumulative preference shares eligible for inclusion as Tier I capital subject *to laws in force from time to time*[*]	

[2] Kept in a separate account in Indian books specifically for the purpose of meeting the capital adequacy norms.

[*] The annexure to the Master Circular on "DBOD.No.BP.BC. 15/21.01.002/2012-13 " dated July 2, 2012 provides the guidelines for Perpetual non-cumulative preference shares eligible for inclusion as Tier I capital.

	Indian Banks	**Foreign Banks operating in India**
	Capital reserves representing surplus arising out of sale proceeds of assets	
	Quarterly / half yearly profits for computation of Tier I capital to be included only if the quarterly / half yearly results are audited by statutory auditors and not when the results are subjected to limited review	
Tier II Capital	Undisclosed reserves	Undisclosed reserves
	Revaluation reserves	Revaluation reserves
	General provisions and loss reserves	General provisions and loss reserves
	Hybrid debt capital instruments, which includes Perpetual Cumulative Preference Shares (PCPS) / Redeemable Non-Cumulative Preference Shares (RNCPS) / Redeemable cumulative preference shares(RCPS) and Debt capital instruments	Hybrid debt capital instruments which includes Perpetual Cumulative Preference Shares (PCPS)/Redeemable Non-Cumulative Preference Shares(RNCPS) /Redeemable cumulative preference shares(RCPS) and Debt capital instruments
	Subordinate debts	Subordinate debts
	Investment reserve account	Investment reserve account
	General Provisions on Standard Assets and 'provisions held for country exposures' subject to the condition that the provisions on 'standard assets' together with other 'general provisions/ loss reserves' and 'provisions held for country exposures' will be	General Provisions on Standard Assets and 'provisions held for country exposures' subject to the condition that the provisions on 'standard assets' together with other 'general provisions/ loss

	Indian Banks	Foreign Banks operating in India
	admitted as Tier II capital up to a maximum of 1.25 per cent of the total risk-weighted assets.	reserves' and 'provisions held for country exposures' will be admitted as Tier II capital up to a maximum of 1.25 per cent of the total risk-weighted assets.
		Head office borrowings raised in foreign currency *Subject to the provisions laid down in the Master Circular on Capital Adequacy*

A special dispensation of amortising the expenditure arising out of second pension option and enhancement of gratuity was permitted to Public Sector Banks as also select private sector banks who were parties to the 9th bipartite settlement with Indian Banks Association (IBA). In view of the exceptional nature of the event, the unamortised expenditure pertaining to these items need not be deducted from Tier I capital.

Attention of the reader is drawn on RBI circular no. DBOD.BP.BC.No. 69 / 21.01.002/ 2009-10 dated January 13, 2010 on "Retail Issue of Subordinated Debt for Raising Tier II Capital" requires banks issuing subordinated debt to retail investors to adhere to the following conditions:

- The requirement for specific sign-off as quoted below, from the investors for having understood the features and risks of the instrument may be incorporated in the common application form of the proposed debt issue.

  "*By making this application, I/We acknowledge that I/We have understood the terms and conditions of the Issue of [insert the name of the instruments being issued] of [Name of The Bank] as disclosed in the Draft Shelf Prospectus, Shelf Prospectus and Tranche Document*".

  - For floating rate instruments, banks should not use its Fixed Deposit rate as benchmark.
  - All the publicity material, application form and other communication with the investor should clearly state in bold letters (with font size 14) how a subordinated bond is different from fixed deposit particularly that it is not covered by deposit insurance.

6.12 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.

Undisclosed Reserves

6.13 They can be included in capital, if they represent accumulations of post-tax profits and are not encumbered by any known liability and should not be routinely used for absorbing normal loss or operating losses.

Re-valuation Reserves

6.14 It would be prudent to consider re-valuation reserves at a discount of 55 percent while determining their value for inclusion in Tier II capital. Such reserves will have to be reflected on the face of the Balance Sheet as re-valuation reserves.

General Provisions and Loss Reserves

6.15 Such reserves can be included in Tier II capital if they are not attributable to the actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses. Adequate care must be taken to see that sufficient provisions have been made to meet all known losses and foreseeable potential losses before considering general provisions and loss reserves to be part of Tier II capital. General provisions/loss reserves will be admitted up to a maximum of 1.25 percent of total risk weighted assets. 'Floating Provisions' held by the banks, which is general in nature and not made against any identified assets, may be treated as a part of Tier II capital within the overall ceiling of 1.25 percent of total risk weighted assets. Excess provisions which arise on sale of NPAs would be eligible Tier II capital subject to the overall ceiling of 1.25% of total Risk Weighted Assets.

Hybrid Debt Capital Instruments

6.16 Those instruments which have close similarities to equity, in particular when they are able to support losses on an ongoing basis without triggering liquidation, they may be included in Tier II capital. At present following instruments have been recognised and placed under this category.

i. Perpetual Cumulative Preference Shares (PCPS)/ Redeemable Non-Cumulative Preference Shares (RNCPS)/ Redeemable Cumulative Preference shares (RCPS) as part of upper Tier II capital.

ii. Debt capital instruments eligible for inclusion as Upper Tier II capital.

The guidelines governing the instruments at (i) and (ii) above, indicating the minimum regulatory requirements are furnished in Annexure 4 and Annexure 3 respectively to the Master Circular on Capital Adequacy.

Subordinated Debt

6.17 Banks can raise, with the approval of their Boards, rupee-subordinated debt as Tier II capital, subject to the terms and conditions given in the Annexure 5 to the Master Circular on Capital Adequacy.

Investment Reserve Account

6.18 In the event of provisions created on account of depreciation in the 'Available for Sale' or 'Held for Trading' categories being found to be in excess of the required amount in any year, the excess should be credited to the Profit & Loss account and an equivalent amount (net of taxes, if any and net of transfer to Statutory Reserves as applicable to such excess provision) should be appropriated to an Investment Reserve Account in Schedule 2 – "Reserves & Surplus" under the head "Revenue and other Reserves" and would be eligible for inclusion under Tier II within the overall ceiling of 1.25 per cent of total Risk Weighted Assets prescribed for General Provisions/ Loss Reserves.

6.19 Banks are allowed to include the 'General Provisions on Standard Assets' and 'Provisions held for Country Exposures' in Tier II capital. However, the provisions on 'standard assets' together with other 'general provisions/ loss reserves' and 'provisions held for country exposures' will be admitted as Tier II capital up to a maximum of 1.25 per cent of the total risk-weighted assets.

Deductions from Computation of Capital Funds

6.20 The Master Circular on Capital Adequacy prescribes the following deductions to be made from the Tier I and Tier II Capital.

Item	**Extent of Deduction (in %)**	
	Tier I	**Tier II**
Equity and non-equity capital instruments issued by a subsidiary	50	50

Intangible assets	100	-----
Losses in current period	100	----
Losses brought forward from previous periods	100	-----
Deferred Tax Asset resulting in increase of Tier I capital	100	---
First loss facility	50	50
Second loss facility	50	50
Credit enhancements provided by third party	50	50
Underwriting by an originator	50	50
Underwriting by third party service provider	50	50

Capital Risk Adequacy Ratio (CRAR)

6.21 The CRAR is computed as follows:

$$\frac{\text{Capital funds}}{\text{Risk weighted assets and – off balance sheet items}} \times 100$$

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 and CRAR.

The New Capital Adequacy Framework–Basel II

6.22 The Reserve Bank of India, vide its circular no. DBOD.No.BP.BC.16/21.06.001/2012-13, dated July 2, 2012 on Prudential Guidelines on Capital Adequacy and Market Discipline – Implementation of the New Capital Adequacy Framework (The circular is given in the CD along with this book) has taken a step forward in the direction of the implementation of the New Capital Accord, i.e., Basel II. In terms of the said circular all foreign banks operating in India and Indian banks having operational presence abroad need to migrate to the new capital adequacy framework with effect from March 31, 2008. All other commercial banks (excluding Local Area Banks and Regional Rural Banks) are required to migrate to these approaches under the Revised Framework by March 31, 2009. These banks shall continue to apply the Standardised Duration Approach (SDA) for computing capital requirement for market risks under the Revised

Framework. The Chapter I of Part V on "Basel-II" provides the detailed guidelines in respect of implementation of New Capital Adequacy Framework.

Parallel run

6.23 With a view to ensuring smooth transition to the Revised Framework and with a view to providing opportunity to banks to streamline their systems and strategies, banks were advised to have a parallel run of the Revised Framework. The Boards of the banks should review the results of the parallel run on a quarterly basis. The broad elements which need to be covered during the parallel run are as under:

(i) Banks should apply the prudential guidelines on capital adequacy – both current guidelines and these guidelines on the Revised Framework – on an on-going basis and compute their Capital to Risk Weighted Assets Ratio (CRAR) under both the guidelines.

(ii) An analysis of the bank's CRAR under both the guidelines should be reported to the board at quarterly intervals.

(iii) A copy of the quarterly reports to the Board should be submitted to the RBI, one each to Department of Banking Supervision, Central Office and Department of Banking Operations and Development, Central Office.

All the banks in India would continue to have the parallel run till March 31, 2013, subject to review, and ensure that their Basel II minimum capital requirement continues to be higher than the prudential floor of 80 per cent of the minimum capital requirement computed as per Basel I framework for credit and market risks.

Migration to other approaches under the Revised Framework

6.24 Having regard to the necessary up-gradation of risk management framework as also capital efficiency likely to accrue to the banks by adoption of the advanced approaches envisaged under the Basel II Framework and the emerging international trend in this regard, it was considered, in July 2009, desirable to lay down a timeframe for implementation of the advanced approaches in India. This would enable banks to plan and prepare for their migration to the advanced approaches for credit risk and operational risk, as also for the Internal Models Approach (IMA) for market risk. Keeping in view the likely lead time that may be needed by banks for creating the requisite technological and the risk management infrastructure, including the required databases, the MIS and the skill up-gradation, etc., the following time schedule has been laid down for implementation of the advanced approaches for the regulatory capital measurement:

Sr. No.	Approach	The earliest date of making application by banks to the RBI	Likely date of approval by the RBI
a.	Internal Models Approach (IMA) For Market Risk	April 1, 2010	March 31, 2011
b.	The Standardised Approach (TSA) for Operational Risk	April 1, 2010	September 30, 2010
c.	Advanced Measurement Approach (AMA) for Operational Risk	April 1, 2012	March 31, 2014
d.	Internal Ratings-Based (IRB) Approaches for Credit Risk (Foundation- as well as Advanced IRB)	April 1, 2012	March 31, 2014

6.25 Accordingly, the banks were advised to undertake an internal assessment of their preparedness for migration to advanced approaches, in the light of the criteria envisaged in the Basel II document, as per the aforesaid time schedule, and take a decision, with the approval of their Boards, whether they would like to migrate to any of the advanced approaches. The banks deciding to migrate to the advanced approaches should approach RBI for necessary approvals, in due course, as per the stipulated time schedule. Based on bank's internal assessment and its preparation, a bank may choose a suitable date to apply for implementation of advanced approach. It may be noted that banks, at their discretion, would have the option of adopting the advanced approaches for one or more of the risk categories, as per their preparedness, while continuing with the simpler approaches for other risk categories, and it would not be necessary to adopt the advanced approaches for all the risk categories simultaneously. However, banks should invariably obtain prior approval of the RBI for adopting any of the advanced approaches.

Basel III[@]

6.26 The Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB) have undertaken an extensive review of the regulatory framework in the wake of the sub-prime crisis. In the document titled 'Basel III: A global regulatory framework for more resilient banks and banking systems', released by the BCBS in December 2010, it has inter alia proposed certain minimum set of criteria for inclusion of instruments in the new definition of regulatory capital. One of the criteria is that instruments should not have step-ups or other incentives to redeem. However, the BCBS has proposed certain transitional arrangements, in terms of which only those instruments having such features which were issued before September 12, 2010 will continue to be recognized as eligible capital instruments under Basel III which was scheduled to become operational beginning January 1, 2013 in a phased manner. The RBI has rescheduled the start date for implementation of Basel III to April 1, 2013 from January 1, 2013 vide its Press Release 2012 – 2013 / 1092 dated 28.12.2012.

6.27 In view of the above, RBI vide its circular no. DBOD.BP.BC.No.75/21.06.001/2010-11 dated January 20, 2011 on "Regulatory Capital Instruments – Step up option" advises the banks that henceforth, banks should not issue Tier 1 or Tier 2 capital instruments with 'step-up option' so that these instruments continue to remain eligible for inclusion in the new definition of regulatory capital. However, such instruments can be issued with only 'call option' as per existing rules contained in the circulars issued by RBI from time to time.

Guidelines on BASEL III Capital Regulations

6.28 The RBI has issued a circular no. DBOD.No.BP.BC.98 /21.06.201/2011-12 dated May 2, 2012 on the subject "Guidelines on Implementation of Basel III Capital Regulations in India". Vide this circular, the RBI has prescribed the final guidelines on Basel III capital regulations. Following are main points of these guidelines:

- These guidelines would become effective from April 1, 2013 in a phased manner. The Basel III capital ratios will be fully implemented as on March 31, 2019.
- The capital requirements for the implementation of Basel III guidelines may be lower during the initial periods and higher during the later years. While undertaking the capital planning exercise, banks should keep this in view.

[@] Revised in 2013 Edition.

- For the financial year ending March 31, 2013, banks will have to disclose the capital ratios computed under the existing guidelines (Basel II) on capital adequacy. The capital ratios computed under the Basel III capital adequacy framework shall be disclosed for the financial year ending March 31, 2014 onwards.

Summary of Basel III Capital Requirements

Improving the Quality, Consistency and Transparency of the Capital Base

- Presently, a bank's capital comprises Tier 1 and Tier 2 capital with a restriction that Tier 2 capital cannot be more than 100% of Tier 1 capital. Within Tier 1 capital, innovative instruments are limited to 15% of Tier 1 capital. Further, Perpetual Non-Cumulative Preference Shares along with Innovative Tier 1 instruments should not exceed 40% of total Tier 1 capital at any point of time. Within Tier 2 capital, subordinated debt is limited to a maximum of 50% of Tier 1 capital. However, under Basel III, with a view to improving the quality of capital, the Tier 1 capital will predominantly consist of Common Equity. The qualifying criteria for instruments to be included in Additional Tier 1 capital outside the Common Equity element as well as Tier 2 capital will be strengthened.
- The transparency of capital base has been improved, with all elements of capital required to be disclosed along with a detailed reconciliation to the published accounts. This requirement will improve the market discipline under Pillar 3 of the Basel II framework.

Enhancing Risk Coverage

- At present, the counterparty credit risk in the trading book covers only the risk of default of the counterparty. The reform package includes an additional capital charge for Credit Value Adjustment (CVA) risk which captures risk of mark-to-market losses due to deterioration in the credit worthiness of a counterparty. The risk of interconnectedness among larger financial firms (defined as having total assets greater than or equal to \$100 billion) will be better captured through a prescription of 25% adjustment to the asset value correlation (AVC) under IRB approaches to credit risk. In addition, the guidelines on counterparty credit risk management with regard to collateral, margin period of risk and central counterparties and counterparty credit risk management requirements have been strengthened

Enhancing the Total Capital Requirement and Phase-in Period

6.29 The minimum Common Equity, Tier 1 and Total Capital requirements will be phased-in between January 1, 2013 and January 1, 2015, as indicated below:

As a %age to Risk Weighted Assets (RWAs)	**January 1, 2013**	**January 1, 2014**	**January 1, 2015**
Minimum Common Equity Tier 1 capital	3.5%	4.0%	4.5%
Minimum Tier 1 capital	4.5%	5.5%	6.0%
Minimum Total capital	8.0%	8.0%	8.0%

Capital Conservation Buffer

6.30 The capital conservation buffer (CCB) is designed to ensure that banks build up capital buffers during normal times (i.e. outside periods of stress) which can be drawn down as losses are incurred during a stressed period. The requirement is based on simple capital conservation rules designed to avoid breaches of minimum capital requirements. Therefore, in addition to the minimum total of 8%, banks will be required to hold a capital conservation buffer of 2.5% of RWAs in the form of Common Equity to withstand future periods of stress bringing the total Common Equity requirement of 7% of RWAs and total capital to RWAs to 10.5%. The capital conservation buffer in the form of Common Equity will be phased-in over a period of four years in a uniform manner of 0.625% per year, commencing from January 1, 2016.

For other guidelines readers may refer to the circular.

Liquidity Risk Management by Banks

6.31 The RBI has issued a circular no. DBOD.BP.No.56/21.04.098/ 2012-13 dated November 7, 2012 on the subject “Liquidity Risk Management by Banks” prescribing the various guidelines on Liquidity Risk Management by

Banks. The guidelines include enhanced guidance on liquidity risk governance, measurement, monitoring and the reporting to the RBI on liquidity positions. The enhanced liquidity risk management measures are required to be implemented by banks immediately.

6.32 As per the circular, a sound liquidity risk management system in a bank would envisage that:

i) A bank should establish a robust liquidity risk management framework.

ii) The Board of Directors (BoD) of a bank should be responsible for sound management of liquidity risk and should clearly articulate a liquidity risk tolerance appropriate for its business strategy and its role in the financial system.

iii) The BoD should develop strategy, policies and practices to manage liquidity risk in accordance with the risk tolerance and ensure that the bank maintains sufficient liquidity. The BoD should review the strategy, policies and practices at least annually.

iv) Top management/ALCO should continuously review information on bank's liquidity developments and report to the BoD on a regular basis.

v) A bank should have a sound process for identifying, measuring, monitoring and controlling liquidity risk, including a robust framework for comprehensively projecting cash flows arising from assets, liabilities and off-balance sheet items over an appropriate time horizon.

vi) A bank's liquidity management process should be sufficient to meet its funding needs and cover both expected and unexpected deviations from normal operations.

vii) A bank should incorporate liquidity costs, benefits and risks in internal pricing, performance measurement and new product approval process for all significant business activities.

viii) A bank should actively monitor and manage liquidity risk exposure and funding needs within and across legal entities, business lines and currencies, taking into account legal, regulatory and operational limitations to transferability of liquidity.

ix) A bank should establish a funding strategy that provides effective diversification in the source and tenor of funding, and maintain ongoing presence in its chosen funding markets and counterparties, and address inhibiting factors in this regard.

x) Senior management should ensure that market access is being actively managed, monitored, and tested by the appropriate staff.

xi) A bank should identify alternate sources of funding that strengthen its capacity to withstand a variety of severe bank specific and market-wide liquidity shocks.

xii) A bank should actively manage its intra-day liquidity positions and risks.

xiii) A bank should actively manage its collateral positions.

xiv) A bank should conduct stress tests on a regular basis for short-term and protracted institution-specific and market-wide stress scenarios and use stress test outcomes to adjust its liquidity risk management strategies, policies and position and develop effective contingency plans.

xv) Senior management of banks should monitor for potential liquidity stress events by using early warning indicators and event triggers. Early warning signals may include, but are not limited to, negative publicity concerning an asset class owned by the bank, increased potential for deterioration in the bank's financial condition, widening debt or credit default swap spreads, and increased concerns over the funding of off- balance sheet items.

xvi) To mitigate the potential for reputation contagion, a bank should have a system of effective communication with counterparties, credit rating agencies, and other stakeholders when liquidity problems arise.

xvii) A bank should have a formal contingency funding plan (CFP) that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations. A CFP should delineate policies to manage a range of stress environments, establish clear lines of responsibility, and articulate clear implementation and escalation procedures.

xviii) A bank should maintain a cushion of unencumbered, high quality liquid assets to be held as insurance against a range of liquidity stress scenarios.

xix) A bank should publicly disclose its liquidity information on a regular basis that enables market participants to make an informed judgment about the soundness of its liquidity risk management framework and liquidity position.

Reserves and Surplus

Balance Sheet Disclosure

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

I. Statutory Reserves

II. Capital Reserves

III. Share Premium

IV. Revenue and Other Reserves including investment Fluctuation Reserve

(In respect of items I – IV above, opening balance, additions during the year and deductions during the year are to be shown separately in respect of each item)

V. Balance in Profit and Loss Account

Statutory Reserves

6.34 Under sub-section (1) of section 17 of the Banking Regulation Act, 1949 every banking company incorporated in India has to transfer 20% of its profits to its reserve fund each year before declaring dividends. The transfer to reserve as above and any other reserve created in pursuance of any section of the Act has also to be disclosed under the aforesaid head. Sec 17(2) of Act provides that where a banking company appropriates any sum or sums from the reserve fund or the share premium account, it shall, within twenty-one days from the date of such appropriation, report the fact to the RBI, explaining the circumstances relating to such appropriation.

6.35 All scheduled commercial banks, including foreign banks operating in India, (except RRBs/LABs) have been instructed to transfer not less than 25% of the 'net profit' (before appropriations) to the Reserve Fund with effect from the year ending 31st March, 2001. Such transfer to reserves may be made "after adjustment / provision towards bonus to staff".

Capital Reserves

6.36 The expression 'capital reserves' does not include any amount regarded as free for distribution through the profit and loss account. According to the Notes and Instructions for Compilation of Balance Sheet, issued by the RBI, surplus on re-valuation or sale of fixed assets is to be treated as capital reserve. The Notes and Instructions further specify that any exchange gain on translation of the financial statements of foreign branches is not a revaluation reserve and that such exchange gain should be shown under the head 'other liabilities, and provisions'.

Securities Premium Account

6.37 According to section 78 of the Companies Act, 1956, where a company issues shares at a premium, the amount of premium should be transferred to a separate account to be called 'the securities premium account'. The provisions of the Companies Act, 1956 regarding reduction of capital also apply to securities premium account. However, as per section 78, the securities premium may be applied for the following purposes:

(a) issuing fully paid bonus securities;

(b) writing off the preliminary expenses;

(c) writing off the expenses of, or the commission paid or discount allowed on, any issue of securities or debentures; or

(d) providing for the premium payable on the redemption of any redeemable preference securities or debentures.

6.38 A banking company has to report to the RBI any appropriations made from the securities premium account. Such an appropriation can be only for the purposes described above or in accordance with the provisions governing reduction of share capital by a company.

Revenue and Other Reserves

6.39 According to the Notes and Instructions for Compilation of Balance Sheet and Profit and Loss Account, issued by the RBI, the expression 'Revenue Reserve' shall mean any reserve other than capital reserve.

6.40 All reserves, other than those separately classified (viz., statutory reserves, capital reserves and share premium) will be shown under this head. The expression 'reserve' shall not include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability. In terms of RBI guidelines, the 'Investment Fluctuation Reserve' representing write back of excess provision on investments has to be treated as revenue reserve.

Balance of Profit

6.41 This item includes balance of profit after appropriations. According to the Notes and Instructions for compilation of balance sheet and profit and loss account, issued by the RBI, in case of loss, the balance may be shown as a deduction. Though it is not mentioned whether the loss is to be deducted from the aggregate of 'reserves' or from 'revenue and other reserves' only, it is obvious on a consideration of legal requirements and sound accounting principles that the loss should be deducted only from revenue reserves.

6.42 Further, as prescribed by RBI's circular no. DBOD.BP.BC.31/21.04.018/2006-07 dated September 20, 2006, the banks need to obtain prior approval of the Reserve Bank of India before any appropriation is made from the statutory reserve or any other reserve.

The said circular also requires that:

(i) all expenses including provisions and write offs recognised in a period, whether mandatory or prudential, should be reflected in the Profit and Loss Account for the period as an 'above the line' item (i.e., before arriving at the net profit);

(ii) wherever draw down from reserves takes place with the prior approval of Reserve Bank, it should be effected only "below the line", (i.e., after arriving at the profit/loss for the period); and

(iii) suitable disclosures should be made of such draw down of reserves in the 'Notes on Accounts' to the Balance Sheet.

Audit Approach and Procedures

Capital

6.43 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, etc. Compliance with section 14 of the Banking Regulation Act, 1949, should also be examined. In case of increase in capital of a nationalised bank through fresh contributions by the government, the auditor should examine correspondence/government notification or order, bank statement, etc.

6.44 In the case of newly formed banking companies/places of business established in India for the first time by a banking company incorporated outside India, the auditor should also examine compliance with the provisions of sections 11 and 12 of the Banking Regulation Act, 1949.

6.45 The auditor should also check the compliance with capital adequacy requirements for banks.

6.46 The auditor should verify the compliance with the RBI reporting and other requirements issued from time to time.

6.47 In case there has been an increase in Share Capital during the year/period under audit, the auditor should verify the effect of such increase on the disclosures in respect of Earnings Per Share (EPS) as well as the percentage of promoter holding.[@]

Reserves and Surplus

6.48 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 securities 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, auditor should examine whether the appropriations from securities premium account conform to the relevant legal requirements.

6.49 Where the local laws or regulations governing overseas branches require creation of certain reserves, the auditor should examine compliance with the relevant requirements concerning the quantum and manner of disclosure of such reserves. The auditor should also ascertain that whenever necessary to secure compliance with the local laws of the respective foreign countries, separate identity of such reserves has been maintained in the balance sheet of the bank as a whole. The auditor should also ascertain that all provisions regarding eligibility criteria and quantum of dividend have been fulfilled in respect of dividend paid by the bank, if any, during the year.

6.50 The auditor should examine the nature of various accounts included under this head to ensure that only accounts in the nature of reserves are included. The auditor should verify whether the utilisations of reserves are in accordance with regulatory and statutory requirements and whether the reporting requirements have been complied with in terms of the requirements of Banking Regulation Act, 1949 and the Guidelines of the RBI, issued from time to time.

[@] Revised in 2013 Edition.

III-7
Other Liabilities and Provisions

Balance Sheet Disclosure

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

(a) Bills payable
(b) Inter-office adjustments (net)
(c) Interest accrued
(d) Others (including provisions)

Bills Payable

7.02 Bills payable represent instruments issued by the branch against moneys received from customers, which are to be paid to the customer or as per his order (usually at a different branch). These include demand drafts, telegraphic transfers, mail transfers, traveller's cheques, pay-orders, banker's cheques and similar instruments issued by the bank but not presented for payment till the balance sheet date.

Inter-office Adjustments

7.03 The balance in inter-office adjustments account, if in credit, is to be shown under this head. Chapter 13 of Part III of the Guidance Note provides the detailed guidelines on the aspects of Inter-office Transactions.

Interest Accrued

7.04 Interest due and payable and interest accrued but not due on deposits and borrowings are to be shown under this head. The interest accrued in accordance with the terms of the various types of deposits and borrowings are considered under this head. Such interest is not to be clubbed with the figures of deposits and borrowings shown under the head 'Deposits and Borrowings'.

Others (Including Provisions)

7.05 According to the Notes and Instructions for compilation of balance sheet and profit and loss account, issued by the RBI, the following items are to be included under this head:

(a) Net provision for income tax and other taxes like interest tax, less advance payment and tax deducted at source.

(b) Surplus in bad and doubtful debts provision account (such surplus is in the nature of a reserve).

(c) Surplus in provisions for depreciation in securities (such surplus is in the nature of a reserve).

(d) Contingency funds, which are actually in the nature of reserves but are not disclosed as such.

(e) Proposed dividend/transfer to Government.

(f) Other liabilities, which are not disclosed under any of the major heads such as unclaimed dividend, provisions and funds kept for specific purposes, unexpired discount, outstanding charges like rent, conveyance, etc.

(g) Certain types of deposits like staff security deposits, margin deposits, etc., which are repayable only subject to compliance with certain conditions. (The interest on such deposits would also be included under this head).

(h) Exchange gain on translation of financial statements of foreign branches. (For details refer to Chapter 12 of Part III on "Consolidation of Branch Accounts").

(i) Amount of subordinated debt raised as Tier II capital. (It may be mentioned that the nature of subordinated debt is similar to that of borrowings. However, the instructions of the RBI require their classification under the head 'Other Liabilities and Provisions').

(j) Blocked Account arising from transfer of credit entries in inter-branch accounts outstanding for more than five years.

7.06 Besides the above items, the following are other important items usually included under this head:

(a) Collections in respect of suit-filed accounts. These are not adjusted against advances till final settlement. (However, for the purpose of provisioning against non-performing advances, such credit balances are taken into account for ascertaining net outstanding).

(b) Collection of income-tax on behalf of the Government.

(c) Collection from DICGC. These are carried till final realisation/write-off of the concerned advance account.

(d) Provisions for frauds. These are ultimately adjusted by way of a write-off.

(e) Insurance claims received in respect of frauds. These are retained separately till final write-off in respect of fraud.

(f) Provision for gratuity, pension and other staff benefits.

(g) Provision for bank's share in the expenses of the Banking Services Recruitment Board.

(h) Provision for audit fees.

7.07 It may be noted that many of the items to be disclosed under this head are accounted for at the head office level and would not therefore form part of balance sheet of a branch.

Audit Approach and Procedures

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

Bills Payable

7.09 The auditor should evaluate the existence, effectiveness and continuity of internal controls over bills payable. Such controls should usually include the following:

(a) Drafts, mail transfers, traveller's cheques, etc. should be made out in standard printed forms.

(b) Unused forms relating to drafts, traveller's cheques, etc. should be kept under the custody of a responsible officer.

(c) 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.

(d) The signatures on a demand draft should be checked by an officer with the specimen signature book.

(e) 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.

(f) If the paying branch does not receive proper confirmation of any telegraphic transfers or demand draft from the issuing branch, it should take immediate steps to ascertain the reasons.

(g) In case an instrument prepared on a security paper, e.g., draft, has to be cancelled (say, due to error in preparation), it should be ensured that the manner of cancellation is such that the instrument cannot be misused. (For example, in the case of drafts, banks generally cut the distinctive serial number printed on the form and paste it in the book in which drafts issued are entered.) Cases of frequent cancellation and re-issuance of drafts, pay orders, etc. should be carefully looked into by a responsible official.

7.10 Based on auditors' evaluation of the efficacy of the relevant internal controls, the auditor should examine an appropriate sample of outstanding items comprised in bills payable accounts with the relevant registers. Reasons for old outstanding 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 also be examined specially in so far as large value items outstanding on the balance sheet date are concerned.

Others (Including Provisions)

7.11 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 issue of determining the adequacy of provision for doubtful advances is discussed in detail in chapter 1 of Part III of this Guidance Note. The auditor should examine other provisions and other items of liabilities in the same manner as in the case of other entities.

III-8
Contingent Liabilities and Bills for Collection

Balance Sheet Disclosure

8.01 The Third Schedule to the Banking Regulation Act, 1949, requires the disclosure of the following as a footnote to the balance sheet.

(a) Contingent Liabilities

- I. Claims against the bank not acknowledged as debts
- II. Liability for partly paid investments
- III. Liability on account of outstanding forward exchange contracts.
- IV. Guarantees given on behalf of constituents
  - (a) In India
  - (b) Outside India
- V. Acceptances, endorsements and other obligations
- VI. Other items for which the bank is contingently liable

(b) Bills for Collection

Contingent Liabilities

8.02 The term 'contingent liabilities' can take two forms. On the one hand, a contingent liability refers to possible obligations arising from past transactions or other events or conditions, the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise. On the other hand, a contingent liability may also take form of a present obligation that arises from past events or transactions but is not recognised due to the fact that either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a reliable estimate of the amount of obligation cannot be made. Thus, contingent liabilities may or may not crystallise into actual liabilities. If they do become actual liabilities, they give rise to a loss or an expense. The uncertainty as to whether there will be any obligation differentiates a contingent liability from a liability that has crystallised. Contingent liabilities should also be distinguished from those contingencies which are likely to result in an obligation on the entity (i.e., the obligation is not merely possible but probable) and which, therefore, require creation of a provision in the financial statements *(Members may refer to Accounting Standard (AS) 29, "Provisions, Contingent Liabilities and Contingent Assets")*

Letter of Credit, Bank Guarantees and Letters of Comfort

8.03 Letters of credit and bank guarantees constitute two of the principal items of contingent liabilities of a bank. Besides, banks also issue what are commonly known as 'letters of comfort'.

Letters of Credit

8.04 Letters of credit are an important payment mechanism especially in international trade. The customers open letters of credit to facilitate import or purchase of goods. By means of such letters, the customers take advantage of the credibility of the bank in as much as the exporter or the seller relies upon the promise of a reputed bank instead of the customer. A letter of credit (LC) is an undertaking by a bank to the payee (the supplier of goods and/or services) to pay to him, on behalf of the applicant (the buyer) any amount up to the limit specified in the LC, provided the terms and conditions mentioned in the LC are complied with and the documents specified in the LC are submitted by the payee to the LC opening bank through the medium of a bank. The LCs are of many kinds. A brief description of the various types of LCs is given in ***Annexure*** to this Chapter.

8.05 A noteworthy feature of LCs is that all banks issue these LCs in accordance with the provisions of the latest version of the Uniform Customs and Practices for Documentary Credits (UCPDC), a publication of the International Chamber of Commerce, and that this fact is prominently mentioned on the face of the LC. The UCPDC guidelines deal with the *inter-se* rights and responsibilities of the various parties to an LC. The latest version, of these Guidelines is called the UCP600 and it formally commenced on 1 July 2007.

8.06 The LCs are, strictly speaking, a non-funded facility for the banks because the bills thereunder are assumed to be paid for by the drawees on due dates. In cases where no such funds are available at the material time, the banks have to per force grant financial accommodation to the LC applicant for the purpose of payment of bills. To that extent, the LC arrangement has the latent potential of becoming a fund-based exposure for the bank. To safeguard against such eventualities, banks normally obtain cash margin at the time of opening the LC, which reduces their exposure in the event of devolvement of LC liability on them. The margin may be held in a current account or in term deposit. Banks also obtain guarantees from customers before opening LC.

8.07 In the case of their established customers, banks sanction LC limits. Whenever an LC is issued, it is recorded in the relevant records and is marked off when the LC is negotiated. The LC limit represents the maximum amount up to which LCs may be outstanding at any point of time. Banks are prohibited to issue stand-by letter of credit in favour of overseas lenders relating to External Commercial Borrowing (ECBs).

Bank Guarantees

8.08 Issuance of guarantees is an important fee-based[@] earning activity for banks. Bank guarantees are required by customers for submission to their buyers to guarantee the performance of contractual obligations undertaken or satisfactory performance of goods supplied by them or for submission to certain departments like, Excise & Customs, Electricity Boards, or to suppliers of materials, etc. in lieu of the stipulated security deposits. A bank guarantee is a contract between the bank and the beneficiary of the guarantee which is independent of the contract between the bank and its customer on whose behalf the guarantee is issued by the bank. This implies that in case the beneficiary makes a demand on the bank for payment of any monies under the guarantees, the bank is obliged to unconditionally pay the sum so demanded, within the amount guaranteed, provided the guarantee has been invoked by the beneficiary strictly in accordance with the terms outlined in the guarantee deed. The guarantees are for a specified amount and a specified period. Banks are expected to get back the original guarantee deeds from the beneficiary within a reasonable period after their expiry of the period of guarantee or on completion of the obligations thereunder, whichever occurs earlier, and to mark off the liability in their books. In practice, however, banks remove this item from their books of account shortly after the expiry of the period of validity of the guarantee and sending a letter to the beneficiary to that effect. (Members may refer to RBI's Master Circular no. DBOD. No. Dir. BC.02/13.03.00/2012-13 dated July 2, 2012 on "Guarantees and Co-acceptances" (The Circular is given in the CD along with the book).

8.09 In terms of the abovementioned circular, in case of guarantees issued by the bank on behalf of its director(s) and the companies/firms in which the director is interested, the bank should ensure that:

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(i) Adequate and effective arrangements have been made to the satisfaction of the bank that commitments would be met out of their own resources by the party on whose behalf guarantee was issued; and

(ii) The bank will not be called upon to grant any loan or advances to meet the liability consequent upon the invocation of the guarantee.

8.10 In case any contingency arises out of (ii) above, the bank would be deemed to have violated the provisions of section 20 of the Banking Regulation Act, 1949.

8.11 A variant of the guarantees issued by banks are the deferred payment guarantees under which the bank guarantees payment of the periodical instalments due by the buyer to the seller.

8.12 The Bank Guarantee Scheme formulated by the Government of India for the issuance of bank guarantees in favour of Central Government Departments, in lieu of security deposits, etc. by contractors has been modified from time to time. Under the scheme, it is open to Government Departments to accept freely guarantees, etc., from all scheduled commercial banks. ***Annexure 1*** to the Master Circular on Guarantees and Co-acceptances contains the Revised Model form of Bank Guarantee Bond.

8.13 The guarantees executed by banks comprise both performance guarantees and financial guarantees. A guarantee may be either a specific guarantee (i.e., in respect of a specific transaction) or a continuing guarantee (extending to a series of transactions). In either case, banks generally specify a time limit upto, which they will be liable unless, of course, the guarantee is renewed for a further period. It is also generally provided that any claim under the guarantee should be made within a specified time after the expiry thereof. All guarantees outstanding as at the date of the balance sheet have to be shown as contingent liabilities of the bank, showing separately the guarantees given on behalf of constituents in India and those outside India.

8.14 As in the case of LCs, banks sanction limits for guarantees for their established customers. Such limit represents the maximum amount of guarantees that may be outstanding at any point of time.

8.15 While issuing guarantees, banks generally take (except in the case of established customers) sufficient margin either in cash or in some other form of security. This margin may be equal to the amount of the guarantee or a proportion thereof. If it is a cash margin, it may be held in a current account or in term deposit. As per the Master Circular, banks should avoid giving unsecured guarantees in large amounts and for medium and long-term periods. Unsecured guarantees on account of any individual constituent should be limited to a reasonable proportion of the bank's total unsecured guarantees. Guarantees on behalf of an individual should also bear a reasonable proportion to the constituent's equity. Guarantees executed on behalf of any individual constituent, or a group of constituents, should be subject to the prescribed exposure norms.

8.16 With regard to period of validity of guarantees, the provisions of section 28 of the Indian Contract Act, 1872 are noteworthy. According to clause (b) of this section, every agreement which extinguishes the right of any party thereto, or discharges any party thereto from any liability, under or in respect of any contract on the expiry of a specified period so as to restrict any party from enforcing his rights is void to that extent. In the context of this provision, it becomes imperative that on expiry of the guarantee, banks take back the original guarantee letter from the beneficiary to avoid any possibility of subsequent claims and resultant litigation.

8.17 Regulation 4 of the Foreign Exchange Management (Guarantees) Regulations, 2000 specifies conditions under which banks are allowed to give guarantees in favour of Foreign Airlines/International Air Transport Association or on behalf of Service Importers or for Commodity hedging. Issue of guarantees in favour of foreign lenders or suppliers (in the case of Supplier's Credits) requires approval of RBI. Banks are prohibited to issue guarantees/ standby letters of credit or letters of comfort in favour of overseas lenders relating to External Commercial Borrowing (ECBs).

8.18 Banks have been allowed to issue guarantees favouring other banks/FIs/other lending agencies for the loans extended by the latter. However, conditions laid down by RBI are required to be complied with. Further, banks have been restricted on execution of guarantees covering inter-company deposits/loans thereby guaranteeing refund of deposits/ loans accepted by NBFC/firms from other NBFC/firms.

Letters of Comfort

8.19 Banks issue a letter of comforts (LoC) normally to their correspondents to confirm that they have created charges on securities of the correspondent's borrowers, on the strength of which the said correspondent releases financial assistance to the borrower. Such LoCs are mainly issued for availing buyers' credit facility for the borrowers of the bank. The LoCs are generally in the nature of Foreign Bank Gurantee wherein the LoC issuing bank guarantees the repayment of financial assistance / loan of the borrower on a given date.[@]

[@] Revised in 2013 Edition.

Claims against the Bank Not Acknowledged as Debts

8.20 Claims against the bank should be included under this head where it is considered possible but not probable that they may crystallise into actual liabilities. Such claims would include suits filed against the bank arising out of its business, claims on account of alleged payment of forged cheques or misappropriation of customer's security or failure to perform obligations as bailee of goods, workmen's demand for compensation etc.

8.21 There could also be claims for expenditure for expenditure items, such as rent, local taxes or from service providers/suppliers. The auditor needs to inquire whether such claims exist and the status thereof. To the extent it is an admitted claim, a liability is to be recognised. The balance needs to be disclosed as a contingent liability in accordance with the requirements of the Accounting Standard (AS) 29, "Provisions, Contingent Liabilities and Contingent Assets". Attention of the readers is also drawn to the paragraph No. 17 (i) of the RBI's Master Circular No. DBOD.No. BL.BC. 26 /22.01.001/2012-13 dated July 2, 2012 on Branch Authorisation relating to Acquisition of Accommodation on Lease/Rental basis by Commercial Banks for their Branches/Offices Liberalisation. . Attention of the reader is also drawn on RBI circular No. DBOD. No. BL.BC. 27 /22.01.001/2010-11 on Section 23 of Banking Regulation Act, 1949 - Mobile Branches and Mobile ATMs dated July 23, 2010.

Liability on Partly Paid Investments

8.22 If the bank holds any partly paid shares, debentures, etc., the auditor should examine whether the uncalled amounts thereof are shown as contingent liability in the balance sheet.

Liability on Account of Outstanding Forward Exchange Contracts

8.23 All branches which undertake foreign exchange business (i.e., those which are authorised foreign exchange dealers) usually enter into forward exchange contracts. The amount of forward exchange contracts, which are outstanding on the balance sheet date, is to be shown under this head.

Guarantees Given on Behalf of Constituents

8.24 The amount of all guarantees outstanding on the balance sheet is to be shown under the above head after deducting therefrom any cash margin.

Acceptances, Endorsements and Other Obligations

8.25 This item includes the following balances:

(a) letters of credit opened by the bank on behalf of its customers; and

(b) Bills drawn by the bank's customers and accepted or endorsed by the bank (to provide security to the payees).

8.26 The total of all outstanding letters of credit as reduced by the cash margin and after deducting the payments made for the bills negotiated under them should be included in the balance sheet. In case of revolving credit, the maximum permissible limit of letters of credit that may remain outstanding at any point of time as reduced by the cash margin should be shown. If the transactions against which the letter of credit was opened have been completed and the liability has been marked off in the books of the bank, no amount should be shown as contingent liability on this account.

Other Acceptances and Endorsements

8.27 Sometimes, a customer of the bank may issue a usance bill payable to his creditor and drawn on the bank. The bank, on accepting such a bill, becomes liable to pay it on maturity. In turn, it has to recover this amount from its customer.

8.28 The total of all outstanding acceptances and endorsements at the end of the year, as reduced by the cash margin, should be disclosed as contingent liability.

Other Items for Which the Bank is Contingently Liable

8.29 Under this head are to be included such items as arrears of cumulative dividends, bills re-discounted, commitments under underwriting contracts, estimated amounts of contracts remaining to be executed on capital account, disputed tax liabilities, credit enhancement in respect of securitised loans to which the assignee or the special purpose vehicle has recourse; etc.

8.30 Underwriting involves an agreement by the bank to subscribe for the shares or debentures which remain unsubscribed in a public issue, in consideration of commission.

8.31 Rediscounting is generally done with the RBI, Industrial Development Bank of India or other financial institutions or, in the case of foreign bills, with foreign banks. If the drawer dishonours the bill, the re-discounting bank has a right to proceed against the bank as an endorser of the bill.

8.32 Tax demands, which has been disputed are in the nature of contingent liability and should be disclosed. Where an application for rectification of mistake has been made by the entity, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of tax is for a certain amount and the dispute relates to only a part and not the whole of the amount, only such amount should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure as per provisions of Accounting Standard (AS) 29, "Provisions, Contingent Liabilities and Contingent Assets".

8.33 Disputed tax liabilities in respect of income-tax and similar central taxes would not form part of balance sheet of a branch as these items are dealt with at the head office level.

Bills for Collection

8.34 Bills held by a bank for collection on behalf of its customers are to be shown as a footnote to the balance sheet.

8.35 These bills are generally *hundies* or bills of exchange accompanied by documents of title to goods. Frequently, no bills of exchange are actually drawn; the bank is asked to present invoices and documents of title with instructions to collect the amount thereof from the party in whose name the invoice has been made. The documents of title enclosed with the bills for collection are usually not assigned to the bank.

8.36 A bank may get bills for collection from -

(a) its customers, drawn on outstation parties; or

(b) its other branches or other outstation banks or parties, drawn on local parties.

8.37 On receipt of the bills drawn on outstation parties, the bank forwards them to its branch or other correspondent at the place where they are to be collected. Such bills are called Outward Bills for Collection.

8.38 Bills received by the bank from its outstation branches and agents, etc. for collection are called Inward Bills for Collection.

8.39 It may be noted that if a bill is received by one branch of the bank from a customer and sent by it to another branch of the bank for collection, the same bill will be shown as an Outward Bill at the first branch and as an Inward Bill at the other branch. In the consolidated balance sheet of the bank, however, all such bills should be shown only once. Therefore, Inward Bills for Collection are excluded from the balance sheet of each branch.

Co-acceptance of Bills

8.40 In its master circular of guarantees and co-acceptances, the RBI had reiterated the need for the banks to be cautious while co-accepting bills of their customers and discounting the same so as to avoid loss to banks arising on account of frauds perpetrated in the guise of bills. The circular requires the banks, *inter alia,* not to extend their co-acceptances to house bills/ accommodation bills drawn by group concerns on one another. In its circular the RBI had also listed a number of safeguards to be undertaken by banks while co-accepting bills.

Audit Approach and Procedures

Contingent Liabilities

8.41 In respect of contingent liabilities, the auditor is primarily concerned with seeking reasonable assurance that all contingent liabilities are identified and properly valued. To this end, the auditor should, generally follow the audit procedures given below:

(a) the auditor should 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.

(b) Ascertain whether there are adequate internal controls to ensure that transactions giving rise to contingent liabilities are executed only by persons authorised to do so and in accordance with the laid down procedures.

(c) The auditor should also ensure that in case of LCs for import of goods, as required by the abovementioned Master Circular on guarantees and co-acceptances, the payment to the overseas suppliers is made on the basis of shipping documents and after ensuring that the said documents are in strict conformity with the terms of LCs.

(d) Ascertain whether the accounting system of the bank provides for maintenance of adequate records in respect of such obligations and whether the internal controls ensure that contingent liabilities are properly identified and recorded.

(e) Performs substantive audit tests to establish the completeness of the recorded obligations. Such tests include confirmation procedures as well as examination of relevant records in appropriate cases.

(f) Review the reasonableness of the year-end amount of contingent liabilities in the light of previous experience and knowledge of the current year's activities.

(g) Review whether comfort letters issued by the bank has been considered for disclosure of contingent liabilities.

(h) Obtain representation from the management that

 (i) all contingent liabilities have been disclosed;

 (ii) the disclosed contingent liabilities do not include any contingencies which are likely to result in a loss/ expense and which, therefore, require creation of a provision in the financial statements;

(iii) the estimated amounts of financial effect of the contingent liabilities are based on the best estimates in terms of Accounting Standard 29, including any possibility of any reimbursement;

(iv) 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 Regulations Act, 1949 has arisen on account of such guarantee; and

(v) 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.

(i) The auditor should also examine whether the bank has given any guarantees in respect of any trade credit (buyer's credit or seller's credit)*. The period of guarantees is co-terminus with the period of credit reckoned from the date of shipment.

(j) 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.

8.42 The specific procedures to be employed by the auditor to verify various items of contingent liabilities are discussed in the following paragraphs. It may be noted that many of the items discussed in the following paragraphs, may be designated in foreign currencies.

***Letters of Comfort*@**

8.43 The auditor should verify that the application form submitted by the borrower is accompanied by the along with supporting documents necessary for sanctioning buyers' credit and the subsequent issue of LoC. The correspondence between the financing bank and the LoC issuing bank needs

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* In terms of the Circular No. A.P. (Dir. Series) 60 dated January 31, 2004, any trade credit extended for a period of three years and above comes under the category of external commercial borrowings.

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to be verified to identify the nature of financial guarantee and the terms and conditions of the sanction. The auditor should verify that the overall outstanding of the borrower under the LC and LoC is within the sanctioned limit. The auditor should also examine whether on the due date the amount of loan along with interest has been repaid. Further, the auditor has to verify compliance of withholding tax and appropriate forms such as A1 and A2 in case of inward and outward remittance of foreign currency.

Claims Against the Bank Not Acknowledged as Debts

8.44 The auditor should examine the relevant evidence, e.g., correspondence with lawyers/others, claimants, workers/officers, and workmen's/officers' unions. The auditor should also review the minutes of meetings of board of directors/committees of board of directors, contracts, agreements and arrangements, list of pending legal cases, and correspondence relating to taxes, and duties, etc. to identify claims against the bank. The auditor should ascertain from the management the status of claims outstanding as at the end of the year. A review of subsequent events would also provide evidence about completeness and valuation of claims. Based on the circumstances of each case, the auditor should verify whether the item would remain a claim against the bank not acknowledged as debt or it would be a liability requiring provisioning.[@]

Liability on Account of Outstanding Forward Exchange Contracts

8.45 The auditor may verify the outstanding forward exchange contracts with the register maintained by the branch and with the broker's advice notes. In particular, the net "position" of the branch in relation to each foreign currency should be examined to see that the position is generally squared and not uncovered by a substantial amount. The net "position" as reported in the financial statements may be verified with reference to the foreign exchange position report prepared by the back office.

Guarantees Given on Behalf of Constituents

8.46 The auditor should ascertain whether there are adequate internal controls over issuance of guarantees, e.g., whether guarantees are issued under proper sanctions, whether adherence to limits sanctioned for guarantees is ensured, whether margins are taken from customers before issuance of guarantees as per the prescribed procedures, etc.

8.47 The auditor should 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

[@] Revised in 2013 Edition.

stock of forms are periodically verified and reconciled with the book records, etc.

8.48 The auditor should examine the guarantee register to seek evidence whether the prescribed procedure of marking off the expired guarantees is being followed or not.

8.49 The auditor should 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. The auditor should also examine that expired guarantees are not included in this head. He should verify guarantees with the copies of the letters of guarantee issued by the bank and with the counter-guarantees received from the customers. He should also verify the securities held as margin. If a claim has arisen, the auditor should consider whether a provision is required in terms of the requirements of AS 29, "Provisions, Contingent Liabilities and Contingent Assets”.

8.50 The auditor should obtain a written confirmation from the management that all obligations in respect of guarantees have been duly recorded and that there are no guarantees issued upto the year-end which are yet to be recorded.

Acceptances, Endorsements and Other Obligations

8.51 The auditor should 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.

8.52 The auditor should verify the balance of letters of credit from the register maintained by the bank. The register indicates the amount of the letters of credits and payments made under them. The auditor may examine the guarantees of the customers and copies of the letters of credit issued. The security obtained for issuing letters of credit should also be verified.

Other Acceptances and Endorsements

8.53 The auditor should study the arrangements made by the bank with its customers. He should test check the amounts of the bills with the register maintained by the bank for such bills. The auditor should also examine whether such bills are marked off in the register on payment at the time of maturity.

8.54 In respect of letters of comfort, the auditor should examine whether the bank has incurred a potential financial obligation under such a letter. If a comfort letter does not cast any such obligation on the bank, no disclosure under contingent liability is required on this account.

Common Procedures

8.55 The auditor should obtain a written confirmation from the management that all obligations assumed by way of acceptances, endorsements and letters of credit have been duly recorded and there are no such obligations assumed upto the year-end, which are yet to be recorded.

8.56 The auditor should ascertain whether a contingent obligation assumed by a bank either by way of acceptance, endorsement etc. has resulted in an actual obligation owing to any act or default on the part of its constituent. In such a case, a provision would have to be made in the accounts for the bank's obligation. The amount of the provision should be determined taking into account the probable recovery from the customer.

Other Items for Which the Bank is Contingently Liable

8.57 The auditor should examine whether commitments under all outstanding underwriting contracts have been disclosed as contingent liabilities. For this purpose, the auditor should examine the terms and conditions of the relevant contracts.

8.58 Rediscounting is generally done with the RBI, Industrial Development Bank of India or other financial institutions or, in the case of foreign bills, with foreign banks. If the drawer dishonours the bill, the rediscounting bank has a right to proceed against the bank as an endorser of the bill. The auditor may check this item from the register of bills rediscounted maintained by the branch. He should satisfy himself that all the bills are properly marked off on payment at the time of maturity.

8.59 In respect of disputed tax demands, the auditor should examine whether there is a positive evidence or action on the part of the bank to show that it has not accepted the demand for payment of tax or duty. Where an application for rectification of mistake has been made by the entity, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of tax is for a certain amount and the dispute relates to only a part and not the whole of the amount, only such amount should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure as per provisions of AS 29, "Provisions, Contingent Liabilities and Contingent Assets". In determining whether a provision is required, the auditor should, among other procedures, make appropriate inquiries of management, review minutes of the meetings of the board of directors and correspondence with the entity's lawyers, and obtain appropriate management representations.

8.60 Disputed tax liabilities in respect of income-tax and similar central taxes would not form part of balance sheet of a branch as these items are dealt with at the head office level. However, the principles enunciated above should be followed in dealing with taxes and duties (such as, local taxes) dealt with at the branch level.

8.61 The auditor should also look into the manner of disclosure of interest rate swaps in the financial statements of the bank. The interest rate swaps would be treated as real or contingent liability depending upon the facts and circumstances of each case in accordance with the provisions of the Accounting Standard (AS) 29.

8.62 The auditor as in the case of other entities may verify other items under this head.

Bills for Collection

8.63 The auditor should ensure that the bills drawn on other branches of the bank are not included in bills for collection.

8.64 Inward bills are generally available with the bank on the closing day and the auditor may inspect them at that time. The bank dispatches outward bills for collection soon after they are received. They are, therefore, not likely to be in hand at the date of the balance sheet. The auditor may verify them with reference to the register maintained for outward bills for collection.

8.65 The auditor should also examine collections made subsequent to the date of the balance sheet to obtain further evidence about the existence and completeness of bills for collection.

8.66 In regard to bills for collection, the auditor should also examine the procedure for crediting the party on whose behalf the bill has been collected. The procedure is usually such that the customer's account is credited only after the bill has actually been collected from the drawee either by the bank itself or through its agents, etc. This procedure is in consonance with the nature of obligations of the bank in respect of bills for collection.

8.67 The commission of the branch becomes due only when the bill has been collected. The auditor should, accordingly, examine that there exists adequate internal control system that debits the customer’s account with the amount of bank’s commission as soon as a bill collected is credited to the customer’s account. The auditor should also examine that no income has been accrued in the accounts in respect of bills outstanding on the balance sheet date.

Co-acceptance of Bills

8.68 The auditor should ensure that the bank has instituted an adequate internal control system to comply with the safeguards as set out by the RBI’s Master Circular on Guarantees and Co-acceptances.

Annexure

Types of Letters of Credit

The letters of credit are of various types, the major ones being the following.

Revocable: *It is an LC which the issuing/opening bank can cancel/revoke/withdraw/ amend /modify at any time prior to its expiry at the instance of the opener unilaterally without notice to the beneficiary. The consent of the beneficiary is not necessary.*

Irrevocable: *In such cases, the issuing/opening bank gives definite and absolute undertaking to honour the bill of exchange drawn in strict conformity with the terms and conditions of the LC. Such LC cannot be amended/modified/cancelled/revoked/ withdrawn during the period of its currency without the prior consent of the beneficiary.*

Confirmed: *The issuing bank authorises the advising bank (its own branch or a correspondent through whom the LC is advised to the beneficiary) to add its confirmation to the LC while advising it to the beneficiary. The confirming Bank then becomes independently liable to the beneficiary to make payment of LC-complied bills. Generally, the banks add confirmation to the Irrevocable LCs only and hence, the confirmed LCs cannot be modified or cancelled without the prior consent of the beneficiary.*

Unconfirmed: *The LCs which are not confirmed by the advising bank.*

With Recourse To Drawer: *In cases where the negotiating bank can recover the amount of the bills already negotiated under an LC from the beneficiary in the event of non-payment by the opening bank, such LCs are called "with recourse to drawer" LCs. Otherwise, they are "without recourse to drawer" LCs.*

Transferable: *Where the beneficiary has a right to transfer, in full or part, the LC to third party, such LCs are called Transferable LCs.*

Back-To-Back: *On the strength and security of an LC in its favour, the beneficiary can request his bank to open a fresh LC in favour of third party. Such LC will be known a Back to Back LC as the original LC is at the back of the second LC.*

Revolving: *In a normal LC, the opening Bank specifies the maximum amount which can be paid under the LC in aggregate. In a revolving LC, the bank specifies the maximum amount that may remain outstanding at any time during the validity of the LC. The bank may also specify the maximum negotiations – number-wise or value-wise – that can be undertaken during the validity of the LC. The revolving LC covers a series of transactions during its currency.*

Red Clause: *The advising bank may be authorised to grant an advance to the beneficiary to meet pre-shipment expenses. Such a clause is generally typed in Red. The liquidation of the advance will be out of the bill proceeds.*

Green Clause: *If an LC provides for the grant of storage facilities at the port of shipment in addition to the pre-shipment finance to the beneficiary, it is called a 'Green Clause LC'.*

Documentary: *In the case of such LCs, the original documents of title to goods are also submitted to the LC opening bank for payment. These documents constitute the security of the bank.*

Clean: *These are LCs where the original documents of title to goods are not submitted to the LC opening bank.*

Other Classifications: *LCs are also classified between demand and issuance depending upon the terms of payment, and between inland and foreign depending upon the location of the LC opening and negotiating banks.*

III-9

Treasury Operations-Foreign Exchange and Derivative Transactions

Overview of Forex and Derivative Operations in a Bank

9.01 Banks in India are moving towards an integrated treasury management system covering fixed income, money market, foreign exchange and derivative markets. The treasury function of the bank manages the funding of the balance sheet, maintenance of the statutory reserve requirements and the foreign exchange resources of the Bank, in accordance with RBI guidelines, keeping in view its objective of liquidity management and maximizing income by trading in the financial markets.

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

9.03 Off-balance sheet activities provide a means to banks and financial institutions to retain their traditional customer bases and boost fee income in the face of increased competitive pressures in, and diminishing margins from conventional on balance sheet business. They also provide useful tools to assist management in managing risk and the balance sheet of the institution. Derivatives are often an attractive proposition for trading as only a limited (or, possibly zero) initial cash outlay is required to establish a relatively much greater position in the market. In effect, they are highly leveraged. This, however, may also bring, with it higher risks. Therefore, it is important that management attention is focussed to ensure appropriate controls are in place.

9.04 Today, treasury operations have grown as one of the key administrative areas of a bank, responsible for the processing of all financial market transactions and usually much more, including a crucial role in the control of risk. Modern international banks have a large daily turnover in numerous currencies from treasury transactions, which result in high value payments and receipts in many financial centers of the world.

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

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

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

Derivatives

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

> "Derivative" means an instrument, to be settled at a future date, whose value is derived from change in interest rate, foreign exchange rate, credit rating or credit index, price of securities (also called "underlying"),

or a combination of more than one of them and includes interest rate swaps, forward rate agreements, foreign currency swaps, foreign currency-rupee swaps, foreign currency options, foreign currency-rupee options or such other instruments as may be specified by the Bank from time to time.

Products offered in Forex and Derivative business

9.09 The following are various types of foreign exchange and derivative contracts offered in normal course of banking business.

Spot contracts

9.10 These are contracts to deliver one currency in exchange for another for value within two banking days of the trade date. The two-day margin results from the industry practice to allow time for communicating payment instructions to the paying agents for the parties to the deal, so that contracts can settle on their value dates.

Tom and Cash contracts

9.11 These are contracts to deliver one currency in exchange for another for value on the next day of the trade date while in a Cash contract the delivery happens on the same day.

Swap transactions

9.12 These transactions combine spot and forward contracts, often with the same counterparty, so that the currency delivered under the spot contract is returned at a later date under the forward contract. The effect of the combination of the two deals is to provide funds in the currency bought spot for the period between the spot value date and the forward value date rather than funds in the currency sold. The difference in the prevailing interest rates in the two currencies is adjusted for in the forward exchange rate.

Currency Swaps

9.13 A currency swap is an interest rate swap where the two legs to the swap are denominated in different currencies. Additionally, the parties may agree to exchange the two currencies normally at the prevailing spot exchange rate with an agreement to reverse the exchange of currencies, at the same spot exchange rate, at a fixed date in the future, generally at the maturity of the swap.

Credit Default Swaps

9.14 Credit Default Swaps (CDS) on corporate bonds provide market participants a tool to transfer and manage credit risk in an effective manner through redistribution of risk. CDS as a risk management product offers the participants the opportunity to hive off credit risk and also to assume credit risk which otherwise may not be possible.

9.15 The Reserve Bank of India, vide its circular no. DBOD.BP.BC.No. 61/21.06.203/2011-12 of 30th November 2011, issued Prudential Guidelines on Credit Default Swaps (CDS) effective from the said date. These Guidelines are applicable on CDS transactions undertaken by Indian banks domestically or through their overseas branches / subsidiaries / joint ventures as well as Indian operations of foreign banks. Further, while undertaking CDS transactions overseas, Indian banks should adhere to guidelines of host country, if they are more conservative / stricter than these guidelines.

9.16 These Prudential Guidelines cover important aspects such as Definitions - Credit Event Payment, Deliverable Asset/ Obligation, Reference Obligation, Underlying Assets Obligation, Classification of CDS into Trading Books and Banking Book Positions, Operational requirements for CDS to be recognised as eligible External / Third-party hedges for Trading Book and Banking Book, Capital Adequacy Requirement for CDS - Positions in the Banking Book, Capital Adequacy for CDS in the Trading Book \, Capital Charge for Counterparty Credit Risk , Treatment of Exposures Below Materiality Thresholds, General Provisions Requirements, Protection Seller, Exposure Norms, Netting of Exposures and Reporting Requirements**.**

Options

Currency Options

9.17 A currency option is a contract where the purchaser of the option has the right but not the obligation to either purchase (call option) or sell (put option) and the seller (or writer) of the option agrees to sell (call option) or purchase (put option) an agreed amount of a specified currency at a price agreed in advance and denominated in another currency (known as the strike price) on a specified date (European option) or by an agreed date (American option) in the future.

Net Open Position

9.18 *The foreign exchange risk of a bank is basically determined by the net open position in a currency. This refers to the uncovered currency position or gap taking into account all relevant assets and liabilities and the unmatured spot and forward contracts in that currency. Foreign currency assets may include foreign currency notes on hand, all nostro balances, loans and advances of the bank, such as term loan, packing credit in foreign currency, FCNR 'B' Loan, bills/cheques/drafts purchased, foreign currency investment, such as, overnight investment, short term deposits. Foreign currency liabilities* *may include FCNR 'B' deposits, EEFC/RFC deposits, Escrow account, cheques, drafts or other bills payable and NOSTRO overdraft balances.*

Long or Short Position

9.19 Net open position may be long or short position. A net position with excess of assets and purchases over liabilities and sales is referred to as long position. A net position with excess of liabilities and sales over purchases and assets is referred to as short position.

Forward Rate Agreement

9.20 A Forward Rate Agreement is a financial contract between two parties to exchange interest payments for a `notional principal' amount on settlement date, for a specified period from start date to maturity date. Accordingly, on the settlement date, cash payments based on contract (fixed) and the settlement rate, are made by the parties to one another. The settlement rate is the agreed bench-mark/ reference rate prevailing on the settlement date.

Interest Rate Swap

9.21 An Interest Rate Swap is a financial contract between two parties exchanging or swapping a stream of interest payments for a `notional principal' amount on multiple occasions during a specified period. Such contracts generally involve exchange of a `fixed to floating' or `floating to floating' rates of interest. Accordingly, on each payment date - that occurs during the swap period – cash payments based on fixed/ floating and floating rates, are made by the parties to one another.

Interest Rate Futures

9.22 Interest Rate Future is a standardized, exchange-traded contract with an actual or notional interest-bearing instrument(s) as the underlying asset. The RBI, *vide* its circular No.IDMC.MSRD.4801/06.01.03 dated June 3, 2003 on "on Exchange-Traded Interest Rate Derivatives" permits banks to transact in Interest Rate Futures for the purpose of hedging the risk in their underlying investment portfolio. The RBI further, *vide* its Circular No. IDMD.PDRD.No. 1056/03.64.00/2009-10 dated September 1, 2009 on "Guidelines on Exchange Traded Interest Rate Derivatives" allows banks to take trading positions also in Interest Rate Futures.

Interest Rate Caps and Floors

9.23 An interest rate cap is an interest rate option in which payments are made when the reference rate exceeds the strike rate. Analogously, an interest rate floor is an interest rate option in which payments are made when the reference rate falls below the strike rate.

Currency Futures

9.24 A currency future contract is a type of contract in which the underlying commodity is a financial instrument or currency and the contract price depends upon an interest rate or an exchange rate. The RBI, *vide* its circular no. RBI/2010-11/147 A.P. (DIR Series) Circular No. 05 dated July 30, 2010 on "Guidelines on trading of Currency Options on Recognised Stock / New Exchanges" -Permitted banks to become trading/clearing member of SEBI-approved exchanges, permits scheduled commercial banks (AD Category I) to become trading / clearing members of the exchange traded currency options market of the Stock Exchanges recognized by SEBI, on their own account and on behalf of their clients, subject to their fulfilling the following prudential requirements.

- Minimum networth of Rs. 500 crores,
- Minimum CRAR of 10%
- Net NPA not exceeding 3%
- Net Profit for last 3 years

9.25 Further, banks which fulfill the conditions mentioned above should lay down detailed guidelines with Board's approval for conduct of this activity and management of risks. It should be ensured that the bank's position is kept distinct from the clients' position. In case of supervisory discomfort with the functioning of a bank, the RBI may impose restrictions on the bank regarding the conduct of this business as it deems fit. Further, RBI vide its circular no. DBOD.No.BP.BC.51 / 21.06.101 / 2010-11 dated October 28, 2010 on "Introduction of Exchange Traded Currency Options – Permitting Banks to Participate in Currency Options on Recognized Stock / New Exchanges" advised as under:

- AD Category - I commercial banks which fulfill the minimum prudential requirements under para 6(ii) of the circular dated July 30, 2010, are hereby permitted to become trading and clearing members of the exchange traded currency options market of the recognized stock exchanges, on their own account and on behalf of their clients.
- All other scheduled commercial banks are permitted to participate in the exchange traded currency options market only as clients.

Foreign Exchange Forward

9.26 A foreign exchange forward is an over-the-counter contract under which a purchaser agrees to buy from the seller, and the seller agrees to sell to the purchaser, a specified amount of a specified currency on a specified date in the future - beyond the spot settlement date - at a known price denominated in another currency (known as the forward price) that is specified at the time the contract is entered into.

Permitted derivative products in India

9.27 As per the prevalent RBI Circulars, the following products and their combinations are permitted:

- Plain Vanilla Rupee FX Options;
- Foreign Currency FX Options;
- Foreign Currency Interest Rate Options;
- Interest Rate Swaps;
- Coupon Only Swaps;
- Interest Rate Swaps, with Options;
- Coupon Only Swaps, with Options;
- Principal Only Swaps, with Options; and
- Commodity derivatives, as permitted under the prevalent RBI guidelines.

Derivatives Markets

9.28 There are two distinct groups of derivative contracts:

- *Over-the-counter (OTC) derivatives*: Contracts that are traded directly between two eligible parties, with or without the use of an intermediary and without going through an exchange.
- *Exchange-traded derivatives*: Derivative products that are traded on an exchange.

Participants

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

- *User:* A user participates in the derivatives market to manage an underlying risk.

- *Market-maker:* A market-maker provides bid and offer prices to users and other market-makers. A market-maker need not have an underlying risk.

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

Purpose

9.30 *Users* can undertake derivative transactions to hedge an existing identified risk on an ongoing basis during the life of the derivative transaction or for transformation of risk exposure, as specifically permitted by RBI. *Market-makers* can undertake derivative transactions to act as counterparties in derivative transactions with users and also amongst themselves.

Broad Principles for Undertaking Derivative Transactions

9.31 The major requirements for undertaking any derivative transaction includes:

- In addition to generic derivative products, market-makers may also offer structured derivative products to users as long as they do not contain any derivative instrument as underlying and have been specifically permitted by the RBI. For the purpose of the guidelines contained in RBI's Circular no. DBOD.BP.BC.44/21.04.157/2011-12 dated 2nd November, 2011,

  a. The following derivative instruments used to hedge an existing interest rate and forex exposure, on a standalone basis, may be treated as generic derivative products:

  - Forex Forward Contracts
  - Forward Rate Agreements
  - Interest rate caps and floors (plain vanilla only)
  - Plain Vanilla Options (call option and put option)
  - Interest Rate Swaps
  - Currency Swaps including Cross-Currency Swaps

  b. The following derivative products may be treated as structured derivative products:

  - Instruments which are combination of either cash instrument and one or more generic derivative products

- Instruments which are combination of two or more generic derivative products

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

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

  (b) In the case of structured products, marking the constituent generic instruments to market.

  (c) If (a) and (b) are not feasible, marking the product to model, provided:

  - All the model inputs are observable market variables.
  - Full particulars of the model, including the quantitative algorithm are documented.

9.32 It may be ensured that structured products do not contain any derivative, which is not allowed on a stand alone basis. Further,

- All permitted derivative transactions, including roll over, restructuring and novation can be contracted only at prevailing market rates.
- All risks arising from derivatives exposures should be analysed and documented, both at transaction level and portfolio level.
- The management of derivatives activities should be an integral part of the overall risk management policy and mechanism. It is desirable that the board of directors and senior management understand the risks inherent in the derivatives activities being undertaken.
- Market-makers should have a 'Suitability and Appropriateness Policy' vis-à-vis users in respect of the products offered, on the lines indicated in the guidelines given in the Circular.
- Market-makers may, where they consider necessary, maintain cash margin/liquid collateral in respect of derivative transactions undertaken by users on mark-to-market basis.

Risk Management and Corporate Governance Aspects

9.33 The Master Circular also sets out the basic principles of a prudent system to control the risks in derivatives activities. These include:

(a) appropriate oversight by the board of directors and senior management;

(b) adequate risk management process that integrates prudent risk limits, sound measurement procedures and information systems, continuous risk monitoring and frequent management reporting; and

(c) comprehensive internal controls and audit procedures.

Suitability and Appropriateness

9.34 While undertaking derivative transactions with or selling structured derivative products to a user, a market-maker should:

(a) document how the pricing has been done and how periodic valuations will be done. In the case of structured products, this document should contain a dissection of the product into its generic components to demonstrate its permissibility, on the one hand, and to explain its price and periodic valuation principles, on the other. The following information may be shared with the user:

   (i) Description of the transaction.

   (ii) Building blocs of the transaction.

   (iii) Rationale along with appropriate risk disclosures.

   (iv) Sensitivity analysis identifying the various market parameters that affect the product.

   (v) Scenario Analysis encompassing both the possible upside as well as the downsides.

(b) analyse the expected impact of the proposed derivatives transaction on the user.

(c) Before offering any derivative product to a client, obtain Board resolution from the corporate which:

- explicitly mentions the limit assigned by the corporate to the bank. While monitoring this limit, bank would take into account absolute notional amount of all outstanding derivative contracts entered into by the corporate with the bank. In other words, notionals of long and short positions will not be netted for the purpose of compliance with the limit.

- mentions the names and designation of the officials of the company authorised to undertake particular derivative transactions on behalf of the company.

- specifies the names of the people to whom transactions should be reported by the bank. These personnel should be distinct from those authorized to undertake the transactions.
- mentions the names and designation of person(s) authorised to sign the ISDA and similar agreements;
- mentions specific products that can be transacted by the designated officials named therein.

9.35 It should also be ensured that the Board resolution submitted by the company is signed by a person other than the persons authorized to undertake the transactions. (Refer RBI's circular no. DBOD.BP.BC.44/21.04.157/2011-12 dated 2nd November, 2011, *Comprehensive Guidelines on Derivatives: Modifications*)

(d) identify whether the proposed transaction is consistent with the user's policies and procedures with respect to derivatives transactions, as they are known to the market-maker.

(e) ensure that the terms of the contract are clear and assess whether the user is capable of understanding the terms of the contract and of fulfilling its obligations under the contract.

(f) inform the customer of its opinion, where the market-maker considers that a proposed derivatives transaction is inappropriate for a customer. If the customer nonetheless wishes to proceed, the market-maker should document its analysis and its discussions with the customer in its files to lessen the chances of litigation in case the transaction proves unprofitable to the customer. The approval for such transactions should be escalated to next higher level of authority at the market-maker as also for the user.

(g) ensure the terms of the contract are properly documented, disclosing the inherent risks in the proposed transaction to the customer in the form of a Risk Disclosure Statement which should include a detailed scenario analysis (both positive and negative) and payouts in quantitative terms under different combination of underlying market variables such as interest rates and currency rates, etc., assumptions made for the scenario analysis and obtaining a written acknowledgement from the counterparty for having read and understood the Risk Disclosure Statement.

(h) guard against the possibility of misunderstandings all significant communications between the market-maker and user should be in writing or recorded in meeting notes.

(i) ensure to undertake transactions at prevailing market rates and to avoid transactions that could result in acceleration/deferment of gains or losses.

(j) should establish internal procedures for handling customer disputes and complaints. They should be investigated thoroughly and handled fairly and promptly. Senior management and the Compliance Department/Officer should be informed of all customer disputes and complaints at a regular interval.

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

Documentation

9.36 The above RBI circular also requires the market participants to ensure that documentation requirements in respect of derivative contracts are complete in all respects.

Identification and Management of Risk

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

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

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

Risk limits

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

Independent Risk control

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

Operational Controls

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

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

Prudential Norms Relating to Derivatives

9.41 The prudential norms relating to derivatives – minimum capital adequacy requirement, credit exposure norms, ALM etc. will be as prescribed by RBI from time to time. Attention of the reader may be drawn on RBI's Circular No. DBOD.No.BP.BC.48 / 21.06.001/2010-11 dated October 1, 2010 and DBOD.No.BP.BC.31/21.04.157/2008-09 dated August 8, 2008 on "Prudential Norms for Off-Balance Sheet Exposures of Banks" and RBI's Master Circular No. DBOD. No.Dir.BC.3/13.03.00/ 2012-13 dated July 2, 2012 on "Exposure Norms" (The Circular is given in the CD along with the Guidance Note).

Asset Classification of Derivatives[@]

9.42 RBI *vide* its Circular No. DBOD.No.BP.BC.57/ 21.04.157/2008-09 dated October 13, 2008 on "Prudential Norms for Off-Balance Sheet Exposures of Banks" and Circular No. DBOD.No.BP.BC.21/ 21.04.048/2012-13 dated July 2, 2012 on "Prudential Norms on Income Recognition, Asset Classification and

[@] Revised in 2013 edition.

Provisioning pertaining to Advances" advised the banks including foreign branches of Indian banks as under:

i. The overdue receivables representing positive mark-to-market value of a derivative contract will be treated as a non-performing asset, if these remain unpaid from the specified due date for payment for 90 days or more.

ii. In case the overdues arising from forward contracts and plain vanilla swaps and options become NPAs, all other funded facilities granted to the client shall also be classified as non-performing asset following the principle of borrower-wise classification as per the existing asset classification norms.

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

iv. If the client concerned is also a borrower of the bank enjoying a Cash Credit or Overdraft facility from the bank, the receivables mentioned at item (i) above may be debited to that account on due date and the impact of its non-payment would be reflected in the cash credit/overdraft facility account. The principle of borrower-wise asset classification would be applicable here also, as per extant norms.

v. In cases where the contract provides for settlement of the current mark-to market value of a derivative contract before its maturity, only the current credit exposure (not the potential future exposure) will be classified as a non-performing asset after an overdue period of 90 days.

vi. As the overdue receivables mentioned above would represent unrealised income already booked by the bank on accrual basis, after 90 days of overdue period, the amount already taken to 'Profit and Loss a/c' should be reversed.

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

9.44 RBI *vide* its Circular No. DBOD.No.BP.BC.21/ 21.04.048/2012-13 dated July 2, 2012 on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances" advised banks that credit exposures computed as per the current marked to market value of the contract, arising on account of the interest rate & foreign exchange derivative transactions, credit default swaps, shall also attract provisioning requirement as applicable to the loan assets in the 'standard' category, of the concerned counterparties. All conditions applicable for treatment of the provisions for standard assets would also apply to the aforesaid provisions for derivative exposures.[@]

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

- in cases where the derivative contracts provides for more settlements in future, the MTM value will comprise of (a) crystallised receivables and (b) positive or negative MTM in respect of future receivables.
- If the derivative contract is not terminated on the overdue receivable remaining unpaid for 90 days, in addition to reversing the crystallised receivable from Profit and Loss Account as stipulated in para 1 above, the positive MTM pertaining to future receivables may also be reversed from Profit and Loss Account to another account styled as 'Suspense Account – Positive MTM'. The subsequent positive changes in the MTM value may be credited to the 'Suspense Account – Positive MTM', not to P&L Account.
- The subsequent decline in MTM value may be adjusted against the balance in 'Suspense Account – Positive MTM'. If the balance in this account is not sufficient, the remaining amount may be debited to the P&L Account.

[@] Revised in 2013 edition.

- On payment of the overdues in cash, the balance in the 'Suspense Account-Crystalised Receivables' may be transferred to the 'Profit and Loss Account', to the extent payment is received.
- If the bank has other derivative exposures on the borrower, it follows that the MTMs of other derivative exposures should also be dealt with / accounted for in the manner as described above, subsequent to the crystalised/settlement amount in respect of a particular derivative transaction being treated as NPA.
- Since the legal position regarding bilateral netting is not unambiguously clear, receivables and payables from/to the same counterparty including that relating to a single derivative contract should not be netted.
- Similarly, in case a fund-based credit facility extended to a borrower is classified as NPA, the MTMs of all the derivative exposures should be treated in the manner discussed above.
- These guidelines are applicable to both outstanding derivatives contracts and the derivatives transactions undertaken from the date of the circular.

Re-structuring of derivative contracts

9.46 In cases where a derivative contract is restructured, the mark-to-market value of the contract on the date of restructuring should be cash settled. For this purpose, any change in any of the parameters of the original contract would be treated as a restructuring.

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

9.47 The RBI *vide* its circular No. DBOD.No.BP.BC.89 /21.04.141/2008-09 dated December 1, 2008 on "Operations of foreign branches and subsidiaries of the Indian banks – Compliance with statutory/regulatory/administrative prohibitions/ restrictions" provides that transactions by the foreign branches / foreign subsidiaries, in financial products which are not available in the Indian market and on which no specific prohibition has been currently placed by the RBI, no prior approval of the RBI would be required for the purpose provided these are merely plain-vanilla financial products. Banks should, however, ensure that their foreign branches / subsidiaries, dealing with such products in foreign jurisdictions, have adequate knowledge, understanding, and risk management capability for handling such products. Such products should also be appropriately captured and reported in the extant off-site returns furnished to the RBI. These products would also attract the prudential norms such as capital adequacy, credit exposure, periodical valuation, and all other applicable norms. In case the current RBI norms do not specify prudential treatment of such financial products, it would be incumbent upon the banks to seek specific RBI guidance in the matter. If, however, the foreign branches / foreign subsidiaries of the Indian banks propose to handle structured financial products, banks should obtain prior approval of the RBI for the purpose by furnishing full particulars of these products including their regulatory treatment prescribed by the host-country regulators (for capital adequacy, valuation, pricing, exposure norms, etc), as also the risk management systems in place in the branch / subsidiary to deal with such products.

Permitted Inter-bank Transactions

9.48 Permitted inter-bank transactions involve the following:

- Swaps/cash/term/spot transaction.
- Placing/accepting/borrowing/lending in foreign currency.
- Overseas/branches/SEZ/EOU.
- Cross currency.
- Initiating position overseas.
- Top management to approve the levels of borrowings/lending.
- Surplus management of funds subject to gap limits.
- Overseas investment in money approved market instruments/debt instrument by a foreign state residual maturity not to exceed one year.
- FCNR (B) funds investment maturity not to extend under FCNR (B).
- Foreign currency funds in Nostro accounts for foreign currency lending to local residents.
- Overseas borrowings from their HO/branches/Companies upto 25% tier one capital or USD 10 million, whichever is high.

Core functions of treasury operations in Bank

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

- Dealing room operations (Front office operations);
- Back office; and
- Product Control Group (Market risk department / Middle office).

9.50 Increasing regulation and compliance requirements, risk management needs and interactive systems developments, have combined to make 'treasury front and back office efficiency' one of the most critical factors in ensuring the well-being of any bank today. This is certain to continue as the work of the back offices becomes more onerous while financial products become increasingly complex, despite streamlining of processing systems.

Front office Operations

9.51 The front office operations consist of dealing room operations wherein the dealers enter into deal with the various corporate and interbank counterparties. Deals are entered into by dealers with various medium such as Reuters' system, telephonic conversation, brokers or any other private channel with the respective counterparty.

9.52 The dealers are primarily responsible to check for counterparty credit limits, eligibility, and other requirements of the Bank before entering into the deal with the customers.

9.53 Dealers must ensure that all risk/credit limits are available before entering into a deal. Also, the deal must not contravene the current regulations regarding dealing in INR with overseas banks/counterparties. All counterparties are required to have executed the International Swaps and Derivatives Association ('ISDA') agreement as well as passed a board resolution allowing it to enter into derivatives contract.

9.54 As soon as the deal is struck with counterparty, the deal details are either noted in a manual deal pad or punched in front office system of the Bank which gets queued in for authorisation.

Back office Operations

9.55 The mainstream role of the back office is in direct support of the trading room or front office. Traditionally, this included the input of deals written and authorized by traders, checking of input, verification by confirmation, settlement, checking existence of a valid and enforceable International Swap Dealers Association ('ISDA') agreement and reconciliation of nostro accounts as soon as possible. However, with the advent of online data capture systems and, more importantly, online trading systems the input of deals has progressively moved to the trading floor as mentioned above.

9.56 An important development in the back office has been the advent of straight-through processing (STP), also called 'hands-off' or exception processing. This has been made possible through enhancement of system to real time on line input in the trading room, which in turn has meant that the back office can recall deals input in the trading room to verify from an external source.

9.57 In practice this is done automatically, comparing incoming data from brokers and counterparties and investigating exceptions. Indeed, with the introduction of full trading systems the deal is 'confirmed' as it is done, allowing the back office to concentrate principally on exception reporting, settlement and risk control. This is a completely different approach to the old style input and checking of written paper-based deals that represented only a dealer's version of what the deal was before external verification could even commence.

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

Input and completion

9.59 The first core function for the back office is to recall the deal through the input system and decide what has to be done to complete the details of the deal. Deals input through front-end data capture or agreed on one of the proprietary trading systems will have already been subjected to numerous system checks to ensure that the transaction is technically correct. Some deals will require settlement instructions to be added, but for straightforward foreign exchange and derivative done with other banks and large corporates, standard settlement instructions (SSIs) may have already been added as informed in the agreement. This could also be true for derivatives transactions in the larger treasuries. However, these types of transactions generally need more checking and manual intervention because of the wide variety of their use. At this stage the bank normally releases its own confirmation to the counterparty, particularly over the counter ('OTC').

Counterparty confirmation

9.60 The second core function for the back office is to verify the deal from the counterparty as soon as possible after the transaction has been done. For bank-to-bank trading, the verification can take the form of a confirmation of a deal done through Reuters or trading systems, or a broker's confirmation if the deal has been done through a broker. Telephone confirmation and faxed confirmations are also sought for immediate authorisation.

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

Settlement

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

9.63 The CCIL settlement process covers inter-bank spot and forward USD/INR transactions for its member banks. The CCIL releases a Net Position report on S-1 date, on the basis of which settlement is made on the value date. Though the individual Settlement Risk ('SR') and Pre-Settlement Likely Exposure ('PSLE') limits for inter-bank parties remain.

Reconciliation

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

Middle office operations

9.65 Although the phrase 'the back office' was originally synonymous with the processing functions of input, confirmation, settlement and reconciliation, this has progressively broadened to include many other aspects supporting the trading room. In some banks this includes 'middle office', risk management, immediate responsibility for treasury accounting, documentation of various types, producing the financial results, analysis and budget forecasts for the treasury business unit, input into regulatory reporting, and systems development (including telecommunications), both for the support areas and the trading room itself. The bigger the treasury unit, the more likely it will have some or more of these functions, depending on the level of expertise within the area.

Risk management

9.66 This is a function that can sit well in the middle office provided it is properly staffed by officers who understand fully the business and risks involved – which usually means ex-market practitioners. It can range from agreeing overnight cash positions for the trading room through to full-risk modelling associated with derivatives trading and hedging. In between can come monitoring of counterparty, country, dealer and market-related limits that have been set and approved in other areas of the bank such as the credit department.

Risk Identification Process

Price or Rate Risk

Foreign Exchange Rate Movement Risk

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

US$/INR FX Forwards Risk

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

Timing Risk

9.69 As per market practice, FX contracts with timing discretion (Option Period Forwards or OPFs) versus INR are typically for a period of one week to a maximum of one month. The customer has the discretion to pick up the contract on any day of the window period. In case the customer is buying the foreign currency ('FCY'), the swap points/contract rate is fixed based on the last date of the period in case the FCY is at a premium against the INR or the first date in case the FCY is at a discount. Hence, unless the swap points change from premium to discount or vice versa after entering into the contract, the counterparty would not benefit by taking delivery before last date in case of premium or after first date in case of discount.

9.70 In the unlikely event of this happening and if the bank has not hedged the contract similarly with another contract with discretion period, an adverse P&L impact could arise. In such a case, the market counterparty could pick up the contract early while the hedge contract would still be outstanding and the gap would have to be covered again at incremental cost.

Credit Risk

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

Pre-Settlement Likely Exposure

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

Settlement Risk

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

Market risk

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

Liquidity Risk

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

Market Liquidity Risk

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

Funding Liquidity Risk

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

Sovereign Risk or Cross Border Risk

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

Operations Risk

9.79 This can occur if an error in processing results in a loss and/or excess over prescribed risk/regulatory limits.

Legal risk

9.80 Legal risk is the risk of loss arising from contracts which are not legally enforceable (e.g. the counterparty does not have the power or authority to enter into a particular type of derivatives transaction) or documented correctly.

Regulatory risk

9.81 Regulatory risk is the risk of loss arising from failure to comply with regulatory or legal requirements.

Reputation risk

9.82 Reputation risk is the risk of loss arising from adverse public opinion and damage to reputation.

Country Risk

9.83 The following items need consideration in respect of funded and non-funded exposures relating to country risk:

- Funded exposures.
- Investments.
- Nostro mirror debit balances.
- Overdraft in vostro accounts.
- Remittances honoured drawing arrangements.
- Loans and advances.
- Trade credit and receivables.
- Other monetary assets.
- Non-funded exposures.
- Bid, performance, advance payment, bonds.
- Confirmation of LC issued by a bank abroad.
- Commitment undertaken against the counter guarantee of a bank overseas.
- Provisioning and capital requirements:
  - Determination of Risk category, ECGC provision segments percentage.

  - ➢ No provision for home country exposures *viz*. on India.
  - ➢ Lower level of provisioning-25% of requirement in respect of short-term exposures upto 180 day.
- Disclosures on the accounts to the balanced sheet.

Risk Management Limits and Monitoring

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

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

9.85 The Bank has to apply for a Net Overnight Open Position Limit (NOOPL) with the RBI. This limits the maximum allowable excess of assets plus exchange bought contracts over liabilities plus exchange sold contracts ("overbought" position) and the reverse ("oversold" position) that may be carried overnight in foreign currencies. Moreover banks have to maintain capital adequacy on this approved limit by Reserve Bank of India.

Daylight Limit

9.86 As mentioned for NOOPL these refer to the maximum net positions that can be taken during the trading day in each currency. However, there is no such requirement for RBI approval so long the banks internally have an approved day limit. However, in case of large intra-day flows and positions, it is expected that the desk will keep the risk department informed about the same.

Value at Risk ('VAR') limits

9.87 Spot VAR measures the change in the economic value of a currency position due to a standard deviation adverse change in the spot rates for that currency. The standard deviation for each currency is a measure of the volatility of movements of the spot exchange rate versus the US$. The Spot VAR along with VAR of other products should be within the VAR limit as stipulated in the Bank's risk guidelines.

9.88 The spot VAR of each currency is computed using the individual currency's volatility and the Factor Sensitivity (DV01) as well as the covariance between currencies. The volatility factors and the covariance coefficients are as per the risk guidelines of the Bank.

Gap DV01 and VAR limits

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

9.90 The bank has to apply to Reserve Bank of India for an approved Aggregate Gap Limit for the whole bank. The Banks are also required to compute VAR on a daily basis as per the RBI model on the overall bank gap. The bank has to maintain a separate VAR limit for derivative transactions as mentioned in the RBI Circular No. MPD.BC.187/07.01.279 dated July 7, 1999.

9.91 As of the last reporting Friday of every month, treasury operations has to prepare the GAP report in prescribed format as given by the RBI for the overall gap position of the Bank.

Aggregate Contract Limit

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

Options Limit

9.93 These are specifically designed to control the risks of the options. Options limit may include Delta, Gamma, Vega, Theta and Rho limits. Delta is a measure of the amount an option price would be expected to change for a unit change in the price of the underlying instrument. Gamma is a measure of the amount delta would be expected to change in response to a unit change in the price of the underlying instrument. Vega is a measure of the amount an option's price would be expected to change in response to a unit change in the price of volatility of the underlying instrument. Theta is a measure of the amount of an option's price would be expected to change in response to changes in options time to expiration. Rho is a measure of the amount an option's price would be expected to change in response to changes in interest rates.

Stop Loss Limit

9.94 Stop loss limits can be based on market prices or the losses reflected by those prices. If market prices reach a level where losses on that position equal or are greater than some predetermined limit then the position is closed out.

Management Action Trigger (MAT)

9.95 MAT trigger represents the management's tolerance for accepting the market risk related losses on a daily and cumulative month-to-date basis especially on the trading portfolio.

9.96 The P&L for spot trading are monitored as part of the Spot MAT limit while the P&L forwards trading is monitored within the Interest rate products MAT.

Limit Exceptions

9.97 A limit exception is a trade or position specific authorization to exceed a limit for a defined period of time. All limit exceptions must be approved in advance of establishing a position that would exceed a limit.

9.98 Normally Market Risk Management is responsible for maintaining all documentation of the excess including the agreed upon corrective action and the resolution date and is responsible for the ongoing monitoring of the excess to ensure the corrective action is carried out.

Accounting for forex and derivative transactions

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

9.100 It also enables treasury operations staff to understand the accounting that is peculiar to treasury, such as the 'trading account' and 'base currency' concepts. This is vital as most of the accounting is 'hidden' by being automatically systems generated as a result of deal input of various types. Indeed, this problem is self-perpetuating as the more complex the deals become the more likely a bank will be to automate to prevent errors.

Documentation

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

Rate Reasonability

9.102 The bank's risk department will perform the rate reasonability process as per the Price Verification Policy of the bank and for any transaction that falls outside the band specified, the same should be enquired into for reasons.

Position and P&L Reconciliation

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

Month-end Revaluation

9.104 The month-end revaluation rates are prescribed by FEDAI. At times, the spot rates or forward rates specified are different from the market rate at the time the rates are received by the treasury operations/traders. Where the rates prescribed by FEDAI are significantly off compared with market levels, ideally the risk department of the bank should advise the revaluation rates based on market polling and other sources such as Reuters' etc.

Regulatory Reporting requirements

9.105 Derivatives are governed by the Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000. Derivatives are allowed only under the provisions of these regulations and amendments since, or with the prior permission of the Reserve Bank of India. The reporting requirements under RBI Master Circular No. 5 /2012-13 dated July 2, 2012 on "Risk Management and Inter-Bank Dealings" and RBI Circular No. DBOD. No. BP. BC. 86/21.04.157/2006-07 dated April 20, 2007 on "Comprehensive Guidelines on Derivatives" should be adhere to.

Following are some of the reports to be submitted to RBI:[@]

i) Daily statements of Foreign Exchange Turnover in Form FTD and Gaps, Position and Cash Balances in Form GPB.

ii) Statement of Nostro / Vostro Account balances on a monthly basis.

[@] Revised in 2013 edition.

iii) Consolidated data on cross currency derivative transactions undertaken by residents.

iv) Details of exposures in foreign exchange as at the end of every quarter as per that details of exposures of all corporate clients who meet the prescribed criteria have to be included in the report. The AD banks should submit this report based on bank's books and not based on corporate returns.

v) Details of option transactions (FCY-INR) undertaken on a weekly basis.

v) Total outstanding foreign currency borrowings under all categories as on the last Friday of every month.

vi) Monthly report (as on the last Friday of every month) on the limits granted and utilized by their constituents under the facility of booking forward contracts on past performance basis.

vii) Statement in form BAL giving details of their holdings of all foreign currencies on fortnightly basis through Online Returns Filing System (ORFS).

viii) A monthly statement, in respect of cover taken by FIIs, indicating the name of the FII / fund, the eligible amount of cover, the actual cover taken, etc.

ix) List (in triplicate) of all bank's offices/branches, which are maintaining Rupee accounts of non-resident banks as at the end of December every year.

x) Quarterly report on the forward contracts booked and cancelled by SMEs and Resident Individuals.

xi) Consolidated data on the transactions undertaken by non-residents under the scheme.

xii) Doubtful transactions involving frequent cancellation of hedge transactions and / or the underlying trade transactions by non-residents under the scheme.

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

9.107 Moreover, treasury operations has to provide forms A2 for all interbank cross-currency deals done with overseas banks which matures during a fortnight to the RBI through the R-Return which is submitted on a fortnightly basis.

9.108 Treasury operations also have to submit a report (MAP/ SIR) in the format as prescribed by the RBI. This is required to be prepared for 4 major currencies (i.e. US$, GBP, YEN and CHF). MAP will be prepared for the last reporting Friday of each month.

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

9.110 As per RBI circular FMD.MSRG.No.72/02.05.002/2012-13 dated October 12, 2012, it is decided with effect from November 5, 2012 that following derivative products need to be reported to CCIL by the banks:[@]

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

Valuation of foreign exchange forwards and derivative products

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

[@] Revised in 2013 edition.

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

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

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

Guidance for Arriving at Fair/Market Value

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

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

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

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

FX spot / forwards	Prices as published by Foreign Exchange Dealers Association of India ('FEDAI')
Exchange traded interest rate futures	Prices quoted on the relevant exchange

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

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

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

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

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

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

[@] Revised in 2013 edition.

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

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

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

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

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

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

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

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

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

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

9.132 In an option pricing model, current quotes of forward prices for the underlying (spot prices for American options) and the implied volatility and market interest rate relevant to the option's maturity would normally be used to calculate the market values. Options sold and purchased with the same counter party should not be netted against each other, nor should offsetting bought and sold options on the same underlying.

Audit Approach

9.133 While innovative products and ways of trading create new possibilities for profit, they also introduce novel and sometimes unfamiliar risks that must be identified and managed. Failure to do so can result, and in recent years has resulted, in large and publicized losses entailing financial and reputational consequences that linger long after the loss is recognized in financial statements. Hence, auditor should assess controls as part of audit work.

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

Audit Programming and Procedures

9.135 In framing the audit program, an auditor will need to take into consideration his findings of the adequacy of controls within the processes as explained in this Guidance Note. Reserve Bank of India prescribes concurrent audit /internal audit for a 100% verification of treasury transactions. Hence, the selection of samples can be influenced by the nature, extent and timings of concurrent/internal audit function including the compliance mechanism of the Bank.

The following illustrative audit steps may form part of the audit program:

Product Program and Policy

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

Customer/User Suitability and Appropriateness Policy[@]

9.137 The auditor should obtain approved 'Customer/User Suitability and Appropriateness Policy' and verify that such policy is in line with the comprehensive guidelines and is approved by the Board.

Credit limits

9.138 For the selected samples check whether appropriate credit limits are in place for foreign exchange and derivative transactions.

- Check whether the name of the counterparty is in the approved counterparty list for the purpose of treasury transactions.
- Check whether the credit limits are set for different customers and they are adhered to in a consistent manner and for any limit breaches, appropriate sanctions / ratifications are in place.

[@] Revised in 2013 edition.

- Check whether the counterparty exposure limit reports for all brokers, lenders, etc., are generated and monitored on a regular basis.
- Check dealer limits- Maximum amount a dealer can transact without seeking higher-level approval and sanctions/ratifications for any breaches.
- Check product limits- Maximum exposure the entity should have in a particular instrument or product.
- Check sector limits – Maximum investment in a particular sector (for example, exposures to companies incorporated with limited liability in India).
- For the selected samples confirm and review signed and authorized ISDA agreement, signed and authorized collateral agreement, credit risk assessment of the customer and confirm, whether credit positions are within established limits for each customer.

Deal Initiation and Recording

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

- For the selected samples check whether the deal ticket is complete and accurate with respect to all transaction details like counterparty name, contract rate, notional amount, transaction date / maturity date, value date / settlement agent and buy / sell date.
- Check whether deal tickets are generated automatically by front office systems, or trader should use sequentially numbered deal tickets.
- Check whether the dealers use dedicated calling lines and all the telephone lines are linked to a voice recording machine.

Deal Authorisation

9.140 Following audit procedures may be followed by an auditor while checking the procedures for deal authoritisation.

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

- Examine the selected deals from the front office and establish that they are confirmed by the back office operations.
- Check that all sampled deals are authorised at the proper levels of authority against the deal slip.
- Check whether alterations and cancellations on deal slips are duly authorised.

Segregation of Duties

9.141 For this, the audit procedure may include:

- Checking and ascertaining that segregation of duties is in place. Under no circumstances staff involved in initiating deals be involved in checking or receiving deal related documents.
- Verifying that there is clear segregation, functionally and physically, between the front office, back office and middle office in respect of derivative transactions.[@]
- Checking that there is segregation between functions of authorisation, execution and recording of transactions.
- In cases where management override has taken place, ensure that satisfactory reasons for doing so were recorded and produced for audit verification.
- Checking whether treasury personnel have availed minimum leave during the financial year.

Counterparty confirmations

9.142 For this, the auditor would inter alia:

- Verify that confirmations from Bank to counterparty are sent within a reasonable time and there exists a mechanism for follow-ups for pending counterparty confirmations.
- Determine the status of any missing / pending confirmations (currently in the Confirmation Tracking List) and assess whether there are any provisioning concerns on the trades
- Check whether the format of the counterparty confirmation is as approved by the Local Legal Counsel of the Bank from time to time.
- Verify controls implemented by banks to ensure completeness of all deal confirmations.[@]

[@] Revised in 2013 edition.

- Inquire of any exception report or other mechanism of tracking missing confirmations.@

Accounting of transaction in the general ledger

9.143 The audit procedures for this aspect include:

- Checking whether there is a direct hands-off between front end system and the accounting system for passing accounting entries in the general ledger.
- Checking whether correct accounting entries are recorded in the general ledger and the back office regularly reviews the accounting entries passed in the general ledger.
- Checking whether the treasury department generates a daily P&L (desk-wise) and same has been reviewed and compared to the general ledger to identify any mismatches.

Position Reconciliation

9.144 The audit procedures include:

- Checking whether daily position reconciliations are performed between front office deal positions and back office deal positions by the treasury back office and position differences if any are appropriately enquired into.
- Checking whether the Bank maintains customer wise, currency wise and deal wise positions on a daily basis in-order to monitor customer limit breaches and sectoral limit breaches.

Deal Settlements

9.145 The audit procedures include:

- Checking whether there exists effective mechanism for settlement of deals on due date and whether deals due for settlement are generated on a daily basis by back office.
- Examining whether customer intimations are sent across as soon as the deal is settled and the respective customer accounts are debited / credited.
- Examining whether the Settlement desk ensures proper settlement of funds through CCIL/RTGS/SWIFT networks. Any deal rejected by CCIL should be examined and settlement through any other means should be taken up only after thoroughly examining the deal/deal confirmation as in most of the cases the rejection is on account of improper deal entry.

Rate Scan

9.146 The audit procedures for this would include:

- Checking whether for the selected deals the rates taken are the prevailing rates in the market at the time of striking the deal.
- Checking whether in outright deals the back office checks the rate scans for the veracity of the rate at which the dealer has struck the deal. Any deviation should be enquired into Compliance with Accounting Standard (AS) 11.

***Assessment of controls*[@]**

9.147 The audit procedure may include existence and assessment of controls including:

- Existence of comprehensive treasury policy and operating procedures manual (SOP).
- Review of the policies and procedures document and assess comprehensiveness of the same.
- Determining whether the above document addresses, in granular detail, the framework within which the treasury business and operations have to be conducted.
- Inquiring on the procedures the bank has when there is a change over or new appointment to a 'review' role within the treasury function.
- Understanding the level of detail in which the process of, i.e., handover of responsibilities operates.
- Inquiring whether there has been any change in responsibilities in the current period and in case there are changes, verifying whether there is an appropriate training mechanism and whether signoffs have been regularized after the new superior has taken over the responsibilities.
- On a test check basis, verifying whether the review process and controls were working effectively during the transition period.
- Obtaining and reviewing on test check basis, the daily Profit and Loss prepared for MIS purpose and assessing the granularity and exhaustiveness of the same;
- Assessing whether such Profit and Loss is granular enough to provide desk wise, product wise and various price component wise Profit and Loss.

[@] Revised in 2013 edition.

- Assessing whether gross position reviews are undertaken and also whether such Profit and Loss are prepared and reviewed at a gross trade level.
- Reviewing the Bank's policy on Valuation. On a test check basis, verifying whether the material valuation adjustments are reviewed, authorized and are appropriate.
- Verifying whether these valuation adjustments are disclosed / visible in the reconciliation.
- Assessing whether there is an independent 'Valuation Control' team.
- Checking whether dealers have access to adjust or modify trade values .
- Checking whether the reconciliations are prepared on a timely basis and the un-reconciled items are independently inquired by the back office.
- Reviewing the ageing and quantum of the un-reconciled items and inquire for the high value and long outstanding reconciling items.
- Assessing whether the escalations are done in a timely manner for the large / unusual / recurring reconciliation items.

Market Risk System@

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

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

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

@ Revised in 2013 edition.

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

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

Breaches of the net delta limits@

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

Failure to identify and escalate risk issues@

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

Quality of supervision@

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

Temporary discontinuance of a process or control@

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

@ Revised in 2013 Edition

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

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

Outsourced/Hubbed process@

- Reviewing the Service Level Agreements (SLA's) and agreements with such agencies and verify the robustness of the controls that reside in house in the bank to review and understand the work undertaken at outsourced / hub locations.
- Reviewing and verifying the documentary evidence of the communication the bank has with these agencies on a regular basis.

Guarantees Against Exports

9.148 Guarantees against exports may be verified having regard to following issues:

- Caution listed exporters – RBI's prior approval to be obtained.
- Whether the guarantee is for performance, bid, advance payments.
- Whether legal department (or the Credit Department) has approved the issue.
- Counter guarantees on performance, advances payment whether obtained a premium remitted to them promptly.
- Collection of commission and accounting for the same, at bank's selling.
- Accounting entries at the BC selling rate since the foreign exchange outflow will be effected, if the guarantee gets invoked.
- FEMA chapter deals with the instances where guarantees are not to be issued.
- Risk weight assessment and capital adequacy.

NOSTRO and VOSTRO Accounts

9.149 A fundamental feature of foreign exchange transactions is that the useful possession of any currency can be had only in the country in which it is a legal tender or countries in which it is circulated. (e.g. US Dollar is widely circulated in Russia, CIS countries). Therefore, in order to be able to put through foreign exchange transactions, banks normally maintain stocks of foreign currencies in the form of bank accounts (usually current accounts) with their overseas branches/correspondents. Such a foreign currency account maintained by a bank at an overseas centre is usually designated by it as

'NOSTRO Account' (i.e. "Our account with you"). Thus, banks in India may maintain a pound-sterling account with its London office/correspondent; such account would be called by it as NOSTRO Account. Conversely, if a foreign bank is to deal in a local currency of another country, it would maintain a 'VOSTRO Account' (i.e. 'your account with us') with the local bank, e.g. a bank in England may maintain a 'VOSTRO Account' in Indian Rupee with a correspondent bank in India. A VOSTRO account is in substance no different from any other account in the local currency.

NOSTRO / VOSTRO Reconciliation

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

9.151 The auditor may consider the following points in respect of NOSTRO reconciliation:

- Periodical reconciliation in place.
- Information to the controlling office.
- Long outstanding whether taken up and reconciled.
- Random check of the method of reconciliation.
- Debits outstanding both in the mirror account and in the Nostro accounts are to be verified and recommend for provision wherever necessary.
- Set off the credit against debits only at the permission of the head office for long outstanding entries.

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

(i) the net credit balance arising out of the netting of entries pertaining to the period prior to April, 1996; and

(ii) credit entries originated on or after April 1, 1996 and remaining unreconciled in NOSTRO/ mirror accounts for more than three years.

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

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

9.155 The audit considerations for this aspect include:

- Examining whether currency wise nostro / vostro reconciliation is performed on a day-to-day basis and check for long outstanding items.
- Checking whether there exists a policy of following up for outstanding reconciliation items with the counterparties or with the respective banks.
- Outstanding debit items over 90 days attract provisioning under RBI provisioning norms.

Evaluation of Internal Audit/Concurrent Audit

9.156 The audit consideration for this aspect include:

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

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

Risk Management[@]

9.157 The audit consideration for this aspect include:

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- Checking whether the bank has adequate risk management process, sound risk measurement procedures, sound information systems, continuous risk monitoring and frequent management reporting for treasury operations.
- Examining whether the mid-office monitors the exchange and gap positions for cut loss limits, overnight limits, daylight limit, liquidity, counterparty exposure limit and aggregate gap limit fixed in the banks trading policy/ guidelines.
- Reviewing the adequacy and effectiveness of the overall risk management system, including compliance with policies, and procedures.
- Investigating unusual occurrences such as significant breaches of limits, unauthorized trades and unreconciled valuation or accounting differences.
- Inquiring whether there is a 'New Product Approval' process prior to undertaking transactions in new or structured derivative products and verifying whether the 'New Product Paper' for all new derivative products is approved and signed-off by the Chief Compliance Officer of the bank.
- Obtaining the 'Risk Management Policy' of the bank and verifying whether risk management pertaining to derivative transactions is an integral part of the policy.
- Verifying that the 'Risk Management Policy' for derivative transactions has been approved by the Board. Verifying that the policy *inter alia* covers the following aspects:
    (i). Defines the approved derivative products and the authorized derivative activities;
    (ii). Details requirements for the evaluation and approval of new products or activities;
    (iii). Ensures appropriate structure and staffing for the key risk control functions, including internal audit;
    (iv). Establishes management responsibilities;
    (v). Identifies the various types of risks faced by the bank and establish a clear and comprehensive set of limits to control these;
    (vi). Establishes risk measurement methodologies which are consistent with the nature and scale of the derivative activities;
    (vii). Requires stress testing of risk positions;
    (viii). Details the type and frequency of reports for monitoring risks which are submitted to the Board (or committees of the Board);
    (ix). Typical risks and commonly used risk limits in respect of derivative transactions.

Information Technology ('IT') Controls

9.158 IT Controls include:

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

- Determine whether the bank has removed/reset default profiles and passwords from new systems and equipment and determine whether access to system administrator level is adequately controlled.
- Check whether the data hands off process from one product processor to another or to any other system is conducted under a secure environment and without or with least but controlled manual intervention.

Valuation of FX contracts and Derivatives

9.159 Valuation of FX contracts and Derivatives is as follows:

- For spot and tom contracts check whether correct FEDAI rates are used by the Bank for marking them to market. In case of automatic feed of FEDAI rates, verify whether the rates are correctly uploaded into the system.
- Re-perform and check on a sample basis the accuracy of the MTM gain / loss booked by the bank on the outstanding forex contract.

9.160 In case of valuations of swaps, options and other derivative products most of the banks have proprietary valuation models developed by them or standard valuation software installed. In case of proprietary valuation models a model validation coupled with checking of input parameters would provide reasonable comfort on valuations. In case of standard valuation models auditors can resort to checking of input parameters along with limited re-performance of derivative valuations.

III-10

Profit and Loss Account

10.01 Sub–section (1) of section 29 of the Banking Regulation Act, 1949, requires the preparation of Profit and Loss Account in Form B of Third Schedule to the Act or as near thereto as the circumstances admit. This sub–section is applicable to Banking Companies, Nationalised Banks, State Bank of India and its Subsidiaries, and Regional Rural Banks.

Disclosures

10.02 The Profit and Loss Account as set out in Form B has four broad heads:

- Income
- Expenditure
- Profit/ Loss
- Appropriations

The information to be provided under each of the above heads is also specified in the Schedule.

Applicability of AS 5 and Materiality

10.03 Accounting Standards are intended to apply only to items that are material. Since materiality is not objectively defined, RBI, vide its Circular No. DBOD.No.BP. BC. 89 /21.04.018/2002-03 dated March 29, 2003 on "Guidelines on compliance with Accounting Standards (AS) by banks", has advised that all banks should ensure compliance with the provisions of accounting standards in respect of any item of prior period income or expenditure, which exceeds one per cent of total income/ total expenditure of the bank if the income or expenditure is reckoned on gross basis or one per cent of the net profit before taxes or net losses as the case may be if the income is reckoned on net of costs.

10.04 Since the format of the profit and loss accounts of banks prescribed in Form B under Third Schedule to the Banking Regulation Act 1949 does not specifically provide for disclosure of the impact of prior period items on the current year's profit and loss, such disclosures, wherever warranted, may be made in the Notes on Accounts to the balance sheet of banks.

Interest Earned

10.05 The following items are included under this head:

(a) *Interest/Discount on Advances/Bills:* This includes interest and discount on all types of loans and advances like cash credit, demand loans, overdrafts, export loans, term loans, domestic and foreign bills purchased and discounted (including those rediscounted), overdue interest and interest subsidy, if any, relating to such advances/bills. The amount to be included under this head is net of the share of participating banks under inter–bank participation schemes on risk–sharing basis.

(b) *Income on Investments:* This includes all income derived from the investment portfolio by way of interest and dividend, except income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India.

(c) *Interest on Balances with RBI and Other Inter–bank Funds:* This includes interest on balances with Reserve Bank and other banks, call loans, money market placements, etc.

(d) *Others:* This includes any other interest/discount income not included in the above heads. Interest on advances given by the bank to staff member in its capacity as employer rather than as banker should be included under this head.

Income from Investments

10.06 Interest and dividend on investments is usually accounted for at the head office. Such interest and dividend, therefore, may not appear in the profit and loss account of a branch. The related audit procedures described below would be relevant only in cases where interest/ dividend on investments is recorded at the branch under audit. Similarly, since only a few designated branches maintain accounts with RBI or are authorised to lend money at call and short notice, this item would appear in the profit and loss accounts of such branches only.

Other Income

10.07 The following items are included under this head:

(i) *Commission, Exchange and Brokerage: This item comprises of the following:*

- (a) Commission on bills for collection.
- (b) Commission/exchange on remittances and transfers, e.g. demand drafts, telegraphic transfers, etc.
- (c) Commission on letters of credit and guarantees, letter of comforts.

(d) Rent from letting out of lockers.[3]

(e) Commission on Government business.

(f) Commission on other permitted agency business including consultancy and other services.

(g) Brokerage on securities.

(h) Fee on insurance referral

(i) Commission on referral of mutual fund clients

(j) Income from rendering other services like custodian, demat, investment advisory and other fee based services, etc.[@]

(ii) *Profit on Sale of Investments:* Investments are dealt in the course of banking activity and hence the profit or loss in sale of investments are taken to Profit & Loss account. As investments are dealt with at the head office level, this item will not appear in the profit and loss account of a branch. This is derived by deducting loss on sale of investments from Profit on sale of Investment..

(iii) *Profit/Loss on Revaluation of Investments:* In terms of guidelines issued by RBI, investments are to be valued at periodical intervals and depreciation or appreciation in valuation should be recognised under this head. As investments are dealt with at the head office level, this item will not appear in the profit and loss account of a branch. This is derived by deducting loss from profit on revaluation of investments.

(iv) *Profit on sale of Land, Buildings and Other Assets:* This item includes profit (net of any loss) on sale of land, buildings, furniture, motor vehicles, gold, silver, etc.

Profit/Loss on Revaluation of Fixed Assets

10.08 According to the Notes and Instructions for compilation of profit and loss account, issued by the RBI, the net profit/loss on revaluation of the aforesaid assets may also be shown under this item. In this regard, the requirements of AS 10, *Accounting for Fixed Assets*, relating to revaluation of fixed assets assume significance. According to the accounting standard, when a fixed asset is revalued in financial statements, the entire class of assets should be revalued, or the selection of assets for revaluation should be made on a systematic basis. It is also provided that an increase in net book value

[3] As per the Notes and Instructions for compilation of the profit and loss account, issued by the Reserve Bank, this item should come under this head. There is, however, a contrary view in some quarters that locker rent should be included in miscellaneous income. The latter view seems more plausible.

[@] Revised in 2013 edition.

arising on revaluation of fixed assets should be credited directly to owners' interests under the head of revaluation reserve. However, if such increase is related to and not greater than a decrease arising on revaluation which was previously recorded as a charge to the profit and loss account, it may be credited to the profit and loss account. On the other hand, any decrease in net book value arising on revaluation of fixed assets should be charged directly to the profit and loss account except that to the extent that such a decrease is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it may be charged directly to revaluation reserve account.

10.09 From the above, it can be seen that as per AS 10, surplus on revaluation of a fixed asset cannot be credited to the profit and loss account except to the extent that such surplus represents a reversal of a related previous revaluation decrease that was charged to the profit and loss account.

Profit on Exchange Transactions

10.10 This item includes profit (net of loss) on dealings in foreign exchange. All income earned by way of foreign exchange commission and charges on foreign exchange transactions except interest are to be included under this head. As foreign exchange transactions take place only at a few select branches of a bank, this item may not appear in the profit and loss accounts of all branches.

The audit procedures in this regard would include:

a) Checking that the year–end outstanding entries are translated/restated at appropriate rates of exchange as communicated by the Controlling authority, for recording profit/ loss on exchange transactions. After the introduction of CBS, this would be a systems driven adjustment. However independent verification of the rate, successful running of the patch etc. needs to be done.[@]

b) Testing of the large transactions and check whether these are recorded in compliance with the directions of the controlling authority.

c) Scrutinising transactions recorded in the post–Balance sheet period to ensure that no material items have been ignored upto the year end.

d) Enquiring into unusually large transactions / entries involving huge gains/ losses for the year.

[@] Revised in 2013 edition.

Income Earned by Way of Dividends, etc., from Subsidiaries and Joint Ventures Abroad/ in India

10.11 It may be noted that any income derived from the investment portfolio by way of interest and dividend is not to be included under this head but under the sub–head 'income on investments' under the head 'interest earned'. As investments are usually dealt with at the head office level, this item may not appear in the profit and loss account of a branch.

Miscellaneous Income

10.12 This head generally includes following items of income:

(a) recoveries from the constituents for godown rents;

(b) income from bank's properties;

(c) security charges;

(d) insurance charges recoverable from customers, etc.

(e) rent- The auditor can ascertain whether any premises or part thereof is let out, and, if, so, whether rent recoveries are recorded upto the year–end at the rates as applicable.

The auditor may verify various items of miscellaneous income in the same manner as in the case of other entities.

10.13 The Notes and Instructions for compilation of profit and loss account, issued by the Reserve Bank, require that in case any item under this head exceeds one per cent of the total income, particulars thereof may be given in the notes.

Expenses

10.14 Expenditure is to be shown under three broad heads: interest expended; operating expenses; and provisions and contingencies.

Interest Expended

10.15 The following items are included under this head:

(a) *Interest on Deposits:* This includes interest paid/ payable on all types of deposits including deposits from banks and other institutions and also brokerage paid by the bank on deposits.

(b) *Interest on Reserve Bank of India/ Inter–Bank Borrowings:* This includes interest/ discount on all borrowings and re–finance from the RBI and other banks.

(c) *Others:* This includes discount/ interest on all borrowings/ re–finance from financial institutions. All other payments like interest on participation

certificates, penal interest paid, etc. may also be included here.

10.16 RBI, *vide* its circular no. DBOD.Dir.BC.42/13.03.00/2011-12 dated October 25, 2011 (as amended by RBI's Circular No. DBOD.Dir.BC.75/13.03.00/2011-12 dated 25th January 2012), has deregulate the savings bank deposit interest rate. In other words, the banks are now free to determine their savings bank deposit interest rate, subject to the following two conditions:

- Each bank will have to offer a uniform interest rate on savings bank deposits up to Rs.1 lakh, irrespective of the amount in the account within this limit.
- For savings bank deposits over Rs.1 lakh, a bank may provide differential rates of interest, if it so chooses, subject to the condition that banks will not discriminate in the matter of interest paid on such deposits, between one deposit and another of similar amount, accepted on the same date, at any of its offices.
- The interest rates applicable on the domestic savings deposit will be determined on the basis of end-of-day balance in the account. Accordingly, while calculating interest on domestic savings bank deposits, banks are required to apply the uniform rate set by them on end-of-day balance up to Rs. 1 lakh and for any end-of-day balance exceeding Rs.1 lakh, banks may apply the differential rate(s) as fixed by them.
- Banks may ensure that interest rate is applied, as stated above, on the end-of-day balances of all domestic savings deposits accounts and no discrimination is made at any of its offices.
- Prior approval of the Board/Asset Liability Management Committee (if powers are delegated by the Board) may be obtained by a bank while fixing interest rates on such deposits.

10.17 These Guidelines are applicable only to savings bank deposits of resident Indians.

10.18 Further, *vide* its Circular No. DBOD.Dir.BC.64/13.03.00/2011-12 dated 16th December 2011,RBI has also deregulated the interest rates on Non Resident (External) Rupee Deposits and Ordinary Non-Resident (NRO) Accounts as follows:

- Banks are free to determine their interest rates on both savings deposits and term deposits of maturity of one year and above under Non-Resident

(External) Rupee (NRE) Deposit accounts and savings deposits under Ordinary Non-Resident (NRO) Accounts. However, interest rates offered by banks on NRE and NRO deposits cannot be higher than those offered by them on comparable domestic rupee deposits.

- Prior approval of the Board/Asset Liability Management Committee (if powers are delegated by the Board) needs to be obtained by a bank while fixing interest rates on such deposits. At any point of time, individual banks need to offer uniform rates at all their branches.
- The revised deposit rates apply only to fresh deposits and on renewal of maturing deposits.
- Banks also need to closely monitor their external liability arising on account of such deregulation and ensure asset-liability compatibility from systemic risk point of view.

Operating Expenses

10.19 The following items are included under this head:

(i) *Payments to and Provisions for Employees:* This item includes salaries and wages of staff, allowances, bonus, other staff benefits like provident fund, pension, gratuity, leave fare concession, staff welfare, medical allowance to staff, etc. It may be noted that provision for terminal benefits like pension and gratuity is usually made only at the head office level. Salaries and allowances payable to the bank's staff and officers are usually governed by agreement with the employee unions or awards of a judicial tribunal. While verifying expense under this head, the provisions of circular DBOD.No. BP.BC.80/ 21.04.018/ 2010-11 February 9, 2011, on Incremental employee benefit liability on account of Re-opening of pension option to employees of Public Sector Banks and enhancement in gratuity limits should be kept in mind.[@]

(ii) *Rent, Taxes and Lighting:* This item includes rent paid by the bank on buildings, municipal and other taxes, electricity charges and other similar charges and levies. It may be noted that income-tax and interest tax are not to be included under this head. Similarly, house rent allowance and other similar payments to staff would not appear under this head.

(iii) *Printing and Stationery:* This item includes books and forms and stationery used by the bank and other printing charges except those

[@] Revised in 2013 edition.

incurred by way of publicity expenditure. While some stationery may have been purchased by the branch, other stationery (particular security paper like draft forms, cheque books) would have been received by the branch from the head office.

(iv) *Advertisement and Publicity:* This item includes expenditure incurred by the bank for advertisement and publicity, including printing charges of publicity material.

(v) *Depreciation on Bank's Property:* This item includes depreciation on bank's own property, motor cars and other vehicles, furniture, electrical fittings, vaults, lifts, leasehold properties, non-banking assets, etc. Depending on the procedure followed in the bank, provision for depreciation may be either centralised at the head office level through fixed asset management software or decentralized and manual at branches and other offices.@

(vi) *Directors' Fees, Allowances and Expenses:* Expenditure incurred in this regard are recorded under this head. This item is dealt with at the head office level and would not therefore be relevant at the branch level.

(vii) *Auditors' Fees and Expenses:* Remuneration payable to Statutory Auditors and Branch auditors and expenses in connection with audit like reimbursements are recorded under this head. This item is usually dealt with at the head office level and would not therefore be relevant at the branch level.

(viii) *Law Charges:* All legal expenses and reimbursement of expenses incurred in connection with legal services are to be included here.

(ix) *Postage, Telegrams, Telephones, etc.:* This item includes all postal charges like stamps, telegrams, telephones, teleprinters, etc.

(x) *Repairs and Maintenance:* This item includes repairs to bank's property, their maintenance charges, etc.

(xi) *Insurance:* This item is usually dealt with at the head office level and may not therefore be relevant at the branch level.

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(xii) *Other Expenditure:* This item includes all expenses other than those included in any of the other heads, like, licence fees, donations[4], subscriptions to papers, periodicals, entertainment expenses, travel expenses, etc. The Notes and Instructions for compilation of profit and loss account, issued by the Reserve Bank, require that in case any particular item under this head exceeds one per cent of the total income, particulars thereof may be given in the notes.

Provisions and Contingencies

10.20 This item represents the aggregate of the provisions made in respect of the following:

(a) Non–performing assets

(b) Taxation

(c) Diminution in the value of investments

(d) Provisions for contingencies

The most important item included in this head is the provision in respect of non–performing assets. The other provisions are usually made at the head office level.

Appropriations

10.21 Under this head, the net profit/ loss for the year as well as profit/ loss brought forward have to be shown. The appropriations of the aggregate thereof are to be shown under the following heads:

(a) Transfer to Statutory Reserves

[4] The Reserve Bank of India, from time to time, prescribes the limits up to which banks can make donations. As per the Reserve Bank of India's circular no. DBOD. No. Dir. BC. 50/ 13.01.01/ 2005–06 dated December 21, 2005, the policy relating to donations given by banks to various entities may be formulated by the Board of Directors of the banks. While formulating any such policy, the circular requires the directors to take into account *inter alia,* the following principles:

(i) profit making banks, during a financial year, may make donations upto one percent of the published profits for the previous years. This limit of one percent would include contributions made by the bank to any fund created for specific purposes such as encouraging research and development. However, donations/ subscriptions to the Prime Minister's National Relief Fund and to professional bodies related to banking industry, such as the Indian Banks Association, Indian Institute of Banking etc., is excluded from such limit of one percent.

(ii) loss making banks can make donations upto Rs. 5 lakhs in a financial year including donations to the Prime Minster's National Relief Fund and other professional organisations listed in (i) above.

The circular has clarified that the unutilised portion of one percent cannot be carried forward to the next year. The Circular also outlines the procedure for making contribution to the Prime Minister's National Relief Fund.

(b) Transfer to Capital Reserves
(c) Transfer to Investment Fluctuation Reserve
(d) Transfer to Debenture Redemption Reserve
(e) Transfer to other reserves
(f) Transfer to government/ proposed dividend
(g) Transfer to Tax on Dividend

10.22 The appropriations of profits are decided at the head office level. This item would not therefore appear in the profit and loss account at the branch level. The central statutory auditor should therefore verify compliance with the statutory requirement regarding transfers to reserve accounts and the other appropriation as applicable will have to be taken into consideration while verifying these.

Audit Approach and Procedure

Income

10.23 In carrying out an audit of income, the auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transactions, which took place during the relevant period and pertain to the bank, that there is no unrecorded income, and that income is recorded in proper amounts and is allocated to the proper period. In view of the mandatory requirement of recognition of income, the recognition of revenue will have to be subjected to examination *vis-à-vis* the guidelines.

Interest Income

10.24 As a measure of control and also to ensure that the legal remedies against defaulting borrowers are not adversely affected, banks commonly follow the procedure of recording interest on non–performing advances in a separate account styled as 'Interest Suspense' or other similar account. Amounts lying in Interest Suspense Account do not represent income of the bank and have also to be deducted from the relevant advances. The auditor should also check whether, in terms of the income recognition guidelines issued by the RBI, the bank has either reversed or made provision in respect of interest accrued and credited to income account, in respect of an advance (including bills purchased and discounted) that becomes NPA as at the close of any year.

10.25 In case of accounts under Corporate Debt Restructuring (CDR) scheme, the auditor should see whether the income on projects under implementation which have been classified as standard has been accounted for on accrual basis pursuant to the RBI's income recognition norms. Banks are not permitted to recognize income on accrual basis from projects under implementation which have been classified as ‘sub–standard’ asset. Bank may recognize income in such accounts only on realisation on cash basis. Income in respect of Funded Interest and where loans are converted into Equity, debentures or any other instrument is to be recognized on the same basis as in the case of Restructuring and Reschedulement of Loans.

10.26 The said norms also require that the banks should not recognise income from those projects under implementation which have been classified as sub standard and it should be recognised only on cash basis. The auditor should also, accordingly, see whether any interest on such projects which has been recognised as income in the past is either reversed or a provision for an equivalent amount is made in the accounts.

10.27 The auditor may assess the overall reasonableness of the figure of interest earned by working out the ratio of interest earned on different types of assets to the average quantum of the respective assets during the year. For example, the auditor may obtain from the bank an analysis of sector–wise deployment of credit, including the lending rates of advances in various sectors and figures of advances outstanding at the end of each quarter. From such information, the auditor may work out a weighted average lending rate. The auditor may then compare this rate with the actual yield on advances as per the annual accounts and enquire into the difference, if material (Analytical procedures on income & expenses items such as interest will be most effective if returns are calculated on the basis of average daily or at least monthly balance information). The auditor may also compare the average yield on advances with the corresponding figures for the previous years and analyse any material differences. Similarly, the auditor may also compare the reported interest yields in percentage terms with 1) Market rates 2) RBI rates 3) Advertised Rates and 4) Rates across various products of the respective bank. Similarly, the auditor may co–relate the interest on different types of investments to the average quantum of the respective interest–bearing investments and the dividend to the average quantum of the investment in shares (separately for preference shares and equity shares) and assess the reasonableness of the resultant ratios in the context of the coupon rates of interest/ rates of preference dividend, corresponding yield in the previous years, etc

10.28 As per Accounting Standard (AS) 9, “Revenue Recognition”, income is recognised on accrual basis, i.e., as it is earned. It is an essential condition for accrual of Income that it should not be unreasonable to expect its ultimate collection. In view of the significant uncertainty regarding ultimate collection of

Income arising in respect of NPA, banks should not recognize interest on NPA until it is actually received. Further, recognition of interest should be deferred where there is uncertainty regarding its collection.

10.29 These norms are also applicable to all Government guaranteed accounts, i.e., if Government guaranteed advances become NPA, interest on such advances should not be taken to income account unless interest has been realised.

10.30 The auditor should, on a test check basis, verify the rates of interest as per terms of sanction in the CBS as well as the calculation of interest through product rate sheets generated by CBS[@] to satisfy himself that –

(a) Interest has been charged on all the performing accounts upto the date of the balance sheet;

(b) Interest rates charged are in accordance with the bank's internal regulations, directives of the RBI and agreements with the respective borrowers. The scrutiny of interest rates charged is particularly important in the case of advances made on floating interest rate basis;

(c) Discount on bills outstanding on the date of the balance sheet has been properly apportioned between the current year and the following year;

(d) Interest on inter–branch balances has been provided at the rates prescribed by the head office; and

(e) Any interest subsidy received (or receivable) from RBI in respect of advances made at concessional rates of interest is correctly computed.

10.31 The auditor should also satisfy himself that interest on non–performing assets has not been recognised unless realised.

10.32 Dividends received should be checked with reference to counterfoils of dividend warrants. As per AS 9, "*Revenue Recognition*", dividends should be recognised when the right to receive payment is established, i.e., dividend has been declared by the corporate body at its Annual General Meeting and the owner's right to receive payment is established.

Income on Investments has been explained in detail in Chapter 2 of the Part III of the Guidance Note.

10.33 In determining the extent of sample checking, the auditor should take into account, *inter alia*, the results of the analytical procedures and the reports, if any, on income and expenditure/ revenue audit as well as other internal and RBI

[@] Revised in 2013 edition.

inspection reports. The auditor's assessment of the effectiveness of concurrent audit would also affect the extent of his detailed checking of interest earned. In determining the extent of sample checking, the auditor may place greater emphasis on examining interest on large advances.

10.34 The auditor may check the items of commission, exchange and brokerage on a test check basis. The auditor should examine whether the commission on non–funded business (e.g., letters of credit, guarantees and bills for collection) has been properly apportioned between the current year and the following year.

10.35 The auditor should also check whether any fees or commission earned by the banks as a result of re–negotiations or rescheduling of outstanding debts has, in terms of the income recognition guidelines issued by the RBI, have been recognised on an accrual basis over the period of time covered by the re–negotiated or rescheduled extension of credit.

10.36 According to the guidelines for income recognition, asset classification, etc., issued by the RBI, if interest income from assets in respect of a borrower becomes subject to non accrual, fees, commission and similar income with respect to same borrower that have been accrued should cease to accrue for the current period and should be reversed or provided for with respect to past periods, if uncollected. The auditor should examine whether the bank has accordingly made suitable adjustments for de–recognition/ reversal of uncollected commission, etc.

10.37 Fee on insurance referral is fast emerging as a major source of income for banks. In terms of the RBI Master Circular No. DBOD. No.FSD.BC 24/24.01.001/2012-13 dated July 2, 2012 on para banking activities, banks are permitted to undertake insurance business as agents of insurance companies on fee basis or referral arrangement without any risk participation subject to the conditions prescribed under the Master Circular. The auditor should carefully examine the agreement entered into by the bank and the concerned insurance company to see the basis for calculation of the said fee, time when the referral fees becomes due to the bank. Normally, as an industry practice, such agency arrangements also contain clauses known as "claw back" of agency fee, whereby if the client referred to the insurance company by the bank fails to pay the insurance premium for a stipulated amount of time, the agency fees paid or due to the bank becomes recoverable from the bank or is frozen. Such clauses have a direct impact on the recognition of income from the agency fees in terms of Accounting Standard 9, Revenue Recognition and may therefore; require creation of a corresponding provision in the accounts.

10.38 *Profit on Sale of Investments:* Investments are dealt in the course of banking activity and hence the profit or losses in sale of investments are taken to Profit & Loss account. As investments are usually dealt with at the head office level, this item may not appear in the profit and loss account of a branch.

10.39 *Profit/ Loss on Revaluation of Investments:* In terms of guidelines issued by RBI investments are to be valued at periodical intervals and depreciation or appreciation in valuation is to be recognised under this head. As investments are usually dealt with at the head office level, this item may not appear in the profit and loss account of a branch.

10.40 *Profit on sale of Land, Buildings and Other Assets:* This item includes profit (net of any loss) on sale of land, buildings, furniture, motor vehicles, gold, silver, etc.

10.41 The auditor can check authority for disposal of:

- fixed assets, if any, sold during the year under audit; and
- non banking assets acquired in satisfaction of claims.

The auditor should also vouch transactions in evidence of profit/ loss recorded by the Branch in respect of assets, as aforesaid.

Profit/ Loss on Revaluation of Fixed Assets

10.42 The auditor should satisfy himself about the appropriateness and proper application of the basis of revaluation of fixed assets adopted by the bank. Where revaluation is based on an appraisal / report / certificate by approved valuers, the auditor should examine the appraisals to the extent possible and satisfy himself about their adequacy for audit purposes.

10.43 The revaluation of fixed assets can be done on the basis of appraisals by competent valuers such as engineers or architects, or on the basis of indexation of historical cost, or with reference to current prices. The auditor should satisfy himself about the appropriateness and proper application of the basis of valuation adopted by the bank. Where revaluation is based on an appraisal by valuers, the auditor should examine the appraisals to the extent possible and satisfy himself about their adequacy for audit purposes.

10.44 The auditor should also examine that the bank has complied with the provisions of AS 28, Impairment of Assets. In terms of paragraph 58 of AS 28, an impairment loss should be immediately recognised as an expense in the Profit and Loss Account immediately, unless the asset is carried at revalued amount in accordance with AS 10. In such a case, any impairment loss of a revalued asset should be treated as a revaluation decrease under AS 10.

10.45 The Notes and Instructions for compilation of profit and loss account, issued by the Reserve Bank, require that in case any item under this head exceeds one per cent of the total income, particulars thereof may be given in the notes.

10.46 The auditor may assess the overall reasonableness of the amount of interest expense by analysing ratios of interest paid on different types of deposits and borrowings to the average quantum of the respective liabilities during the year. For example, the auditor may obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material. The auditor may also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences.

10.47 The auditor should, on a test check basis, verify the calculation of interest. He should satisfy himself that –

(a) interest has been provided on all deposits and borrowings upto the date of the balance sheet; and verify whether there is any excess or short credit of material amount.

(b) interest rates are in accordance with the bank's internal regulations, of the RBI directives, and agreements with the respective depositors;

(c) in case of Fixed Deposits it should be ensured that the Interest Rate in the accounting system are in accordance with the Interest Rate mentioned in the Fixed Deposit Receipt/ Certificate.

(d) interest on Savings Account should be checked on a test check basis in accordance with the rules framed by the bank in this behalf.

(e) discount on bills outstanding on the date of the balance sheet has been properly apportioned between the current year and the following year;

(f) payment of brokerage is properly authorised; and

(g) interest on inter–branch balances has been provided at the rates prescribed by the head office.

(h) interest on overdue/ matured term deposits should be estimated and provided for.

Expenditure

Operating Expenses

10.48 Generally the audit procedures followed by auditors in any entity are to be followed.

Payments to and Provisions for Employees

10.49 The auditor should ascertain the procedure followed by the bank in this regard while verifying this item.

10.50 The auditor should check the calculation of salaries and allowances, etc. on a test check basis with reference to relevant agreements/ awards. He may also assess the reasonableness of expenditure on salaries, allowances, etc. by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.

Rent, Taxes and Lighting

10.51 The auditor may check the following on a test check basis:

- Rent paid and verify whether adjustments have been made for the full year on account of rent at the rates as applicable and as per agreement in force.
- Rent does not include House Rent Allowance to employees.
- Whether municipal rates/ taxes are duly paid/ adjusted for the year under audit.
- Enquire whether any disputed liability exists on this account upto the year–end.

Printing and Stationery

10.52 The auditor should verify this item with reference to documents evidencing purchase/ debit note received.

Advertisement and Publicity

10.53 Expenditure incurred by the bank for advertisement and publicity, including printing charges of publicity material be verified with the documents.

Depreciation on Bank's Property

10.54 The auditor should ascertain the exact procedure followed by the bank while verifying this item.

10.55 This item includes depreciation on bank's own property, motor cars and other vehicles, furniture, electrical fittings, vaults, lifts, leasehold properties, non–banking assets, etc. Depending on the procedure followed in the bank, provision for depreciation may either be centralised at the head office level or decentralised.

10.56 The auditor should check Head Office instructions as regards adjustments of depreciation on the fixed assets of the Branch.

10.57 The auditor should also check whether depreciation on fixed assets has been adjusted at the rates and in the manner required by H.O.

10.58 The auditor may also report unadjusted depreciation on assets acquired but not capitalised.

10.59 The auditor should ascertain the exact procedure followed by the bank while verifying this item.

(i) *Directors' Fees, Allowances and Expenses:* Expenditure incurred in this regard are recorded under this head. This item is dealt with at the head office level and would not therefore be relevant at the branch level.

(ii) *Auditors' Fees and Expenses:* Remuneration payable to Statutory Auditors and Branch auditors and expenses in connection with audit like reimbursements are recorded under this head. This item is usually dealt with at the head office level and would not therefore be relevant at the branch level.

(iii) *Law Charges:* All legal expenses and reimbursement of expenses incurred in connection with legal services are to be included here. The Auditors should verify the legal charges payable by the bank in respect of all legal disputes/ cases currently being fought at various courts of laws, etc are accounted for in the accounts. For this purpose, the auditor may go through the list of contingent liabilities prepared by the bank as at the year end to verify the disputes/ cases which the bank is contesting.

(iv) *Postage, Telegrams, Telephones, etc.:* This item includes all postal charges like stamps, telegrams, telephones, teleprinters, etc.

(v) *Repairs and Maintenance:* This item includes repairs to bank’s property, their maintenance charges, etc.

(vi) *Insurance:* This item is usually dealt with at the head office level and may not therefore be relevant at the branch level

(vii) *Other Expenditure:* This item includes all expenses other than those included in any of the other heads, like, licence fees, donations, subscriptions to papers, periodicals, entertainment expenses, travel expenses, etc. The Notes and Instructions for compilation of profit and loss account, issued by the Reserve Bank, require that in case any particular item under this head exceeds one per cent of the total income, particulars thereof may be given in the notes.

Provisions and Contingencies

10.60 Provisions in respect of NPA and NPI should be verified with the regulatory requirements to ensure full provisioning. The other provisions for expenditure, taxes, etc are to be examined with the circumstances warranting the provisioning and the adequacy of the same.

III-11

Disclosure Requirements in Financial Statements

11.01 Sub-sections (1) and (2) of section 29 of the Banking Regulation Act, 1949 deal with form and content of financial statements of a banking company. Sub-section (1) of section 29 requires every banking company to prepare a balance sheet and a profit and loss account in the forms set out in the Third Schedule to the Banking Regulations Act, 1949 (hereinafter referred to as 'the Act'). Form A of the Third Schedule to the Act contains the form of balance sheet and Form B contains the form of profit and loss account.

11.02 The disclosures requirement for disclosure in the financial statements can be broadly classified in the following four categories:

(i) Prescribed by regulatory authorities
(ii) Prescribed by Accounting Standards
(iii) Requirement emanating from Statues
(iv) Requirement emanating from Listing Agreement

11.03 *Disclosures Prescribed by RBI*: In addition to the disclosures to be made in the balance sheet and profit and loss account in pursuance of the requirements of the Third Schedule to the Act, the RBI has, vide its Master Circular no. DBOD.BP.BC No.14 /21.04.018/2012-13 dated July 2, 2012[@] on "Disclosure in Financial Statements- Notes to Accounts", prescribed disclosures to be made in the Notes to Accounts in respect of certain significant aspects of the items of financial statements of banks (The circular is given in the CD along with the Guidance Note). The Banks should, at a minimum, disclose the items listed in the circular in the 'Notes to Accounts'. However, banks are also encouraged to make more comprehensive disclosures than the minimum required under the circular if they become significant and aid in the understanding of the financial position and performance of the bank. The disclosure listed is intended only to supplement, and not to replace, other disclosure requirements under relevant

[@] Revised in 2013 edition.

legislation or accounting and financial reporting standards. Where relevant, a bank should comply with such other disclosure requirements as applicable.

11.04 RBI has issued circular DBOD.No.BP.BC.78/C.686/91-92, dated February 6, 1992 giving the format of Balance sheet and Profit and Loss Account. The Circular also gives notes and instructions for compilation of each line item of Balance Sheet and Profit and Loss Account.

11.05 *Disclosures Required Under Accounting Standards*: The disclosure requirements under the various Accounting Standards, issued by the Central Government under the Companies (Accounting Standards) Rules, 2006 (as amended) as well as any other Accounting Standards issued by the ICAI, as may be applicable, are also to be complied with.

11.06 *Requirements of Statutes*: The requirements of the Companies Act, 1956 relating to the balance sheet and profit and loss account of a company, in so far as they are not inconsistent with the Act, also apply to the balance sheet or profit and loss account of a banking company [sub-section (3) of section 29 of the Act]. It may be noted that this provision applies only to those banks which have been incorporated as companies.

11.07 *Requirement of Listing Agreement:* Banks listed on a stock exchange have to also comply with the requirements of the Listing Agreement as amended from time to time.

Disclosure of Summary of the Significant Accounting Policies

11.08 Banks should disclose the accounting policies regarding key areas of operations at one place, i.e., under Schedule 17, along with notes to accounts in their financial statements. This may includes disclosure, such as, Basis of Accounting, Transactions involving foreign exchange, Investments – classification, valuation, etc, Derivative Transactions, Advances and Provisions thereon, Fixed Assets and Depreciation, Revenue Recognition, Employee Benefits, Provision for Taxation, etc.

11.09 The Form A and B of the Third Schedule contains 16 schedules, which is to be uniformly used by all the banks. In addition to the 16 detailed prescribed schedules, banks are required to furnish the 'Summary of Significant Accounting Policies' and 'Notes to Accounts' under Schedule 17 and Schedule 18 respectively, to maintain uniformity. This Chapter deals with disclosure requirements in Notes to Accounts as laid down in the abovementioned RBI circular. The disclosures requirement contained in the Master Circular are minimum disclosure requirements. The banks may consider disclosing significant additional information for enhancing the understanding of the users of the financial statements. Further, the disclosures listed herein intended only to supplement, and not replace, other disclosure requirements under relevant legislation or accounting and financial reporting standards. Where relevant, a bank should comply with such other disclosure requirements as applicable.

11.10 The previous year's comparatives should also be disclosed along with the disclosures for the current year.

Audit Approach

11.11 The auditor's primary objective in audit of disclosures made in the notes to accounts is to satisfy himself that such disclosures are free from material misstatement. Examination of compliance with statutory, regulatory and accounting standard's requirements is also an important objective in as much as non-compliance may have a direct and material affect in understanding the financial statements. The auditor should keep this in view while designing his audit procedures relating to disclosures.

Disclosures Prescribed by RBI[5]

11.12 Banks are also required to comply with the Accounting Standard 1 on "Disclosure of Accounting Policies" issued by the Institute of Chartered Accountants of India (ICAI). In addition to the 16 detailed prescribed schedules to the balance sheet, banks are required to furnish the information as discussed in the following paragraphs in the "Notes to Accounts":

11.13 Capital[6]

(i) The Capital to Risk-weighted Assets Ratio (CRAR) as assessed by the Bank on the basis of the guidelines issued by the RBI for implementation of the Capital Adequacy Framework should be computed and disclosed in Notes to accounts.

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[5] The RBI vide its Master Circular No. DBOD.BP.BC No.14 /21.04.018/2012-13 dated July 2, 2012 on "Disclosure in Financial Statements - Notes to Accounts" prescribes the disclosures to be made by the banks in the notes to accounts. (The circular is given in the CD along with the Guidance Note.)

[6] For the format of disclosures please refer to the relevant paragraphs of "Master Circular-Disclosure in Financial Statements-Notes to Accounts", which is given in the CD.

(ii) CRAR should be computed on over all basis (i.e. Total Capital) and also for Tier I and Tier II capital.

(iii) Amount of subordinated debt raised as Tier-II Capital[@]

(Note: The total amount of subordinated debt through borrowings from Head Office for inclusion in Tier II capital may be disclosed in the balance sheet under the head 'Subordinated loan in the nature of long term borrowings in foreign currency from Head Office)

(iv) Amount raised by issue of IPDI

(v) Amount raised by issue of Upper Tier II instruments

(vi) . (Note- Total amount of eligible amount of HO borrowings shall be disclosed in the balance sheet under the head 'Upper Tier II capital raised in the form of Head Office borrowings in foreign currency'.).

(vii) For nationalised banks percentage of the shareholding of the Government of India should also be disclosed.

Audit Approach

11.14 The final consolidation of Capital to Risk Weighted Assets Ratio (CRAR) is done at the head office. For this purpose, apart from consolidation of the Capital Adequacy returns related to risk weighted assets received from various audited and unaudited branches and other offices, the auditor should examine the records maintained at head office relating to various components of Tier I and Tier II capital and other items of risk weighted assets which are compiled at Head Office. The branch auditors should also be requested to report their observations on the risk weighted assets at the branches. The Central Statutory Auditor should examine whether the consolidation of branch returns of risk weighted assets has been correctly done.

11.15 The items eligible for the Tier I and Tier II capital and risk weights assigned to various assets are dealt in Chapter 6 of Part III of the Guidance Note.

11.16 Investments

(i) The details of investments and the movement of provisions held towards depreciation of investments of the bank should be stated under following heads:

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(a) gross value of investments in India and outside India;

(b) aggregate of provisions for depreciation, separately on investments in India and outside India;

(c) net value of investments in India and outside India; and

(d) Movement of provision held towards depreciation on investment stating opening balance, provisions made during the year, write-off/ write back of excess provisions and closing balance.

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

Audit Approach

11.17 The Central Statutory Auditor should verify the provision for depreciation in the value of investments as well as provision for non performing investments. The provision to be reduced from gross value of investments includes provision for depreciation in the value of investments as well as provision for non performing assets.

11.18 The auditor should verify that the opening balance of the provision should correspond with the closing balance of the previous year. Further, the closing balance of provision plus net value of investments should correspond with the gross value of investments.

Repo Transactions

11.19 The details of Securities sold under repo and Securities purchased under reverse repo for Government and Corporate debt securities during the year should be disclosed stating minimum and maximum outstanding balance daily average outstanding balance of securities and Outstanding as on March 31.

Audit Approach

11.20 The auditor should examine the deal register to verify the details disclosed. Care should be taken that balances and average of all the days should be taken and not only of days when there was outstanding balance.

11.21 Non-SLR Investment Portfolio

(i) The composition of issuer of Non SLR investments should be disclosed in notes to account categorising the issuer into PSUs, FIs, Banks, Private Corporates, Subsidiaries/Joint Ventures and Others.

(ii) The Grand total of the issuer wise details of Non-SLR investment should tally with the total of Investments included under the following categories in Schedule 8 to the balance sheet:

a. Shares

b. Debentures & Bonds

c. Subsidiaries/joint ventures

d. Others

(iii) The investments held with each category of issuer should be classified into extent of private placement, below investment grade security, unrated securities and unlisted securities. Amounts reported under the above classification may not be mutually exclusive.

(iv) Provision held towards depreciation of investments should be shown separately.

(v) The movement in gross non-performing Non-SLR investments (i.e. securities other than government and other approved securities) should also be disclosed separately along with total provision thereof.

Audit Approach

11.22 The auditor should examine the letter of offer or other relevant documents to verify the classification into private placement, unrated securities, issuer type and listing. To facilitate the work of verification, the auditor may advise the bank to list out non SLR investments in different classification and also make available letter of offer and confirmation from rating agencies about the rating assigned by them.

Sale and transfers to/from HTM Category@

11.23 If the value of sales and transfers of securities to / from HTM category exceeds 5 per cent of the book value of investments held in HTM category at the beginning of the year, the bank should disclose the market value of the investments held in the HTM category and indicate the excess of book value over market value for which provision is not made. This disclosure is required to be made in 'Notes to Accounts' in the bank's audited Annual Financial Statements. The 5 per cent threshold referred to above will exclude the one - time transfer of securities to / from HTM category with the approval of Board of

@ Revised in 2013 edition.

Directors permitted to be undertaken by banks at the beginning of the accounting year and sales to the Reserve Bank of India under pre-announced OMO auctions.

Audit Approach

11.24 The auditor should examine the sale and transfer of securities to / from HTM category. If it exceeds 5 per cent of the book value of investments held in HTM category at the beginning of the year, the auditor should see whether necessary disclosures have made in the Notes to Accounts.

11.25 Derivatives

(i) *Forward Rate Agreement/ Interest Rate Swap*: Following details are required to be disclosed with respect to Forward Rate Agreement/Interest Rate Swap:

(a) Notional principal of swap agreements,

(b) Losses which would be incurred if counterparties failed to fulfil their obligations under the agreements,

(c) Collateral required by the bank upon entering into swaps,

(d) Concentration of credit risk arising from the swaps (for e.g. exposures to particular industries or swaps with highly geared companies) and,

(e) Fair value of the swap book.

(ii) Nature and terms of the swaps including information on credit and market risk and the accounting policies adopted for recording the swaps should be disclosed.

(iii) Examples of concentration could be exposures to particular industries or swaps with highly geared companies.

(iv) If the swaps are linked to specific assets, liabilities, or commitments, the fair value would be the estimated amount that the bank would receive or pay to terminate the swap agreements as on the balance sheet date. For a trading swap the fair value would be its mark to market value.

(v) *Exchange Traded Interest Rate Derivatives*: With respect to Exchange Traded Interest Rate Derivatives instrument-wise disclosure of Notional principal amount of Exchange Traded Interest Rate Derivatives undertaken during the year, derivatives outstanding as on March 31, derivatives outstanding and not "highly effective" should be disclosed. Mark-to-market value of exchange traded interest rate derivatives outstanding and not "highly effective instrument-wise should also be disclosed.

Audit Approach

11.26 The auditor should examine the list of outstanding derivative contracts. To facilitate the work of verification, the auditor should obtain the list of all outstanding derivative contracts along with their marked to market value as on the balance sheet date. For the purpose of verifying the losses which would be incurred if counterparties failed to fulfil their obligations under the agreements, the auditor should verify the existence of right of set off of losses in one contract against the gains in other contract. In the absence of such right of set off, the only contracts with positive marked to market value should be considered.

11.27 Disclosures on risk exposure in derivatives

(i) *Qualitative Disclosure*: Banks should discuss their risk management policies pertaining to derivatives with particular reference to the extent to which derivatives are used, the associated risks and business purposes served. The discussion shall also include:

a) the structure and organisation for management of risk in derivatives trading,

b) the scope and nature of risk measurement, risk reporting and risk monitoring systems,

c) policies for hedging and/or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges/mitigants, and

d) accounting policy for recording hedge and non-hedge transactions; recognition of income, premiums and discounts; valuation of outstanding contracts; provisioning, collateral and credit risk mitigation.

(ii) *Quantitative Disclosure*: Quantitative disclosure with regard to currency and interest rate derivatives should be disclosed in notes to accounts stating:

a) The notional principal amount of derivatives both for hedging and trading.

b) Mark to market position separately for positive and negative marked to market position.

c) Credit Exposure.

d) Likely impact of one percentage change in interest rate on hedging and trading derivatives and maximum and minimum change in interest rate observed during the year.

Audit Approach

11.28 The auditor should examine the list of outstanding derivative contracts. To facilitate the work of verification, the auditor should obtain the list of all outstanding derivative contracts along with their marked to market value and credit exposure as on the balance sheet date. Besides, Accounting Standard (AS) 30, "Financial Instruments: Recognition and Measurement"[7] issued by the Institute of Chartered Accountants of India deals with principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Requirements for presenting information about financial instruments are dealt in Accounting Standard (AS) 31, "Financial Instruments: Presentation". Requirements for disclosing information about financial instruments are in Accounting Standard (AS) 32, "Financial Instruments: Disclosures"

11.29 Asset Quality

(i) *Non-performing assets*: Banks are required to disclose Net NPA as percentage to net advances and the details of movement of gross NPAs, net NPAs and provisions during the year.

(ii) *Information in respect of Loan Assets subjected to Restructuring*:[@] RBI has revised the disclosure requirements on Advances restructured by Banks *vide* its Circular No. DBOD.BP.BC.No.80/21.04.132/2012-13 dated January 31, 2013. As per this Circular the following details are to be disclosed:

i. details of accounts restructured on a cumulative basis excluding the standard restructured accounts which cease to attract higher provision and risk weight (if applicable);

ii. provisions made on restructured accounts under various categories; and

iii. details of movement of restructured accounts.

Above details are to classified under different categories as under:

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[7] AS 30, AS 31 and AS 32 issued by the ICAI, comes into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. The Standards will become mandatory in respect of accounting periods commencing on or after 01.04.2011 for all commercial, industrial and business entities except small and medium–sized entity

[@] Revised in 2013 edition.

i. Type of restructuring- Under CDR Mechanism, Under SME Debt Restructuring Mechanism and Others

ii. Asset Classification of restructured accounts- Standard, Sub-standard, Doubtful and Loss assets

iii. Movement under different each of the above disclosing No. of borrowers, Amount outstanding and Provision thereon

These details are to be disclosed in a tabular format as given in the Annex to the Circular referred to above

Banks must disclose the total amount outstanding in all the accounts / facilities of borrowers whose accounts have been restructured along with the restructured part or facility. This means even if only one of the facilities / accounts of a borrower has been restructured, the bank should also disclose the entire outstanding amount pertaining to all the facilities / accounts of that particular borrower.

(iii) *Financial assets transferred during the year to securitisation company (SC)/reconstruction company (RC)* - With regards to financial assets transferred by the bank to securitisation/reconstruction company the bank is required to disclose the number of accounts transferred, aggregate value (net of provisions) of accounts sold to SC/RC, aggregate consideration and additional consideration realized in respect of accounts transferred in earlier years. Aggregate gain/loss over net book value is also required to be computed and disclosed.

(iv) Details of non-performing financial assets purchased/sold - Banks which purchase/ sold non-performing financial assets from/to other banks shall be required to make the following disclosures in the Notes on Accounts to their Balance sheets:

A. Details of non-performing financial assets purchased:

(a) No. of accounts purchased during the year

(b) Aggregate outstanding

- Of these, number of accounts restructured during the year
- Aggregate outstanding

B. Details of non-performing financial assets sold:

(a) No. of accounts sold during the year

(b) Aggregate outstanding

(c) Aggregate consideration received

(v) Provisions on Standard Asset: Provisions made towards Standard Assets should be disclosed separately in notes to account. It may be noted that the amount need not be netted of from gross advances but shown separately as ' Provisions against Standard Assets', under 'Other Liabilities and Provisions - Others' in Schedule No. 5 of the balance sheet.

Audit Approach

11.30 The gross non performing advances represents outstanding amount of all non performing accounts. The net non performing advances are gross non performing advances as reduced by (i) provision for such non performing advances (provision made against standard assets should not be considered), (ii) interest debited to borrowers account but unrealised, by whatever name called, (iii) amount received from borrowers and parked in a separate account and (iv) amount of claim received from DICGC, EGCG etc. and not appropriated to the borrowers account.

11.31 The auditors should obtain the list of accounts restructured under various categories and financial assets sold from the branch management and should verify the same with reference to approval from the appropriate authority. The list of assets restructured under CDR is generally centralized at HO of the bank. The list of the same should be obtained from HO and compared with the consolidation statement prepared based on the statements received from the branches. The details to be disclosed relates to restructuring, rescheduling, renegotiation etc. Accordingly, if there are changes in terms of payment, the same should be included under the same. The auditor should understand what records have been maintained by the bank so that it can determine the values as required to be disclosed as per RBI Circular No. DBOD.BP.BC.No.80/21.04.132/2012-13 dated January 31, 2013.[@]

11.32 The auditors should also obtain the list of non performing advances purchased/sold from the bank's management and should verify the same with reference to approval from the appropriate authority and documents executed for purchase/sale of such non performing advances.

11.33 *Business Ratios*: RBI has prescribed following ratios to be computed by the bank to be disclosed in the notes forming part of the balance sheet:

(i) *Interest Income as a percentage to Working Funds*- Working funds is to be reckoned as average of total assets (excluding accumulated losses, if

[@] Revised in 2013 edition.

any) as reported to RBI in Form X under Section 27 of the Banking Regulation Act, 1949, during the 12 months of the financial year.

(ii) *Non-interest income as a percentage to Working Funds*- Non-interest income is to be reckoned as income reported under Schedule 14.

(iii) *Operating Profit as a percentage to Working Funds*- Operating Profit is to be reckoned as profit before making provisions, i.e., Total income as per Schedule 13 and Schedule 14 less Total expenditure as per Schedule 15 and Schedule 16.

(iv) *Return on Assets (it should be with reference to average working funds i.e., total of assets excluding accumulated losses, if any):* The return is to be reckoned as the net profit for the year after making all the provisions.

(v) *Business (Deposits plus advances) per employee (inter- bank deposits may be excluded):* This ratio may be computed based on the average business and average no. of employees during the year.

(vi) *Profit per employee:* This ratio may be computed based on the average no. of employees during the year.

11.34 *Asset Liability Management*: Banks are required to disclose the maturity pattern of Deposits, Advances, Investments, Borrowings, Foreign Currency assets, Foreign Currency liabilities as on balance sheet date. The maturity pattern needs to be disclosed in following time buckets-

(i) Day 1

(ii) 2 to 7 days

(iii) 8 to 14 days

(iv) 15 to 28 days

(v) 29 days to 3 months

(vi) Over 3months & upto 6 months

(vii) Over 6 months & upto 1 year

(viii) Over 1 year & up to 3 years

(ix) Over 3years & upto 5 years

(x) Over 5years

The maturity pattern of demand deposits and demand loans (including in foreign currency) is to be based on empirical study carried by the bank. Based on such study, such deposits and loans should be classified under different buckets.

11.35 *Exposures:* The Reserve Bank of India, vide its Master Circular DBOD. No.Dir.BC. 3/13.03.00/2012-13 of July 2, 2012 on “Exposure Norms” (The circular is given in the CD along with the Guidance Note) provides requirements in respect of exposure limits for banks. Under the master circular on Disclosure in Financial Statements the RBI has prescribed the details which need to be disclosed with respect to Banks exposure to real estate sector and capital market:

(A) *Exposure to Real Estate Sector*- Banks are required to disclose direct and indirect exposure to real estate sector in the below mentioned format

a) *Direct exposure*

(i) Residential Mortgages: Includes lending fully secured by mortgages on residential property that is or will be occupied by the borrower or that is rented; (Individual housing loans eligible for inclusion in priority sector advances may be shown separately)

(ii) *Commercial Real Estate*- Both fund and non-fund based lending secured by mortgages of commercial real estate (office buildings, retail space, multi-purpose commercial premises, multi-family residential buildings, multi-tenanted commercial premises, industrial or warehouse space, hotels, land acquisition, development and construction, etc.).

(iii) Investments in Mortgage Backed Securities (MBS) and other securitised exposures-

a. Residential,

b. Commercial Real Estate.

b) *Indirect Exposure:* Fund based and non-fund based exposures on National Housing Bank (NHB) and Housing Finance Companies (HFCs).

(B) *Exposure to Capital Market*- Banks are required to disclose the total exposure to capital market under the following heads:

a. direct investment in equity shares, convertible bonds, convertible debentures and units of equity-oriented mutual funds the corpus of which is not exclusively invested in corporate debt;

b. advances against shares/bonds/debentures or other securities or on clean basis to individuals for investment in shares (including IPOs/ESOPs), convertible bonds, convertible debentures, and units of equity-oriented mutual funds;

c. advances for any other purposes where shares or convertible bonds or convertible debentures or units of equity oriented mutual funds are taken as primary security*;*

d. advances for any other purposes to the extent secured by the collateral security of shares or convertible bonds or convertible debentures or units of equity oriented mutual funds i.e. where the primary security other than shares/convertible bonds/convertible debentures/units of equity oriented mutual funds does not fully cover the advances;

e. secured and unsecured advances to stockbrokers and guarantees issued on behalf of stockbrokers and market makers;

f. loans sanctioned to corporates against the security of shares / bonds/ debentures or other securities or on clean basis for meeting promoter's contribution to the equity of new companies in anticipation of raising resources;

g. bridge loans to companies against expected equity flows/issues;

h. underwriting commitments taken up by the banks in respect of primary issue of shares or convertible bonds or convertible debentures or units of equity oriented mutual funds. However, RBI, *vide* its Master Circular No. DBOD. No.Dir.BC. 3/13.03.00/2012-13 dated July 2, 2012 on "Exposure Norms" has clarified that with effect from April 16, 2008, banks may exclude their own underwriting commitments, as also the underwriting commitments of their subsidiaries, through the book running process for the purpose of arriving at the capital market exposure of the solo bank as well as the consolidated bank.

i. financing to stockbrokers for margin trading;

j. all exposures to Venture Capital Funds (both registered and unregistered).

The exposure is to be reckoned with reference to higher of outstanding and sanctioned limit. Exposure to the sensitive sector would include lending which is primarily secured against such sensitive sector.

Audit Approach

11.36 The Statutory Central Auditors should check the consolidation of returns being obtained from the respective branch auditors for compiling the above figures. Further, the auditors should also verify the same based on the mechanism in place at HO of the bank to cross verify the figures reported by branches.

11.37 *Risk category-wise country-wise exposure:* As per the extant RBI guidelines, the country wise net exposure of the Bank and the provision held thereof is categorised into various risk categories listed below:

(i) Insignificant
(ii) Low
(iii) Moderate
(iv) High
(v) Very High
(vi) Restricted
(vii) Off-credit
(viii) Total

11.38 Till the banks move over to own internal rating systems, they may use the seven category classification followed by Export Credit Guarantee Corporation of India Ltd. (ECGC) for the purpose of classification and making provisions for country risk exposures. ECGC shall provide to banks, on request, quarterly updates of their country classifications and shall also inform all banks in case of any sudden major changes in country classification in the interim period.

11.39 *Details of Single Borrower Limit (SGL), Group Borrower Limit (GBL) exceeded by the bank:* The bank should make appropriate disclosure in respect of cases where it had exceeded the prudential exposure limits during the year. The sanctioned limit or entire outstanding, whichever is high, shall be reckoned for arriving at exposure limit and for disclosure purpose. The same needs to be verified from the minutes of Board meeting of the bank.

11.40 Unsecured Advances - In order to enhance transparency and ensure correct reflection of the unsecured advances in Schedule 9 of the banks' balance sheet, it is advised as under:

- For determining the amount of unsecured advances for reflecting in Schedule 9 of the published balance sheet, the rights, licenses, authorisations, etc., charged to the banks as collateral in respect of projects (including infrastructure projects) financed by them, should not be reckoned as tangible security. Hence such advances shall be reckoned as unsecured.
- Banks should also disclose the total amount of advances for which intangible securities such as charge over the rights, licenses, authority, etc. has been taken as also the estimated value of such intangible collateral. The disclosure may be made under a separate

head in “Notes to Accounts”. This would differentiate such loans from other entirely unsecured loans.

11.41 Provision made for income tax during the year.

11.42 *Disclosure of Penalties imposed by RBI:* At present, Reserve Bank is empowered to impose penalties on a commercial bank under the provision of Section 46 (4) of the Banking Regulation Act, 1949, for contraventions of any of the provisions of the Act or non-compliance with any other requirements of the Banking Regulation Act, 1949; order, rule or condition specified by Reserve Bank under the Act. Consistent with the international best practices in disclosure of penalties imposed by the regulator, it has been decided that the details of the levy of penalty on a bank in public domain will be in the interests of the investors and depositors. It has also been decided that strictures or directions on the basis of inspection reports or other adverse findings should be placed in the public domain. The penalty should also be disclosed in the "Notes on Accounts" to the Balance Sheet.

11.43 *Provisions and Contingencies:* To facilitate easy reading of the financial statements and to make the information on all Provisions and Contingencies available at one place, banks are required to disclose in the ‘Notes to Accounts’ the following information:

(i) Provisions for depreciation on Investment
(ii) Provision towards NPA
(iii) Provision towards Standard Asset
(iv) Provision made towards Income tax
(v) Other Provision and Contingencies (with details)

11.44 *Floating Provisions*- Banks should make comprehensive disclosures on the movement of floating provisions in the “notes to accounts” to the balance sheet as follows:

- Opening balance in the floating provisions account
- The quantum of floating provisions made in the accounting year
- Amount of draw down made during the accounting year
- Closing balance in the floating provisions account

For draw down of provision during the year, purpose of draw down may be mentioned.

11.45 *Draw Down from Reserves:* Suitable disclosures should be made regarding any draw down of reserves in the 'Notes to Accounts'.

11.46 *Disclosure of complaints*- Banks are also advised to disclose the following brief details along with their financial results:

(i) *Customer Complaints*
   - (a) No. of complaints pending at the beginning of the year
   - (b) No. of complaints received during the year
   - (c) No. of complaints redressed during the year
   - (d) No. of complaints pending at the end of the year

(ii) *Awards passed by the Banking Ombudsman*
   - (a) No. of unimplemented Awards at the beginning of the year
   - (b) No. of Awards passed by the Banking Ombudsmen during the year
   - (c) No. of Awards implemented during the year
   - (d) No. of unimplemented Awards at the end of the year

11.47 Disclosure of Letter of Comforts (LOCs) issued by banks- The banks should disclose full particulars of all the Letter of Comforts (LoCs) issued by them during the year, including their assessed financial impact, as also their assessed cumulative financial obligations under the LoCs issued by them in the past and outstanding at the end of current year.

11.48 Provisioning Coverage Ratio PCR - The PCR (ratio of provisioning to gross non-performing assets) should be disclosed in the Notes to Accounts to the Balance Sheet.

11.49 *Bancassurance Business* - Banks should disclose in the 'Notes to Accounts', from the year ending March 31, 2010, the details of fees/remuneration received in respect of the bancassurance business undertaken by them.

11.50 *Concentration of Deposits* - Total Deposits of twenty largest depositors and Percentage of Deposits of twenty largest depositors to Total Deposits of the bank should be disclosed by the bank in the notes to accounts.

11.51 *Concentration of Advances* - Total Advances of twenty largest borrowers and Percentage of Advances to twenty largest borrowers to Total Advances of the bank should be disclosed by the bank in the notes to accounts. Advances should be computed as per definition of Credit Exposure including derivatives furnished in the Master Circular on Exposure Norms.

11.52 *Concentration of Exposures* - Total Exposure to twenty largest borrowers/customers and Percentage of Exposures to twenty largest borrowers/customers to Total Exposure of the bank on borrowers/customers should be disclosed by the bank in the notes to accounts. Exposures should be computed based on credit and investment exposure as prescribed in the Master Circular on Exposure Norms.

11.53 *Concentration of NPAs* - Total Exposure to top four NPA accounts should be disclosed by the bank in the notes to accounts.

11.54 *Sector-wise NPAs* – Percentage of NPAs to Total Advances in the sectors, such as, Agriculture & allied activities, Industry (Micro & small, Medium and Large), Services, Personal Loans, should be disclosed by the bank in the notes to accounts.

11.55 *Movement of NPAs* – Movement in NPAs during the year including opening balance, additions during the year, less up gradations, recoveries (excluding recoveries made from upgraded accounts) and write off during the year, should be disclosed by the bank in the notes to accounts.

11.56 *Overseas Total Assets, Total NPAs and Total Revenue* should be disclosed by the bank in the notes to accounts.

11.57 Off-balance Sheet SPVs sponsored (which are required to be consolidated as per accounting norms) both domestic and overseas should be disclosed by the bank in the notes to accounts.

11.58 Unamortised Pension and Gratuity Liabilities: Appropriate disclosures of the accounting policy followed in regard to amortization of pension and gratuity expenditure may be made in the Notes to Accounts to the financial statements.[@]

11.59 Disclosures on Remuneration: Private sector banks and foreign banks (to the extent applicable) are advised to disclose remuneration as specified in the Master Circular on " Disclosure in Financial Statements- Notes to Accounts".[@]

11.60 Disclosures relating to Securitisation: The Notes to Accounts of the originating banks should indicate the outstanding amount of securitized assets as per books of the SPV sponsored by the bank and total amount of exposures retained by the bank as on the date of balance sheet to comply with the Minimum Retention Requirement(MRR). These figures should be based on the

[@] Revised in 2013 edition.

information duly certified by the SPV's auditors obtained by the originating bank from the SPV.@

11.61 Credit Default Swaps: Banks using a proprietary model for pricing CDS, shall disclose both the proprietary model price and the standard model price in terms of extant guidelines in the Notes to the Accounts and should also include an explanation of the rationale behind using a particular model over another.

Disclosures prescribed by Accounting Standards

11.62 The Accounting Standards issued by the Central Government under the Companies (Accounting Standards) Rules, 2006 (as amended) as well as any other Accounting Standards issued by the ICAI prescribes various disclosures to be made in financial statements. Banks are defined as Level I enterprises by ICAI and as such all Accounting Standards are applicable to banks unless specifically excluded (Certain provisions of Accounting Standard 11 (Revised 2003), Accounting Standard 13). This Guidance Note deals with only those disclosure requirements where RBI has issued guidelines in respect of disclosure as per Accounting Standards.

11.63 As the format of the profit and loss account of banks prescribed in Form B under Third Schedule to the Banking Regulation Act 1949 does not specifically provide for disclosure of the impact of prior period items on the current year's profit and loss, such disclosures, wherever warranted, may be made in the Notes on Accounts of banks. (AS-5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies")

11.64 Disclosure with regards to the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.(AS-9, "Revenue Recognition")

11.65 Banks may follow the disclosure requirements prescribed under AS 15 (revised), 'Employees Benefit' issued by ICAI. (AS-15, "Employee Benefits")

11.66 While complying with AS-17, "Segment Reporting", banks are required to adopt the following:

i) The business segment should ordinarily be considered as the primary reporting format and geographical segment would be the secondary reporting format.

ii) Reported business segments should be 'Treasury', 'Corporate/Wholesale Banking', 'Retail Banking' and 'Other banking operations'.

iii) 'Domestic' and 'International' segments will be the geographic segments for disclosure.

iv) Banks may adopt their own methods, on a reasonable and consistent basis, for allocation of expenditure among the segments.

For the formats relating to the segment reporting disclosures, readers may refer to the above Master Circular.

11.67 *Related Parties:* Related parties for a bank are its parent subsidiary(ies), associates/joint ventures, Key Management Personnel (KMP) and relatives of KMP. KM are the whole time directors for an Indian bank and the chief executive officer for a foreign bank having branches in India Banks need to report related party relationships and transactions between a reporting enterprise and its related parties. No disclosure is required in respect of related parties which are "State-controlled Enterprises" as per paragraph 9 of Accounting Standard (AS) 18. Further, in terms of paragraph 5 of AS 18, transactions in the nature of Banker-customer relationship are not required to be disclosed in respect of Key Management Personnel and relatives of Key Management Personnel. Further, where there is only one entity in any category of related party, banks need not disclose any details pertaining to that related party other than the relationship with that related party. RBI has modified illustrative disclosure format recommended by the ICAI to suit banks. (AS-18, "Related Party Disclosures").

11.68 As regards disclosures in the 'Notes on Accounts' to the Consolidated Financial Statements (AS-21, "Consolidated Financial Statements"), banks may follow the general clarifications issued by Institute of Chartered Accountants of India from time to time. A parent company, presenting the CFS, should consolidate the financial statements of all subsidiaries - domestic as well as foreign, except those specifically permitted to be excluded under the AS-21. The reasons for not consolidating a subsidiary in CFS should be disclosed in the CFS. The responsibility of determining whether a particular entity should be included or not for consolidation would be that of the Management of the parent entity. In case, its Statutory Auditors are of the opinion that an entity, which ought to have been consolidated, has been omitted, they should incorporate their comments in this regard in the "Auditors Report".

11.69 Adoption of AS 22, "Accounting for Taxes on Income", may give rise to creation of either a deferred tax asset (DTA) or a deferred tax liability (DTL) in the books of accounts of banks. This would give rise to certain issues which have a bearing on the computation of capital adequacy ratio and banks' ability to declare dividends. In this regard RBI has clarified as under:

(i) DTL created by debit to opening balance of Revenue Reserves on the first day of application of the Accounting Standards 22 or to Profit and Loss account for the current year should be included under item (vi) 'others (including provisions)' of Schedule 5 - 'Other Liabilities and Provisions' in the balance sheet. The balance in DTL account will not be eligible for inclusion in Tier I or Tier II capital for capital adequacy purpose as it is not an eligible item of capital.

(ii) DTA created by credit to opening balance of Revenue Reserves on the first day of application of Accounting Standards 22 or to Profit and Loss account for the current year should be included under item (vi) 'others' of Schedule 11 'Other Assets' in the balance sheet.

(iii) The DTA computed as under should be deducted from Tier I capital:

- DTA associated with accumulated losses; and
- The DTA (excluding DTA associated with accumulated losses), net of DTL. Where DTL is in excess of the DTA (excluding DTA associated with accumulated losses), the excess shall neither be adjusted against item (i) nor added to Tier I capital.

11.70 A bank may acquire more than 20% of voting power in the borrower entity in satisfaction of its advances and it may be able to demonstrate that it does not have the power to exercise significant influence since the rights exercised by it are protective in nature and not participative. In such a circumstance, such investment may not be treated as investment in associate under AS 23, "Accounting for Investments in Associates in Consolidated Financial Statements". Hence the test should not be merely the proportion of investment but the intention to acquire the power to exercise significant influence.

11.71 Merger/ closure of branches of banks by transferring the assets/ liabilities to the other branches of the same bank may not be deemed as a discontinuing operation and hence AS 24, "Discontinuing Operations", will not be applicable to merger / closure of branches of banks by transferring the assets/ liabilities to the other branches of the same bank. Disclosures would be required under the Standard only when:

(i) discontinuing of the operation has resulted in shedding of liability and realization of the assets by the bank or decision to discontinue an operation which will have the above effect has been finalised by the bank and

(ii) the discontinued operation is substantial in its entirety.

11.72 With regards to Accounting Standard (AS) 25, "Interim Financial Reporting", the half yearly review prescribed by RBI for public sector banks, in consultation with SEBI, vide circular DBS. ARS. No. BC 13/ 08.91.001/ 2000-01 dated 17th May 2001 is extended to all banks (both listed and unlisted) with a view to ensure uniformity in disclosures. Banks may adopt the format prescribed by the RBI for the purpose.

11.73 Other Accounting Standards - Banks are required to comply with the disclosure norms stipulated under the various Accounting Standards issued by the Institute of Chartered Accountants of India.

11.74 With regards to Accounting Standard (AS) 26, *"Intangible Assets"* an enterprise discloses the change in an accounting estimate or accounting policy such as that arising from changes in the amortisation method, the amortisation period or estimated residual values, in accordance with AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies. The financial statements should also disclose:

(a) if an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset; (b) a description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole; (c) the existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities; and (d) the amount of commitments for the acquisition of intangible assets.[@]

11.75 With regard to Accounting Standard (AS) 27, *"Financial Reporting of Interests in Joint Ventures"* disclosure of relating to joint venture given in AS 27 need to be given in standalone financial statements as well as in Consolidated Financial Statements.[@]

[@] Revised in 2013 edition.

11.76 With regard to Accounting Standard (AS) 28, *"Impairment of Assets"* amount of impairment loss recognized and reversed during the period need to disclosed.@

11.77 With regard to Accounting Standard (AS) 29, *"Provisions, Contingent Liabilities and Contingent Assets"* if any provision is created as per AS 29, disclosure need to be given as per para 66 and 67 of AS 29. With respect to contingent liability following disclosure need to be given in financial statements: Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable: (a) an estimate of its financial effect, (b) an indication of the uncertainties relating to any outflow; and (c) the possibility of any reimbursement. (para 68 of AS 29).@

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III-12
Consolidation of Branch Accounts

12.01 One of the important functions of the central statutory auditors of banks is to examine the consolidation of accounts of branches – those which have been audited by branch auditors as well as those which are unaudited. The procedures regarding consolidation of accounts vary from bank to bank. In some of the banks, the accounts of branches pertaining to a region are consolidated at the regional level. The accounts of all the regions within a zone are consolidated at the zonal office, and the accounts of all the zones are consolidated at the head office. In other banks, the entire work of consolidation is centralised at the Head Office. Preparation of the financial statements of the bank as a whole (after consolidation of accounts of branches) is the responsibility of the bank's management.

12.02 The process of consolidation involves the consolidation of balance sheet, profit and loss account, LFAR, Capital Adequacy Returns, branch audit reports and returns of various types (e.g., returns relating to advance classification, fixed assets, bills payable, sundries, suspense, etc.) received from audited and unaudited branches under various main heads and sub-heads as per the form of balance sheet and profit and loss account. In doing so, it has to be ensured that:

(1) fixed assets return is consolidated and reconciled for transfer of Fixed Assets effected during the year.

(2) the detailed heads of accounts, which are grouped under a sub-head, are correctly classified.

Similarly, the correctness of various sub-heads under a main head has also to be ensured.

12.03 The general practice in most banks is that the pre-audited accounts as prepared by the branch are sent to the head office (or regional office or zonal office, as the case may be). After the completion of the audit of branches, the accounts of the branches along with the audit report thereon and a memorandum of changes (MoC) showing distinctly the changes to be made in the pre-audited accounts in the light of the observations made by the branch auditors are forwarded to the head office (or other controlling office). The memorandum of changes generally specifies:

(a) the changes required from one account head to another;

(b) recommendations for provision for expenses;

(c) changes relating to classification of advances and provisions thereon;

(d) recommendations regarding changes in recognition of income.

12.04 Generally, the pre-audited returns are consolidated without any change. The memoranda of changes received from branches are consolidated separately and finally, the consolidated accounts of the bank are prepared by giving effect to the memoranda of changes.

12.05 The RBI vide its Circular No. DBOD.No.BP.BC.72/21.04.018/2001-02 dated February 25, 2003 has issued guidelines to banks on consolidated accounting and other quantitative methods.

12.06 The central statutory auditor should examine whether the consolidation of branch returns has been correctly done. He should particularly examine whether the interest on inter-branch balances and other similar items have been reversed during consolidation. The auditor should specifically examine that transfers of assets among branches get cancelled in the consolidated accounts.

12.07 Apart from examining the consolidation of figures, the central statutory auditor should also consider the notes on accounts appearing in branch returns, as well as the observations made by the branch auditors, in the main report as well as the Long Form Audit Report. Further, the bank branch auditors have recently been advised by ICAI to give the total number and amount of debits/ credits arising pursuant to the Memorandum of changes submitted by them in their audit reports under the “Other Matters Paragraph” The Central Statutory auditor should review these information and where required, the central statutory auditor may also advise the bank to make necessary entries and adjustments based on the comments made by the branch auditors.[@]

12.08 It is not possible for the central statutory auditor to re-examine the audited returns or to conduct an audit of the unaudited returns to determine the correctness of income recognition and asset classification. However, they may review any large advances showing sign of weakness for detailed discussions with the bank management. Further,[@] while examining advances, the central statutory auditors should pay special attention to those large advance accounts, which are operated at more than one branch, since individual branch auditors would not be in a position to have an overall view of such advances.

[@] Revised in 2013 edition.

12.09 RBI has advised banks to ensure that the identification of NPAs and provision against the same is carried out by the system driven and the Core Accounting system of the bank should generate the same to avoid any manual errors and manipulation.

12.10 There may be cases where the returns received from some of the unaudited branches are incomplete or incorrectly filled up or have improper grouping of accounts. The central statutory auditors have to be careful in examining the consolidation of such unaudited returns. They should particularly examine the internal controls in relation to preparation of such returns, especially those which seek to minimise the possibility of incorrect recognition of revenue in respect of non-performing advances as also incorrect classification of advances. The auditor should ensure that the NPA/ NPI are classified borrower wise and not facility wise. Further, if an account of a borrower is classified as NPA in any of the branch (Indian or foreign) then all his accounts across the bank will be classified as NPA. In case the auditors find that the total amount relating to unaudited branches is material and that the returns from such branches indicate incorrect recognition of revenue or wrong classification of items, they should consider making a suitable disclaimer/qualification in their report.

12.11 There are various returns and forms which are required to be certified by the respective branch auditors for disclosure purposes or for making additional provisions at HO level. The central statutory auditor shall discuss with the bank and review the format sent to branch auditors for such certification to ensure that all the information is captured. Further, consolidation of the same needs to be properly checked at HO/controlling office.

12.12 The central statutory auditors have also to ensure that the returns of all the branches under audit as well as those, which are not under audit, have been consolidated and that no branches are left out. In case of non-receipt of return from any branch, a suitable qualification/disclaimer should be made.

Special Considerations in Case of Returns of Overseas Branches

12.13 The returns from overseas branches have certain special features which need to be kept in mind.

12.13 The figures in the returns from overseas branches would be expressed in terms of the local currencies of the respective countries in which those branches are located. However, for the purposes of consolidation, these returns will need to be translated into Indian rupees.

12.14 The auditor should examine whether the translation of transactions in foreign currencies as well as year-end re-statement of assets and liabilities designated in foreign currencies is appropriate. In this regard it may be noted that the Accounting Standard (AS) 11 (revised 2003), "The Effects of Changes in Foreign Exchange Rates" deals with (a) accounting for transactions in foreign currencies, and (b) translating the financial statements of foreign operations. The RBI has issued circular on "Guidelines on compliance with Accounting Standard (AS) 11 (revised 2003), "The Effects of Changes in Foreign Exchange Rates" (DBOD.BP.BC.No.76/21.04.018/2005-06) dated April 5, 2006.

12.15 The Council of ICAI has, however, clarified that AS 11 (Revised 2003) does not apply for accounting of exchange difference arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction. The Standard does apply, however, to other foreign exchange transactions of banks and also for translation of financial statements of foreign branches of banks.

12.16 In verifying foreign exchange transactions, the auditor should pay special attention to the instructions given in circular issued by RBI, whereby foreign branches of Indian banks would be classified as "non-integral foreign operations". Similarly, Offshore Banking Units (OBUs) set up in India by banks would also be classified as "non-integral foreign operations". Taking into consideration the operation of the representative offices of banks set up abroad and the explanation in paragraph 18 of AS 11, Representative Offices would be classified as "integral foreign operations". These classifications are for the limited purpose of compliance with the Standard.

12.17 As per AS 11 (revised 2003), the method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise. For this purpose, foreign operations are classified as either "integral foreign operations" or "non-integral foreign operations".

12.18 The following are indications that a foreign operation is a non-integral foreign operation rather than an integral foreign operation:

a. while the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise;
b. transactions with the reporting enterprise are not a high proportion of the foreign operation's activities;
c. the activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise;
d. costs of labour, material and other components of the foreign operation's

products or services are primarily paid or settled in the local currency rather than in the reporting currency;

e. the foreign operation's sales are mainly in currencies other than the reporting currency;

f. cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation;

g. sales prices for the foreign operation's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation; and

h. there is an active local sales market for the foreign operation's products, although there might also be significant amounts of exports.

12.19 The transactions between position-maintaining and reporting branches during the year are accounted for as inter-branch transactions. The auditor should examine whether the relevant transactions have been properly recorded.

12.20 The auditor should also examine whether any profit or loss arising from foreign exchange transactions has been accounted for correctly.

12.21 In terms of its circular no DBOD.BP.BC.76/ 21.04.018/2004-05 dated March 15, 2005, the RBI has prescribed that with the issuance of the said circular, there should normally be no need for any statutory auditor for qualifying financial statements of a bank for non-compliance with Accounting Standard 11 (revised 2003). Hence, it is essential that both the banks and the statutory central auditors adopt the guidelines and the procedures prescribed. Whenever specific difference in opinion arises among the auditors, the statutory central auditors would take a final view. Continuing difference, if any, could be sorted out in prior consultation with RBI, if necessary.

12.22 The branches of an Indian bank have to operate in a foreign country in accordance with the rules and regulations of that country. Such requirements may include maintenance of a fixed capital and other measures for protection of local depositors' money. For example, the local regulations in many countries require that to the extent of erosion or probable erosion of net assets, replenishment of funds to the extent required under the regulations should be made by way of remittances. Therefore, in addition to the fixed capital sent at the time of opening of the branches, additional capital remittances towards eroded funds are also to be made from time to time. This is commonly known as 'Assigned Capital'. It should be examined whether the bank holds sufficient provision against the eroded assets of such branches if it was required to remit fresh capital for replenishment of the eroded net assets. In this regard, it may be noted that the amount of loss is to be reckoned with reference to the rate of exchange at which the relative remittance is actually made to the foreign branch.

12.23 The overseas branch accounts as well as the report of the auditor indicate separately the element of doubtful assets as per the remittance requirement. The auditors should keep in mind the fact that the requirement of the quantum of remittance against eroded net assets varies from country to country. Therefore, in many cases, the amount of provision required for doubtful assets may be higher than the quantum of remittance. In case of Advances it must be ensured that NPA is classified borrower wise and hence a borrower whose account is classified as NPA in an Indian Branch should also be classified as NPA in foreign branch and vice versa. For this purpose, the Central Statutory Auditor in–charge of International Division may obtain the relevant information from the bank in the following format:

Summary of provisions held as on 31/3/13 in respect of Foreign Currency Loans of corporates/ parties whose rupee accounts are classified as NPA at domestic offices.

S. No	Branch	Name of Borrower	Foreign office	Asset Classification	Currency	Outstanding amount as on 31/3/13	Provision for Principal amount	Rupee equivalent	Provision for shortfall in security	Total provision

12.24 Where an overseas branch is required to reduce its capital pursuant to local regulation, the figure of capital so reduced should be incorporated in the consolidated accounts of the bank.

12.25 LFAR of Foreign Branches is required to be made and for each branch it should be made as per the format of LFAR mentioned in Part **IV** of the Guidance Note and consolidated at Head Office.

Investments

12.26 Provision for depreciation on investments of foreign offices should be made scrip wise keeping in view the policy followed by the bank as a whole. Thus, in case depreciation on investments of a foreign office is not in accordance with the policy followed by the bank, additional provision for depreciation may have to be accounted for at Head Office. Accordingly, the auditor should ensure that uniformity is maintained in classification of investments in the manner maintained by the Indian operations of the bank and wherever a deviation is observed, the difference in depreciation should be calculated and provided for at the Head Office.

Inter - Office Transactions and Balances

12.27 While examining the consolidation of accounts, the auditor should pay special attention to inter-office adjustments account.

12.28 Ideally, all inter-office transactions should reconcile (though with a certain time lag in the case of some types of transactions like drafts issued). The unreconciled inter-office transactions indicate the existence of errors or, more seriously, of frauds.

12.29 While the inter-office transactions are recorded at the respective branches (i.e., those where transactions are initiated and responded), the work of reconciliation of these transactions is usually centralised at the head office. The auditor at the central level is therefore, concerned with the efficacy of the reconciliation procedure and with the effect of unreconciled transactions on the financial statements and consequently on his audit report.

12.30 Given the large volume of transactions in inter-office adjustments account and the extent of non-reconciliation, this area is fraud-prone. The auditor should bear this fact in mind while designing his audit procedures relating to this area.

12.31 Vide circular No. BP.BC.73/21.04.018/98 dated July 27, 1998, banks have been advised by the RBI to segregate the credit entries outstanding for more than five years in inter-branch accounts and transfer them to a separate Blocked Account which should be shown in the balance sheet under the head 'Other Liabilities and Provisions – Others' (Schedule 5). While arriving at the net amount of inter-branch transactions for inclusion in the balance sheet, the aggregate amount of Blocked Account should be excluded and only the amount representing the remaining credit entries should be netted against debit entries. Banks have been advised that any adjustment from the Blocked Account should be permitted only with the authorisation of two officials, one of whom should be from outside the branch concerned, preferably from the controlling/head office, if the amount exceeds Rs.1 lakh.

12.32 The banks have been required to reconcile the entries outstanding in their inter branch accounts within a period of six months (Circular DBOD

No.Fol.BC.114/16.01.001-93 dated April 28, 1993). The Reserve Bank of India vide its circular DBOD.No.BP.BC.73/21.04.018/2002-03 dated February 26, 2003 has reduced the time period allowed to banks for making provision against the net debit balance in the inter-branch account from one year to six months from the year ending March 31, 2004.

12.33 Accordingly, banks are required to arrive at the category-wise position of unreconciled entries outstanding in the inter-branch accounts for more than six months as on March 31, 2004 and make provision equivalent to 100 percent of the aggregate net debit under all categories. While doing so, the banks are required to ensure that:

(a) The credit balance in the Blocked Account created is also taken into account (Circular DBOD.No.BP.BC.73/ 21.04.018/98 dated July 27, 1998); and

(b) The net debit in one category is not set-off against net credit in another category.

12.34 While designing his audit procedures relating to this item, the auditor should also take into consideration the requirements of the Long Form Audit Report. The auditor is required to report on the following aspects in relation to inter-branch reconciliation:

- Comments on the system/ procedure and records maintained.
- Test check for any unusual entries put through inter-branch/ head office accounts.
- Position of outstanding entries; system for locating long outstanding items of high value.
- Steps taken or proposed to be taken for bringing the reconciliation up-to-date.
- Compliance with the RBI guidelines with respect to provisioning for old outstanding entries.

12.35 The existence and effective operation of adequate internal controls is of utmost significance in the case of banks to prevent the occurrence of errors and frauds in branch daily statements and to ensure expeditious reconciliation of inter-office transactions. The auditor should study and evaluate these controls. In particular, he should examine the existence and effective operation of internal controls relating to the following aspects:

- System of ensuring timely despatch of the daily statements by the branches. The procedures instituted for this purpose may include identification of branches that are habitually late in sending the statements and advising the controlling office of such branches to follow-up with the branches concerned.

- System of checking the opening balance of the daily statement of the branches to ensure that it tallies with the closing balance of the previous statement. As the entire system of inter-office reconciliation is usually computerised, the computer program itself may contain an instruction to check this aspect.
- System of pre-edit scrutiny of data to ensure the following:
  - Continuity of the branch daily statements.
  - Detection of obvious errors in the branch daily statements and initiation of immediate action for correction of such errors.
- System for segregation of the error data from the accepted data and editing of the error data to make it acceptable for processing.
- System of follow-up with branches regarding outstanding entries till they are cleared/ reconciled. Also indicate the date up to which various accounts pertaining to Inter Branch Transactions (e.g. Demand draft paid/ payable) is available with the bank. A year wise break up of outstanding entries in inter branch accounts, together with the statement of reasons for their remaining outstanding and the steps being taken by the management in respect thereof, should be obtained from the management and examined.
- System of review by the Board of Directors of the bank (half-yearly or at even shorter intervals) as desired by RBI.
- System to restrict originating debits to head office account to cash/funds transfer, purchase of securities/capital assets, withdrawals from Provident Fund, advances to inspection and other staff members, etc. as advised by the RBI vide its circular DBS.CO.SMC.BC. No.54/22.09.001 dated 13th June, 1999.

12.36 In evaluating the efficacy of the system for reconciliation of inter-office transactions, the auditor should also take into account the following factors:

(a) Application of the concept of A-B-C analysis to reconciliation of inter-office transactions, e.g., segregation of bulk transactions, high value items, cash and other items that are vulnerable to frauds.

(b) Special procedures, if any, evolved by the bank to expedite clearance of the arrears, particularly in respect of large-value entries.

(c) Action taken by the head office regarding any entries (particularly debit entries) not being responded by the branch concerned within a reasonable time.

12.37 The auditor should test check the reconciliation statements prepared by the bank. He should pay particular attention to high value items and old outstanding items. The auditor should also examine whether the balances under the head include items in the nature of cash-in-transit (e.g., cash meant for deposit into currency chest) which remain pending for more than a reasonable period, say within a week. He should review the steps taken or proposed to be taken by the management for clearing the outstanding entries in inter-branch accounts.

12.38 In respect of drafts, the auditor should examine whether there are old debits which have not been reported/reconciled.

12.39 The auditor should consider the extent of non-reconciliation in forming his opinion on the financial statements. He should obtain from the bank management, information about the unreconciled entries in inter-branch accounts, showing separately the gross debit amount and the gross credit amount, in respect of such entries together with their year-wise break up. Where the amounts involved are material, the auditor should suitably qualify his audit report. The qualification in this regard should explain the matter with sufficient details (including the gross debit and gross credit amounts which remain unreconciled as aforesaid together with the year-wise break up of outstanding entries) so that the readers can assess the significance of this qualification.

12.40 The auditor should obtain the particulars of frauds discovered during the year under audit at the bank's foreign offices in the following format and suggest ways, if any, to minimise its recurrence:

FRAUDS REPORTED BY FOREIGN OFFICES

Sr. No	Branch/ JV	Date of reporting by branch	Account	Nature of fraud	Amount involved	Provision held	Recovery status	Remarks including status regarding staff accountability exercise

III-13

Inter Office Transactions

13.01 One of the items to be shown under the head 'Other Assets' is the balance in the inter-office adjustments account or 'inter-branch account' (if in debit). The inter-office adjustments account is more commonly known at branch level as 'inter-branch account' or 'head office account'.

13.02 Each branch of a bank has a number of transactions with other branches/ offices as well as with the head office of the bank. In many transactions undertaken by the branch, one leg of the transaction involved is Inter Office Account. The major types of transactions are:

- Issue of remittance instruments like drafts/TTs/MTs on other branches.
- Payment of remittance instruments like drafts/TTs/MTs drawn by other branches.
- Payment to / receipts from other branches of the proceeds of instruments received/sent for collection/realisation/clearing.
- Payments made under LCs of other branches.
- Cash sent to/received from other branches.
- Payment of instruments like gift cheques/banker's cheques/interest warrants/dividend warrants/repurchase warrants/refund warrants / travellers cheques, etc. which are paid by the branch on behalf of other branches which have received the amount for payment of these instruments from the customers concerned.
- Head office interest receivable and payable by the branches.
- Profit/loss transferred by the branch to head office.
- Government receipts and payments handled by the branch either as the nodal branch or as an agent of the nodal branch.
- Operations by the authorised branches on the bank's NOSTRO accounts.
- Foreign exchange transactions entered into by the branch for which it has to deal with the nodal forex department of the bank for exchange of rupees with foreign currency.
- Deposits into and withdrawal of money, by branches into currency chest maintained by another branch.
- Gold Banking Transactions at the branch on behalf of nodal branches.

- Transactions through NEFT, ECS and RTGS.
- ATM transactions of the customer either at ATM linked with other branches or with merchant establishments.
- Internet based transactions other than inter account transfers with the same branch.
- Credit card related transactions of the customers.
- Nostro Accounts of Indian Branches maintained with Overseas Branches of the bank.
- Capital Funds with the Overseas Branches.
- Head Office balances with the overseas branches including subordinated debt lent to the overseas branches.

13.03 In recent years, many banks have implemented the concept of 'service branches'. These branches do not maintain any accounts of the public. They merely provide the following services:

- They act as agents for the other branches of the bank for collection of instruments drawn on local branches of other banks.
- To centralise the payment of drafts drawn by other outside branches. For example, if New Delhi branch of bank 'A' is the service branch, all other branches of the bank will be under instructions to issue drafts on this service branch only if any customer asks for a draft payable at New Delhi.

13.04 As regards the procedure of reconciliation of inter-branch transactions discussed later in this chapter, a service branch is like any other normal branch.

13.05 In the current scenario of virtual banking/core banking and also off-site banking like ATMs, mobile banking facilities etc., the use of technology gains immense importance. Unlike traditional banking where bank officials originate the transactions between inter-branch or inter-bank (both within and outside the country), the customer triggers such transactions automatically from e-banking/ATM usage etc.

13.06 The sheer number of inter-branch transactions makes their reconciliation a tedious task. Lack of reconciliation causes this account to be susceptible to frauds. Recognising this, RBI has taken a number of measures to achieve an expeditious reconciliation of these transactions by the banks concerned. Non-reconciliation results in a 'fraud risk factor' as defined in SA 240 (Revised) "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements". This Standard further provides that in such situation, auditor needs to modify his audit procedures to reduce the effect of the constituents of fraud risk.

13.07 In all inter-office transactions, one branch originates a transaction (called the 'reporting branch' or the 'originating branch') and the other branch (called the 'responding branch') settles the transactions at its end. For example, in respect of a draft issued by Branch X and paid by Branch Y, Branch X is the originating branch and Branch Y is the responding branch. As both the branches handle the same transaction, the debit and credit sides should perfectly match in the reconciliation department.

13.08 A separate department (mainly part of head/central office) of each bank handles the work of reconciliation of inter-branch transactions. In the case of some banks, the reconciliation department is sub-divided into segments, each segment handling the work of reconciliation of a specific kind of transactions, e.g., drafts, traveller's cheques, ATM, Nostro, etc.

13.09 The reconciliation procedure is generally on the following lines:

- Each branch submits a daily statement (commonly referred to as 'branch daily statement') in the prescribed format to the concerned segment of the reconciliation department containing particulars of all its dealings during the day with other branches/offices of the bank relating to that particular segment. In most banks, branches have to send the statement even if there have been no inter-branch transactions during the day; of course, the statement will be a 'nil' statement in such a case. (In some banks, the task of collection and despatch of the branch daily statements is entrusted to the zonal/regional offices concerned to ensure timely despatch by branches). A separate statement or schedule is normally required to be prepared covering a particular kind of transactions during a day. Thus, there would be separate statements covering transactions relating to TTs issued, TTs paid, collection items realised and sent to other branches, collection items received from other branches, and so on. The branch also prepares a summary (commonly known as H.O. A/c Summary) showing opening balances of the account, debits of all kinds, credits of all kind, and the closing balance. This summary is sent to the reconciliation department with all schedules and details of underlying transactions. For example, in the case of drafts, the branch sends details of all drafts handled during the day (issued as well as paid) giving particulars like draft no., other branch code no., amount, etc. Considering the large volume of transactions relating to demand drafts, RBI had advised the banks (vide its circular dated April 28, 1993) to segregate inter-branch transactions relating to demand drafts from other inter-branch transactions. Further, vide its circular no. DBS.CO.SMC.BC No. 28/22.09.001 dated 20th August, 1998, RBI has directed the banks to introduce the system of segregating DD/TT/MT transactions, with reconciliation at weekly intervals and close monitoring of large amounts.

- The statements, on receipt at the head office reconciliation section, are arranged date-wise and branch-wise. The statements are scrutinised before being entered into the computer system. This is known as pre-edit exercise and ensures the following:
  - Continuity of the branch daily statements by checking the opening/closing balances in the same. Any missing statements trigger follow up with the branch concerned.
  - Detection of obvious errors in the branch daily statements and initiation of immediate action for correction of such errors.
- The data from the branch daily statements are then fed into the computer. The error data are then separated from the accepted data. The error data are then edited and made acceptable for processing.
- As and when the other branch settles the funds transfer transaction in its books (by way of payment of draft/traveller's cheques, etc. or by acting on the advices received under the inter-branch account mechanism), it advises the details of these transactions like the reporting branch code no., date of transaction at the reporting branch, type of transaction, draft no., etc., to the reconciliation department.
- The type of transaction, the dates of transaction, the code nos. of the two branches and the amount involved in a transaction are the most important parameters for the reconciliation department. Some banks follow a process called 'forced matching' whereby, if two legs of a transaction as advised by the reporting and the responding branches concerned match on most parameters except a few, the transactions are considered as reconciled by suitably modifying the unmatched aspects. Forced matching is, however, not resorted to in case of substantial difference in amounts. The parameters for forced matching of transactions are explicitly laid down and have to be observed strictly. These parameters are of concern to the auditor as too liberal parameters may indicate the possibility of incorrect reconciliation.
- It is expected that as all transactions advised by a branch (either reporting or responding) have a contra leg, they should match (there may of course be some time lag between the dates of handling of two sides of the same transaction by the two branches). However, at times, the transactions do not reconcile due to incorrect particulars advised by a branch, or incorrect imputing of transactions in the computer system (including omission and duplication of transactions). More seriously, lack of reconciliation may be due to absence of one side of the

transaction, which might indicate a fraud if a debit at a branch does not have a corresponding credit at another branch.

- At regular intervals, the reconciliation department generates the particulars of transactions advised by a branch, which remain outstanding on a particular date. Sometimes, if the amount involved is very large, the department at more frequent intervals may generate special reports. These particulars are communicated to the branches concerned which are required to submit their point-wise replies to each outstanding entry within a given time schedule. In some cases, branches are required to submit documentary evidence in support of their entries. Besides, either or both the branches which are party to an un-reconciled transaction may also be advised by the reconciliation department to get in touch with each other to seek clarifications. The head office also keeps the controlling offices (i.e., the zonal/regional office) informed of the outstandings of the branches under their control to ensure follow up and to take necessary action as instructed by the head office.
- At all points – the reconciliation department, the originating branch and the responding branch – proper records of number of outstanding entries received/disposed of must be maintained.

13.10 The transactions which remain unmatched/unreconciled appear as inter-office adjustments balance in the balance sheet of the bank – under the head, 'Other Assets' if in debit, and under the head, 'Other Liabilities and Provisions' if in credit.

13.11 As the branch daily statements constitute the basis for reconciliation of inter-branch transactions, it is important to ensure that they are error-free and sent to the reconciliation department without delay. It has been observed that the following are the most common types of errors in branch daily statements.

- Wrong identification of the type of transaction.
- Recording of particulars in incorrect fields.
- Wrong accounting of bank charges, commission, etc.
- Errors in writing the amounts.
- Incorrect branch code nos.
- Incorrect schedule nos.
- Recording the same transaction twice.
- Difference between the closing and opening balances in successive daily statements.

13.12 In the context of the large bulk of transactions and enormous amounts involved, banks need to have adequate internal controls to prevent the occurrence of errors (and frauds) in branch daily statements and for their timely despatch.

13.13 Banks have been advised by RBI to segregate the credit entries outstanding for more than five years in inter-branch accounts and transfer them to a separate Blocked Account which should be shown in the balance sheet under the head 'Other liabilities and provisions–Others' (Schedule 5). While arriving at the net amount of inter-branch transactions for inclusion in the balance sheet, the aggregate amount of Blocked Account should be excluded and only the amount representing the remaining credit entries should be netted against debit entries. Banks have been advised that any adjustment from the Blocked Account should be permitted only with the authorisation of two officials, one of whom should be from outside the branch concerned, preferably from the controlling/head office if the amount exceeds Rs.1 lakh.

13.14 RBI vide its Circular DBOD No.BP.BC.73/21.04.018/2002-03, dated February 26, 2003, requires banks to make 100 per cent provision for net debit position in their inter-branch accounts arising out of the unreconciled entries, both debit and credit, outstanding for more than six months from the year ending March 31, 2004.

13.15 RBI has also advised the banks to maintain, beginning April 1, 1999, category-wise (head-wise) accounts for various types of transactions put through inter-branch accounts so that the netting can be done category-wise.

Audit Approach

13.16 While examining the inter-branch accounts, the auditor should ascertain the procedure followed by the bank for recording inter-branch transactions. This aspect assumes importance due to the fact that the methodology of recording various types of inter-branch transactions and the nomenclature of various accounts relating to inter-branch transactions differ from one bank to another. The procedure followed by the bank for maintaining inter-branch accounts should be such, as the same would facilitate compliance by the bank with the requirements of the RBI.

13.17 As already stated, given the large volume of inter-branch transactions and the large number of unreconciled entries, the area is fraud-prone. The auditor should bear this fact in mind while designing his audit procedures.

13.18 The auditor should ascertain the internal control procedures instituted at the branch to ensure the accuracy and timely dispatch of branch daily statements. He should also ascertain whether the branch responds quickly to queries received from the reconciliation department of the head office in respect of errors in branch daily statements and long outstanding items. For this purpose, the dates of dispatch of branch daily statements and of responses to queries received from reconciliation department of the head office should be examined on a sampling basis. The auditor should verify the year-end balance stated in the balance sheet with reference to the ledger balances and the closing balance as per the branch daily statement for the last day of the year. The auditor should also check on a sample basis some of the other branch daily statements (preferably consecutive) with reference to balances in the general ledger to see whether the balances as per the daily statements match with the ledger balances.

13.19 The auditor may pay special attention to the following points in the conduct of audit of inter-branch transactions:

(a) While verifying the closing balance, special attention should be paid to the origin and validity of old outstanding unmatched entries, particularly debit entries. The auditor may also seek confirmation of transactions relating to outstanding in appropriate cases.

(b) Whether there are any reversal entries indicating the possibility of irregular payments or frauds.

(c) Whether the balances include any items in the nature of cash-in-transit (e.g., cash meant for deposit into currency chest) included in this head which remain pending for more than a reasonable period, say, one week. This is because such items are not expected to remain outstanding beyond a very small period during which they are in transit.

(d) Whether transactions other than those relating to inter-branch transactions have been included in inter-branch accounts. Any unusual items put through inter-branch accounts as well as old or large entries outstanding in inter-branch accounts should be carefully looked into. The auditor may also seek explanations from the management in this regard in appropriate cases.

13.20 The auditor should test check the computation of interest on inter-branch transactions by the branch, wherever such interest is computed on outstanding balance in the inter branch account. Such interest is calculated on the basis of daily inter-branch balances and is advised to head office under the inter-branch accounting system by debiting or crediting the profit and loss account of the branch depending on whether the interest is payable or receivable. It may be noted that such interest gets offset during the process of consolidation and does not figure in the financial statements of the bank as a whole.

13.21 A group of inter-branch transactions which deserves special attention of the auditor relates to encashment of dividend warrants/interest warrants/refund orders, etc. (In the recent past due to number of frauds reported by the banks in these group it has gained significant importance). As the funds relating to these accounts are deposited by the customer at one branch and the payments take place in many other branches, to prevent frauds as well as accumulation of errors, it is essential that these payments should be squared off as soon as possible. At the branch level, the auditor should ask for ageing statements of debit balances appearing in these accounts and enquire into old balances.

13.22 The auditor is required to specify, in his long form audit report, the date up to which the reconciliation in various accounts pertaining to inter-branch transactions is available with the branch. Year-wise break-up of outstanding entries in the inter-branch accounts is also required to be obtained from the management in the prescribed format, along with a statement of the reasons for their remaining outstanding and the steps being taken by the management in respect thereof. The auditor should insist that the information as to the reasons for outstanding entries and steps being taken in respect thereof is specific. The auditor should pay special attention to large/old outstanding items.

13.23 Even if the entries are not old and constitute for last few days of the end of year, the auditor should check if there are any material entries which are shown in inter branch account and has an impact on the other major heads of accounts. In such case, the auditor shall advise the bank to account the same in natural head of account.

13.23 The following procedures may be adopted by the auditor for the audit of the reconciliation process:

1. Understanding and mapping the different transactions affecting inter office adjustment and their triggers including the scheme of accounting entries both at originating branch and final respondent branch office.
2. Understanding the reconciliation process of the Bank and the persons responsible towards this including mechanism of elimination of contra entries.
3. Checking the periodicity / effectiveness of such reconciliations and handling of the exception reports.
4. Understanding the ageing of the reconciliation and action taken towards the same including necessity of provisioning as per norms.

PART - IV

IV-1

Long Form Audit Report in Case of Bank Branches

1.01 In the case of branches, the auditors have to answer a detailed questionnaire formulated by the RBI. Such a report is usually termed as Long Form Audit Report (LFAR).

1.02 In the year 1985, RBI advised the Public Sector Banks to obtain LFAR from the auditors. The LFAR is not a substitute for the statutory report and is not deemed to be a part of the said report. The operations and audits of a bank are mainly based on the effective internal controls and this report serves the purpose of bringing to the notice of the management. The lacunae, shortcomings and failures in respect of compliance or adherence to the internal control measures adopted by the Banks. The main report is to be submitted as per the requirements of the Banking Regulations Act, 1949. LFAR is a separate report to be submitted to the Management, the format of which is prescribed by the RBI. The latest format of LFAR has been revised in the year 2003 and was made effective from 31st March, 2003.

1.03 LFAR is a questionnaire, which asks specific questions for which replies should be specific. Auditor should give specific comments and should refrain from answering issues for which replies were never sought unless relevant. The replies so prepared would reveal some facts which may be required to be looked into by the management for improving the working of the bank. It is advisable to discuss the contents of the LFAR with the branch head and get his responses before finalising the same. The object is to ensure correct presentation so as to state facts which have been verified during the course of audit.

1.04 It should be noted that specific disclosure, such as, in respect of extent of checking, manner of sample selection, limitations of documents verified, representations received, etc., should be made in the LFAR. The reliance placed on the computer system, which the auditor has not tested in depth for its reliability, should be clearly brought out in the LFAR. The auditor should also seek written representation from the management regarding any changes in CIS (Computer Information System) that have taken place during the year. In the preparation of the LFAR, the auditor should call for and look into the previous reports to ascertain whether in respect of the accounts for the year under audit, there are any matters, which deserve the attention of the management, particularly as regards adverse comments of a material nature in which remedial action was warranted.

1.05 The main report is a self-contained document and should not make any reference to the LFAR. However, matters in the main report may be elaborated in the LFAR. Where any of the comments made by the auditor in the LFAR is adverse, he should consider whether a qualification in the main report is necessary. Situations where relevant instances are giving rise to reservation/adverse remarks should be given along with reasons. It should not, however, be assumed that every adverse comment in the LFAR would necessarily result in a qualification in the main report. In deciding whether a qualification in the main report is necessary, the auditor should use his judgement in the facts and circumstances of each case.

1.06 In designing his audit program the auditor should take into consideration the requirement of the LFAR questionnaire and should, accordingly, plan his audit work so as to cover the areas mentioned in the LFAR simultaneously. This would enable the auditor to appreciate and consider the effect of various matters to be reported in his LFAR and his main audit report. As far as possible both the report should be submitted simultaneously. LFAR should not be finalised after the main audit report is signed but should be completed simultaneously in the case of a branch. However, the submission of the main report should not be delayed merely because the LFAR is pending for completion.

1.07 LFAR in respect of bank branches is prepared in such a manner so as to enable the expeditious completion and submission of the LFAR by the statutory auditors. It would also be desirable that the branch auditor familiarise themselves with the questionnaire applicable to the statutory auditors. In response to a question, the statutory auditor has to take into account comments made by the branch auditors in their LFAR with respect to such question. He should use his judgement to determine whether or not comments/observations made in the branch LFAR is material enough to be incorporated in his own report.

1.08 Some of the matters dealt with in the LFAR need compilation of detailed information/statements. It should be recognised that the responsibility for such compilation is that of the bank/branch concerned. Further, the auditor may also give disclaimer in LFAR with respect to any significant problem faced by him in the preparation of LFAR. Some of such problems are as follows:

(a) Lack of availability of necessary information;

(b) Lack of availability of computer systems to conduct audit;

(c) Instructions of Controlling Authorities not recorded or not shown to the auditors;

(d) Reliance placed on the computer system in operation should be stated if a system audit has not been done; and

(e) Reliance placed, if any, on the previous year's LFAR/concurrent and other audit reports.

1.09 In the LFAR, replies are given only to questions enumerated in the LFAR. The LFAR is only indicative in nature and additional areas like, KYC compliance/Demat accounts/ Lockers/ Security arrangements/ Risk based audits/ BCTT/ Service/ ATM's/ TDS, etc., can also be covered.

1.10 Some important areas to be noted while preparing LFAR are as follows:

(a) The auditor should be aware of the limits fixed or of various Instructions given by the controlling authorities of the bank with respect to various aspects covered in the LFAR.

(b) The auditor should note that in certain questions he has to specifically give an opinion.

(c) In certain questions replies are to be given specifically based on the cases examined/test checks done.

(d) In certain cases he has to study the system presently in operation in the bank so as to give his reply.

(e) In certain questions he has to specifically give suggestions, especially, regarding improvement in computerised information system and minimising possibility of frauds.

An illustrative list of data which is to be collected by the Auditor from the Branch for the purpose of compiling LFAR

- Branch closing instructions.
- Instructions of Controlling Authorities w.r.t. various issues.
- Organisation chart.

- Authorisation level and powers of branch officials.
- Previous years audit report/ LFAR/ Tax audit report inspection report of the branch, concurrent audit report@ and compliance thereon.
- Cash Retention Limit.
- Bank confirmations/Bank reconciliations.
- Insurance for Cash/Cash-in-transit.
- In case of advances of more than Rs. 2 crore sanctioned limit and outstanding balance (both funded and non-funded)
- List of NPA's and provisioning thereon.
- List of overdues/overdrawings.
- Stock audit reports/Unit inspection reports.
- Valuation reports of NPA Accounts where outstanding is more than Rs.1 crore and valuation has been done prior to three years.
- List of Frauds and follow-up action.
- Break up of Suspense A/c's.
- List of Provisions/Prepaid expenses.
- List of Security items as at 31st March.
- List of all Advances party-wise and limit-wise.
- List of Outstanding facility-wise.
- List of Contingent liabilities.
- List of fixed assets.
- Status of claims lodged with ECGC/DICGC/CGST@
- Cases of overdue proposals for review/renewal.
- Cases of sanctions not disbursed.
- Yearly break-up of matured deposits.
- Schedule of Charges (for booking of Income).
- System audit report, conducted, if any.
- List of Non corporate entities enjoying limit more than Rs.10 lakh.
- List of Sundry deposits/Bills payables.
- Report in desired format of Advances of more than Rs. 2 Crore.
- Stock register/ Insurance register/ Stationery draw power register/ Cheque book issuance register/ Cash book/ Sanction register/

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Custody register/ DD issued register/ Document register. • Head office/ Inter-branch reconciliation/ Cheque bouncing register. • Financial Statements of all the quarters of the year under audit. • List of Computer system (configuration-wise) and Accounting system in operation. • List of MIS reports/Returns submitted to various authorities. • Overdue locker rents/Vacant lockers. • Cash withdrawals/deposits of more than Rs.10 lakhs. • ATM Cards/Pin Cards not issued and lying in stock. • Cheque books not issued and lying in stock. • Status of PC virus upgrades. • Number of inoperative accounts. • Number of accounts maintaining balances below prescribed minimum. • Listing of Expired Guarantees. • Details of Customers complaints. • System generated statement for documents time barred by limitation.@ • System generated list of accounts which were due for review and not reviewed/renewed.@

1.11 Management Representation Letter should be demanded for matters as considered appropriate by the auditor, and which may include matters as enumerated below:

a) Use of fixed assets.
b) Effective operation of the internal control system throughout the year.
c) Maintenance of effective joint custody of cash at all times during the year.
d) Proper recording of all customer complaints.
e) Notice and reporting of frauds during the year.
f) Adherence to branch timings.
g) Non-sharing of passwords.
h) Nil window dressing of accounts.
i) Genuineness of credits, if any, in NPA accounts at the year end.

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Long Form Audit Report of Bank Branches

1.12 The clauses in the LFAR questionnaire to be dealt with by the branch auditors are discussed in the following paragraphs. The key word used in these paragraphs is 'Controlling Authority'. The auditor should refer the relevant circulars issued by the relevant controlling authority, as in the case of a branch any authority which is in a position to control its affairs can be called as a Controlling Authority, e.g., head office/zonal office or regional office.

1.13 It should be noted that replies are sought specifically in conjunction with the relevant bank instructions. A branch may be observing a system of control which may be perfectly in order but if the same is contrary to the instructions of the controlling authority on the same then it has to be specifically stated as a violation in the report.

I. Assets

Cash

(a) Does the branch generally carry cash balances, which vary significantly from the limits fixed by the controlling authorities of the bank? Whether excess balances have been reported to the controlling authorities of the bank?

1.14 The auditor should report on major and persistent deviations from the norms fixed by the controlling authority for the balances of cash held at the branch. This should be done with reference to a general scrutiny of cash balances. The auditors are also required to verify whether all excess balances have been reported to the controlling authorities by the branch as per the required norms and within the specified time frame. The auditor should also comment on the reasons for the excesses and the steps taken to ensure conformity with the retention limits.

(b) Does the branch hold adequate insurance cover for cash-on-hand and cash-in- transit?

1.15 The auditor should examine the adequacy of the insurance cover for cash-on-hand and cash-in-transit with reference to the cash balances generally carried by the branch. He should also examine whether the insurance policy is in force. The auditor should report whether the bank has obtained a global insurance policy in respect of cash-on-hand and cash in transit at all the branches. In case the answers are in negative, he should comment on the steps, if any, being undertaken to ensure conformity with the norms.

(c) *Is cash maintained in effective joint custody of two or more officials, as per the instructions of the controlling authorities of the bank?*

1.16 Cash is normally maintained under joint custody of the branch manager and the cashier. The main key to the safe is with the branch manager, whereas the second and the third keys are with accountant and/ or cashier. Each branch is generally required to maintain records showing details of keys and the key-holders. The auditor should ascertain whether instruction of the controlling authority in this regard have been complied with by the branch.

(d) *Have the cash balances at the branch been checked at periodic intervals as per the procedure prescribed by the controlling authorities of the bank?*

1.17 The auditors have to verify whether the procedure prescribed by the controlling authorities has been followed in relation to checking of cash balances at periodic intervals by the branch (preferably by a person who is not connected with the cash on day to-day basis.)[@]

1.18 In the normal course, cash balances are expected to be verified on a daily basis and recorded in the cash book (both in figures and in words) under the signature of the branch manager and another authorised signatory, since cash is generally under dual charge at the branch level.

1.19 A general scrutiny should be made of the cash book to ascertain whether, in accordance with the instruction, cash has been physically verified and tallied with the books maintained, with due authentication of such balances by the authorised signatories in the relevant books. Non-implementation of the cash verification procedure at the branch should be appropriately reported. Generally, a bundle count is done but a total cash count should be done preferably every quarter in case the instructions on the same are silent. Auditor should also comment on use of ultra-violet lamps, note counting machines or any other counterfeit note detection equipment. Observations should also be made on soiled notes, counterfeit notes and stapling of notes.

1.20 In cases where the branch has been authorised to operate currency chest/ small coin deposits, the auditor should ensure that the transaction relating to deposits into and withdrawals from currency chest/small coin

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deposits are recorded immediately. In case the relevant transactions are required to be communicated to a link office of the bank for the purpose of reporting the same to the RBI, the auditor may verify whether this has been done regularly. Special care should be taken to ensure that deposits into and withdrawals from currency chest/small coin deposits up to the year-end are properly recorded in the books. In verifying the balances with the RBI, the effect of currency chest/small coin deposits operation should also be seen.

The branch auditor should verify that 'clean note' policy guidelines issued by RBI have been followed.

The auditor should verify that soiled notes are submitted to exchanging authority from time to time and the balance of soiled notes should be minimum.

Balances with Reserve Bank of India, State Bank of India and Other Banks

(a) Were balance confirmation certificates obtained in respect of outstanding balances as at the year-end and whether the aforesaid balances have been reconciled? If not, the nature and extent of differences should be reported.

1.21 The auditor should insist on production of bank confirmation certificates as a part of his audit procedure. He should report the name of the banks and the year-end outstanding balances, which remain unconfirmed by the other banks. In case balance confirmation certificate have been received but the same have not been reconciled, the auditor should report, in respect of each bank, the balances as per books maintained by the branch and the balance as per the relevant balance confirmation certificate, stating in either case whether the balance is debit or credit.

(b) Your observations on the reconciliation statements may be reported in the following manner:

- *(i) Cash transactions remaining unresponded (give details)*
- *(ii) Revenue items requiring adjustments/ write-off (give details)*
- *(iii) Old outstanding balances remaining unexplained/ unadjusted. Give details for:*
  - *Outstanding between six months and one year; (including Receivable or payable)@*

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- *One year and above (including Receivable or payable)*@

1.22 The auditor should scrutinize the reconciliation statements and report his observations, stating the extent of major transaction of the nature specified in the questionnaire. It may be noted that in order to enable the auditor to cross-check and report his observation on the reconciliation statements, the reconciliation statements are usually required to be prepared in a standardised format. The auditor should obtain the details of old outstanding balances and examine whether any such balance has remained unexplained/ unadjusted. Such details need to be furnished in the LFAR, giving the break-up as outstanding between six months and one year; one year and above(Age wise analysis of entries needs to be seen).@

(c) In case any item deserves special attention of the management, the same may be reported.

1.23 Persistent defaults by the branch in not following the procedure for obtaining bank confirmation certificates and/or preparing reconciliation statements should be reported. Where any of the items of a material amount appearing in the reconciliation statements remain unresponded/unadjusted for an unreasonably long period, the auditor should state in respect of each such item, the nature, amount and the period for which it has remained unresponded/unadjusted. In doing so, items of the nature stated in the previous question may be reported separately.

Money at Call and Short Notice

Has the Branch kept money-at-call and short notice during the year? If so, whether instructions/ guidelines, if any, laid down by the controlling authorities of the bank have been complied with?

1.24 The auditor should examine the balances held at the branch in the above-mentioned account with reference to the general or specific authority from the controlling authority. He should also examine whether the instructions/guidelines laid down by the controlling authority in this regard have been complied with. Unauthorised deposits including those made in excess of the authorised limits arising in this account should be reported by the auditor, indicating dates on which the deposits were so made, the period for which these continued and the name(s) of the bank(s) with which such deposits were held. Similarly, cases of non-compliance with the relevant instructions/guidelines should also be reported.

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Investments

(A) For Branches in India

a) Are there any investments held by branches on behalf of Head Office/ other offices of the bank? If so, whether these have been made available for physical verification or evidences have been produced with regard to the same where these are not in possession of the branch?

1.25 The auditor should obtain a certificate from the branch head regarding the investments held by the branch on behalf of Head Office, with full details of the investments and dates of maturity. A 'Nil' certificate may be obtained in case no investments are held. The auditor should ensure physical verification of investments held by the branch on behalf of the Head Office/ other branches. Where any such investment is not made available to the auditor for physical verification and there is also no certificate/ acknowledgement of its having been deposited/ lodged with another office/ branch, etc., the auditor should report the nature and amount of the relevant investments.

b) Whether any amounts received as income on such investments have been reported to the Head Office?

1.26 The auditor should ensure that income received on investments held by the branch on behalf of the Head Office/ other branch is promptly reported to the Head Office/other branch.

c) In respect of investments held by branches on behalf of Head Office/ other offices of the bank whether any income is accrued/ received and recognised as income of the branch contrary to the instructions of the controlling authorities of the bank?

1.27 Auditor should verify that income received/ accrued on investment held by it on behalf of Head Office is recognised as income of the branch only if specific instructions are received from the controlling authorities of the bank in this regard. Auditor should report cases where income accrued/ received is recognised wrongly as income of the branch contrary to the instructions of the controlling authorities of the bank.

d) Whether there are any matured or overdue investments, which have not been encashed? If so, give details?

1.28 The auditor should verify the cases where investments are matured or overdue and have not been encashed. The auditor should report the nature, amount, maturity date, and reason for which the overdue investments are not encashed. The auditor should verify the same with the Investment Register maintained and correspondences of the branch and Head Office in this regard.

e) *Whether the guidelines of the Reserve Bank of India regarding Transactions in Securities have been complied with.*

1.29 The RBI has issued a number of guidelines for regulation of investments of banks. The auditor in his audit procedure has to verify whether the guidelines relating to transaction in securities have been complied (Refer Chapter III-2 on "Investments"). If any deviation is observed, the same has to be reported with details.

f) *Whether the guidelines of the Reserve Bank of India regarding valuation of Investments have been complied with.*

1.30 The auditor should enquire the mode of valuation of investments followed by the branch and examine whether it is following the guidelines issued by the RBI (Master Circular on "Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by banks" RBI/2012-2013/40 DBOD No. BP. BC.13/21.04.141/2012-13 dated July 2, 2012[@]). The auditor should also obtain from the branch management, a statement showing the basis of valuation of investments and state such valuation in his report. If the aforesaid statement is not made available to the auditor, he should report this fact. Impact of the same on the profit should also be reported. In case of any deviation in the mode of valuation, the auditor should report this fact, stating the nature of deviation, basis of valuation and amount of relevant investments.

(B) For Branches outside India

a) *In respect of purchase and sale of investments, has the branch acted within its delegated authority, having regard to the instructions/ guidelines in this behalf issued by the controlling authorities of the bank?*

1.31 Normally, the central/head office of the bank deals with the investment portfolio. However, in case of any regulatory requirements of the country in which the branch is located, the transactions of purchase and/or sale of investments should be verified with reference to the delegated

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authority from the controlling authority. Any unauthorised investments, including those made in excess of the specific limits or in contravention of the instructions/guidelines issued by the controlling authority, should be reported, stating the date of transaction, nature of investment and the amount involved in respect of each such transaction.

b) *Have the investments held by the branch whether on its own account or on behalf of the Head Office/ other branches been made available for physical verification? Where the investments are not in the possession of the branch, whether evidences with regard to their physical verification have been produced?*

1.32 The audit procedure should ensure physical verification of investments available with the branch, including those held by it on behalf of the Head Office/ other branches. Where any such investment is not made available to the auditor for physical verification and there is also no certificate/ acknowledgement of its having been deposited/ lodged with another office/ branch, etc., the auditor should report the nature and amount of the relevant investments.

c) *Is the mode of valuation of investments in accordance with the RBI guidelines or the norms prescribed by the relevant regulatory authority of the country in which the branch is located, whichever are more stringent?*

1.33 The auditor should enquire into the mode of valuation of investments followed by the branch and examine whether it is consistent with the practice as laid down by the relevant regulatory authority of the country in which branch is located. In case of any deviation, the auditor should report this fact, stating the nature of deviation, basis of valuation and amount of relevant investments. In case the mode of valuation of investments as laid down by the relevant regulatory authority of the country is different from the mode of valuation of investments followed by the head office, the auditor should state this fact along with the valuation. If the aforesaid statement is not made available to the auditor, he should report this fact.

d) *Whether there are any matured or overdue investments, which have not been encashed? If so, give details?*

1.34 The auditor should verify the cases where investments have matured or are overdue but have not been encashed. The auditor should report the nature, amount, maturity date, and reason for which the overdue investments have not been encashed.

Advances

1.35 With regard to the nature and extent of the auditor's response to the various questions relating to advances, the questionnaire states as below:

(The answers to the following questions may be based on the auditor's examination of all large advances and a test check of other advances. In respect of large advances, all cases of major adverse features, deficiencies, etc., should be reported. In respect of other advances, the auditor may comment upon the relevant aspects generally, along with instances of situations giving rise to his reservations or adverse remarks. For this purpose, large advances are those in respect of which the outstanding amount is in excess of 5% of the aggregate advances of the branch or Rs.2 crores, whichever is less.)

(a) Credit Appraisal

In your opinion, has the branch generally complied with the procedures/ instructions of the controlling authorities of the bank regarding loan applications, preparation of proposals for grant/ renewal of advances, enhancement of limits, etc., including adequate appraisal documentation in respect thereof.

1.36 For the purpose of proper credit appraisal, appropriate forms are generally prescribed by the Head Office for different categories of borrowers and for different types of credit facilities. The auditor is expected to report, based on his examination of advances sanctioned during the year.

1.37 Generally, banks have a system of periodic review of each advance. The primary purpose of this review is to ensure that the assumption on the basis of which the loans had been sanctioned continue to hold good; that the loan is being used for the purpose for which it was sanctioned (end use of funds)[@] and in case of deviation in respect of any aspect of the sanction, approval of appropriate authority has been obtained; that the project has been implemented as per the approval; there are no unexplained overruns in cost of the project;(physical and financial progress)[@] the borrowing unit is functioning properly; the stipulated installments/ interest are being paid regularly and promptly and in case of defaults, delays in payments, the reasons are looked into; the terms and conditions of the loan, particularly its restrictive covenants, are being duly complied with; the required margins are maintained in the accounts at all times; the properties mortgaged/

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hypothecated/ pledged are maintained in good order by the borrower and adequately insured, etc. The auditor should examine whether the system of periodic review is functioning effectively. Where there were any lapses in obtaining loan applications in appropriate forms, the auditor should state the nature and amount involved in relevant cases of large advances.

1.38 The auditor should check all large advances and test check other advances to ascertain whether the branch has complied with the instructions and/or the procedure prescribed by the Head Office regarding preparation of proposals for grant/review/renewal of advances, enhancement of limits, etc. In this regard, the auditor should also examine whether the procedure adopted for preparation of the proposals is such that the proposals are recommended after due consideration of all the relevant factors like, latest audited financial statements,(the financial statements should not be older than six months)[@] bank statements, past dealings, repayment capacity, etc., of the parties. He should examine copies of the proposals sent to the controlling office/Head Office and/or put-up to the branch manager for grant/review/renewal/enhancement of credit facilities. He should ascertain whether the proposals contain the requisite information along with the recommendations or comments. The auditor should also examine whether the review/renewal proposals are submitted in time so as to ensure that the facilities are not allowed to be availed of without appropriate sanction or authority after they have fallen due for review/renewal.

1.39 In order that the bank may be able to have proper recourse to legal action against the defaulting borrowers and/or guarantors, it is necessary that the documents obtained against credit facilities extended to the constituents are correct, appropriately stamped and properly executed; that all legal formalities in respect thereof are complied with; and that they are in force. In the case of large advances, the auditor should examine the documents to ascertain the deficiencies, if any. In case of other advances, the auditor should examine documents on a test-check basis and verify the documents/ security register to satisfy himself that the branch has followed the laid-down procedure in obtaining the documents

(b) Sanctioning/ Disbursement

(i) In the cases examined by you, have you come across instances of credit facilities having been sanctioned beyond the delegated authority

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or limit fixed for the branch? Are such cases promptly reported to higher authorities?

1.40 Normally, the system in a bank provides for limits on the sanctioning powers of authorities at various levels. The auditor should examine the documents prescribing such limits, e.g., operations manual, circulars from the Head Office, etc. Where, in the course of his examination of advances, the auditor comes across any cases of credit facilities sanctioned beyond the aforesaid limits, he should state this fact. He should also examine whether such cases have been reported to higher authorities as per the procedure laid down in this behalf. If not, he should report the fact along with the relevant details.

(ii) In the cases examined by you, have you come across instances where advances have been disbursed without complying with the terms and conditions of the sanction? If so, give details of such cases.

1.41 Where, in the course of his examination of advances, the auditor comes across cases of the nature referred to in the question, he should report the fact, along with the relevant details. He should also examine the causes for such breach and comment on the same. The auditor should examine whether there is a threat to the security.[@]

(c) Documentation

(i) In the cases examined by you, have you come across instances of credit facilities released by the branch without execution of all the necessary documents? If so, give details of such cases.

1.42 Generally, the system of a bank prescribes the documents to be executed in respect of various types of credit facilities. The auditor should scrutinise the documents executed in respect of the advances examined by him. In case the auditor comes across cases where credit facilities have been released by the branch without execution of all the documents, he should state this fact, giving details of relevant cases. Generally, most of the banks have a procedure of getting the documents over a particular sanction amount vetted by the bank's legal department or by a legal expert. The auditor should comment on the same.

(ii) In respect of advances examined by you, have you come across instances of deficiencies in documentation, non-registration of charges, non-obtaining of guarantees, etc.? If so, give details of such cases.

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1.43 Adverse features, particularly of the nature specified in the above question, noticed by the auditor in the course of his examination of advances should be reported as, defective mortgages. The auditor should give the relevant details in respect of each account in which such adverse features are noticed.

In case there is a system for vetting of the documents by the panel Advocate, the Advocate's report should be seen. The Advocate should certify the enforceability of the documents through Court.

The auditor should also go through the list of time barred documents generated through the system and form opinion regarding its recovery in such accounts and suggest appropriate provision, if necessary.@

(iii) Whether advances against lien of deposits have been properly granted by marking a lien on the deposit in accordance with the guidelines of the controlling authorities of the bank.

1.44 The auditor should verify that the advances given against lien of deposits have been properly granted by marking lien on deposit in accordance with the guidelines prescribed by the controlling authority. Cases where the prescribed guidelines have not been followed should be reported with relevant details. The lien on deposits should be marked in CBS.@

(d) Review/Monitoring/ Supervision

(i) Is the procedure laid down by the controlling authorities of the bank, for periodic review of advances including periodic balance confirmation/ acknowledgement of debts, followed by the branch?

Provide analysis of the accounts overdue for review/ renewal

- *between 6 months and 1 year, and*
- *over 1 year*

1.45 In the course of his examination of advances, the auditor should ascertain whether the procedure prescribed by the controlling authority for review of advances is strictly followed by the branch and whether the irregularities if any, are rectified and/ or brought to the notice of the controlling authority for remedial action, as may be required. Particular attention should be given to the requirement of obtaining periodic balance confirmation/ acknowledgement of debts by the branch to ensure that the documents are not rendered time-barred.

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1.46 To facilitate periodic review of advances, a register is maintained at the branch level (either manually or in the system) noting the due dates for review of limits. The auditor should ascertain whether there is a system of intimating the borrower well in advance of the due date for review and for obtaining the latest financial statements and other supporting papers required for review. The auditor should also examine whether there is a system of recording any adverse features in the operation of the account experienced by the branch or observed by internal auditors, inspectors, etc., in the review note.

1.47 The auditor should analyse and report the accounts overdue for review/ renewal for classification between 6 months and 1 year; and over 1 year. Causes for the delays should also be noted and reported.

1.48 The auditor should also examine where there is a system for charging penal interest for non renewal of accounts, such penal interest should be recovered till the date of renewal.[@]

(ii) Are the stock/ book debt statements and other periodic operational data and financial statements, etc., received regularly from the borrowers and duly scrutinised? Is suitable action taken on the basis of such scrutiny in appropriate cases?

1.49 The auditor should ascertain whether stock/ book debt statements, quarterly information statements, and other periodic operational data and financial statements, etc., are received from the borrowers in the prescribed format on a regular and timely basis. He should also ascertain whether effective system of scrutiny of such statements, data, etc., exists. Such scrutiny is generally aimed at ensuring that the valuation given by borrower is not in excess of market value/ cost price; the sale proceeds of the hypothecated stocks are by and large routed through the account as indicated by the operation in the account in relation to party's sales turnover; the prescribed margin is maintained; for the purpose of calculation of drawing power, the paid stock should be reckoned[@] the drawing power is revised from time to time on the basis of the stock statements; the composition and age of the hypothecated stocks are satisfactory; the directives of the RBI as issued from time to time regarding restrictions on advances against certain commodities are complied with; and the stocks are kept adequately insured. The auditor should also examine that remedial measures are initiated on any irregularities noticed, and/ or these are brought to the notice of the higher authorities for suitable action, as may be required. The auditor should report lapses in this behalf, which come to his notice during the course of audit.

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(iii) *Whether there exists a system of obtaining reports on stock audits periodically? If so, whether the branch has complied with such system?*

1.50 Stock audit in respect of large advances is very important for monitoring of the advance. Hence, auditors in the course of audit should verify whether there is any system of obtaining stock audit report periodically and branch has complied with such system. In case of non-compliance of the system, the auditor should report the same. Further, auditor should also verify whether the deficiencies noticed by the Stock Auditors are taken care of by the branch, if not, the same should be reported.

(iv) *Indicate the cases of advances to non-corporate entities with limits beyond Rs.10 lakhs where the branch has not obtained the accounts of borrowers, duly audited under the RBI guidelines with regard to compulsory audit or under any other statute.*

1.51 The RBI has issued a circular (dated 22nd December 1977 and revised by Circular dated April 12, 1985) advising all scheduled banks to ensure that non-corporate borrowers enjoying aggregate working capital limits of Rs. 10 lakhs or more from the banking system get their accounts audited by chartered accountants in the prescribed manner and submit a report in the format mentioned in *Guidance Note on Audit of Accounts of Non-Corporate Entities (Bank Borrowers)*. It would, therefore, be necessary for the auditor to report the names of the borrowers who have been sanctioned such limits, or in whose cases such limits have been renewed, without obtaining report in prescribed format.

1.52 However, vide circular DBOD NO. BP.BC.33/ 21.04.018/ 2002-03 dated October 21, 2002, RBI has further advised boards of the banks to suitably fix the cut off limit for such audited accounts depending upon the individual bank's policies. The auditor should ascertain whether such policy is formulated by the bank. Further the auditor should obtain from the branch management, cases of advances where limits have been granted or renewed beyond the stipulated limit and list out the names of borrowers and the year-end outstanding balances where the borrowers have not furnished their audited accounts and auditors' reports prior to the sanction/ renewal of the limits. In some cases, a part of the limit sanctioned at a branch is transferred to other branches of the bank to enable the borrower to utilise it at such branches. In such a case, the auditor of the branch at which the limit has been sanctioned should, where such limit is in excess of the stipulated limit, insist on the production of audited accounts of the borrower even where the available at the branch is below the stipulated limit. It should be noted that tax audit report and the auditor's report as required under this clause are not the same.

(v) *Has the inspection or physical verification of securities charged to the Bank been carried out by the branch as per the procedure laid down by the controlling authorities of the bank?*

1.53 The importance of physical verification of securities charged to the bank cannot be over-emphasised. The auditor has to ascertain that the hypothecated stocks, machinery, etc., are inspected by the branch officials at frequent intervals as per the procedure prescribed by the controlling authorities. For this purpose, the auditor should obtain from the branch management a statement of inspections due and inspections actually made during the year. The auditor should also scrutinise the relevant inspection reports. Cases of non-compliance of the prescribed procedure should be reported by the auditor.

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

1.54 The branch should give advances only after obtaining adequate security, which should be inspected before sanctioning the advances, if applicable in case of a collateral security, and thereafter regularly inspected by the branch. If the auditor comes across cases where there are deficiencies in value of securities and inspection thereof or any other adverse features such as, frequent/ unauthorised overdrawing beyond limits, inadequate insurance coverage, etc., he should report the details such as, name of the client, amount advanced, details of security, adverse features persisting in the account, etc. The auditor should verify the value of stocks as per the last balance sheet with the stock statement of that date and if wide variations are there, the same should be reported. The auditor should ascertain the reasons for the same from the branch.[@] The auditor should keep in mind the possible reduction in the value of security such as

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computers, software and other electronic items on account of technological changes or obsolescence.

(vii) In respect of leasing finance activities, has the branch complied with the guidelines issued by the controlling authorities of the bank relating to security creation, asset inspection, insurance, etc? Has the branch complied with the accounting norms prescribed by the controlling authorities of the bank relating to such leasing activities?

1.55 In course of his examination of lease finance activities, the auditor should ascertain whether the guidelines prescribed by the controlling authority of the bank relating to security creation, asset inspection, insurance, etc., are complied with in all respects. The auditor should also ascertain that the branch has compiled with the accounting norms prescribed by the controlling authorities of the bank relating to leasing activity. Reference may be made to "Master Circular - Para-banking Activities" dated July 2, 2012 (DBOD. No. FSD.BC 24/24.01.001/2012-13).[@] The Master Circular requires the banks to frame an appropriate policy on leasing business with the approval of the Boards and evolve safeguards to avoid possible asset liability mismatch. Further, it clarifies that while banks are free to fix the period of lease finance in accordance with such policy framed by them, they should ensure compliance with Accounting Standard (AS) 19 "Leases" prescribed by the Institute of Chartered Accountants of India (ICAI).

(viii) Are credit card dues recovered promptly?

1.56 The auditor in the course of his audit should verify whether credit card dues are recovered promptly and proper action as prescribed by the controlling authority has been taken by the branch in the cases where the dues are not recovered. The RBI has issued a Master Circular on "Credit Card Operations of banks" DBOD. No. FSD.BC. 23/ 24.01.011/ 2012-13, dated July 2, 2012 which *inter alia* discusses aspects of "Fair Practice in debt collection".

(ix) Has the branch identified and classified advances into standard/sub-standard/ doubtful/ loss assets in line with the norms prescribed by the Reserve Bank of India (The auditor may refer to the relevant H.O. Instructions for identification of NPAs and Classification of Advances).

1.57 The guidelines issued by the RBI for classifying advances into standard/ sub-standard/ doubtful/ loss assets are laid down in Master Circular on "Prudential norms on Income Recognition, Asset Classification

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and Provisioning pertaining to Advances" DBOD.No.BP.BC.9/21.04.048/2012-13 dated July 2, 2012. The auditor should examine whether the advances have been properly classified in accordance with the guidelines. In doing so, the auditor may also refer to the instructions of the head office regarding identification of non-performing assets and classification of advances.

(x) Where the auditor disagrees with the branch classification of advances into standard/ sub-standard/ doubtful/ loss assets, the details of such advances with reasons should be given. Also indicate whether suitable changes have been incorporated/ suggested in the Memorandum of Changes.

1.58 The auditor should check calculation of provisions under different categories of the non performing assets@. If the auditor does not agree with the classification of advances into standard/ sub-standard/ doubtful/ loss assets, by the branch, the details of such advances, with reasons and suitable changes, should be incorporated/ suggested in the Memorandum of Changes.

(xi) Have you come across cases where the relevant Controlling Authority of the bank has authorised legal action for recovery of advances or recalling of advances but no such action was taken by the branch? If so, give details of such cases.

1.59 The auditor should obtain from the branch management a list of cases where legal action for recovery of any advances or recalling of advances was authorised by the Board/ Local Board or Controlling Authority. The auditor should also examine previous reports in this regard. All the cases where action was required to be taken by the branch management pursuant to authorisation/ directions but has not been taken by the branch management, should be pointed out by the auditor.

A statement of suit filed and decreed accounts should be examined by the auditor to ascertain whether there is undue delay in obtaining Court decisions or filing execution proceedings.@

(xii) Have all non-performing advances been promptly reported to the relevant Controlling Authority of the bank? Also state whether any rehabilitation programme in respect of such advances has been undertaken, and if so, the status of such programme.

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1.60 The auditor is required to examine and report whether the branch has been submitting promptly the information regarding non-performing assets to the controlling authority as per the procedure laid down in this behalf. In cases where nursing or rehabilitation programmes have been initiated in respect of any non-performing assets, the status as at the year end and any important developments in relation thereto, including those after the close of the year, should be ascertained from the management and reported.

(xiii) Have appropriate claims for DICGC/CGSTE[@] and Export Credit Guarantee/ Insurance and subsidies, if any, been duly lodged and settled? The status of pending claims giving year wise break-up of number and amounts involved should be given in the following format:

Particulars	Number	Amount (Rs.)
Claims as at the beginning of the year (Give year-wise details)		
Further claims lodged during the year		
	____	_______
Total A	____	_______
Amounts representing:		
(a) Claims accepted/ settled (give year-wise details)		
(b) Claims rejected (give year-wise details)		
	____	_______
Total B	____	_______
Balance as at the year-end (give year-wise details)	____	_______
A-B		
	===	**======**

1.61 The auditor should ascertain the procedure for identifying accounts, which have become doubtful for recovery and in respect of which claims of the nature mentioned in the above clause are required to be lodged. He should then examine whether appropriate steps were initiated and the claims have been duly lodged. The status of the claim should be ascertained from the management and reported by the auditor in the format mentioned above.

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In addition, the auditor should also obtain a year-wise break up of outstanding claim from the management to determine the recoverability of the same. The auditor should ask for claims pending/ rejected and further action initiated by the bank.[@]

1.62 The number and amount of claims, which ought to have been lodged but not yet lodged, should also be ascertained from the management and reported.

1.63 In case the procedure of the bank requires the branch to lodge the claim through another branch or office designated for the purpose by the bank, the auditor should report whether the procedure has been implemented and the follow-up action for recovery of such claim duly taken.

(xiv) In respect of non-performing assets, has the branch obtained valuation reports from approved valuers for the fixed assets charged to the bank, once in three years, unless the circumstances warrant a shorter duration?

1.64 Valuation of securities is important in respect of non-performing assets, especially for deriving the provision amount required in advance accounts. The auditor should ensure that the securities charged to the bank in case of non-performing assets are valued by approved valuers at least once in three years, unless the circumstances warrant a shorter duration, and such value is considered for provisioning purposes.

(xv) In the cases examined by you has the branch complied with the Recovery Policy prescribed by the controlling authorities of the bank with respect to compromise/ settlement and write-off cases? Details of the cases of compromise/ settlement and write-off cases involving write-offs/ waivers in excess of Rs.50 lakhs may be given.

1.65 The auditor should verify the cases of compromise/ settlement and write-off during the year. The auditor should ensure that the branch has complied with the recovery policy prescribed by the controlling authorities. If any adverse feature has been observed by the auditor such as, acting beyond the delegated authority of the branch, etc., the same should be reported. The details of the cases of compromise/ settlement and write-off involving amount in excess Rs. 50 lakhs should be given.

(xvi) List the major deficiencies in credit review, monitoring and supervision.

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1.66 The primary purpose of credit review, monitoring and supervision is to ensure that the assumptions on the basis of which the loans have been sanctioned continue to hold good; the loan is used for the purpose for which it is sanctioned and in case of deviation in respect of any aspect of the sanction approval of appropriate authority is obtained; the project is implemented as per the approved lines; there are no unexplained overruns in cost of the project; the borrowing unit is functioning properly; the stipulated instalments/interest are paid regularly and promptly and, in case of defaults or delay in payment, the reasons are looked into; the terms and conditions of loan, particularly restrictive covenants, are being duly complied with; the required margins are maintained in the accounts at all times; the properties mortgaged/ hypothecated/ pledged are maintained in good order by the borrower and adequately insured, etc. Any major deficiencies in the design of the system of credit review, monitoring and supervision or in its actual implementation should be reported, particularly if these are not covered under clauses (i)-(xv) relating to advances, as discussed above.

(e) Guarantees and Letters of Credit

(i) Details of outstanding amounts of guarantees invoked and funded by the branch at the end of the year may be obtained from the management and reported in the following format:

(a) Guarantees invoked, paid but not adjusted:

Sr. No.	Date of invo-cation	Name of the party	Name of bene-ficiary	Amount	Date of Recovery	Remarks

(b) Guarantees invoked but not paid:

Sr. No.	Date of invo-cation	Name of the party	Name of bene-ficiary	Amount	Date of Recovery	Remarks

1.67 Guarantees being off-balance sheet items are prone to being crystallised into actual liability due to its invocation on non-performance by the borrower of the bank. [Master Circular on “Guarantees and Co-acceptances”, DBOD. No. Dir. BC. 02/13.03.00/2012-13 dated July 2, 2012] Frequent invocations and reasons thereof should be inquired by obtaining the relevant data in the aforesaid format from the branch.

(ii) Details of the outstanding amounts of letters of credit and co-

acceptances/letter of comfort@ funded by the Branch at the end of the year may be obtained from the management and reported in the following format:

Sr. No.	Date of funding	Name of the party	Nature (LC/ co-accep-tance, etc.)	Amount	Date of Recovery	Remarks

1.68 Similar to guarantees, letter of credit and co-acceptance, which are off-balance sheet items have a tendency to become fund-based limit on its devolvement due to non-payments of dues on the due dates by the borrower. Frequent developments in particular borrower accounts should be inquired and specifically commented. The auditor should obtain the relevant data in the aforesaid format from the branch.

Other Assets

(a) Stationery and Stamps

(i) Does the system of the Bank ensure adequate internal control over issue and custody of stationery comprising security items (Term Deposit Receipts, Drafts, Pay Orders, Cheque Books, Traveller's Cheques, Gift Cheques, etc.)? Whether the system is being followed by the branch?

1.69 The branch auditor should familiarise himself with the internal control system for issue and custody of stationery comprising of security paper and assess its effectiveness, since misuse of un-issued security paper or un-systematic issue thereof may lead to adverse consequences for the bank. The system should provide for physical check and periodic reconciliation of the relevant particulars with the records, and the differences, if any, should be reported to the controlling authorities. It should be examined whether the system for receipt, custody, storage and issue of security paper is properly implemented.

1.70 Cases of non-implementation of the internal control procedure, as laid down by the controlling authorities, with regard to security paper or any other inadequacies therein should be reported. The auditor should also offer his suggestions, if any, for improvement in the existing procedure.

(ii) Have you come across cases of missing/ lost items of such stationery?

1.71 If the auditor had come across any cases of missing/ lost items of

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stationery, it should be reported along with the details of missing/ lost items of stationery**.** The auditor should also comment on the weaknesses in controls which led to such loss of items.

(b) Suspense Accounts/ Sundry Assets

(i) Does the system of the Bank ensure expeditious clearance of items debited to Suspense Account? Details of old outstanding entries may be obtained from the branch and the reasons for delay in adjusting the entries may be ascertained. Does your scrutiny of the accounts under various sub-heads reveal balances, which in your opinion are not recoverable and would require a provision/ write-off? If so, give details in the following format:

Year	Amount (Rs.)	Remarks

1.72 The auditor should obtain from the branch management, details of old outstanding entries in suspense or other similar accounts as at year-end. The auditor should also ascertain from the branch management the reasons for delay in adjusting the outstanding entries. The auditor may review the steps being taken by the branch management for clearing outstanding entries.

1.73 The auditor may obtain the requisite information from the branch management in the abovementioned format (the format is merely suggestive in nature).

1.74 Where the auditor considers that the procedure for clearance of items in suspense account is inadequate or requires modification, he should give the relevant details in his report.

1.75 Where the auditor's enquiries from the management indicate that the outstanding balances comprised in the suspense or other similar accounts require a provision/write-off and such provisions/write-off has not been made, the branch auditor would have covered this matter in his main report (if the amount involved is material). Details of such outstanding balances should be given in the LFAR.

(ii) Does your test check indicate any unusual items in these accounts? If so, report their nature and the amounts involved.

1.76 Where, in the course of audit, the auditor comes across any unusual items in the suspense or other similar accounts, he should report the details of such items, indicating their nature and the amounts involved.

II. Liabilities

Deposits

(i) *Have the controlling authorities of the bank laid down any guidelines with respect to conduct and operations of Inoperative Accounts? In the cases examined by you, have you come across instances where the guidelines laid down in this regard have not been followed? If yes, give details thereof.*

1.77 Banks generally prescribe guidelines with respect to inoperative accounts like, permission for operation only on approval by higher authorities, transfer of such accounts from operative accounts ledger, etc. The auditor while scrutinising deposit accounts should confirm whether the controlling authority has prescribed any guidelines with respect to conduct and operations of inoperative accounts. If yes, then ascertain whether the branch has followed the same. In cases where the guidelines are not being followed, details of the deposits should be given, viz., name of the party, the amount due, due date, nature of the deposit, etc. The inoperative deposit accounts over 10 years should be separately listed for initiating action.[@]

(ii) *After the balance sheet date and till the date of audit, whether there have been any unusual large movements (whether increase or decrease) in the aggregate deposits held at the year-end? If so, obtain the clarifications from the management and give your comments thereon.*

1.78 In cut-off procedure if the auditor notices any unusual large movements (increase or decrease) in the aggregate deposits held at the year-end (31st March) till the date of audit, the auditor should report the same after obtaining suitable clarifications from the management.

(iii) *Are there any overdue/ matured term deposits at the end of the year? If so, amounts thereof should be indicated.*

1.79 Overdue/ matured term deposits should be identified and listed in the LFAR with the period for which it is overdue/ mature and whether interest has been provided by the branch on such overdue/ matured deposits. This would enable bank's management to take a view on the amount of provisioning required for interest thereon.

Other Liabilities

Bills Payable, Sundry Deposits, etc.

(i) *The number of items and the aggregate amount of old outstanding*

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items pending for three years or more may be obtained from the branch and reported under appropriate heads. Does the scrutiny of the accounts under various sub-heads reveal old balances? If so, give details in the following format:

Year	No. of items	Amount (Rs.)	Remarks

1.80 The auditor should obtain from the management list of old outstanding items comprised in bills payable account, sundry deposits account, etc., and verify the same. The number and the aggregate amount of items outstanding for over three years or more should be reported.

(ii) Does your test check indicate any unusual items or material withdrawals or debits in these accounts? If so, report their nature and the amounts involved.

1.81 Where, in the course of audit, the auditor comes across any unusual items in the bills payable, sundry deposits or other similar accounts, he should report the details of such items, indicating their nature and the amounts involved.

Contingent Liabilities

List of major items of the contingent liabilities (other than constituents' liabilities such as guarantees, letters of credit, acceptances, endorsements, etc.) not acknowledged by the branch?

1.82 In respect of contingent liabilities, the auditor is primarily concerned with seeking reasonable assurance that all contingent liabilities are identified and properly disclosed. To this end, the auditor should, generally follow the audit procedures given below:

a) Ascertain whether there are adequate internal controls to ensure that transactions giving rise to contingent liability are executed by persons authorised to do so and in accordance with the laid down procedures.

b) 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 the contingent liabilities are properly identified and recorded.

c) Perform substantive audit tests to establish the completeness of the recorded obligations. Such tests include confirmation procedures as well as examination of relevant records in appropriate cases.

d) Review the reasonableness of the year-end amount of contingent liabilities in the light of previous experience and also knowledge of the current year's activity.

e) Obtain representation from the management that all contingent liabilities have been disclosed and that the disclosed contingent liabilities do not include any contingencies which are likely to result in a loss and which, therefore, require consequent adjustments of assets and liabilities.

III. Profit and Loss Account

(a) Whether the branch has a system to compute discrepancies in interest/ discount and for timely adjustment thereof in accordance with the guidelines laid down in this regard by the controlling authorities of the bank? Has the test checking of interest revealed excess/ short credit of a material amount? If so, give details thereof.

1.83 A test check of interest/ discount income may reveal discrepancies in the amount of interest/ discount credited during the year. The auditor should verify that the adjustments of the discrepancies have been done in accordance with the guidelines laid down in this regard by the controlling authority. It may be useful for the auditor to scrutinise the revenue audit report/ income and expenditure audit report to identify excess/ short credit of material amount of interest/ discount. While reporting significant discrepancies in his main report, the branch auditor should elaborate the same in his LFAR. Where the auditor finds discrepancies in recording of interest/ discount income in a large number of cases, he should also assess their effect on his planned audit procedures.

(b) Has the branch complied with the Income Recognition norms prescribed by the RBI? (The auditor may refer to the instructions of the controlling authorities of the bank regarding charging of interest on non-performing assets).

1.84 The RBI guidelines for income recognition are laid down in Master Circular "Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances" DBOD.No.BP.BC.9/21.04.048/2012-13 dated July 2, 2012). The auditor should examine compliance with these guidelines. For this purpose, the auditor may also refer to the instruction regarding charging of interest on non-performing advances as may have been issued by the controlling authorities. The auditor should also ensure that if any advance, including bills purchased and discounted, becomes NPA as at the close of any year, interest accrued and credited to income account in the corresponding previous year, should be reversed or provided for if the same is not realised.

1.85 The exemptions or capitalisation of interest in specific accounts during the moratorium period should be seen e.g. educational loans/agricultural lons/project loans etc.@

(c) *Whether the branch has a system to compute discrepancies in interest on deposits and for timely adjustment of such discrepancies in accordance with the guidelines laid down in this regard by the controlling authorities of the bank? Has the test check of interest on deposits revealed any excess/ short debit of material amount? If so, give details thereof.*

1.86 A test check of interest on deposits may reveal discrepancies in the amount of interest on deposits debited during the year. The auditor should verify that the adjustments of the discrepancies have been done in accordance with the guidelines laid down by the controlling authority. It may be useful for the auditor to scrutinise the revenue audit report/ income and expenditure audit report to identify excess/ short debit of material amount of interest on deposits. While reporting significant discrepancies in his main report, the branch auditor should elaborate the same in his LFAR. Where the auditor finds discrepancies in recording of interest on deposits in a large number of cases, he should also assess their effect on his planned audit procedures.

(d) *Does the bank have a system of estimating and providing interest accrued on overdue/ matured term deposits?*

1.87 The auditor should perform a systematic verification of the overdue deposits. He should check whether the branch estimates and provides interest on overdue/ matured term deposits. If yes, the auditor may assess the overall reasonableness of the figures of interest expense on overdue deposits by working out the ratio of inertest on different types of deposits to the average quantum of respective liabilities during the year. For example, the auditor may obtain from the branch an analysis of the various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The auditor may then compare this rate with the actual rate of interest provided on the relevant deposits as per the financial statements and enquire into the difference, if material. The auditor may also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous year and analyse any material differences.

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(e) *Are there any divergent trends in major items of income and expenditure, which are not satisfactorily explained by the branch? If so, the same may be reported upon. For this purpose, an appropriate statement may be obtained from the branch management explaining the divergent trends in major items of income and expenditure.*

1.88 The auditor should request the management to co-relate the interest and other income to the relevant aggregate of average advances/ outlay of funds and make a comparison of the figures for the year under audit with those of the earlier years and explain any divergent trends noticed between the figures upon co-relation thereof. To the extent these are not satisfactorily explained by the management or the auditor observes reasons, which are different from those stated by the management, this should be suitably reported. Similarly, divergent trends, if not satisfactorily explained by the management when co-relating interest paid on deposits, borrowings, etc., with the relevant figures of aggregate average deposits and borrowings, should be commented upon by the auditor.

IV. General

Books and Records

(a) *In case any books of account are maintained manually, does general scrutiny thereof indicate whether they have been properly maintained, with balances duly inked out and authenticated by the authorised signatories?*

1.89 If the auditor has any observations as to the books of account maintained manually not having been properly maintained, e.g., where balances have not been inked or authenticated, he should point out in the LFAR the relevant defects, specifying the books of account in respect of which he has noticed these defects.

1.90 Proper maintenance of books of account would include books being written in a fairly legible manner. The branch auditor should carry out a general scrutiny of the books and report if they are mutilated, torn or otherwise destroyed. He should also generally examine whether over-writing, cutting or rubbing of the figures, or alteration of books of account without proper authentication, is a regular feature.

(b) *In respect of computerised branches:*

- *Whether hard copies of accounts are printed regularly?*

1.91 The auditor should verify whether the hard copies of the accounts have been printed regularly, as changes are not traceable in soft copies. Auditor should check the transactions of the day and verification of the same by the senior official. To verify this, the auditor should obtain a list of day-end and exceptional reports generated by the system. The indicative list of day-end and exceptional reports is as follows:

- Negative Balance Report
- Supervisory Report
- Demographic Changes Report
- Interest/Changes Parameter Changes Report
- Exceptional transactions report.@
- Cash balance exceeding retention limit@
- General Ledger
    - *Indicate the extent of computerisation and the areas of operation covered.*

1.92 Auditor should check the extent of computerisation and give specific thrust on the following areas:

- Account Opening/Closure
- Interest Calculation
- Cheque Book Issue
- Clearing
- Drawing power monitoring
- NPA provisioning
- Cash Management System
- ATM Transactions
- Books of Accounts
- Generation of Financial Statements
- Remittances
- Payment before maturity of term deposits.@
- Death claim settlements.@
    - *Are the access and data security measures and other internal controls adequate?*

1.93 The auditor should check whether there exists a proper security system. The system provides for a number of controls which seek to ensure that the system is not put to unauthorised use, the transactions entered in the

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system are valid and accurate, and exceptional matters as well as other significant matters are reported on a timely basis. For example, the following controls seek to ensure that the system is not put to unauthorised use:

- A valid login name and password are essential to enter into the system.
- A user can login from a specified workstation only.
- A minimum password length is required.
- The password needs to be changed at least once during a prescribed period.
- The maximum number of attempts to enter the system from a workstation is specified. Thus, if an incorrect password(s) is entered from a workstation as soon as the number of attempts reaches the specified limit, the user is locked out and a message to this effect, identifying the workstation, is flashed on the system administrator's console/ other workstations.
- Access to the system is available only during stipulated hours and specified days only.
- Individual users can access only specified directories and files.
- The access to various menus (such as, opening of an account, closing of an account, change in limit or drawing power in a cash credit account, interest rate change, cheque book issue, etc.) is controlled through passwords. Thus, while an operator may enter into the system using his login name and password, he cannot access the menus that have been password protected for use by systems administrator.
- The access to systems software is restricted through password protection. (The systems software contains several utilities, such as, copy, delete, etc., that can be used for unauthorised copying or deletion of files.)
- Exceptional situations, such as, limit excess, re-activating dormant accounts, etc. can be handled only with a valid supervisory level password.
- A user timeout is prescribed. If the keyboard of a workstation remains inactive for the specified duration (say 0.5 minutes), the user has to re-enter the system using his password. This control prevents any unauthorised use when a workstation is left unattended.
- Wherever any rectification or alteration is carried out by more than one level of the officers, such alterations or changes are made as

an additional entry and not by changing or deleting an existing recorded entry.

- Once the end-of-the-day process is over, the ledgers cannot be opened without a supervisory level password.
- The system maintains a record of all log-ins and log-outs. The access to this record is not possible without the systems administrator's password.
- The system maintains a record of date and time of the changes in password.

1.94 Similarly, the following controls seek to ensure the validity and accuracy of transactions entered in the system.

- The system requires maker checker control at the time of input.
- The operation instructions, such as, single operation, joint operation, either or survivor operation are flashed on the screen when the account is accessed.
- The system checks for cheque number range and stop payment instructions before processing a transaction.
- The system checks whether the amount to be withdrawn is within the drawing power.
- The system flashes a message if the balance in a lien account would fall below the lien amount after the processing of the transaction. The transaction processing is halted and can be proceeded with only with the supervisory password.
- If the transaction is sought to be posted to a dormant (or inoperative account), the processing is halted and can be proceeded with only with a supervisory password.
- The branch manager is required to send a certificate to the controlling authority at stipulated intervals regarding the functioning of the entire computerised system including compliance with prescribed procedures and processes.

1.95 Some important areas pertaining to the functioning of the computerised system are as follows:

- Direct access to database restricted
- Automatic flagging of NPAs and provisioning thereof
- Verification of parameters defined for the master record of the account holder, permission to change parameters restricted to authorised personnel
- In-built controls in system to collect pending charges from account

- Controls over using data transmission devices
- Access to internet is under supervisory control
    - *Whether regular back-ups of accounts and off-site storage are maintained as per the guidelines of the controlling authorities of the bank?*

1.96 After end of the day, the stipulated number of back-ups are taken on the prescribed media. The system provides for the off-site back up of at least one copy of the updated data. The backup is required to be retained as part of the branch records as per policy formulated by the bank for retention of records.

- *Whether adequate contingency and disaster recovery plans are in place for loss/ encryption of data?*

1.97 The auditor should verify whether any contingency and disaster recovery plans (DRP) are in place for loss/ encryption of data. In case no plans are in place, it should be reported. For example, the following steps should be taken to ensure that Business Contingency Plans (BCP) and DRP exists:

- Stipulated number of back-ups is taken on the prescribed media.
- Identification and accessibility to off-site backup is supervised.
- Service Level Agreements with vendors for maintenance are in force during the period.
- Interview with branch management for awareness of BCP and DRP.
    - *Do you have any suggestions for the improvement in the system with regard to computerised operations of the branch? [to be added]*

1.98 The auditor should review risks arising from use of information system and examine whether appropriate internal controls have been put in place in response to those risks. Any suggestion for improvement of the computerised operation of the branch should be incorporated with details (Reference may be made to chapter II-3 of the Guidance Note).

Reconciliation of Control and Subsidiary Records

1.99 *Have the figures, as at the year-end, in the control and subsidiary records been reconciled? If not, the last date upto which such figures have been reconciled should be given under the respective heads, preferably in the following format:*

Account	Date	General Ledger Balance (Rs.)	Subsidiary Balance (Rs.)	Last Date on which balanced

1.100 The auditor is expected to list out the heads of account and indicate the balances as per the general ledger control account and those as per the subsidiary records in the manner indicated in the question. Where the subsidiary records have not been balanced or are incomplete, the relevant particulars should be reported indicating the date(s) up to which the control and subsidiary records are balanced.

Inter-Branch Accounts

(i) Does the branch forward on a daily basis to a designated cell/ Head Office, a statement of debit/ credit transactions in relation to other branches?

1.101 The auditor should verify that the branch forwards on a daily basis to the designated cell/ Head Office, a statement of debit/ credit transaction in relation to other branches. In case of non-compliance, the auditor should report the same with illustrative list of days on which the statement has not been forwarded.

(ii) Does a check of the balance in the Head Office Account as shown in the said statement during and as at the year-end reveal that the same is in agreement with the Head Office Account in the general ledger?

1.102 The auditor should verify that the balance in the Head Office Account as shown in the statements sent by the branch on a daily basis and as at the year-end are in agreement with Head Office Account in the General Ledger. If these are not in agreement, the auditor should report the difference with the reasons.

(iii) Are there any outstanding debits in the Head Office Account in respect of inter-branch transactions?

1.103 The auditor should obtain the outstanding debit balance in the Head Office Account in respect of inter-branch transactions with the details thereof. Based on his review of the details and the provisions of the RBI with respect to IBR transactions, he should form an opinion as to the provisioning or otherwise of such transactions.

(iv) Does the branch expeditiously comply with/ respond to the communications from the designated cell/ Head Office as regards

unmatched transactions? As at the year-end are there any unresponded/ uncomplied queries or communications? If so, give details?

1.104 The auditor should in case of unmatched transactions verify whether the branch expeditiously comply with/ respond to the communications from the designated cell/ Head Office to reconcile the items. If at the year-end there are any unresponded/ uncomplied queries or communication, he should report the same in the LFAR with details thereof like, date of transaction, amount, debit/ credit, particulars, etc.

(v) Have you come across items of double responses in the Head Office Account? If so, give details.

1.105 In case of transaction for which double responses have been received in the Head Office Account, the auditor has to report the same with the details like, date of the responses, date of transaction, details of the transaction as per the head office records and as per the branch records, etc.

(vi) Are there any old/ large outstanding transaction/ entries at debits as at year-end which remain unexplained in the accounts relatable to inter-branch adjustments?

1.106 The auditor should verify and report any old/ large outstanding transaction/entries at debits lying in the branch adjustments as at the year-end which remain unexplained. Based on his review of the details and the provisions of the RBI with respect to IBR transactions, he should form an opinion as to the provisioning or otherwise of such transactions.

Audits/Inspections

(i) Is the branch covered by concurrent audit or any other audit/ inspection during the year?

1.107 The auditor should see whether the branch is covered by concurrent audit or any other audit/ inspection during the year. If it is covered whether audit has been conducted and if yes, then report of the other auditor should be obtained and ascertained whether reliance can be placed on the findings of such audit reports in framing his opinion. If such audit/ inspection has not been conducted the same should be reported.

(ii) In framing your audit report, have you considered the major adverse comments arising out of the latest reports of the previous auditors, concurrent auditors, stock auditors or internal auditors, or in the special

audit report or in the inspection report of the Reserve Bank of India? State the various adverse features persisting in the branch, though brought out in these audit/ inspection reports.

1.108 The auditor should make a written request to the branch management for furnishing him the latest available reports of the statutory auditors (including the LFAR, if any, pertaining to the branch) and of the concurrent auditor or stock auditor or internal auditors, as also of the RBI where inspection or special audit has taken place for the branch. The auditor should scrutinise the contents of such reports and take a note of relevant major adverse comments. In case the adverse features are observed to persist at the branch or where no remedial action has been taken he should report accordingly.

1.109 It is suggested that the auditor should report on the adverse features in a proper sequential order, for example, by first considering all items of assets, then liabilities, income and expenditure and, thereafter, general issues related to other matters including house-keeping of records. The auditor should comment whether the remedial action undertaken addresses the root cause of the problem and seeks to rectify the cause of the error rather than just correcting the error.

Frauds

Furnish particulars of frauds discovered during the year under audit at the branch, together with your suggestions, if any, to minimise the possibilities of their occurrence.

1.110 Banks normally maintain a record, usually in a separate register, of frauds which have taken place at any branch or other office and which have been brought to the notice of the head office/ controlling authority of the bank. The auditor should look into the cases of major frauds, which have been discovered and recorded including those, which have been reported after the year-end. The auditor is expected to report on major frauds discovered and recorded by the bank. In this regard, RBI has issued "Master Circular-Frauds-Classification and Reporting" DBS.FrMC.BC.No. 1/23.04.001/2012-13 dated July 2, 2012.

1.111 In case the auditor observes weaknesses in the internal control system, which has resulted in frauds, or where the *modus operandi* is common, he may give his suggestions for overcoming such weaknesses.

1.112 The auditor should verify loan against NRI deposits and see that proper procedures have been adopted as there are instances of frauds in these accounts.

Miscellaneous

(i) Does the examination of the accounts indicate possible window dressing?

1.113 Where the auditor's examination indicates possibility of window dressing, e.g., large number of deposits accepted close to the balance sheet date and refunded immediately after the balance sheet date, deposits from and advances to same borrower/ sister concerns/ group, he should report the fact of possibility of window-dressing, along with a general description of the nature of relevant transactions and the amounts involved.

(ii) Does the branch maintains records of all the fixed assets acquired and held by it irrespective of whether the values thereof or depreciation thereon have been centralised? Where documents of title in relation to branch or other branches are available at the branch, whether the same have been verified.

1.114 The auditor should verify that the branch maintains records of all fixed assets acquired and held by it irrespective of whether the values thereof or depreciation thereon have been centralised. The documents of title, if available with the branch, should be verified and in case these are not available, appropriate evidence from the management should be taken.

1.115 If the branch premises are on lease basis/rental basis, the agreement to that effect should be seen. The auditor should also examine whether the same has been on due date.@

(iii) Are there any other matters, which you as a branch auditor would like to bring to the notice of the management or the Central Statutory Auditors?

1.116 Besides covering specific issues in response to the questions in the questionnaire, the branch auditor may report on other significant areas, which, in his opinion, deserve to be highlighted in his report. These areas would generally be on issues which are detected by him at the particular branch but would have implications at all/any other branches of the bank.

@ Revised in 2013 Edition.

Questionnaire Applicable to Specialised Branches

For Branches dealing in Foreign Exchange Transactions

1.117 It should be noted that certain branches do not deal in foreign exchange transactions but foreign currency accounts are maintained there and all records of account opening documentation are held at these branches. In such cases, checking and reporting should be done of the account opening documentation and commented upon in this section of LFAR.

1. *Are there any material adverse features pointed out in the reports of concurrent auditors, internal auditors and/ or the Reserve Bank of India's inspection report which continue to persist in relation to NRE/ NRO/ NRNR/ FCNR-B/ EEFC/ RFC and other similar deposit accounts If so, furnish the particulars of such adverse features.*

1.118 The auditor should make a written request to the branch management for furnishing him the latest available reports of the statutory auditors and of the concurrent auditor or stock auditor or internal auditors, as also of the RBI where inspection or special audit has taken place for the branch. The auditor should scrutinise the contents of such reports in relation to NRE/ NRO/ NRNR/ FCNR-B/ EEFC/ RFC and other similar deposit accounts and take a note of relevant major adverse comments. In case adverse features are observed to persist at the branch or where no remedial action has been initiated or taken by the branch management, he should report the same.

2. *Whether the Branch has followed the instructions and guidelines of the controlling authorities of the bank with regard to the following in relation to the foreign exchange and, if not, state the irregularities.*

   (a) deposits
   (b) advances
   (c) export bills
   (d) bills for collection
   (e) dealing room operations (where a branch has one)
   (f) any other area

1.119 The auditor also has to make himself familiar with the relevant aspects of the Exchange Control Manual and its compliance. The auditor should verify whether the instruction and guidelines of the controlling authorities of the bank in relation to the foreign exchange have been followed by the branch in respect of these areas. If any irregularity is observed the same should be reported with details.

3. *Obtain a list of all NOSTRO Accounts maintained/ operated by the Branch from the branch management.*

1.120 The auditor should obtain a list of all NOSTRO Accounts for the purpose of verification from the branch management.

(a) *Are the NOSTRO Accounts regularly operated?*

1.121 The auditor should verify whether the NOSTRO Accounts are being regularly operated. If not give the list of NOSTRO Accounts with balances outstanding, which are not operated regularly, the date of last transaction, etc. The auditor should specifically comment on overdrafts in Nostro accounts, if any.

(b) *Are periodic balance confirmations obtained from all concerned overseas branches/ correspondents?*

1.122 The auditor should verify whether the balance confirmation from all concerned overseas branches/ correspondents have been obtained on a periodic basis. He should report the names of the bank and the period wise outstanding balances, which remain unconfirmed.

(c) *Are these accounts duly reconciled periodically? Your observations on the reconciliation may be reported.*

1.123 While examining the transaction in foreign exchange, the auditor should also pay attention to reconciliation of NOSTRO Accounts with the respective minor account. The amount in the NOSTRO account is stock of foreign currency in the form of bank accounts with the overseas branches and correspondents. Un-reconciled NOSTRO Accounts, on an examination, may reveal unauthorised payments from the foreign currency account, unauthorised withdrawals, and unauthorised debit to minor account. The auditor should also evaluate the internal control with regard to inward/ outward messages. The inward/outward messages should be properly authenticated and discrepancies noticed should be properly dealt with in the books of accounts. In case balance confirmation certificate have been received but the same have not been reconciled, the auditor should report, in respect of each bank, the balances as per books maintained by the branch and the balance as per the relevant balances confirmation certificate, stating in either case whether the balance is debit or credit.

4. *Does the Branch follow the prescribed procedures in relation to maintenance of Vostro Accounts?*

1.124 The auditor should verify whether prescribed procedure in relation to inter bank confirmation in the Vostro account is followed or not. In case balance confirmation certificate have been received but the same have not been reconciled, or where confirmation has not been received the same should be reported, in respect of each Vostro Account. The RBI has also issued the Master circular on "Memorandum of Instructions for Opening and Maintenance of Rupee/Foreign Currency Vostro Accounts of Non-resident Exchange Houses" No. 3/2012-13 dated July 2, 2012.

For branches dealing in very large advances, such as, Corporate Banking Branches and Industrial Finance Branches or branches with advances in excess of Rs. 100 crores

1. *In respect of borrowers with outstanding of Rs. 2 crores and above, the information in the enclosed format should be obtained from the Branch Management. Comments of the Branch Auditor on advances with significant adverse features and which might need the attention of the Management/Central Statutory Auditors should be appended to the Long Form Audit Report.*

1.125 The branch auditor should obtain details and other information, in respect of all advances, which are in excess of Rs.2 Crores, which would be relevant to complete the enclosed format from branch manager.

1.126 Any advances account with significant adverse features like, non-operative for quite a long time, renewed without adequate credit appraisal, fresh advances granted without obtaining necessary approval, etc., on which branch auditor has commented and which is of such a nature that central statutory auditor is required to consider it for qualifying and/or disclosing in main report, should be attached as an annexure to LFAR.

2. *What, in your opinion, are the major shortcomings in credit appraisal, monitoring, etc.?*

1.127 Major shortcomings in credit appraisal will have to be disclosed in the LFAR which could either be stated on the face of the report or could be reference to an annexure. Examples of major shortcomings in credit appraisal are stated below:

- Loan application not on record at Branch.

- The appraisal form was not filled up correctly and thereby the appraisal and assessment was not done properly.
- Loan application is not in the form prescribed by Head Office.
- The Bank did not receive certain necessary documents and annexures required with the application form.
- Basic documents such as Memorandum and Articles of Association, Partnership deed, etc., which are pre-requisite to determine the status of the borrower have not been obtained.
- Certain adverse features of the borrower not incorporated in the appraisal note forwarded to the management.
- Industry/ group exposure and past experience of the Bank is not dealt in the appraisal note sent to the management for sanction.
- The level for inventory/ book-debts/ creditors for finding out the working capital is not properly assessed.
- Techno-economic feasibility report, which is required to know the technical aspects of the borrower's business, is not obtained from Technical Cell.
- Credit report on principal borrowers and confidential report from their banks are not insisted from the borrowers.
- The opinion reports of the associate and/or sister concerns of the borrower are not scrutinised/ called for/ not updated/ not satisfactory.
- The procedure/ instructions of Head Office regarding preparation of proposals for grant or proposals for renewal of advances or proposals for enhancement of limits, etc., are not followed.
- No exposure limits are fixed for forward contract for foreign exchange sales/ purchase transactions.
- No adequate security obtained/ charge created.
- The director/borrower's names do not appear in RBI/CIBIL defaulters list.[@]

3. List the accounts (with outstanding in excess of Rs.1 crore), which have either been downgraded or upgraded with regard to their classification as Non Performing Asset or Standard Asset during the year and the reasons therefore.

1.128 For advance accounts where outstanding balance is in excess of Rs.

[@] Revised in 2013 Edition.

1 crore and which have been re-classified from non-performing asset to standard asset or *vice-a-versa*, the list will have to be attached to the report specifying the reasons with brief explanations for such re-classification.

For branches dealing in recovery of Non Performing Assets such as Asset Recovery Management Branches

1. In respect of every advance account in excess of Rs. 2 crores, the information in the enclosed format should be obtained from the Branch Management. Comments of the Branch Auditor on advances with significant adverse features and which might need the attention of the Management/Central Statutory Auditors should be appended to the Long Form Audit Report.

1.129 The Branch auditor should obtain details and other information, in respect of all advances, which are in excess of Rs. 2 crores, which would be relevant to complete the format (given in the Annexure) obtained from branch management.

1.130 Any advances account with significant adverse features like, non-operative for quite a long time, renewed without adequate credit appraisal, fresh advances granted without obtaining necessary approval, etc., on which branch auditor has commented and which is of such a nature that attention of central statutory auditor requires to consider it for qualifying and/ or disclosing in main report, should be attached as an annexure to LFAR.

2. List the accounts (with outstanding in excess of Rs. 2 crores), which have been upgraded from Non Performing to Standard Assets during the year and the reasons therefor.

1.131 For advance accounts where outstanding balance are in excess of Rs. 2 crores which have been reclassified from Non Performing Assets to Standard Assets, the list will have to be attached to the report specifying the reasons with brief explanations for such re-classification.

3. Whether the Branch has a system of updating periodically, the information relating to the valuation of security charged to the bank?

1.132 The branch auditor should enquire as to the existence of the system, if any, pertaining to the valuation of security charged to the bank. If the system is in existence, the auditor should examine whether the system periodically updates the information pertaining to the value of such security and takes necessary steps for increase/diminution in the value of such security.

4. Age-wise analysis of the recovery, suits-filed and pending may be *furnished.*

1.133 Age-wise analysis of the recovery suits filed and pending should be given along with the current status of each recovery suit.

5. Is the Branch prompt in ensuring execution of decrees obtained for recovery from the defaulting borrowers? Also list the time-barred decrees, if any, and reasons therefor.

1.134 In case decrees have been obtained for recovery from the defaulting borrowers, the auditor should check whether the branch is prompt in execution of decrees like, drawings from the account and payment from these accounts have been stopped. If not, the same should be reported. The list should be given in the case of time barred decrees with the reasons therefor.

6. List the recoveries and their appropriation against the interest and the principal and the accounts settled/ written off/ closed during the year.

1.135 A list will have to be annexed which will specify the non-performing advances recovered and the amounts adjusted towards interest and principal. A list of the accounts settled, written closed, if any, will also have to be attached. The auditor should satisfy himself whether the recoveries appropriated against interest are in accordance with the RBI guidelines and normal accounting principles.

7. List the new borrower accounts transferred to the Branch during the year. Have all the relevant documents and records relating to these borrower accounts been transferred to the Branch? Has the Branch obtained confirmation that all the accounts of the borrower (including non-fund based exposures and deposits pending adjustment/ margin deposits) been transferred to the Branch?

1.136 A list of new borrower accounts transferred to the branch from the other branches during the year should be annexed. The auditor should verify whether the documents and records relating to the transferred accounts have been obtained like, letter from the transferor branch, detail of the accounts, etc. The branch should also obtain a confirmation that all the accounts of the borrower (including non-fund based exposures and deposits pending adjustment/ margin deposits) have been transferred to the branch. In case any adverse features have been observed in such transfer, the same should be reported.

For branches dealing in Clearing House Operations, normally referred to as Service Branches

1. *Does the branch have a system of periodic review of the outstanding entries in clearing adjustments accounts? In your view has the system generally been complied with?*

1.137 The auditor should verify whether the branch is having system of periodic review of the outstanding entries in clearing adjustments accounts. On a test check, auditor should verify whether the system, generally, has been complied with.

2. *Whether review of the clearing adjustments accounts (inwards/ outwards) reveals any old/ large/ unusual outstanding entries, which remain unexplained? Give year-wise break-up of outstanding in number and value:*

1.138 If the review of clearing adjustments accounts (inwards/outwards) reveals any old/large/unusual outstanding entries, which remain unexplained, the auditor should report the same. Year-wise break up should be given of outstanding clearing in number and value in the following format.

- Inward Clearing

	Number	**Value**
Normal Clearings		
High Value Clearings		
Inter-Branch Clearings		
National Clearings		
Returned/ Dishonored Clearings		

- Outward Clearing

	Number	**Value**
Normal Clearings		
High Value Clearings		
Inter-Branch Clearings		
National Clearings		
Returned/ Dishonored Clearings		

3. Has the Branch strictly followed the guidelines of the controlling authority of the bank with respect to operations related to clearing transactions? Comment on the systems and procedures followed by the Branch in this regard.

1.139 Auditor should verify whether the guidelines of the controlling authority of the bank with respect to operations related to clearing transactions has been strictly followed. In case the same has not been followed, the auditor should report the same. The auditor should report on the system and procedures followed by the branch in this regard.

Annexure

LFAR (For Large/ Irregular/ Critical Advance Accounts)

(To be obtained from the branch management by the Branch Auditors of branches dealing in large advances/ asset recovery branches)

1. Name of the Borrower
2. Address
3. Constitution
4. Nature of business/ activity
5. Other units in the same group
6. Total exposure of the branch to the Group+
   Fund Based (Rs. in lakhs)
   Non-Fund Based (Rs. in lakhs)
7. Name of Proprietor/ Partners/ Directors
8. Name of the Chief Executive, if any
9. Asset Classification by the Branch
   (a) during the current year
   (b) during the previous year
10. Asset Classification by the Branch Auditor
    (a) during the current year
    (b) during the previous year
11. Are there any adverse features pointed out in relation to asset classification by the Reserve Bank of India Inspection or any other audit.
12. Date on which the asset was first Classified as NPA (where applicable)

Facilities sanctioned:

Date of Sanc-tion	*Nature of facili-ties*	*Limit (Rs. in Lakhs)*	*Prime Secu-rity*	*Colla-teral Secu-rity*	*Margin %*	*Balance outstanding at the year-end*	
						Current Year	*Previous Year*
Provision made: Rs.________ lakhs							

13. Whether the advance is a consortium advance or an advance made on multiple-bank basis.

14. If Consortium,-
    (a) names of participating banks with their respective shares
    (b) name of the Lead Bank in Consortium
15. If on multiple banking basis, names of other banks and evidence thereof.
16. Has the Branch classified the advance under the Credit Rating norms in accordance with the guidelines of the controlling authorities of the Bank.
17. (a) Details of verification of primary security and evidence thereof;
    (b) Details of valuation and evidence thereof

Date verified	**Nature of Security**	**Value**	**Valued by**
Insured for Rs. _______ lakhs (expiring on ________)			

18. (a) Details of verification of collateral security and evidence thereof
    (b) Details of valuation and evidence thereof

Date verified	**Nature of Security**	**Value**	**Valued by**
Insured for Rs. _______ lakhs (expiring on ________)			

19. Give details of the Guarantee in respect of the advance
    (a) Central Government Guarantee;
    (b) State Government Guarantee;
    (c) Bank Guarantee or Financial Institution Guarantee;
    (d) Other Guarantee

Provide the date and value of the Guarantee in respect of the above.

20. Compliance with the terms and conditions of the sanction

Terms and Conditions	**Compliance**
(i) Primary Security a) Charge on primary security b) Mortgage of fixed assets c) Registration of charges with Registrar of Companies d) Insurance with date of validity of Policy	

Terms and Conditions	Compliance
(ii) Collateral Security a) Charge on collateral security b) Mortgage of fixed assets c) Registration of charges with Registrar of Companies d) Insurance with date of validity of policy	
(iii) Guarantees - Existence and execution of valid guarantees	
(iv) Asset coverage to the branch based upon the arrangement (i.e., consortium or multiple-bank basis)	
(v) Others: a) Submission of Stock Statements/ Quarterly Information Statements and other Information Statements b) Last inspection of the unit by the Branch officials: Give the date and details of errors/ omissions noticed c) In case of consortium advances, whether copies of documents executed by the company favouring the consortium are available. d) Any other area of non compliance with the terms and conditions of sanction	

21. Key financial indicators for the last two years and projections for the current year (Rs. in lakhs)

Indicators	Audited year ended 31st March___	Audited year ended 31st March___	Estimates for year ended 31st March ___
Turnover			
Increase in turnover % over previous year			

Profit before depreciation, interest and tax Less: Interest Net Cash Profit before tax Less: Depreciation Less: Tax Net Profit after Depreciation and Tax			
Net Profit to Turnover Ratio			
Capital (Paid-up)			
Reserves			
Net Worth			
Turnover to Capital Employed Ratio (The term "Capital Employed" means the sum of Net Worth and Long Term Liabilities)			
Current Ratio			
Stock Turnover Ratio			
Total Outstanding Liabilities/Total Net Worth Ratio			
In case of listed companies, Market Value of Shares (a) High; (b) Low; and (c) Closing			
Earnings Per Share			
Whether the accounts were audited? If yes, upto what date; and are there any audit qualifications			

22. Observations on the operations in the account:

	Excess over drawing power	Excess over limit
1. No. of occasions on which the Balance exceeded the drawing power/ sanctioned limit (give details)		
Reasons for excess drawings, if any		
Whether excess drawings were reported to the Controlling Authority and approved		

	Debit Summation (Rs. in Lakhs)	Credit Summation (Rs. in Lakhs)
2. Total summation in the account during the year Less: Interest Balance		

23. Adverse observations in other audit reports/ Inspection Reports/ Concurrent Auditor's Report/ Internal Audit Report/ Stock Audit Report/ Special Audit Report or Reserve Bank of India Inspection with regard to:

    (i) Documentation; (ii) Operations;

    (iii) Security/Guarantee; and (iv) Others.

24. Branch Manager's overview of the account and its operation.

25. (a) In case the borrower has been identified/ classified as Non-performing Asset during the year, whether any unrealised income including income accrued in the previous year has been accounted as income, contrary to the Income Recognition Norms.

    (b) Whether any action has been initiated towards recovery in respect of accounts identified/ classified as Non-performing Assets.

Date: Signature and Seal of Branch-in-Charge

IV-2

Long Form Audit Report in Case of Banks

2.01 The statutory auditors should address their LFAR to the Chairman of the bank concerned and also a copy thereof should be forwarded to the designated office of the RBI. Many of the matters to be dealt with by the statutory auditors in their LFARs are, normally, based on the LFARs received from the branch auditors. In dealing with such matters, the statutory auditors are expected to make their observations on the basis of review of branch auditors' LFARs.

2.02 Where any of the comments made by the auditor in his LFAR is adverse, he should consider whether a qualification in his main report is necessary. It should not, however, be assumed that every adverse comment in the LFAR would necessarily result in a qualification in the main audit report. In deciding whether a qualification in the main report is necessary, the auditor should use his professional judgement having regard to the facts and circumstances of each case.

2.03 Where the auditors have any reservation or adverse remarks with regard to any of the matters to be dealt with in their LFARs, they should give the reasons for the same.

2.04 The matters to be dealt with by the statutory auditors in their LFARs are discussed in the following paragraphs.

I. Advances

2.05 Lending activities constitute an important part of a bank's operations. The statutory auditors are expected to offer their comments on various aspects of lending activities in their LFARs. The format of LFAR requires the statutory auditors to offer their comments on the following aspects:

(a)	Loan policy	(e)	Review/monitoring/ supervision
(b)	Credit appraisal		

(c)	Sanctioning/ disbursement	(f)	Bad/doubtful advances
(d)	Documentation	(g)	Large advances

2.06 The statutory auditors are expected to offer their comments on the adequacy and effectiveness of the internal control systems relating to the above aspects of credit administration. In order to form an opinion on these matters, the statutory auditors would also need to consider the branch auditors' LFARs. In cases where sanctions are accorded otherwise than at the branch level (i.e., by higher/controlling authorities), the auditors should carry out, on a selective basis, an examination of the specified matters at the head office and/or other controlling offices of the bank.

2.07 Every bank usually has a written manual of instructions which describes in detail the procedures to be followed for executing various types of transactions and also lays down limits on delegated powers in respect of various operations of the bank. The auditor should examine such manual of instructions and report his views as to the adequacy of the relevant instructions in the LFAR.

2.08 Further, as per the "Master Circular – Loans and Advances – Statutory and Other Restrictions" dated July 2, 2012, DBOD.No.Dir.BC.4/13.03.00/2012-13 issued by the RBI, all banks are required to frame "Fair Practices Code for Lenders" based on the Guidelines contained in the Master Circular. The Fair Practices Code Covers areas, such as, applications for loans and their processing, loan appraisal and terms/conditions, disbursement of loans including changes in terms and conditions, post disbursement supervision, general aspects, etc. Further, the RBI vide its circular no. DBOD. Leg. BC. 61 /09.07.005/2010-11 dated November 12, 2010 on "Guidelines on Fair Practices Code for Lenders – Disclosing all information relating to processing fees / charges" requires the banks to disclose 'all in cost' inclusive of all such charges involved in processing / sanction of loan application in a transparent manner to enable the customer to compare the rates / charges with other sources of finance. It should also be ensured that such charges / fees are non-discriminatory.

Loan Policy

2.09 In respect of loan policy, the auditor is expected to give his observations on –

- *Existence of Loan Policy – specifying the prudential exposure norms, industry-wise exposures, regular updation of the policy, system of monitoring and adherence thereto.*

2.10 Each bank has its own policy for sanctioning, disbursing, supervising and renewing loans. The policy usually includes the terms and conditions for granting loans, limits upto which loans may be disbursed to individual clients, industry wise exposure, i.e., different exposure limits for different industries, etc. The policy should specifically include the prudential norms given by the RBI. The auditor should report whether the policy is in existence and the same is regularly updated depending on the guidelines issued by the RBI. The Master Circular on "Loans and Advances – Statutory and other Restrictions" DBOD.No.Dir.BC.4/13.03.00/2012-13) dated July 2, 2012, provides a framework of the rules/ regulations/ instructions issued to Banks on statutory and other restrictions on loans and advances. The Master Circular on "Lending to Micro, Small & Medium Enterprises (MSME) Sector" RPCD.MSME & NFS. BC. No. 11/06.02.31/2012-13 dated July 2, 2012, contains guidelines/ instructions/ directives issued by the RBI to banks in regard to matters relating to lending to Micro, Small & Medium Enterprises sector. The auditor should also enquire whether there is any system followed by the bank for regularly monitoring the policy laid down by the bank.

Credit Appraisal

2.11 In respect of credit appraisal, the auditor is expected to give his observations on –

- *Existence of a well-laid system of appraisal of loans/credit proposals, including adequacy of information for appraising the creditworthiness of the applicant, and adherence thereto.*

2.12 Credit appraisals require a detailed analysis of the borrower's or, counterparties financial position and debt-servicing ability, a thorough understanding of their background and the purpose of the credit and an evaluation of the collateral pledged, if any. The auditor should review the system of credit appraisal followed by the bank. He should examine whether the system facilitates a proper evaluation of the credit risk. In order to facilitate collection and analysis of all the relevant data for evaluating creditworthiness of a prospective borrower, banks generally use standardised loan application forms. The factors considered in evaluating loan applications normally include the purpose of loan, prospects of the business, the sources and period of repayment (in case of term loans), the borrower's stake and security, etc. Further, information in the form of financial statements, costing analyses, market information, tax status, project reports (in case of new projects), etc., is also usually obtained from prospective borrowers and analysed.

2.13 The auditor should also satisfy himself that the system of credit appraisal is actually in force. For this purpose, he should review the relevant observations of the bank's branch auditors contained in their LFARs. Where the auditor has serious reservations about the quality of credit appraisal, he may also give his observations in this regard.

Sanctioning/Disbursement

2.14 In respect of sanctioning/disbursement of advances, the auditor is expected to comment on –

- *Delegation of powers/authority at various levels; adherence to authorised limits; whether limits are disbursed after complying with the terms and conditions of sanction.*

2.15 The auditor should familiarise himself with the system of sanctioning and disbursement of advances. He should also familiarise himself with the relevant directives of RBI. Normally, the system in a bank provides for limits on the sanctioning powers of authorities at various levels. The auditor should examine the documents prescribing such limits, e.g., operation manual, circulars from head office, etc. Where the branch auditors' reports indicate cases of credit facilities sanctioned beyond the aforesaid limits, the auditor should draw attention to this fact in his LFAR. The auditor should also examine the branch auditors' report to ascertain whether such cases have been promptly reported to higher authorities as per the procedure laid down in this regard. If not, he should report the fact, giving illustrations of non-compliance with the laid down procedure in his LFAR.

2.16 The auditor should also review the sanctions made at different levels. For this purpose, the auditor should randomly select a sample of sanctions made at various levels and review whether the procedure laid down for the concerned level has been followed. Where the auditor has serious reservations about any of the aspects thereof, he should give his observations in this regard in his LFAR. Where the branch auditors' reports indicate cases where limits have been disbursed without complying with the terms and conditions of the relevant sanctions or cases of frequent overdrawing beyond sanctioned limits, the auditor should state this fact in his LFAR, giving illustrations.

Documentation

2.17 The auditor is expected to comment on the following aspects of documentation in respect of advances:

- *System of ensuring that documents are executed as per the terms of sanction.*

- *Nature of documentation defects observed during audit and suggestions to avoid such defects.*
- *System of documentation in respect of joint/consortium advances.*
- *Renewal of documents.*

2.18 Generally, the system of a bank prescribes the specific documents to be executed in respect of various types of credit facilities, including special documentation required in cases of consortium advances, advances to companies, statutory corporations and government undertakings, etc. It may be noted that in case of consortium advances, original documents are held by the lead bank, however, copies of such documents are available with each of the participating banks. Banks also usually have a system of renewal of documents and of periodically obtaining confirmation of balances to ensure that the documents do not become time-barred.

2.19 The auditor should review the system of obtaining the loan documents, including renewal thereof. He should examine whether the system provides for obtaining all such loan documents which are required to protect the interests of the bank.

2.20 Where the branch auditors' reports indicate cases of credit facilities accorded without proper documentation, the auditor should state this fact in his report, giving illustrations.

2.21 The auditor is also required to comment on the nature of documentation defects observed during the audit and to make suggestions to avoid such defects. The auditor can obtain the relevant information substantially from the branch audit reports and from records maintained at the head office/regional or zonal offices of the bank.

Review/ Monitoring/ Supervision

2.22 In respect of review, monitoring and supervision of advances, the auditor is required to comment on the following aspects:

- Periodic balance confirmation/ acknowledgement of debts.
- Receiving regular information, Stock/Book Debt statements, Balance Sheet, etc.
- Receiving audited accounts in case of borrowers with limits beyond Rs.10 lakhs.
- System of scrutiny of the above information and follow-up by the bank.
- System of periodic physical verification or inspection of stocks, equipment and machineries and other securities.

- System and periodicity of stock audits.
- Inspection reports and their follow-up.
- Norms and awarding of Credit Rating.
- Review/renewal of advances including enhancement of limits.
- Monitoring and follow-up of overdues arising out of other businesses such as leasing, hire purchase, credit cards, etc.
- Overall monitoring of advances through maturity/ aging analyses; Industry-wise exposures and adherence to the Loan Policy.
- System of monitoring of off-balance sheet exposures including periodic reviews of:
  (a) claims against the bank not acknowledged as debts
  (b) letters of credit
  (c) guarantees
  (d) ready forward transactions
  (e) co-acceptances
  (f) swaps, etc.
- The auditor should examine whether the internal credit rating system has linkage with pricing of advances with various products.[@]

2.23 Generally, banks have a system of periodic review of each advance. The primary purpose of such a review is to ensure that the assumptions on the basis of which the loan had been sanctioned continues to hold good; the loan is used for the purpose for which it was sanctioned and in case of deviation in respect of any aspect of the sanction, approval of appropriate authority has been obtained; the project has been implemented as per the approved lines; there are no unexplained overruns in cost of the project; the borrowing unit is functioning properly; the stipulated installments/interest are being paid regularly and promptly and, in case of default or delay in payment, the reasons are looked into; the terms and conditions of the loan, particularly restrictive covenants, are being duly complied with; the required margins have been maintained in the account at all times; the properties mortgaged/hypothecated/ pledged are maintained in good order by the borrower and adequately insured, etc. The auditor should examine whether the system of periodic review is functioning effectively. He should review the LFARs given by the branch auditors to identify any weaknesses in the design of the system and in its implementation.

2.24 The auditor should examine whether there is an effective system of

[@] Revised in 2013 Edition.

obtaining confirmations/ acknowledgement of debts periodically. For this purpose, the auditors should also review the branch audit reports.

2.25 The RBI has issued a circular (dated April 12, 1985) advising all scheduled banks to ensure that non-corporate borrowers enjoying aggregate working capital limit of Rs.10 lakhs or more from the banking system get their accounts audited by chartered accountants in the prescribed manner. The auditor is expected to report on compliance with this requirement in case of sanction or renewal of limits, primarily on the basis of a review of branch audit reports. The auditor should report the number of branches and the total number of accounts in respect of which audited accounts have not been placed on record.

2.26 The auditor is also expected to comment on the effectiveness of system of physical verification or inspection of stocks, machineries and such other securities which have been charged to the bank. The auditor's comments will be based primarily on a review of branch audit reports.

2.27 In 1985, the RBI advised banks to introduce a comprehensive and uniform Health Code System indicating the quality or health of individual advances. At present the health code system is not in operation.[@]

2.28 However, in the wake of the introduction of guidelines for income recognition, assets classification and provisioning vide RBI's Circular No. DBOD.BP.BC.129/ 21.04.043-92 dated April 27, 1992, the RBI reviewed the need to continue to require the classification of advances as per the Health Code System. Based on the review, the RBI made the continuance of the Health Code System discretionary for banks. The Master Circular on "Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances" (DBOD.No.BP.BC.9/21.04.048/2012-13) dated July 2, 2012 lays down that "With the introduction of prudential norms, the Health-Code based system for classification of advances has ceased to be a subject of supervisory interest. As such, all related reporting requirements, etc., under the Health Code System also cease to be a supervisory requirement. Banks may, however, continue the system at their discretion as a management information tool".

2.29 The auditor should examine whether the bank has continued to classify the advances as per the Health Code System. If so, the auditor should familiarise himself with the procedure followed by the bank for classifying advances as per the Health Code System. Any defects or inadequacies in the

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procedure should be dealt with in the report along with recommendations/ suggestions for improvement or for remedial action to be taken on the existing procedure by the management. The auditor should also review whether the classification of advances as per the Health Code System has been made on the basis of a realistic assessment. Where, in the opinion of the auditor, the classification should have been different from that made by the bank, he should report the same.

2.30 Where the bank has discontinued the Health Code System the auditor should state this fact.

2.31 The auditor may review the statistical and analytical reports on advances which are often placed for information before the Board of Directors or submitted to the RBI. Based on this data, the Board assesses the bank's exposure to various industries. The auditor is expected to comment on the effectiveness of such reporting system in vogue in the bank.

2.32 Generally, banks have a system of periodic review of credit rating awarded to various clients. The purpose is to review whether the rating which had been awarded to a particular client continues to hold good as per the norms or whether a review of the credit rating was required. The auditor should examine whether the system of periodic review is functioning effectively as per the norms fixed by the bank. He should review the LFARs given by the branch auditors to identify whether the norms for credit rating are being followed consistently. Where the branch auditors have pointed out any weaknesses in the review/monitoring/supervision of such norms, the auditor should, if the weaknesses are material, comment and find out the impact.

2.33 Apart from conducting the normal banking business, banks also undertakes other activities like, leasing, hire purchase, etc. The auditor should examine whether the bank has a system for monitoring the overdue arising out of this business. The auditor should also examine whether for the purpose of overdue, regular follow-up is done with the customers from which the funds are due.

Recovery Policy in Respect of Bad/Doubtful Debts/ NPAs

2.34 The auditor is expected to report on the following aspects of the recovery period:

- *Existence of a recovery policy; regular updation thereof; monitoring and adherence thereto; compliance with the RBI guidelines.*
- *System of monitoring of recovery from credit card dues in respect of credit cards issued.*

- *Effectiveness of the system for compiling data relating to the bad and doubtful debts and the provision in respect thereof.*
- *System for identification, quantification and adequacy of provision (including that at foreign branches).*
- *System for suspension of charging of interest and adherence thereto.*
- *Ascertaining the realisable value of securities (including valuation of fixed assets) and the possible realisation from guarantors including DICGCI/ ECGC/CGST.*
- *Assessment of the efficacy of rehabilitation programmes.*
- *Method of appropriation of recoveries against principal, interest, etc.*
- *System of compromise/ settlement. Review such cases and cases of recovery of over Rs.1.00 crore and also the cases wherein limit of sacrifices laid down in the Recovery Policy is exceeded. Compliance with RBI guidelines.*
- *Provision/write-offs under proper authority.*
- *Recovery procedures including those relating to suit filed and decreed accounts.*
- *System of identifying and reporting of willful defaulters.*

2.35 The Bank should have a policy for recovery of the bad and doubtful debts and NPAs. The auditor should examine whether the policy framed complies with the RBI guidelines and also that the same policy is followed by the branches. The policy should be regularly monitored and updated keeping in view the RBI guidelines where the bank gives credit to its customers by way of credit card also, the auditor should examine whether proper procedure is adopted to recover the credit card dues. The RBI has issued a Master Circular on "Credit Card Operations of Banks" (DBOD.No.FSD.BC. 23/ 24.01.011/ 2012-13) dated July 2, 2012. The circular provides general guidelines to banks on their credit card operations, and the systems and control expected of them in managing their credit card business.

2.36 The RBI has issued detailed guidelines for income recognition, asset classification, provisioning and other related matters *(Master Circular on "Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances (DBOD.No.BP.BC.9/21.04.048/2012-13)dated July 2, 2012)*. Under the guidelines, the quantum of provision as also the charging of interest is dependent upon the classification of advances into performing or non-performing. The non-performing advances are required to be further classified into sub-standard, doubtful and loss assets. The auditor should satisfy himself that there exists a system of ensuring correct classification of advances as per the RBI guidelines. For this purpose, the auditor should review the adequacy and appropriateness of the instructions issued to the branches.

2.37 According to the aforesaid guidelines, income from Non-performing Advances (NPAs) is not recognised on accrual basis but is booked as income only when it is actually received. However, interest on advances against term deposits, NSCs, IVPs, KVPs and life policies may be taken to income account on the due date, provided adequate margin is available in the accounts. As a measure of control and also to ensure that the legal remedies against defaulting borrowers are not adversely affected, banks normally follow the procedure of recording interest on non-performing advances in a separate account styled as 'Interest Suspense' or maintaining only a record of such interest in proforma accounts . It may be noted that the amounts held in Interest Suspense Account (or other similar account) cannot be reckoned as part of provision in respect of non-performing advances. Amounts lying in Interest Suspense Account are to be deducted from the relevant advances, and provisions (as required by the RBI norms) is to made on the balances after such deduction.

2.38 The auditor should enquire into the procedure followed by the bank for recording interest on non-performing advances. Any departures from the laid down procedure which comes to the auditor's attention should be reported. The auditor should also comment on the increase/ decrease during the year in the aggregate balance held in Interest Suspense Account.

2.39 Realisable value of securities is relevant in determining provisioning against doubtful debts. Therefore, the auditor should examine whether there is a system of having realistic estimates of the value of security available, such as immovable properties, plant and machinery and stocks. The availability of security or net worth of borrower/guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise, as income recognition is based on record of recovery.

2.40 Every bank usually has a procedure for the write-off of bad debts, including the limits on authority to deal with/approve such write-offs. These limits are normally sanctioned by the Board of Directors or other similar authority. The auditor should examine the relevant procedure as also whether the provisions/write-off confirm to the laid down procedures.

2.41 At times, the management may opt for one-time settlement or an out-of-court settlement with the defaulting borrowers on agreed stipulations as to down payment and installment over a period. The auditor should verify the authority for write-off, if any, arising out of such settlement and the system for proper accounting thereof.

2.42 As regards advances to sick units which are under rehabilitation programmes, the auditor should examine whether the bank has adhered to the broad parameters for grant of relief/ concessions as per the RBI guidelines. The auditor should examine the efficacy of rehabilitation programs by comparing the actual performance with the estimates contained in the rehabilitation programme. On the basis of such assessment, the auditor should examine whether any further provision is required in respect of the units concerned. In this regard, it may be pointed out that the Guidelines require that provision should continue to be made in respect of the dues to a bank in respect of existing credit facilities sanctioned to a unit under rehabilitation, as per their classification as sub-standard or doubtful asset. As regards the additional facilities sanctioned as per package finalised by BIFR and/or term lending institutions, provision on additional facilities sanctioned need not be made for a period of one year from the date of disbursement. Further, in respect of additional credit facilities granted to SSI units which are identified as sick and where rehabilitation packages/ nursing programs have been drawn by the bank themselves or under consortium arrangements, no provision need to be made for a period of one year.

2.43 The auditor is also expected to comment on the efficacy of the procedure for recovery of bad/doubtful advances, including that relating to suit-filed and decreed accounts. The auditor can get the relevant information from the branch audit reports and from the records maintained at head office/regional or zonal offices. The auditor should particularly review the efficacy of procedure for recovery in cases where decrees have been obtained in favour of the bank. Where there are significant doubts about the execution of the decrees, the auditor should take this fact into account in determining the adequacy of the provision.

Large Advances

2.44 In respect of large advances, the auditor's responsibility is as under:

- *Comments on adverse features considered significant and which need management's attention.*

2.45 In the normal course of audit, the auditor would obtain from the management a list of problem accounts and discuss the same to determine whether any such account is doubtful of recovery. On the basis of information and explanations provided by the management, the auditor may be satisfied that certain problem accounts need not be considered doubtful of recovery and, therefore, not be provided for beyond the provision required under the guidelines for provisioning issued by the RBI. In respect of such major accounts, the auditor should give relevant details in the LFAR. The details to be given in respect of each such account should include the name of the borrower, the amount outstanding and a brief history and statement of facts. It would be desirable for the auditor to obtain the relevant explanations from the management in writing.

2.46 As regards adverse features in large accounts, the auditor can obtain relevant information substantially from the branch LFARs and from records maintained at the head office/regional or zonal offices. Banks usually have a system of reporting to the Board on large accounts (e.g., accounts where the borrowings are of Rs 2 crores or 5% of aggregate year-end advances of the branch whichever is lower) where the adverse features have been observed, including accounts which require a review or close monitoring to ensure that they do not become sub-standard or doubtful at a later stage. Unhealthy features in such accounts include frequent over-drawing beyond sanctioned limits, non-furnishing of data relating to security, defaults in furnishing of the information relating to the security charged to the bank, non- registration of charge in the case of companies, default in the matter of various stipulations for borrowings (for example, keeping the security uninsured, accumulation of old/obsolete stocks, etc.), non-renewal of documents, defaults in complying with the repayment schedules, frequent returning of bills in bill-discounting facility, and non-observance of the covenants between the bank and the borrower which may have a significant impact on the realisability of the advance or which may cause detriment to the security charged. The auditor should review the relevant reports submitted to the Board, where available.

2.47 The auditor should indicate the name of the branch, the name of the borrower, the balance as at the year-end and the general nature of adverse features noticed during the year. In case the adverse features have been persistent over a period of time and adverse comments have been made by the previous auditor(s) on these accounts, the same should also be reported.

II. Liquidity and Funds Management

Investments

2.48 The auditor is expected to comment on the following aspects of investments:

- *Existence of investment policy and adherence thereto; compliance with RBI guidelines.*
- *System of purchase and sale of investments; delegation of powers; reporting system; segregation of back office function, etc.*
- *Controls over investments, including periodic verification/ reconciliation of investments with book records.*

- *Valuation mode; changes in mode of valuation compared to previous year; shortfall and provision thereof.*
- *Investments held at foreign branches; valuation mode; regulatory reserve requirements; liquidity.*
- *Composition of investment portfolio as per RBI guidelines and the depreciation on investments, if any, not provided for.*
- *System relating to unquoted investments in the portfolio and the liquidity of such investments.*
- *System relating to SGL/BRs; control over SGL/BRs outstanding at the year end and their subsequent clearance.*
- *System and periodicity of concurrent and internal audit/ inspection of investment activities; follow up on such reports.*
- *System of recording and accounting of income from investments.*
- *System of monitoring of income accrued and due but not received.*
- *System of monitoring matured investments and their timely encashment.*
- *Average yield on investments.*
- *System related to Repos*

2.49 The auditor is required to comment whether there exists any investment policy in accordance with RBI guidelines and whether the same has been properly implemented. For that purpose, the auditor should not only familiarise himself with the investment policy of the bank, including broad investment objectives, authorities competent to make investments, procedure to be followed to put through deals, procedure to be followed for obtaining sanction of the appropriate authority, prescribed exposure limits and the system of reporting but also report whether the same is in existence in accordance with the RBI Guidelines and whether the same is being properly implemented. The RBI has issued detailed guidelines concerning investment portfolio of banks (*Master Circular on "Prudential Norms for Classification, Valuation and Operation of Investment portfolio by Banks" DBOD No. BP. BC.13/21.04.141/2012-13 dated July 2, 2012).*[@] These guidelines include instructions in respect of ready forward or buy-back deals, transactions in government securities for which Subsidiary General Ledger (SGL) facility is available, issue of bank receipts (BRs) and related records, internal control system for buying and selling securities, dealings through brokers and uniform accounting for Repo/Non-Repo transactions. The RBI has also issued detailed guidelines in respect of accounting of investments, including their classification

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under permanent and current categories. The auditor should familiarise himself with these guidelines and examine whether the bank has complied with them.

2.50 The auditor should examine the efficacy of various controls over investments, including the functional separation of various operations, custody of investment scrips, periodic physical verification of investments and reconciliation with book records. Any shortcomings in the prescribed system or non-compliance with the prescribed system should be reported.

2.51 The auditor should enquire into the mode of valuation of investments and ascertain whether the mode of valuation followed during the year is same as that followed in the previous year. The auditor's reporting requirements include: (a) the mode of valuation of year-end investments, and (b) any change in the mode of valuation of investments as compared to that of the previous year.

2.52 The auditor should ascertain the method followed for recording of the shortfall (depreciation) in the value of investments which is arrived at by comparing the market value of Investments with their book value as at the year end. If bank has not provided for depreciation on investments then the auditor should state the fact.

2.53 While reporting on the shortfall in value as at the year-end, the auditor may give the relevant information separately in respect of various kinds of investments (e.g., government securities, other approved securities, etc.). The manner of arriving at the shortfall in the value of securities should be indicated particularly in the case of non-traded or unquoted securities. Further, the auditor should also verify entries made in “Investment Reserve Account” and proper utilisation of the same, if any.

2.54 The auditor should carefully scrutinize the entire investment portfolio keeping in mind the RBI guidelines and comment whether investment portfolio is as per the RBI guidelines. The auditor should also verify that the accounting methodology for Repo/ Reverse Repo transactions is appropriate and uniform throughout the year. For this purpose, the auditor should thoroughly familarise himself with the RBI guidelines. A brief discussion of RBI guidelines is already given in earlier chapters.

2.55 In case of unquoted investments, reporting requirements of the auditor include:

- *Whether appropriate system is followed for valuation of the unquoted investment in the portfolio. The basis of valuation is different depending on the type of investment.*

- *Whether the unquoted investments are liquid in nature, i.e., they are easily saleable in the open market. This depends on the trend of the sale price, net-worth of the enterprise, the market condition, etc.*

2.56 Amongst internal audit of various areas and departments, internal audit of investment activities is one of the important requirements. While not only the scope and frequency of various types of internal audits in different banks varies, their form also varies, one of which is concurrent audit. Concurrent audit is to be regarded as bank’s early-warning system to ensure timely detection of irregularities and lapses which helps in preventing fraudulent transactions. It also refers to examination of the transactions by an independent person not involved in its documentation. The emphasis is in favour of substantive checking in key areas rather than test checking.

2.57 Auditor is expected to report whether the bank has a proper system of conducting concurrent and internal audit of investment activities either through its own staff or external auditors. The option to consider bank’s own staff or external auditors is at the discretion of the individual banks. The auditor is expected to comment on the system in existence. The auditor should also enquire whether the bank has appropriate system for carrying out the inspection of investment activities on a regular basis. The auditor should report whether the bank has undertaken a follow up of the report and implemented relevant suggestions.

2.58 Income from investments includes all income derived from the investment portfolio by way of interest and dividend etc., from subsidiaries and joint ventures abroad/ in India. The bank should have an appropriate system of recording income so that all the incomes which arose from the transaction which took place during the relevant period and pertain to the bank are actually recorded. The auditor should report whether there are no unrecorded incomes and that income is recorded in proper amounts and that it is allocated to the proper period.

2.59 The auditor should report whether there is a proper system for monitoring income accrued and due but not received and whether appropriate steps have been taken by the bank to recover the same.

2.60 The bank should have a system of keeping a track of investments which would mature in the near future so that its encashment can be done as soon as they mature. The auditor is required to report whether investments are encashed on time. The auditor should also report whether the bank has a system of monitoring the matured investment, i.e, the matured investments and depending on the requirement for funds, reinvestment of the same. The funds should be reinvested taking into consideration the risk-return analysis.

2.61 In case of investments held at foreign branches, the auditor should satisfy himself for existence of such investments. The auditor should examine that such investments are as per the rules and regulations set out by the bank and the RBI. Valuation policy of such investment should be on same line as of investments held in India. Such investment should be critically examined from the point of view of their liquidity.

2.62 Auditor should find out average yield on investments made by the bank. Such yield should be compared with the previous year as well as with industry norms. In case of investment where average yield is not adequate, such investment should be scrutinized for their continuity.

SLR/CRR Requirements-System of Ensuring Compliance

2.63 The auditor is expected to comment on the following aspects of the system for ensuring compliance with the SLR/CRR requirements:

- *System of compiling weekly DTL position from branches.*
- *Records maintained for the above purpose.*

2.64 Section 24 of the Banking Regulation Act, 1949, requires that every scheduled commercial bank shall maintain, in India, in cash, gold or unencumbered approved securities, an amount which shall not, at the close of business on any day, be less then twenty-five per cent, of the total of its net demand and time liabilities in India as on the last Friday of the second preceding fortnight. This is referred to as 'statutory liquidity ratio' (SLR). Section 18 of the Act requires that every banking company, not being a scheduled bank, shall maintain in India by way of cash reserve with itself, or by way of balance in a current account with the RBI, or by way of net balance in current accounts, or in one or more of the aforesaid ways, a sum equivalent to at least three per cent of the total of its demand and time liabilities in India as on the last Friday of the second preceding fortnight. Every scheduled bank is similarly required, by virtue of the provisions of section 42(1) of the Reserve Bank of India Act, 1934, to maintain with the RBI an average daily balance the amount of which shall not be less than three per cent of the total of its demand and time liabilities in India. The said rate may, however, be increased by the RBI by notification up to 20% of the total of demand and time liabilities in India. Consequent upon the amendment to sub-section (1) of Section 42 of the RBI Act, 1934, effective from June 22, 2006, the RBI having regard to the needs of securing monetary stability in the country, can prescribe the Cash Reserve Ratio (CRR) for Scheduled Commercial Banks without any floor rate or ceiling rate. 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.

2.65 These requirements seek to ensure that banking institutions maintain adequate liquid assets in an unencumbered form so as to safeguard the interests of depositors.

2.66 To comply with these requirements, banks have evolved systems whereby all branches send their weekly trial balance as on every Friday and these are consolidated at the head office. Based on this consolidation, the total demand and time liabilities (DTL) is determined for every alternate Friday (normally called 'the reporting Friday'). Banks have to maintain cash or other eligible assets on the basis of the DTL position during the following fortnight.

2.67 The auditor should examine the system for compilation of DTL position, including verification of returns and their consolidation by the bank. The auditor should request the management to provide him a compilation of all the circulars/instructions of the RBI regarding composition of items of DTL. He should review their compliance by the bank. Any weaknesses in the system of compilation of DTL and its reporting to the RBI in the prescribed form should be reported by the auditor, along with the suggestions, if any, to overcome such weaknesses.

2.68 The auditor may examine compliance with SLR/CRR requirements with reference to the eligible assets maintained by the bank.

2.69 It may be noted that the RBI, vide its Master Circular No. DBOD. No.Ret. BC.22/12.01.001/2012-13 dated July 2, 2012 on "Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)" requires that the statutory auditors should verify and certify that all items of outside liabilities, as per the bank's books had been duly compiled by the bank and correctly reflected under DTL/NDTL in the fortnightly/monthly statutory returns submitted to RBI for the financial year.

Cash

2.70 The auditor is required to comment on cash operations as under:

- *System of monitoring of cash at branches; and management of cash through currency chest operations.*
- *Insurance cover (including insurance for cash in transit).*
- *System and procedure for physical custody of cash.*

2.71 The auditor is supposed to comment whether the bank has an appropriate system of monitoring the cash at the branches. For this purpose, the auditor should ensure that the bank has the system of verifying that the norms for cash-holding followed by the branch are the same which are fixed by the bank.

2.72 The cash is normally maintained under joint custody of the branch manager and the cashier. The main key to the safe is with the branch manager while the second and the third keys are with the accountant and/ or cashier. Each branch should maintain the records showing the details of keys and key-holders. Further, the bank should have a system of verifying whether the instructions of the bank in this regard have been complied with consistently throughout the year.

2.73 In the normal course, cash balances are expected to be verified on a daily basis and recorded in the cash book under the signature of the branch manager and another authorised signatory, since cash is under dual charge at the branch level. The auditor should ensure whether the bank has a system for verifying the same. The system should include general scrutiny of the cash book to ascertain whether it is in accordance with the instructions given by the bank, physical verification of cash and agreeing the same with the books maintained, with due authentication of such balances by the authorised signatories. For this purpose, the auditor should review the LFARs of the branches.

2.74 The auditor should ensure whether the bank has the system of checking the cash balance at the branches at periodic intervals by the authorised officials of the bank.

2.75 The auditor is also supposed to comment whether the system relating to management of the cash through currency chest operations is appropriate. The currency chest operations are those where the bank holds cash as an agent of RBI. The auditor should report whether the bank has a system of regularly monitoring the currency chest operations. The balances in the chest should be periodically verified by the bank officials.

2.76 The auditor should examine and report on the adequacy of the insurance cover for cash with reference to the cash balance generally carried by the bank. He should also examine whether the insurance policy is in force. The auditor should ensure and comment whether the bank has obtained a global insurance policy in respect of cash at all the branches. The auditor is also supposed to report whether the insurance obtained includes the insurance for cash-in-transit.

2.77 The auditor should ensure about the system followed for the physical custody of cash. The system may include as to maintenance of cash will be in joint custody of which two or more officials, verification of the cash balance on daily basis and tallying the same with the books maintained, etc. The system should also include the names of the person who will have the custody of the keys. The auditor should properly examine the system and procedure and report whether the same is appropriate or there are any loopholes.

Call Money Operations

2.78 The auditor is required to make comments on system relating to call money operations as under:

- *System related to inter-bank call money.*

2.79 The auditor should verify that aspects relating to call money operations, viz., prudential limits in respect of outstanding borrowing and lending transactions, reporting requirement, documentation, etc., are adhered to in accordance with the guidelines of RBI Master Circular on "Call-Notice Money Market Operations" dated July 2, 2012 (IDMD.PCD. 03/14.01.01/2012-13) Any changes made to the rules and regulation during the year should be scrutinised. Auditor should check that all the above changes are promptly and correctly conveyed to all the branches and whether any branch LFAR contains any negative remarks for the above system.

Asset Liability Management

2.80 Regarding asset liability management, the auditor is expected to make comment on the following aspects:

- *Existence of Policy on Asset – Liability Management and monitoring thereof; compliance with the RBI guidelines.*

Functioning of Asset-Liability Management Committee

2.81 RBI has issued guidelines on ALM system vide circular no BP.BC.8/21.04.098/99 dated February 10, 1999 advising banks to give adequate attention to put in place an effective ALM system. Bank should set up an internal Asset-Liability Committee, headed by CEO/CMD or ED. The Management Committee or any specific Committee of the Board should oversee the implementation of the system and review its functioning periodically. The auditor should ensure whether the bank has a policy on Asset-Liability Management and whether the same complies with the RBI guidelines. As per the RBI guidelines the ALM process rests on three pillars:

- *ALM Information Systems*
    - ➢ Management Information Systems
    - ➢ Information availability, accuracy, adequacy and expediency
- *ALM Organisation*

- Structure and responsibilities
- Level of top management involvement

- *ALM Process*
  - Risk parameters
  - Risk identification
  - Risk measurement
  - Risk management
  - Risk policies and tolerance level

The auditor should also report whether the ALM policy is regularly monitored.

2.82 As per the circular No.BP.BC.8/21.04.098/99 dated February 10, 1999 Asset Liability Management Committee consists of the bank's senior management including CEO. This committee should be responsible for ensuring adherence to the limits set by the Board as well as deciding the business strategy of the bank (on the asset-liability sides) in line with the bank's budget and decided risks, management objectives. As per the circular, each bank is supposed to decide on the role of its Asset Liability Committee, its responsibility as also the decisions to be taken by it. The auditor should ensure and report whether the committee is functioning as per the decisions formed by the bank. The functioning of the committee should be useful and helpful to the Bank.

- *Structural liquidity at periodical intervals.*

2.83 The final guidelines issued in circular no BP.BC.8/21.04.098/99 dated February 10, 1999 suggest the bank to prepare Statements of Structural Liquidity by placing all cash inflows and outflows in the maturity ladder according to expected timing of cash flows. As a measure of liquidity banks are required to monitor their cumulative mismatches across all time buckets in their Statement of Structural Liquidity by establishing internal prudential limits with the approval of the Board/ Management Committee. As per the guidelines, the mismatches (negative gap) during the time buckets of 1-14 days and 15-28 days in the normal course, are not to exceed 20% of the cash outflows in the respective time buckets. The RBI has issued "Guidelines on Asset-Liability Management (ALM) system – amendments" (DBOD. No. BP.BC. 38/21.04.098/2007-08) dated October 24, 2007 wherein the time buckets for preparation of Statement of Structural Liquidity has been revised. The banks are required to adopt a more granular approach to measurement of liquidity risk by splitting the first time bucket in to three time buckets viz., next day, 2-7 days and 8-14 days. Accordingly, format of Statement of Structural Liquidity has been revised and also guidance for slotting the future cash flows of banks in the revised time buckets has also been suitably modified. However, the frequency of supervisory reporting of the Structural Liquidity position shall be fortnightly, with effect from the fortnight beginning April 1, 2008. In this regard, RBI, vide its circular on "Guidelines on Asset Liability Management (ALM)

System (DBOD.No.BP.BC.68/21.04.098/2007-08 dated April 9, 2008), has advised banks to submit the Statement of Structural Liquidity as on the first and third Wednesday of every month to RBI. The auditor is required to report whether the bank is preparing the Statement on Structural Liquidity at the prescribed periodical intervals.

III. Internal Control

2.84 The auditor is expected to comment on the following aspects of internal control:

- *Written guidelines/instructions/manual for accounting aspects.*
- *Balancing of Books/Reconciliation of control and subsidiary records*
- *Inter-branch Reconciliation*
- *Branch Inspections*
- *Frauds/Vigilance*
- *Suspense Accounts, Sundry Deposits, etc.*

Written Guidelines/Instructions/Manual for Accounting Aspects

2.85 Generally, every bank has a written guidelines/manual/ instructions, which describes in detail, the procedures to be followed for executing various types of transactions. The manual normally also includes guidelines for accounting of various types of transactions. The auditor should examine whether there exists a written manual or other compilation in relation to various accounting aspects in the bank. The auditor should also examine whether there is a system of updating the manual or other compilation periodically. He should particularly enquire whether the directions/ instructions of the RBI relating to accounting aspects are incorporated in the manual promptly. The auditor should also examine the system of communicating any changes in the manual to the branches.

Balancing of Books/Reconciliation of control and subsidiary records

2.86 These are:

- *System of monitoring the position of balancing of books/ reconciliation of control and subsidiary records.*
- *Follow-up action.*

2.87 The auditor's comments would cover the head office/regional or zonal offices as well as the branches. The auditor can get the requisite information in respect of branches substantially from the LFARs pertaining to branches. The auditor is also expected to comment on the balancing of the books of account, e.g., whether the primary books of account have been tallied and the general ledger balanced. The auditor should examine the position relating to balancing of books which form the basis of the financial statements. The status as at the year-end relating to books not balanced should be clearly indicated by stating the relevant particulars and indicating the extent to which these remain to be balanced.

2.88 The auditor should state the number of branches in respect of which the control and subsidiary records have not been reconciled. Where such records have been reconciled after the year-end, the auditor should exercise his judgment as to whether such cases need to be reported.

2.89 In so far as the head office is concerned, the auditor should give his observations on the unreconciled balances between the control and subsidiary records. It is suggested that, in respect of the relevant heads of account, the report should show the amount appearing in the general ledger, the aggregate amount appearing in the subsidiary records, and the difference between the two. The observations of the auditor would cover non-balancing of subsidiary records at the head office and persistent defaults observed in reconciliation of control and subsidiary records.

2.90 The auditor should critically examine the system for reporting the status of balancing/reconciliation by branches and offer his comments and suggestions, if any.

Inter-branch Reconciliation

2.91 These are:

- *Comments on the system/ procedure and records maintained.*
- *Test check for any unusual entries put through inter-branch/ head office accounts.*
- *Position of outstanding entries; system for locating long outstanding items of high value.*
- *Steps taken or proposed to be taken for bringing the reconciliation up-to-date.*
- *Compliance with the RBI guidelines with respect to provisioning for old outstanding entries.*

2.92 Inter-branch accounts are normally reconciled by each bank at the central level. While practices with various banks may differ, the inter-branch accounts are normally sub-divided into segments or specific areas, e.g., 'Drafts paid/ payable', 'inter-branch remittances', 'H.O. A/c', etc. 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 can obtain the relevant information primarily from branch audit reports. Where, in the course of audit, the auditor comes across any unusual items in inter-branch/head office accounts, he should report the details of such items, indicating the nature and the amounts involved. The auditor should examine the procedure for identifying the high-value items remaining outstanding in inter-branch reconciliation. He should review the steps taken or proposed to be taken by the management for clearing the outstanding entries in inter-branch accounts, particularly the high-value items. If he has any specific suggestions for expeditious reconciliation of inter-branch accounts including any improvements in the systems to achieve this objective, the same may be incorporated in the report. In the new CBS environments the branch reconciliation is done of IT department at H.O. in most of the banks.[@]

2.93 Considering the extent of arrears in inter-branch accounts, the RBI, vide its circular no. DBOD No. BP.BC. 73 /21.04.018/2002-03 dated February 26, 2003 has advised banks to arrive at the category-wise position of unreconciled entries outstanding in the inter-branch accounts for more than six months as on March 31, 2004 and make provision equivalent to 100 percent of the aggregate net debit under all categories. While doing so, it may be ensured that:

(i) The credit balance in the Blocked Account created in terms of instructions contained in circular DBOD No. BP.BC.73/21.04.018/98 dated July 27, 1998 is also taken into account; and

(ii) The net debit in one category is not set-off against net credit in another category.

Branch Inspections

2.94 These are:

- *System of branch inspections: frequency; scope/ coverage of inspection/ internal audit, concurrent audit or revenue audit; reporting.*
- *System of follow-up of these reports; position of compliance.*

2.95 The auditor should acquaint himself with the scheme of various internal inspections existing in the bank, *viz.,* internal audit, concurrent audit, revenue audit, etc. He should consider whether the frequency and coverage of various types of audit are adequate having regard to the size of the bank. He should also examine the system of follow-up and compliance with reports of various auditors.

[@] Revised in 2013 Edition.

Frauds/Vigilance

2.96 These are:

- *Observations on major frauds discovered during the year under audit.*
- *System of follow-up of frauds/ vigilance cases. (Reported to RBI in FMR1.)*[@]

2.97 The auditor is expected to give his observations on major frauds discovered during the year under audit. He is also expected to comment on the efficacy of the system of follow-up on vigilance reports.

2.98 Banks normally maintain a record, usually in separate register, of the frauds that have taken place at any branch or other office which have been brought to the notice of the head office/controlling authority of the bank. A brief history of each of the frauds discovered is also available to the statutory auditor, through reports by the management to the Board of directors as also to the RBI. The RBI has issued Master Circular on "Frauds-Classification and Reporting" (DBS.FrMC.BC.No.1/23.04.001/2012-13) dated July 2, 2012. The circular requires the banks to report to RBI complete information about frauds and the follow-up action taken thereon.

2.99 The auditor should look into the cases of major frauds which have been discovered and recorded including those which have been reported after the year-end. He should report on major frauds discovered and recorded by the bank. He should also examine the quarterly and annual review of frauds done by the bank and ascertain the number of frauds where final action has been taken by the banks and cases disposed of.

2.100 In case the auditor observes weaknesses in the internal control system which have resulted in frauds, or where the *modus operandi* is common, he may give his suggestions for overcoming such weaknesses by taking preventive steps to reduce/minimise incidence of frauds.

Suspense Accounts, Sundry Deposits, etc.

2.101 These are:

- *System for clearance of items debited/credited to these accounts.*

2.102 The auditor should look into the procedure of the bank to determine whether entries raised in nominal heads of account including 'Suspense Accounts' and 'Sundry Deposits' or 'Sundries Account' are cleared expeditiously.

[@] Revised in 2013 Edition.

2.103 In the course of audit, the auditor would have examined large items and also old outstanding entries included in the year-end balances in such accounts. It is possible that whereas a debit entry has been raised to 'Suspense Account', the corresponding credit may be lying in 'Sundry Deposits'; or other similar account and an exercise may not have been carried out by the bank to adjust these transactions on matching, after proper scrutiny thereof. In his report, the auditor should bring out large and old outstanding entries which deserve the attention of the management for expeditious clearance. He may also make his suggestions to the management for expeditious clearance of these entries by adjustment thereof after making a thorough scrutiny of the transitions. The auditor may also point out any adjustments of large outstanding in these accounts which have not been specifically explained to him in the course of his audit, for example, for want of relevant documents/evidence or vouchers, etc., and where he is not satisfied with the nature of adjustments made.

2.104 Where, in the course of audit, the auditor comes across any unusual items in 'Suspense' or 'Sundry Deposits Account', he should report the details of such items, indicating the nature and the amounts involved. The relevant information will be available to the auditor primarily from the branch audit reports.

IV. Capital Adequacy

2.105 The auditors are required to:

- *Enclose a copy of the capital adequacy certificate.*

2.106 The RBI in April 1992 introduced a risk asset ratio system for banks (including foreign banks) in India as a capital adequacy measure in line with the Capital Adequacy Norms prescribed by Basel Committee. The RBI has issued Master Circular on "Prudential Norms on Capital Adequacy – Basel I Framework" (DBOD. No. BP.BC. 15/21.01.002/2012-13) dated July 2, 2012, which is applicable to all banks, which are migrating to Basel II norms with effect from March 31, 2009. However, for banks that have migrated to Basel II norms with effect from March 31, 2008, instructions contained in Master Circular DBOD.No.BP.BC.16/21.06.001/2012-13 dated July 2, 2012 on "Master Circular – Prudential Guidelines on Capital Adequacy and Market Discipline - Implementation of the New Capital Adequacy Framework (NCAF)" will be applicable. The auditor should verify whether the certificate is as per the requirements of the circular and the figures given in the certificate matches with the books of account of the bank. The auditor is required to enclose the same along with the LFAR.

V. Automation and Computerisation

2.107 Regarding computerisation, the auditors are required to comment on the following aspects:

- *Existence of Computerisation and Automation Policy; progress made during the year under review.*
- *Critical areas of operations not covered by automation.*
- *Number of branches covered by computerisation and the extent of computerisation.*
- *Procedures for back-ups, off-site storage, contingency and disaster recovery and adherence thereto.*
- *Existence of Systems/ EDP audit; coverage of such audit.*
- *Electronic Banking; existence of systems and procedures; monitoring; regular updation of technology; method of review and audit of procedures.*
- *Suggestions, if any, with regard to computerisation and automation.*

2.108 Computerisation results in changes in the processing and storage of information and affects the organisation and procedures employed by the entity to achieve adequate internal control. The auditor should ensure whether there exist any policy for computerisation and automation. The auditor is also required to comment whether any progress has been made during the period under review. Progress may be in the nature of conversion of partially computerised bank into fully computerised, or increasing the level of computerisation and thereby making the work simpler. In fully computerised banks, all the customer transactions as well as internal transactions are routed through the computer systems whereas in partly computerised banks, generally the back office work (i.e., internal processing of transactions in the branch) is done on computers whereas the customers' transaction (i.e., the front office work) is carried out manually.

2.109 The auditor is also required to comment whether the critical areas are covered by automation. For that purpose, auditor should first locate the critical areas and enquire whether the same is covered under automation. which may include calculation of interest on deposits and loans, expense recording, etc. The auditor should also report the number of branches covered by computerisation and the extent of computerisation. The extent of computerisation may include inquiring whether the branch is fully or partially computerised. For this purpose auditor will have to go through the LFARs of the branches.

2.110 The bank should have the procedure for off-site backup of at least one copy of the updated data. The auditor should enquire about the procedure followed for the recovery of data in case of contingency and disaster. The auditor should report whether approved Information Technology Security Policy is in place and communicated to all the branches for implementation.

2.111 The auditor should report whether the bank has the system of conducting EDP/ Systems audits periodically to assess the effectiveness of the software, hardware and operations to identify any changes required therein. In this regard, the RBI has issued circular on "Information System Audit – Review of Policies and Procedures" (DBS.CO. OSMOS.BC/11/33.01.029/2003-04) dated April 30, 2004.

VI. Profitability

2.112 The auditor is required to comment on the profitability aspects as under:

- *Analysis of variation in major items of income and expenditure compared to previous year.*
- *Important ratios such as ROA, ROE etc; comparison and analysis in relation to previous year.*
- *Policy relating to general provisions/ reserves.*

2.113 The auditor is expected to present an analysis of variations in major items of income and expenditure compared to previous year, along with important ratios. This information is normally compiled by banks as per the requirements of the RBI. Wherever feasible, the auditor may also comment on the extent of income generated through non-traditional and specialized activities, such as, merchant banking, consumer banking, etc., as also on any unusual items of income and expenditure which may have had a significant impact on the profit/loss for the year.

2.114 The effects of any changes in accounting policies on the profit/loss for the year should be reported by the auditor.

VII. Systems and Controls

2.115 The auditor is required to comment on systems and controls as under:

- *Existence of systems and procedures for concurrent and internal audits, inspections, EDP audit of computer systems/software, etc.; monitoring and follow - up on such reports;*

2.116 Internal audit is an important constituent of the system of internal control in banks. Banks should generally have well organised system of internal audit. The internal audit is carried out either by separate departments within the bank or by firms of chartered accountants. The scope and frequency as also the form of various types of internal audits in different banks varies, and one of which is concurrent audit.

2.117 A system of concurrent audit at large and other selected branches has been in vogue in most banks for quite long. Recognising the importance the concurrent audit in the banking sector, the RBI, vide its circular no BC.182/16.13.108/93-94 dated October 11,1993 addressed to all scheduled commercial banks (except regional rural banks) formally advised such banks to institute an appropriate system of concurrent audit. It may be also noted that the RBI vide its circular no DOS. NO.8.C.16/08-91-021/96 dated August 14, 1996 has incorporated new guidelines for concurrent audit system in commercial banks. The system includes scope of concurrent audit, coverage of business/branches, types of activities covered, appointment of auditors, facilities for effective concurrent audit, remuneration and the reporting systems. Concurrent audit is regarded as bank's early-warning system to ensure timely detection of irregularities and lapses which helps in preventing fraudulent transactions. It also refers to examination of the transactions by an independent person not involved in its documentation. The emphasis is in favour of substantive checking in key areas rather than test checking.

2.118 The auditor should enquire whether the bank has a system of conducting concurrent and internal audit, inspections of various departments inside the bank, etc. either through its own staff or external auditors. The option to consider bank's own staff or external auditors to undertake audit is at the discretion of the individual banks. The auditor is required to comment on the system in existence. The auditor should report whether the follow-up of the reports of internal and concurrent audits, etc. is carried out and relevant suggestions implemented timely. For this purpose, the auditor should refer to the internal/ concurrent/ inspection audit reports.

- *Existence of Management Information System; method of compilation and accuracy of information.*
- *Reliability of regulatory reporting under the Off Site Surveillance System of the RBI.*

2.119 The management of banks requires database information for taking policy decisions as well as for taking other corrective measures. Banks operate their business through network of their branches spread over a vast geographical area. Thus, auditor should check that an effective management information system exists which generates timely, accurate, reliable, relevant and complete information.

VIII. Other Matters

2.120 Besides the above matters, the auditor is also expected to comment on the following:

- *Comments on accounting policies, if any, including comments on changes in accounting policies made during the period.*
- *Policies and systems for monitoring activities such as underwriting, derivatives, etc.*
- *Adequacy of provisions made for statutory liabilities such as Income Tax, Interest Tax, Gratuity, Pension, Provident Fund, etc.*
- *Adequacy of provisions made for off-balance sheet exposures and other claims against the bank.*
- *Any major observations on branch returns and process of their consolidation in final statement of accounts.*
- *Balances with other banks - observations on outstanding items in reconciliation statements.*
- *Procedure for revaluation of NOSTRO accounts and outstanding forward exchange contracts.*
- *Observations on the working of subsidiaries of the bank:*
  - *(a) reporting system to the holding bank and*
  - *(b) major losses of the subsidiary, if any.*
- *Any other matter, which the auditor considers should be brought to the notice of the management.*

2.121 The Long Form Audit Report (LFAR) issued by the RBI clarifies that the matters required to be reported by the auditor therein are illustrative and not exhaustive. Therefore, if it is felt that if there is any other important matter which deserves to be included in the LFAR the statutory auditor may do so. The LFAR format was drafted in 2003. There have been significant changes in the banking Industry ever since. As a result certain additional areas which have not been considered in any of the above paragraphs can also be considered. The following is an illustrative list of few such matters:

• Corporate Governance • Borrowings • Premises • Stationery department • Jilani and Ghosh Committee	• Legal departments (Details relating to suit filed and decreed accounts) • Merchant banking activity • Inter Office adjustments

Compliances • Implementation of recommendation of Mitra Committee • Service Tax • Fringe Benefit Tax	• Planning department • Raj Bhasha • Voluntary retirement scheme • Demat accounts and Loan against Shares • Legal Compliance Certificate • Stress Testing

2.122 The auditor should examine whether the Income Tax liability is computed as per the provisions of the Income Tax Act, 1961. Apart from that the auditor should review the appellate orders received during the year and consider the need for any additional provision/ reversal. If there is no requirement to retain a provision, it can be reversed.

2.123 Provisions for certain employee costs, such as, bonus, ex-gratia in lieu of bonus, and gratuity, pension and other retirement benefits are usually made at the head office level. The auditor should examine whether the liability for bonus is provided for in accordance with the Payment of Bonus Act, 1965 and/or agreement with the employees or an award of a competent authority.

2.124 The auditor should examine whether provisions in respect of termination benefits; retirement benefits such as gratuity, pension, post-employment life insurance and post-employment medical care; and other long term employee benefits like, long-service leave, bonuses, deferred compensation, etc., are made in accordance with the requirements of Accounting Standard (AS) 15, “Employee Benefits”. The auditor should examine the adequacy of the provisions made with reference of such documentary evidence as reports of actuaries or certificates from the LIC, as appropriate under the facts and circumstances of the case.

2.125 Auditor should reassess all off-balance sheet exposures and other claims against the bank for its contingency and chances of accrual. Auditor can go through the relevant files, papers and documents related to legal case.

PART - V

V-1
Basel II

Introduction

1.01 Capital is the starting point for any business and, similarly, in a bank capital is one of the critical factors which decide its financial soundness. In the banking industry basically there are three types of risks – Credit, Market and Operational. Based on the risk appetite each, bank will execute its business plans. As part of its journey, it is important for it to monitor its financial soundness on a regular basis. Apart from enhancing the shareholder value, the bank's management is equally responsible to ensure that the bank's financial standing is not crippled by irrational decisions, which are usually led by market factors. A sufficiently justifiable capital level is fair yard stick for a stakeholder, including the regulator, to assess the overall financial position of the bank. Also from the bank's perspective, there is always a cost of capital. Hence it will try to leverage by maintaining sufficient capital only. Having said, it is important for it to maintain sufficient capital for foreseeable future, else it will impact the future growth of the business plans.

1.02 Basel II is more risk-sensitive than the erstwhile regime and aimed to significantly reduce the incentive for capital arbitrage. Higher risks will at least, in principle, result in higher risk weights and, thus, higher capital requirements. In the recent financial debacle which has impacted many large global organisations capital optimisation will play an important role. The underlying purpose of Basel Accord is the protection of depositors/ shareholders by prescriptive rules for measuring capital adequacy, thereby evolving a common language to assess the quality of assets and liabilities of the banks and evolving methods of determining regulatory capital and ensuring efficient use of capital.

1.03 Basel II has been implemented in most of the banks in India with effect from March 31, 2008. In this regard, the RBI issued a Master Circular no. DBOD.No.BP.BC.16/21.06.001/2012-13 dated July 2, 2012 on "Prudential Guidelines on Capital Adequacy and Market Discipline- New Capital Adequacy Framework (NCAF)".

1.04 Basel II brought in significant changes in the way a bank does its business, especially in terms of the class of its borrowers and the way it manages its operations considering that capital will need to be maintained on its operational risks. Under Basel I, the bank needed to maintain equal capital irrespective of the level of credit risk under the same class of borrower. Under Basel II, credit risk is monitored based on the customer class. This indicates that lending to a blue chip limited company or to a financial institution, lending to a partnership and lending to an individual are treated separately and based on the credit rating, the credit risk is computed and accordingly capital requirements are calculated. Higher the risk profile, higher the need for capital. This brought in change in the capital requirements in the banks, with some able to leverage their secured lending and higher credit rated lending portfolio for a reduction in capital needs, whereas those banks which had higher unsecured lending portfolio needed an increase in their capital needs.

Impact on emerging markets and smaller risks

1.05 In an attempt to assess the impact of Pillar 1 requirements of capital adequacy Basel Committee on Banking Supervision (BCBS) did undertake a few Quantitative Impact Surveys (QIS), the last of which is referred to as QIS 3. The results indicated that, in general, banks' required capital would decrease with respect to credit risks and increase with respect to operational risks. However, in Asia and other emerging markets, several factors may raise the required capital even for credit risks, as real estate continues to be widely used as collateral for business loans, and the standardised approach, which is the most liked approach for many banks, places a 150 per cent risk weight on non-performing loans. Basel II increased the level of capital that is required for banking institutions in the emerging markets, mainly owing to the new operational risk charge, which will be higher if the basic indicator approach is used.

1.06 By application of differential risk weights on the basis of sovereign rating as a benchmark, the capital inflows in emerging markets could be seriously impacted, as most of the borrowers in such markets will be categorised under the speculative grade. Smaller banks therefore, might have found the investments on Basel II compliance too big for their existing budgets.

Role of chartered accountants who are auditors of banks

1.07 Chartered Accountants, by serving the banking industry, contribute to the country's financial system as bank managers, financial executives, analysts, internal and external auditors, and advisers. Their role in strengthening the internal control and transparency of banking organisations is a major one that RBI, as banking supervisor, is increasingly recognising in its risk-focused examination policies, capital adequacy approaches, and disclosure initiatives.

- Currently the auditors of the bank are required to provide a certification on the capital adequacy ratio computation. Implementation of Basel II does not impacting this certification process from an auditor's perspective, other than that the computation mechanism has changed considerably. The auditor therefore needs, to understand more comprehensively the approach and mechanism adopted by the bank, and accordingly certify the computation. Considering the intricacies involved in the computation itself further supplemented by enhanced judgement factor, it would be prudent for the certifying auditor to deploy more senior members of its staff to audit the capital adequacy computations.
- It is imperative that the chartered accountant fraternity, especially those in practice enhance their awareness on Basel II norms as specified by the RBI so as to be ready to meet their stakeholder's expectations.

1.08 Some of the banks would prefer to avail services of chartered accountants as their external auditors to review the quality of internal controls and systems, and assess the scope and adequacy of internal audit function.

Role of branch auditors

1.09 The concept of Basel II is primarily aimed from central/head office perspective, i.e., the underlying decisions will be top-down driven. This should be the logical approach so as to ensure a consistent implementation across the bank, of the regulatory requirements. Accordingly, the statutory central auditors should primarily look into the capital adequacy computation as part of their attest function. As per requirements set by the RBI, the statutory central auditors are required to certify the capital adequacy computation. This requirement has been there in Basel I regime and continues to exist in Basel II regime. The underlying requirements from the auditor's perspective have not changed. It is only the computation methodology has changed due to the change in parameters as defined in Basel II. Having said, Basel II is not only about capital adequacy but is all about creating a robust risk management structure. Hence, apart from the capital adequacy computation, the auditors should verify the robustness of the risk management structure embedded in the bank, across its branches. This risk management spreads across all the types of risk, i.e., credit risk, market risk and operational risk. Hence, the branch auditors will also play a critical role in ensuring that the bank has adopted a consistent practice across its branches and as part of their attest function report on its appropriateness to the statutory central auditors.

1.10 In case of credit risk management the underlying computation for Basel II is based on credit ratings, which primarily is driven centrally and passed onto branches such that branches follow head office instructions in its entirety. This way the bank branch auditors check only the computation process and test check the source rather than getting into the credit rating process. Similarly, for operational risk computation the simplified approach currently approved by the RBI requires computation based on gross revenues of the bank as a whole and not dependent on branch revenues. The branch auditors can assess any issues relating to completeness and correctness of the data which is used to compute the underlying risks emanating from credit, market and operational risk. It is finally the pyramid approach whereby all the data from branches will get consolidated at head office. The statutory central auditors may choose to test check certain source data and also verify the basis considered at the head office. The statutory central auditors may review the work done by internal auditors, as may be stipulated by the management or the regulators. The Basel Accord does provide specific areas where internal auditors play a role.

1.11 It will not be practical to expect the branch to comprehensively understand the Basel II requirements in its entirety. The bank branch auditor should assess the sufficiency of the instructions provided to the branch by the head office and its adherence at the branch level. Any errors at bank branch can have a cascading effect at the head office, especially more when a large number of branches are involved.

Overview of Basel II

1.12 Basel or Basle or Bazel or Bal spellings and pronunciation have been different across places. Basically, Basel is a place in Switzerland where the accord was signed off. This accord is applicable to the banking world across the globe. In India, RBI has made it mandatory for certain classes of banks operating in India to implement the norms effective 31 March, 2008 and for the rest (other than LAB and RRB) by 31 March, 2009. Globally this accord is effective since 31 December, 2007.

Basel Committee – a Historical Perspective

1.13 The background of the Basel Committee is as follows:

- On 26th June 1974, a number of banks had released Deutschmarks to Bank Herstatt in Frankfurt in exchange for dollar payments that were to be delivered in New York. Due to differences in time zone, there was a lag in dollar payments to counterparty banks during which Bank Herstatt was liquidated by German regulators, i.e. before the dollar payments could be effected. The risk of settlement that arose from time-difference came to be known as 'Herstatt Risk'.

- The Herstatt accident promoted the G-10 countries to form towards the end of 1974 the Basel Committee on Banking Supervision (BCBS), under the auspices of the Bank of International Settlements (BIS), comprising of Central Bank Governors from the participating countries.
- The Basel Committee consists of senior representatives of bank supervisory authorities and central banks from various countries, i.e., Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Spain, Sweden, Switzerland, UK and the US. They meet each quarter at the Bank for International Settlements in Basel. It is not a regulatory body, but does provide guidelines.
- The Committee does not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended to, have legal force. Rather, it formulates broad supervisory standards and guidelines and recommends, statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements – statutory or otherwise which are best suited to their own national systems. In this way, the Committee encourages convergence towards common approaches and common standards without attempting detailed harmonisation of member countries' supervisory techniques. One important objective of the Committee's work has been to close gaps in international supervisory coverage in pursuit of two basic principles: that no foreign bank establishment should escape supervision; and that supervision should be adequate'.

The Evolving Process

1.14 The evolving process is as follows:

Decade	Event
1970's	• Committee of Banking Supervisory authorities established by central bank governors in 1975

1980's	• Basel I formulated in 1988
1990's	• RBI introduces risk asset ratio system in 1992 • Market risk included from 1996 under Basel I • Basel II formulated in 1999
2000	• Basel II Accord issued in 2004 • Updated in 2006 • RBI issues guidelines on maintenance of capital charge for market risks • RBI's draft guidelines on Basel II in Feb 2005 and March 2007 • RBI guidelines on Pillar 1 and 3 issued in April 2007 • Stress testing guidelines in June 2007 • Global launch of Basel II from 31 December 2007 • India launch of Basel II from 31 March 2008 • RBI guidelines on Pillar 2 issued in March 2008
2010	• Compliance across the globe • RBI issues guidelines on the road map for implementation of Basel III

- Increased number of bank failures and falling levels of equity capital led to the Basel I Accord.
- The Basel I principles included:
  - Strengthen the soundness and stability of the international banking system; and
  - Create minimum risk based capital adequacy requirements based on types of counterparties dealt with.
- The Basel I benefits were:
  - Reduced global systemic risk without suppressing competition.
  - Increased banks capital.
  - Relatively simple framework.
  - Widely adopted.

1988 Basel Accord

1.15 Historical perspective of 1988 Basel Accord is as follows:

- 1980's was post deregulation era (in India deregulation started in nineties). Deregulation inspired competition indeed resulted in increasing the risks of the banks and it translated in several bank failures. This outlined the need for risk control and linking banking risks with banks' capital. In 1988, the Basel Committee published a set of minimal capital requirements for banks, known as the 1988 Basel Accord. These were enforced by law in the G-10 countries in 1992. The Japanese banks were permitted an extended transition period.

- The 1988 Basel Accord primarily sought to put in place a framework for minimum capital requirement for banks that was linked to credit exposure. Keeping in view different accounting practices in vogue across the world, it also defined the capital for the purpose of capital adequacy.
- Bank assets were classified into five buckets i.e., grouped under five categories according to credit risk carrying risk weights of zero, ten, twenty, fifty and one hundred per cent. Assets were to be classified into one of these risk buckets based on the parameters of counterparty (sovereign, banks, public sector enterprises or others), collateral (e.g., mortgages of residential property) and maturity. Generally, government debt was categorised at zero percent, bank debt at twenty per cent, and other debt at one hundred per cent. Off-balance sheet exposures such as performance guarantees and letters of credit were brought into the calculation of risk-weighted assets using the mechanism of variable credit conversion factor. Banks were required to hold capital equal to 8% of the risk-weighted value of assets. Since 1988, this framework has been progressively introduced not only in member countries but also in almost all other countries having active international banks.
- The accord provided a detailed definition of capital. Tier 1 or core capital, which includes equity and disclosed reserves, and Tier 2 or supplementary capital, which could include undisclosed reserves, asset revaluation reserves, general provisions and loan-loss reserves, hybrid (debt/equity) capital instruments and subordinated debt.

Limitations of Basel I

1.16 Some of the perceived limitations of Basel I are as follows:

- Lack of risk sensitivity of capital requirements - It promotes financial decision making on the basis of regulatory constraints rather than on the basis of economic opportunities. Capital requirement for all corporate accounts being the same, it encouraged financing of assets with more risks for higher returns. Whereas a sound decision should take into account risk and return characteristics of an asset, it was discouraged, as capital requirement was not differentiated based on risk characteristic of assets.

- 'One-size-fits-all' approach to risk management - Credit risk assessment under Basel I is not risk-sensitive enough. Capital need assessment under the Basel I Accord was not being able to differentiate between banks with lower risks and banks with higher risks. For example, exposure on a company with AAA rating and a company with B rating are treated identically for the purpose of capital adequacy. Both will be placed in 100% risk weight category although, risks associated with them would be quite different.
- Limited attention to credit risk mitigation - It did not recognise the role of credit risk mitigants, such as credit derivatives, securitizations, collaterals and guarantees, in reducing credit risk.
- Over emphasis on minimum capital requirements.
- Exclusive focus on financial risk.

1.17 This was believed to have led to sub-prime lending behaviour, fall out of large financial institutions, increased divergence between regulatory capital, and economic capital, and regulatory capital arbitrage through product innovation. The fundamental objective to revise the 1988 Accord has been:

- To develop a framework that would strengthen the soundness and stability of the international banking system;
- To ensure that it does not become a source of competitive inequality among internationally active banks and yet have a capital adequacy regulation that is sufficiently consistent; and
- To help promote the adoption of stronger risk management practices by the banking industry.

Change Management

1.18 The revised accord is also called Basel II. The BCBS has since released the document, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" on 26 June, 2004. Its significant features are:

- Significantly more risk sensitive capital requirements, and takes into account operational risk of banks apart from credit and market risks. It also provides for risk treatment on securitization.

- Greater use of assessment of risk provided by banks' internal systems as inputs to capital calculations.
- Provides a range of options for determining the capital requirements for credit risk and operational risk to allow banks and national regulators to select the approaches that are most suitable.
- Capital requirement under new accord is the minimum. It has a provision for supplementary capital that can be adopted by national regulators.
- The accord in fact promotes stronger risk management practices by banks by providing capital incentive for banks with better risk management practices.
- Capital requirement under Basel II does not include liquidity risk, interest rate risk of banking book, strategic and business risks. These risks would be under 'Supervisory Review Process', if supervisors feel that the capital held by a bank is not sufficient, they could require the bank to reduce its risk or increase its capital or both. In the matter of interest rate risk on banking book it has put in place a criteria for 'Outliers'. Where a bank under 200 basis point interest rate shock faces reduction in capital by 20% or more, such banks would be outliers.
- Return on capital is one of the most significant measures used by the market in assessing the value of an organisation.
- The current revision of the regulatory capital requirements will have fundamental impact on the markets and the major banks strategies.
- Explicit recognition of non-credit risks.
- Embedded sophisticated risk management.
- Enhance the levels of internal controls.
- Capital requirements will become volatile.
- Significant reduction in risk weights for assets rated 'A'/'P2' or higher, resulting into capital relief for the banks.
- Cost of equity or subordinate debt is higher than the cost of deposits. Capital relief will result in cost savings for banks, which can possibly be shared with the corporates.
- High quality of data – granular level and accuracy.
- Convergence of risk and finance data.

Capital Funds

1.19 The minimum capital maintained by banks on implementation of the Revised Framework was subjected to a prudential floor♣, which was stipulated to be the higher of the following amounts during the first three years of implementation of Basel II framework:

a) Minimum capital required to be maintained as per the Revised Framework;

b) A specified per cent of the minimum capital required to be maintained as per the Basel I framework for credit and market risks. The specified per cent will progressively decline as indicated in Table 1.

Table 1 – Prudential Floor

Financial year ending*	**March 2008**	**March 2009**	**March 2010**
Prudential Floor (as % of minimum capital requirement computed as per current (Basel I)	100	90	80

1.20 The adequacy and the need for the capital floors was reviewed in April, 2010, on the basis of the quality and integrity of Basel II implementation in banks , and it was decided to continue with the prudential floor until further advice. Accordingly, the foreign banks in India and Indian banks having operational presence outside India would continue to have the parallel run beyond the aforesaid 3 year period (i.e. March 31, 2010)* and ensure that their Basel II minimum capital requirement continues to be higher than 80 per cent of the minimum capital requirement computed as per Basel I framework for credit and market risk. All other commercial banks would also continue to ensure compliance with the prescribed prudential floor in terms of the paragraph above.

♣ The need for continuing with the prudential floor will be reviewed periodically by the Reserve Bank.

* The relevant periods shall be March 2009, 2010, and 2011 for banks implementing the Revised Framework with effect from March 31, 2009

* In the Monetary Policy 2010-11, banks were advised to continue with the parallel run for a period of three years, i.e. till March 31, 2013, subject to review. Accordingly, all the banks in India would continue to have the parallel run till March 31, 2013, subject to review, and ensure that their Basel II minimum capital requirement continues to be higher than the prudential floor of 80% of the minimum capital requirement computed as per Basel I framework for credit and market risks.

Capital – What Constitutes Tier 1 and Tier 2 – a Representative Sample

1.21 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. The following table shows the components of the capital funds for Indian *vis a vis* foreign banks operating in India:

	Indian Banks	**Foreign Banks operating in India**
Tier I Capital	Paid up equity capital (ordinary shares)	Interest free funds from Head Office[1]
	Statutory reserves	Statutory reserves kept in Indian books
	Other disclosed free reserves, if any	Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India
	Innovative perpetual debt instruments eligible for inclusion as Tier I capital	Innovative Instruments eligible for inclusion as Tier I capital
	Perpetual non-cumulative preference shares eligible for inclusion as Tier I capital subject to laws in force from time to time[2]	Capital reserves representing surplus arising out of sale proceeds of assets
		Interest free funds remitted from abroad for the purpose of acquisition of property
		Head office borrowings in foreign currency by foreign banks operating in India
Tier II Capital		
	Revaluation reserves	Revaluation reserves
	General provisions and loss	General provisions and loss

1 Kept in a separate account in Indian books specifically for the purpose of meeting the capital adequacy norms.

2 The annexure to Master Circular on Prudential Norms on Capital Adequacy-Basel I Framework provides guidelines for Perpetual non-cumulative preference shares eligible for inclusion as Tier I capital.

	Indian Banks	Foreign Banks operating in India
	reserves	reserves
	Hybrid debt capital instruments, which includes Perpetual Cumulative Preference Shares (PCPS)/Redeemable Non-Cumulative Preference Shares(RNCPS) /Redeemable cumulative preference shares(RCPS) and Debt capital instruments	Hybrid debt capital instruments which includes Perpetual Cumulative Preference Shares (PCPS)/Redeemable Non-Cumulative Preference Shares(RNCPS) /Redeemable cumulative preference shares(RCPS) and Debt capital instruments
	Subordinate debts	Subordinate debts
	Innovative Perpetual Debt Instruments (IPDI) and Perpetual Non-Cumulative Preference Shares (PNCPS)	

1.22 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 funds to be maintained by such banks.

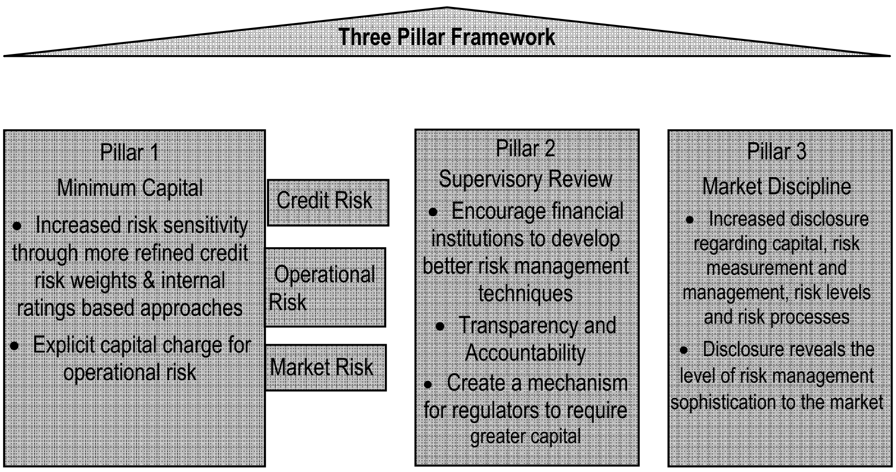
Deductions from Tier I and Tier II

1.23 The deductions from Tier I and Tier II are tabulated below:

Item	Extent of Deduction (in %)	
	Tier I	Tier II
Intangible assets	100	---
Losses in the current period	100	---
Losses brought forward from previous periods	100	---
Deferred tax asset associated with accumulated losses	100	----
Gain-on-sale arising at the time of securitisation of standard assets	100	
Securitization exposure	50	50

Item	Extent of Deduction (in %)	
Investment in financial subsidiaries and associates which is above 30 per cent in the paid up equity of entity and not consolidated for the capital adequacy purposes	50	50
Shortfall in the regulatory capital requirements in the de-consolidated entity	50	50
Such amount of investment in the following which is in excess of 10% of investing bank's capital funds: • Equity shares; • Perpetual Non- Cumulative Preference Shares; • Innovative Perpetual Debt Instruments; • Upper Tier II Bonds; • Upper Tier II Preference Shares; • Subordinated debt instruments; and • Any other instrument approved as in the nature of capital.	50	50
Investments made by a banking subsidiary/associate in the equity or non-equity regulatory-capital instruments issued by its parent bank	50	50

The 3 pillars of Basel II



1.24 The 3 pillars of Basel II are as follows:

- Minimum capital
  - Sets minimum acceptable capital
  - Credit risk tied to ratings
  - Public ratings
  - Internal ratings
  - More risk sensitive measures of credit risk, e.g., Corporate risk weighting will change from standard 100% to a weighting based on external/internal credit rating
  - Explicit treatment of Operational Risk (a new risk in addition to credit and market risk)
- Supervisory review
  - Sets out rules and powers for regulators to supervise the complex framework
  - Regulators have flexibility to set higher capital requirements, if necessary
  - Based on four principles -
    - Self assessment
    - Supervisory review of bank's assessments
    - Buffers in excess of minimum capital
    - Regulators will intervene at an early stage, if capital level deteriorates
  - Aims to cover areas not covered by Pillar 1, e.g., Credit Concentration Risk
- Market discipline
  - Enhanced Market Discipline
  - Greater and Improved disclosure of Risk Management Metrics
  - Aims to strengthen market discipline by increasing disclosure requirements in relation to :
    - Capital structure
    - Risk measurement and management practices
    - Risk profile
- The key risks considered include Credit risk, Market risk and Operational risk
- RBI's risk assessment (e.g., regulator can increase the risk weights where default experience warrants the same)

- New Basel Accord will set minimum requirements, but RBI has the flexibility to set higher capital requirements, as deemed necessary
- Disclosures

1.25 Approaches under Basel II

Credit risk		**Market risk**	**Operational Risk**
Whole sale banking	**Retail banking**		
Standardised	*Standardised*	*Standardised*	*Basic Indicator Approach (BIA)*
Foundation IRB (Internal Rating Basis)		Internal models	The Standardised Approach (TSA)
Advanced IRB	Retail IRB		Advanced Management Approaches (AMA)

1.26 The italicised approaches are currently permitted by the RBI. In this chapter we will focus on the permitted approach and any other references will be merely for academic reasons.

- The approaches increase sophistication, resulting in possible reduction in capital requirements.
- Each approach has increasing and more complex data requirements.
- Several national discretions available to supervisory authorities. RBI has opted to permit only the above italicised approaches.

1.27 From a corporate governance point of view, the banks would need to have the following in place to follow AMA (note that this method is currently not permitted by RBI):

- Board and Senior Management oversight.
- Independent enterprise-wide operational risk framework and function.
- Policies and procedures for all aspects of the operational risk framework.
- Independent testing and verification (e.g. audit).
- Lines of business responsible for day-to-day risk management.
- Reporting of operational risk exposures, losses, risk indicators etc to Board and Senior Management.

- Sound internal control environment.

1.28 Three approaches to Credit Risk are:

(a) Standardised approach (the approach adopted by the RBI in India – the other two methods are not yet approved, hence, any further reference in this chapter is merely for academic reasons)
   - External ratings
   - Limited recognition
   - Supervisory treatment of collateral and guarantees

(b) Foundation IRB approach
   - Internal models for PD
   - Externally provided EAD and LGD
   - Limited recognition
   - Supervisory treatment of collateral and guarantees

(c) Advanced IRB approach
   - Internal models for PD, EAD and LGD
   - Internal estimation - including guarantees, collateral, credit derivatives

Credit Rating

1.29 Currently in India, the credit rating agencies are providing ratings specific to an issue. Basel II warrants for these credit rating agencies to provide ratings specific to an issuer and per facility. Currently the rating penetration in India is low. Bank Facilities Rating is gaining importance and becoming a norm. Extending credit facilities to an unrated issuer may require the bank to maintain a higher capital. Hence, banks will require each borrower to get themselves rated by RBI approved credit rating agencies (i.e., CARE, CRISIL, FITCH, ICRA, Brickwork and SME Rating Agency of India ('SMERA'))@ (in case of non resident borrowers: Moody's, S&P, FITCH). A borrower is not required to get rated by all CRAs. There is no need to take a separate rating for each banker. Foreign ratings to be used for FCY exposure only. Short term ratings cannot be used to map long term unrated exposures. The rating has to be carried out in the last 15 months. The understanding is that the rating related fees payable to the credit agency will

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have to be borne by the borrower. Potential capital savings may prompt banks to provide incentives to corporates to get themselves rated.

Auditors' role

1.30 The auditor's role in case of the standardised approach would be to verify the correct assignment of the risk weights prescribed by the external credit rating agencies to each asset.

Credit rating – Bank loan rating

1.31 Bank loan rating is, essentially, a credit rating which the rating agency will assign to various facilities provided by the banks, such as, working capital demand loans, cash credit, project loans, loans for general corporate purposes, and non-fund based facilities.

1.32 Bank loan ratings indicate the degree of risk with regards to timely payments of interest and principal on the facilities being rated. The long term and short term rating scales are as under:

Long term rating scale	**Short term rating scale**
Term loans > one year	Term loans < one year
FCNRB Term loans	Packing credit
Cash credit (book debts)	Bill discounting
Cash credit (Stocks)	Letter of credit
Working capital demand loan	Bank guarantee

Credit Risk - Standardised Approach

1.33 Standard approaches towards Credit Risk are as follows:

- Ratings by External Credit Assessment Institutions (ECAI) for Sovereigns, Corporates and banks.
- Defined criteria for recognizing ECAIs (and hence their ratings) by regulators.
- Risk weights – subject to national discretion.
- Defined criteria for classifying 'retail' portfolios (viz., orientation, product, granularity, absolute value).
- Retail portfolios to be risk-weighted at 75% (except housing loans 35%, CRE 100%).
- Considers value/quality of collateral.

- Provides a range of eligible collateral, viz., cash, debt securities, equities, guarantees, credit derivatives, etc.
- Claims secured by residential property, attracts lower risk weight, compared to claims subject to commercial real estate, which requires higher risk weight.
- Consumer lending - cards and personal loans, are categorised as retail regulatory portfolio, and requires lower risk weight recognising retail nature of facilities.
- SME facilities categorised as retail (based on aggregate exposure and size of the entity being within specified limits) require lower risk weight.
- Other forms of consumer lending require 100% risk weight.
- Exposure on banks will be based on a combination of risk weight on domestic currency exposures being based on risk weights specified by the regulator and/ or based on credit rating of the bank (based on the CRAR of the scheduled bank- if CRAR is => 9 %, the RW is 20%).
- Non performing assets are segregated and risk weighted based on whether they are secured or unsecured.
- Off-balance sheet exposures arising on Trade related exposures will have applicable credit conversion factors, on which risk weights % will be applied based on credit risk of counterparty.
- Credit Risk Mitigation is recognised for collaterals, basically:
  - Cash; Marketable securities, subject to hair cuts for price movements & forex gaps; and irrevocable guarantees, subject to guarantor being credit rated at required levels by external agencies.
- Above can be recognised subject to bank having complete legal rights to enforce security, including specific lien where applicable and subject to hair cuts for residual tenor mismatch and currency mismatch.
- Netting of balances is permissible only in case of completely legally enforceable arrangements backed by specific lien, and meeting requirements of match in residual tenor and currency.

Risk weights

1.34 The risk weights are as follows:

(i) Sovereign, PSEs, MDBs, Primary dealers

(ii) Corporates

- External ratings
- Country of incorporation
- Tenor of exposure - Contractual Maturity > one year is long term and less than one year is short term. Overdraft facility, though repayable on demand should be treated as long term.
- Risk weights based on credit rating from external rating agencies chosen by RBI. Unrated exposures attract RW of 100% from April 1, 2008 if the total exposure of the counterparty exceeds Rs 50 Crores (Rs 10 Crores from 1 April 2009).

(iii) Retail

- Product based and not customer based

(iv) Banks

- Local: Scheduled vs. Non Scheduled (to source from IBA/RBI)
- Foreign: External ratings

(v) NPAs

- Linked to specific provisions

1.35 Considering that the rates may change in the interim, the specific rates have not been specified in this chapter. For the individual risk weights make reference to the current RBI circular.

Undrawn Commitments

1.36 Undrawn or partially undrawn facility (unutilised limit) is subject to Risk Weighted Assets & Contingents RIWAC.[@] The risk weight depends upon the risk weight of the applicable classification/counterparty/rating. The Credit Conversion Factor depends upon the original maturity of the commitment. If original maturity is less than one year then CCF is 20% and for greater than 1 year the CCF is 50%. "Unconditionally cancellable" clause should be included in facility letters e.g. "Notwithstanding anything contained herein, the facility is at the bank's sole discretion and subject to cancellation at any time by the bank". Progressive drawdown's of funded lines (e.g., project finance), if subsequent drawdown's need specific Credit Approval.

[@] Revised in 2013 Edition.

Failed Transactions

1.37 Unsettled transactions are required to be monitored very closely and there are stringent guidelines for risk weighting them. For DVP transactions, see table below. In case of non - DVP transactions not settled within five days, deduction from capital will be necessitated.

DVP Transactions	
No of working days after settlement date	*Risk Multiplier*
5 – 15 days	9%
16 – 30 days	50%
31 – 45 days	75%
46 or more days	100%

Risk weights for NPAs

1.38 Unsecured balance of NPA net of provision needs to be risk weighted. Risk Weight is based on the level of provisioning. Higher the provision, lower the risk weight.

Provision	**Risk Weight (other than residential mortgage)**	**Risk Weight (residential mortgage)**
Less than 20%	150%	100%
20% to 50%	100%	75%
50% and above	50%	50%

Securitisation transactions – risk weights

1.39 Securitisation Exposures includes - as investor, as credit enhancer, as liquidity provider, as underwriter, and as provider of credit risk mitigations. Further, cash collateral provided as credit enhancement will also be treated as securitisation exposure. Other matters to be considered may include - true sale status, rating below BB, unrated exposure, gain on sale, etc.

Originator	Securitisation Exposure	CRE Exposure
Rating	*Risk Weight*	*Risk Weight*
AAA	20%	50%
AA	30%	75%
A	50%	100%
BBB	100%	150%
BB	350%	Deduction@
B and below/unrated	Deduction	Deduction

Auditor's role

1.40 Given the reliance on monitoring and control systems to limit credit risk, as per Basel Accord 2004, the bank should have an effective internal process for assessing compliance with all critical policies and procedures, including:

- regular internal and/or external audits of all critical phases of the bank's receivables purchase programme; and
- verification of the separation of duties (i) between the assessment of the seller/servicer and the assessment of the obligor and (ii) between the assessment of the seller/servicer and the field audit of the seller/servicer.

1.41 A bank's effective internal process for assessing compliance with all critical policies and procedures should also include evaluations of back office operations, with particular focus on qualifications, experience, staffing levels, and supporting systems.

Standardised approach – Collaterals

1.42 The scope of eligible collateral has been enhanced and it no longer constitutes of only cash deposits.

Nature of collateral	Volatility Adjustment
Rated Debt Securities, if it is liquid (say listed on SE) and rated > BBB, including Government Securities	Depends on counterparty, credit rating and residual maturity. (Range 0.5% -

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	12%)
Listed Equities (including convertible bonds) on recognised stock exchange	15%
Other Equities (Listed only)	25%
Mutual Fund Units – if NAV is daily quoted and MF invests in above listed securities	As per security invested
Life Insurance Policies, NSC/Kisan Vikas Patra	0%
Cash in the same currency	0%
Gold	15%@

1.43 Haircuts or adjustment of collateral values is done as follows:-

Volatility adjustment to reflect market risk	Using regulatory prescribed % collateral value is adjusted downwards
Maturity Mismatch – tenor of exposure exceeds collateral	Using a regulatory formula collateral value is adjusted downwards
Currency mismatch - currency of exposure differs from that of collateral	Using regulatory prescribed % (8%) collateral value is adjusted downwards
Scaling factor (when the time to realisation of collateral exceeds 10 days or where collaterals are not revalued on daily)	Using a regulatory formula collateral value is adjusted downwards

Auditor's role in collateral management

1.44 Collateral management is an important activity in secured lending business. The Basel Accord 2004 has specified that the bank must maintain a continuous monitoring process that is appropriate for the specific exposures (either immediate or contingent) attributable to the collateral to be utilised as a risk mitigant. This process may include, as appropriate and relevant, ageing reports, control of trade documents, borrowing base certificates, frequent audits of collateral, confirmation of accounts, control of the proceeds of accounts paid, analyses of dilution (credits given by the borrower to the issuers) and regular financial analysis of both the borrower and the issuers of the receivables,

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especially in the case when a small number of large-sized receivables are taken as collateral. Observance of the bank's overall concentration limit should be monitored. Additionally, compliance with loan covenants, environmental restrictions, and other legal requirements should be reviewed.

1.45 The types of physical collateral accepted by the bank, and policies and practices in respect of the appropriate amount of each type of collateral relative to the exposure amount must be clearly documented in internal credit policies and procedures and available for examination and/or audit review.

Credit Risk Mitigation

1.46 Cash Risk Mitigation (CRM) is recognised for collaterals, basically in case of cash, marketable securities, subject to hair cuts for price movements and FX gaps, and irrevocable guarantees, subject to guarantor being credit rated at required levels by external agencies. This can be recognised subject to bank having complete legal rights to enforce security, including specific lien where applicable and subject to hair cuts for residual tenor mismatch and currency mismatch. Netting of balances is permissible only in case of completely legally enforceable arrangements backed by specific lien, and meeting requirements of match in residual tenor and currency.

1.47 Wider range of collaterals is recognised under Basel II. Standard Supervisory Method has been prescribed by the RBI. Collaterals are subject to various kinds of haircut. Eligible collaterals include Cash, Bank Deposits, Gold, Government Securities, National Savings Certificates, Life Insurance Policies, Debt Securities, Mutual Fund units, and Guarantees.

1.48 Following are the various types of haircuts:

Type of Haircut	Meaning and regulation
Volatility adjustment to reflect market risk	Using regulatory prescribed % collateral value is adjusted downwards.
Maturity Mismatch	Where tenor of exposure exceeds collateral. Using a regulatory formula collateral value is adjusted downwards.
Scaling factor	When the time to realisation of collateral exceeds 10 days or where collaterals are not revalued daily. Using a regulatory formula collateral value is adjusted downwards.

Currency mismatch	Currency of exposure differs from that of collateral. 8% collateral value is adjusted downwards.

Standardised Approach – Capital Efficiency

1.49 Standardised approach for capital efficiency is as follows:

(i) Unrated exposures - Banks to pursue the borrowers to be rated, else the bank runs the risk of maintaining higher capital as the risk weight is 100%.

(ii) Undrawn commitments - If limits are not 'Unconditionally Cancellable' then there is a capital charge on the undrawn portion (e.g., credit card, overdrafts, cash credit, consortium lending). Banks may consider reviewing their agreements with customers and also the current limits. Based on past trends, the banks may curtail the limits to bring to a realistic number.

(iii) Inter Group Transactions - Risk Weight on Group exposures at 50% (presuming credit rating of A+). The risk weight under Basel I was 20%.

(iv) LTV Criteria for Residential Mortgage - Usually banks compute the LTV at the disbursement time and not based on the latest data. If updated periodically, it would lead to more loans falling in the less than 75% bucket. This will entail additional computation work.

(v) Turnover Details (SME, Supply chain financing) - SME/SCF to qualify has to be Regulatory retail (and beneficial risk weight 75%), 3 years turnover data is required (entity should have turnover less than Rs 50 crores over previous years). For this the banks will need to approach their customers for past financials, especially in case of new customers.

(vi) Securitisation transactions - Securitisation exposures is risk weighted based on the credit rating; hence possibility of significant benefit. Deduction from capital should be done only if rated below B or unrated.

Benefits of advanced level compliance

1.50 The RBI is yet to release any guidelines on advanced approaches, hence, they are not relevant in the current context. However, the benefits would include:

(i) Difference in capital requirement will be of a substantial amount between the Foundation and Advanced IRB options.

(ii) Advanced level recognises a wider range of credit risk mitigants such as collateral, guarantees and credit derivatives.

(iii) Gives superior risk management techniques and therefore better decision making capabilities.

(iv) Reputational implications of not achieving Advanced Level.

(v) Potential pricing disadvantage from not achieving Advanced Level.

Market risk

1.51 Risk of losses in on and off-balance positions arising from movements in market prices. The market risk positions subject to capital charge requirement are the risks pertaining to interest rate related instruments and equities in the trading book and foreign exchange risk (including open position in precious metals) throughout the bank (both banking and trading books). Capital for Market risk shall be provided for risks pertaining to interest rate related instruments and equities in trading book (including AFS), and Foreign exchange risk (including open position in precious metals) throughout the bank, both banking and trading books.

1.52 The BCBS and RBI have issued guidelines for providing capital towards market risk and suggested two methodologies for measuring market risk and consequent capital requirements.

(i) Standardised Method

(ii) Internal Models to measure market risk (Internal Risk Management Models Method).

1.53 Market risk is the uncertainty resulting from changes in market prices. Market Risks arises due to movements in interest rate, currency, equity, commodity, and volatility. Directional risks arises from taking a net long/short position in a given asset class.

1.54 Market risk measurement:

- Quantify the risk of losses due to movements in financial market variables.
- Various measures to assess market risk:
  - Investment Limits
  - Risk Factors (PV01, Delta, Gamma, etc.)
  - VaR.

Market risk evolvement in India

1.55 In India, in 1998 as an initial step towards prescribing capital charge for market risks, banks were advised to:

(i) Assign an additional risk weight of 2.5 per cent on the entire investment portfolio.

(ii) Assign a risk weight of 100 per cent on the open position limits on foreign exchange and gold.

(iii) Build up Investment Fluctuation Reserve up to a minimum of 5% of the investments held in HFT and AFS categories in the investment portfolio.

Auditor's role

1.56 Though there are no significant changes in the area of market risk measurement and management in the past few years, the auditor's role would be there in reviewing the provisions arising out of risk weightages associated with different financial assets/instruments. There is also embedded market risk in various deposit and loan products where "put or call" options are made available to the customers. Auditors should examine/review the determination of provisions arising out of market conditions.

Interest Rate Risk – Introduction

1.57 The capital charge for interest rate related instruments is applied to current market value of these items in bank's trading book. The minimum capital requirement is expressed in terms of two separately calculated charges. The first one is specific risk which is designed to protect against an adverse movement in the price of an individual security owing to factors related to the individual issuer. The second one is general market risk which is designed to capture the risk of loss arising from changes in market interest rates.

Interest rate risk in foreign currencies

1.58 Capital charges should be calculated for each currency separately and then summed with no offsetting between positions of opposite sign. In the case of those currencies in which business is insignificant (where the turnover in the respective currency is less than 5% of overall foreign exchange turnover) separate calculations for each currency are not required. Instead, slot within each appropriate time-band, the net long or short position for each currency. These individual net positions are to be summed within each time band, irrespective of whether they are long or short positions, to produce a gross position figure. The gross positions in each time-band will be subject to the assumed change in yield set out earlier with no further offsets.

Capital charge for equity risk

1.59 It is applicable to all instruments that exhibit market behaviour similar to equities but not to non-convertible preference shares (which are covered by the interest rate risk requirements described earlier). It consists of specific and general market risk. Capital charge for specific risk (akin to credit risk) will be 9% and specific risk is computed on the banks' gross equity positions. The general market risk charge is also 9% on the gross equity positions. 'Capital market exposures' will attract a higher risk weight of 125% or a risk weight warranted by the external rating (or the lack of it) of the counterparty, whichever is higher. Thus, for normal equity shares the effective capital charge for specific risk becomes 11.25% (9%*1.25).

Capital charge for foreign exchange risk

1.60 Foreign exchange open positions and gold open positions are at present risk-weighted at 100%. Thus, capital charge for market risks in foreign exchange and gold open position is 9%. These open positions, limits or actual whichever is higher, would continue to attract capital charge at 9%. This capital charge is in addition to the capital charge for credit risk on the on-balance sheet and off-balance sheet items pertaining to foreign exchange and gold transactions.

Capital charge for treatment of Options

1.61 In recognition of the wide diversity of banks activities in options and the difficulties of measuring price risk for options, alternative approaches are permissible as under:

(i) Those banks which solely use purchased options will be free to use the simplified approach.

(ii) Those banks which also write options will be expected to use one of the intermediate approaches.

Operational risk

1.62 Operational Risk in Banking is, considered to be having three albeit interlinked segments: a) People, Process and System related risks including Legal Risk; b) External Events related Risk and c) Strategic and Reputational Risk. As per Basel II accord definition, operational risk is risk of direct and indirect loss resulting from inadequate or failed internal processes, people and systems or from external events, includes legal risk but excludes strategic and reputational risk. Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements. Operational Risk is managed through systems and procedures, internal controls, audit, New Product Approval Process, Fraud Analysis and Operational Risk Policy Operational risk exposures are opaque and is part of being in business, rather than a part of any particular transaction.

Basic Principles of Management of Operational Risk

1.63 Basel Committee has identified following basic 10 principles for successful management of Operational Risk:

(i) Board of Directors should be aware of major aspects of Operational Risk of the organisation as distinct risk category.

(ii) The Board of Directors should ensure that operational management framework of the organisation provides for effective and comprehensive internal audit.

(iii) Senior Management of the organisation should consistently implement approved operational management framework of the organisation.

(iv) In all material products, activities, processes and systems, operational risk contract should be identified and assessed.

(v) Regular Monitoring System of Operational Risk profiles and material exposures to losses should be in place.

(vi) Policies, processes and procedures to control/mitigate Operational Risk should be evolved.

(vii) Contingency business plans should be evolved.

(viii) Regulatory Authorities should review periodically about organisation's approach to identify, assess, monitor and control/mitigate Operational Risk.

(ix) Regulatory Authorities may ensure that appropriate mechanisms are put in place to allow them to remain apprised of position of Operational Risk Management of the supervised organisations.

(x) Adequate Public Disclosures to be made to enable market participants to assess organisation's approach to Operational Risk.

The Three approaches to Operational risk

1.64 As per Accord there are three approaches defined to operational risk:

(i) Basic Indicator Approach (BIA)

- One simple calculation for all risk event types and all business lines;
- Bank must hold 15% operational capital against the 3-year average gross income (ignore negative income).

(ii) Standardised approach

- Under the Standardised Approach the bank's activities are divided into eight business lines. A capital charge is required for each one of these business lines. This capital charge is a fixed percentage (beta factor) of the average annual gross income (as defined in the Basic Indicator Approach above) of each business line over the previous three years. The annual total capital charge is calculated as a three-year average by simply adding together the regulatory capital charges of the individual business lines. Thus, bank's business is segregated into following eight broad business types:

Sector	%
Retail Banking	12
Retail Brokerage	12
Commercial Banking	15
Corporate Finance	18
Asset Management	12
Agency Services	15
Trading and Sales	18
Payment and Settlement	18

(iii) Advanced Measurement Approach (AMA)

- Internal Models, e.g., Operational Loss distribution and scenario based models.
- Firms determine their own capital charge based upon internal model.
- Bank must satisfy regulator on quantitative and qualitative criteria, internal data, external data and scenario analysis, business environment and internal control factors and any risk mitigation such as, insurance coverage.

1.65 Banks in India to follow BIA. RBI to review credibility of capital charge as per BIA vis-à-vis peers and if needed, act under Pillar 2.

The RBI vide its circular dated April 27, 2011 has issued guidance for Banks intending to migrate to AMA for computing capital charge for operational risk to assess their preparedness with reference to these guidelines.[@]

Operational risk – What is gross income?

1.66 Gross income is net interest income plus net non-interest income. It is gross of any provisions (e.g., for unpaid interest) and write-offs and gross of operating expenses, including fees paid to outsourcing service providers. Fees received for offering outsourcing services part of gross income. It excludes following:

(i) reversal of provisions and write-offs made during previous year/s;

(ii) income on disposal of items of movable and immovable property;

[@] Revised in 2013 Edition.

(iii) realised profits/losses from sale of HTM securities (as per Basel: exclude for both AFS & HTM (banking book));
(iv) income from legal settlements in favour of bank;
(v) other extraordinary or irregular items of income and expenditure; and
(vi) income derived from insurance activities (i.e., income derived by writing insurance policies) and insurance claims in favour of bank.

Operational risk – challenges

1.67 The following are challenges related to operational risk:

(i) Operational risk is not significantly affected by economic behaviour;

(ii) Cannot be managed consistently;

(iii) Cannot be captured through same model;

(iv) Losses in one area does not suggest a likely weakness in another area;

(v) Major operational risk not predictable;

(vi) Operational risk cannot be validated / back tested;

(vii) So existing models are backward looking (loss data approach);

(viii) Context dependency of operational risk -

- Size and likelihood of an event occurring differs in different situations
- Relevance of data gets lost with change in process / procedure; and

(ix) Wide variation in mean size of data collected on fraud losses, etc.

Legal risks

1.68 The following are some types of legal risks:

(i) Ineffectiveness of untested documentation;

(ii) Refusal or delay by guarantor to pay;

(iii) Inability to seize or realise collateral in a timely manner;

(iv) Inability of the bank to enforce the documents/claims due to above factors;

(v) Bank should have standard documents for different types of borrowers and facilities and such documents should be reviewed and modified based on legislative changes, decisions of the courts; and

(vi) Considering that such instances would be very nominal when banks may have sustained loss on account of lacuna in documentation, no additional capital cushion may be envisaged.

Reputational risk

1.69 Bank's reputation refers to its image in the eyes of the stakeholder such as, share holders, lenders, depositors, and employees. Reputational Risk refers to the potential adverse effects on profitability and/or CRAR arising from bank's reputation deviating negatively from its expected level. The bank should ensure to mitigate reputation risk by –

- Honouring counter party commitments timely.
- Ensuring compliance with prescribed guidelines, procedures and code of conduct.
- Adopting sound management practices aimed at delivering consistently efficient and value added services.
- Having a control over outsourcing arrangements.
- Adhering to all regulatory and prudential limits.
- Strengthening Corporate Governance Practices protecting the interest of all the stakeholders and leading to value preservation and maximisation.

1.70 Considering that such instances would be very nominal when banks may have sustained loss on account of the above risk, no additional capital cushion may be envisaged.

Business cycle risk

1.71 Business Cycle Risk concerns a downturn in the economy and consequently, results in adverse behaviour of assets as to repayment/recycling/honouring of commitments, etc. Historical data and empirical evidence will best support such an analytics. In the absence of requisite information, more particularly due to economic upswing experience only, banks should consider Stress Analysis to represent business cycle effect. RBI has issued guidelines on stress testing which will, among other things, cover impact on bank's CRAR.

1.72 Impact on business due to heavy rains impacting agricultural produce, exchange rate fluctuations (recent appreciation of rupee has impacted many an exporters), interest rates swinging by say 100 bps +/- are few examples of stress testing avenues. "What if" analysis can play a good role out here.

Earnings at risk

1.73 Earnings at risk arises due to bank's inability to attain a sufficient and sustaining level of profitability and inadequate diversification in bank's earnings structure affecting stability of earnings. Bank's should monitor its earnings and can take measures such as:

- Cost control measures, including cost management, thus, improving the cost to income ratio;
- Increase in interest income;
- Increase in net interest margin;
- Increase in net fee income; and
- Exploring other avenues of revenue by introducing new products/initiatives.

Auditor's role

1.74 The bank's operational risk assessment system (including, the internal validation processes) must be subject to regular review by external auditors and/or supervisors. Internal and/or external auditors must perform regular review of the operational risk management processes and measurement systems. This review must include both the activities of the business units and of the independent operational risk management function. The validation of the operational risk measurement system by external auditors and/or supervisory authorities must include the following:

- Verifying that the internal validation processes are operating in a satisfactory manner; and
- Making sure that data flows and processes associated with the risk measurement system are transparent and accessible. In particular, it is necessary that auditors and supervisory authorities are in a position to have easy access, whenever they judge it necessary and under appropriate procedures, to the system's specifications and parameters.

1.75 As the Basic Indicator approach is a very straight forward approach the auditor does not need to perform any other procedures than what he was already performing, i.e., verifying that the income was fairly stated and recognised in the financial statements. For the Standardised approach, the recording of the total income between the various business lines is of relevance and hence it is essential for the auditor to verify the internal controls related to capturing of financial and business information across the various business lines.

ICAAP process (Internal Capital Adequacy Assessment Process)

1.76 The objectives of Internal Capital Adequacy Assessment Process (ICAAP) process are as follows:

(i) Create a transparent and consensual general framework for assessment and for internal risk management of all material risks, thus, securing the organisation's objective in the long run.

(ii) Enable bank to understand capital requirement under different scenarios.

(iii) Build and support linkage between risk and capital.

(iv) Strengthen bank's position on capital management.

(v) Support the bank's long-term goal to move away from regulatory capital model to a regime of internal models that addresses both regulatory and economic capital.

(vi) Move eventually to a system of 'on-line' calculation of Capital, both under Pillar 1 and Pillar 2.

1.77 The components of ICAAP process are appropriate identification and measurement of various risks, appropriate level of internal capital in relation to bank's risk profile and enhanced level of Risk Management System. Further, capital adequacy under ICAAP needs to be seen from two angles - regulatory capital under Pillar 1, which explicitly covers minimum capital for Credit, Market and Operational Risk; and capital cushion to cover other risks dealt in Pillar 2.

Auditor's role under ICAAP

1.78 The bank's internal control structure is essential to the capital assessment process. Effective control of the capital assessment process includes an independent review and, where appropriate, the involvement of internal or external auditors.

1.79 The bank's board of directors has a responsibility to ensure that management establishes a system for assessing various risks, develops a system to relate risk to the bank's capital level, and establishes a method for monitoring compliance with internal policies. The board should regularly verify whether its system of internal controls is adequate to ensure well-ordered and prudent conduct of business.

1.80 The ICAAP should be subject to regular and independent review through an internal or external audit process, separately from the SREP conducted by the RBI, to ensure that the ICAAP is comprehensive and proportionate to the nature, scope, scale and level of complexity of the bank's activities so that it accurately reflects the major sources of risk that the bank is exposed to. A bank shall ensure appropriate and effective internal control structures, particularly in regard to the risk management processes, in order to monitor the bank's continued compliance with internal policies and procedures.

1.81 As a minimum, a bank shall conduct periodic reviews of its risk management processes, which should ensure:

a) the integrity, accuracy, and reasonableness of the processes;

b) the appropriateness of the bank's capital assessment process based on the nature, scope, scale and complexity of the bank's activities;

c) the timely identification of any concentration risk;

d) the accuracy and completeness of any data inputs into the bank's capital assessment process;

e) the reasonableness and validity of any assumptions and scenarios used in the capital assessment process; and

f) that the bank conducts appropriate stress testing.

1.82 The Basel Accord 2004 has indicated that an independent review of the risk measurement system should be carried out regularly in the bank's own internal auditing process. A review of the overall risk management process should take place at regular intervals (ideally not less than once a year) and should specifically address, at a minimum:

- the integration of risk measures into daily risk management;
- the validation of any significant change in the risk measurement process;
- the accuracy and completeness of position data;
- the verification of the consistency, timeliness and reliability of data sources used to run internal models, including the independence of such data sources; and the accuracy and appropriateness of volatility assumptions.

1.83 The bank has to organise a testing and adoption of the ICAAP. It may avail services of external consultants to facilitate this process. The bank is expected to send to the RBI a copy of any report obtained from an external reviewer or internal auditor.

Supervision (Pillar 2)

1.84 The RBI has the supervision powers where they can verify the approach adopted by the banks and the efficacy of its embedded/periodic controls. Based on RBI's assessment, it will decide on the factors which lead to capital management. Since the auditor is not directly involved in this process, only an outline of this aspect has been considered below.

(i) Whether the systems adopted by banks to assess, monitor and manage their risks are prudent and comprehensive?

(ii) Whether banks maintain capital commensurate with their risk profile?

(iii) How much more capital is required and its sustainability?

(iv) Prompt supervisory intervention.

(v) Bank management is primarily responsible for capital adequacy – beyond core minimum requirements.

(vi) Commensurate with bank's risk profile and control environment -

- Develop an ICAAP;
- Set capital targets; and
- Demonstrate rationale for internal capital targets vis-à-vis risks.

(vii) Reckon stage of business cycle.

(viii) Stress Tests.

(ix) Strategic capital planning - Desirable capital levels, Capital needs and External sources of capital.

(x) Sound capital assessment process - Identify, measure and report all material risks; Link capital to risk level; and State capital adequacy goals.

(xi) Market risk

- Methodologies
  - Standardised duration + bank specific volatilities.
  - Above + stress test.
  - Even Risk Method (Scenario Analysis).

(xii) Eligibility for inclusion in trading book.

(xiii) Valuation.

(xiv) Stress testing.

(xv) Risks not directly captured in Pillar 1 -

- Interest rate in banking book;
- Impact of standardised shock on economic value; and
- Relate to capital.

(xvi) Liquidity risk and other risks – reputational, strategic, etc.

(xvii) Monitoring and reporting to top management

- Level and trend in risk exposures
- Validity and sensitivity of key assumptions
- Compliance with capital adequacy goals

- Assess future capital requirements and decide strategy – business / capital.

(xviii) Internal control and review of the ICAAP -

- Appropriateness and adequacy
- Accuracy and completeness of data inputs
- Reasonableness and validity of scenarios used
- Stress testing – analysis of assumptions.

(xix) Review and evaluation of banks' internal capital adequacy assessments, i.e., ICAAP and strategies.

(xx) Review and evaluation of banks' ability to monitor and ensure their compliance with regulatory capital ratios.

(xxi) Appropriate supervisory intervention, if necessary.

(xxii) Periodical review of banks' ICAAP -

- Quality and adequacy of risk assessment.
- Comprehensive; adequacy of internal rating system; stress tests; business cycle; Impact of errors in methodology and assumptions.
- Quality of risk management and control – MIS; record of responding to changing risks.
- Adequacy of capital – comprehensive; review; stress.
- Quality of capital.

Disclosure (Pillar 3)

1.85 The RBI is supporting sound accounting policies and meaningful public disclosures by banking and financial organisations with the objective of improving market discipline and fostering stable financial markets. Effective market discipline can complement bank supervision and regulation. The Basel II approach to capital regulation, with its market-discipline component, signals that sound accounting and disclosure will continue to be important parts of RBI's supervisory approach for many years to come. The goal in the Basel process is to develop a risk-sensitive framework that provides appropriate incentives to banking organisations to maintain strong capital positions and sound risk-management systems. On an international level, Basel II would also improve disclosure by many banks in foreign countries as well as in India. The accord recommends specific disclosures to convey better capital adequacy and risk profile. Objective is better disclosure, market discipline and safe and sound banking system. Disclosures have to be consistent with risk assessment and management processes. Disclosures should be based on internal reporting systems providing information to senior management and the board of directors.

1.86 Pillar 3 aims primarily at disclosure of a bank's risk profile and capital adequacy. It is recognised that the Pillar 3 disclosure framework does not conflict with requirements under accounting standards, which are broader in scope. The bank's in India has to follow Pillar 3 disclosure over and above the RBI master circular on "Disclosure in Financial Statements - Notes to Accounts". Information would be regarded as material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information. Pillar 3 disclosure will be required to be made by the individual banks on a stand alone basis when they are not the top consolidated entity in the bank.

1.87 With a view to enhance the ease of access to the Pillar 3 disclosures, banks may make their annual disclosures both in their annual reports as well as their respective websites. The risks to which banks are exposed and the techniques that banks use to identify, measure, monitor and control those risks are important factors market participants consider in their assessment of an institution. In recognition of the increased risk sensitivity of the Revised Framework, all banks with capital funds of Rs. 500 crores or more, and their significant bank subsidiaries, must disclose their Tier 1 capital, total capital, total required capital and Tier 1 ratio and total capital adequacy ratio, on a quarterly basis on their respective websites. The disclosure on the websites should be made in a web page titled "Basel II Disclosures" and the link to this page should be prominently provided on the home page of the bank's website. The disclosures should be subjected to adequate validation. For example, since information in the annual financial statements would generally be audited, the additional material published with such statements must be consistent with the audited statements. Currently, it is not envisaged for the auditors to certify this additional disclosure separately.

1.88 Supplementary material (such as Management's Discussion and Analysis) that is published should also be subjected to sufficient scrutiny (e.g., internal control assessments, etc.) to satisfy the validation issue. Information would be regarded as material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making economic decisions. Required disclosures also relate to methods and instruments used by banks to mitigate credit risk (credit risk mitigation) and to transfer credit risk (securitizations).

1.89 General disclosures of credit risk provide market participants with a range of information about overall credit exposure and need not necessarily be based on information prepared for regulatory purposes and may include following:

(i) Disclosure about approach which received supervisory approval for application.

(ii) Amount of capital requirements generated by adoption of the said approach.

(iii) For each separate risk area (e.g., credit, market, operational, banking book interest rate risk) banks must describe their risk management objectives and policies, including:

- strategies and processes;
- the structure and organisation of the relevant risk management function;
- the scope and nature of risk reporting and/or measurement systems;
- policies for hedging and/or mitigating risk and strategies and processes for monitoring the continuing effectiveness.

(iv) Bank's objectives relating to securitization activity, including the extent to which these activities transfer credit risk of the underlying securitized exposures away from the bank to other entities.

(v) The regulatory capital approach that the bank follows for its securitization activities.

(vi) Summary of the bank's accounting policies for securitization activities.

(vii) Risk management objectives and policies to be disclosed.

(viii) Trading book portfolios -

- Under the Standardised Approach (SA)
- Internal Models Approach (IMA).

(ix) For each portfolio covered by an IMA -

- the characteristics of the models used;
- a description of stress testing applied to the portfolio; and
- a description of the approach used for back testing/validating the accuracy and consistency of the internal models and modeling processes.

(x) Capital requirements for – IRS, Equity position risk, Forex risk and Commodity risk.

(xi) For trading portfolio -

- High mean and low VAR values over the reporting period.
- Comparison of VAR estimates with actual gains/losses experienced by the banks with important outlier in back test results Qualitative disclosures.

(xii) General qualitative disclosures -

- Nature of IRRBB;
- Key assumptions;
- Assumptions regarding loan repayment; and
- Frequency of IRRBB measurement.

(xiii) Quantitative Disclosures - increase/decline in earnings or economic value for up/down rate shock by management method of measurement.

Disclosures (as specified by the RBI) – validation thereof

1.90 The disclosures in this manner should be subjected to adequate validation. For example, since information in the annual financial statements would generally be audited, the additional material published with such statements must be consistent with the audited statements. In addition, Basel II Final Guidelines supplementary material (such as, Management's Discussion and Analysis) that is published should also be subjected to sufficient scrutiny (e.g., internal control assessments, etc.) to satisfy the validation issue. If material is not published under a validation regime, for instance in a stand alone report or as a section on a website, then management should ensure that appropriate verification of the information takes place, in accordance with the general disclosure principle set out below. In the light of the above, Pillar 3 disclosures will not be required to be audited by an external auditor, unless otherwise required by accounting standards setters, securities regulators or other authorities. Thus, the responsibility of adequate and appropriate disclosure is the responsibility of the banks' management. The auditor's duties and responsibilities with respect to such information are governed by the Standard on Auditing (SA) 720 'The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements' issued by ICAI.[@]

1.91 The specific disclosure templates are described under:

DF 1 – Scope of Application

1.92 *Qualitative Disclosures*

(a) The name of the top bank in the group to which the Framework applies.

(b) An outline of differences in the basis of consolidation for accounting and regulatory purposes, with a brief description of the entities within the group (i) that are fully consolidated; (ii) that are pro-rata consolidated; (iii) that are given a deduction treatment; and (iv) that are neither consolidated nor deducted (e.g., where the investment is risk-weighted).

[@] Revised in 2013 Edition.

Quantitative Disclosures

(c) The aggregate amount of capital deficiencies in all subsidiaries not included in the consolidation, i.e., that are deducted and the name(s) of such subsidiaries.

(d) The aggregate amounts (e.g., current book value) of the bank's total interests in insurance entities, which are risk-weighted as well as their name, their country of incorporation or residence, the proportion of ownership interest and, if different, the proportion of voting power in these entities. In addition, indicate the quantitative impact on regulatory capital of using this method versus using the deduction.

DF 2 – Capital structure

1.93 ***Qualitative Disclosures***

(a) Summary information on the terms and conditions of the main features of all capital instruments, especially in the case of capital instruments eligible for inclusion in Tier 1 or in Upper Tier 2.

Quantitative Disclosures

(b) The amount of Tier 1 capital, with separate disclosure of:

- paid-up share capital;
- reserves;
- innovative instruments;
- other capital instruments;
- amounts deducted from Tier 1 capital, including goodwill; and
- investments.

(c) The total amount of Tier 2 capital (net of deductions from Tier 2 capital).

(d) Debt capital instruments eligible for inclusion in Upper Tier 2 capital

- Total amount outstanding;
- Of which amount raised during the current year; and
- Amount eligible to be reckoned as capital funds.

(e) Subordinated debt eligible for inclusion in Lower Tier 2 capital

- Total amount outstanding;
- Of which amount raised during the current year; and
- Amount eligible to be reckoned as capital funds.

(f) Other deductions from capital, if any.

(g) Total eligible capital.

DF 3 – Capital adequacy

1.94 ***Qualitative disclosures***

(a) A summary discussion of the bank's approach to assessing the adequacy of its capital to support current and future activities.

Quantitative disclosures

(b) Capital requirements for credit risk:
   - Portfolios subject to standardised approach
   - Securitisation exposures.

(c) Capital requirements for market risk:
   - Standardised duration approach;
   - Interest rate risk
   - Foreign exchange risk (including gold)
   - Equity risk

(d) Capital requirements for operational risk:
   - Basic indicator approach;

(e) Total and Tier 1 capital ratio:
   - For the top consolidated group; and
   - For significant bank subsidiaries (stand alone or sub-consolidated depending on how the Framework is applied).

DF 4 – Credit risk – general disclosures for all banks

1.95 ***Qualitative Disclosures***

(a) The general qualitative disclosure requirement with respect to credit risk, including:
   - Definitions of past due and impaired (for accounting purposes);
   - Discussion of the bank's credit risk management policy.

Quantitative Disclosures

(b) Total gross credit risk exposures, fund based and non-fund based separately.

(c) Geographic distribution of exposures, fund based and non-fund based separately for overseas and domestic operations.

(d) Industry type distribution of exposures, fund based and non-fund based separately.

(e) Residual contractual maturity breakdown of assets.

(f) Amount of NPAs (Gross)–Substandard, Doubtful 1, Doubtful 2, Doubtful 3 and Loss.

(g) Net NPAs.

(h) NPA Ratios -
- Gross NPAs to gross advances
- Net NPAs to net advances.

(i) Movement of NPAs (Gross) - Opening balance, Additions, Reductions and Closing balance.

(j) Movement of provisions for NPAs - Opening balance, Provisions made during the period, Write-off, Write-back of excess provisions and Closing balance.

(k) Amount of Non-Performing Investments.

(l) Amount of provisions held for non-performing investments.

(m) Movement of provisions for depreciation on investments - Opening balance, Provisions made during the period, Write-off, Write-back of excess provisions and Closing balance.

DF 5 – Credit risk – disclosure for portfolios subject to the standardised approach

1.96 ***Qualitative Disclosures***

(a) For portfolios under the standardised approach:
- Names of credit rating agencies used, plus reasons for any changes;
- Types of exposure for which each agency is used; and
- A description of the process used to transfer public issue ratings onto comparable assets in the banking book.

Quantitative Disclosures

(b) For exposure amounts after risk mitigation, subject to the standardised approach, amount of a bank's outstandings (rated and unrated) in the three major risk buckets (below 100% risk weight), as well as those that are deducted.
- Below 100 % risk weight
- 100 % risk weight
- More than 100 % risk weight
- Deducted

DF 6 – Credit risk mitigation – disclosures for standardised approaches

1.97 ***Qualitative Disclosures***

(a) The general qualitative disclosure requirement with respect to credit risk mitigation including:

- Policies and processes for, and an indication of the extent to which the bank makes use of, on- and off-balance sheet netting;
- policies and processes for collateral valuation and management;
- a description of the main types of collateral taken by the bank;
- the main types of guarantor counterparty and their creditworthiness; and
- information about (market or credit) risk concentrations within the mitigation taken.

Quantitative Disclosures

(b) For disclosed credit risk portfolio under the standardised approach, the total exposure that is covered by eligible financial collateral, after the application of haircuts.

(c) For each separately disclosed portfolio the total exposure (after, where applicable, on- or off-balance sheet netting) that is covered by guarantees/credit derivatives (whenever specifically permitted by RBI)

DF 7 – Securitisation – disclosure for standard approach

1.98 ***Qualitative Disclosures***

(a) The general qualitative disclosure requirement with respect to securitisation, including a discussion of:

- the bank's objectives in relation to securitisation activity, including the extent to which these activities transfer credit risk of the underlying securitised exposures away from the bank to other entities;
- the nature of other risks (e.g. liquidity risk) inherent in securitised assets;
- the various roles played by the bank in the securitisation process (For example: originator, investor, servicer, provider of credit enhancement, liquidity provider, swap provider[*], protection provider[♣]) and an indication of the extent of the bank's involvement in each of them;
- a description of the processes in place to monitor changes in the credit and market risk of securitisation exposures (for

[*] A bank may have provided support to a securitisation structure in the form of an interest rate swap or currency swap to mitigate the interest rate/currency risk of the underlying assets, if permitted as per regulatory rules.

[♣] A bank may provide credit protection to a securitisation transaction through guarantees, credit derivatives or any other similar product, if permitted as per regulatory rules.

example, how the behaviour of the underlying assets impacts securitisation exposures

- a description of the bank's policy governing the use of credit risk mitigation to mitigate the risks retained through securitisation exposures;

(b) Summary of the bank's accounting policies for securitisation activities, including:

- methods and key assumptions (including inputs) applied in valuing positions retained or purchased
- changes in methods and key assumptions from the previous period and impact of the changes;
- policies for recognising liabilities on the balance sheet for arrangements that could require the bank to provide financial support for securitised assets.

(c) In the banking book, the names of ECAIs used for securitisations and the types of securitisation exposure for which each agency is used.

Quantitative Disclosures (Banking Book)

(d) The total amount of exposures securitised by the bank

(e) For exposures securitised losses recognised by the bank during the current period broken by the exposure type (e.g. Credit cards, housing loans, auto loans etc. detailed by underlying security)

(f) Amount of assets intended to be securitised within a year

(g) Of (f), amount of assets originated within a year before securitisation.

(h) The total amount of exposures securitised (by exposure type) and unrecognised gain or losses on sale by exposure type.

(i) Aggregate amount of:

- on-balance sheet securitisation exposures retained or purchased broken down by exposure type and
- off-balance sheet securitisation exposures broken down by exposure type

(j) • Aggregate amount of securitisation exposures retained or purchased and the associated capital charges, broken down between exposures and further broken down into different risk weight bands for each regulatory capital approach

• Exposures that have been deducted entirely from Tier 1 capital, credit enhancing I/Os deducted from total capital, and other exposures deducted from total capital (by exposure type).

Quantitative Disclosures: (Trading Book)

(k) Aggregate amount of exposures securitised by the bank for which the bank has retained some exposures and which is subject to the market risk approach, by exposure type.

(l) Aggregate amount of:

- on-balance sheet securitisation exposures retained or purchased broken down by exposure type; and
- off-balance sheet securitisation exposures broken down by exposure type.

(m) Aggregate amount of securitisation exposures retained or purchased separately for:

- securitisation exposures retained or purchased subject to Comprehensive Risk Measure for specific risk; and
- securitisation exposures subject to the securitisation framework for specific risk broken down into different risk weight bands.

(n) Aggregate amount of:

- the capital requirements for the securitisation exposures, subject to the securitisation framework broken down into different risk weight bands.
- securitisation exposures that are deducted entirely from Tier 1 capital, credit enhancing I/Os deducted from total capital, and other exposures deducted from total capital(by exposure type).

DF 8 – Market risk in trading book

1.99 ***Qualitative disclosures***

(a) The general qualitative disclosure requirement for market risk including the portfolios covered by the standardised approach.

Quantitative disclosures

(b) The capital requirements for interest rate risk; equity position risk; and foreign exchange risk.

DF 9 – Operational risk

1.100 ***Qualitative disclosures***

In addition to the general qualitative disclosure requirement, the approach(es) for operational risk capital assessment for which the bank qualifies.

DF 10 – Interest rate risk in the banking book

1.101 ***Qualitative Disclosures***

(a) The general qualitative disclosure requirement, including the nature of IRRBB and key assumptions, including assumptions regarding loan pre-payments and behaviour of non-maturity deposits, and frequency of IRRBB measurement.

Quantitative Disclosures

(b) The increase (decline) in earnings and economic value (or relevant measure used by management) for upward and downward rate shocks according to management's method for measuring IRRBB, broken down by currency (where the turnover is more than 5 per cent of the total turnover).

Role of internal auditors in a bank – a brief overview

1.102 As indicated elsewhere in this chapter that Basel II is not only about the capital adequacy computation. It is more about ensuring a robust risk management structure within the bank. Capital is like a cushion available to the bank for any business losses and provides added comfort to its stakeholders, primarily its depositors. Internal audit function is one of the fundamental checks and balances for sound corporate governance. Now more than ever, a robust and objective internal audit function with the skills to identify risk control problems and the authority to pursue its concerns is essential to the proper discharge of management's responsibilities. Corporate governance, as we all know, has been under a strong and critical public scrutiny in recent years, in the wake of a succession of blows to market confidence and integrity. The society's expectation of the bank's management and of those charged with governance providing an independent review of the bank's operations and financial accounts have been raised. To meet these expectations, there has been a concerted effort to improve the standards of corporate behaviour and transparency through international harmonisation of accounting standards, strengthening the principles of corporate governance, raising the bar in general on risk appetite and introducing improved market disclosure standards. Enforcement along cannot guarantee good corporate governance. In this demanding environment, management need quality advice from sources that can be trusted and that can offer an objective viewpoint. It is evident that the significance of internal auditing as a key contributor to corporate governance has emerged as a theme.

Role of external auditors in a bank – an overview

1.103 The RBI has long recognised the key role that the accounting and auditing profession plays in assessing internal controls. Guidance issued by the RBI and ICAI reflects the important role that both internal and external auditing play in enhancing internal systems and monitoring risk. The Basel Committee has produced extensive guidance on the roles of both the external audit and internal audit and the ways these can be factored into the supervisory process. Market discipline is becoming a key element of supervisory thinking, and market discipline depends on prompt, accurate financial information. External auditors help significantly in ensuring that financial statements are reliable and useful to the marketplace. Periodic financial statements of banking organisations are also used by RBI in its risk-focused supervision programmes. These reports contribute to pre-examination planning, facilitate off-site monitoring programs, and ultimately help in determining the institution's financial condition.

1.104 A strong external audit program assists RBI in moving away from detailed, burdensome and invasive examinations. Supervised institutions might well decide to use the expertise of the external auditor for more than routine financial reports. External auditors could also review the quality of internal controls and systems and assess the internal audit function's scope and adequacy. Furthermore, a financial institution's board of directors is responsible for setting the control environment, and management are responsible for laying down the internal control process. Recognising that responsibility, it is no surprise if boards of directors and management are asking their external auditors to review the internal audit function and recommend improvements in light of the changed business environment. External auditors can also help RBI by encouraging financial institutions to frequently reassess and refine their risk-management practices. A risk-management system should continually monitor financial risks in a changing business climate, such as the outlook for credit risk, market risk, liquidity risk, and operational risk.

Auditor's role in evaluating the state of readiness

1.105 As part of the auditor's work, the auditor, based on interactive sessions, interviews with senior management and complemented with some level of substantive checking, can evaluate the bank's state of readiness to adopt the Basel II requirements successfully. Like any other attest function, the auditor is expected to verify sufficiently the underlying facts including seeking confirmation about any particular management assertions through management representations.

1.106 As part of the audit process the auditor should verify that the capital computation provided to the auditor is complete and accurate. The auditor should evaluate the robustness of the process adopted to compute the capital adequacy ratios, should verify the complete computation spreadsheet for correctness of the formulae, the logic, the risk weights, and the credit conversion factors. The static data such as formulae should be secured such that it does not get changed without anybody's approval.

1.107 A representative sample of some of the activities which banks have to do as part of its preparedness process includes:

- Understanding of the Basel II accord and RBI guidelines;
- Seeking clarifications from the RBI;
- Creating awareness across the bank through effective staff training;
- Setting up of business intelligence for slicing and dicing of data;
- Data warehousing, including populating past few year's data to facilitate the process of building models;
- Identify ratings of customer;
- Identification and implementing system changes where required;
- Work out a process to obtain various forms of data from financial systems;
- Manual work around wherever system support does not exist;
- Meetings with credit rating agencies in understanding the rating process and how it can impact the bank;
- Meetings with customers to make them understanding of the changes expected;
- Review of internal controls;
- Embedding a risk management framework;
- Periodic review of operational risks and assurance thereof;
- Governance and Independent validation of models;
- Parallel run process before going live;
- Periodic (say, quarterly or as stipulated by the regulations from time to time) certification by a chartered accountant; and
- Enhance capital where required.

1.108 A representative sample of some of the challenges which the banks may face is as follows:

- Dedicated staff members will be required, hence fresh recruitment or having appropriate backups for existing staff so as to ensure continuity of business;
- Staff training will be necessary across all the branches;
- Realising benefits of external credit ratings;
- Likely competition (at least in the short run) with resultant margin pressures for highly rated borrowers;
- Data quality management and increased data requirements (past, current, and additional);
- LGD and EAD data is not readily available or maintained by banks in the past – though not relevant in the current scenario;
- Additional costs (resources, system);
- IT system configuration;
- Changes to customer documentation where required to enhance the quality of the collateral;
- Potential for confusion due to multiple set of computations (especially, for foreign banks as local and group Basel II requirements are different);
- The scope for national supervisors to use differing thresholds and subjective interpretations is a source of competitive concern.

Illustrative audit checklist on Basel II has been given as Annexure.

Annexure

Illustrative Audit Checklist for Basel II

The checklist is only illustrative in nature. Members are expected to exercise their professional judgement while using the checklist depending upon facts and circumstances of each case.

Audit Procedures	
Tier I and Tier II Capital	
1. Tally the balances in the various elements from the audited accounts	
2. Check whether the various instruments comply with the guidelines as laid down in the Master Circular by referring to the Terms of Offer and whether the same are approved by the Board or other appropriate committee	
3. In case of foreign banks ensure that the undertaking has been obtained that the bank would not remit abroad the funds received and shown as Capital Reserve or Remittable Surplus	
4. Ensure that the various limits upto which individual elements are to be included in Tier I and II capital as laid down in the Master Circular are adhered to.	
5. Verify the various deductions with the balances in the audited accounts and check the same for limits and eligibility (e.g. securitisation exposure) as laid down in the Master Circular.	
Capital Charge on Credit Risk	
The capital charge for credit risk is the	

sum total of the capital charge to be maintained in respect of the following: • On balance sheet items • Off balance sheet items • Failed transactions • NPAs • Securitisation transactions duly adjusted for haircuts based on the nature of the collateral.	
Risk Weights – On Balance Sheet Items	
The risk weights for all on balance sheet items need to be determined based on the credit ratings assigned by the rating agencies chosen by the RBI.	
1. Reconcile the balances of various advances and other operating receivables where there is a credit risk and which are considered for calculation with the following schedules in the financial statements to ensure completeness: • Schedule 6 – Cash and balances with Reserve Bank of India • Schedule 7- Balances with Banks and Money at Call and Short Notice • Schedule 9- Advances • Schedule 11(vi) – Other Assets - Others	
1. Review and document the process of compilation and mapping of the various on	

balance sheet item based on the categories and their risk weights together with the appropriate ratings and / or other conditions, as applicable.	
2. For a sample of transactions verify the ratings with the letters issued by the rating agencies and accordingly check the correctness of the risk weights assigned..	
3. In cases where the risk weights are dependent on the fulfilment of certain conditions (other than ratings) verify the compliance therewith based on the appropriate documentary evidence. (E.g. claims on banks, regulatory retail portfolio, claims against residential property etc.)	
Risk Weights – Off Balance Sheet Items	
The risk weight for all off balance sheet credit exposures is generally calculated as a two step process as under, separately for market and non-market related exposures: • The notional amount is converted into a credit equivalent amount by multiplying the amount by the specified credit conversion factor (for non market transactions) or by applying the current exposure method (for market related	

transactions). • The resulting credit equivalent amount is multiplied by the risk weight applicable to the counterparty or the purpose for which finance is extended or the type of asset, whichever is higher. Where the exposure is secured by eligible collateral or guarantee the credit risk mitigation guidelines may be applied.	
1. Reconcile the balances of the various off balance sheet exposures which are considered for calculation with the financial statements, especially the schedule of contingent liabilities.	
2. Review and document the process of compilation and mapping of the various off balance sheet item based on the nature of the instruments.	
3. For a sample of non market transactions check the calculations of the credit equivalent amount with specified credit conversion factor based on the nature of the instrument. Check the necessary documentation to confirm the nature of the instrument.	
4. For a sample of market related transactions check the necessary documentation to confirm the nature of the contract and	

accordingly check the calculations for the current credit exposure and the potential future exposure.	
Capital Charge – Failed Transactions	
1. Review and document the procedures for tracking and monitoring the credit risk exposure arising from unsettled transactions, both on DVP and non DVP basis.	
2. For a sample of DVP transactions ensure that the settlement has taken place on a timely basis. In case of delays, check the calculation of the capital charge by multiplying the positive current exposure by the prescribed factor depending upon the number of days delayed.	
3. For a sample of non DVP transactions ensure that the settlement has taken place as per the contracted maturity. In case of delays, ensure that any payment made is considered as a loan and the appropriate risk weight is considered. In case of settlement beyond five days ensure that the full amount is deducted from the capital.	
Risk weights – NPAs	
1. Review and document the procedures for identifying the unsecured portion of NPAs separately for qualifying residential	

mortgages and others.	
2. For a sample of residential mortgages which are NPAs, ensure that they meet with the qualifying criteria with regard to the LTV ratio and other factors and accordingly check the assignment of the risk weight for the unsecured portion depending upon the level of provisioning.	
3. For a sample of NPAs other than residential mortgages check the assignment of the risk weight based on the level of provisioning.	
4. IN respect of 3 above for identifying the secured portion ensure that only eligible collateral are considered and the same are properly documented and the bank has a clear and marketable title to realise the same.	
Capital Charge – Securitisation transactions	
Banks are required to hold regulatory capital after adjusting the prescribed deductions eligible against all securitisation exposures including those arising from provision of credit mitigants, investment in asset backed securities, retention of subordinated tranche and extension of liquidity facility or credit enhancement.	
Ensure that the securitisation transactions fulfil the requirements as prescribed in the guidelines dated February 1, 2006 and Annex 7A (extract of the 'Revision to the	

Guidelines on Securitisation Transactions', issued vide circular DBOD.No.BP.BC.103/ 21.04.177/ 2011-12 dated May 07, 2012) to be eligible for deduction from capital.	
1. Based on the above, for a sample of transactions / deals ensure that the prescribed deduction from both Tier I and II capital has been correctly done based on the rating and the level of provisions. Review the necessary documentation in support of the same.	
2. Based on the above ensure that the appropriate risk weights have been assigned,	
Collateral Risk Management and Credit Risk Mitigation	
The objective of collateral management is to ensure that only the eligible collateral are considered for netting off which are adjusted for volatility depending upon the nature of the capital and further subjected to various types of hair cuts for different categories of mismatches like currency and tenor mismatches.	
1. Review and document the process for collateral risk management as appropriate and relevant including but not limited to: • Ageing reports • Confirmation procedures. • Control of documents • Compliance with covenants • Audit of collateral by independent agencies	
2. Ensure that the bank has	

complete legal rights to enforce the security including specific lien and is subject to hair cuts for residual tenor mismatch and currency mismatch. Check the necessary documentation in respect thereof.	
Capital Charge for Market Risk	
Capital charge for market risk involves computation of the capital charge on interest rate related instruments and equities in the trading book and foreign exchange risk, including gold and other precious metals. Accordingly, the following would be covered: • Securities under the HFT and AFS category • Open gold and FX position limits • Trading position in derivatives • Derivatives entered into for hedging trading book exposures	
Interest Rate – General Market Risk	
The capital requirement for general market risk is the sum of the following four components: (i) Net short (only derivatives) or long position in the trading book (ii) Small proportion of matched position for each time band (vertical disallowance) (iii) A larger proportion of the matched positions across different time bands (horizontal disallowance)	

(iv) Net change for positions in options where applicable	
1. Reconcile the balances considered for calculation of the general interest rate risks trading book positions with the figures reported in the financial statements.	
2. Review and document the process for computation of the price sensitivity (modified duration) for each instrument and test check the calculations for a sample of instruments.	
3. Review the process of capturing the above data into different time bands based on the maturity and accordingly apply the prescribed change in yield and check the calculations for the resulting capital charge and the consequential vertical and horizontal disallowances	
Interest Rate – Specific Risk	
The specific interest rate capital charge for different types of debt securities / issuers is prescribed separately for the following categories: • Central, State and Foreign government bonds under HFT and AFS category • Banks bonds under HFT and AFS category • Corporate bonds and securitised debt under HFT and AFS category	

1. Reconcile the balances of government securities under AFS and HFT considered for computation of specific interest rate capital charge with the financial statements.	
2. Review and document the process of compilation of data in respect of various types of government securities under AFS and HFT based on the type of investment and the residual maturity.	
3. For a sample of transactions in respect of the above, verify the allocation percentage of the specific risk capital based on the type of investment and residual maturity based on the verification of the relevant documentation.	
4. Reconcile the balances of bonds issued by banks under AFS and HFT considered for computation of specific interest rate capital charge with the financial statements.	
5. Review and document the process of compilation of data in respect of various types of bonds issued by banks held as investments under AFS and HFT based on the following parameters: • Level of capital adequacy • Nature of the bank (scheduled or non scheduled) • Residual maturity	
6. For a sample of transactions in respect of the above, verify the allocation percentage of the	

specific risk capital based on the various parameters based on the verification of the relevant documentation.	
7. Reconcile the balances of corporate bonds and securitised debt under AFS and HFT considered for computation of specific interest rate capital charge with the financial statements.	
8. Review and document the process of compilation of data in respect of corporate bonds and securitised debt instruments held as investments under AFS and HFT based on the following parameters: • Rating assigned • Nature of the investment • Residual maturity	
9. For a sample of transactions in respect of the above, verify the allocation percentage of the specific risk capital based on the various parameters based on the verification of the relevant documentation.	
Equity – General and Specific Market Risk	
A uniform percentage of 9% is currently attracted for the gross equity position for both specific and general risks	
Foreign Exchange and Gold	
These currently attract a risk weight of 100% which is in addition to the capital charge for credit risk for on	

and off balance sheet items	
1. Check the computation of the net open position in each currency as a summation of the following: • Net spot position • Net forward position • Guarantees and similar instruments • Net future expenses / incomes not yet accrued but fully hedged	
2. Based on the calculations of the market risk for each of the above check the computation of the aggregate capital charge of market risks **Interest rate risk** a) General market risk • Net position • Horizontal disallowance • Vertical disallowance b) Specific market risk **Specific and general market equity risk Foreign Exchange and gold**	
Capital Charge for Operational Risk	
Currently banks are required to maintain capital charge for operational risk at 15% of the average gross income for the last three financial years	
1. Obtain the computation of the gross total income and verify the same from the respective years audited financial statements. 2. Ensure that the various deductions from the net profit are appropriately considered.	

- General Provisions for the purpose of Tier II Capital would henceforth also include floating provisions as per the RBI circular dated 9th April, 2009.
- In respect of foreign banks operating in India, the RBI Master Circular also lays down the following additional provisions:

Tier I Capital		
	Interest free funds from Head Office kept in a separate account in Indian books specifically for the purpose of meeting the capital adequacy norms	
	Remittable surplus retained in Indian books which is not repatriable as long as the bank functions in India	
	Capital Reserve representing surplus arising from sale of assets in India held in a separate account and which is not eligible for repatriation as long as the bank functions in India	
	Interest free funds remitted from abroad for the purpose of acquisition of property and held in a separate account in Indian books	
	Head Office borrowings in foreign currency eligible for inclusion in Tier I Capital	
	Treatment of Head Office Debit balance for Foreign Banks vide RBI notification dated 9 July, 2012	

- There are certain specific clarifications with regard to the use of credit rating by banks for the purpose of assignment of risk weights. These deal with the following aspects:

  Care should be taken to ensure that the Bank does not use any other rating which the borrower would have obtained for the purposes of assigning risk weights. As directed by the RBI guidelines, the credit rating should be available in the public domain which the bank has access to. While considering the credit rating, the bank has to consider *its exposure and not just go by the overall credit rating i.e. in the credit rating letter the name of the bank, the underlying products, and the limits covered.*

- For computing the gross income for determining the capital to be held against operational risk, there is a clarification that the same should be considered based on the average of the last three financial years. However, there is no clarity as to whether this includes the current financial year though the better practice would be to consider the average of the preceding three years.

Basel III

The Reserve Bank of India on 2nd May, 2012, vide its circular no. DBOD.No.BP.BC. 98/21.06.201/2011-12, issued guidelines on implementation of Basel III Capital Regulation in India. These guidelines were initially to be implemented in a phased manner from January 1, 2013 upto March 31, 2018. Subsequently, RBI has, however, rescheduled implementation to April 1, 2013. Further, the RBI has also mandated that the Banks should get the capital adequacy computation as on March 31, 2013 verified by their external auditors and keep the verification report on record.[@]

[@] Revised in 2013 Edition.

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Special-Purpose Reports and Certificates

Reporting of Frauds[@]

2.01 The Reserve Bank of India *vide* its Circular No: DBS.FrMC.BC.No. 1/23.04.001/2012-13 Dated July 02, 2012 on "Frauds- Classification and Reporting", issues guidelines for classification of frauds and reporting of frauds to RBI, Central Office as well as the concerned regional office of the Department of Banking Supervision / Financial Conglomerate Monitoring Division (FCMD) (12 banks listed in the Annex) at Central Office under whose jurisdiction the bank's Head Office/branch is situated as per the reporting requirements specified in Para 3.1.4 of the circular as given below:

a) **Fraud cases involving an amount more than Rs. 1 lakh and up to Rs. 50 lakh**

   i) To the R.O under whose jurisdiction the branch where the fraud has taken place is located.

   ii) To the R.O under whose jurisdiction the Head Office where the fraud has taken place is located.

   Note: - In case the bank falls under the supervisory purview of Financial Conglomerate Monitoring Division (FCMD) (12 banks listed in the Annex.), the reporting is to be done to Reserve Bank of India, Financial Conglomerate Monitoring Division (FCMD), Department of Banking Supervision, Central office, **4th Floor**, Centre 1, World Trade Centre, Cuffe Parade Mumbai-400005. In place of R.O under whose jurisdiction the Head Office where the fraud has taken place is located.

b) **Fraud cases involving an amount of Rs. 50 lakh and above.**

   i) To the concerned R.O of DBS under whose jurisdiction the head office where the fraud has taken place is located.

   Note: - In case the bank falls under the supervisory purview of Financial Conglomerate Monitoring Division (FCMD) (12 banks listed in the Annex.), the reporting is to be done to Reserve Bank of India, Financial Conglomerate Monitoring Division (FCMD), Department of Banking

[@] Revised in 2013 edition.

Supervision, Central office, 4th Floor, Centre 1, World Trade Centre, Cuffe Parade Mumbai-400005 in place of R.O under whose jurisdiction the Head Office where the fraud has taken place is located.

ii) To Reserve Bank of India, Fraud Monitoring Cell, Department of Banking Supervision, Central office, 2nd Floor, Centre 1, World Trade Centre, Cuffe Parade Mumbai-400005

There will not be any change regarding submission of soft copy of fraud reports in FMR format to Reserve Bank of India, Fraud Monitoring Cell, Department of Banking Supervision, Central office immediately after the detection of fraud in all cases involving an amount of Rs. 1.00 lakh and above.

Banks may ensure to place the copy of the circular on modus-operandi of fraud issued by them for alerting their branches/ controlling offices etc., on specific frauds before the Audit Committee of Board (ACB) in its periodical meeting.

c. Fraud involving Rs. 100.00 lakh and above

Banks may report the fraud by means of a D.O. letter addressed to the Chief General Manager- In – Charge, Department of Banking Supervision, RBI, Central Office, within a week of such frauds coming to the notice of the bank's Head Office. The letter may contain brief particulars of fraud such as amount involved, nature of fraud, modus operandi in brief, names of officials involved, and whether the complaint has been lodged with the police/CBI. A copy of D.O. letter should also be endorsed to the Regional Office of RBI/FCMD under whose jurisdiction the bank's branch, where the fraud has been perpetrated, is functioning.

d. Cases of attempted fraud:

RBI vide its Circular No. DBS.FrMC.BC.No. 04/23.04.001/2012-13 dated November 15, 2012, discontinued the earlier requirements of reporting attempted fraud cases of Rs 100 lakh and above to RBI, Fraud Monitoring Cell, Department of banking supervision, central office may be discontinued from the date of the circular. However, the bank should continue the place to individual cases involving Rs 100 lakh and above before the audit committee of its board.

The report to be placed before ACB should cover the following:

- The modus operandi of the attempted fraud.
- How the attempt did not materialize in the fraud or how the attempt failed/was foiled.
- The measures taken by the bank to strengthen the existing systems and controls.

- New systems and controls put in place in the area where fraud was attempted.
- In addition yearly consolidated review of such cases detected during the year containing information such area of operations where such attempts were made, effectiveness of new process and procedures put in place during the year, trend of such cases during the last three years, need for further change in process and procedures, if any, etc as on March 31 every year starting from the year ending March 31, 2013 within three months of the end of the relative year.

2.02 Further RBI vide its circular No. DBS.FrMC.BC.No.5/ 23.04.001/2012-13 dated January 4, 2013 has amended para 5.2.1, 5.2.3 and 5.3.1 of Master Circular DBS. FrMC. BC. No. 1/23.04.001/2012-13 dated July 02, 2012 on 'Frauds – Classification and Reporting' relating to reporting of fraud cases to various offices of RBI. *Vide* this amendment, the banks have been advised to place the information relating to the fraud before the audit committee/ Local Boards for the quarter ended June, September and December and Annual review note is required to be placed before the Board. As per the revised circular separate review for the quarter ended March is not necessary.[@]

2.03 In addition to their reports on the financial statements, the central auditors as well as the branch auditors of the banks may also be required by their terms of engagement or statutory or regulatory requirements to issue other reports or certificates. For example, presently, the branch auditors are required to issue reports/certificates on the following matters besides their main audit report:

- Long Form Audit Report. (Discussed in Part IV of the Guidance Note)
- 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 audit of DICGC items, wherein auditors have to specifically verify and certify the correctness of the data in various returns and the insurance premiums paid to DICGC.
- Report on status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to frauds and malpractices and of the recommendations of the Jilani Committee on internal control and inspection/credit system.
- Certificate for Prime Minister Rozgar Yojna for Unemployed Youth.
- Certificate of cash and bank balances.

[@] Revised in 2013 edition.

- Certificate relating to MOC entries of the previous years.
- Certificate relating to credit/ deposit ratio.
- Certification of technology up gradation fund scheme (TUFS) – non SSI textile centre.
- Certification for advances to infrastructure project and income generated thereon.
- Statement of accounts Re-structured/ Re-scheduled/ Re-negotiated related to CDR and non-CDR accounts.
- Certificate of advances exceeding Rs.10 Crores.
- Certificate regarding Special Deposit Scheme, 1975.
- Certificate regarding Compulsory Deposit (Income-tax Payers) Scheme, 1974.
- Certificate relating to recoveries in claim paid accounts under Small Loans Guarantee Scheme 1971/Small Loans (SSI) Guarantee Scheme, 1981.
- Certification of Borrowal Companies by Chartered Accountants/Company Secretaries (as per RBI circular on "Lending under Consortium Arrangements/ Multiple banking Arrangements" dated December 08, 2008.

2.04 Besides this, central statutory auditors are required to give following certificates/reports:

- Certificate on Corporate Governance.
- 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.
- Certificate on reconciliation of securities by the bank. (both on its own investment account as well as PMS clients' account).
- Certificate on compliance by the bank in key areas of prudential and other guidelines relating to such transactions issued by the RBI.
- Certificate in respect of custody of unused BR forms and their utilisation. (as such banks do not use BR forms any more. Further it is difficult to certify unused forms as they are not available for verification. This certificate should be strictly based on and against the management representation. The auditor is advised to bring out this fact clearly in the certificate.)@

@ Revised in 2013 edition.

- Authentication of the capital adequacy ratio and other ratios reported in the "Notes on Accounts".
- Report on instances of adverse credit- deposit ratio in the rural areas.
- Report on compliance with SLR requirements.
- Certificate on adherence to the computation of the Risk Weighted Assets Ratio as per Capital Adequacy norms.
- Certification in respect of subsidy claimed by the bank under the PMRY Scheme during the financial year.
- Certificate on compliance by bank on recommendations of:
  - Ghosh Committee, regarding frauds and malpractices in banks.
  - Jilani Committee, regarding internal control system in banks.
  - Dr. N. L. Mitra Committee, regarding maintenance of legal compliance certificate for credit sanction and other transactions of Rs. 1 crore and above.
- Long Form Audit Report.
- In line with the Master Circular on frauds, the auditor should ensure that the branch has complied with the reporting as specified in the said circular. A separate Report should be given on any matter susceptible to be a fraud or a fraudulent activity or any foul play in any transaction. In cases where the amount of fraud brought to the notice during audit and has remained to be reported, the auditors are advised to report such instances directly to the CGM, Central office of Department of Banking Supervision, RBI, Mumbai.

2.05 While issuing a special purpose report or certificate, the auditors should bear in mind the following recommendations made in the Guidance Note on Audit Reports and Certificates for Special Purposes issued by the Institute of Chartered Accountants of India (ICAI):

(a) A reporting auditor should have a clear understanding of the scope and nature of the terms of his assignment, it is desirable for him to obtain the terms in writing to avoid any misunderstanding.

(b) In many cases, a reporting auditor can choose the form and contents of his report or certificate. In other cases the form and contents of the report or certificate are specified by statute or notification and cannot be changed.

(c) Where a reporting auditor is free to draft his report or certificate, he should consider the following:

    (i) Specific elements, accounts or items covered by the report or certificate should be clearly identified and indicated.

(ii) The report or certificate should indicate the manner in which the audit was conducted, e.g., by the application of generally accepted auditing practices, or any other specific tests.

(iii) If the report or certificate is subject to any limitations in scope, such limitations should be clearly mentioned.

(iv) Assumptions on which the special purpose statement is based should be clearly indicated if they are fundamental to the appreciation of the statement.

(v) Reference to the information and explanations obtained should be included in the report or certificate. In certain cases, apart from a general reference to information and explanations obtained, a reporting auditor may also find it necessary to refer in his report or certificate to specific information or explanations on which he has relied.

(vi) The title of the report or certificate should clearly indicate its nature, i.e., whether it is a report or a certificate. Similarly, the language should be unambiguous, i.e., it should clearly bring out whether the reporting auditor is expressing an opinion (as in the case of a report) or whether he is only confirming the accuracy of certain facts (as in the case of a certificate). For this, the choice of appropriate words and phrases is important.

(vii) If the special purpose statement is based on general purpose financial statements, the report or certificate should contain a reference to such financial statements. However, the report or certificate should not contain a reference to any other statement unless the same is attached therewith. It should be clearly indicated whether or not the statutory audit of the general purpose financial statements has been completed and also, whether such audit has been conducted by the reporting auditor or by another auditor. In case the general purpose financial statements have been audited by another auditor, the reporting auditor should specify the extent to which he has relied on them. He may communicate with the other auditor for securing his cooperation and in appropriate circumstances, discuss relevant matters with him, if possible.

(viii) Where a report requires the interpretation of a statute, the reporting auditor should clearly indicate the fact that he is merely expressing his opinion in the matter. He should take sufficient care to ensure that in respect of matters which are capable of more than one interpretation; his report is not misconstrued as representing a settled legal position.

(ix) An audit report or certificate should ordinarily be a self-contained document. It should not confine itself to a mere reference to another report or certificate issued by the reporting auditor but should include all relevant information contained in such report or certificate.

(x) The reporting auditor should clearly indicate in his report or certificate, the extent of responsibility, which he assumes. Where the statement on which he is required to give his report or certificate, includes some information, which has not been audited, he should clearly indicate in his report or certificate the particulars of such information.

(d) In certain cases, the form and contents of the report or certificate, as prescribed by a statute or a notification, may not be appropriate or adequate. In such situations, the reporting auditor may consider modifying the report or certificate on the basis of the suggestions made earlier, to the extent applicable. In case this is not possible, he should clearly indicate the limitations in his report or certificate itself.

(e) Where a special purpose engagement is undertaken after the statutory audit has been completed, a reporting auditor should invariably review the statutory audit report to ascertain whether there are any matters which have a bearing on his report or certificate.

(f) In cases, where a reporting auditor is required to report or certify certain specific matters arising from the financial statements taken as a whole, he should not normally issue his report or certificate until the statutory audit has been completed. Where an audit report or certificate is required before the statutory audit is completed, a reporting auditor should clearly state in his audit report or certificate that he is reporting on or certifying specific matters arising out of the financial statements of the enterprise, the statutory audit of which has not been completed.

(g) Where the reporting auditor prepares his report or certificate on the basis of duly audited general purpose financial statements he may take the following precautions:

(i) He may clearly state in his report or certificate that the figures from the audited general purpose financial statements have been used and relied upon.

(ii) He may include in his report or certificate a statement showing the reconciliation between the figures in the general purpose financial statements and the figures appearing in his report or certificate.

Annexure 1

List of banks under the supervisory purview of Financial Conglomerate Monitoring Division (FCMD):

1. State bank of India.
2. Bank of Baroda.
3. Bank of India.
4. Canara Bank.
5. Punjab National bank.
6. Axis bank.
7. HDFC bank.
8. Kotak Mahindra bank.
9. ICICI bank.
10. Citi bank.
11. HSBC.
12. Standard Chartered bank.

V-3

Compliance Report on Frauds and Other Aspects in Banks

3.01 The RBI in its efforts towards ensuring a strong, efficient and resilient banking system in the country, vide its Circular No. DBS.Co.PPP.BC.No.39/ND-01.005/99-2000 dated November 1, 1996, issued instructions relating to frauds and malpractice in banks. The Circular was issued for the implementation of the 44th report of the Committee on Government Assurances – Ghosh and Jilani Committees' Recommendations.

Implementation of the Ghosh Committee Recommendations

3.02 The RBI set up a High Level Committee on Frauds and Malpractices in Banks under the Chairmanship of Shri A. Ghosh, the then Dy. Governor, to enquire into various aspects of frauds and malpractices in banks with a view to make recommendation to reduce such incidence. The Committee submitted its Report in June, 1992. The recommendations contained in the report are related to frauds and malpractices in banks.

3.03 The RBI has divided all the recommendations into four groups as under:

(i) *Group-A*: Recommendations, which have to be implemented by the banks immediately.

(ii) *Group-B*: Recommendations requiring RBI's approval.

(iii) *Group-C*: Recommendations requiring approval of Government of India.

(iv) *Group-D*: Recommendations requiring further examination in consultation with IBA.

3.04 The RBI has summarised each of these recommendations for the purpose of reporting of their implementation by the banks, in a 'yes' or 'no' format. The RBI has also categorised these recommendations into (i) applicable to branches (ii) applicable to Controlling Offices like, Regional and

Zonal Offices (some banks may have some other name for controlling offices), (iii) applicable to Head Office and (iv) applicable to Treasury Operations.

3.05 The report of the Ghosh Committee deals, mainly with the issues related to day-to-day administrative functions that take place in a bank. The main objective behind the recommendations contained in the Ghosh Committee Report is to ensure that there exists a proper system in banks to ensure the safety of assets, compliance with the laid down policies and procedures, accuracy and completeness of the accounting and other records, proper segregation of duties and responsibilities of the staff and also timely prevention and detection of frauds and malpractices. The text of the recommendations of the Ghosh Committee is given in ***Annexure B*** to this Chapter.

Implementation of Jilani Committee Recommendations

3.06 The RBI had set up a "Working Group to Review the Internal Control and Inspection and Audit System in Banks" under the Chairmanship of Mr. Rashid Jilani. The Working Group was constituted in February, 1995 to review the efficiency and adequacy of internal control and inspection and audit system in banks with a view to strengthening the supervision system, both on-site and off-site, and ensuring reliability of data. The Group submitted its reports in July, 1995 and made recommendations to strengthen the internal control system of banks. The RBI had been issuing circulars from time to time to ensure implementation of the recommendations. The RBI, vide its circular on "Reducing burden on Banks Rationalisation of returns submitted by banks to RBI" (DBS. CO. PP. BC. 12/11.01.005/2004-05) dated December 30, 2004, has discontinued submission of quarterly progress report on the implementation of the recommendations of the working group to review the internal control and inspection/audit systems in banks (Jilani Committee).

3.07 The 44th Report of the Committee on Government Assurances expressed concern that despite reporting of the compliance with recommendations of the Jilani Committee, by the controlling office/branches, the same might have not been implemented. Accordingly, RBI laid down the following procedure to ensure the implementation of recommendations:

- A format containing 25 questions was issued to indicate the answer as either "Implemented" or "Not Implemented".
- Information received from all branches and ROs/ZOs to be consolidated at Head Office level and submission of consolidated statement to RBI.

- Implementation of recommendations to be verified during concurrent audit/inspection of branches/controlling offices and comment on the same to be included in their report.

3.08 The report of the Jilani Committee contains twenty five recommendations which can broadly be divided into three categories, those dealing with the EDP environment in the banks, those dealing with the inspection/internal audit system in the bank and finally those which deal with other miscellaneous aspects of functioning of a bank. For example, matters relating to the internal management of the bank, training of the bank's staff, accountability of the inspectors, follow up action taken by the bank regarding the irregularities pointed out during concurrent/revenue audits and inspections, remedial action taken by the bank to do away with the inadequacies pointed out in the thrust areas such as audit ratings, levels of NPAs, asset quality, revenue leakage etc., consistency and reliability of the data produced by the EDP applications etc. As in the case of the Ghosh Committee recommendations, some of the recommendations are to be implemented by the banks at the branch office level, whereas some others are applicable to the regional/zonal/head office level. However, some recommendations find applicability at both the branch office as well as the other levels. The recommendations of the Jilani Committee are given in ***Annexure B*** to this Chapter.

Responsibility of the Management

3.09 The RBI, vide its subsequent Circular dated June 28, 2002, issued to the banks has required the concurrent auditors and inspectors of the bank branches/controlling offices to verify and comment in their reports as to the status of implementation of the recommendations of the Ghosh and the Jilani Committees in the banks.

3.10 In terms of the letters issued to the banks regarding appointment of the statutory central auditors by the RBI, the auditors are also required to verify and comment upon the compliance by the bank in regard to the status of the implementation of the recommendations of the Ghosh and the Jilani Committees.

3.11 From the above it is clear that the implementation of the recommendations of the Ghosh and the Jilani Committees is the responsibility of the management of the banks. The responsibility of the statutory auditors is to verify and report on the status of implementation of these recommendations, thus far and no further. The results of the verification carried out by the statutory auditor and his comments thereon would be given in a separate report.

3.12 RBI through its "Master Circular - Guarantees and Co-acceptances" (DBOD. No. Dir. BC. 02/13.03.00/2012-13) dated July 2, 2012 (The Circular is given in the CD along with the Guidance Note) has required that Banks should implement the following recommendations made by the Ghosh Committee:

(i) In order to prevent unaccounted issue of guarantees, as well as fake guarantees, as suggested by IBA, bank guarantees should be issued in serially numbered security forms.

(ii) Banks should, while forwarding guarantees, caution the beneficiaries that they should, in their own interest, verify the genuineness of the guarantee with the issuing bank.

3.13 RBI through its Master Circular "Loans and Advances – Statutory and Other Restrictions" (DBOD.No.Dir.BC.4/13.03.00/2012-13) dated July 2, 2012 (The Circular is given in the CD along with the Guidance Note) requires that banks should ensure compliance with the recommendations of the Ghosh Committee and other internal requirements relating to issue of guarantees to obviate the possibility of frauds in this area.

3.14 In this regard, it may be noted that the RBI has also issued Master Circular on "Frauds- Classification and Reporting" (DBS. FrMC. BC. No.1/23.04.001/2012-13 dated July 2, 2012) read with amended circular no.: DBS.FrMC.BC.No. 4/23.04.001/2012-13 on "Frauds- Classification and Reporting" dated on November 15, 2012 and DBS.FrMC.BC.No.5/ 23.04.001/2012-13 dated January 4 2013. These circulars deal with Classification of Frauds, Reporting of Frauds to RBI, Quarterly Returns, Reports to the Board, Fraud Monitoring Returns, etc.

3.15 The RBI has issued a Master Circular on "Willful Defaulters" (DBOD No. CID.BC. 10 /20.16.003/2012-13 dated July 02, 2012) which also specifies the role of auditors. It states that in case any falsification of accounts on the part of the borrowers is observed by the banks/FIs and if it is observed that the auditors were negligent or deficient in conducting the audit, they should lodge a formal complaint against the auditors of the borrowers with the Institute of Chartered Accountants of India (ICAI) to enable the ICAI to examine and fix accountability of the auditors[@].

3.16 In order to ensure that directors are correctly identified and in no case, persons whose names appear to be similar to the names of directors appearing in the list of willful defaulters appearing in the list of willful defaulters, are

[@] Revised in 2013 edition.

wrongfully denied credit facilities on such grounds, bank/FI have been advised to include the Director Identification Number (DIN) as one of the fields in the data submitted by them to RBI/CIC.

3.17 In terms of Para 2.9 of Master Circular on Willful Defaulters dated July 2, 2012, Banks / FIs have already been advised to submit the list of suit-filed accounts of willful defaulters of Rs. 25 lakh and above as at end-March, June, September and December every year to credit information company which has obtained Certificate of Registration from RBI and of which that bank is a member.

3.18 With a view to monitoring the end-use of funds, if the lenders desire a specific certification from the borrowers' auditors regarding diversion / siphoning of funds by the borrower, the lender should award a separate mandate to the auditors for the purpose. To facilitate such certification by the auditors the banks and FIs will also need to ensure that appropriate covenants in the loan agreements are incorporated to enable award of such a mandate by the lenders to the borrowers / auditors.

Audit Procedures

3.19 The RBI has prescribed separate formats to be filled in by the banks for reporting on compliance with/ implementation of the recommendations of the Ghosh and Jilani Committees. The responsibility of the statutory auditors is to certify the status of compliance with/ implementation of the recommendations of the Ghosh and Jilani Committees. Accordingly, the following procedures may be adopted by the statutory auditors of branches as well as the central statutory auditors for certifying the compliance/ implementation status of the Ghosh and Jilani Committees recommendations.

- Enquire from the management of the branch whether it has prepared the prescribed report on the implementation status of the recommendations of the Ghosh and Jilani Committees. If yes, then whether the same has been forwarded to the Head Office for necessary action. If no, then the auditor should obtain necessary representation from the management as to why the report has not been prepared and/ or submitted and should appropriately qualify his report.
- In case of the Head Office, the central statutory auditor should obtain a confirmation from the management whether it has received the report on the implementation status of the recommendations of the Ghosh and Jilani Committees from all the branches, regional/ zonal offices, etc. and also whether it has prepared the status report as applicable to the Head Office level. The auditor should obtain a list of

the branches, regional/ zonal offices which have not submitted the prescribed report. Such a list would help the auditor to have a broad idea as to the extent of implementation of the recommendations by the bank as a whole.

- The auditor should obtain and review a copy of the implementation status report(s) so prepared and submitted. Such a review would help the auditors identify areas which are susceptible to fraud/ malpractices. The results of such a review may also require the auditor to re-consider the nature, timing and extent of the procedures adopted by him for carrying out the audit as well as his audit findings.
- Where the concerned branch has been subjected to a concurrent audit, then the report of the concurrent auditor on the status of implementation of the recommendations of the Ghosh and Jilani Committees should also be obtained. In case, the branch is not subject to a concurrent audit, the auditor should enquire whether it had been subjected to any inspection either by the in-house inspection department or by the inspectors of the RBI. The auditor should review the comments, if any, of the concurrent auditor or such inspectors on the said implementation status report.
- The central statutory auditor may also request the management to provide him with a list of branches which had been subject to a concurrent audit/ inspection by the in-house inspection department or the inspectors from the RBI. He may, if considered necessary, select some such branches and review the comments of the concurrent auditors/ inspectors on the status of implementation on of the recommendations. This would help him identify any common cause of concern among the bank branches.
- Where the status report, as prepared by the management indicates that any of the recommendations have not been implemented, the auditor should request the concerned management to give a written representation as to why the particular recommendation(s) has/have not been implemented.
- The auditor may also consider it necessary to carry out test checks to ensure whether the recommendations which have been said to have been implemented in the status report have indeed been implemented by the management.

3.20 In case, his examination reveals that any of the recommendations indicated as having been implemented have in fact not been implemented by the management, or where there is a failure to comply with any of the recommendations of the two Committees, could not only indicate a weakness in the internal control system in the bank but also raise doubts as to the integrity of the management. The auditor may, accordingly, also need to re-consider the nature, timing and extent of his other audit procedures as also the truth and accuracy of any other management re-presentations obtained by the auditor.

Certificate of the Statutory Auditor on the Status of Compliance

3.21 Based on the work done, the auditor should assess whether any information obtained during the verification indicates that any of the recommendations of the Ghosh and Jilani Committees have not been implemented, either in full or in part. The auditor may consider expressing either disclaimer or appropriate comments in respect of certain clauses such as Item Nos. 1.1 and 1.11 of Part II of Group A of Ghosh Committee about precautions against theft of cash, customer's education, etc.

3.22 The above-mentioned Certificate should describe the scope of the verification undertaken to enable the readers to understand the nature of work performed and make it clear that a full fledged investigation had not been undertaken. The Certificate of the auditor should also draw attention to the following facts:

- That the responsibility for the implementation of the recommendations of the Ghosh and the Jilani Committees is solely that of the management of the bank.
- That the auditor has also considered the reports of all or certain, as the case may be, concurrent auditors/inspectors of the bank branches on the status of implementation of the recommendations of the Ghosh and Jilani Committees at the branch office and controlling offices.
- That the verification was limited primarily to enquiries and obtaining confirmations from the management and other appropriate persons.
- That the auditor has carried out test checks to assess the status of implementation of the recommendations of the Ghosh and Jilani Committees.

3.23 The ***Annexure A*** to this Chapter provides an illustrative format of the auditor's certificate w.r.t. compliance with/ implementation of the recommendations of the Ghosh and Jilani Commiittees.

Annexure A

Illustrative Format of Certificate w.r.t. Compliance/ Implementation Status of the Recommendations of the Ghosh and Jilani Committee

We have examined the attached Format of compliance/ implementation by _____________ *(name of bank/ bank branch)* with the recommendations of the Ghosh Committee relating to Frauds and Malpractices in Banks and Fomat of Progress in Implementation of Jilani Committee recommendations, as prepared by the management. The responsibility for compliance with/ implementation of the recommendations of the Ghosh and the Jilani Committees is that of the management of the ___________ *(name of the bank/ bank branch)*. Our responsibility is to examine the report on the status of compliance therewith as contained in the attached Formats, as prepared by the management, thus far and no further.

We have not carried out an investigation into the status of compliance by/ implementation of the management with the recommendations of the Ghosh and Jilani Committees. Our examination is limited to inquiries and obtaining confirmations from the management and other appropriate persons and test checks of the attached status of recommendations.

Based on our above examination, subject to the matter highlighted below, we certify that to the best of our knowledge and belief and according to the information and explanation given to us and as shown by the records examined by us, the attached Formats of compliance with the recommendations of the Ghosh and Jilani Committees, as prepared by the management is correct.

1. ………………………

2. ……………………….

Date:

Place:

For and on behalf of
Chartered Accountants
………………………………..
(Name and Designation)
(Membership Number)

Annexure B

Ghosh Committee Recommendations – Relating to Frauds and Malpractices in banks – action taken in respect of

Note: The form below in respect of various recommendations of the Ghosh Committee are required to be filled by each Branch Manager (heading the branch) and the Regional Manager/Zonal Manager / ZM Admn. at Head Office. All answers are to be in Yes/No mode only and there are no options like "Being done", "Sometime/Often", etc. If the activity does not relate to the branch only then NA (not applicable) may be indicated. Subsequently, these forms are to be consolidated in the same format at Head Office for each recommendation. For example, for a bank with 60 branches, it could be 40 yes, 20 No (in block for branch) for Recommendations 5.3 and 5 yes, 2 No and 53 NA for recommendation No.3.4. The consolidated forms (one for each bank) may be sent to Dy. General Manager, Department of Banking Supervision, Frauds & Vigilance Wing, World Trade Centre No.1 (2nd floor), Cuffe Parade, Mumbai-400005. For any queries, please contact Shri Vijay Chugh on phone No.(22) – 2188796.

Recommendation No. Group A Part I	Nature of Recommendation	Implementation status at BRANCH*	Implementation status at RO/ZO/HO
3.3	Joint custody and dual responsibility of cash and other valuables.	Yes / No	
3.4	Transactions in the currency chest to be reported to RBI on the same day.	Yes / No	
3.5	Adhering to the prescribed norms and safeguards issued by RBI on issue and payment of high value drafts, depositing large amounts in new accounts without verifying antecedents, opening of benami accounts, etc., to prevent misuse of banking channel.	Yes / No	
4.3	Banks should clearly put down the		Yes / No

* Attention is invited to format to certificate wherein auditor may also give his comments, if any, on the implementation status of any of the Ghosh Committee Recommendations.

Recommen-dation No. Group A Part I	Nature of Recommendation	Implemen-tation status at BRANCH*	Implemen-tation status at RO/ZO/HO
	authority to put through investment deals and reporting system to be adopted in accordance with guidelines issued by Govt./RBI from time to time.		
4.5	Periodical review of broker's performance and relationships. All transactions to be recorded with full details. Periodical review of investment transactions in a critical manner and to put up large transactions to the Board for information.		Yes / No (Treasury Desk)
4.6	Purchases and sales (Treasury) to be periodically reported to top management with reasons for the same.		Yes / No (Treasury Desk)
4.7	There should be a panel of brokers. Quotations for all deals to be recorded in the appropriate registers.		Yes / No (Treasury Desk)
4.8	To ensure ability of counter party to fulfill the contract. Deals to be put through at market rates and directly with the counter party. BRs to be issued when unavoidable strictly following RBI guidelines and in the format prescribed by IBA on security paper and serially numbered and duly signed by authorised officials. Nomenclature of securities and their distinctive numbers to be indicated and proper record maintained. Prudential limits for acceptance of BRs of others to be prescribed. Payments should be released only on getting a written confirmation of the deal from the counter party.		Yes / No (Treasury Desk)
4.9	Securities to be recorded and kept in the joint custody. Periodical		Yes / No (Treasury

Recommendation No. Group A Part I	Nature of Recommendation	Implementation status at BRANCH*	Implementation status at RO/ZO/HO
	verification of securities say once in a quarter or half year by persons other than dealing persons		Desk)
4.10	Periodic reconciliation of securities, BRs, SGL balances at PDO.		Yes / No (Treasury Desk)
4.11	Verification of deals by internal inspectors and concurrent auditors and surprise sample checks by Vigilance Cell.		Yes / No (Treasury Desk)
5.9	There should be a formal written lending policy, amplified by adequate written procedures.		Yes / No (Treasury Desk)
5.14	To set up an internal loan review department. To evaluate the quality of credit portfolio and report on the health of the loan portfolio directly to the Board at periodic intervals.		Yes / No
8.2 & 8.4	Periodicity of the internal audit should be once every 12 months (and of surprise nature) and coverage of inspection reports should be comprehensive including a thorough examination of the internal control system obtaining at the branch, besides other features indicated in the Report.		Yes / No
8.3	Inspection Department to be manned by a senior person of sufficient experience and exposure and proven integrity.		Yes / No
8.5	Surprise/spot inspection of large branches.		Yes / No
8.6	Revenue audit of large branches and accountability.		Yes / No
8.7	Concurrent audit at all large and exceptionally large branches. The irregularities of Chartered Accounts		Yes / No

Recommen-dation No. Group A Part I	Nature of Recommendation	Implemen-tation status at BRANCH*	Implemen-tation status at RO/ZO/HO
	firms should be brought to the notice of RBI and Institute of Chartered Accountants of India		
8.8	Inspection of Head Office departments and controlling offices regularly and by Senior officers.		Yes / No
8.10	(a) System of exclusive scrutiny of credit portfolio with focus on larger advances and group exposures.	Yes / No	Yes / No
	(b) Special scrutiny of high value accounts shifted to the bank along with executives and accounts transferred from other branches along with officials. The observations of RBI inspections should be promptly and effectively followed up by banks.	Yes / No	Yes / No
8.11	Inspectors to educate staff on hazards of deviation from the prescribed system/guidelines.		Yes / No
8.12	Rationalisation of returns and strengthening present information system of reporting to top management.		Yes / No
8.13	To obtain confirmation from branches once in a quarter for the nil arrears position of control returns.		Yes / No
8.14	Monthly certificate on inspection of associated units and on stocks pledged/hypothecated to bank.	Yes / No	Yes / No
8.15	Checks to be carried out by controller at the time of visit.		Yes / No
8.16	To carry out surprise inspection on noticing abnormal irregularities in control returns.		Yes / No
8.17	Appropriate guidelines to be issued for control over subsidiaries.		Yes / No

Recommendation No. Group A Part I	Nature of Recommendation	Implementation status at BRANCH*	Implementation status at RO/ZO/HO
8.18	To evolve a system in which an employee coming across an irregular practice in any of the operational areas should be made responsible to report the same to higher authorities for remedial action.		Yes / No
9.9	Adoption of preventive measures of vigilance in letter and spirit as enumerated.	Yes / No	Yes / No
10.1	Need for class coordination between internal inspection/ audit – set up, personnel department, discipline cell and vigilance machinery.		Yes / No
10.2	Conduct of simultaneous departmental enquiry on banking lapses along with CBI investigation by segregating charges.		Yes / No
10.3	Vigilance Cell to have exclusive officials for field jobs.		Yes / No
11.3	Verification of antecedents of persons before appointment in banks and at their previous appointment where applicable. The Confidential Reports recorded on staff should give clear cut assessments of their work and conduct.		Yes / No
11.4	Rotation of staff/duties and transfer covering all categories of staff, including dealing room/securities department staff, etc.	Yes / No	Yes / No
11.9	Desk cards for staff to be prepared, banks to designate one of the senior officers as a Compliance Officer.	Yes / No	Yes / No
11.10	Financial and administrative powers of officials should be laid down.	Yes / No	Yes / No

Recommen-dation No. Group A Part I	Nature of Recommendation	Implemen-tation status at BRANCH*	Implemen-tation status at RO/ZO/HO
Group A Part II			
1.1	Precautions in handling cash and valuables – restriction of entry to cash cabin, dual custody of cash valuables, surprise verification at regular intervals, etc.	Yes / No	
1.2	Precautions against theft of cash – staff should not indulge in conversations answering queries, but direct such persons to Enquiry Counter only.	Yes / No	
1.3	Precautions against shortage in cash reported by cashier. Introduction of surprise checking at frequent intervals.	Yes / No	
1.4	Precautions against misappropriation of cash by member of staff in the guise of customer service. Only authorised personnel should accept cash / issue counterfoils in cash departments. Cashiers should not be allowed to make entries in Pass Book.	Yes / No	
1.5	Proper systems should be evolved in respect of cash balances, insurance and prompt reporting of inter-branch and inter bank remittances of cash.	Yes / No	Yes / No
1.6	Banks should evolve proper systems of adequate security and custody of cash in dacoit/terrorist attack prone areas.	Yes / No	Yes / No
1.7	Precaution against misusing banking channels for tax evasion. Pos/TCs in excess of Rs. 50,000/- should be by way of debit to constituents account and not by cash. Doubtful cases should be	Yes/No	Yes/No

Recommendation No. Group A Part I	Nature of Recommendation	Implementation status at BRANCH*	Implementation status at RO/ZO/HO
	reported to higher authorities.		
1.8	Periodical reporting of deposits withdrawals from currency chests to Issue Department of RBI.	Yes/No	
1.10	Exercise of caution at the time of opening of new deposit accounts of all types.	Yes/No.	
1.11	Customers to be educated about implications of introducing an account without knowing the party.	Yes/No.	Yes/No.
1.13	Close watch on the operations in the new accounts should be kept.	Yes/No	
1.14	Issue of fresh cheque book should be only against requisition slip from previous check books and other precautions to be taken in respect of cheque books.	Yes/No.	
1.15	Precautions in payment of cheques/verification of signature, custody of specimen signatures, custody and control of blank cheque books, etc.	Yes/No	
1.16	Balancing of ledgers periodically by staff other than ledger keepers, scrutiny of unauthorised entries/corrections, and other precautions in respect of ledgers.	Yes/No	
1.17	In operative accounts to be kept in separate ledger, specimen signature to be in custody of Manager and other precautions.	Yes/No	
1.18	Safe custody of/access to vouchers through written orders of Manager – records to be maintained of those who have accessed such records.	Yes/No	
1.19	Safe custody of specimen signature cards and verification of instructions in respect of operations of the account.	Yes/No	

Recommen-dation No. Group A Part I	Nature of Recommendation	Implemen-tation status at BRANCH*	Implemen-tation status at RO/ZO/HO
1.21	Blank draft and mail transfer forms to be treated as security items and usual precautions should be taken in respect of their issue and safe custody.	Yes/No	
1.22	Steps to check/prevent forgery in cheques/drafts –use of special paper.		Yes/No
1.23	Precautions in writing of drafts/mail transfers – use of pin point typewriters or reverse carbon.	Yes/No	
1.26	Way in which telegraphic/telex messages for telegraphic remittances should be sent-use of codes and accessibility to top most officers of branch, etc.	Yes/No	
1.27	Verification of signatures/handwriting should be part of training programme and necessary study material should be obtained from National Institute of Criminology.		Yes/No
1.28	Precaution against frauds perpetrated by employee – effective supervision, timely receipt of control returns and scrutiny thereof, rotation/transfer of staff, etc. Strict watch on clearing operations, house keeping, reconciliation of inter bank/branch accounts.	Yes/No	Yes/No
1.29	Precaution against frauds perpetrated by staff in clearing – checking of Branch Clearing General A/c dispatch of statement, verification of instruments with relative schedules, etc.	Yes/No	
1.30	Safe transit of cheques and instruments between the branches/clearing house.	Yes/No	Yes/No
1.31	Precautions to be taken to prevent	Yes/No	

Recommen-dation No. Group A Part I	Nature of Recommendation	Implemen-tation status at BRANCH*	Implemen-tation status at RO/ZO/HO
	fraud through entries in suspense account – periodical balancing and checking, signing of debit voucher by Manager/officer authorised by him, sending periodical statement specifying reasons for non-adjustment for large and long outstanding entries, etc.		
1.32	Mechanisation of operations relating to inter branch reconciliation. All branches to clear outstanding entries above Rs. 2 lakhs and not allow them to remain outstanding for more than a month, etc.	Yes/No	
2.2	Unhealthy practice of granting advances beyond discretionary power or by oral or telephonic instructions. Issue of instructions by bank managements.		Yes/No
2.3	Post-disbursement safeguards to be followed – critical assessment of all advances periodically, review of sticky advances and look into staff side of case when there is shift in health code status of account.	Yes/No	Yes/No
2.7	Observance of laid down rules/guidelines/ safeguards by bank officials-credit appraisal, pre-sanction visit to borrowers premises/ godown, proper monitoring of end use of funds by allowing payments to parties connected with borrower's line of business and not allowing transfer of large amounts to sister concerns, etc.	Yes/No	Yes/No
2.8	Check list of guidelines to avoid misuse of hypothecation/pledge facilities – verification of borrower's title top goods pledged, safety of	Yes/No	

Recommen-dation No. Group A Part I	Nature of Recommendation	Implemen-tation status at BRANCH*	Implemen-tation status at RO/ZO/HO
	godowns, obtention of stock statement, etc.		
2.8 (d)	Controlling offices should obtain a monthly certificate from branches indicated that periodical Stock Statements are received.		Yes/No
2.8 (e)	Controlling offices/Vigilance Department should have a squad for surprises inspection of goods pledged/hypothecated.		Yes/No
2.13	Safeguards against frauds through Kite flying operations in cheques – limits against clearing cheques only for prime customers, limited drawings, spare use of discretionary powers, etc.	Yes/No	
2.15	Precautions against frauds in bills portfolios –to ensure bills represent genuine trade transactions, insistence on submission of all related documents, ascertaining creditworthiness of borrowers and drawees, lorry receipts of approved transporters, etc.	Yes/No	
3.4	Precautions for averting frauds in the areas of letters of credit issue of guarantees and co-acceptance facilities.	Yes/No	Yes/No
3.7	Bank guarantees/LCs to be issued in security forms serially numbered, under two signatures above certain cut off point in triplicate, binding on beneficiary to seek conformation of Controlling Office (incorporation of suitable condition in the document), etc.	Yes/No	Yes/No
3.8	One of two authorised signatures on LCs may be from controlling office.	Yes/No	Yes/No
3.9	Bills discounting facility under L/C,	Yes/No	

Recommendation No. Group A Part I	Nature of Recommendation	Implementation status at BRANCH*	Implementation status at RO/ZO/HO
	co-acceptance should be extended only to customers having regular sanctioned limits.		
4.2	All Premises transactions with approval of Board. Bank may take the services of Engineers on deputation from CPWD or State PWD in their premises department for assistance in examining proposals.		Yes/No
4.3	Bank should maintain separate record of large premises deals and should be undertaken only with the approval of the Board/Management.		Yes/No
4.4	Precautions relating to deals in items like furniture and fixtures, stationery –proper system of receiving quotations, delegation of authority, proper inventory management and periodical checking, etc.	Yes/No	Yes/No
5.2	Devising standards for suitable internal control in computerised environment.	Yes/No	Yes/No
5.3	Relevant paragraphs covering computerised aspects to be added while issuing general administrative instructions.		Yes/No
5.4	Training programmes should include computer aspects of each topic in each season.		Yes/No
5.5	Micro Filming of records, vouchers, books.	Yes/No	Yes/No
5.6	Evolving standards for fully computerised branches.	Yes/No	Yes/No
5.8	Screening/selection of employees in EDP cells, computer areas.	Yes/No	Yes/No
5.9	Replacement of unwilling workers in computer area.	Yes/No	Yes/No

Recommen-dation No. Group A Part I	**Nature of Recommendation**	**Implemen-tation status at BRANCH***	**Implemen-tation status at RO/ZO/HO**
5.11	Suggestion from preventive vigilance angle in computer installations.		Yes/No
5.12	To obtain insurance cover in respect of risks in computer area.		Yes/No
Group-B Part – I			
8.9	Banks to introduce portfolio inspections particularly in critical/sensitive areas, such as credit, investment, off balance sheet items etc.		Yes/No
10.4	Periodical meetings between bank officials and investigating officials of CBI/Police.		Yes/No
11.10	Six months prior to the retirement officials should exercise their sanctioning powers jointly with next higher authority.		Yes/No
Group B Part-II			
1.22	Paper used for cheques/drafts should be such that any use of chemicals for making material alterations in the instrument should be visible to the naked eye.	Yes/No	Yes/No
Group C Part-I			
9.6	Chief Vigilance Officer should directly refer to CVC, cases having vigilance angle involving CMD.		Yes/No
9.10	Fraud cases upto Rs. 25,000/- having involvement of an insider should not be reported to Police where recovery is not doubtful.	Yes/No	Yes/No
11.8	Banks should introduce a return for staff members to ensure strict submission of the information of assets & liabilities and proper scrutiny thereof.	Yes/No	Yes/No

Recommen-dation No. Group A Part I	Nature of Recommendation	Implemen-tation status at BRANCH*	Implemen-tation status at RO/ZO/HO
Group D Part-I			
4.8	BRs should not be outstanding for more than 7 days.		
11.8	Banks should introduce a return for staff members to ensure strict submission of the information of assets and liabilities and proper scrutiny thereof.		Yes/No
Group D Part-II			
1.12	Obtaining photographs of depositors at the time of opening of accounts.	Yes/No	

RESERVE BANK OF INDIA

DBS.CO.PPD.BC.No. 29/21.01.023/98-99

44th Report of the Committee on Government Assurances – Ghosh Committee & Jilani Committee Recommendations relating to frauds and malpractices in banks – Review of implementation thereof.

We invite a reference to our circular DoS. No.PP.BC 20/16.03.026/96-97 dated November 1, 1996 advising banks to initiate immediate steps to implement the recommendations made by the Working Group (Jilani Committee) set up to review the internal inspection and audit system in banks. In this connection, we advise that during discussions with the Government to firm up their response to the points contained in the 44th Report of the Committee on Government Assurances, it was pointed out that in spite of public sector banks certifying implementation of most of the recommendations contained in the Ghosh and Jilani Committee reports, frauds in banks continue to rise. Government expressed its concern and indicated that the implementation at branch level might not have taken place despite reporting compliance to the same by the controlling offices/branches. Government therefore desired that an objective analysis should be undertaken to determine how many branches/controlling offices have actually adopted these recommendations.

With a view to determining the exact level of implementation of each of the recommendations of Ghosh Committee at branch and controlling office (RO/ZO/HO) level we have already issued necessary instructions under cover of our letter DBS. No. FGV. CO. No.212/23.02.001/99-00 dated 14th September 1999. For carrying out a similar exercise in the case of Jilani committee recommendations, we are forwarding herewith another format, which may be circulated to all your branches and controlling offices with instructions to indicate their answers as either "Implemented" or 'Not implemented' only against each recommendation. The information received from all branches and RO/ZOs may be consolidated at Head Office level and forwarded to us for our perusal and analysis. The above exercise may be completed within a month from the date of receipt of this letter and a consolidated statement relating to your bank may be forwarded to us as well as to the Regional Office of DBS under whose jurisdiction the H.O of your bank operates by June 30, 2000.

2. Further, during the course of review meeting it was also desired by the Government that the implementation of the Ghosh and Jilani Committee recommendations may also be verified during concurrent audit/inspection of branches/controlling offices and commented upon in the reports. You may therefore arrange to advise your inspection and audit Department suitably in the matter under advice to us.

3. Please acknowledge receipt.

Yours faithfully,

(Anand Sinha)
General Manager

Encls: 5 Sheets.

PROGRESS IN IMPLEMENTATION

JILANI COMMITTEE RECOMMENDATIONS – relating to internal control and inspection/audit system in banks which are to be compulsorily implemented by banks

Sl. No	*Recommendation No. in the WG Report*	*Nature of recommendation*	*Implementation Status at Branch*	*Implementation status at RO/ZO*	*Implementation status at HO*	
1.	4	Co-ordination between inspection and operational wings be ensured for bringing about positive changes in functioning of the bank.				
2.	6	Profiles of bank branches be maintained on computer on performance in thrust areas like audit ratings, assets quality, level of NPAs, revenue leakages, profitability, etc. for enabling the bank to pinpoint inadequacies/ set-off trigger for taking remedial action. Computer data on branches in reporting compliance to help Audit Committee and ZO/HO functionaries also be maintained.				
3.	8	Broad guidelines to establish accountability for inspectors/auditors should be laid down.				
4.	15	Development of database on training inventory of each inspector/auditor for the improvement and updating their knowledge by Central Audit and Inspection Department/				

Sl. No	*Recommendation No. in the WG Report*	*Nature of recommendation*	*Implementation Status at Branch*	*Implementation status at RO/ZO*	*Implementation status at HO*	
		Zos/ROs/Inspectorates.				
5.	18	A copy of booklet/ compendium of instructions incorporating RBI norms, circulars, etc. to be supplied to each inspecting/auditing official by Inspection and Audit Department periodically (preferably yearly).				
6.	20	Revenue/income audit should be conducted at certain select branches/ branches where leakages noticed (but not in those where concurrent audit has been undertaken).				
7.	21	Every bank should have a manual of instructions for its inspectors/ auditors and periodically update the same.				
8.	23	Inspection/audit of any branch should not be continued beyond two months except very large branches for which three months would suffice.				
9.	24	All poorly rated branches should be inspected within 12 months and others between 12-18 months from the date of previous inspection.				
10.	25	Inspection/audit report format should be updated periodically incorporating changes in products,				

Sl. No	Recommendation No. in the WG Report	Nature of recommendation	Implementation Status at Branch	Implementation status at RO/ZO	Implementation status at HO	
		systems, procedures, etc., check-list of major and serious irregularities in various areas of banking operations to be provided to inspectors/auditors. An executive summary should be prepared by the inspecting officer for every inspection for submitting to higher authorities.				
11.	30	Banks should have a system for rating its branches on the basis of inspection reports and the rating system to be reviewed periodically.				
12.	32	A computerised track record of efficiency ratings over the previous 4-5 inspections to be maintained in the Inspectorate with periodical updations and submissions to the functionaries.				
13.	39	Follow-up on major/ serious irregularities detected during concurrent audit to be immediately taken up with the HO. A time-bound action programme for rectification to be drawn up and closely monitored. Fraudulent transactions to be reported to Vigilance/ Chief of Inspection/audit etc.				
14.	41	Smaller/medium sized branches to rectify irregularities pointed out during inspection/ audit within 4 months.				

Sl. No	Recommendation No. in the WG Report	Nature of recommendation	Implementation Status at Branch	Implementation status at RO/ZO	Implementation status at HO	
15.	44	Inspectors/ auditors to get majority of irregularities rectified during their stay at the branches concerned and guide them as well.				
16.	45	Immediate action to be taken to plug gaps in serious irregularities/ revenue leakages which have surfaced due to loopholes in existing procedures, abnormal deviations from laid down procedures/norms in consultation with the departments concerned by issue of fresh guidelines.				
17.	46	There is scope for Audit Committee to broaden its domain and effectiveness through study of additional areas like frauds, progress in AFI conducted by RBI, inter-branch/inter-bank reconciliation etc. and the frequency of Committee meetings. Banks should have structured items for discussion by the Audit Committee and decide the periodicity of the Audit Committee meetings.				
18.	49	Inspection findings relating to frauds detected during inspection and matters involving malafides corrupt practices and gross indiscipline should be submitted as special report to the concerned authorities				

Sl. No	Recommendation No. in the WG Report	Nature of recommendation	Implementation Status at Branch	Implementation status at RO/ZO	Implementation status at HO	
		for initiating action and not to be included in regular report. These reports should be thoroughly scrutinized by the authorities concerned and shortcomings/ gaps/lacunae that contributed to such events should be removed by policy decisions.				
19.	53	Appropriate control measure should be devised and documented to prevent the computer system from attacks of unscrupulous elements. All aspects of security, reliability, and accessibility are ensured before introduction of EDP application in place of manual system by having pilot parallel runs.				
20.	54	Various tests to be carried out to ensure that EDP applications have resulted in consistent and reliable system for inputting, processing and generation of output of data.				
21.	56	While engaging the outside computer agencies, banks should ensure to incorporate the "clause of visitorial rights" in the contract to have the right to inspect the process of application and ensure the security of the data/inputs given to outside agencies.				
22.	59	Entire domain of EDP				

Sl. No	***Recommendation No. in the WG Report***	***Nature of recommendation***	***Implemen-tation Status at Branch***	***Implementation status at RO/ZO***	***Imple-mentation status at HO***	
		activities be brought under scrutiny of Inspection and Audit including the underlying financial aspects.				
23.	61	In order to bring about uniformity of software used by various branches/offices, there should be a formal method of incorporating change in standard software and it should be approved by senior management. Such changes to be inspected and monitored continuously.				
24.	71	Banks should complete enquiries expeditiously and bring to book the delinquent staff to deter others 7from perpetuating frauds and malpractices. Internal vigilance machinery to be strengthened and its working to be reviewed by the Board every six months.				
25.	74	Regular checking by inspectors/auditors to verify correctness of information compiled/furnished by branches regarding income recognition, asset classification, provisioning, and NPA quantification in conformity with prescribed norms. Discrepancy to be immediately brought to the notice of Branch Manager for rectification on the spot.				

Note:

(i) Please reply whether 'implemented' or 'not implemented'.

(ii) The form broadly indicates the set up within banks where actions lie in respect of each of the 25 recommendations of the Jilani Committee. Banks can however modify it depending upon their organisation of the inspection/audit setup in their banks and the demarcation of responsibilities.

(iii) This form is required to be filled in by each branch – controlling office and one copy thereof may be kept on their record for verification by RBI officials during their inspection.

(iv) These forms are to be consolidated for 'branches' and 'controlling offices' at H.O for each recommendation.

(v) A consolidated form indicating number of branches/controlling offices against each recommendation, where the recommendations have been implemented/not, implemented may be sent to our RO's under whose jurisdiction the H.O of the bank operates and to DBS, PPD, Central Office, Colaba, Mumbai-400 005.

V-4

Compliance with SLR Requirements

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

4.02 The RBI vide its Master circular No. DBOD. No.Ret. BC.22/12.01.001/2012-13@ on "Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)" dated July 2, 2012, (The circular is given in the CD along with the Guidance Note) has specified that consequent upon amendment to the

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@ Revised in 2013 Edition.

Section 24 of the Banking Regulation Act, 1949 through the Banking Regulation (Amendment) Act, 2007 replacing the Regulation (Amendment) Ordinance, 2007, effective January 23, 2007, the Reserve Bank can prescribe the Statutory Liquidity Ratio (SLR) for SCB in specified assets. The value of such assets of a SCB shall not be less than such percentage not exceeding 40 per cent of its total demand and time liabilities in India as on the last Friday of the second preceding fortnight as the Reserve Bank may, by notification in the Official Gazette, specify from time to time. Further, the RBI has specified vide notification DBOD.No.Ret.91/12.02.001/2010-11 dated May 09, 2011@ that all scheduled commercial banks should continue to maintain a uniform SLR of 25 per cent on their total net demand and time liabilities (NDTL) as on the last Friday of the second preceding fortnight as prescribed vide notification DBOD.No.Ret.BC.66/12.02.001/2010-11 dated December 16, 2010,@ valued in accordance with the method of valuation specified by the Reserve Bank of India from time to time.

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

4.04 As section 24 of the Banking Regulation Act, 1949 is also applicable to nationalised banks, State Bank of India and its subsidiaries, and regional rural banks too have to comply with the above requirements.

4.05 According to Section 24(3) of the Banking Regulation Act, 1949, for the purpose of ensuring compliance with this section, every banking company is required to furnish to the RBI, in the prescribed form and manner, a monthly return showing particulars of its assets maintained in accordance with this section and its demand and time liabilities in India at the close of the business on each alternate Friday during the month. In case any such Friday is a public holiday, the computation of SLR is to be done at the close of business on the preceding working day. The return in form VIII is to be furnished within 20 days after the end of the month to which it relates. The banks should also submit a statement as annexure to the form VIII giving daily position of –

(a) value of securities held for the purpose of compliance with SLR and

(b) the excess cash balances maintained by them with RBI in the prescribed format.

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

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

Computation of SLR

4.08 The SLR to be maintained by a banking company, as explained above should be in the following assets as laid down by the RBI in the above mentioned Master Circular:

(a) Cash, or

(b) Gold valued at a price not exceeding the current market price, or

(c) Unencumbered investment in the following instruments which will be referred to as 'statutory liquidity ratio (SLR) securities':

   i. Dated securities issued up to May 06, 2011 as listed in the Annex to Notification DBOD.No.Ret.91/12.02.001/2010-11 dated May 09, 2011;[@]

   ii. Treasury Bills of the Government of India;

   iii. Dated Securities of the Government of India issued from time to time under the market borrowing programme and market stabilization scheme;

   iv. State Development Loans of the State Governments issued from time to time under their market borrowing programme; and

   v. Any other instrument as may be notified by the RBI.

4.09 The cash management bill would be treated as Government of India Treasury Bill and accordingly shall be treated as SLR securities.

4.10 The notification clarifies that 'unencumbered investment' of a banking company shall include

   i. its investment in the aforesaid securities lodged with another institution for an advance or any other credit arrangement to the

[@] Revised in 2013 Edition.

extent to which such securities have not been drawn against or availed of and,

ii. Its investment in the aforesaid securities offered as collateral to the Reserve Bank of India for availing liquidity assistance from Marginal Standing Facility (MSF) up to two percent of the total NDTL in India carved out of the required SLR portfolio of the bank concerned.[@]

4.11 Market borrowing programme means the domestic rupee loans raised by the Government of India and the State Governments from the public and managed by the Reserve Bank of India through issue of marketable securities, governed by the Government Securities Act, 2006 and the Regulations framed thereunder, through an auction or any other method, as specified in the Notification issued in this regard.

4.12 In computing the amount for the above purpose, the following shall be deemed to be cash maintained in India:

(i) The deposit required under sub-section (2) of Section 11 of the Banking Regulation Act, 1949 to be made with the Reserve Bank by a banking company incorporated outside India;

(ii) Any balances maintained by a scheduled bank with the Reserve Bank in excess of the balance required to be maintained by it under Section 42 of the Reserve Bank of India Act, 1934 (2 of 1934); and

(iii) Net balances in current accounts with other scheduled commercial banks in India.

4.13 For the purposes of statutory liquidity ratio, the term 'demand liabilities' means liabilities, which must be met on demand. Examples of demand liabilities are current deposits; demand liabilities portion of savings bank deposits; margins held against letters of credit/guarantees; balances in overdue fixed deposits, cash certificates and cumulative/recurring deposits; outstanding telegraphic/mail transfers and demand drafts; unclaimed deposits; credit balances in the cash credit accounts; and deposits held as security for advances which are repayable on demand. Money at Call and Short Notice from outside the banking system should be shown against liability to others.

4.14 The term 'time liabilities' means liabilities which are payable otherwise than on demand and they include fixed deposits, cash certificates, cumulative and recurring deposits, time liabilities portion of savings bank deposits, staff security deposits, margins held against letters of credit if not payable on

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demand, deposits held as securities for advances which are not payable on demand and gold deposits.

4.15 The following explanation have been furnished by the RBI through its circulars regarding demand and times liabilities:

(a) Other Demand and Time Liabilities (ODTL) include interest accrued on deposits, bills payable, unpaid dividends, suspense account balances representing amounts due to other banks or public, net credit balances in branch adjustment account, any amounts due to the "Banking System" which are not in the nature of deposits or borrowing. Such liabilities may arise due to items, like (i) collection of bills on behalf of other banks, (ii) interest due on other banks and so on.

(b) If a bank cannot segregate from the total of "Other Demand and Time Liabilities" (ODTL) the liabilities to the banking system, the entire 'Other Demand and Time Liabilities' are shown as other demand and time liabilities (against item II(c) of the return in Form 'A').

(c) Participation certificates issued to other banks, the balances outstanding in the blocked account pertaining to segregated outstanding credit entries for more than 5 years in inter branch adjustment account, the margin money on bills purchased / discounted and gold borrowed by banks from abroad, should also be included in ODTL..

(d) Loans/borrowings from abroad by banks in India will be considered as 'liabilities to others' and will be subject to reserve requirements.

(e) Income flows received in advance such as, annual fees and other charges which are not refundable should not be included in computation of Demand and Time Liability/Net Demand and Time Liability of the bank for maintenance of SLR. The expression 'liabilities in India' does not include:

    i. the paid up capital or the reserves or any credit balance in the profit and loss account of the banking company;

    ii. any advance taken by the banking company from the RBI (Refer Circular no. DBOD No. Ret. BC. 29 /12.02.001/2010-11 dated July 27, 2010 on "Section 24 of the Banking Regulation Act, 1949 Maintenance of Statutory Liquidity Ratio (SLR)").or from and the amount of refinance taken from the Export-Import Bank of India or from the National Housing Bank or from the National Bank for Agriculture and Rural Development or from Small Industries Development Bank of India;

    iii. Net income tax provision.

    iv. Amount received from DICGC towards claims and held by banks pending adjustments thereof.

v. Amount received from ECGC by invoking the guarantee.

vi. Amount received from insurance company on ad-hoc settlement of claims pending judgment of the Court.

vii. Amount received from the Court Receiver.

viii. The liabilities arising on account of utilization of limits under Bankers Acceptance Facility (BAF).

ix. District Rural Development Agency (DRDA) subsidy of Rs.10,000/- kept in Subsidy Reserve Fund account in the name of Self Help Groups.

x. Subsidy released by NABARD under Investment Subsidy Scheme for Construction/Renovation/Expansion of Rural Godowns.

xi. Net unrealized gain/loss arising from derivatives transaction under trading portfolio.

xii. Income flows received in advance such as annual fees and other charges which are not refundable.

xiii. Bill rediscounted by a bank with eligible financial institutions as approved by RBI.

xiv. Provision not being a specific liability arising from contracting additional liability and created from profit and loss account.

4.16 The expression ‘net balance in current accounts' means the excess of the aggregate of the credit balances in current account maintained by the banking company with State Bank of India or a subsidiary of State Bank or a nationalised bank over the aggregate of the credit balances in current account held by the said banks with the banking company.

4.17 Explanation (d) to sub-section (1) of section 18 provides that in computing the liabilities for purposes of sections 18 and 24, the aggregate of liabilities of the banking company to the State Bank of India and its subsidiaries, nationalised banks, regional rural banks, other banking companies, co-operative banks and other financial institutions notified by the Central Government in this behalf is reduced by the liabilities of all such banks and financial institutions to the banking company. The financial institutions notified by the Central Government in this behalf are: Discount and Finance House of India Ltd., Securities Trading Corporation of India Ltd., PNB Gilts Ltd., SBI Gilts Ltd., Gilts Securities Trading Corporation Ltd., and ICICI Securities and Finance Company Limited. Foreign banks operating in India are covered by the expression ‘another banking company'. Co-operative banks do not include a primary credit society, or a co-operative mortgage bank/development bank.

4.18 Under sub-section (2) of section 18, the RBI has been empowered to specify, from time to time, that any transaction or class of transactions shall be regarded as liability in India of a banking company. The aforesaid sub-section also provides that if any question arises as to whether any transaction or class of transactions is to be regarded as liability in India of a banking company, the decision of the RBI thereon shall be final.

4.19 Gold imported under the authorisation given to a bank by the RBI qualifies as an eligible asset for SLR purposes provided it is held by the bank on its own account. Gold borrowed from abroad by banks in terms of paragraph 2(i) of the RBI circular AD (GP) Series No.7, dated 6th March, 1998 will form part of liabilities of the bank. Deposits under the Gold Deposit Scheme would constitute a liability for SLR purposes. Gold mobilised under the scheme would constitute an eligible asset for SLR purposes if the bank holds such gold with itself in physical form. (Circular DBOD.No.IBS.BC.96/23.67.001/1999-2000 dated October 5, 1999). The liability and asset in terms of gold would be expressed into rupee term based on London AM fixing for gold-US dollar rate converted into Indian rupees by applying rupee-US dollar reference rate announced by the RBI. The prevalent customs duty on import of gold would be added to the above to arrive at the final value. A similar position would prevail in respect of gold borrowed from abroad by authorised scheduled commercial banks and lent to jewellery exporters in India, except that no customs duty would be added in such a case. (Circular DBOD.No.IBS.BC.73/ 23.67.001/99-2000 dated July 21, 1999.)

4.20 Liabilities in India include liabilities under ACU dollar balances in VOSTRO accounts of commercial banks of ACU member countries.

4.21 In computing the value of assets maintained for SLR purposes, the price of gold should not be taken at higher than the current market price. In this regard, the RBI has specified that securities held on 31st March every year, so long as these are held continuously and are still in the bank's portfolio, shall be valued by adopting the system of valuation as per the balance sheet as on that date. The valuation shall remain unchanged throughout the financial year immediately following. However, the securities acquired during the ensuing financial' year shall be valued at face value or cost price as on the date of acquisition whichever is lower. These securities shall be shown at the same value till they remain in the portfolio of the bank or till the end of the financial year whichever is earlier.

4.22 When a bank accepts funds from a client under its remittance facilities scheme, it becomes a liability (liability to others) in its books. The liability of the bank accepting funds will extinguish only when the correspondent bank honours the drafts issued by the accepting bank to its customers. As such, the balance amount in respect of the drafts issued by the accepting bank on its correspondent bank under the remittance facilities scheme and remaining unpaid should be reflected in the accepting bank's books as an outside liability under head “Liability to others in India” and the same should also be taken into account for computation of NDTL for SLR purpose.

4.23 The amount received by correspondent banks has to be shown as “Liability to the Banking System’ by them and not as ‘Liability to Others’ and this liability could be netted off by the correspondent banks against the inter-bank assets. Likewise sums placed by banks issuing drafts/interest/dividend warrants are to be treated as ‘Assets with Banking System' in their books and can be netted off from their inter-bank liabilities.

4.24 The banks are required to include inter-bank term deposits / term borrowing liabilities of all maturities in 'Liabilities to the Banking System. Similarly banks should include their inter-bank assets of term deposits and term lending of all maturities in 'Assets with the Banking System' for computation of NDTL for SLR purpose.

Temporary/Ad-hoc measures

4.25 At present, banks obtain liquidity from the Reserve Bank under the liquidity adjustment facility (LAF) against the collateral of eligible securities that are in excess of their prescribed statutory liquidity ratio (SLR). In addition, purely as a temporary measure, scheduled commercial banks may avail additional liquidity support under the LAF to the extent of up to 0.5 per cent of their net demand and time liabilities.

Audit Approach and Procedures

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

(a) correctness of the compilation of DTL position; and

(b) maintenance of liquid assets as specified in section 24 of the Act.

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

4.28 To comply with the requirements relating to statutory liquidity ratio, banks have evolved systems whereby all branches 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 central auditor should request the branch auditors to verify the correctness of the trial balances relevant to the dates selected by him. The central auditor should also request the branch auditors to verify the cash balance at the branch on the dates selected by him. It should be ensured that such request is communicated to the branch auditors well in advance of commencement of the audit so that they can draw up their audit programme accordingly.

4.29 As regards weekly returns received from unaudited branches, the auditor should broadly review the relevant returns on a sampling basis to identify any obvious errors or omissions or inconsistencies.

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

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

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

(a) Part amounts of recoveries from the borrowers in respect of debts considered bad and doubtful of recovery.

(b) Amounts received in Indian currency against import bills and held in sundry deposits pending receipts of final rates.

(c) 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.

(d) Margins held and kept in sundry deposits for funded facilities.

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

(a) Net credit balance in Branch Adjustment Accounts.

(b) Interest on deposits as at the end of the first half year reversed in the beginning of the next half-year.

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

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

4.36 It may be noted that provisions for expenses and liabilities are usually made at the year-end. Similarly, even though interest accrues on a daily basis, it is recorded in the books only at periodic intervals. These items, though liabilities of the bank, are not included in the computation of DTL. The central auditor should state this fact in his report.

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

4.38 While reporting on compliance with SLR requirements, the auditor should specify the number of unaudited branches and state that he has relied on the returns received from the unaudited branches in forming his opinion.

V-5
Other Aspects

Head Office

5.01 Apart from examination of consolidation of branch returns, verification of capital and reserves, and verification of investments and provisioning in respect thereof, the central auditors also usually deal with the following items:

- provision for non-performing assets;
- depreciation on assets like, premises, etc. where the recording of the relevant fixed assets is centralised at the head office;
- provisions for certain employee costs, such as, bonus/ex-gratia in lieu of bonus, gratuity, pension and other retirement benefits;
- provision for taxation;
- provision for audit fee;
- provisions to meet any other specific liabilities or contingencies the amount of which is material, for example, provision for revision in pay-scales of employees, provision for foreign exchange fluctuations, etc; and
- dividends.

Provisioning for Non-performing Assets

5.02 The prudential norms issued by the RBI prescribe the percentage of provision to be made in respect of advances classified under different categories, viz., standard, sub-standard, doubtful and loss assets. In this context, the RBI has issued "Master Circular – Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances" (DBOD.No.BP.BC.9/21.04.048/2012-13) dated July 2, 2012 (The circular is given in the CD along with the Guidance Note). The primary responsibility for making adequate provisions for any diminution in the value of loan assets, investment or other assets is that of the bank management and the statutory auditors. The assessment made by the inspecting officer of the RBI is furnished to the bank to assist the bank management and the statutory auditors in taking a decision in regard to making adequate and necessary provisions in terms of prudential guidelines. It may be emphasised that the percentages prescribed by the RBI reflect the minimum proportion of an advance that a bank ought to provide for to comply with the guidelines. A bank can, at its discretion, make a higher provision than that required under the prudential guidelines.

5.03 It has also been mentioned earlier that provisions in respect of non-performing assets are usually not made at the branch level but at the head office level. The amount of provision (or minimum amount) to be made at the head office level is based on classification of assets into standard, sub-standard, doubtful and loss assets. Branch returns contain analysis of the advances into these categories. The central auditor examines prima facie the correctness of the classification as a part of his examination of consolidation of branch returns. The branch auditors' reports may also point out cases where in their opinion, there are threats to recovery that warrant a higher amount of provision than that arrived at on the basis of the percentages specified by the RBI.

5.04 The auditor should examine whether the provision made by the management at the head office level meets the minimum provisioning requirements prescribed by the RBI and also takes into account the threats to recovery in specific cases. With regard to the latter, the auditor should ensure that the provision made by the management is not less than that recommended by the respective branch auditors unless, based on the information and explanations, which were not available to the branch auditors, he holds a contrary view, or unless he otherwise believes that the branch auditors' objections have been met or are not of such nature and significance as to warrant a provision in the overall context of the bank as a whole.

5.05 The Third Schedule to the Banking Regulation Act, 1949 lays down the requirements of disclosure concerning advances. Accordingly, advances are required to be classified under various heads (Notes and Instructions for Compilation' of Balance Sheet and Profit and Loss Account, issued by the RBI require that provisions made to the satisfaction of the auditors should be excluded from advances under each head). The concern of the auditor is with the overall adequacy of provisions in respect of each of the heads under which advances are required to be shown in the balance sheet of a bank. Thus, for example, the auditor has to examine the adequacy of the overall provisions recommended by the bank separately in respect of (a) bills purchased and discounted, (b) cash credits, overdrafts and loans repayable on demand, and (c) term loans. Similarly, the auditor should examine the overall adequacy of the provisions recommended under each of the other heads of advances in the balance sheet. If, in his opinion, the overall provision recommended by the bank in respect of any of the heads is inadequate, he should make a suitable disclosure in his report.

5.06 The RBI has specified that advances against book debts may be included under the head 'secured by tangible assets'. Where the amount of advances covered by book debts is significant, the auditor should make a suitable qualification in his audit report.

Recognition of Certain Expenses

5.07 Certain expenses, such as the following, are usually recognised at the head office level (or at zonal or regional level):

(a) directors' fees, allowances and expenses;

(b) insurance;

(c) auditors' fees and expenses fee; and

(d) service tax, etc.

Directors' Fees, Allowances and Expenses

5.08 This item includes sitting fees and all other items of expenditure incurred in relation to directors. The daily allowance, hotel charges, conveyance charges, etc., though in the nature of reimbursement of expenses incurred, may be included under this head. Similar expenses of local Committee members may also be included under this head. Under the Companies Act, 1956 a director may receive remuneration by way of a fee for each meeting of the Board or a Committee attended by him. Local Committees are appointed by banks as advisory bodies in respect of the areas allotted to them. Their members are also paid fees or allowances.

5.09 The auditor may check the sitting fees and allowances with reference to the articles of the banking company, agreements, minutes of the Board and Local Committees, etc. It may be noted that in the case of nationalised banks, the fees and the basis of reimbursement of travelling expenses are fixed by the Central Government in consultation with the RBI. Copies of the relevant orders may be examined in this behalf.

Insurance

5.10 This item includes insurance charges on bank's property. It also includes insurance premium paid to DICGC, etc., to the extent they are not recovered from the parties concerned.

5.11 Banks submit a Return on Total Insurable Deposits to RBI on a periodic basis. Insurance premium is payable on such deposits. The auditor should check the basis of computation of insurable deposits and the insurance premium paid on same.

5.12 The DICGC guarantee fees payable by banks are based on the outstanding amount of priority sector advances covered by DICGC as on 31st March every year. The auditor should check the basis of payment/provision for such guarantee fees.

Auditors' Fees and Expenses

5.13 This item includes the fees paid to the statutory auditors and auditors for professional services rendered and all expenses for performing their duties, even though they may be in the nature of reimbursement of expenses. The said fees and expenses should be as per RBI Circular DBS.ARS.No.BC.7 / 08.92.001/ 2003-04 dated March 17, 2004.[@] If external auditors have been appointed by banks themselves for internal inspections and audits and other services, the expenses incurred in that context including fees incurred for such assignments may not be included under this head but shown under 'other expenditure'.

Provision for Depreciation

5.14 As mentioned earlier, practices differ amongst banks with regard to accounting for fixed assets and provision for depreciation thereon. In case these accounting aspects in respect of all or certain categories of fixed assets are centralised at the head office level, the central auditor should examine the same. The procedures to be followed by the auditor in this respect would be similar to those discussed in the Chapter III-4 on "Fixed and Other Assets" at the branch level, except that the central auditor may request the respective branch auditors to examine the evidence of physical existence of fixed assets that, as per the records, are located at the branch or have been provided to employees for use (such as residential premises).

Provisions for Certain Employee Costs

5.15 Provisions for certain employee costs such as bonus/ex-gratia in lieu of bonus, and gratuity, pension and other retirement benefits are usually made at the head office level.

5.16 The auditor should examine whether the liability for bonus is provided for in accordance with the Payment of Bonus Act, 1965 and/or agreement with the employees or award of competent authority. The auditor should examine the adequacy of provision for variable pay or performance bonus *vis-à-vis* the Bank's policy, if any, on these matters.

5.17 The auditor should examine whether provisions in respect of employee benefits are made in accordance with the requirements of

[@] Revised in 2013 Edition.

Accounting Standard (AS) 15 (Revised), "Employee Benefits", the auditor should particularly examine whether provision for leave encashment has been made by the bank. As per AS 15, employee benefits include all forms of consideration given by an enterprise in exchange for services rendered by employees. It includes short-term employee benefits such as wages, salaries and social security contributions and non-monetary benefits, post-employment benefits, other long-term employee benefits and termination benefits. The auditor should examine the adequacy of the provisions made with reference to such documentary evidence such as reports of actuaries or certificates from the LIC, as appropriate under the facts and circumstances of the case.

5.18 As per RBI's circular DBOD.No. BP.BC.80/ 21.04.018/ 2010-11 February 9, 2011, public sector banks were given an option to amortise the incremental employee benefit liability on account of re-opening of pension option to employees of Public Sector Banks and enhancement in gratuity limits over five years, starting from year ending March 31, 2011. The auditor should check proper amortization of same over the period. Further, as per same circular, in view of the exceptional nature of the event, new pension option and enhanced gratuity related unamortised expenditure were not required to be reduced from Tier I capital.[@]

5.19 In the case of employee benefits, the Master Circular on "Disclosure in Financial Statements – Notes to Accounts" (DBOD.BP.BC No.14 /21.04.018/2012-13) dated July 2, 2012 issued by the RBI with reference to Accounting Standard 15, specifies that Banks may follow the disclosure requirements prescribed under AS 15 (revised), 'Employee Benefits' issued by ICAI.

Provision for Taxation

5.20 Provision for taxation relates to income-tax, (including corporate dividend tax) and wealth tax. The auditor must ensure compliance with AS 22, "Accounting for Taxes on Income".

Income-tax

5.21 Some of the items which have an effect on the liability of a bank for income-tax and therefore, need to be specifically considered by the auditor, are discussed in the following paragraphs.

Bad Debts and Provision for Bad and Doubtful Debts

5.22 Section 36(1)(vii) of the Income-tax Act, 1961 deals with the allowability of bad debts and section 36(1)(viia) deals with the allowability of provision for bad and doubtful debts.

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5.23 According to section 36(1)(vii), bad debts written off are admissible deduction subject to the conditions prescribed under section 36(2), i.e.,–

(i) no such deduction shall be allowed unless such debt or part thereof has been taken into account in computing the income of the assessee of the previous year in which the amount of such debt or part thereof is written off or of an earlier previous year, or represents money lent in the ordinary course of the business of banking or money-lending which is carried on by the assessee;

(ii) if the amount ultimately recovered on any such debt or part of debt is less than the difference between the debt or part and the amount so deducted, the deficiency shall be deductible in the previous year in which the ultimate recovery is made;

(iii) any such debt or part of debt may be deducted if it has already been written off as irrecoverable in the accounts of an earlier previous year, but the [assessing] Officer had not allowed it to be deducted on the ground that it had not been established to have become a bad debt in that year;

(iv) where any such debt or part of debt is written off as irrecoverable in the accounts of the previous year and the [Assessing] Officer is satisfied that such debt or part became a bad debt in any earlier previous year nor falling beyond a period of four previous years immediately preceding the previous year in which such debt or part is written off, the provisions of sub-section (6) of section 155 shall apply;

(v) where such debt or part of debt relates to advances made by an assessee to which clause (viia) of sub-section (1) applies, no such deduction shall be allowed unless the assessee has debited the amount of such debt or part of debt in that previous year to the provision for bad and doubtful debts account made under that clause.

5.24 The said deduction is limited to the amount by which the bad debts exceed the credit balance in the provision for bad and doubtful debts account made under section 36(1)(viia). According to section 36(1)(viia), a specified percentage of the total income and a specified percentage of the aggregate average advances made by the rural branches of the bank, both computed in the prescribed manner, is allowable as a deduction in respect of provision for bad and doubtful debts made by banks other than foreign banks.

5.25 A scheduled bank/non-scheduled bank has the option to claim a further deduction for an amount not exceeding the income derived from redemption of securities in accordance with a scheme framed by the Central

Government. This is in addition to the deduction specified in paragraphs above with respect to section 36(i)(viia). However, for the purpose of claiming this deduction, it is necessary that such income should be disclosed in the return of income under the head 'Profit and gains of business or profession".

5.26 Section 36(1)(vii) requires the amount of any bad debt or part thereof to be written off as irrecoverable in the accounts of the assessee for the previous year. It is sufficient compliance of the section if the write off is done at Head Office level.

Domestic Transfer Pricing

5.27 The Banks having transactions with domestic related parties will get covered under purview of domestic transfer pricing from year 2012-13. Hence, the auditor needs to review whether all related party transactions are at arm's length. Accordingly, the impact of domestic transfer pricing may need to be considered in tax provisioning.[@]

Special Reserve

5.28 Deduction in respect of a special reserve created and maintained by a banking company –

(a) Section 36(1)(viii) provides deduction in respect of any special reserve created and maintained by a specified entity, which includes a banking company.

(b) The quantum of deduction, however, should not exceed 20% of the profits derived from eligible business computed under the head "Profits and Gains of Business or Profession" (before making any deduction under this clause) carried to such reserve account.

(c) The eligible business, in case of a banking company, means the business of providing long-term finance for –

    (i) industrial or agricultural development or development of infrastructure facility in India; or

    (ii) development of housing in India.

(d) However, where the aggregate amount carried to such reserve account exceeds twice the amount of paid up share capital and general reserve, no deduction shall be allowed in respect of such excess.

Interest on Non-Performing Accounts (NPAs)

5.29 According to section 43D, read with Rule 6EA of the Income-tax Rules, 1962, the income of a scheduled bank by way of interest in relation to

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[@] Revised in 2013 Edition.

such categories of bad or doubtful debts as may be prescribed having regard to the guidelines issued by the RBI in relation to such debts, shall be chargeable to tax only in the previous year in which it is credited to the Profit and Loss Account or in the year of actual receipt, whichever is earlier.

Transactions with Foreign Banks/Foreign branches of Indian banks

5.30 The applicability of any Double Taxation Avoidance Agreement is to be taken into account for the purpose of computation of tax in respect of transactions with foreign banks or foreign branches of Indian banks.

5.31 Similarly the applicability of Transfer Pricing Regulations is to be taken into account for the purpose of computation of tax in respect of international transactions with Associated Enterprises covered under section 92E of the Income-tax Act, 1961. Reference may also be made to the "Guidance Note on Report on International Transactions under section 92E of the Income-tax Act, 1961 (Transfer Pricing)" issued by ICAI.

5.32 In respect of any provision for bad and doubtful debts made by a foreign bank, an amount not exceeding 5% of the total income (computed before making any deduction under Chapter VI-A) is allowable as deduction.

Corporate Dividend Tax

5.33 A holding company receiving dividend from its subsidiary company can reduce the same from dividends declared, distributed or paid by it. For this purpose, a holding company is one which holds more than 50% of the nominal value of equity shares of the subsidiary.

5.34 There are certain conditions to be fulfilled to avail this benefit. They are -

- the subsidiary company should have actually paid the dividend distribution tax;
- the holding company should be a domestic company; and
- it should not be a subsidiary of any other company.

5.35 It may be noted that the matching principle does not apply, i.e., dividend received from the subsidiary company during the year can be reduced from the dividend distributed by the holding company during the same year, irrespective of the period to which the dividends relate to. Even if the dividend received and dividend distributed relate to different periods, the same can be adjusted and tax can be paid by the holding company on the net figure. However, the dividend shall not be taken into account for reduction more than once.

5.36 According to the “Guidance note on Accounting for Corporate Dividend Tax”, issued by the Institute of Chartered Accountants of India (ICAI), the liability for such tax should be recognised in the accounts of the same financial year as appropriation of profit and not as a charge against profit in which the dividend concerned is recognised.

Tax Refunds/Demands

5.37 Where an assessment order is received during the year, the auditor should examine the assessment order and if any interest is determined on the amount of refund, the same should be considered as income. In case where the assessment results in fresh demand, the auditor should consider the need for additional provisioning. Where an assessment order is received during the course of audit, the auditor should examine the same and consider its impact, if any, on the accounts under audit.

5.38 It is not prudent to recognise interest on possible refund which is not determined by any order from tax authorities.

Pending Proceedings

5.39 The auditor should review the appellate orders received during the year and consider the need for any additional provision/reversal.

Method of Accounting

5.40 Many banks account for commission, exchange, brokerage, interest on bills, locker rent and other fees as income upon realisation. Section 145 of the Income-tax Act, 1961 provides, *inter alia*, that income chargeable under the head "Profits and Gains of Business and Profession" shall be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. Therefore, the auditor should consider the impact of this section on provision for taxation and also the need for appropriate disclosure in this regard.

Reversal of Earlier Year’s Provision

5.41 It is possible that subsequent judicial pronouncements/ appellate orders may make the provisions of earlier years excessive.

5.42 As per Accounting Standard (AS) 29, "Provisions, Contingent liabilities and Contingent Assets", a provision should be recognised only when (a) an enterprise has a present obligation as a result of a past event, (b) it is possible that an outflow of resources embodying economic benefits will be required to settle the obligation, and (c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision should be recognised.

5.43 Only in rare cases, e.g., a law suit, it may not be clear whether an enterprise has a present obligation. In such a case, an enterprise determines whether a present obligation exists at the balance sheet date by taking into account all available evidence. On the basis of such evidence, if it is more likely than not that a present obligation exists at the balance sheet date a provision is recognised (if other recognition criteria are also met). However, where it is more likely that no obligation exists at the balance sheet date, a contingent liability is disclosed unless the possibility of an outflow of resources embodying economic benefits is remote.

5.44 On the above considerations, if there is no requirement to retain a provision, it can be reversed and the amount of liability is included in contingent liability. A suitable note on the following lines is recommended:

(a) Provision for Income Tax is arrived at after due consideration of decisions of the Appellate authorities and advice of counsels; and

(b) No provision is made for the disputed demands of Income tax keeping in view the judicial pronouncements and/or legal counsels' opinion.

Items Requiring Special Consideration

Tax Implications of Valuation of Investments

5.45 The RBI has issued various circulars on valuation of investments, according to which the difference between the market value/value as per yield to maturity method (YTM) will have to be provided in the books of accounts for certain types of investments. The various judicial decisions on the allowability of depreciation in valuation of investments should be considered while provisioning.

Notional Gain/Loss on Foreign Exchange Translations

5.46 Banks are required to translate their foreign exchange balances / obligations in foreign currency as per FEDAI Guidelines. The following decisions may be considered by the auditor while recognising gains or loss for tax purposes:

- The Madras High Court in the case of *Indian Overseas Bank Vs. Commissioner of Income-tax (1990) 183 ITR 200* has held that notional profits on translation of foreign exchange forward contracts is not taxable.
- The Madras High Court in the case of *Commissioner of Income-tax Vs. Indian Overseas Bank (1985) 151 ITR 446* has held that notional loss on translations of foreign exchange contracts is not tax deductible.

Broken Period Interest

5.47 The RBI, vide its Master Circular No. DBOD No. BP. BC.13/21.04.141/2012-13 on, "Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks" dated July 2, 2012, (The Circular is given in the CD along with the Guidance Note) advises that the banks should not capitalise the broken period interest paid to the seller as part of the cost, but treat it as an item of expenditure under Profit & Loss Account in respect of investments in Government and other approved securities.. It is to be noted that the above accounting treatment does not take into account taxation implications and hence banks will have to comply with the requirements of Income-tax Authorities in the manner prescribed by them.

5.48 However, a number of judicial decisions support the view that the interest is allowable as a business deduction consequent to deletion of sections 18 to 21 of the Income tax Act, 1961. Honourable Bombay High Court in case of *American Express International Banking vs. CIT [2002] 258 ITR 601 (Bom)* supports this view. The said judgement has been followed in case of *CIT vs. Citi Bank N.A. [2003] 264 ITR 18 (Bom)*, *CIT vs. Nedungadi Bank Ltd [2003] 264 ITR 545 (Ker)* and by Honourable Bombay High Court in case of *Union Bank of India in judgement dated October 9, 2002 in I.T.R. No.28 of 1998*. The Special Leave Petition (SLP) filed by the Department against the judgement in case Union Bank of India has been dismissed by the Supreme Court. [Refer 268 ITR (St) 216]

Disallowance of expenditure incurred in earning income which is exempt from tax

5.49 Section 14A has been inserted by the Finance Act, 2001, with retrospective effect from 1-4-1962, to provide that no deduction shall be allowed in respect of expenditure incurred by an assessee in relation to income which does not form part of the total income under the Income-tax Act, 1961. This principle will have application in the matter of exempted income earned by banks also, e.g., income from tax-free securities and dividend from shares of domestic companies.

5.50 Section 14A(2) empowers the Assessing Officer to determine the amount of expenditure incurred in relation to such income which does not form part of the total income in accordance with such method as may be prescribed. The method for determining expenditure in relation to exempt income is to be prescribed by the CBDT for the purpose of disallowance of such expenditure under section 14A. Such method should be adopted by the Assessing Officer if he is not satisfied with the correctness of the claim of the assessee, having regard to the accounts of the assessee. Further, the Assessing Officer is empowered to adopt such method, where an assessee claims that no expenditure has been incurred by him in relation to income which does not form part of total income [section 14A(3)].

5.51 The CBDT has, vide Notification No.45/2008 dated 24.3.2008, inserted a new Rule 8D which lays down the method for determining amount of expenditure in relation to income not includible in total income.

5.52 If the Assessing Officer, having regard to the accounts of the assessee of a previous year, is not satisfied with –

(a) the correctness of the claim of expenditure by the assessee; or

(b) the claim made by the assessee that no expenditure has been incurred in relation to exempt income for such previous year,

he shall determine the amount of expenditure in relation to such income in the manner provided hereunder -

5.53 The expenditure in relation to income not forming part of total income shall be the aggregate of the following:

(i) the amount of expenditure directly relating to income which does not form part of total income;

(ii) in a case where the assessee has incurred expenditure by way of interest during the previous year which is not directly attributable to any particular income or receipt, an amount computed in accordance with the following formula, namely :

$$A \times \frac{B}{C}$$

Where,

A = amount of expenditure by way of interest other than the amount of interest included in clause (i) incurred during the previous year;

B = the average of value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year;

C = the average of total assets as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year;

(iii) an amount equal to one-half per cent of the average of the value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year.

5.54 'Total assets' means total assets as appearing in the balance sheet excluding the increase on account of revaluation of assets but including the decrease on account of revaluation of assets.

5.55 The various judicial decisions on disallowance of expenses U/s.14A should be considered while making a provision for Income-tax. Reference may also be made to the, “Supplementary Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961” issued by ICAI for detailed discussion.

Share Issue Expenses

5.56 The Supreme Court in the case of *Brooke Bond India Ltd. Vs. Commissioner of Income-tax, 224 ITR 798*, has held that expenditure incurred on issue of shares is a capital expenditure for the purpose of taxation.

5.57 However, the expenditure incurred by a banking company on account of stamp duty and registration fees for the issue of bonus shares is allowable as revenue expenditure as held by the Supreme Court in *CIT v. General Insurance Corporation (2006) 286 ITR 232.*

5.58 Preliminary expenses are allowed as deduction under section 35D over a period of 5 successive years starting from the year of commencement of business, i.e., one-fifth of the expenditure is allowed as deduction in each year. Such preliminary expenses include the following:

(a) expenditure in connection with:

- (i) preparation of feasibility report;
- (ii) preparation of project report;
- (iii) conducting market survey or any other survey necessary for the business of the assessee;
- (iv) engineering services relating to the business of the assessee:

Provided that the work in connection with the preparation of the feasibility report or the project report or the conducting of market survey or of any other survey or the engineering services referred to in this clause is carried out by the assessee himself or by a concern which is for the time being approved in this behalf by the Board;

(b) legal charges for drafting any agreement between the assessee and any other person for any purpose relating to the setting up or conduct of the business of the assessee;

(c) Where the assessee is a company, also expenditure:

    (i) by way of legal charges for drafting the Memorandum and Articles of Association of the company;

    (ii) on printing of the Memorandum and Articles of Association;

    (iii) by way of fees for registering the company under the provisions of the Companies Act, 1956;

    (iv) in connection with the issue, for public subscription, of shares in or debentures of the company, being underwriting commission, brokerage and charges for drafting, typing, printing and advertisement of the prospectus;

(d) such other items of expenditure (not being expenditure eligible for any allowance or deduction under any other provision of this Act) as may be prescribed.

Where the aggregate amount of the expenditure referred to above exceeds an amount calculated at five per cent:

    (a) of the cost of the project; or

    (b) where the assessee is an Indian company, at the option of the company, of the capital employed in the business of the company,

The excess shall be ignored for the purpose of computing the deduction allowable for the preliminary expanses.

5.59 Such preliminary expenses incurred before commencement of business is allowed as deduction to companies in both the manufacturing and service sector. However, so far, such expenses incurred after commencement of business for extension of an industrial undertaking or for setting up a new industrial unit were allowed only for the companies in the manufacturing sector. This benefit has now been extended to the companies in the service sector as well. Consequently, the banking sector would also be benefited. This amendment has been effected by the Finance Act, 2008.

Depreciation

5.60 Generally, in respect of buildings, pending registration of documents of title, a note is given mentioning this fact. The Supreme Court has held in the case of *Mysore Minerals Ltd., (1999) 106 Taxman 166*, that “anyone in possession of property in his own title exercising such dominion over the property as would enable others being excluded therefrom and having the right to use and occupy the property and/or to enjoy its usufruct in his own right would be the owner of the building though a formal deed of title may not have been executed and registered as contemplated by the Transfer of Property Act 1882, Registration Act, etc." The judgement clarifies that an assessee will be entitled to depreciation under section 32 of the Income tax Act, 1961 even where documents of title are pending registration.

5.61 The Courts have held in the case of *Syndicate Bank Vs. Commissioner of Income tax (1988) 172 ITR 561* and in the case of *Commissioner of Income-tax Vs. Central Bank of India Ltd. (1976) 103 ITR 196* that lockers (including, air - conditioners in locker rooms) are plant and machinery.

5.62 Where banks enter into sale and lease back transactions, according to Explanation 4A to Section 43(1), the written down value (as per the provisions of the Income Tax Act, 1961) of the original seller will be the cost to the bank for the purpose of depreciation.

Carry forward of unabsorbed business loss and depreciation on amalgamation of a banking company with a banking institution

5.63 With a view to provide for carry forward and set-off of accumulated loss and unabsorbed depreciation allowance of a banking company against the profits of a banking institution under a scheme of amalgamation sanctioned by the Central Government, section 72AA has been inserted in the Income-tax Act, 1961. This section provides that where a banking company has been amalgamated with a banking institution under a scheme sanctioned and brought into force by the Central Government under sub-section (7) of section 45 of the Banking Regulation Act, 1949, the accumulated loss and unabsorbed depreciation of the amalgamating banking company shall be deemed to be the loss or the allowance for depreciation of the banking institution for the previous year in which the scheme of amalgamation is brought into force. It is to be noted that all the provisions contained in the Income-tax Act, 1961, relating to set-off and carry forward of loss and unabsorbed depreciation will apply accordingly in such a case.

5.64 The *Explanation* to this section defines the expressions "accumulated loss", "banking company, "banking institution" and "unabsorbed depreciation", for the purposes of this section as follows–

(i) "accumulated loss" means so much of the loss of the amalgamating banking company under the head "Profits and gains of business or profession" (not being a loss sustained in a speculation business) which such amalgamating banking company, would have been entitled to carry forward and set-off under the provisions of section 72 if the amalgamation had not taken place;

(ii) "banking company" shall have the same meaning assigned to it in clause (c) of section 5 of the Banking Regulation Act, 1949;

(iii) "banking institution" shall have the same meaning assigned to it in sub-section (15) of section 45 of the Banking Regulation Act, 1949;

(iv) "unabsorbed depreciation" means so much of the allowance for depreciation of the amalgamating banking company which remains to be allowed and which would have been allowed to such banking company if amalgamation had not taken place.

5.65 Any transfer of a capital asset by a banking company to a banking institution in a scheme of amalgamation of such banking company with such banking institution sanctioned and brought into force by the Central Government under sub-section (7) of section 45 of the Banking Regulation Act, 1949 shall not be regarded as a transfer for the purposes of capital gains.

5.66 The cost of acquisition of the capital asset transferred to the banking institution, under the scheme of amalgamation of a banking company with the banking institution, shall be deemed to be the cost for which the banking company acquired it.

Wealth tax

5.67 Banks are liable to pay wealth tax in relation to specified assets mentioned in section 2(a) of the Wealth-tax Act, 1957. The auditor should examine whether the computation of net wealth and of the wealth tax payable is correctly made.

Gold Deposit Scheme

5.68 A Gold Deposit Scheme has been introduced by the Finance Minister in his budget for the year 1999. The incidence of wealth-tax on the gold held by the bank will have to be examined. Explanation 2 to section 2(ea) clarifies that 'jewellery' does not include the gold deposit bonds issued under the Gold Deposit Scheme, 1999 notified by the Central Government.

Service Tax@

5.69 With effect from 01-07-2012, the category wise taxability of services has been done away with and the negative list regime has been introduced wherein all services provided by banks are covered under the service tax net unless specifically excluded vide inclusion in the negative list or exempted vide the various exemption notifications issued by CBEC from time to time.

5.70 Negative List:

Section 66D of the Finance Act 1994, contains the negative list of services. The following services relating to the banking business are covered under the negative list:

(b) Services by the Reserve Bank of India;

(n) Services by way of -

(i) extending deposits, loans or advances in so far as the consideration is represented by way of interest or discount;

(ii) inter-se sale or purchase of foreign currency amongst banks or authorized dealers of foreign exchange or amongst banks and such dealer.

Hence except above, all the services rendered by the Bank will now get covered under purview of service tax.

5.71 *Rate of Service Tax*

Period	Service Tax	EC	SHEC	Net Rate
01-07-1994 to 13-05-2003	5%	-	-	5.00%
14-05-2003 to 09-09-2004	8%	-	-	8.00%
10-09-2004 to 17-04-2006	10%	2%	-	10.20%
18-04-2006 to 10-05-2007	12%	2%	-	12.24%
11-05-2007 to 23-02-2009	12%	2%	1%	12.36%
24-02-2009 to 31-03-2012	10%	2%	1%	10.30%
01-04-2012 onwards	12%	2%	1%	12.36%

5.72 Each branch of the Bank providing or receiving taxable services has to get itself registered with the service tax authorities. However there is an option for the banks having centralized accounting or centralized billing system to opt for single centralized registration for all branches. This will require the respective auditors to ensure compliance.

5.73 An Illustrative checklist for **Central Statutory Auditors** is given below:

@ Revised in 2013 Edition.

In case of Branch-wise Registration

- Whether the head office, regional offices, zonal offices have properly availed the CENVAT Credit of the tax/duty paid on the input services, input, capital goods as the case may be?
- Whether the head office, regional offices, zonal offices has properly distributed the amount of service tax in the manner as specified in the CENVAT Credit Rules, 2004?

In Case of Single Registration of Head Office/Regional Office/Zonal Offices

- Whether the permission of the Commissioner has been obtained for seeking single registration for the Head Office/Regional Office/Zonal Offices on the basis of Centralised Accounting?
- Whether the head office have filed the periodical return of service tax within the due dates. If the return is filed after the due date, whether the late filing fee has been paid?
- Whether the head office have made the payment of service tax monthly, by 6th day of the following month, if the duty is deposited electronically through internet banking and in accordance to Point of Taxation Rules, 2011? In the case of month of March, the payment should be made by 31st day of March.
- Whether the bank is discharging the liability on input services which are covered under the reverse charge mechanism?
- Whether bank has discharged the interest liability under section 75 of Finance Act, 1994 on late payment of service tax made by bank?
- Whether the appropriate amount of CENVAT Credit of the tax/duty paid on the eligible input services, inputs and the capital goods have been availed?
- Whether the head office has not availed depreciation u/s 32 of the Income Tax Act, 1961 on the amount of duty on the capital goods on which CENVAT Credit has been availed?
- Whether the CENVAT Credit have been taken on the basis of proper documents containing all particulars as prescribed by rule 4A of Service Tax Rules, 1994, i.e., serially numbered invoice/bill, etc. containing the requisite information like, Name and address of the service provider, Service Tax/Central Excise Registration Number, description of the services / goods, Amount of the service tax / excise duty, Name, address and the registration number of the bank, etc?

- Similarly, whether the bank has taken the CENVAT Credit in respect of input and capital goods on the basis of proper duty paying documents, containing all particulars as prescribed by Central Excise Rules, 2002, i.e., serially numbered invoice / bill etc. containing the requisite information like, Name, address and registration no. of manufacturer, description of the goods, amount of the excise duty, name and address bank, etc.?
- Where the credit in respect of input services is taken on receipt of invoices, whether the payment of the value of input services and service tax payable thereon (as shown in invoice issued by input service provider) is made within three months of the date of invoice?
- Whether the credit on input services where the service tax is paid on reverse charge is taken on or after the day of payment of value of input service and deposit of service tax?
- Whether the credit availed has not been more than the payment made for service tax, which has been made available on the last day of the respective month?
- Whether an amount equivalent to 50% of the CENVAT credit availed on input goods and services availed during the month has been paid, as specified in sub-rule 3B of Rule 6?
- Whether the Bank has made repayment of CENVAT Credit availed in respect of capital goods sold, discarded, disposed off, or removed for any reason by the bank as specified in Rule 3(5A) of the CENVAT Credit Rules, 2004?
- Whether the branch has submitted (in compliance of requirement of provision of rule 5(2) of Service Tax Rules, 1994) a list of records maintained by branch to the concerned Superintendent, Service Tax. Whether bank maintains the records specified by it in said submission submitted in terms of Notification no. 45/2007 dated 28.12.2007?

General

- Whether the branches have followed the proper procedure? If any discrepancy is noticed by the branch auditor, the same has been properly considered at the head office level.
- Whether the bank has followed the uniform policy of collection and payment of service tax in respect of all the branches?
- Whether the Head Office / Regional Office / Zonal Offices have issued the proper guidelines in respect of taxable and exempted services?

Branch

Service Tax

5.74 An Illustrative Check List for **Bank Branch Auditors** with respect to Service Tax is given below:

- Whether the branches have taken the Registration of Service Tax within 30 days from the date of levy of service tax or the date of start of business of the branch, whichever is later?
- Whether the branches have collected the service tax separately from the customers on the value of the taxable services. If it is inclusive of service tax, has the amount of service tax been properly calculated?
- Whether the branches have made the payment of service tax monthly, by 6th day of the following month, if the duty is deposited electronically through internet banking and in accordance to Point of Taxation Rules, 2011? In the case of month of March, the payment should be made by 31st day of March.
- Whether the bank is discharging the liability on input services which are covered under the reverse charge mechanism?
- Whether the branch has discharged the interest liability under section 75 of Finance Act, 1994 on late payment of service tax made by the branch?
- Whether the branches have filed the periodical return of service tax within the due dates? If the return is filed after the due date, whether the late filing fee has been paid?
- Whether the branches have taken the appropriate amount of CENVAT Credit of the tax/duty paid on the eligible input services, inputs and the capital goods used for rendering output services?
- Whether the branches have taken the CENVAT Credit in respect of input services on the basis of proper documents containing all particulars as prescribed by rule 4A of Service Tax Rules, 1994, i.e., serially numbered invoice / bill, etc. containing the requisite information like Name, address and registration no. of the service provider, Description of the services / goods, Amount of the service tax, Name, address and the registration number of the bank's branch, etc.?
- Similarly, whether the branches have taken the CENVAT Credit in respect of input and capital goods on the basis of proper duty paying documents containing all particulars as prescribed by Central Excise

Rules, 2002 i.e., serially numbered invoice/bill etc., containing the requisite information like Name, address and registration no. of manufacturer, Description of the goods, Amount of the excise duty, Name and address of the bank's branch etc.?

- Where the credit in respect of input services is taken on receipt of invoices, whether the payment of the value of input services and service tax payable thereon (as shown in invoice issued by input service provider) is made within three months of the date of invoice?
- Whether the credit on input services where the service tax is paid on reverse charge is taken on or after the day of payment of value of input service and deposit of service tax?
- Whether the branches have not availed the credit more than the payment made for service tax, which has been made available on the last day of the respective month?
- Whether an amount equivalent to 50% of the CENVAT credit availed on input goods and services availed during the month has been paid, as specified in sub-rule 3B of Rule 6?
- Whether the branches have made repayment of CENVAT Credit availed in respect of capital goods sold, discarded, disposed off, or removed for any reason by the branch as specified in Rule 3(5A) of the CENVAT Credit Rules, 2004?
- Whether the banks have sought registration as input service distributor under Service Tax (Registration of Special Category of Persons) Rules, 2005 for distribution of CENVAT to its various branches where such banks are registered on centralised basis? In all such cases auditor shall ensure that the returns are being regularly filed for input service distributor. Auditor shall also ensure that office registered as 'input service distributor' is issuing invoice for distributing the CENVAT Credit as per rule 4A (2) of Service Tax Rules, 1994.
- Whether the branches have taken the appropriate credit on the invoice / challan / bill or any other documents issued by the head office, regional office, zonal office as an input service distributor?
- Whether the branches have mentioned their service tax registration number on the statement, slips, challan, bill, invoice or any other documents issued to the customer for the services rendered by the Bank?
- Auditor shall also ensure that office registered as 'input service distributor' is issuing invoice for distributing the CENVAT Credit as per

rule 4A (2) of Service Tax Rules, 1994.

- Whether bank maintains the records specified by it in said submission submitted in terms of Notification no. 45/2007 dated 28.12.2007?
- Whether the branches have made arrangements to ensure that service tax is not collected on the interest amount?

APPENDICES

Draft Engagement Letter to be sent to the Appointing Authority of the Bank

{The following letter is for use as a guide and will need to be varied according to individual requirements and circumstances relevant to the engagement.}

To the Board of Directors (or the appropriate representative of senior management).

This has reference to the letter No. ……………. dated …….received from ………………………………….(Name of the relevant authority) whereby we have been offered to carry out the statutory audit the following branches of your Bank for the financial year ended 31st March 20XX, including Tax Audit, issuance of the Long Form Audit Report and, as a part of the audit, verification and/ or certification of certain specific aspects, as listed in your aforementioned letter.

We are pleased to confirm our acceptance for the aforementioned assignment through the Letter of Acceptance attached herewith subject to the following:

i) Our audit of the financial statements of these branches will be conducted with the objective of our expressing an opinion on the truth and fairness of the financial statements of these branches. These financial statements include the Balance Sheet, the Profit and Loss Account and Cash Flow Statement for the year ended 31st March 2012, and a summary of significant accounting policies and other explanatory information.

ii) We will conduct our audit in accordance with the Standards on Auditing (SAs) and any other applicable pronouncement of the Institute, as well as the requirements of the Banking Regulation Act, 1949, and the guidelines/ directions issued by the Reserve Bank of India under the said statutes, from time to time. Those Standards require that we comply with the ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements.

iii) An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend upon the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also includes evaluating the appropriateness of accounting principles used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

iv) Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with SAs.

v) In making our risk assessments, we consider internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.

vi) Our assignment will be conducted on the basis that the branch management and, where appropriate, those charged with governance of the Bank acknowledge and understand that they have responsibility:

(a) For the preparation of financial statements that give a true and fair view in accordance with the applicable Financial Reporting Framework. This includes:

- the responsibility for the preparation of financial statements on a going concern basis;
- the responsibility for selection and consistent application of appropriate accounting policies, including implementation of applicable Accounting Standards, along with proper explanation relating to any material departures from those Accounting Standards;
- the responsibility for making judgements and estimates that are reasonable and prudent, so as to give a true and fair view of the state of affairs of the branch at the end of the financial year and of the profit or loss of the branch for that period.

(b) for such internal controls, as the branch management determines, are necessary to enable the preparation of financial statements, that are free from material misstatement, whether due to fraud or error. The responsibility for internal controls also implicitly enshrines the responsibility for compliance with the relevant directions/ circulars of the Reserve Bank of India, including for those aspects which have been specifically listed for verification/ certification by us in your aforementioned letter; and

(c) to provide us with:

(i) access to all information, including the books, account, vouchers and other records and documentation, of the branch, whether kept at the branch office or elsewhere, of which the branch management is aware, that is relevant to the preparation of the financial statements such as records, documentation and other matters;

(ii) additional information that we may request from the branch management for the purpose of the audit, including any internal audit, concurrent audit, revenue audit, stock audit, Reserve Bank of India's Inspection report; and

(iii) unrestricted access to persons within the entity, from whom we determine it necessary to obtain audit evidence. This includes our entitlement to require from the officers of the branch such information and explanations, as we may think necessary for the performance of our duties as auditor.

As part of our assignment, we will request from the branch management, written confirmation concerning representations made to us in connection with the audit, including confirmations in respect of the balances held by the Branch with other banks, and such other items on the financial statements of the Branch, as may be considered necessary by us for the purpose of our assignment.

It may also be noted that non provision of any information/ confirmation, requested by us from the branch management, may result in limitation on the scope of our assignment.

We also wish to invite your attention to the fact that, our audit process is subject to 'peer review' under the Chartered Accountants Act, 1949, to be conducted by an independent reviewer. The reviewer may inspect, examine or take abstracts of our working papers, in the course of the peer review.

We look forward to full cooperation from your staff during our audit.

Our fees for the said audits (excluding fees for Tax Audit and the travelling expenses will be as specified by the Reserve Bank of India/ State Bank of India[1].

Our fees for audit of Non Business Offices/ CMS Branches, as well as the tax audit fees of the branches, would be as specified in your aforementioned letter.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our aforementioned assignment/s including our respective responsibilities. (Kindly also mark a copy of such acknowledgement to the concerned official/s of the respective branch managements.)

XYZ & Co.
Chartered Accountants
…………………………
(Signature)

Date : (Name of the Member)
Place : (Designation[2])

Acknowledged on behalf of ………………. Branch of …………………Bank

……………………..
(Signature)
Name and Designation
Date

Attached: Letter of Acceptance duly signed by us.

[1] As may be appropriate.

[2] Partner or proprietor, as the case may be.

The Third Schedule to the Banking Regulation Act, 1949

(See Section 29)

FORM 'A'

Form of Balance Sheet

Balance Sheet of ____________________ (here enter name of the Banking Company)

Balance Sheet as on 31st March – (Year) (000's omitted)

	Schedule	*As on 31.3__ (current year)*	*As on 31.3__ (previous year)*
Capital & Liabilities			
Capital	1		
Reserves & Surplus	2		
Deposits	3		
Borrowings	4		
Other liabilities and provisions	5		
Total			
Assets			
Cash and Balances with Reserve Bank of India	6		
Balances with banks and money at call and short notice	7		
Investments	8		
Advances	9		
Fixed Assets	10		
Other Assets	11		
Total			
Contingent Liabilities	12		
Bills for Collection			

Schedule I
Capital

		As on 31.3__ (current year)	*As on 31.3__ (previous year)*
I.	***For Nationalised Banks***		
	Capital (Fully owned by Central Government)		

II.	***For Banks Incorporated Outside India***		
	Capital (The amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head.)		
	Amount of deposit kept with RBI under section 11(2) of the Banking Regulation Act, 1949		
	Total		
III.	***For Other Banks***		
	Authorised Capital (……. shares of Rs…. each)		
	Issued Capital (…… shares of Rs….. each)		
	Subscribed Capital (…..shares of Rs….. ..each)		
	Called-up Capital (……. shares of Rs… each)		
	Less: Calls unpaid		
	Add: Forfeited shares		
	Total		

Schedule 2
Reserves & Surplus

		As on 31.3__ (current year)	*As on 31.3__ (previous year)*
I.	***Statutory Reserves***		
	Opening Balances		
	Additions during the year		
	Deductions during the year		
II.	***Capital Reserves***		
	Opening Balances		
	Additions during the year		
	Deductions during the year		
III.	***Share Premium***		
	Opening Balances		
	Additions during the year		
	Deductions during the year		
IV.	***Revenue and Other Reserves***		
	Opening Balance		
	Additions during the year		
	Deductions during the year		
V.	***Balance in Profit and Loss Account***		
	Total (I, II, III, IV and V)		

Schedule 3
Deposits

				As on 31.3__ (current year)	As on 31.3__ (previous year)
A.	I.	***Demand Deposits***			
		(i)	From banks		
		(ii)	From others		
	II.	***Savings Bank Deposits***			
	III.	***Term Deposits***			
		(i)	From banks		
		(ii)	From others		
			Total (I, II and III)		
B.		(i)	Deposits of branches in India		
		(ii)	Deposits of branches outside India		
			Total		

Schedule 4
Borrowings

			As on 31.3__ (current year)	As on 31.3__ (previous year)
I.	***Borrowings in India***			
	(i)	Reserve Bank of India		
	(ii)	Other banks		
	(iii)	Other institutions and agencies		
II.	***Borrowings outside India***			
		Total (I & II)		

Secured borrowings included in I & II above – Rs.

Schedule 5
Other Liabilities and Provisions

		As on 31.3__ (current year)	As on 31.3__ (previous year)
I.	Bills payable		
II.	Inter-office adjustments (net)		
III.	Interest accrued		
IV.	Others (including provisions)		
	Total		

Schedule 6
Cash and Balances with Reserve Bank of India

		As on 31.3__ (current year)	*As on 31.3__ (previous year)*
I.	***Cash in hand*** (including foreign currency notes)		
II.	***Balances with Reserve Bank of India***		
	(i) in Current Account		
	(ii) in Other Accounts		
	Total (I & II)		

Schedule 7
Balances with Banks and Money at Call & Short Notice

		As on 31.3__ (current year)	**As on 31.3__ (previous year)**
I.	***In India***		
	(i) Balances with banks		
	(a) in current accounts		
	(b) in other deposit accounts		
	(ii) Money at call and short notice		
	(a) with banks		
	(b) with other institutions		
	Total (i & ii)		
II.	***Outside India***		
	(i) in current accounts		
	(ii) in other deposit accounts		
	(iii) Money at call and short notice		
	Total		
	Grand Total (I & II)		

Schedule 8
Investments

		As on 31.3__ (current year)	*As on 31.3__ (previous year)*
I.	***Investments in India in***		
	(i) Government securities		
	(ii) Other approved securities		
	(iii) Shares		
	(iv) Debentures and bonds		

	(v) Subsidiaries and/or joint ventures		
	(vi) Others (to be specified)		
	Total		
II.	***Investments Outside India in***		
	(i) Government securities (including local authorities)		
	(ii) Subsidiaries and/or joint ventures abroad		
	(iii) Other investments (to be specified)		
	Total		
	Grand Total (I & II)		

Schedule 9
Advances

			As on 31.3__ (current year)	*As on 31.3__ (previous year)*
A.	(i)	Bills purchased and discounted		
	(ii)	Cash credits, overdrafts and loans repayable on demand		
	(iii)	Term loans		
		Total		
B.	(i)	Secured by tangible assets		
	(ii)	Covered by bank/Government guarantees		
	(iii)	Unsecured		
		Total		
C.	*I.*	*Advances in India*		
		(i) Priority sectors		
		(ii) Public sector		
		(iii) Banks		
		(iv) Others		
		Total		
	II.	*Advances outside India*		
		(i) Due from banks		
		(ii) Due from others		
		(a) Bills purchased and discounted		
		(b) Syndicated loans		
		(c) Others		
		Total		
	Grand Total (C.I. & C.II)			

Schedule 10
Fixed Assets

		As on 31.3__ (current year)	*As on 31.3__ (previous year)*
I.	***Premises***		
	At cost as on 31st March of the preceding year		
	Additions during the year		
	Deductions during the year		
	Depreciation to date		
II.	***Other Fixed Assets*** (including furniture and fixtures)		
	At cost as on 31st March of the preceding year		
	Additions during the year		
	Deductions during the year		
	Depreciation to date		
	Total (I & II)		

Schedule 11
Other Assets

		As on 31.3__ (current year)	*As on 31.3__ (previous year)*
I.	Inter-office adjustments (net)		
II.	Interest accrued		
III.	Tax paid in advance/tax deducted at source		
IV.	Stationery and stamps		
V.	Non-banking assets acquired in satisfaction of claims		
VI.	Others*		
	Total		

* In case there is any unadjusted balance of loss the same may be shown under this item with appropriate footnote.

Schedule 12
Contingent Liabilities

		As on 31.3__ (current year)	As on 31.3__ (previous year)
I.	Claims against the bank not acknowledged as debts		
II.	Liability for partly paid investments		
III.	Liability on account of outstanding forward exchange contracts		
IV.	Guarantees given on behalf of constituents		
	(a) In India		
	(b) Outside India		
V.	Acceptances, endorsements and other obligations		
VI.	Other items for which the bank is contingently liable		
	Total		

Form 'B'

Form of Profit & Loss Account for the year ended 31st Match ________

(000's omitted)

		Schedule	Year ended 31.3__ (current year)	Year ended 31.3__ (previous year)
I.	***Income***			
	Interest earned	13		
	Other income	14		
	Total			
II.	***Expenditure***			
	Interest expended	15		
	Operating expenses	16		
	Provisions and contingencies			
	Total			
III.	***Profit / Loss***			
	Net profit/loss (–) for the year			
	Profit/loss (–) brought forward			
	Total			
IV.	***Appropriations***			

Transfer to statutory reserves Transfer to other reserves Transfer to - Government/Proposed dividend Balance carried over to balance-sheet		
Total		

Schedule 13
Interest Earned

		Year ended 31.3__ (current year)	*Year ended 31.3__ (previous year)*
I.	Interest/discount on advances/bills		
II.	Income on investments		
III.	Interest on balances with Reserve Bank of India and other inter-bank funds		
IV.	Others		
	Total		

Schedule 14
Other Income

		Year ended 31.3__ (current year)	*Year ended 31.3__ (previous year)*
I.	Commission, exchange and brokerage		
II.	Profit on sale of investments *Less:* Loss on sale of investments		
III.	Profit on revaluation of investments *Less:* Loss on revaluation of investments		
IV.	Profit on sale of land, buildings and other assets *Less:* Loss on sale of land, buildings and other assets		
V.	Profit on exchange transactions *Less:* Loss on exchange transactions		
VI.	Income earned by way of dividends etc. from subsidiaries, companies and/or joint ventures abroad/in India		
VII.	Miscellaneous income		
	Total		

Note: Under items II to V, loss figures may be shown in brackets.

Schedule 15
Interest Expended

		Year ended 31.3__ (current year)	*Year ended 31.3__ (previous year)*
I.	Interest on deposits		
II.	Interest on Reserve Bank of India/inter-bank borrowings		
III.	Others		
	Total		

Schedule 16
Operating Expenses

		Year ended 31.3__ (current year)	*Year ended 31.3__ (previous year)*
I.	Payments to and provisions for employees		
II.	Rent, taxes and lighting		
III.	Printing and stationery		
IV.	Advertisement and publicity		
V.	Depreciation on bank's property		
VI.	Directors' fees, allowances and expenses		
VII.	Auditors' fees and expenses (including branch auditors' fees and expenses)		
VIII.	Law charges		
IX.	Postage, telegrams, telephones, etc.		
X.	Repairs and maintenance		
XI.	Insurance		
XII.	Other expenditure		
	Total		

An Illustrative Format of Report of the Auditor of a Banking Company

INDEPENDENT AUDITOR'S REPORT

To
The Shareholders

Report on the Financial Statements

1. We have audited the accompanying financial statements of the ABC Bank Limited, which comprise the Balance Sheet as at 31st March, 2XXX and the Statement of Profit and Loss and the cash flow statement for the year then ended and a summart of significant accounting policies and other explanatory information. Incorporated in these financial statements are the returns of ________ branches audited by us, ______________ branches audited by branch auditors and unaudited returns of ______________ branches in respect of which exemption has been granted by the Central Government under Rule 4 (1) (a) of the Companies (Branch Audit Exemption) Rules, 1961 from the provisions of sub-sections (1) and (3) of Section 228 of the Companies Act, 1956. These unaudited branches account for ______________________ per cent of advances, _______________ per cent of deposits, ___________________ per cent of interest income and ____________________ per cent of interest expense.

Management's Responsibility for the Financial Statements

2. Management is responsible for the preparation of these financial statements in accordance with XYZ Law of India. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation of the financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

3. Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

4. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

5. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

6. In our opinion and to the best of our information and according to the explanations given to us, the said accounts together with the notes thereon give the information required by the Banking Regulation Act, 1949 as well as the Companies Act, 1956, in the manner so required for the banking companies and give a true and fair view in conformity with the accounting principles generally accepted in India:

(i) in the case of the Balance Sheet, of the state of affairs of the Bank as at 31st March, 2XXX;

(ii) in the case of the Profit and Loss Account of the profit/loss for the year ended on that date; and

(iii) in the case of the Cash Flow Statement, of cash flows for the year ended on that date.

Report on Other Legal and Regulatory Matters

7. The Balance Sheet and the Profit and Loss Account have been drawn up in accordance with the provisions of Section 29 of the Banking Regulation Act, 1949 read with Section 211 of the Companies Act, 1956.

8. We report that:

(a) we have obtained all the information and explanations which, to the best of our knowledge and belief, were necessary for the purpose of our audit and have found them to be satisfactory.

(b) the transactions of the Bank, which have come to our notice, have been within the powers of the Bank.

(c) the returns received from the offices and branches of the Bank have been found adequate for the purposes of our audit.

9. In our opinion, the Balance Sheet, Profit and Loss Account and Cash Flow Statement comply with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956.

10. We further report that:
    - (i) the Balance Sheet and Profit and Loss Account dealt with by this report, are in agreement with the books of account and the returns.
    - (ii) in our opinion, proper books of account as required by law have been kept by the Bank so far as appears from our examination of those books.
    - (iii) the reports on the accounts of the branches audited by branch auditors have been dealt with in preparing our report in the manner considered necessary by us.
    - (iv) as per information and explanation given to us the Central Government has, till date, not prescribed any cess payable under section 441A of the Companies Act, 1956,
    - (v) on the basis of the written representation received from the directors and taken on record by the Board of Directors, none of the directors is disqualified as on 31st March, 2XXX from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956.

For ABC and Co.
Chartered Accountants

Signature
(Name of the Member Signing the Audit Report)
(Designation)#
Membership Number
Firm Registration Number

Place of Signature:
Date of Report:

Partner or proprietor, as the case may be.

An Illustrative Format of
Report of the Auditor of a Nationalised Bank

INDEPENDENT AUDITOR'S REPORT

To
The President of India

Report On The Financial Statements

1. We have audited the accompanying financial statements of XY Bank as at 31st March, 2XXX, which comprise the Balance Sheet as at March 31, 2XXX, and Profit and Loss Account and the cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information. Incorporated in these financial statements are the returns of ___________ branches audited by us and ______________ branches audited by branch auditors. The branches audited by us and those audited by other auditors have been selected by the Bank in accordance with the guidelines issued to the Bank by the Reserve Bank of India. Also incorporated in the Balance Sheet and the Statement of Profit and Loss are the returns from _______________ branches which have not been subjected to audit. These unaudited branches account for ___________________per cent of advances, _____________ per cent of deposits, _______________ per cent of interest income and _______________ per cent of interest expenses.

Management's Responsibility for the Financial Statements

2. Management is responsible for the preparation of these financial statements in accordance with XYZ Law of India. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation of the financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

3. Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

4. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

5. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

6. In our opinion, as shown by books of bank, and to the best of our information and according to the explanations given to us:

(i) the Balance Sheet, read with the notes thereon is a full and fair Balance Sheet containing all the necessary particulars, is properly drawn up so as to exhibit a true and fair view of state of affairs of the Bank as at 31st March 2XXX in conformity with accounting principles generally accepted in India;

(ii) the Profit and Loss Account, read with the notes thereon shows a true balance of profit/loss, in conformity with accounting principles generally accepted in India, for the year covered by the account; and

(iii) the Cash Flow Statement gives a true and fair view of the cash flows for the year ended on that date.

Report on Other Legal and Regulatory Requirements

7. The Balance Sheet and the Profit and Loss Account have been drawn up in Forms "A" and "B" respectively of the Third Schedule to the Banking Regulation Act, 1949.

8. Subject to the limitations of the audit indicated in paragraph 1 to 5 above and as required by the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980, and subject also to the limitations of disclosure required therein, we report that:

(a) We have obtained all the information and explanations which to the best of our knowledge and belief, were necessary for the purposes of our audit and have found them to be satisfactory.

(b) The transactions of the Bank, which have come to our notice have been within the powers of the Bank.

(c) The returns received from the offices and branches of the Bank have been found adequate for the purposes of our audit.

9. In our opinion, the Balance Sheet, Profit and Loss Account and Cash Flow Statement comply with the applicable accounting standards.

For ABC and Co.
Chartered Accountants

Signature
(Name of the Member Signing the Audit Report)
(Designation)[#]
Membership Number
Firm registration number

Place of Signature:
Date of Report:

[#] Partner or proprietor as the case may be.

An Illustrative Format of Report of the Branch Auditor of a Nationalised Bank

Independent Bank Branch Auditor's Report

To,
The Statutory Central Auditors
________ Bank

Report on Financial Statements

1. We have audited the accompanying Financial Statements of ______________Branch of ____________ *(name of the Bank)* which comprise the Balance Sheet as at 31st March 20XX, Profit and Loss Account for the year then ended, and other explanatory information.

***Management's Responsibility for the Financial Statements**:*

2. Management of the Branch is responsible for the preparation of these Financial Statements that give true and fair view of the financial position and financial performance of the Branch in accordance with the Banking Regulation Act, complying with Reserve Bank of India Guidelines from time to time. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility:

3. Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

4. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The Procedures selected depend on the auditors' judgement, including the assessment of the risks of material misstatement of the financial statement, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

5. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our Audit opinion.

Opinion

6. In our opinion, and to the best of our information and according to the explanation given to us, read with the Memorandum of Changes mentioned in paragraph 11 below, the financial statements give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the Balance Sheet, of the state of affairs of the Branch as at March 31, 20XX; and

(b) in the case of Profit and Loss Account, of the Profit / Loss for the year ended on that date;

Report on Other Legal and Regulatory Requirements

7. The Balance Sheet and the Profit and Loss Account have been drawn up in accordance with Section 29 of the Banking Regulation Act, 1949;

8. Subject to the limitations of the audit as indicated in Paragraphs 3 to 5 above and paragraph 10 below, we report that:

a. We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of the audit and have found them to be satisfactory.

b. The transactions of the branch which have come to my/our notice have been within the powers of the Bank.

9. We further report that:

a. the Balance Sheet and Profit and Loss account dealt with by this report are in agreement with the books of account and returns;

b. in our opinion, proper books of account as required by law have been kept by the branch so far as appears from our examination of those books;

Other Matters

10. No adjustments/provisions have been made in the accounts of the Branch in respect of matters usually dealt with at Central Office, including in respect of:

(a) Bonus, ex-gratia, and other similar expenditure and allowances to branch employees;

(b) Terminal permissible benefits to eligible employees on their retirement (including additional retirement benefits), Gratuity, Pension, liability for leave encashment benefits and other benefits covered in terms of 'AS 15 –Employee Benefits' issued by the Institute of Chartered Accountants of India;

(c) Arrears of salary/wages/allowances, if any, payable to staff;

(d) Staff welfare contractual obligations;

(e) Old unreconciled/unlinked entries at debit under various heads comprising Inter branch/office Adjustments;

(f) Interest on overdue term deposits;

(g) Depreciation on fixed assets;

(h) Auditors' fees and expenses;

(i) Taxation (Current Tax and Deferred Tax).

11. The following is a summary of Memorandum of Changes submitted by us to the branch management[3].

Memorandum of Changes (summary)				
		No.	Increase	Decrease
a. In respect of Income				
b. In respect of expenditure				
c. In respect of Assets				
d. In respect of Liabilities				
e. In respect of Gross NPAs				
f. In respect of Provision on NPAs[4]				
g. In respect of Classification of Advances				
h. In respect of Risk Weighted Assets				
i. Other items (if any)				

For ABC and Co.
Chartered Accountants

Signature
(Name of the Member Signing the Audit Report)
(Designation)[5]
Membership Number
Firm registration number

Place of Signature
Date

3 Where applicable.

4 Applicable in cases where banks determine provision at Branch level.

5 Partner or proprietor as the case may be.

APPENDIX-5

Draft of Management Representation Letter* to be obtained from the Branch Management

M/s XYZ & Co.,
Chartered Accountants,
Place

Dear Sir(s),

Sub.: Audit for the year ended March 31, 20XX

This representation letter is provided in connection with your audit of the financial statements of ____________ branch of ______________ bank, for the year ended March 31, 20XX, for the purpose of expressing an opinion as to whether the financial statements give a true and fair view of the state of affairs of __________ branch of ______________ bank as of March 31, 20XX, and of the results of operations for the year then ended. We acknowledge our responsibility for preparation of financial statements, in accordance with the financial reporting framework applicable to the Bank, including the regulatory requirements of the Reserve Bank of India.

We confirm, to the best of our knowledge and belief, the following representations:

1. **Accounting Policies**

The accounting policies, as approved by the board of directors of the Bank, have been duly followed. There are no changes in the accounting policies followed by the branch during the current year.

2. **Assets**

2.1 All the assets owned by the bank and transferred to the branch and such other asset/s, as has/ have been acquired by the branch, has/have been duly accounted for, and none of the assets is encumbered.

2.2 Fixed assets held by Branches have been properly accounted and have been physically verified at the year end. No discrepancies have been noticed on such verification. Depreciation on these assets has been adequately provided as per the policy of the bank.

2.3 In respect of assets other than fixed assets, the same do not have a value lower than realizable value.

2.4 The branch is operating from a leased premises and there is no dispute with respect to the tenancy and lease charges.

3. **Capital Commitments**

At the balance sheet date, outstanding commitments for capital expenditure have been duly depicted in the financial statements.

4. **Cash and Bank Balances**

The cash balance as on March 31, 20XX is Rs.____________, and has been verified by us.

* Kindly also refer Revised Standard on Auditing (SA) 580, “Written Representations”.

5. **Liabilities**

The branch has recorded all known liabilities in the financial statements.

6. **Contingent Liabilities**

6.1 The branch has fully disclosed in the notes to the financial statements ;

(a) guarantees that we have given to third parties;

(b) Letters of Credits (Local/ Import);

(c) Letters of Comfort (Local/ Import);

(d) Deferred Payment Credits/ Guarantees (Local/ Import); and

(e) Other contingent liabilities.

6.2 Other than for advances, there are no matters involving the branch in any claims in litigation, arbitration or other disputes, in which there may be some financial implications, including for staff claims, branch rentals, municipal taxes, local levies, etc., except for those which have been appropriately included under contingent liabilities.

6.3 None of the contingent liabilities disclosed are likely to result in a loss, requiring adjustment of assets or liabilities.

Provisions for Claims and Losses

7. Provision has been made in the accounts for all known losses and claims of material amounts.

8. There have been no events subsequent to the balance sheet date, that require adjustment of, or disclosure in, the financial statements or notes thereto.

9. We have made available to you all the following latest reports on the accounts of our branch, and compliance by the branch on the observations contained therein:

a) Previous year's branch audit report;

b) Internal inspection reports;

c) Report on any other Inspection Audit, that has been conducted in the course of the year, relevant to the financial year 2011-12.

Apart from the above, the branch has not received any show cause notice, inspection advice, etc., from the Government of India, Reserve Bank of India or any other monitoring or regulatory authority of India, that could have a material effect on the financial statements of the branch during the year.

10. **Balancing of Books**

The books of the accounts are computerised and hence the subsidiary records are automatically balanced with the relevant control records. In the case of manual sub-ledgers maintained, we confirm that they duly match with the general ledger balances.

11. **Overdue/Matured Term Deposits**

All overdue/ matured term deposits are held as matured term deposits.

12. **Advances**

In respect of the Advances and income thereon, the income recognition and asset classification norms prescribed by the Reserve Bank of India have been complied with.

13. **Outstanding in Suspense/ Sundry Account**

The year–wise/ entry–wise break up of amounts outstanding in Sundry deposits/ Sundry assets, as on March 31, 2011, has already been submitted to you along with explanation of the nature of the amounts in brief, and supporting evidences relating to the existence of such amounts in the aforesaid accounts.

14. **Interest Provisions**

Interest provision has been made on deposits, etc., in accordance with the extant instructions of the Head Office.

The interest provision for Head Office Interest shall be made at the Head Office.

15. **Long Form Audit Report–Branch Response to the Questionnaire**

In connection with the Long Form Audit Report, complete information as regards each item in the questionnaire, has been made available to you in order to enable you to verify the same for the purpose of your audit.

16. **Other Certification**

Duly authenticated, information as regards other matters which, as per the bank's letter of appointment, require certification, has been made available to you.

17. **General**

There is no enquiry going on or concluded during the year by the Central Bureau of Investigation (CBI), or any other vigilance or investigating agency, on the branch or on its employees and no cases of frauds or of misappropriation of assets of the branch have come to the notice of the Management during the year, other than for amounts for which provisions have already been made in the books of accounts.

18. The provision for non–performing assets, depreciation, provision for income tax, provision for bonus, gratuity, etc., is made at the Head Office. Therefore, the same has not been provided in the branch accounts.

19. FIMMDA guidelines have been followed, wherever applicable.

20. The branch has complied with all aspects of contractual agreements, that could have a material effect on the financial statements in the event of non–compliance. There has been no non–compliance with requirements of regulating authorities, that could have a material effect on the financial statements in the event of non–compliance.

21. The other particulars required, have already been given to you, and particulars and other representations made to you from time to time are true and correct in all respects.

Thanking you,

Yours faithfully

For & on behalf of __________ branch of ______________ bank

Authorised Signatory

Draft Bank Branch Audit Program for the year ended March 31, 2013

NOTE:

1) The above audit program is illustrative and the members are advised to modify the same suitably to suit their requirement.

2) Documentation should be done to support the above audit programme.

Name of the Bank and Branch: ______________________

Region/ Zone in which the Branch is located: ______________________

Date of Commencement: ______________________

Date of Completion:

Audit Team Partner/s: ______________________

Name of Seniors	Man Days	Initials	Remarks, if any

Name of Juniors	Man Days	Initials	Remarks, if any

Details of the Authorised Persons of the bank	Branch Manager:
Others (Specify):	

Audit Aspects	Covered By Whom	Extent of Check
General		
1. Engagement letter to the appointing authority and letter of requirement to the Branch.		
2 Reporting to the Branch.		
3. Review of previous year's audit report/		

Audit Aspects	Covered By Whom	Extent of Check
LFAR, current period's Internal Audit Report/ Revenue Audit Report/ Concurrent Audit Report/ RBI Inspection Report and any other report and their compliance.		
4. Physical verification of cash, stationery, and valuable securities.		
5 Physical verification of Investments (obtain certificate from bank manager for the same).		
6. Understand the system in CBS Branch a) verify controls b) start of day and end of day report c) verify exceptional report		
.		
7 Compliance of bank's circulars, accounting policy as well as Mandatory Accounting Standards/Auditing Standards and RBI Circulars.		
8. Checking of various returns.		
Checking of Balance Sheet Items		
1. Checking of the advances:		
i) Detailed checking of forms classifying the advances		
1. Critical review of all large advances.		
2. Classification of advances.		
3. Latest valuation of security given against advances.		
4. Provisions on NPA as per RBI guidelines.		
ii) Loan Accounts		
i) Review of all large advances with balance of lower of 5 % or Rs.2 crore of total advance.		
ii) Review of loans sanctioned during the year. Also verify all the credit card dues which are overdue.		
iii) Review of other advances on test check basis.		
iv) Review of adverse comments by Concurrent auditors, RBI/internal inspectors.		
v) Review of suit filed and decreetal accounts and provision and progress thereof and Classification		

Audit Aspects	Covered By Whom	Extent of Check
vi) Review of accounts upgraded during the year from NPA to standard. Review of all accounts frequently exceeding limits/DP		
NOTE: (i) Following aspects of the advances to be verified:		
Pre sanction: System of credit Appraisal and review/renewal.		
Post sanction: Compliance of terms of sanction, documentation, end use of funds.		
Monitoring: Stock and Book statements, drawing power, insurance, inspection of stock/security, operations in the account, etc.		
(ii) All the accounts verified in category (i) to (v) should be documented.		
2. Verify controls in respect of the following important items of assets. (i) Dual custody of cash (ii) Custody and issue of cheques books/pay orders/ATM cards etc (iii) ATM cash as per books and actual balance tallied at year end.		
3 Checking of balance books with ledgers (only in case of manual branches).		
4. Checking of additions/deduction/transfers of fixed assets. Compliance of Accounting Standard (AS)-6, AS10,,AS 26 and AS28 related to fixed assets		
4a. Fixed Assets Schedule for furniture & fixtures and other assets.		
5. Reconciliation of accounts with other banks, head office and inter branch adjustment accounts.		
6 Detailed checking of suspense accounts – credit as well as debit schedules. i.e., Nominal ledger.		
7. Details of Bills Rediscounted/Refinance obtained from IDBI, SIDBI, etc.		
8. Shares/ Bonds/ Securities held in safe custody on banks investment account.		

Audit Aspects	Covered By Whom	Extent of Check
Balance Sheet Finalisation		
1. Verifying Balance Sheet figures with General Ledger		
2. Casting of Balance Sheet and cross–checking with Balance Sheet schedules		
3. Scrutiny of Balance sheet, particularly –		
i) that all the balances are shown in proper heads and broadly compare previous year figure to understand material variance		
ii) check in case of advances:		
a) that interest accrued but not due on loans is not included in advances.		
b) that credit balances in O/D, C/C in–operative current accounts should not be netted off with advances and the same should be shown under demand deposits.		
iii) Check in case of deposits:		
a) Verification of Anti Money Laundering guidelines and Compliance with KYC norms on test check basis		
b) that overdue deposits, matured time deposits, cash certificates and certificates of deposits are shown in Demand deposits.		
c) Interest accrued but not due should not be included in deposits but, should be shown under other liability.		
d) Operation and conduct of demat accounts.		
4. Checking, (i) Liability under Bank Guarantee/ L/C. (ii) Reconciliation of General Ledger and Subsidiary Ledger.		
5. Inter Office Reconciliation (IOR) Accounts (i) Verify Inter Branch Items In Transit (IBIT) account for old entries. (ii) Compare on test Check basis, the		

Audit Aspects	Covered By Whom	Extent of Check
balance and the entries in IOR Accounts with the copies of the statements submitted to the IOR department/s. (iii) Critically verify the daily enquiry memos received from the respective IOR department/s for any old and odd items and action taken by the branch for the same. (iv) Old un reconciled entries are being provided/ reported to HO for provision		
Checking of Profit and Loss Items		
1. Test checking of interest on deposits, (particularly, Interest checking should be done on Test basis for the period subsequent to the period of revenue/ concurrent audit). Ensure that interest provision on overdue F.D. has been made as per latest RBI guidelines.		
2. Test checking of interest/commission on various advances, bills, L.C., Guarantees, etc.		
3. Test checking of discount/commission on bills discounted and others.		
4. Critical scrutiny of the Expenses/Income accounts and checking of important vouchers.		
5. Provision for expenses, accrued interest on deposits and advances. (Particularly check whether or not interest has been provided/charged on all types of deposits/ advances.		
6. Checking of interest in NOSTRO Accounts debit balances.		
7. Verification of recovery on account of locker rent, staff accommodation, etc., with details of arrears, if any.		
8. Commission income on account of Government Business, i.e., collection as well as remittance of Income tax, sales tax, excise duty, etc.,		
9. Details of Prior Period items of Income		

Audit Aspects	Covered By Whom	Extent of Check
as well as expenses and complete details of provisions to be made, if any.		
10. Rebate on Bills discounted.		
11. Checking of depreciation on fixed assets		
12. Booking of Interest Income on account of partial recovery in NPA's.		
Profit and Loss Account Finalisation		
1. Verification of Profit and Loss Account with Profit And Loss Ledgers.		
2. Casting of Profit and Loss Booklets and cross checking with Profit and Loss Account schedules.		
3. Profit and Loss Account Scrutiny.		
4. Ratio analysis with previous years figures.		
Others		
1. Checking of statement of frauds.		
2. Checking of statement of claims against the bank not acknowledged as debt.		
3. Checking of Foreign Currency forward exchange contracts showing sales and purchase separately. Review of NRE and FCNR accounts, if any.		
4. Checking of Guarantees given on behalf of Constituents.		
5. Checking of Acceptance, endorsements and other obligations, i.e., L/C and bills accepted by the bank on behalf of customers.		
(Particularly check in case of Clause 4 and 5 above, whether the above guarantees and L/C issued are within the powers of the authorised person and proper procedures have been followed for issuing the same. Review the position of the above as at the year-end)		
6. Other contingent liability, if any.		
7. Checking of and preparation of Interest Subsidy.		
8. Checking of write off proposal and DICGC claims, sharing of recovery, etc.		
9. Checking of annual returns on protested bills/ recalled debt accounts (PB/RD).		
10. Checking of LFAR schedules and		

Audit Aspects	Covered By Whom	Extent of Check
preparation of LFAR. (Detailed planning for preparation of LFAR be done at the time of commencement of audit and detailed guidance be sought from the chapter on LFAR in this guidance note).		
11. Checking of Tax Audit schedules and preparation of Tax Audit Report.		
12. Checking of service tax collected and paid.		
Final Audit and Reporting		
1. Preparation of Audit Report.		
2. Preparation of memorandum of changes for changes to be made in classification of advances and in any item of asset/liability and profit and loss account with other remarks and/ or information which requires further attention at Regional/Zonal Office level.		
3. Obtain detailed notes on above accounts.		
4. Preparation of Tax Audit Report.		
5. Preparation of Long Form Audit Report.		
To Collect the following Certificates:		
1. Physical verification of the fixed assets carried out on March 31, 2013/During the year		
2. Physical verification of the cash as on March 31, 2013.		
3. Physical verification of cash periodically by officers of the bank.		
4. Certificate from the branch for the persons attended the audit.		
5. Management Representation Letter.		
To verify and issue the certificates(as applicable) :Illustartive list		
1. Certificate of Ghosh and Jilani committee Recommendations.		
2. Cash on 12 odd dates.		
3. Commitment charges payable to IDBI/ SIDBI.		
4. Interest claim on (FCNR) deposits.		
5. Risk weighted assets as per the capital adequacy report.		

Audit Aspects	Covered By Whom	Extent of Check
6. Certificate for treating an account as bad or doubtful of recovery as per the requirement of DI and CGC.		
7. Average month end rural branch advances.		
8. Subsidy claim under Prime Minister Rojgar Yojna.		

Prepared by: Reviewed by: